Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: March 11, 2009

to: Associate Area Counsel
(Large & Mid-Size Business)

from: Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

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subject: Nuclear Decommissioning Costs under § 468A and Specified Liability Losses under § 172(f)(1)(B)(i)(II)

This memorandum responds to your request for assistance dated December 12, 2008, regarding the meaning of "nuclear decommissioning costs" under § 468A of the Internal Revenue Code in certain situations and whether certain costs constitute specified liability losses under § 172(f)(3).

LEGEND

Taxpayer =
State =
X =
Y =
Plant A =
Plant B =
Date A =
Date B =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =

Year 8 =
Year 9 =
Year 10 =
Item 1 =
Item 2 =
Item 3 =
Item 4 =
Item 5 =
Item 6 =
Amount T =
Amount U =
Amount V =
Amount W =
Amount X =
Amount Y =
Amount Z =

ISSUES

1. Whether a nuclear power plant must have permanently ceased the production of electric energy or have a plan to permanently cease the production of electric energy in the near future in order for the costs of removing and replacing components to qualify as nuclear decommissioning costs under § 468A.

2. Whether the costs incurred to remove components are specified liability losses under § 172(f)(3).

   (a) Whether the four components which were removed and permanently retired qualify as specified liability losses under § 172(f)(3).

   (b) Whether the two components which were removed with the intent that they be refurbished and placed back into service qualify as specified liability losses under § 172(f)(3).

3. Whether nuclear fuel disposal fees paid to the Department of Energy qualify as nuclear decommissioning costs under § 468A.

CONCLUSIONS

1. We disagree with the conclusion in your memorandum. It is not necessary that a nuclear power plant has permanently ceased the production of electric energy or have a plan to permanently cease the production of electric energy in the near future in order for the costs of removing and replacing components to qualify as nuclear decommissioning costs.

Under § 1.468A-1(b)(5) of the Income tax regulations,[1] the component may be decommissioned by permanently removing it from the plant but the plant itself may continue to operate.

2. Additional factual development is required to determine whether the removal costs at issue are deductible as repairs or must be capitalized as improvements. This determination affects the analysis of whether § 263A requires those costs to be capitalized into the basis of the replacement assets or included in inventory costs. This, in turn, affects the analysis under § 172 of whether the removal costs are specified liability losses. We have identified below additional information that would be helpful in determining whether the removal costs are deductible as repairs or must be capitalized as improvements. We have also analyzed the results that would follow from determining that the costs at issue either are deductible as repairs or must be capitalized as improvements.

3. We concur with your conclusion that nuclear fuel disposal fees paid to the Department of Energy are governed by the Nuclear Waste Policy Act of 1982 and are excluded from the definition of nuclear decommissioning costs by § 1.468A-1(b)(5).

FACTS

Taxpayer is a corporation organized under the laws of the State. Taxpayer has Y nuclear reactors in the State; X nuclear reactors at its Plant A location and X nuclear reactors at its Plant B location. Nuclear power plants are granted licenses by the Nuclear Regulatory Commission ("NRC") which permits operation for 40 years. In 1995, the NRC began permitting nuclear power plants to apply for the renewal of their operating licenses for a period of an additional 20 years. Subsequent to an extensive application and review process, all Y of Taxpayer's State nuclear reactors received such extensions. The dates are as follows:

[1] Regulation citations herein are to the regulations removed and replaced by temporary regulations on December 31, 2007 (72 FR 74175). The definition of "nuclear decommissioning costs" contained in the temporary regulations is the same in all material respects to that in the prior regulations and so the analysis contained in this memorandum has continued vitality under the temporary regulations.

