Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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PLR-127592-07

Date:
April 15, 2008

LEGEND:

Taxpayer =
Parent =
Affiliate A =
Affiliate B =
Affiliate C =
Corp X =
Corp Y =
Customer =

City =
State =
Station =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Agreement 1 =
Agreement 2 =
Agreement 3 =
Lease 1 =
Lease 2 =

Term =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
$a =
$b =
$c =
$d =
e% =
f =
g =
$h =

Dear :

This ruling is in response to your letter dated June 5, 2007, supplemented by letters dated July 11, 2007, September 11, 2007, November 1, 2007, December 3, 2007, February 28, 2008, and March 18, 2008. Specifically, you requested rulings concerning the federal income tax treatment of the consideration paid to or on behalf of Corp X pursuant to a termination agreement, and the expenses incurred by Taxpayer in connection with the termination agreement, as described below.

FACTS

Taxpayer is a member of an affiliated group of which Parent is the common parent, and is taxable as a corporation under Subchapter C of the Internal Revenue Code. Other members of the affiliated group include Affiliate A and Affiliate B. Affiliate C, a corporation in State, merged into Taxpayer during the time of the events described below. Taxpayer uses the calendar year as its taxable year and an overall accrual method of accounting.

Taxpayer is a public utility (as defined in the Federal Power Act) and is subject to regulation by the Federal Energy Regulatory Commission under the Federal Power Act. Taxpayer is currently engaged in the business of leasing and operating electric generation assets that are owned by Corp X or City, producing electricity from these assets, purchasing electricity from City, and selling the electricity produced and purchased by it on a wholesale basis.

Corp X is a rural electric generation and transmission cooperative in State. Corp X has member owners, one of which is Corp Y, a cooperative corporation in State. Taxpayer represents that Taxpayer is not related to Corp X in any manner, and that none of Taxpayer's affiliated group are related to Corp X or any of Corp X's member owners (for instance, there is no patronage relationship between Corp X (and any of its

member owners) and Taxpayer (and any of the members of Taxpayer's affiliated group)). Corp X is currently engaged in the business of purchasing electric power, reselling that electric power on a wholesale basis, and transmitting that electric power and other electric power over an extensive electricity transmission system owned and operated by Corp X. Corp X owns certain electric generation assets in State (hereinafter, Generators). Prior to Date 1, Corp X operated the Generators and a generating plant owned by City (Station) from which it purchased a portion of the electricity output.

Prior to the bankruptcy reorganization (described below), Corp X had obligations to supply electric energy to two rural electric distribution cooperatives that were subsequently merged to become Corp Y.

Corp X filed a voluntary petition in bankruptcy on Date 1.

Pursuant to an overall bankruptcy reorganization of Corp X, the following transactions occurred in accordance with the terms of Agreement 1 dated Date 2, and Agreement 2 dated Date 3, to be effective Date 4:

(1) Corp X leased the Generators to Taxpayer for Term pursuant to the terms of Lease 1 dated Date 4.

(2) Corp X and Affiliate A entered into a Power Purchase Agreement (PPA), as described below, dated Date 4. Affiliate A subsequently assigned its rights and obligations to Taxpayer under the PPA. However, Affiliate A was not released from its liability under the PPA.

(3) Affiliate A and Corp Y entered into Agreements for Electric Service (Agreements E1 & E2), as described below, dated Date 4. Affiliate A subsequently assigned its rights and obligations under Agreements E1 & E2 to Taxpayer, although Affiliate A was not released from its liability under Agreements E1 & E2. Under Agreements E1 & E2, electric energy is sold by Taxpayer to Corp Y at substantially fixed prices.

(4) Corp X executed and delivered to Affiliate A a promissory note dated Date 4 of $a, which was subsequently assigned by Affiliate A to Taxpayer.

(5) Pursuant to Lease 2 dated Date 4, Affiliate C assumed certain of Corp X's contractual operating responsibilities with respect to the Station generation plant owned by City, and assumed Corp X's right and obligation to purchase from City certain quantities of electric power generated by Station for Term. Affiliate C subsequently assigned its right and obligation to purchase power generated by Station to Affiliate A. Affiliate A subsequently assigned its right and obligation to Taxpayer.

Under the terms of the PPA, Affiliate A (hereinafter Taxpayer, as successor to Affiliate A) is obligated to sell to Corp X power and energy at substantially fixed prices for Term. Taxpayer is obligated to supply Corp X no less than certain minimum requirements and no more than maximum power purchase amounts as outlined in the PPA. The quantities of power required to be sold to Corp X pursuant to the terms of the PPA is represented by Taxpayer to be significantly less than the total power generated by the Generators.

Section 4.1(b) of the PPA provides that Taxpayer shall supply Corp X with all of the power Corp X requires to service three specified customers of Corp X. Section 4.1(b) further provides that to the extent Corp X has any rights to extend or renew the contracts with these customers, Corp X shall not extend or renew the contracts without Taxpayer's prior consent. Taxpayer represents that the contracts with the three specified customers have expired and have not been renewed.

Taxpayer represents that the PPA is not a "unit power contract" (that is, a contract in which there is an obligation to deliver power from a specific facility). Taxpayer represents that it has engaged in numerous wholesale power purchase and sale transactions with entities other than Corp X and its members.

