OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: TL-N-5122-99-WLI2.wpd_

This Field Service Advice responds to your memorandum dated August 27, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Corp X =
Year 1 =
Year 2 =

ISSUE(S):

1. Whether the amounts paid by Corp X for its Year 1 and Year 2 tax years pursuant to the Florida Everglades Agricultural Privilege Tax can be deducted as a tax pursuant to I.R.C. § 164.

2. Whether the amounts paid by Corp X pursuant to the Everglades Agricultural Privilege Tax are deductible as an ordinary and necessary business expense pursuant to I.R.C. § 162.

CONCLUSION:

1. The amounts paid by Corp X pursuant to the Everglades Agricultural Privilege Tax are not deductible as a tax pursuant to I.R.C. § 164(a) because the Everglades Agricultural Privilege Tax is an item similar to a tax, but it is not a tax.

2. The Everglades Agricultural Privilege Tax can be deducted because it was paid or accrued in carrying on a trade or business and it is not a capital expenditure.

FACTS:

The South Florida Water Management District [hereinafter referred to as District] was created during 1949 for purposes of flood control and water conservation for the South Florida area. During 1972, the responsibilities of the District were greatly expanded from flood control to a full range of water management activities including the conservation, development and proper utilization of surface and groundwater, the supplying of water storage for beneficial purposes, prevention of damage from floods, soil erosion and excessive drainage, and preservation of natural resources, fish and wildlife.

Florida undertook clean-up efforts in the Everglades throughout the 1980s but, in 1988, the federal government sued the District and the State of Florida for allegedly not enforcing water quality laws in the Loxahatchee National Wildlife Refuge and the Everglades National Park, two federal areas. In an effort to end the litigation with the federal government, the Florida legislature passed the Everglades Protection Act during 1991. This law was intended to promote the restoration and protection of the Everglades, and to reduce the levels of phosphorus in the water flowing into the Everglades Protection Area (including the Loxahatchee National Wildlife Refuge and the Everglades National Park). The goal of the Everglades Protection Act was to insure that all Everglades waters met the standards necessary to sustain recreation and a healthy well-balanced population of fish and wildlife by the year 2002.

To accomplish the phosphorus reduction and the protection of the Everglades, the 1991 Act granted the District the authority to collect fees to fund an agricultural stormwater management system[1] and the power of eminent domain to acquire the necessary land. The lawsuit was settled later that year.

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[1] States are encouraged by the Federal Water Pollution Control Act, administered by the Environmental Protection Agency, to develop area-wide waste treatment management plans to treat agricultural run-off. Miccosukee Tribe of Indians of Florida v. United States, 1998 U.S. Dist. LEXIS 15838 (S.D. Fla. 1998).

In addition to agreeing to establish stormwater treatment areas, the agreement settling the litigation provided for a regulatory permitting program aimed at agricultural discharges from the Everglades Agricultural Area. Pursuant to the regulatory program, the District would regulate the water quality of agricultural discharges through a permitting scheme by which permit applicants would be required to comply with designated phosphorus load allocations and adopt best management practices [stormwater retention, sediment control, and restrictions on the use of pesticides and fertilizer] aimed at reducing the level of phosphorus in agricultural discharge. United States v. South Florida Water Management District, 847 F. Supp. 1567 (S.D. Fla 1992), aff'd in part, 28 F.3d 1563 (11th Cir. 1994).

During 1994, Florida passed the Everglades Forever Act to promote the expeditious implementation of the Everglades restoration and protection program and to end litigation brought challenging the clean-up plan. The 1994 Act established the Everglades Agricultural Privilege Tax for the privilege of conducting an agricultural trade or business on property located within the Everglades Agricultural Area or the C-139 Basin. These are two areas located south of Lake Okeechobee with primarily agricultural lands. The Everglades Agricultural Area was determined to contribute 45 percent of the phosphorus entering the Everglades Protection Area, with the C-139 Basin contributing 7 percent of the phosphorus entering the Everglades Protection Area.

Phosphorus is a necessary element in the fertilizer used by the agricultural growers. Its presence in the drainage waters that travel through the ditches and canals of the District is considered a contaminant as it enters the Everglades Protection Area.