PLANT	Original Expiration Date	Date License Extension Granted by NRC	Renewed Expiration Date
Plant A ▪ Nuclear Reactor Unit #1 ▪ Nuclear Reactor Unit #2	▪ Year 5 ▪ Year 6	Date A	▪ Year 9 ▪ Year 10
Plant B ▪ Nuclear Reactor Unit #3 ▪ Nuclear Reactor Unit #4	▪ Year 3 ▪ Year 4	Date B	▪ Year 7 ▪ Year 8

In Year 1 and Year 2, Taxpayer spent $Amount T and $Amount Z in removal costs, respectively. The removed components and their respective costs of removal were as follows:

	Year 1	Year 2
Item 1	$Amount T	
Item 2		$Amount U
Item 3		$Amount V
Item 4		$Amount W
Item 5		$Amount X
Item 6		$Amount Y

Taxpayer subsequently replaced the aforementioned removed components. Of the removed assets, four were permanently retired from service. The other two, Item 3 and Item 4, are in the process of being refurbished, and it is intended that they will be placed back into service. Taxpayer claimed the abovementioned costs as nuclear decommissioning costs so that the portion of their net operating losses attributable to these expenditures be treated as specified liability losses under § 172(f)(3).

LAW AND ANALYSIS

ISSUE 1

Section 468A(a) was added to the Code in 1984 by Deficit Reduction Act of 1984, Pub. L. No. 98-369. Section 468A(a) allows owners/operators of nuclear power plants to currently deduct the future costs of decommissioning a nuclear power plant by making contributions to a Fund prior to when economic performance occurs.

Section 468A(c)(1) generally requires the owner/operator to include in gross income amounts that are distributed from a Fund. In addition to any deduction under section 468A(a) for contributions to a Fund, section 468A(c)(2) recognizes that an owner/operator may deduct otherwise deductible nuclear decommissioning costs, (such as under § 162), for which economic performance (within the meaning of section 461(h)) occurs during a taxable year.

Section 1.468A-1(b)(5) states, in part, that “nuclear decommissioning costs” means “all otherwise deductible expenses to be incurred in connection with the entombment, decontamination, dismantlement, removal and disposal of the structures, systems and components of a nuclear power plant that has permanently ceased the production of electric energy. Such term includes all otherwise deductible expenses to be incurred in connection with the preparation for decommissioning, such as engineering and other planning expenses, and all otherwise deductible expenses to be incurred with respect to the plant after the actual decommissioning occurs, such as physical security and radiation monitoring expenses.”

Taxpayer is not in the process of final decommissioning of its nuclear plants; on the contrary, it has recently received an extension of its operating license from the NRC and the replacements of the components at issue herein are meant to extend the life of these nuclear plants not to conclude that life.

Section 1.468A-1(b)(5) has always been given a broad reading. For example, in PLR 200711015, we concluded that the costs of removing the vessel head and steam generator were nuclear decommissioning costs despite the immediate substitution of a new vessel head and steam generator and the continuation of operation of the nuclear power plant after the components were replaced. There, the components had permanently ceased their use in the production of electric energy. In addition, all schedules of ruling amounts provided to taxpayers under § 468A implicitly contain the conclusion that interim replacements of components are included within the ambit of “nuclear decommissioning costs.” This view is in accord with the generally understood meaning of that term as used by public service commissions or other regulators of the nuclear industry in calculating the amount that utilities are allowed to recover from ratepayers. Thus, we conclude that it is not necessary that a nuclear power plant has

permanently ceased the production of electric energy or have a plan to permanently cease the production of electric energy in the near future in order for the otherwise deductible costs of removing and replacing components to qualify as nuclear decommissioning costs.

We recognize that § 1.468-1(b)(5) can be read more strictly, as advocated by your office, and that the ambiguity in those regulations may cause uncertainty. However, we believe that the conclusion reached herein is more in concert with the principles underlying § 468A and the common practice in the nuclear industry.

ISSUE 2

I. Removal Costs

Section 162 generally allows a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Even though a particular taxpayer may incur an expense only once in the lifetime of its business, the expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on that business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure. Commissioner v. Tellier, 383 U.S. 687 (1966); Deputy v. du Pont, 308 U.S. 488 (1940); Welch v. Helvering, 290 U.S. 111 (1933). Section 162 has been applied to allow business expense deductions for the costs of removing and disposing of waste materials produced in a taxpayer's business. See H.G. Fenton Material Co. v. Commissioner, 74 T.C. 584 (1980).

