

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

May 1, 2024

Third Party Communication: NONE
Date of Communication: NONE

Number: **202434011**
Release Date: 8/23/2024
Index (UIL) No.: 162.21-01
CASE-MIS No.: TAM-122851-21

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Parent =
Subsidiary =
Month 1 =
Month 2 =
Month 3 =
Month 4 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =
Date 3 =

Date 4 =
State =
State Code =
State Agency =
Federal Agency =
City =
section a =
section b =
section c =
section d =
section e =
A =
B =
C =

Parent is a publicly-traded corporation and files a consolidated U.S. federal income tax return on behalf of an affiliated group (collectively, Taxpayer) that includes Subsidiary. The Parent is a holding company whose primary operating subsidiary is Subsidiary,

In Month 1, Subsidiary was found to have violated various provisions of the State Code in a civil proceeding conducted by State Agency. As a result of Subsidiary's violations, State Agency issued a decision imposing

IRS Examination (Exam) is auditing the Taxpayer's Year 1 and Year 2 tax returns. The Taxpayer and Exam agree that section 162(f)¹ of the Internal Revenue Code (Code) prohibits the Taxpayer from deducting amounts incurred . The Taxpayer and Exam request technical advice from the IRS Office of Chief Counsel regarding the proper tax treatment of amounts

¹ Unless otherwise indicated, all statutory and regulatory references are to the Internal Revenue Code and Income Tax Regulations in effect for the taxable years .

ISSUES:

(1) Whether

and, if so, whether section 162(f), 263(a), or 263A, or the public policy doctrine, precludes the Taxpayer from deducting or capitalizing amounts incurred

;

(2) Whether

and, if so, whether section 162(f) precludes the Taxpayer from deducting, or otherwise reducing gross receipts or taxable income, to account for amounts incurred ; and

(3) Whether sections 162(f), 263(a), or 263A, or the public policy doctrine, precludes the Taxpayer from deducting or capitalizing amounts incurred

CONCLUSIONS:

(1)

. Further, section 162(f) prohibits the Taxpayer from deducting amounts incurred

that would otherwise be currently deductible under section 162(a) because they are imposed as fines or similar penalties for the violation of laws, and are paid to the government within the meaning of section 162(f). Additionally, the public policy doctrine, and sections 263(a) and 263A, prohibit the Taxpayer from capitalizing amounts incurred such capital expenditures are analogous to the types of fines or penalties that are disallowed under section 162(f), and are not otherwise permitted to be taken into account in determining taxable income;

(2)

Section 162(f) prohibits the Taxpayer from deducting amounts incurred because

that are imposed as fines or similar penalties for the violation of laws, and are paid to the government within the meaning of section 162(f);

(3) Section 162(f), the public policy doctrine, and sections 263(a) and 263A do not prohibit the Taxpayer from deducting or capitalizing amounts incurred

. Such amounts are nonpunitive compensatory payments or amounts incurred to cure identified violations of law, and are therefore not subject to the prohibition of section 162(f).

FACTS:

A. State's Regulation of

State Agency is the state regulatory body that oversees and regulates . State Agency has broad authority over enforcing state laws and regulations that provide safety requirements .

State Code section a provides that

. State Code section b provides

, and imposes a penalty of . State Code section c provides, in relevant part, that every violation is a separate and distinct offense. Further, State Agency has authority to order equitable remedies, in part pursuant to State Code sections d and e. State Code section d confers broad authority on State Agency to

. State Code section e provides,

B.

On Date 1,

Subsidiary's safety practices were the subject of federal and state investigations, and civil and criminal proceedings.

1.

2.

3.

C. State Agency Investigation & Initial Decisions (Year 3—Year 1)

In Year 3 and Year 4, State Agency opened A investigations related to _____ to determine whether Subsidiary's _____ resulted in violations of State Code section a, or any other applicable statute, law, general order or State Agency decision _____. In opening each investigation, State Agency indicated that, should these investigations result in a determination that Subsidiary violated any legal safety requirements, State Agency would exercise its authority to impose penalties and/or remedies as provided under State Code.