The funds collected from the Everglades Agricultural Privilege Tax are used for the construction of stormwater treatment areas [hereinafter referred to as STAs] which clean the runoff and drainage from the agricultural area prior to the water entering the Everglades Protection Area. The STAs consist of approximately 40,000 acres of water retention ponds, constructed marshlands, and drainage improvements such as pumps, ditches and canals. Water leaving the agricultural properties generally flows southward through District canals. Persons wanting to discharge into the canals had to obtain permits. The water from the canals is pumped into containment ponds where measurements are taken and the flow through the STAs can be regulated to obtain a beneficial rate of water entering the Everglades. The water is then pumped out of the containment ponds and allowed to enter the constructed marsh section. The plants in the marsh filter the water and reduce the level of phosphorus in the water. The initial test STA was determined to be a success and reduced the level of phosphorus in the water by 75 percent.

The estimated costs of building the STAs was apportioned between farmers, state government and the federal government, based on the burden each group would place on the system. None of the amounts collected from the Everglades Agricultural Privilege Tax is used for restoration of the Florida Everglades. The actual restoration costs are funded by other sources, such as state and federal monies, highway toll revenues and the mitigation settlement.

Corp X owns and leases agricultural land in the Everglades Agricultural Area. Corp X had permits allowing it to discharge into several canals. These canals would be treated by various STAs which were scheduled to be built as part of the program to improve and maintain the Everglades. For Year 1 and Year 2, Corp X paid the Everglades Agricultural Privilege Tax and deducted the amounts paid as real property taxes on its federal tax returns.

LAW AND ANALYSIS

I.R.C. § 164

A deduction is allowed for any qualified tax pursuant to I.R.C. § 164. There are five specifically enumerated categories of taxes that are deductible regardless of the existence of a trade or business or for-profit activity. These five categories are specified at I.R.C. § 164(a)(1)-(5). They include state and local and foreign real property taxes. I.R.C. § 164(a)(1).

The deduction is statutorily denied for certain taxes, even if paid or accrued in carrying on a trade or business or for-profit activity . These taxes include taxes assessed against local benefits of a kind tending to increase the value of the property assessed, except taxes allocable to maintenance or interest charges. I.R.C. § 164(c)(1).

Taxes that are in neither list (specifically enumerated deductible or nondeductible taxes) are deductible if paid or accrued in carrying on a trade or business or for-profit activity pursuant to the flush language to I.R.C. § 164(a). However, state, local or foreign taxes (other than real property taxes and the other specified taxes) that are incurred in connection with the acquisition or disposition of property are to be capitalized, even if incurred in a trade or business or in a for-profit activity. I.R.C. § 164(a) last sentence of flush language; H. Conf. Rep. 99-841 (Vol. 2) at II-20 (1986).

Corp X deducted the Everglades Agricultural Privilege Tax as a real property tax pursuant to I.R.C. § 164(a)(1). Such a deduction is not appropriate under that Code section. Treas. Reg. § 1.164-3(b) defines real property taxes as follows: “The term ‘real property taxes’ means taxes imposed on interests in real property

and levied for the general public welfare, but it does not include taxes assessed against local benefits. See § 1.164-4."

Treas. Reg. § 1.164-4 discusses taxes for local benefits. It further defines real property taxes as follows: "The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all properties in the territory over which such authorities have jurisdiction." See Fife v. Commissioner, 73 T.C. 621 (1980); Wright Rumstad Properties Limited Partnership v. United States, 1998 U.S. Claims LEXIS 93 (Fed. Cl. 1998).

Fla. Stat. Ch. 373.4592(6) (1994) imposes the Everglades Agricultural Privilege Tax. It provides:

> (a) There is hereby imposed an annual Everglades agricultural privilege tax for the privilege of conducting an agricultural trade or business on:
>
> 1. All real property located within the EAA Everglades Agricultural Area] that is classified as agricultural ... and
>
> 2. Leasehold or other interests in real property located within the EAA owned by the United States, the state or any agency thereof permitting the property to be used for agricultural purposes ...
>
> It is hereby determined by the Legislature that the privilege of conducting an agricultural trade or business on such property constitutes a reasonable basis for imposition of the Everglades agricultural privilege tax and that logical differences exist between the agricultural use of such property and the use of other property within the EAA for residential or nonagricultural commercial use.