Section 1.162-4 of the Income Tax regulations provides that a deduction is allowed for the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition. However, § 1.162-4 also provides that the cost of repairs in the nature of replacements that arrest deterioration and appreciably prolong the life of the property must be capitalized and depreciated in accordance with § 167.

Section 263(a) generally prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. Section 263(a)(2) provides that no deduction shall be allowed for any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made in the form of a deduction for depreciation, amortization, or depletion. Section 1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Section 1.263(a)-2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Rev Rul. 2000-7, 2000-1 C.B. 712, provides that if the retirement and removal of a depreciable asset occurs in connection with the installation or production of a replacement asset, the costs incurred in removing the retired asset are not required to be capitalized under § 263 or 263A as part of the cost of the replacement asset under the facts of that ruling, which did not relate to the removal of a component of a depreciable asset. The costs of removing a component of a depreciable asset are either deductible or capitalizable based on whether replacement of the component constitutes a repair or an improvement. See §§ 1.162-4 and 1.263(a)-1(b).

Your memorandum analyzes Rev. Rul. 2000-7 and concludes that it does not apply because the taxpayer treats the removed assets as components of a depreciable asset. We agree with this conclusion provided that the taxpayer treats the removed assets as components of a depreciable asset.

II. Basis of retired assets

Section 165 allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. For the allowance under § 165(a) of losses arising from the permanent withdrawal of depreciable property from use in a trade or

business or in the production of income, § 1.165-2(c) cross references § 1.167(a)-8(a), which permits, in part, a loss from physical abandonment of retired property. Your memorandum states that Item 1, Item 2, Item 5, and Item 6 are deductible under § 165 because the assets were permanently retired and abandoned subsequent to their removal. We agree with this conclusion.

III. Property Produced by the Taxpayer

Section 263A provides that taxpayers that produce real property or tangible personal property must capitalize (1) all direct costs of producing the property, and (2) the property's properly allocable share of indirect costs. See also § 1.263A-1(a)(3)(ii). Section 263A(g)(1) provides that, for purposes of section 263A, the term produce includes construct, build, install, manufacture, develop, or improve. Section 1.263A-2(a)(3)(i) provides that any cost required to be capitalized by § 263A must be capitalized regardless of whether the cost was incurred before, during, or after production.

Section 1.263A-1(c)(1) provides that to determine capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities. Section 1.263A-1(c)(1) further provides that after § 263A costs are allocated to the appropriate production activities, these costs generally are allocated to the items of property produced during the taxable year and capitalized to the items that remain on hand at the end of the taxable year. As a result, costs incurred during the taxable year allocable to the production of inventory are either included in the cost of goods sold during the taxable year or are capitalized to the items that remain on hand at the end of the taxable year (e.g., included in ending inventory) using a method permitted under § 1.263A-1(f).

Section 1.263A-1(c)(2)(ii) provides that the amount of any cost required to be capitalized under § 263A may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii). Section 1.263A-1(c)(4) provides that costs that are capitalized under § 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer.

