INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-136589-03/CC:ITA:B5

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Tax Year(s) Involved:

Date of Conference:

LEGEND:

Partnership A =
Facility A =

Partnership B =

Company C =
Company D =
Partnership L =

Facility L =

Company M =
Company N =
Company R =
LLC G =
LLC H =
LLC K =
Tax Year 1 =
Tax Year 2 =
Date 1 =
Date 2 =

Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
States:	
p	=
q	=
r	=
s	=
$x	=
$y	=
$z	=

ISSUES:

1. Whether Partnership A, the Taxpayer, (now Partnership B) must recognize gain in Tax Year 1, in the amount of $y, because it did not purchase property, within the meaning of § 1033(a)(2)(A) of the Internal Revenue Code (hereinafter IRC), when it acquired Facility L as its replacement property following a Date 1 involuntary conversion of certain property (Facility A) ?

2. Whether Partnership A, the Taxpayer, (now Partnership B) must recognize gain in Tax Year 1, in the amount of $y, because it acquired Facility L from a related person or persons (Partnership L and its owners) within the meaning of IRC. § 1033(i)?

3. Whether Partnership A, the Taxpayer, (now Partnership B) must recognize gain in Tax Year 1, in the amount of $y, because its replacement property, Facility L , is not similar or related in service or use to the property involuntarily converted, within the meaning of IRC. § 1033(a)(1) ?

CONCLUSIONS:

1. and 2. Partnership A, the Taxpayer, (now Partnership B) is not required to recognize gain in Tax Year 1 in the amount of $y, because it “purchased” property as its replacement property, within the meaning of IRC §§ 1033(a)(2)(A) and 1033(i)(1), when it acquired ownership interest of the L Facility, within the replacement period referred to in IRC § 1033(a)(2)(B), from a related party or parties that had “purchased” Facility L from an unrelated party, Company R, within such replacement period.

3. Partnership A, the Taxpayer, (now Partnership B) acquired replacement property reasonably similar or related in service or use to its involuntarily converted property when it acquired ownership interest of the L Facility under the described circumstances.

FACTS:

Partnership A, the "Taxpayer" herein, was a State p limited partnership organized as an independent power producer for the purpose of generating and selling electrical power from property interests at its facility (the A Facility) in State q.

Partnership A had two partners: Company C, a State r corporation, owning 49.5% in the form of a general partner interest and .05% in the form of a limited partner interest; and Company D, a State p corporation, owning the other 50% in the form of a general partner interest. Company C was owned by LLC G, a State p limited liability company. LLC G was owned by LLC H, a State p limited liability company, which was the common parent of all parties referred to as related parties herein. Company D was a subsidiary of an unrelated company.

Partnership L was a State p limited partnership similarly formed for the purpose of generating and selling electric power in State s. Partnership L had two partners: Company M, a State r corporation owning 49% in the form of a general partner interest and 2% in the form of a limited partner interest; and Company N, a State p corporation, owning the other 49% in the form of a general partner interest. Companies M and N were wholly-owned subsidiaries of LLC K, a State p limited liability company, which was wholly owned by LLC H, referred to earlier herein. On Date 5, Partnership L filed an application with State s regulatory authorities to construct the L Facility in State s. Its application was approved, and construction commenced on Date 6, continuing through Date 7. Facility L was built for Partnership L by Company R (a party unrelated to Partnerships A and L), pursuant to which Partnership L incurred substantial construction-costs. Partnership L met these liabilities with construction loans from related party LLC H.

On Date 1, as a result of certain regulatory and administrative actions, suffered an "involuntary conversion" of its property interests at the A Facility. That the Taxpayer's Facility A property interests were involuntarily converted is not an issue in dispute in this case: the Taxpayer received a private letter ruling (IR Letter Ruling 200011060, dated December 16, 1999) in which that issue was resolved, and in which this office determined that the Taxpayer's leasehold and other, contractual interests relative to the A facility constituted a single property interest, or economic unit, for purposes of IRC § 1033(a)(2).

On its Tax Year 1 partnership return, Partnership A reported one-half ($y) and elected to defer recognition under IRC 1033(a) of the other half, of approximately $x of gain realized on the involuntary conversion of it's A Facility property interests. The "replacement period" of IRC § 1033(a)(2)(B), which is also not an issue before us, began approximately on Date 2, when the Taxpayer first had notice of the threat of an involuntary conversion of Facility A, and terminated, following an extension, on Date 3.