Under Agreements E1 & E2, Taxpayer, after assuming Affiliate A's obligations under the agreements, is obligated to sell electric energy with substantially fixed pricing for terms expiring in Year 1 and Year 2, respectively, to Corp Y. Taxpayer provides the electricity from Generators and Station, although Taxpayer may provide the electricity from any source. The terms of Agreements E1 & E2 provide that Taxpayer will supply a maximum of f and g kilowatts of energy for each respective agreement, and would supply additional energy at a higher rate if needed. As a result of Agreements E1 & E2, Corp X was relieved of similar obligations to provide this electric energy.

Also, on Date 4, Taxpayer and Customer entered into Agreement 3. Agreement 3 provided Customer with contractual assurances of Taxpayer's performance under Agreements E1 & E2, including that Taxpayer serve the retail load of Customer.

Historically, Corp X and Corp Y used approximately e% of the actual total power generated by the Generators and Station. Taxpayer represents that it sold the power generated from the Generators and Station that was not sold to Corp X or Corp Y under the PPA or Agreements E1& E2 on the open market.

Under the terms of Lease 1 and Lease 2, Taxpayer is required to pay a portion of the costs of equipment used in connection with the Generators and Station (hereinafter, Improvements). All Improvements affixed to the Generators became the property of Corp X upon being affixed. All Improvements affixed to Station became the property of City upon being affixed. Taxpayer capitalized the costs of the Improvements paid by it and has been depreciating the costs for federal income purposes.

Pursuant to amendments to Agreement 2 dated Date 5, Corp X approved the construction, installation, and use of scrubber facilities with respect to one of the Generators. All of the costs in connection with these scrubber facilities were to be borne by Taxpayer through the expiration or termination of Lease 1. Title to the scrubber facilities vested in Corp X upon installation and construction. Taxpayer capitalized the costs and has been depreciating and/or amortizing these costs for federal income tax purposes.

Taxpayer represents that the PPA and Agreements E1 & E2 have fixed pricing and minimal opportunities to pass on to Corps X and Y the costs of operation and production contingencies such as rising fuel costs, costs of new pollution control equipment mandated by changes in applicable law, and unexpected equipment outages and associated costs. Taxpayer represents that these costs have resulted in Taxpayer incurring significant losses, with projections that larger losses will be incurred by Taxpayer in the future. Taxpayer represents that it has estimated that operating financial statement losses incurred by it and Affiliate A in Year 3 through Year 4 were collectively approximately $h. Taxpayer further represents that it has recorded substantial financial statement reserves for losses expected through the remaining term of PPA and Agreements E1 & E2. Thus, Taxpayer represents that the obligations it undertook under Agreement 1 (that is, its obligations under the PPA, Agreements E1 & E2, and Leases 1 and 2) are burdensome and uneconomic.

Taxpayer represents that as a result of its incurred and expected losses, Taxpayer, Affiliate A, and Corp X entered into a termination agreement (Termination Agreement) dated Date 6.

The Termination Agreement contemplates that the following transactions will occur at the closing date of the Termination Agreement:

(1) Taxpayer will make a termination payment to Corp X in the amount of $b (Termination Payment).

(2) Taxpayer will convey to Corp X inventory and personal property (not in excess of $d), and owned intellectual property.

(3) The promissory note will be cancelled.

(4) The PPA and Leases 1 and 2 will be terminated and Taxpayer will be released from its obligations. Taxpayer will no longer have any interest in the Improvements or scrubber facilities.

(5) Corp X will assume Taxpayer's obligation to sell electric power to Corp Y under Agreements E1 & E2. Upon Corp X's assumption of Taxpayer's obligations, Corp Y will release Taxpayer from further obligation under Agreements E1 & E2.

(6) Taxpayer will convey to Corp X certain SO_2 and NO_x allowances.

(7) Corp X will purchase certain parcels of real property from Taxpayer for a purchase price equal to Taxpayer's original cost to purchase the same.

Taxpayer represented that none of the consideration paid by Taxpayer to terminate the PPA and Agreements E1 & E2 is allocable to the release of Affiliate A from Affiliate A's obligations under those agreements.

Contemporaneous with the closing of the transactions contemplated in the termination, Corp X and Corp Y will enter into new agreements whereby Corp X will sell to Corp Y electric energy to replace what was sold by Taxpayer pursuant to Agreements E1 & E2. Taxpayer is not a party to these subsequent agreements.

Subsequent to entering into the Termination Agreement, on Date 7, Taxpayer entered into a letter agreement with Customer. In this letter agreement, Taxpayer agreed to make a payment to Customer of $c in exchange for the release of Taxpayer from further obligation under Agreement 3.

In connection with the Termination Agreement, Taxpayer entered into or is a party to other agreements that would compensate Corp X for expenses that Corp X will incur under the Termination Agreement . These agreements are:

(1) An agreement between Corp X and Affiliate B, under which Affiliate B will reimburse Corp X for certain due diligence and transaction costs incurred by Corp X (Corp X Transaction Costs) related to the Termination Agreement. This agreement was amended, which resulted in Taxpayer becoming the party obligated to reimburse the Corp X Transaction Costs.

(2) An agreement between Corp X, Affiliate B, and Customer to share certain due diligence and transaction costs (Creditor Costs) incurred by certain creditors of Corp X. The Creditor Costs are contemplated to arise in connection with the creditors i) consenting to the transactions in the Termination Agreement (as relating to the creditors), and ii) accommodating various changes in Corp X's capital structure and associated financing agreements in order to facilitate the consummation of the transactions contemplated in the Termination Agreement (Consenting Parties). Some Consenting Parties have insisted upon reimbursement by Corp X or Taxpayer of such Creditor Costs. Creditor Costs may include legal costs, costs to retain financial advisors to consider the termination, and internally generated costs and expenses.