1. Proposed _____ and Penalty Decisions (Year 5)

On Date 2, State Agency issued proposed decisions _____, finding that Subsidiary violated State Code and other authorities _____

. State Agency issued a separate proposed decision recommending that “the penalty imposed” for Subsidiary’s violations totaling approximately \$B (Proposed Penalty Decision). This Proposed Penalty Decision contained C orders directing Subsidiary to:

(1)

(2)

(3)

2. Appeal/Request for Review of Proposed Penalty Decision (Year 5)

Subsidiary and intervenors appealed and requested review of the Proposed Penalty Decision.

3. Final and Penalty Decisions (Year 1)

On Date 3, State Agency largely adopted the findings and determinations of the proposed decisions in the , finding that Subsidiary engaged in numerous violations of the State Code, applicable State Agency orders, and the laws, regulations, and standards incorporated thereby

(Final Penalty Decision).

In the Final Penalty Decision, State Agency observed that

Accordingly, in the Final Penalty Decision State Agency imposed on Subsidiary a fine and other

consisting of:

- (1) ;
 - (2) ;
 - (3) ;
- and

(4)

State Agency imposed the . pursuant to State Code sections b and c. With regard to the

State Agency noted that these were equitable remedies imposed pursuant to its authority under the State Constitution and State Code sections d and e.

a.

b.

c.

d.

e.

D.

E. Parties' Positions

1. Taxpayer's Position

The Taxpayer argues that neither section 162(f) nor the public policy doctrine applies to prohibit the deduction or capitalization of any of the amounts at issue.

While the Taxpayer does not dispute that the State Agency acted with punitive intent in

, and therefore does not implicate section 162(f) nor the public policy doctrine, which apply to expenses.

In the alternative, the Taxpayer argues that

the costs

may still be distinguished

from a fine or penalty subject to section 162(f). The Taxpayer argues that those costs originated from non-punitive

Finally, Taxpayer argues that none of these amounts were paid to a government, nor were they “in lieu of” a fine or similar penalty.

Therefore, the Taxpayer contends that the costs of complying with the order are not deductible expenses that may be disallowed by section 162(f) or the public policy doctrine.

In the alternative, the Taxpayer argues the costs were not a fine or similar penalty for which a deduction is disallowed under section 162(f). Instead, the Taxpayer argues that these costs represented compensatory damages,

Finally, _____, the Taxpayer argues that the _____ are analogous to compensatory damages and court costs and are therefore excluded from the scope of section 162(f) by Treas. Reg. section 1.162-21(b)(2). With respect to the _____, the Taxpayer indicates that many of those costs were necessary to cure Subsidiary's violations of law and _____. As such, the Taxpayer argues the _____ are costs of complying with applicable requirements, and are excluded from the scope of section 162(f) as illustrated by Treas. Reg. section 1.162-21(c), Example 3.

Additionally, the Taxpayer argues that, except for _____, none of these amounts were paid to a government, nor were they "in lieu of" a fine or similar penalty under section 162(f).

2. Exam's Position

Exam disagrees with the Taxpayer's position that

_____. Additionally, Exam argues that section 162(f) and the public policy doctrine preclude deduction or capitalization of all the amounts incurred by the Taxpayer

_____. In support of this position, Exam relies on the holdings of the _____ Decisions, and the rationale offered by State Agency in the Proposed and Final Penalty Decisions,

_____. Those decisions _____ primarily focused on Subsidiary's violations of the State Code and expressed State Agency's overarching intent to impose a penalty proportionate to the scope and severity of Subsidiary's violations of law. Viewing the totality of the record, then, Exam argues that the amounts at issue are a comprehensive penalty meant to punish Subsidiary for its violations of safety requirements, and to deter _____ from ever engaging in similar conduct in the future.

Specifically, _____, Exam argues that the Taxpayer's liability arises "in lieu of" its liability for a portion of an otherwise warranted cash penalty.

Exam thus takes the position that Taxpayer's liability arises "in lieu of" its liability for a cash penalty that may have otherwise been imposed and paid to the government for Subsidiary's violations of the State Code.

Exam also argues that section 162(f) and the public policy doctrine disallow any tax benefit for all costs associated with . In particular, Exam argues that State Agency imposed as a means of punishing Subsidiary's malfeasance. Accordingly, Exam takes the position that is an amount for which a deduction would otherwise be subject to disallowance under section 162(f).