In order to complete the replacement of its involuntarily converted property, Partnership A undertook a plan to acquire the L Facility through a plan of internal merger whereby Partnership L would merge with and into Partnership A, with Partnership A being the surviving partnership. A full discussion of the reorganization and merger transactions is not necessary here. In short, Partnership L merged into Partnership A; upon the merger, Partnership L terminated for tax purposes under IRC § 708(b). Following transfer of the assets (including Partnership L's property interests in Facility L) and liabilities of Partnership L through and to Partnership A pursuant to an "Agreement for Purchase of Membership Interests," and termination of Partnership L, Partnership A was renamed Partnership B.

Included in the assets and liabilities acquired or purchased from Partnership L was all of the remaining unpaid construction indebtedness, in the amount of $z, incurred by that partnership in connection with construction of the L Facility by Company R (the indebtedness at that point owed to related entity LLC H). Numerous other inter-company financial transactions, including the offsetting of other, unrelated liabilities, accompanied the reorganization and merger.

When on Date 9, the Taxpayer filed its Tax Year 2 partnership return, it designated the L Facility as its replacement property under IRC § 1033 for that involuntarily converted, and requested an extension of the "regular" § 1033(a)(2)(B)(ii) replacement period for an additional year, which was granted.

APPLICABLE LAW:

Section 1033(a)(2)(A) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money, and, during the period specified in section 1033(a)(2)(B), the taxpayer purchases property similar or related in service or use to the converted property, at the election of the taxpayer, gain will be recognized only to the extent that the amount realized upon the conversion exceeds the cost of the replacement property.

Under section 1033(a)(2)(A) and section 1.1033(a)-2(c)(4) of the Income Tax Regulations, property is not generally treated as "purchased" unless its unadjusted basis is its cost to the taxpayer within the meaning of section 1012 of the Code. Costs incurred in the construction of replacement property would generally satisfy this requirement. *See* Rev. Rul. 70-265, 1970-1 C.B. 170. Under section 1.1012-1 of the regulations, "cost" generally includes the amount paid for property in cash or other property. Liabilities incurred in the purchase of property, including replacement property, would generally constitute a cost of property. *See* Rev. Rul 70-144, 1970-1 C.B. 170 and Rev. Rul 99-6, 1999-1-C.B. 432.

Section 1033(a)(2)(B) provides that the replacement period referred to in subparagraph (A) is the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending two years after the close of the first taxable year in which any part of the gain upon the conversion is realized (or such later date as the Secretary may designate upon application of the taxpayer).

Section 1033(i) provides a general rule that the "replacement property" must be acquired from an unrelated person; property generally may not be “purchased” from a party bearing a relationship described in IRC § 1033(i)(3), e.g., in §§ 267(b) or 707(b)(1). However, the statute provides an exception to this limitation: the limitation does not apply to the extent the related person acquired the replacement property (or stock) from an unrelated person during the "replacement period" described generally above. Thus, property acquired within the replacement period in a “purchase” transaction from outside the group of related persons, and retransferred to a taxpayer member of the group within the requisite period, will ordinarily qualify as replacement property in the hands of the taxpayer, to the extent that the property’s basis or other net tax consequences to the group do not change as a result of the transfer. *See* the Legislative History to HR 831, P.L. 104-7 (JCS-12-6), December 18, 1996 (HR Report 104-92; Senate Report 104-16; and the JCT’s General Explanation of Tax Legislation Enacted in the 104th. Congress).

“Replacement property” must be substantially “similar or related in service or use to the property” converted, under § 1033(a)(2)(A); while there is no requirement that the new property be identical to that converted or destroyed, there must nonetheless be a substantially similar continuation of the taxpayer’s capital commitment and business operations. Whether or not replacement property is similar or related in service or use to that converted or destroyed is an inherently factual matter, to be determined under the circumstances of each case.

<u>ANALYSIS</u>:

The present case presents an interesting application of the “purchase” and “acquisition” requirements of IRC §§ 1033 (a)(2)(A) and 1033(i)(1). Although the number of parties involved in the complicated financial and restructuring transactions that occurred herein are numerous, and their interrelated ownership interests confusing, fortunately no extended analyses of these matters is required since it is agreed by all the parties involved that the Taxpayer, Partnership <u>A</u>, acquired its ownership of Facility

L, the replacement property, from a party or parties related to the Taxpayer within the contemplation of IRC § 1033(i)(2) and (3) (e.g., whether Partnership L, Companies C and D, or LLC H). Accordingly, resolution of whether or not the Taxpayer complied with the replacement rules of IRC § 1033 generally, will be determined principally under IRC § 1033(i)(1).

Area District Counsel (hereinafter the "Field") has extensively questioned characterization of Partnership A's acquisition of the L Facility property interests from Partnership L and/or its related entities as a true "purchase." The offsetting of inter-company liabilities, assignments of debt and gain, repayment considerations, and other factors have caused the Field to question whether Partnership A truly assumed the benefits and burdens of ownership, or "purchased," the subject L Facility.