(3) An agreement between Corp X, Affiliate B, and Customer to share certain consent fees that may become payable to the Consenting Parties in exchange for their consents and contractual commitments (Creditor Consent Fees). Taxpayer agreed to compensate Corp X for the Creditor Consent Fees Corp X incurs in connection with the Termination Agreement.

Taxpayer represents that no other contracts or financial instruments were or are contemplated to be created, originated, entered into, renewed or renegotiated by or on behalf of Taxpayer in connection with the Termination Agreement.

RULINGS REQUESTED

(1) The conveyances and transfers of inventory, personal property, and owned intellectual property, the SO_2 and NO_x allowances, and Improvements to Corp X constitute realization events of Taxpayer under § 1001(a) of the Internal Revenue Code.

(2) Taxpayer will recognize gain or loss upon such realization events in an amount equal to the difference between Taxpayer's tax basis in each asset and the amount realized with respect to that asset, taking into account the allocation of consideration pursuant to § 1060 and the regulations thereunder.

(3) The consideration paid to or on behalf of Corp X to enable Taxpayer to terminate the PPA and the Agreements E1 & E2 constitute ordinary and necessary business expenses of the Taxpayer and are deductible under § 162. Specifically, the consideration is: (a) the Termination Payment; (b) the fair market value of the inventory and personal property (not in excess of $d) and owned intellectual property conveyed to Corp X; (c) the cancellation of a promissory note; (d) the fair market value of the SO_2 and NO_x allowances conveyed to Corp X; (e) the Corp X Transaction Costs, Creditor Costs, and Creditor Consent Fees; and (f) the fair market value of the Improvements.

(4) The costs incurred by Taxpayer in connection with terminating the PPA and Agreements E1 & E2, such as its legal, accounting, and other transaction costs which include the payment to Customer (Taxpayer Transaction Costs), Creditor Costs, and Creditor Consent Fees constitute ordinary and necessary business expenses of the Taxpayer and are deductible under § 162.

(5) Taxpayer may deduct the consideration paid to or on behalf of Corp X in the taxable year in which the consideration is paid or transferred by the Taxpayer to or on behalf of Corp X.

CONCLUSIONS

(1) Taxpayer's conveyances and transfers to Corp X of inventory, personal property, owned intellectual property, the SO_2 and NO_x allowances, and Improvements will be realization events under § 1001(a).

(2) Taxpayer will recognize gain or loss upon the above transfers and conveyances to the extent provided under § 1001(c). The amount of gain or loss recognized will be equal to the difference between Taxpayer's tax basis in each asset and

the amount realized with respect to that asset, taking into account the allocation of consideration pursuant to § 1060 and the regulations thereunder.

(3) Consideration paid by Taxpayer to or on behalf of Corp X pursuant to the Termination Agreement is not required to be capitalized under § 263 and the regulations thereunder. Furthermore, to the extent the consideration paid by Taxpayer is an expense negotiated at arm's length of relieving itself of an onerous or burdensome contract, the consideration paid by Taxpayer may be treated as an ordinary and necessary business expense of the Taxpayer that is deductible under § 162. However, any part of the consideration that is allocable to the release of Affiliate A's liability under the PPA and Agreements E1 & E2 will not be allowed to Taxpayer as a deduction under § 162. We do not rule upon or express any opinion on whether any portion of the amount is allocable to the release of Affiliate A's liability.

(4) To the extent the Taxpayer Transaction Costs, Creditor Costs, and Creditor Consent Fees incurred by Taxpayer in connection with carrying out the Termination Agreement represent transaction costs incurred on the Taxpayer's behalf in terminating an onerous or burdensome contract, they constitute ordinary and necessary business expenses of the Taxpayer and are deductible under § 162. Any portion of Taxpayer Transaction Costs, Creditor Costs, and Creditor Consent Fees that are attributable to the cost of the disposition of assets will result in an adjustment to the amount realized under § 1001 rather than a deduction under § 162.

(5) Taxpayer will incur a liability for (1) the Termination Payment, (2) the fair market value of inventory and personal property (not in excess of $d) and owned intellectual property, (3) the cancellation of the promissory note, (4) the fair market value of the SO_2 and NO_x allowances, (5) the fair market value of the Improvements, and (6) the Corp X Transaction Costs in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability in accordance with §§ 1.461-1 and 1.461-4 of the Income Tax Regulations (that is, in the taxable year in which the consideration is paid or transferred by the Taxpayer to Corp X). We decline to rule upon the taxable year in which Taxpayer will incur a liability for the Corp X Creditor Costs and Creditor Consent Fees on the basis of lack of sufficient information to determine when the fact of Taxpayer's liability will be established for these costs.

LAW & ANALYSIS

Ruling Request 1: Whether the conveyances and transfers of inventory, personal property, owned intellectual property, SO_2 and NO_x allowances, and Improvements to Corp X constitute realization events for Taxpayer under § 1001(a).

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

The transfer of in-kind property will result in realization of gain or loss to Taxpayer under § 1001(a). In United States v. Davis, 370 U.S. 65 (1962), reh'g denied, 371 U.S. 854 (1962), the Supreme Court held that the transfer of appreciated stock by a former husband to his former wife in an arm's length transaction was a realization event under § 1001(a). The amount realized by the husband was the fair market value of the property received (the former wife's relinquished marital rights), which were presumed to be equal in value to the property given in exchange by the husband (the appreciated stock). The husband's realized (and recognized) gain was the difference between his amount realized and his adjusted basis in the appreciated stock.