Further, Exam argues that State Agency's exists as a component piece of an overarching penalty meant to punish the Taxpayer in a manner proportionate to the scope and severity of its safety violations. In support of that position, Exam relies on the entirety of the record

LAW:

Section 162(a) of the Code generally provides taxpayers with a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 162(f), as applicable to the years at issue, provides that no deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law.²

² The reference to subsection (a), which allows a deduction for ordinary and necessary expenses paid or incurred, indicates that section 162(f) applies to amounts paid or incurred for fines or similar penalties. For accrual-method taxpayers, a liability is incurred, and generally taken into account for Federal income tax purposes, in the taxable year in which the events have occurred that establish the fact of liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. See section 461(h) and section 1.461-1(a)(2)(i). Additionally, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property. Section 1.446-1(c)(ii)(B). We do not express any opinion on whether any of the amounts at issue were properly

Section 1.162-21(b)(1)(ii) and (iii) of the Regulations provides that for purposes of section 162(f), a fine or similar penalty includes an amount paid as a civil penalty imposed by Federal, state, or local law or in settlement of a taxpayer's actual or potential liability for a fine or penalty. The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of or prosecution or civil action arising from a violation of the law imposing the fine or civil penalty. Id. At (b)(2). Additionally, compensatory damages paid to a government do not constitute a fine or penalty. Id.

Section 1.162-21(a) provides that "a government" includes the government of the United States, a state, or any political subdivision, corporation, or other entity serving as an agency or instrumentality thereof.

Section 263(a) provides that no deduction shall be allowed for permanent improvements or betterments to increase the value of any property or estate or for amounts expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. See Treas. Reg. section 1.263(a)-1(a).

Section 1.263(a)-1(d) provides that capital expenditures include, for example, amounts paid to acquire, produce, or improve a unit of real or personal tangible property. See section 1.263(a)-2(d); section 1.263(a)-3(d).

Section 1.263(a)-1(b) provides that "nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code . . . other than section 162(a) or section 212" and the regulations associated with those sections.

Section 263A prohibits current deductions for certain direct and indirect costs of producing property.

Section 263A(a) and (b) provide, in part, that a taxpayer must capitalize all the direct and allocable indirect costs of any real or tangible personal property produced by the taxpayer. Section 263A(g)(1) provides that the term "produce" includes construct, build, install, manufacture, develop, or improve.

Section 263A(a)(2) provides that any cost which (but for section 263A and the regulations thereunder) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in that paragraph. See Treas. Reg. section 1.263A-1(c)(2).

reported on Taxpayers' Year 1 and Year 2 returns, including whether the amounts were incurred in those taxable years.

Sections 1.263A-1(c)(3), 1.263(a)-2(g) and 1.263(a)-3(o) provide that amounts capitalized are included in inventory costs or charged to a capital account or basis. Section 1012 provides that the basis of a taxpayer's property shall be the cost of such property. Section 1016 provides that a taxpayer's basis in property must be adjusted by the amount of any expenditures properly chargeable to a capital account, including the cost of improvements or betterments made to the property. See Treas. Reg. section 1.1016-2(a).

Sections 1.263A-1(c)(4), 1.263(a)-2(h) and 1.263(a)-3(p) provide that taxpayers may recover capitalized amounts, generally, through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time property is used, sold, placed into service, or otherwise disposed of by the taxpayer.

Section 61 of the Code generally provides that gross income means all income from whatever source derived. The term "income" is broadly defined as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

ANALYSIS:

A.

1. Costs Otherwise Currently Deductible under Section 162

We conclude that

. Further, we hold that costs incurred to satisfy the order that are otherwise currently deductible under section 162 are disallowed pursuant to section 162(f) because they are imposed as fines or similar penalties for the violation of laws, and are paid to the government within the meaning of section 162(f).

a. Fines or Similar Penalties for Violation of Law

Courts have long held that section 162(f) prohibits a deduction for liabilities "imposed for purposes of enforcing the law and as punishment for the violation thereof," or otherwise imposed for the purpose of deterring future proscribed conduct. Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987), aff'd, 850 F.2d 611 (9th Cir. 1988). Amounts imposed as a nonpunitive measure, such as to compensate another party, fall outside the prohibitions of section 162(f). Id. Courts—and the Service—have recognized that the origin of an ostensible penalty may bear a dual nature, in that its effect may be both punitive and nonpunitive. When confronted with this duality in applying section 162(f), courts assess the primary purpose of and for the imposition of that ostensible penalty. Waldman, 88 T.C. at 1387; see also Stephens v. Commissioner, 905 F.2d 667, 673 (2^d Cir. 1990).