The Everglades Agricultural Privilege Tax is not levied on all properties within the same tax jurisdiction at a like rate. Therefore, amounts paid or accrued pursuant to the Everglades Agricultural Privilege Tax cannot be deducted as real property taxes pursuant to I.R.C. § 164(a)(1).

Some items are similar to taxes but are not taxes. Items that are not taxes are deductible only if they are ordinary and necessary expenses of carrying on a trade or business or ordinary and necessary expenses of a for-profit activity. I.R.C. §§ 162(a), 212. As is explained in greater detail below, the Everglades Agricultural Privilege Tax is not a tax. Therefore, it is not deductible under I.R.C. § 164.

The Service has defined a tax as follows:

> A tax is an enforced contribution pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes. Taxes are not payments for some special privilege granted or service rendered and are, therefore, distinguishable from various other charges imposed for particular purposes under particular powers or functions of the government. Ordinarily, when amounts are paid into a specific fund or earmarked for a specific purpose, they are treated as imposed as a regulatory measure or as a charge for a privilege or service rendered.

Rev. Rul. 77-29, 1977-1 C.B. 44.

In Rev. Rul. 77-29, the Service addressed whether an annual fee imposed by the county on all real property for the collection and disposal of refuse was deductible as a real estate tax. The assessed value of the property determined the amount of the tax imposed on such property. All property assessed at over a stated dollar amount was subject to a maximum fee. Additional fees were imposed for special services. The fees were deemed assessments under state law and were enforceable and collected in the same manner as county ad valorem taxes. The fees were specifically earmarked for sanitation services and ordinarily fully funded the county sanitation department.

The revenue ruling concluded that the sanitation fees were not deductible as real property taxes under I.R.C. § 164. The rationale was that the fees were for sanitation services provided by the county, were specifically earmarked for the sanitation department and were not levied at a like rate against all property in the county.

The Service has recognized that the term used for a charge is not controlling. In Rev. Rul. 61-152, 1961-2 C.B. 42, the Service noted:

> [T]he question whether a particular charge is to be regarded as a tax depends upon its real nature. If it is in the nature of a tax, it is not material that it may be called by a different name; conversely, if it is not in the nature of a tax, it is not material that it may be so called.

See also Rev. Rul. 71-49, 1971-1 C.B. 103.

In Rev. Rul. 61-152, the Service opined that charges imposed upon the owners of buildings and tangible personal property in Wheeling, West Virginia for fire and police services were taxes within the meaning of I.R.C. § 164(a). The revenue ruling concluded that the charges were deductible notwithstanding their local characterization as "charges for services upon the users thereof."

The revenue ruling reached this result because the charges were exacted at a uniform rate from all owners of designated property. While designated as a service charge, there was no reasonable relation between the charge and the extent of the services provided. There was no variation in the rate of the charges to allow for properties subject to varying degrees of risk. The revenue ruling distinguished its fact pattern from situations in which the municipal charge for services was measured by the benefits which were, or could be, derived therefrom.

In Rev. Rul. 71-49, the Service concluded that tax equivalency payments could be deducted as real estate taxes pursuant to I.R.C. § 164(a). The payments were made to a city educational construction fund [fund] which leased high-rise structures on air space above school structures. Instead of the city collecting real estate taxes on the space rights covered by the leasehold and then paying a rental fee to the fund in an amount necessary for the fund to meet debt service payments incurred to pay for construction of the school portion of the structure, the payments were made directly to the fund by the lessees.

The revenue ruling recognized that ordinarily when amounts are paid into a specific fund, they are imposed as a regulatory measure (such as licensing fees), or as a charge for a privilege or service rendered. The revenue ruling concluded that a different result was required under its facts. The charges were to obtain revenue the city would otherwise lose because it treated the fund as a tax-exempt corporation. The charges were measured by and equal to the amounts imposed by the regular taxing statutes and the payments were designated for a public purpose rather than for some privilege, service, or regulatory function or for some local benefit tending to increase the value of the property upon which the payments are made.

Examining the criteria relied upon in the revenue rulings in determining whether a charge was or was not a tax, it is apparent that the Florida Everglades Agricultural Privilege Tax is not a tax. It is a charge for a service provided.