Although the specific result in divorce cases has been changed by enactment of § 1041,[1] the Davis rationale continues to apply to arm's length transfers of property. Thus, Taxpayer will realize gain or loss under § 1001(a) on its conveyance to Corp X of the inventory, personal property, owned intellectual property, certain SO_2 and NO_X allowances, and the Improvements.

Ruling Request 2: Whether Taxpayer will recognize gain or loss upon the realization events equal to the difference between Taxpayer's tax basis in each asset and the amount realized with respect to that asset, taking into account the allocation of consideration pursuant to § 1060.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of gain or loss determined under § 1001(a) on the sale or exchange of property shall be recognized.

[1] Section 1041 was enacted in 1984 by the Deficit Reduction Act of 1984, § 421(a), Pub. L. 98-369. Section 1041(a) provides that no gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) (1) a spouse, or (2) a former spouse, but only if the transfer is incident to divorce.

Section 1060 provides that, in the case of an applicable asset acquisition, the consideration received for such assets shall be allocated among the acquired assets in the same manner as amounts are allocated to assets under § 338(b)(5). Section 1.1060-1(a)(1) provides that, in the case of an applicable asset acquisition, sellers and purchasers must allocate the consideration under the residual method as described in §§ 1.338-6 and 1.338-7 in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets.

Taxpayer will recognize gain or loss upon the realization events above to the extent provided in § 1001(c). Adjustments to the amounts realized are required for costs that are attributable to the disposition of assets.[2] See Ruling Request 4. The gain or loss will be recognized in an amount equal to the difference between Taxpayer's tax basis in each asset and the amount realized for that asset, applying the consideration and basis allocation rules under § 1060 and the regulations.

Ruling Request 3: Whether the consideration paid to or on behalf of Corp X pursuant to the Termination Agreement constitutes an ordinary and necessary business expense of Taxpayer that is deductible under § 162.

Section 162(a) provides generally that there is allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1(a) provides that deductible business expenses include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. Under § 161, if a cost is a capital expenditure, the capitalization rules of § 263 take precedence over the deduction rules of § 162. Commissioner v. Idaho Power Company, 418 U.S. 1, 17 (1974). Therefore, a capital expenditure cannot be deducted under § 162, regardless of whether the expenditure is ordinary and necessary in carrying on a trade or business.

Section 263(a) provides generally that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate or any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 1.263(a)-4 provides rules for applying § 263 to amounts paid to acquire or create intangibles. Section 1.263(a)-4(b)(1) provides that except as otherwise provided in § 1.263(a)-4, a taxpayer must capitalize an amount paid to: (i) acquire an intangible (see § 1.263(a)-4(c)); (ii) create an intangible described in § 1.263(a)-4(d); (iii)

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[2] In general, the amount realized under § 1001(b) on the sale of property is reduced by the expenses incurred in selling that property. See Woodward v. Commissioner, 397 U.S. 572, 576 (1970); Ward v. Commissioner, 224 F.2d 547 (9th Cir. 1955) (fees of attorney and appraiser were not deductible but instead reduced amount realized); § 1.263(a)-2(e) (commissions paid in connection with the sale of securities are non-deductible capital expenditures reducing amount realized).

create or enhance a separate and distinct intangible asset within the meaning of § 1.263(a)-4(b)(3); (iv) create or enhance a future benefit identified in the Federal Register or the Internal Revenue Bulletin as an intangible for which capitalization is required; and (v) facilitate (as defined in § 1.263(a)-4(e)(1)) the acquisition of creation of an intangible.

The payment made pursuant to the Termination Agreement does not acquire any intangible (as provided in § 1.263(a)-4(c)) from any other party to the agreement. The payment is made only to terminate the relationships established under Agreement 2 (specifically, the PPA, Agreements E1 & E2, and Leases 1 and 2). Similarly, there is no intangible identified in published guidance created or enhanced, or the acquisition of an intangible facilitated, by the payment. Thus, § 1.263(a)-4(b)(1)(i), (iv), and (v) do not require capitalization of the payment made under the Termination Agreement.

Section 1.263(a)-4(b)(3)(ii) provides that amounts paid to another party to terminate (or facilitate the termination of) an agreement with that party are treated as amounts that do not create a separate and distinct intangible asset. Taxpayer represents that the payment will be made in order to terminate Taxpayer's obligations under the PPA and Agreements E1 & E2. Therefore, the amounts paid pursuant to the terms of the Termination Agreement do not create a separate and distinct intangible asset as defined in § 1.263(a)-4(b)(3)(i), and § 1.263(a)-4(b)(1)(iii) does not require capitalization. However, § 1.263(a)-4(b)(3)(ii) provides a cross-reference to § 1.263(a)-4(d)(2), (6), and (7), which have rules that specifically require capitalization of amounts paid to create or terminate certain agreements.

Section 1.263(a)-4(d)(1) provides a general rule that a taxpayer must capitalize amounts paid to create an intangible described in § 1.263(a)-4(d). See also § 1.263(a)-4(b)(1)(ii). Section 1.263(a)-4(d)(2)(i) provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of the financial interests enumerated in § 1.263(a)-4(d)(2)(i).