Whether an amount is imposed as a fine or similar penalty, for the violation of any law, requires a determination of the origin and character of the liability. Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985); Ostrom v. Commissioner, 77 T.C. 608 (1981); see also Nacchio v. United States, 824 F.3d 1370, 1380-81 (Fed. Cir. 2016); see also United States v. Gilmore, 372 U.S. 37, 48-49 (1963). Subsidiary's violations of law as determined _____, and the imposition of _____ as a consequence for those violations, serve as the origin of the Taxpayer's liability for amounts incurred _____.

We conclude that the State Agency's primary purpose for the _____ was punitive. The _____ was imposed pursuant to State Agency's authority under State Code sections d and e, which provide State Agency with the equitable authority to _____.

_____. The order reflects State Agency's intent to punish Subsidiary for its violations of law as determined in the _____.

we find the primary purpose was punitive; specifically, _____ as a substitute for a cash penalty that was otherwise warranted under the law.

The State Agency's decision to _____ also demonstrates State Agency's punitive intent. In the Final Penalty Decision,

As discussed above, the punitive aspects of the [redacted] are express, and outweigh any ostensibly competing nonpunitive purpose for the [redacted]. Accordingly, the primary purpose of [redacted] is to enforce the law by punishing the Taxpayer for Subsidiary's violations of law, and to deter future offenses.

We disagree with the Taxpayer's characterization of the [redacted]

For similar reasons, we do not agree with the Taxpayer that the costs cannot be viewed as punitive because the origin of this liability is laws that applied to all _____ regardless of wrongdoing. As noted above, we find the origin of the Taxpayer's liability for these costs is the _____ and the subsequent _____, for which the State Agency's primary purpose was to punish Subsidiary. Therefore, we do not agree the

Finally, the Taxpayer argues that the costs of satisfying the _____ cannot be punitive because they

_____. The Taxpayer fails to explain why this is relevant to the determination of the origin and character of the Taxpayer's liability. In order to evaluate the deductibility of an amount imposed as a potential fine or similar penalty, the courts and the Service look to the origin and character of the liability giving rise to the claim, not the effect of the payment on the taxpayer.

b. Paid to the Government Within the Meaning of Section 162(f)

Although section 162(f) prohibits deductions for penalty amounts paid to the government, courts have held that "paid to a government" does not mean that the "government must actually 'pocket' the fine or penalty." Waldman, 88 T.C. at 1389. Rather, courts have held that fines for a violation of law otherwise payable to the government, and that are redirected by the government to a non-government payee, may remain nondeductible fines or similar penalties within the meaning of section 162(f). Id. (criminal restitution payments made directly to victims was a nondeductible penalty); Bailey, 756 F.2d at 47 (civil penalty imposed for violating a Federal Trade Commission consent order was not deductible even though taxpayer was permitted to apply the settlement of his liabilities in a class-action lawsuit toward the penalty); Allied-Signal, Inc. v. Commissioner, T.C. Memo. 1992-204, aff'd in unpublished opinion, 54 F.3d 767 (3d Cir. 1995) (trial court reduced criminal penalty by amount of taxpayer's payment to environmental endowment fund; payment to fund held to be nondeductible penalty).

In Waldman, the Tax Court held that restitution paid to victims in lieu of incarceration was a nondeductible penalty under section 162(f). In that case, the taxpayer pleaded guilty to a count of conspiracy to commit grand theft. The trial court sentenced the taxpayer to one to 10 years in prison, but stayed execution of that sentence on condition that taxpayer pay restitution to his victims. The Tax Court determined that, while restitution is generally a compensatory remedy, the trial court's primary purpose for imposing a restitution obligation in lieu of incarceration remained a punishment for taxpayer's crime, i.e., a punitive measure to deter future criminality and enforce the law.

In Allied-Signal, the Tax Court held that an \$8 million contribution to an environmental endowment constituted a fine or similar penalty for purposes of section 162(f). In that case, the taxpayer was criminally indicted for, and pleaded no contest to, violations of environmental laws. As a result, the trial court sentenced the taxpayer to the maximum criminal fine. In doing so, however, the court noted that although it wished to allocate the criminal fine to the parties and individuals harmed by the taxpayer's violations, it determined that it lacked the authority to do so. Consequently, the trial court signaled its receptiveness to a motion to reduce that fine in consideration of any uncompelled efforts undertaken by the taxpayer to directly alleviate the public harms caused by the taxpayer's criminal violations. After engaging in discussions with the trial court, the taxpayer established an environmental endowment to research and remedy the effects of the taxpayer's environmental crimes, and provided that endowment with a contribution of \$8 million. The next day, the taxpayer filed a motion to reduce its criminal penalty. This effort was successful, and on reconsideration the court reduced the taxpayer's fine by an amount roughly equal to the contribution. In determining whether section 162(f) disallowed the taxpayer's deduction for the \$8 million contribution to the endowment, the Tax Court evaluated the substance of the arrangement giving rise to the contribution. Relying on Waldman, the court determined that the primary purpose of the contribution—and that of the statute giving rise to the initial otherwise warranted penalty—was to enforce the law and exact a punishment, and that on balance this purpose outweighed any remedial purpose or other effect served by the endowment arrangement. The structure of the arrangement had no bearing on this determination; the form did not control, and the substance of the taxpayer's contribution remained a nondeductible payment imposed as a punishment for, and deterrent to future, environmental crimes.

Here, State Agency found itself presented with competing interests, similar to the courts in Allied-Signal and Waldman. The State Agency determined that Subsidiary's violations warranted a significant penalty that would enforce the law by appropriately punishing Subsidiary, and deter future violations.

The Taxpayer argues that unless there is a "quid pro quo" involving a government reducing or eliminating a fine or sanction in exchange for some other payment, the "in lieu of" argument—as exhibited in Allied-Signal and Waldman—fails. We do not agree that the relevant case law requires such an arrangement in order for the "in lieu of"

analysis to apply. We note that the trial court in *Allied-Signal* lacked authority to order the tailored outcome it desired, thus necessitating a voluntary arrangement between the court and the defendant. In contrast, in the present case, State Agency had authority to order the outcome desired, and thus did not need to obtain the Taxpayer's agreement.

Thus, because the Taxpayer's liability for these amounts originates from a punitive sanction for Subsidiary's violation of law imposed in lieu of a otherwise warranted, cash penalty to be paid to the State, we conclude that such amounts are paid to the government within the meaning of section 162(f). Such a determination is consistent with case law including *Allied-Signal*, *Waldman* and *Bailey*.

2. Costs that are Otherwise Capital Expenditures

We conclude that the costs

may not be capitalized pursuant to the public policy doctrine and sections 263(a) and 263A, because such capital expenditures are analogous to fines or penalties that are disallowed under section 162(f), and these costs are not otherwise permitted to be taken into account in determining taxable income.

a. Public Policy Doctrine

The public policy doctrine is a common law rule that disallows deductions when allowance of such deductions "would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof." *Tank Truck Rentals*, 356 U.S. at 34. The Supreme Court has noted that "[d]eduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature." *Id.* Congress enacted section 162(f), inter alia, to effectively codify the public policy doctrine. While the doctrine has been in part codified (and its scope limited) by the text of section 162 and associated regulations, courts continue to apply the judicial public policy doctrine to limit tax benefits when warranted. See e.g., *Smith v. Commissioner*, 34 T.C. 1100 (1960), *aff'd per curiam* 294 F.2d 957 (5th Cir. 1961) (disallowing section 165 loss or section 166 bad debt deduction for a penalty imposed for failure to pay F.I.C.A. and F.U.T.A taxes, in part, because the deterrent impact of the tax penalty would be reduced, and violations of statutory duty would be encouraged); *Nacchio v. United States*, 824 F.3d 1370 (Fed. Cir. 2016) (public policy precludes

deduction under section 165 for mandatory punitive forfeitures); Coit v. Green, 404 U.S. 997 (1971) (private schools maintaining racially discriminatory admissions policies that clearly violate Federal policy denied qualification under section 501(c)(3)).

Allowing the Taxpayer to capitalize and recover basis for amounts imposed as a penalty would permit the Taxpayer to derive a tax benefit that would “soften the sting” of that intended penalty. As described previously, State Agency determined that Subsidiary’s conduct violated applicable statutory and regulatory safety requirements, _____, and that Subsidiary should be subjected to penalties. Accordingly, the

_____ was a punitive sanction for Subsidiary’s violation of a sharply defined public policy objective:

Therefore, the public policy doctrine applies to these amounts to prevent capitalization and recovery of basis, because allowing these amounts would severely and immediately frustrate the statutory scheme regarding _____, and would undermine State’s ability to enforce that policy as intended by blunting the punitive and deterrent effect of State’s penalty provisions. See e.g., Rev. Rul. 82-74, 1982-1 C.B. 110 (public policy doctrine precludes arsonist from basis adjustments under section 165); see also Rev. Rul. 77-126, 1977-1 C.B. 47 (public policy precludes deduction under section 165 for forfeiture losses of illegal gambling devices).

b. Capitalization under Sections 263(a) and 263A

In addition to the public policy doctrine, the Taxpayer is precluded from capitalizing its costs of complying with _____ under sections 263(a) and 263A because, as discussed below, to capitalize an amount under sections 263A and 263(a), the Code must otherwise permit that amount to be taken into account in determining taxable income. Because Subsidiary’s capital expenditures result from a fine or similar penalty under section 162(f), these costs are not otherwise permitted to be taken into account in determining taxable income. Accordingly, the Taxpayer may not capitalize these expenditures under sections 263(a) or 263A.

Section 263A provides that capital expenditures include the direct and allocable indirect costs of any real or tangible personal property produced by the taxpayer. Congress intended section 263A to be a single, comprehensive set of capitalization rules for property produced by a taxpayer or acquired for resale; therefore, section 263A is often referred to as the “uniform capitalization rules”. Prior to the enactment of section 263A, cost capitalization requirements varied between types of property and among industries. Congress enacted section 263A in part due to its belief that “a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property....” S. Rep. No. 99-313, at 140 (1986). Additionally, Congress believed

that a single, comprehensive set of capitalization rules would make the income tax more neutral in its effect on business decisions.

Section 263A(a)(2) provides that “[a]ny cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.” The regulations under section 263A clarify this by stating:

Any cost which (but for section 263A and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year is not treated as a cost properly allocable to property produced . . . under section 263A and the regulations thereunder.

Treas. Reg. section 1.263A-1(c)(2); see Patients Mutual Assistance Collective Corporation v. Commissioner, 151 T.C. 176, 207-09 (2018); Lord v. Commissioner, T.C. Memo. 2022-14, *3-*6 (capitalization under section 263A is not permitted for costs otherwise proscribed by section 280E).

Accordingly, the legislative history of section 263A indicates that Congress intended section 263A to provide a uniform approach to determining the types of costs that must be capitalized to property produced by a taxpayer, and within that uniform approach, costs could not be capitalized under sections 263(a) or 263A unless they may be taken into account in determining taxable income under another provision of the Code. This interpretation of section 263A is consistent with the legislative history of section 263A(a)(2), which indicates that the flush language of section 263A(a)(2) was added to clarify “that a cost is subject to capitalization . . . only to the extent it would otherwise be taken into account in computing taxable income.” H. R. Rep. No. 100-795, at 98 (1988). Indeed, the legislative history of section 263A(a)(2) clarifies that an amount that is not otherwise allowable in determining taxable income may not be capitalized and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner. Id. This reasoning prohibits the Taxpayer from including in the basis of assets under section 263A any portion of the costs that represents an amount analogous to a fine or similar penalty, the deduction of which is prohibited by section 162(f). This reasoning also extends to section 263(a), which would similarly result in an addition to basis, thus permitting these amounts to be depreciated, amortized, and eventually be recovered upon the property’s disposition.

B.

We find that the _____ required the Taxpayer to pay \$ _____

_____ . Additionally, we find that the amounts incurred to _____ are disallowed pursuant to section 162(f) because they are _____

imposed as fines or similar penalties for the violation of laws, and are paid at the direction of the government.

1.

Before discussing the applicability of section 162(f), we must first determine whether

Generally, taxpayers are taxed on net income and may deduct under section 162(a) all ordinary and necessary expenses paid or incurred in carrying on a trade or business, including judgments, settlements, and similar payments. It is axiomatic that, before a refund may be deducted, a corresponding amount must have been included in a taxpayer's gross income. Section 61 provides, generally, that gross income means all income from whatever source derived. The term "income" is broadly defined as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

2. Section 162(f)

Having concluded

, the next step in our analysis is to determine whether section 162(f) bars a deduction for the amount of incurred in Year 2.

Subsidiary's violations of law as determined in the , and the imposition of as a consequence for those violations, serve as the origin of the Taxpayer's liability for amounts to be paid

As with the , we conclude State Agency's primary purpose for the was punitive. was imposed pursuant to the State Agency's authority under State Code sections d and e, which provide State Agency with the

. State Agency generally characterized as a component piece of the comprehensive penalty arrangement imposed on the Taxpayer as a consequence of the violations of law determined by , including its failure to

We do not agree with the Taxpayer's argument that

. As noted previously, the facts indicate that the [redacted] was intended to serve as a punishment for Subsidiary's violations of law and to deter future failures to comply with State's safety mandates.

As with the [redacted], the fact that the ultimate payee of this punitive sanction was not the government does not convert a non-deductible punitive exaction into a deductible expense. See Bailey, 756 F.2d at 47; Waldman, 88 T.C. at 1389-1390. Accordingly, section 162(f) precludes the Taxpayer from deducting amounts incurred to satisfy [redacted].

C.

Finally, we must determine whether the Taxpayer is precluded from deducting costs incurred to satisfy [redacted] pursuant to sections 162(f), 263(a), or 263A, or the public policy doctrine.

1.

Section 162(f) does not preclude a deduction for amounts incurred by the Taxpayer to satisfy the [redacted] to reimburse State Agency for costs associated with the investigation of [redacted] and [redacted].

. Pursuant to Treas. Reg. section 1.162-21(b)(2), a fine or penalty does not include legal fees and related expenses related to a civil action arising from a violation of the law imposing a civil penalty, nor compensatory damages paid to a

government. These reimbursement amounts fall within the exception provided by Treas. Reg. section 1.162-21(b)(2), and section 162(f) will not preclude a deduction for those costs. As a corollary matter, the public policy doctrine does not serve to limit deductions attributable to the

2.

Additionally, section 162(f) does not preclude a deduction for amounts incurred by the Taxpayer to satisfy

State Agency believed these to address or cure the violations of law determined in the Investigations. As a result, State Agency's primary purpose in directing Subsidiary to execute these was to correct the violations determined in the and to bring Subsidiary's operations into conformity with its pre-existing legal obligations; in other words, to cure its violations of law.

This is distinct, for instance, from amounts required to be expended to satisfy of the . State Agency considered the as intended to correct the specified violations of law determined in the . By contrast, the work completed to satisfy the lacks such a direct connection to any specific violation of law identified in the .

Additional distinctions between costs incurred to satisfy , and costs incurred to satisfy , demonstrate the non-punitive aspect of . For example, this order declines to fix an exact liability on the Taxpayer, but instead simply directs and supplies an estimated cost of doing so; the State Agency acknowledged that some of the

. This is distinct from that fixed a defined monetary liability upon the Taxpayer.

Accordingly, we conclude the order directing Subsidiary to execute the bears no indicia of a measure meant to punish or deter. Rather, the are meant to specifically cure Subsidiary's violations of law. Accordingly, amounts paid or incurred in executing the are nonpunitive and not subject to disallowance under section 162(f). See Treas. Reg. section 1.162-21(c), Example 3 (concluding that a manufacture of motor vehicles found to have violated laws regarding selling uncertified vehicles was prohibited under section 162(f) from deducting amounts paid as a civil fine, but was not prohibited from deducting amounts it was required to pay to remedy the vehicle's non-conformity). As a corollary matter, the public

policy doctrine, section 263(a), and section 263A do not serve to limit deductions or cost recovery attributable to the .

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.