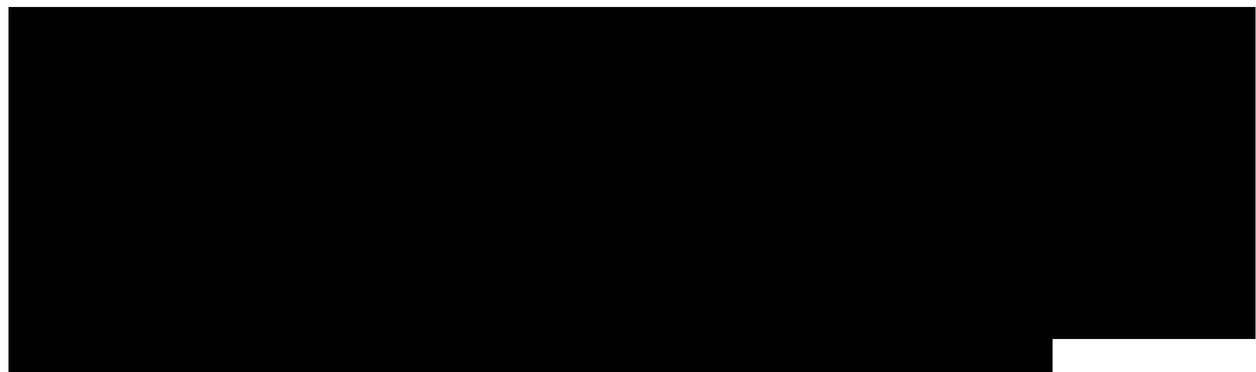
Section 1.263A-1(e)(3)(i) provides, in part, that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. Cost recovery, production facility repair and maintenance costs, and scrap and spoilage costs are examples of indirect costs that must be capitalized to the extent the costs are properly allocable to produced property. See § 1.263A-1(e)(3)(ii)(I), (O) and (Q). In addition, costs related to temporarily idle production equipment or facilities, other than depreciation, amortization and cost recovery allowances, are indirect costs that are required to be capitalized. See § 1.263A-1(e)(3)(iii)(E).

Section 1.263A-1(e)(3)(iii)(D) provides that losses under § 165 and the regulations thereunder are indirect costs that are not required to be capitalized under section 263A.

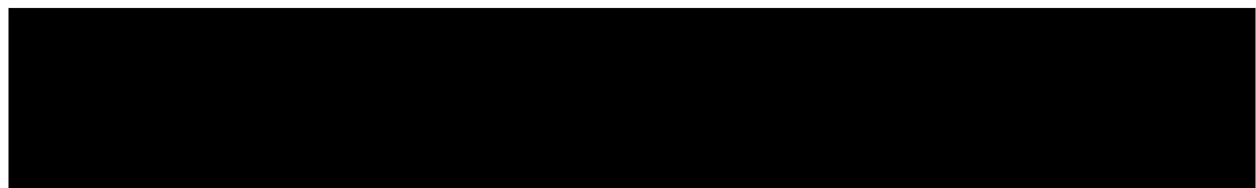
Rev. Rul. 94-38, 1994-1 C.B. 35, holds that costs incurred to clean up land and to treat groundwater contaminated with hazardous waste from the taxpayer's business are not capital expenditures under § 263 because these costs do not materially add value to the land, prolong the useful life of the land or adapt the land to a new or different use and, therefore, such costs are deductible by the taxpayer as business expenses under § 162. Costs incurred for constructing groundwater treatment facilities, however, are capital expenditures under § 263.

Rev. Rul. 2004-18, 2004-1 C.B. 509, considers whether costs incurred to clean up land that a taxpayer contaminated with hazardous waste by the operation of the taxpayer's manufacturing activities are includible in inventory costs under § 263A. Rev. Rul. 2004-18 states that the holding of Rev. Rul. 94-38 that the costs to construct a groundwater treatment facility must be capitalized under §§ 263(a) and 263A, rather than deducted under § 162, demonstrates the distinction between capital expenditures and costs that are more in the nature of repairs than capital improvements. As with other types of deductible business costs, such as labor costs, taxes, rent, and supplies, once repair costs are determined to be deductible under § 162, a taxpayer with inventories still must apply the rules of § 263A to determine whether the repair costs must be included in inventory. Rev. Rul. 2004-18 concludes, therefore, that environmental remediation costs are subject to capitalization under § 263A and are required to be included in inventory costs under the facts of that ruling.

a. Inventory vs. generating asset



b. Deductible vs. capitalizable



IV. Specified Liability Loss

Section 172(a) allows as a deduction for a taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year.

Section 172(c) defines a net operating loss as the excess of the deductions allowed by Chapter 1 of the Internal Revenue Code over the gross income.