The Everglades Agricultural Privilege Tax was imposed to pay for the phosphorus removal service provided by the District. The fees collected were specifically earmarked for the Stormwater Treatment Areas [see Everglades Project Funding]. The charges were not levied at a like rate against all properties located in the District, as described above. Thus, under the rationale in Rev. Rul. 77-29, the Everglades Agricultural Privilege Tax charge is not a tax despite its nomenclature.

This is borne out by an even closer examination of the statute enacted for the Everglades improvement and management, Fla. Stat. ch. 373.4592. Special assessments are imposed against agricultural land in the EAA via the Everglades Agricultural Privilege Tax in Fla. Stat. ch. 373.4592(6). Special assessments are imposed against agricultural land in the C-139 Basin via the C-139 Agricultural Privilege Tax in Fla. Stat. ch. 373.4592(7). The Florida legislature allowed the District to levy special assessments to fund additional stormwater management systems for other benefit areas. Fla. Stat. ch. 373.4592(8).

The charges imposed by the Everglades Agricultural Privilege Tax and the C-139 Agricultural Tax are not levied against all agricultural lands at the same rate. As was previously noted, the Everglades Agricultural Privilege Tax was imposed on real property classified as agricultural located within the EAA. The C-139 Agricultural Privilege Tax parallels the Everglades Agricultural Privilege Tax but it is imposed upon real property classified as agricultural located within the C-139 Basin. The Everglades Agricultural Privilege Tax was to be assessed at a statutorily prescribed rate per acre per year. A minimum rate was also prescribed beneath which the privilege tax could not fall despite reductions in the phosphorus load being treated. Owners, lessees or other appropriate interestholders of the property can apply to have the privilege tax reduced to a minimum tax by proving that the phosphorus load attributable to such parcel of property was reduced. Furthermore, the privilege tax imposed on vegetable farmers was statutorily set at the minimum rate. For the C-139 Basin, the privilege tax was initially set by taking a set amount and dividing it by the number of agricultural acres during each year.

The Florida legislature allowed the District to levy special assessments for benefit areas not subject to the Everglades Agricultural Privilege Tax or the C-139 Agricultural Privilege Tax. These levies have to have a reasonable relationship to the benefits received. Fla. Stat. ch. 373.4592(8) provides as follows:

> (A) In addition to all other legally available funding mechanisms, the district may create ... one or more stormwater management benefit areas including property located outside the EAA and the C-139 Basin, and property within the EAA and the C-139 Basin that is not subject to the Everglades agricultural privilege tax or the C-139 agricultural privilege tax. The district may levy special assessments within said benefit areas to fund the planning, acquisition, construction, financing, operation, maintenance and administration of stormwater management systems for the benefitted areas. Any benefit area in which property owners receive substantially different levels of stormwater management system benefits shall include stormwater management

> benefit subareas within which different per acre assessments shall be levied from subarea to subarea based upon a reasonable relationship to benefits received. ... (Emphasis added)

The Florida legislature went on to emphasize that the special assessments were to be used only for water quality treatment and that the assessments could not exceed the cost of providing water management attributable to water quality treatment. The legislature specifically provided that the costs for hydroperiod restoration (one of the goals of the statute) had to be provided by funds other than those derived from the special assessments. Fla. Stat. Ch. 373.4592(8)(d) provides as follows:

> In no event shall the amount of funds collected for storm water management facilities pursuant to paragraph (a) exceed the cost of providing water management attributable to water quality treatment resulting from the operation of stormwater management systems of the landowners to be assessed. Such water quality treatment may be required by the plan or permits issued by the district. Prior to the imposition of assessments pursuant to paragraph (a) for construction of new stormwater management systems or the acquisition of necessary land, the district shall establish the general purpose, design, and function of the new system sufficient to make a fair and reasonable determination of the estimated costs of water management attributable to water quality treatment resulting from operation of stormwater management systems of the landowners to be assessed. This determination shall establish the proportion of the total anticipated costs attributable to the landowners. In determining the costs to be imposed by assessments, the district shall consider the extent to which nutrients originate from external sources beyond the control of the landowners to be assessed. Costs for hydroperiod restoration within the Everglades Protection Area shall be provided by funds other than those derived from the assessments. ...

The property owners are being assessed for the costs of treating contaminants in order to preserve water quality. Thus, the fees collected are for a service provided by the county, the fees are earmarked for the service and only for the service (not for public or governmental purposes). See Rev. Rul. 77-29, 71-49. Furthermore, there is a relation between the fees and the extent of the services provided. There

is a variation in the rate of the charges to allow for the fact that different properties produce different amounts of contaminants. See Rev. Rul. 61-152.

Therefore, the Everglades Agricultural Privilege Tax is not a tax and cannot be deducted pursuant to I.R.C. § 164.

The case law also supports this finding. The courts have recognized that it can be difficult to determine whether an assessment qualifies as a tax pursuant to I.R.C. § 164. The Fifth Circuit stated this difficulty as follows:

> A more difficult question is presented in determining whether the assessment qualifies as a tax under Section 164 of the Code. Prior to the 1964 Amendments and during the taxable year 1962, Section 164 provided that taxes paid or accrued within the taxable year were deductible with certain exceptions not applicable here. No definition of 'taxes' is found in the Code. As is frequently the case, the drafting of an acceptable definition has proven easier than applying the definition to a particular fact pattern. ...

Campbell v. Davenport, 362 F.2d 624 (5th Cir. 1966).

The Board of Tax Appeals analyzed the differences between fees and taxes in The Borg and Beck Co. v. Commissioner, 24 B.T.A. 995 (1931). The court recognized that what the statute of a state designated as a fee may be a tax. The court held that a tax could be defined as a burden or charge imposed by the legislative power of the state upon persons or property for public use. The word fees signifies compensation for particular acts or services rendered by proper officers in the line of their duties to be paid by the person obtaining the benefit of the services or at whose instance they were performed. Where a charge is made primarily for the purpose of revenue, it is a tax. The court concluded that a charge imposed for changing the par value of stock was a tax. This was because the charge was in substantial excess to the cost of the service rendered by the state, the receipts were used for general state purposes and the charge was in substantial excess to the benefit to the corporation.

In contrast, the special assessments for the STAs were imposed upon the lands producing contaminants. The fees were earmarked for only that purpose, not for general state purposes, and the fees bore a reasonable relation to the cost to the District of providing the service.

In the case of Cox v. Commissioner, 41 T.C. 161 (1963), the Tax Court determined that turnpike tolls were not deductible as taxes under I.R.C. § 164. The Tax Court opined that a tax is a revenue raising levy by a governmental unit without relationship to a specific governmental privilege or service. In the instant case, the Everglades Agricultural Privilege Tax is related to the construction and functioning of the STAs. The funds are not being used for general public or governmental purposes. See also Chicago and North Western Transportation Co. v. Webster County Board of Supervisors, 880 F. Supp. 1290 (C.D. Iowa 1995).

In In re Adams, 40 B.R. 545 (E.D. Pa. 1984), the court held that monies owed to the city for water and sewer use were charges for services rendered and not taxes. The court specifically held that the manner of collection and remedies for non-payment of charges could not transform the charges into taxes. Therefore, in determining whether the Everglades Agricultural Privilege Tax is a tax, it is not relevant whether the charge is assessed and collected in the same manner as a real property tax.

In PLR 8115021, the Service looked at the difference between user fees and taxes. The PLR looked at several cases and revenue rulings and noted:

> Under federal law amounts paid to a government for the privilege of using or purchasing the government's property cannot qualify as taxes. See . . . which defined 'tax' under section 164 of the Code to exclude a levy related '. . . to a specific governmental privilege or service . . .' and . . . which likewise defined 'tax' under Code section 164 to exclude '. . . A payment for some special privilege granted or service rendered . . .' by a government. . . .
>
> The Sands, a logging company argued that levies paid to Michigan for use of an improved waterway were 'taxes'. The Supreme Court rejected this argument stating that:
>
> There is no analogy between the imposition of taxes and the levying of tolls . . . Taxes are levied for the support of the government and are regulated by its necessities. Tolls are the compensation for use of another's property, or of improvements made by him; and their amount is determined by the cost of the property, or of the improvements, and consideration of the return which such values or expenditures should yield.

(Citations omitted)

Again, the amounts paid pursuant to the Everglades Agricultural Privilege Tax are paid to construct and maintain the STAs and not for general government purposes. Once constructed, the STAs will remove the phosphorus from the agricultural run-off, a service to the agricultural landowners. Thus, the charge is a user fee and not a tax.

The conclusion that the Everglades Agricultural Privilege Tax is a charge for a service (a user fee) and not a tax is strengthened when non-tax areas of the law are examined. In United States v. The City of Huntington, West Virginia, 793 F. Supp. 1370 (S.D. W.V. 1992), the United States sought an injunction to prevent the assessment and collection of so-called municipal service taxes from the U.S. Postal Service and GSA. The municipal service taxes were for fire and flood protection services. The United States contended the charges were taxes and that states were without authority to tax the United States. The court concluded the charges were user fees. The court noted that a tax is an enforced contribution to provide for the support of government. The charges at issue, while enacted in a section dealing with the state's taxing power, were fees imposed in a reasonable attempt to charge those who used the fire and flood protection services, i.e., property owners. The court noted that, although placed in the general revenue account, the fees were assessed to recoup funds expended for fire and flood protection.

In Augusta Towing Co., Inc. v. United States, 5 Cl. Ct. 160 (Cl. Ct. 1984), a towing company challenged the constitutionality of the Inland Waterway Act of 1978. The revenue act established a trust fund to pay for construction and rehabilitation expenditures for navigation on inland and intracoastal waterways. The trust fund was financed by a "tax" on fuel used in vessels engaged in commercial waterway transportation. There were exemptions for certain specified vessels. The court concluded the charges were a user fee and not a tax. The court held that a charge for services rendered or for conveniences provided is in no sense a tax or a duty. The court emphasized that a user fee is a revenue measure designed to compensate the government for supplying a benefit to the user. The court held the fact that the monies collected were placed in a trust fund intended to be used for waterway maintenance and construction and that the legislative history emphasized the goal of recovering maintenance and construction costs made this a user fee intended to recoup part of the cost of facilities provided by the government.

In United States v. Sperry Corporation, 493 U.S. 52 (1989), the Supreme Court upheld a statute requiring payment to the United States of a percentage of awards made by the Iran-United States Claims Tribunal to American claimants from constitutional challenges. The Court held the payment was a user fee intended to reimburse the United States for its costs in connection with the Tribunal. The court held that a governmental body has an obvious interest in making those who specifically benefit from its services pay the cost.

In Capitol Greyhound Lines v. Brice, 339 U.S. 542 (1950), a "tax" of two percent of its fair market value was imposed on each common carrier transporting passengers on Maryland roads. The Supreme Court held the "tax" was not wholly invalid as an undue burden on interstate commerce. The Court held the "tax" was used by Maryland wholly for road purposes and that it was imposed for the privilege of road use. The court held so long as the fees are reasonable, it is within the discretion of the State to determine whether compensation for the use of its highways shall be determined by way of a fee or by a toll. Thus, the fee was not a "tax" but was a user fee for the use of Maryland highways. The court noted that a levy will be sustained if it is a fair imposition for the use of highways constructed and maintained by the State or for the cost of traffic regulation.

In the bankruptcy context, the court in In re Park, 212 B.R. 430 (D. Mass. 1997), looked at taxes versus user fees for purposes of determining priority of claims. The court noted that user fees are meant to restore to the government the costs of the benefits supplied, rather than to produce general revenues.

The Everglades Agricultural Privilege Tax was imposed to pay for the phosphorus removal service to be provided by the District. The fees collected were earmarked specifically for the STAs and could not be used for any other governmental purposes. The fees were charged against those who would be using the service, i.e., people owning or leasing agricultural property. Thus, under the rationale of the above-cases, the Everglades Agricultural Privilege Tax is a user fee, not an I.R.C. § 164 tax.

Corp X cannot deduct the Everglades Agricultural Privilege Tax as a tax pursuant to I.R.C. § 164. Based upon the totality of the facts, the Everglades Agricultural Privilege Tax is not a tax[2]. The amounts paid pursuant thereto are deductible under I.R.C. § 162, see below.

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[2] Even if it were determined that the Everglades Agricultural Privilege Tax was a tax assessed against a local benefit pursuant to I.R.C. § 164(c), unless the amounts were capital expenditures, the amounts paid could be deducted under I.R.C. § 162 if they were incurred in the landowners' trade or business. Rev. Rul. 67-337, 1967-2 C.B. 92; Rev. Rul. 73-188, 1973-1 C.B. 62; Nobel v. Commissioner, 70 T.C. 916 (1978).

I.R.C. §§ 461, 162

I.R.C. § 461 governs when a liability is incurred and taken into account. Under the cash receipts and disbursements method, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Treas. Reg. § 1.461-1(a). Treas. Reg. § 1.471-6 provides, in general, that it is optional with the farmer/taxpayer to make its return upon an inventory method or a cash method of accounting. Corp X makes its return using a cash method of accounting.

Under the cash basis method of accounting, deductions are taken for the year in which actually paid, unless they should be taken in a different period in order to clearly reflect income. Private Letter Ruling 8112035.

Fees and charges may be deductible as ordinary or necessary business expenses under I.R.C. § 162 or as amounts expended for the production of income under I.R.C. § 212. However, where such expenditures are capital in nature, they must be capitalized.

I.R.C. § 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

I.R.C. § 212 allows a deduction for individuals for ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income; the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, collection or refund of any tax.

Governmental fees and taxes incurred in a trade or business or for-profit activity are deductible under I.R.C. §§ 162 and 212, as long as they are not capital expenditures.

The taxpayer is a corporation, not an individual, so I.R.C. § 212 is not at issue and will not be further addressed herein.

The two main requirements for deductibility under I.R.C. § 162 are the "ordinary and necessary" and "trade or business" elements. There is no statutory or regulatory definition of a trade or business. It has generally been recognized that any activity of a corporation, at least within the scope of its charter, is part of its "business." Corporate deductions have rarely been challenged on this aspect of the statute in the absence of questions about which taxpayer benefitted, i.e., the corporation or its shareholders, or related companies.

Even if the expense is incurred in carrying on a trade or business, it must also be an "ordinary and necessary" expense proximately related to the trade or business. "Necessary" means merely "appropriate" or "helpful" to the business. Welch v. Helvering, 290 U.S. 111, 113 (1933). "Ordinary" connotes a payment which is normal in relation to the business of the taxpayer and the circumstances. Deputy v. DuPont, 308 U.S. 488, 496 (1940).

In the instant case, all the requirements for deductibility under I.R.C. § 162 have been met. Corp X is engaged in an agricultural business. The expense was a government fee charged to all agricultural landowners and leaseholders in a designated area. The amounts collected were to be used to build the STAs necessary to remove the phosphorus from the water runoff from the agricultural lands and to operate and maintain the STAs once they were operational. Thus, amounts paid pursuant to the Everglades Agricultural Privilege Tax were ordinary and necessary expenses paid or incurred during the taxable year in carrying on the business of agriculture.

While I.R.C. § 162 generally allows a taxpayer a deduction for ordinary and necessary costs incurred in carrying on a trade or business, Treas. Reg. § 1.263(a)-2(a) requires that the costs of property having a useful life substantially beyond the taxable year must be capitalized. I.R.C. § 161 clarifies the relationship between deductions allowable under I.R.C. § 162 and capital expenditures under I.R.C. §§ 263 and 263A. I.R.C. § 161 provides that the deductions allowed in Part VI of the Code, including I.R.C. § 162, are subject to the exceptions set forth in part IX, including I.R.C. §§ 263 and 263A. Thus, the capitalization rules take precedence over the rules for deductions, with the result that an expenditure that is otherwise an ordinary and necessary business expense deductible under I.R.C. § 162 must be capitalized if it is also a capital expenditure under I.R.C. §§ 263 and 263A.

The principle case involving capitalization is INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). In that case, the Supreme Court held that certain investment banking and legal fees incurred by a target corporation incident to a friendly takeover of that corporation created significant long-term benefits for the taxpayer and were capital in nature, not currently deductible.

> Although the mere presence of an incidental future benefit-"some future aspect"-may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization....Indeed the text to the Code's capitalization provision, section 263(a)(1), which refers to

> "permanent improvements or betterments," itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer.

Id. at 112.

An argument could be made that payments made pursuant to the Everglades Agricultural Privilege Tax are for a prepaid benefit, STA usage in the future. Prepayments, by definition, are considered investments producing only future benefits. Generally accepted accounting principles treat prepaid expenses such as insurance, interest, rent and taxes as current assets the cost of which is amortized over the life of the asset. See Accounting Research Bulletin No. 43, Ch. 3a para. 8; Sellin, Attorney's Handbook of Accounting, para. 6.06[3]; Treas. Reg. § 1.461-4(g)(8) e.g. 6. Generally, an expense is considered prepaid if it is paid in a taxable year prior to the taxable year in which the benefits therefrom are received. Texas Instruments, Inc. v. United States, 551 F.2d 599, 604 (5th Cir. 1977).

A contention could be made that the Everglades Agricultural Tax was paid in Year 1 and Year 2 and that the STAs will not be operational until a later year. Therefore, the payments at issue herein would arguably be prepaid expenses. However, this position should not prevail. First, the payments at issue herein did not result in the acquisition of an asset by Corp X. Affected agricultural property owners and leaseholders will continue to pay the Everglades Agricultural Privilege Tax for at least 30 years and the amounts payable are not dependent upon whether the STAs are operational in that year or not. Therefore, payments in years 1 and 2 do not affect Corp X's receipt of services in the later years when the STAs become operational. The amounts expended do not result in the acquisition of an asset by Corp X [for instance, prepaid rent or interest is an asset because the payor is entitled to the benefits from the payment in a future period], but actually reduce its resources. It is not a capital investment . See Schneider v. Commissioner, T.C. Memo. 1992-24.

Second, the Service postulated a three-part test to determine the current deductibility of prepaid cattle feed in Rev. Rul. 75-152, 1975-1 C.B. 144. The Service argued this test should also be used to determine if prepaid intangible drilling costs could be currently deducted. The court agreed the three-part test should be used. Keller v. Commissioner, 79 T.C. 7 (1982).

The three-part test is as follows: (1) the expenditure must be a payment rather than a mere deposit; (2) the prepayment must be made for a valid business purpose and not merely for tax avoidance; and (3) the deduction of such costs in the taxable year of prepayment must not result in a material distortion of income. If, by express, implied or customary terms, a taxpayer retains a unilateral power to get the money back, then the monetary transfer is a deposit rather than a payment.

Packard v. Commissioner, 85 T.C. 397 (1985). Corp X has no unilateral power to recoup the monies paid pursuant to the Everglades Agricultural Privilege Tax from the District. Therefore, the monetary transfer is a payment and the first part of the test is satisfied.

The Tax Court in Keller determined that, insofar as cash basis taxpayers are concerned, a substantial legitimate business purpose satisfies the distortion of income test. The Everglades Agricultural Privilege Tax is a levy imposed by the government on all agricultural landowners or leaseholders in designated areas. Payment of a government levy serves a legitimate business purpose. Even though the third part of the test would not be reached under the Keller analysis, no material distortion of income results from deducting payments made pursuant to the Everglades Agricultural Privilege Tax in the year paid. These payments continue to be an annual expense both before the STAs are constructed and thereafter. See also Frysinger v. Commissioner, 645 F.2d 523 (5th Cir. 1981). Therefore, even if an argument could be advanced that payments in Years 1 and 2 are prepayments, Corp X would be able to deduct them in the years paid.

In addition to prepaid expenses, any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate are not currently deductible. I.R.C. § 263(a)(1). The STAs are being funded from many sources, not just the Everglades Agricultural Privilege Tax. The STAs are also being funded by ad valorem taxes, other government levies and other federal and state funds. Furthermore, the STAs do not increase the value of Corp X's land. Corp X does not have any ownership or proprietary interest in the STAs. Therefore, the amounts expended pursuant to the Everglades Agricultural Privilege Tax do not need to be capitalized.

For the reasons stated above, Corp X can currently deduct amounts spent pursuant to the Everglades Agricultural Tax and does not have to capitalize such expenditures. I.R.C. §§ 162, 263.

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