Section 1.263(a)-4(d)(6) provides rules for capitalization of a payment made by a taxpayer to another party to create, originate, enter into, renew, or renegotiate with that party certain enumerated agreements or covenants. Section 1.263(a)-4(d)(6)(iii) provides that a taxpayer is treated as renegotiating an agreement if the terms of the agreement are modified. Section 1.263(a)-4(d)(6)(iii) also provides that a taxpayer is treated as renegotiating an agreement if the taxpayer enters into a new agreement with the same party (or substantially the same parties) to a terminated agreement, the taxpayer could not cancel the terminated agreement without the consent of the other party or parties, and the other party or parties would not have consented to the cancellation unless the taxpayer entered into the new agreement. See also § 1.263(a)-4(d)(2)(iii), which provides substantially the same rules with respect to financial interests as defined therein. The regulations pertaining to amounts paid to obtain or modify contract rights are the exclusive capitalization provisions for created contracts, meaning

that amounts paid to enter into an agreement not identified in these rules are not required to be capitalized under the general principle of capitalization. See Notice of Proposed Rulemaking, 2003-1 C.B. 373 (Explanation of Provision, IV, E), 67 Fed. Reg. 77,701 (Dec. 19, 2002).

Accordingly, Taxpayer need not capitalize under either § 1.263-4(d)(2) or (6) the amounts paid under the Termination Agreement because Taxpayer did not create, originate, enter into, renew, or renegotiate financial interests or other agreements in connection with the Termination Agreement.

Under § 1.263(a)-4(d)(2)(iii) and (6)(iii) there was no renegotiation of any of the terminated agreements. Taxpayer did not renegotiate any financial interest or agreement because the PPA, Agreements E1 & E2, and the Leases were terminated, not modified. Taxpayer represents that no new agreements are being entered into, or financial interests created, between Taxpayer and any of the same parties to the terminated agreements. Moreover, Taxpayer represents that no new financial interest or other agreement between Taxpayer and a party to any of the agreements is contemplated to be entered into after the Termination Agreement takes effect.

The amount of the payment allocable to Corp X's assumption of Taxpayer's obligations under Agreements E1 & E2 is not paid by Taxpayer to Corp Y, the other party to Agreements E1 & E2; furthermore, it does not appear that Corp X's assumption of Taxpayer's obligations, and Corp Y's simultaneous release of Taxpayer from the obligations, constitute a renegotiation or modification of Agreements E1 & E2 so much as, in substance, a termination with respect to Taxpayer's obligations thereunder. Although Corp X did enter into subsequent agreements with Corp Y to provide electric energy, Taxpayer was not a party to the subsequent agreements.

Section 1.263(a)-4(d)(7)(i) provides in relevant part that a taxpayer must capitalize amounts paid to another party to terminate (i) a lease of real or tangible personal property between the taxpayer (as lessor) and the other party (as lessee) or (ii) an agreement that grants that party the exclusive right to acquire or use the taxpayer's property or services or to conduct the taxpayer's business. Section 1.263(a)-4(d)(7)(i)(A) and (B). With respect to the requirement that an amount paid to a party to terminate an agreement that grants that party the exclusive right to acquire or use the taxpayer's property or services, capitalization would be required, for example, for a payment made by a taxpayer to terminate a contract that grants another person the exclusive right to conduct business in a defined geographic area. See Notice of Proposed Rulemaking, 2003-1 C.B. 373 (Explanation of Provision, IV, F), 67 Fed. Reg. 77,701 (Dec. 19, 2002); see also Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974); § 1.263(a)-4(d)(7)(iii) ex. 2.

Any amount of the consideration paid under the Termination Agreement that is allocable to the termination of these agreements is not within the purview of § 1.263(a)-

4(d)(7)(i)(A) because neither agreement involved a lease of property between Taxpayer as lessor and another party as lessee. Under the terms of Lease 1, Taxpayer as the lessee leased tangible property (the Generators) from Corp X. Under the terms of Lease 2, Taxpayer assumed Corp X's right to operate Station and was the lessee with the right to operate Station.

Furthermore, the PPA and Agreements E1 & E2 are not agreements within the purview of § 1.263(a)-4(d)(7)(i)(B) because the PPA and Agreements E1 & E2 do not grant to Corp X or Corp Y an exclusive right to acquire or use Taxpayer's property or services or to conduct Taxpayer's business. Under the PPA, Taxpayer is only required to provide minimum and maximum quantities of power to Corp X. Similar provisions are in Agreements E1 & E2 with regard to Taxpayer's obligation to sell power to Corp Y. Under the terms of the PPA and Agreements E1 & E2, Taxpayer is not prevented from selling power on the open market. Corp X and Corp Y used approximately e% of the actual total power generated by the Generators and Station; Taxpayer was able and in fact sold the remaining power through agreements with other customers. While section 4.1(b) could be interpreted as an exclusivity provision (providing that Taxpayer had to supply Corp X with all the power Corp X required to service three specified customers with which Corp X had contracts), Corp X's contracts with those customers have expired and have not been renewed. In addition, section 4.1(b) of the PPA provides that Corp X could not renew those contracts without the consent of Taxpayer.

Further, neither Corp X nor Corp Y have an exclusive right to use Taxpayer's property because the PPA and Agreements E1 & E2 do not obligate Taxpayer to deliver power generated from a specific facility. Nor do the agreements give Corp X or Corp Y an exclusive right to the use of Taxpayer's property (Taxpayer's leasehold interest in the Generators and Station), because, as noted above, Taxpayer has power sale agreements with other customers to sell power generated by Generators and Station. Lastly, there is no indication that either the PPA or Agreements E1 & E2 provide Corp X and Corp Y with an exclusive right to conduct Taxpayer's business of generating and selling electric power.

Therefore, § 1.263-4(b)(1)(ii) does not require capitalization of the payment made under the Termination Agreement because the amount does not create an intangible described in § 1.263(a)-4(d).