The Taxpayer has similarly attempted to demonstrate that the complicated restructuring of Partnership L, the subsequent mergers, terminations, and transfers of the assets and liabilities of Partnership L into Partnership A (the Taxpayer), indeed constituted a true "purchase."

The problemsome issues raised by the Field, present in any related party transaction, are precisely the considerations that led the Congress to amend IRC § 1033 to preclude "purchases" from related parties from satisfying the "replacement property" requirements of IRC § 1033. The opportunity for meaningless transfers of property already owned by the related parties, basis shifting, endless deferral of gains, and other tax avoidance machinations, led the Congress to legislate that a taxpayer is not entitled to defer gain under IRC § 1033 if the replacement property is acquired, whether or not characterized by the parties involved as a "purchase" event, from certain related parties, as defined in IRC § 1033(i)(2) and (3).

Accordingly, whether or not the property interests constituting ownership of the L Facility were "purchased" by Partnership A, the Taxpayer, from Partnership L or any other related party, is not the salient issue in this case, since, effectively, no "purchase" can occur between such parties for purposes of satisfying the statute. The Congress did, however, provide an exception to this blanket prohibition in a circumstance that satisfies the underlying purpose and intent of IRC § 1033. That exception, consistent with the purpose of the "replacement" rule generally, provided that the described limitation will not apply where (to the extent that) the related party acquired, by purchase, the subject replacement property from an unrelated party during the applicable replacement period. The Congress thus sought to avoid consideration of the endless vagaries of inter-related party transactions by, effectively, treating the group of related parties as a single taxpayer for purpose of the replacement rule. The legislative history of the limitation and its exception indicates that property acquired from outside the group of related persons within the requisite time period, and "retransferred" to the (replacing) taxpayer member of the group within the subject period, will qualify in the hands of such taxpayer to the extent that the property's basis or other net tax consequences to the group do not change as a result of the inter-group transfer.

Accordingly, the “purchase” that is required in the instant case is a purchase of “new” property into the group from outside the related group, within the replacement period. That “purchase” occurred when Partnership L “purchased,” by construction and the incurring of construction-cost materials, supplies, and services liabilities, the L Facility built for it by unrelated Company R. As long as that property was designated by the Taxpayer as the replacement property and retransferred to it within the requisite period, the requirements (and purpose) of the statute are satisfied. There is no requirement in the statute for an additional, second “purchase” within the group, e.g., by Partnership A from Partnership L, for the very reasons that the Congress barred consideration of inter-related “purchases” generally. The property’s basis and other net tax consequences to the group do not change as a result of such transfers.

In the instant case, Partnership A suffered an involuntary conversion of its Facility A property interests on Date 1. The “replacement period” commenced generally on Date 2, and terminated on an authorized extension on Date 3. Partnership L, a party related to Partnership A within the meaning of IRC § 1033(i), “purchased” the L Facility by construction (and the incurring of construction costs and liabilities) between Dates 5 and 7, when that facility was built for it by unrelated Company R. The Taxpayer designated the L Facility property as its replacement property on Date 9. The subject L Facility property interests (including assets and liabilities) were largely “acquired” by Partnership A upon Partnership L’s reorganization and merger into Partnership A (thereafter Partnership B) on Date 4, with complete reinvestment/construction occurring on Date 8. Under these circumstances, it appears that the purchase and reinvestment requirements of the statute have been satisfied.

Finally, we agree with the Taxpayer that the “replacement property,” Taxpayer’s interests and operations in Facility L, is substantially similar and related in use to the Taxpayer’s converted property interests for purposes of IRC § 1033(a)(2)(A). In our letter ruling of December 16,1999, to the Taxpayer (IR Letter Ruling 200011060), we concluded that the converted interests of the Taxpayer at Facility A included both its leasehold and power purchase agreement interests, and that such “property” constituted a single economic unit or interest respecting the generation and sale of electrical power for purposes of § 1033.

The Taxpayer points out that changes in the energy market and regulatory environment of the late-1990's made an identical reinvestment impossible. However, an identical reinvestment is not required. We conclude that the economic involvement, functional use of property, and business operations of the Taxpayer at prior Facility A and new Facility L are substantially similar, with the Taxpayer continuing in its regulated business of generating and selling electrical power. Accordingly, we conclude that the “similar or related in service or use” requirement of the statute has been satisfied.

CAVEAT:

A copy of this technical advice memorandum is to be given to the Taxpayer(s) in accordance with the procedures outlined in section 22 of Rev. Proc. 2003-2. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.