Section 172(b)(1)(A) provides that, generally, a net operating loss for any taxable year is carried back to each of the 2 taxable years preceding the taxable year of the loss and carried forward to each of the 20 taxable years following the year of the loss.

Under § 172(b)(1)(C), in the case of a taxpayer that has a specified liability loss (as defined in § 172(f)) for a taxable year, the specified liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss. However, under § 172(f)(3), except as provided in regulations, the portion of any specified liability loss that is attributable to amounts incurred in the decommissioning of a nuclear power plant (or any unit thereof) may be carried back to each of the taxable years during the period beginning with the taxable year in which such plant (or unit thereof) was placed in service and ending with the taxable year preceding the loss year.

Section 172(f)(1)(B)(i) defines a specified liability loss, in part, as any amount taken into account in computing the net operating loss for the taxable year and that is allowable as a deduction under Chapter 1 of the Code (other than § 468A(a)) which is in satisfaction of a liability under a Federal or State law requiring the decommissioning of a nuclear power plant (or any unit thereof) if (I) the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, and (II) the taxpayer used an accrual method of accounting throughout the period or periods during which such act (or failure to act) occurred. Under § 172(f)(2), the amount of a specified liability loss for a taxable year cannot exceed the amount of the net operating loss for the taxable year.

Under § 1.468A-1(b)(5), all otherwise deductible costs to remove components of a nuclear power plant from service constitute nuclear decommissioning costs. Federal law imposes the obligation to incur such costs. For purposes of applying section 172(f), we conclude that amounts allowable as deductions that qualify as nuclear decommissioning costs under § 1.468A-1(b)(5) satisfy the requirements of § 172(f)(1)(B)(i)(II).

a. Inventory

If the nuclear decommissioning costs are allocable to inventory, the taxpayer treats these costs as a cost of producing electricity for sale, and recovers these costs through cost of goods sold. Cost of goods sold is taken into account in determining gross income pursuant to § 1.61-3(a) rather than deducted from gross income in determining taxable income.

To generate a specified liability loss, § 172(f)(1)(B)(i) requires the nuclear decommissioning expense to be "allowable as a deduction" under Chapter 1 of the Code. Although an amount recovered through cost of goods sold reduces taxable income to the same extent as an equivalent amount of allowed "deductions," case law arising in contexts outside of § 172(f) distinguishes deductions from cost of goods sold. See B.C. Cook & Sons, Inc. v. Commissioner, 65 T.C. 422 (1975), nonacq., 1977-2 C.B. 1, aff'd per curiam, 584 F.2d 53 (5th Cir. 1978) (court rejected the government's argument that an amount included in cost of goods sold was a deduction for purposes of § 1312(2)); Max Sobel Wholesale Liquors v. Commissioner, 630 F.2d 670 (9th Cir. 1980) (court rejected the government's argument that § 162(c)(2), which prohibits a deduction for illegal payments, precludes a taxpayer from recovering the payments through its cost of goods sold).

In our view, Congress used the phrase "allowable as a deduction" in § 172(f)(1)(B)(i) to mean amounts that may be taken into account in computing taxable income. Congress did not mean to distinguish "deductions" from "cost of goods sold." For example, amounts such as fines and penalties that are nondeductible by reason of § 162(f) cannot qualify as specified liability losses. This interpretation is consistent with § 263A. Section 1.263A-1(c)(2)(i) prohibits taxpayers from treating as inventoriable costs amounts that "may not be taken into account in computing taxable income for any taxable year." As an example, the regulations refer to the § 274(n) disallowance of meal and entertainment expenses.

Unlike fines and penalties disallowed by § 162(f), and meals and entertainment disallowed by § 274(n), nuclear decommissioning costs that must be recovered through cost of goods sold, though not deductible by the producer of electricity under § 162(a), are "allowable" deductions that can be taken into account in computing taxable income under the Code. As "allowable" deductions, such nuclear decommissioning costs are both (1) eligible to be allocated to inventory to the extent required by § 263A, and (2) eligible for treatment as a specified liability loss to the extent the other requirements of § 172(f) are met.

We conclude that to the extent repair costs, required to be treated as inventory costs under § 263A and incurred to satisfy a liability to decommission a nuclear power plant, are taken into account as cost of goods sold resulting in a net operating loss, such costs generate a specified liability loss under § 172(f)(1)(B). However, we emphasize that § 172(f)(1) requires that amounts must be "taken into account in computing the net operating loss for the taxable year." Otherwise qualifying costs that are allocated to inventory under § 263A are taken into account in computing the net operating loss for

the taxable year only to the extent they are included in cost of goods sold for that year. In the case of a nuclear power plant, we assume most costs to generate such power will be taken into account through cost of goods sold at the time of generation.

b. Capitalized to generating asset

To the extent nuclear decommissioning costs must be capitalized to the generating asset, such costs will be recovered through depreciation. Presumably, the depreciation expense will be treated as an inventory cost under section 263A and, as in the case of the incidental repair costs discussed above, recovered through cost of goods sold. The question arises as to whether recovery of these costs may also generate a specified liability loss.

In Notice 2005-20, 2005-1 C.B. 635, the Service addressed the question of whether for purposes of § 172(f)(1)(B), prior to its amendment by § 3004(a) of the Tax and Trade Relief Extension Act of 1998 (the 1998 Act), depreciation deductions were allowable with respect to the liability giving rise to the depreciable basis of a depreciable asset. The Service concluded that depreciation deductions are not allowable with respect to the liability giving rise to the depreciable basis of a depreciable asset. Instead, depreciation deductions may be allowable with respect to liabilities satisfied through the use of the depreciable asset.

Prior to its amendment by the 1998 Act, § 172(f)(1)(B) applied to any amounts [other than product liability expenses and certain expenses related thereto] allowable as a deduction under [Chapter 1 of the Internal Revenue Code] with respect to a liability which arises under a Federal or State law or out of any tort of the taxpayer if certain requirements were meet. The notice analyzed and resolved the depreciation issue as follows:

> Section 167(a) allows a depreciation deduction only for property that is either used in a trade or business or held for the production of income. Whether a depreciation deduction is allowable "with respect to" a liability depends upon the property's actual use. For example, if a taxpayer uses equipment to satisfy an environmental cleanup liability imposed by federal law, the portion of the equipment's depreciation allocable to satisfying the environmental cleanup liability is allowable with respect to the environmental cleanup liability. If the environmental cleanup liability arose as a result of a chemical spill that occurred at least 3 years before the beginning of the taxable year and the environmental cleanup liability is otherwise deductible, the depreciation deductions may generate a specified liability loss. However, if a taxpayer uses equipment to satisfy environmental cleanup liabilities that arise during the same taxable year the depreciation deductions are allowable, for example, by preventing the discharge of pollutants resulting from manufacturing activities during the current taxable year, the act giving rise to the taxpayer's environmental cleanup liability will not satisfy the 3-year act or failure to act requirement of former

§ 172(f)(1)(B)(i), irrespective of when the taxpayer placed the cleanup equipment in service.

Because the replacement components are used to generate electricity, rather than to decommission the nuclear power plant, the depreciation allowances for the replacement components do not qualify as nuclear decommissioning costs notwithstanding that a portion of the basis of such components may be attributable to nuclear decommissioning costs. Consequently, the depreciation allowances cannot generate a specified liability loss.

ISSUE 3

The nuclear fuel disposal fees paid to the Department of Energy do not qualify as nuclear decommissioning costs. Section 1.468A-1(b)(5) specifically excludes "deductible expenses to be incurred in connection with the disposal of spent nuclear fuel under the Nuclear Waste Policy Act of 1982" from the definition of nuclear decommissioning costs.

If you have any further questions with respect to issues 1 and 3, please contact Patrick Kirwan at 202-622-3110. If you wish more information in regard to issue 2, please contact Nancy Lee at 202-622-5020.

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