Thus, the amounts paid by Taxpayer to terminate its obligations under the Agreement 2 are not required to be capitalized under § 263 and § 1.263(a)-4.

Based on the representations made by Taxpayer, the amounts paid under the Termination Agreement by Taxpayer to or on behalf of Corp X constitute ordinary and necessary business expenses of the Taxpayer and are deductible under § 162. See Capitol Indemnity Insurance Co. v. Commissioner, 237 F.2d 901 (7th Cir. 1956); Cassatt v. Commissioner, 137 F.2d 745 (3rd Cir. 1943) (payments made to free oneself from a

burdensome contract are ordinary and necessary expenses and deductible); Montana Power Co. v. U.S., 145 Ct. Cl. 611 (1959); Rev. Rul. 77-204, 1977-1 C.B. 40, and cases cited therein (corporation may deduct under § 162 costs connected with liquidation but not costs connected with sale of assets). Taxpayer represents that the PPA and Agreements E1 & E2 have become burdensome, and that due to the substantially fixed pricing in the PPA and Agreements E1 & E2 and the rising fuel costs, costs of new pollution control equipment, and unexpected equipment outages and associated purchased power costs, Taxpayer and Affiliate A have incurred significant losses, with projections of larger losses for the future.

In determining the amount of the deduction permitted under § 162, it is appropriate for Taxpayer to take into account both the amount of the cash paid and the fair market value of the property conveyed or transferred. In general, taxpayers have been permitted to deduct the fair market value of property in payment of a business expense if the payment of cash would have otherwise given rise to a deduction under §162. See International Freighting Corp., Inc. v. Commissioner, 135 F.2d 310 (2nd Cir. 1943); see also Montana Power Co. v. U.S..

Besides the cash paid and property transferred to Corp X under the Termination Agreement, Taxpayer requests a ruling that its reimbursement of Corp X's Transaction Costs, Creditor Costs, and Creditor Consent Costs and the cancellation of the promissory note are deductible under § 162.

Taxpayer's reimbursement of Corp X's Transaction Costs and payment of the Creditor Costs and Creditor Consent Costs on Corp X's behalf may be treated as consideration paid to or on behalf of Corp X provided the reimbursement is bargained for in an arm's length negotiation; i.e., the reimbursement is the price that Taxpayer has agreed to pay and Corp X has agreed to accept in order to terminate Taxpayer's obligations under the contracts entered into pursuant to Agreement 2. Generally, deductions attributable to expenditures are allowable to the taxpayer who bears the economic burden of the expenditure and who receives the benefits of the expenditures. See, e.g., Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943); Lohrke v. Commissioner, 48 T.C. 679 (1967). The reimbursements to Corp X for its Transaction Costs and the payment of Corp X's Creditor Costs and Creditor Consent Fees have been represented by Taxpayer to be bargained for consideration Taxpayer must pay in order to induce Corp X to release it from its obligations under the PPA, and to assume Taxpayer's obligations under Agreements E1 & E2.

With regard to the promissory note, under its terms Corp X is indebted to Taxpayer for $a. Taxpayer represents that although Corp X has paid Taxpayer a substantial amount of principal and interest on the promissory note, Corp X still owes a significant amount of principal. Taxpayer further represents that Taxpayer will treat its cancellation of the promissory note as additional consideration paid by it to Corp X, and that Taxpayer will not claim a bad debt deduction under § 166.

Based on Taxpayer's representations, we conclude that Taxpayer's cancellation of Corp X's promissory note will constitute additional consideration deemed paid to Corp X that will be deductible by Taxpayer under § 162. Taxpayer can not claim a bad debt deduction under § 166 because Corp X's deemed payment to Taxpayer will have satisfied in full Corp X's obligation to Taxpayer on the promissory note.[3] Taxpayer will, however, be required to include in income under § 61(a)(4) any accrued interest due on Corp X's promissory note before the Termination Agreement goes into effect.

Because Affiliate A was not released from liability when Taxpayer was assigned the PPA and Agreements E1 & E2, any of Taxpayer's payment that is allocable to terminating Affiliate A's liability will be disallowed as a deduction under § 162 to Taxpayer. See Moline Properties v. Commissioner, 319 U.S. 436 (1943); Interstate Transit Lines v. Commissioner. We do not express any opinion on whether any of Taxpayer's payment is allocable to terminating Affiliate A's liability under the PPA or Agreements E1 and E2.

Ruling Request 4: Whether the costs incurred by Taxpayer under the Termination Agreement constitute ordinary and necessary business expenses of Taxpayer and are deductible under § 162.

Taxpayer has incurred and will incur costs in connection with the Termination Agreement. These costs include legal, accounting, and other transaction costs (Taxpayer Transaction Costs), creditor costs (Taxpayer Creditor Costs), and creditor consent fees (Taxpayer Creditor Consent Fees). These expenses are of the same type as those the Taxpayer will pay on behalf of or reimburse to Corp X.

Section 1.263(a)-4(b)(1) provides in relevant part that, except as otherwise provided in the section, a taxpayer must capitalize an amount paid to facilitate (within

[3] In general, a debtor will realize gross income under § 61(a)(12) on the cancellation of indebtedness, and the creditor may claim a bad debt deduction under § 166. However, §§ 61(a)(12) and 166 do not apply if, as in the present situation, a cancellation of indebtedness is simply the medium for payment of some other form of income. When the Termination Agreement goes into effect, Corp X will be deemed to have paid Taxpayer the remaining principal balance on the promissory note, and, in turn, Taxpayer will be deemed to have paid over the same amount to Corp X as additional consideration. Thus, the cancellation will be a medium for the payment of additional consideration by Taxpayer to Corp X. See generally United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991); Rev. Rul. 84-176, 1984-2 C.B. 34; Rev. Rul. 83-60, 1983-1 C.B. 39; Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, Vol. 1, para. 7.4 (Warren, Gorham and Lamont, 3d ed., 1999).

the meaning of paragraph (e)(1) of the section) an acquisition or creation of an intangible described in paragraph (b)(1)(i), (ii), (iii), or (iv).

Section 1.263(a)-4(e)(1)(i) provides that in general, an amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Section 1.263(a)-4(e)(3) defines the term “transaction” as all of the factual elements comprising an acquisition or creation of an intangible and includes a series of steps carried out as part of a single plan. Section 1.263(a)-4(e)(2) provides that, in the case of an amount paid to facilitate the creation of an intangible described in § 1.263(a)-4(d), the provisions of § 1.263(a)-4(e) apply regardless of whether a payment described in paragraph (d) was made. As analyzed in Ruling Request 3, no payment described in § 1.263(a)-4(d) was made.

Section 1.263(a)-5(a)(1) provides that a taxpayer must capitalize an amount paid to facilitate an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in or target of the acquisition). Section 1.263(a)-5(g)(2)(ii)(A) provides that, in the case of an acquisition, merger, or consolidation that is not described in § 368 and that is treated as an acquisition of the assets of the target for federal income tax purposes, an amount required to be capitalized by the target under this section is treated as a reduction of the target’s amount realized on the disposition of its assets.

The Transaction Costs, Creditor Costs, and Creditor Consent Fees incurred by Taxpayer are not amounts paid to facilitate an acquisition or creation of an intangible as described under § 1.263(a)-4. As in the prior discussion concerning Ruling Request 3, paragraphs § 1.263(a)-4 (b)(1)(i) and (iv) are not applicable to the instant case (no intangible is acquired, and no future benefit created or enhanced). Further, the payment of the transaction costs incurred and paid by Taxpayer did not create a separate and distinct intangible asset. Section 1.263(a)-4(b)(3)(ii). Also, as in the discussion in Ruling Request 3, the Taxpayer’s termination of its obligations entered into pursuant to Agreement 2 does not fall within the definition of a created or renegotiated intangible under §1.263(a)-4(d). The Taxpayer Transaction Costs, Taxpayer Creditor Costs, and Taxpayer Creditor Consent Fees incurred by Taxpayer facilitate the termination the various agreements entered into under Agreement 2 (that is, the PPA, Agreements E1 & E2, and Leases 1 and 2). Accordingly, the Taxpayer Transaction Costs, Taxpayer Creditor Costs, and Taxpayer Creditor Consent Fees incurred by Taxpayer are not required to be capitalized under § 1.263(a)-4.

However, to the extent the Taxpayer Transaction Costs, Creditor Costs, and Creditor Consent Fees are allocable to transfer of the assets, these amounts must be capitalized pursuant to § 1.263(a)-5(g)(2)(ii), and may not be allowed as a deduction under § 162. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992); Woodward v. Commissioner, 397 U.S. 572 (1970); Alphaco, Inc. v. Nelson, 385 F.2d 244 (7th Cir. 1967); Rev. Rul. 77-204. Rather, any cost incurred that is attributable to the disposition

of an asset is taken into account as an adjustment to the amount realized under § 1001 with respect to the asset.

In addition, based on Taxpayer's representations that the costs are being incurred in the course or relieving itself from onerous or burdensome contracts (that is, the PPA and Agreements E1 & E2), the Transaction Costs, Creditor Costs, and Creditor Consent Fees incurred by Taxpayer appear necessary to terminate Taxpayer's obligations under Agreement 2. Thus, based on Taxpayer's representations, these costs are more in the nature of deductible costs than capital expenditures under § 263. Amounts paid to terminate burdensome contracts or to reduce or eliminate future costs, without more, are generally considered ordinary and necessary business expenses under § 162. See Capitol Indemnity Insurance Co; T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581, 589 (1993); Rev. Rul. 95-32, 1995-1 C.B. 8.

Further, the Transaction Costs, Creditor Costs, and Creditor Consent Fees are more in the nature of deductible costs under § 162 because these costs arose directly from the termination of Taxpayer's obligations under the various agreements (PPA, Agreements E1 & E2, Leases 1 and 2). The nature of a payment is determined under the "origin of the claim doctrine" established in U.S. v. Gilmore, 372 U.S. 39 (1963). See also Woodward v. Commissioner. This doctrine provides that the origin and character of a claim determine the deductibility of the related expense. See Wells Fargo v. Commissioner, 224 F.2d 874 (8th Cir. 2000) (extending origin of the claim doctrine to distinguish capital expenses from ordinary business expenses). The underlying origin of the Transaction Costs, Creditor Costs, and Creditor Consent Fees is the termination of the various agreements which, as discussed above, is deductible in nature.

As a result, to the extent they represent costs incurred in relieving itself of burdensome or onerous contracts and are not attributable to the transfer of the assets, the Transaction Costs, Creditor Costs, and Creditor Consent Fees incurred by Taxpayer in connection with terminating the agreements entered into under Agreement 2 constitute ordinary and necessary business expenses of the Taxpayer and are deductible under § 162 in the taxable year incurred under § 461 and the regulations thereunder.

Ruling Request 5: Whether Taxpayer may deduct the consideration paid to or on behalf of Corp X in the taxable year in which the consideration is paid or transferred by the Taxpayer to or on behalf of Corp X.

Section 461(a) provides generally that the amount of any deduction shall be taken for the taxable year which is the proper year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) provides generally that under the accrual method of accounting, a liability (as defined in § 1.446-1(c)-1(ii)(B)) is incurred and generally taken

into account for federal income tax purposes, in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

All the events have occurred that establish the fact of the liability when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment therefore is due, whichever happens earliest. Rev. Rul. 80-230, 1980-2 C.B. 169; Rev. Rul. 79-410, 1979-2 C.B. 213, amplified by Rev Rul. 2003-90, 2003-2 C.B. 353. With regard to services, the event fixing the liability generally is the performance of services, unless payment is due prior to the services being performed. The term “liability” is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred. Section 1.446-1(c)(1)(ii)(B).

Section 461(h)(1) and § 1.461-4 provide that, for purposes of determining whether an accrual basis taxpayer can treat the amount of any liability as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

Section 1.461-4(g)(1)(i) provides that, in the case of liabilities described in paragraphs (g)(2) through (7), economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed. The liabilities described in (g)(2) through (6) are not applicable in the instant case. Section 1.461-4(g)(7) provides that, in the case of a taxpayer’s liability for which economic performance rules are not provided elsewhere in this section or in any other Internal Revenue regulation, revenue ruling, or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed.

Section 1.461-4(g)(1)(ii)(A) provides that the term “payment” has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. For example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Section 1.461-4(g)(1)(ii)(B) provides that payment to a particular person is accomplished if § 1.461-4(g)(1)(ii)(A) is satisfied and a cash basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment as gross income under the principles of § 451.

On the closing date of the Termination Agreement, all events have occurred that establish the fact of the liability and Taxpayer can determine the amount of the liability with reasonable accuracy with regard to (a) the Termination Payment, (b) the fair

market value of the inventory, personal property, and owned intellectual property conveyed to Corp X, (c) the cancellation of the promissory note, (d) the SO_2 and NO_x allowances conveyed to Corp X, and (e) the Improvements because the amounts are due to Corp X at that time. Further, all events have occurred that establish the fact of the liability and Taxpayer can determine the amount of the liability with reasonable accuracy with regard to Taxpayer's reimbursement of Corp X Transaction Costs because these costs will have been incurred by the closing date of the Termination Agreement.

Pursuant to § 1.461-4(g)(1)(i) and (7), economic performance will occur when Taxpayer pays cash or cash equivalents to Corp X with regard to (a) the Termination Payment, (b) the inventory, personal property, and owned intellectual property, (c) the cancellation of the promissory note, (d) the SO_2 and NO_x allowances, (e) the Improvements, and (f) the Corp X Transaction Costs. Taxpayer's liability to pay for the termination of the PPA and Agreements E1 & E2 constitutes a liability for which economic performance rules are not provided elsewhere in § 1.461-4 or in any other Internal Revenue regulations, revenue ruling, or revenue procedure. Under § 1.461-4(g)(7), economic performance occurs as Taxpayer makes payment in satisfaction of the liability to the person to whom the liability is owed. Under § 1.461-4(g)(1)(ii)(B), payment is made when Taxpayer provides the cash and other consideration to Corp X and a cash basis taxpayer in the position of Corp X or such appropriate party would be treated under § 451 as having actually or constructively received the amount of the payment as gross income.

As a result, to the extent the requirements of §162 are met, Taxpayer will incur a liability for (1) the Termination Payment, (2) the fair market value of inventory and personal property (not in excess of $d) and owned intellectual property, (3) the cancellation of the promissory note, (4) the fair market value of the SO_2 and NO_x allowances, (5) the fair market value of the Improvements, and (6) the Corp X Transaction Costs in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred by payment of cash or cash equivalents by Taxpayer to Corp X.

However, the fact of the liability may not be established and the amount of the liability may not be determinable with reasonable accuracy on the closing date of the Termination Agreement with regard to Taxpayer's liability to reimburse or pay directly the Corp X Creditor Costs and Creditor Consent Fees. It is fundamental to the all events test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established. U.S. v. General Dynamics Corp., 481 U.S. 239 (1987). A taxpayer may not deduct a liability that is contingent, nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. Brown v. Helvering, 291 U.S. 193 (1934). The terms of a contract are relevant in

determining the events that establish the fact of the taxpayer's liability. Decision, Inc. v. Commissioner, 46 T.C. 58 (1966), acq. 1967-2 C.B. 2; see also Rev. Rul. 2007-3, 2007-4 I.R.B. 350. Each of the three prongs of the all events test (fact of liability, amount determinable with reasonable accuracy, and economic performance) must be met before the liability is incurred.

We are unable to determine when the fact of Taxpayer's liability to reimburse or pay directly the Corp X Creditor Costs and Creditor Consent Fees will be established because the Termination Agreement only provides that such costs "may" be required to be reimbursed by Taxpayer. Until the event occurs that establishes Taxpayer's liability for these costs, Taxpayer's liability is contingent and may not be taken into account. This is the case even if Taxpayer prepays the costs.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Specifically, no opinion is expressed as to whether any investment adjustments must be made under § 1.1502-32 to the basis of the stock of any member of the Parent consolidated group as a result of the transactions described in this ruling letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Patricia M. Zweibel
Senior Counsel, Branch 2
(Income Tax & Accounting)

cc: