INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 23, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Number:	**200627024**
Release Date:	7/7/2006
Index (UIL) No.:	1033.02-00, 1033.03-00
CASE-MIS No.:	TAM-125889-05

Director- Compliance

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Company	=
Sub 1	=
Power Plant	=
State	=
Year A	=
Year B	=
Year C	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 6	=
Date 1	=
Date 2	=
Date 3	=

$A	=	
$B	=	
$1x	=	
PUC	=	
The Decision	=	
The Act	=	
Act 2	=	

ISSUES:

1. Whether Taxpayer's franchise rights[1], access easements, and Power Plant were, as a result of State's deregulation program, involuntarily converted because of a seizure, requisition, or condemnation or threat or imminence thereof within the meaning of § 1033 of the Internal Revenue Code.

2. Whether funds received by Taxpayer were proceeds for the involuntary conversion of franchise rights and access easements as required by § 1033.

3. Whether certain property acquired by Taxpayer in Year B through Year 3 was acquired with the intent to replace the franchise rights, access easements, and Power Plant as required by § 1033.

4. Whether the claimed replacement properties are "similar or related in service or use" within the meaning of § 1033.

CONCLUSIONS:

1. Taxpayer's franchise rights, access easements, and Power Plant were not, as a result of State's deregulation program, involuntarily converted within the meaning of § 1033.

2 Funds received by Taxpayer were not proceeds for any involuntary conversion of franchise rights and access easements.

3. Taxpayer's replacement property was not acquired with the intent to replace the franchise rights, access easements, and Power Plant as required by § 1033.

---

[1] "Franchise rights" are sometimes referred to herein (and in Taxpayer's submissions) as the rights to a public monopoly or as rights under a compact with the state government. Throughout this document, the terms "monopoly," "franchise," "compact rights," etc., are used interchangeably.

4. Most of the claimed replacment properties are not “similar or related in service or use” to the converted property within the meaning of § 1033.

FACTS:

Company, a wholly owned subsidiary of Taxpayer,[2] is seeking to treat certain amounts received from Year 1 through Year 3 from its customers pursuant to State energy deregulation legislation (Competition Transition Charges or “CTCs”) and from the Year 1 sale of one of its gas-fired generation facilities, Power Plant, as amounts to be taken into account under the deferral provisions of § 1033.

A. Background of Deregulation

In Year A, PUC began a comprehensive review of the future of regulated electric service in State to determine how best to reduce energy costs for State’s ratepayers. The review led PUC to conclude that, in the future, State’s ratepayers should have a choice of electricity suppliers and that traditional cost-of-service utility regulation would be replaced by competition. After three years of deliberations, PUC issued the Decision. The Decision established PUC’s plan for restructuring State’s electric industry. In Year B, State’s legislature passed the Act, establishing the legal framework for the restructuring.

Taxpayer supported the restructuring plan to deregulate the electric utility industry. A letter from Taxpayer’s chairman to shareholders states as follows:

> Dear Shareholders,
>
> Our achievements in [Year B] point the way to the future of [Taxpayer]. Our “defend and grow” strategy was advanced by landmark legislation in [State] that restructured the electric industry, by new incentive regulation . . . . The unanimous passage of restructuring legislation, *which [Taxpayer] advocated*, placed [State] in the forefront of a national movement offering customer choice among electricity suppliers. For [Taxpayer]*, the legislation also provided a fair opportunity for sharply accelerated recovery of about [$A] in past utility investments*. The new law substantially deregulates the generation of electricity and opens retail markets to competition. [Sub 1’s] skills and experience position us well for success in the field of deregulated power generation.” (Emphasis added.)

Taxpayer’s Year B 8-K Security & Exchange Commission (SEC) filing includes a press release stating, in pertinent part, the following:

---

[2] Both Company and Taxpayer are hereafter referred to collectively and interchangeably as “Taxpayer.”

> "This historic legislation is the product of consensus building and compromise," said . . . [Taxpayer's] chairman and chief executive officer. "We commend Governor . . ., the State Legislature, the numerous customer groups, other utilities, municipalities and other stakeholders for their hard work and cooperative spirit in the formation of this new law. The new legislation ensures a timely and fair transition to a competitive electricity market. . . . Moreover, it will help lower rates for millions of customers and provides a fair opportunity for utilities to compete to serve customers in a restructured energy marketplace."
>
> The restructuring legislation garnered broad support among various stakeholders, because: . . .
>
> > *It provides utilities with a fair opportunity to recover costs they incurred in meeting their legal obligation to serve all customers under the state's regulatory system*. (Emphasis added.)

As a result of the restructuring, Taxpayer would no longer have an exclusive right to provide bundled services (power generation, transmission and distribution) within its service territory. Taxpayer would continue to have an exclusive right to transmit and to distribute electricity within specified service areas in State. Also, while Taxpayer retained some generation assets, it would be precluded from providing generation services directly to its distribution customers.

B. Transition Costs Resulting From Deregulation

As a consequence of allowing competition, PUC determined that market forces would cause certain utility assets purchased, and certain utility obligations entered into, in a regulated environment to become uneconomic in the hands of the utilities after the deregulation occurred. Both the legislature and PUC concluded that State's investor-owned utilities made significant investments in the generation assets dedicated to fulfilling their obligations incurred prior to deregulation. Applying the constitutional ratemaking principle of *Duquesne Light Co. v. Barasch,* 488 U.S. 299 (1989), and its predecessors, PUC determined that the utilities and their shareholders should be allowed the opportunity to recover the value of investments rendered uneconomic as a result of the restructuring. The legislature and PUC referred to these uneconomic costs as "transition costs." Transition costs are the net difference between the fair market value of the utility's generation related assets in the deregulated market and the net book value of such assets. Taxpayer was allowed to collect these costs from ratepayers over a four-year period ("Transition Period").

C. Collection of Transition Costs through the Competition Transition Charges ("CTCs")

During the transition period, rates were to remain at a static level even while costs were expected to decline. The transition costs or stranded costs were to be recoverable through rates frozen at the rate levels in effect on Date 1. Collected revenues in excess of declining costs were presumed to create “headroom”, i.e., revenues beyond those required to provide service that could be applied toward transition cost recovery. This “headroom” would enable Taxpayer to recover the CTCs. The CTCs were separately charged on ratepayer bills and were designed to reimburse Taxpayer for its transition costs. These costs have always been a part of the ratepayer’s rates, but were previously being recovered over a longer period of time and were not separately identified.

Following the enactment of the Act, revenues earned by Taxpayer were first to be applied against transmission and distribution and public purpose costs. Thereafter, revenues were applied to offset all generation costs, which included purchases from a newly created Power Exchange and the costs of Taxpayer’s retained generation properties. The revenue left after these expenses was the CTCs (or “headroom”). The Act allowed State’s investor-owned utilities to recover these costs within an accelerated, four-year timeframe, ending no later than Date 3.

In no event could Taxpayer collect more than its transition costs, which were determined to be about $B. Of this $B, certain funds were guaranteed, such as employee severance benefits due to restructuring. However, the majority, including transition costs associated with power generation facilities, were not guaranteed. The CTCs were to end and the rate freeze lifted at the earlier of the recovery of all transition costs or Date 3. PUC could monitor the progress of the transition cost recovery process. Taxpayer could not recover CTCs after Date 3.

In the Summer of Year 3, contrary to expectations, power generation costs sharply increased in State. For a brief period Taxpayer recovered no CTCs and even suffered heavy losses. However, despite the high costs in Year 3 and the brief period in which Taxpayer collected no CTCs, Taxpayer nevertheless recovered a significant portion of its CTCs even in that year (as it did in every other year in which the accelerated recovery process for CTCs was in effect).

Due to the ecomomic difficulties within State’s electric utility industry that arose in Year 3, the rate scheme was substantially altered when Act 2 was enacted on Date 2. Act 2 ended the rate freeze and essentially returned State to regulated cost of service ratemaking before transition costs were fully recovered and before a fully deregulated market could be implemented. However, for the years at issue in this Technical Advice Memorandum, the transition to deregulation was in effect.

D. Deregulation and Sale of Fossil Fuel Generation Assets

To ensure that competition occurred and to prevent Taxpayer from exercising undue market power, PUC ordered Taxpayer to file a plan to voluntarily divest at least 50 percent of its fossil generating assets. PUC also provided economic incentives for doing so.[3] Divestiture could be achieved either by spin-off or direct sale to an unaffiliated entity. The divestiture would curtail Taxpayer's market power and allow competitors immediate access to State's electric market. After restructuring, customers in Taxpayer's service territory had two choices for obtaining electricity. Customers could obtain electricity from a new market participant or they could have Taxpayer obtain electricity from someone other than Taxpayer on the customers' behalf.

In response to this order, Taxpayer presented a plan to auction its fossil generation assets. In approving Taxpayer's auction plan, PUC put potential bidders on notice that in addition to eliminating Taxpayer's market power through divestiture, it would not permit another party to acquire undue market power by acquiring the divested assets. In November of Year B, Taxpayer applied to PUC for permission to sell 100 percent of its gas-fired generation assets, including Power Plant. The sale of 100 percent instead of 50 percent was a move encouraged by FERC. Taxpayer sold all of these assets in Year 1.

E. State Control of Taxpayer's Transmission System Through the Independent System Operator ("ISO")

Under the Act, State's electrical utility corporations, including Taxpayer, retained exclusive rights to distribution and transmission of electricity within their respective service territories and also retained legal title to their transmission facilities. However, they were required to commit control of their transmission facilities to a newly created public benefit corporation, the Independent System Operator ("ISO"). This change was made to assure fair access to these facilities among competing power providers. However, Taxpayer still owned and charged ratepayers for transmission services and for use of its transmission facilities.

F. Taxpayer's Prior Arguments that the Act Effected a Taking

In Year C, Taxpayer argued at a proceeding before PUC that the Decision was unconstitutional and effected a taking because it failed to guarantee Taxpayer's full transition cost recovery, due to the rate freeze mechanism. PUC disagreed that Taxpayer was entitled to full transition cost recovery but ultimately found Taxpayer's claim to be moot for lack of jurisdiction in light of the passage of the Act. PUC asserted that it was only obliged to provide Taxpayer with a reasonable opportunity to recoup its costs and that no guarantees were required.

---

[3] One such incentive pertained to PUC's order that the equity component of Taxpayer's cost of capital be set at 90 percent of its embedded cost of debt, effectively reducing the return below the long-term cost of debt for the investment made uneconomic by the restructuring. However, as an incentive for divestiture, PUC provided as follows: "the 10 percent reduction may be eliminated by the utility divesting (spinning off or selling to an unaffiliated entity) at least 50 percent of its fossil generation. . . ."

In the same proceeding, an unrelated utility argued that the forced opening of the unrelated utility's transmission system amounted to a physical taking. However, Taxpayer never made such a claim and did not join in the other utility's claim regarding an alleged physical taking. In any event, PUC disagreed with the other utility, stating that PUC's mandates in these areas are merely a legitimate exercise of its police power to regulate these facilities, which have been dedicated to public use, in order to promote competition and lower consumer rates. Ultimately, PUC disallowed the unrelated utility's claim on the grounds that it was moot for lack of jurisdiction.

Taxpayer also sued PUC in federal court, claiming as its primary position that the rate freeze imposed by the Act was depriving it of its right, under federal law, to recover the costs of purchasing electricity for its customers. More particularly, Taxpayer claimed the frozen rates had violated the federal "filed rate" rule, which allows a utility to recover in state-regulated retail sales the costs of purchases made under federally approved tariffs. Taxpayer made a supplemental claim that the rate freeze deprived it of its "reasonable" rate of return on invested capital and was, therefore, a taking. However, these points were not extensively litigated. The case settled in Year 4.

Although Taxpayer had ample opportunity to do so in this proceeding, Taxpayer never raised the theory that its "monopoly franchise" had been taken or that it had been forced to grant an "easement" in any PUC proceeding or in its federal case. Neither did Taxpayer allege that it was forced to sell Power Plant or that this amounted to a taking.

G. Taxpayer's Tax Treatment of CTCs

Taxpayer treated the CTCs it received in Year 1 as gross income and did not make any election under § 1033. For Years 2 and 3, Taxpayer elected pursuant to § 1033 to defer 3.7 percent and 9 percent of the gain from CTCs for those years, respectively, alleging that the CTCs were paid as compensation for the involuntary conversion of the regulatory compact (the asserted monopoly franchise). These original returns also noted that replacement property acquired for Year C through Year 3 had a value nearly nine times greater than the deferral claimed on these original returns. With the initial elections, Taxpayer also filed amended returns for Year C and Year 1 to reduce the basis of property that it contended was acquired in those years as § 1033 replacement property. Then, in May of Year 6, Taxpayer filed additional amended returns for Year C through Year 3, claiming additional deferral amounts for those years. Eighty-two percent of the property asserted as acquired as replacement property consists of power lines and substations. The remainder of the replacement property consists of land, buildings, and capitalized remodeling costs.

H. Taxpayer's Tax Treatment of Proceeds of Power Plant

On an amended Year 1 return, filed in December of Year 2, Taxpayer elected to defer capital gain from the sale of Power Plant pursuant to § 1033. Taxpayer claimed it was forced to dispose of Power Plant by the Act. Alternatively, Taxpayer claims Power Plant was "part of the same economic property unit as Taxpayer's right to operate as a regulated monopoly and as a result the sale of such facility qualifies for the deferral of gain pursuant to [§] 1033." Taxpayer identified as replacement property for Power Plant assets of nuclear, hydro and steam electrical generation plants placed in service during Year C through Year 3.

LAW AND ANALYSIS:

Section 1033(a)(2) 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 if the taxpayer during the period specified in § 1033(a)(2)(B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, then, at the election of the taxpayer, the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such property.

Thus, a condition precedent for non-recognition treatment under § 1033 is involuntary conversion of property by destruction, theft, seizure, or requisition or condemnation or threat or imminence thereof. In this case, Taxpayer asserts that its property was taken by way of seizure, requisition or condemnation or threat or imminence thereof. Neither destruction nor theft is alleged. Thus, the first question we must address is whether there was a condemnation or any other kind of governmental taking. Other questions to be addressed, and on which the validity of Taxpayer's election under § 1033 depends, are whether money was received for the alleged conversions, whether Taxpayer acquired property for the purpose of replacing the property so converted, and whether the acquired property was similar or related in service or use to the property so converted.

Issue One: Whether Taxpayer's franchise rights, access easements, and Power Plant were, as a result of State's deregulation program, involuntarily converted because of a seizure, requisition, or condemnation or threat or imminence thereof within the meaning of § 1033 –

1. Common Forms of Governmental Takings

A requisition or condemnation occurs where a taxpayer's property is subjected to a governmental taking for public use compensable under the 5th Amendment of the U.S. Constitution. *American Natural Gas Co. v. United States*, 279 F.2d 220 (Ct. Cl. 1960); *Behr-Manning Corp. v. United States.*, 196 F. Supp. 129 (D.C. Mass. 1961); Rev. Rul. 69-254, 1969-2 C.B. 162; Rev. Rul. 58-11, 1958-1 C.B. 273. The 5th Amendment provides that: "nor shall private property be taken for public use, without just compensation."

Fifth Amendment takings commonly occur in three forms.[4] The first is a per se taking, where the government seizes property directly for public use. *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982). This form is only of limited relevance here because the "franchise" allegedly taken is intangible and Power Plant was sold by Taxpayer to a third party and not condemned as hereafter discussed. However, a per se taking may be relevant for consideration of the taking of "access easements" alleged by Taxpayer. *See Gulf Power Co. v. U.S.*, 998 F. Supp. 1386, 1394-95 (N.D. Dist. Fla. 1998), *aff'd*, 187 F.3d 1324 (11th Cir. 1999) (where the government forced utilities to grant cable companies access to their power lines).

The second form is the deemed or de facto taking described in *Duquesne Light Co. v. Barasch*, *supra*. In that case, the Supreme Court determined that if a government regulator fails to authorize a rate sufficient to both cover the utility's prudently incurred costs and provide a reasonable return to its investors, the investors' capital is deemed to have been "taken." However the deemed form of taking described in *Duquesne* is of limited relevance here. Any condemnation award pursuant to this theory would be in the form of increased rates authorized in order to give investors a reasonable return on capital. Such a taking would not give rise to a claim under § 1033 because compensation for lost income, as opposed to lost assets, may not be deferred pursuant to a § 1033 election.[5]

The third common form of government taking is inverse condemnation as discussed in *Penn Central Transportation Co. v. City of New York*, 438 U.S. 104 (1978). In that case, the taxpayer's application for a permit to extend the height of the structure housing Grand Central Station in New York City, from eight to 55 stories, was denied by the local government to preserve the historic character of that structure. The taxpayer alleged that government regulation had effectively reduced the value of property to such an extent that the property was "taken" by the regulation. In the present case, Taxpayer asserts that there was an inverse condemnation of its property, claiming that the change in the regulatory regime with respect to State's power industry eliminated or

---

[4] Other forms of governmental taking may indeed be discerned and distinguished; but for purposes of analyzing the issues presented in this memo, the three discussed herein are sufficient.

[5] *See Commissioner v. Gillette Motor Co.*, 364 U.S. 130 (1960) (holding that compensation for the use of rental property is equivalent to income, not property, and therefore currently taxable as such and not deferred); *Miller v. Hocking Glass Co.*, 80 F.2d 436 (6th Cir. 1935), *cert. denied,* 298 U.S. 659 (1936) (holding that proceeds of business interruption insurance are taxable as income); Rev. Rul. 75-381, 1975-2 C.B. 25, 27 (regarding current includibility of indemnity for loss of income from honeybees destroyed by pesticides); Rev. Rul. 73-477, 1973-2 C.B. 302 (proceeds from business interruption insurance not deferred under § 1033); and Rev. Rul. 57-261, 1957-1 C.B. 262 (although forced leasehold pursuant to condemnation was subject to § 1033, rent payments by the city and pursuant to the lease arrangement were taxable as ordinary income). *See also* § 1.1033(a)-2(c)(8) (distinguishing insurance compensating for the use of property from insurance compensating for the property itself, the former being currently taxable as income and not subject to § 1033).

substantially diminished the value of key tangible and intangible properties in its power generation, transmission and distribution businesses.

2. Application of Takings Law to Taxpayer's Alleged Franchise

Under its prior system of utility regulation, State granted licenses to investor-owned utilities to provide electrical services within specific geographical areas. Utilities *were* allowed to be monopolies. That does not mean, however, that utilities such as Taxpayer had any vested right to be monopolies recognized by the state. Indeed, governments are well within their police power to regulate industries and commerce, and to determine whether it is best for a given business to operate in a monopolistic environment or a competitive environment.

Outside the context of a per se physical taking, a finding of a "taking" is rare due to the broad sphere of regulatory authority enjoyed by governments, especially when they act for the greater public good. *See e.g., Mugler v. Kansas*, 123 U.S. 627 (1887). Pursuant to this power, governments limit the use of property pursuant to zoning, health and environmental concerns (*Gains v. Commissioner*, T.C. Memo 1982-731 and *Hay v. Commissioner*, T.C. Memo 1992-409); limit business practices to encourage competition, and even force businesses to divest property pursuant to anti-trust rules (*Behr-Manning Corp. v. United States*, *supra*; Rev. Rul. 58-11, *supra*), and SEC orders (*American Natural Gas Co. vs. United States*, *supra*). Yet, these acts are not viewed as takings because they are within the sphere of the government's police powers. As the Supreme Court stated in *Penn Central*, "[a] taking may more readily be found when the interference with property can be characterized as a physical invasion by the government, than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good." *Penn Central* at 124.

In the present case, it is evident that deregulation is intended to promote the common public good. PUC was attempting to reduce the price of electrical power in State by shifting from a regulated to a competitive market. This was an action performed with the public welfare in mind. Although the legislation altered the regulatory framework, Taxpayer retained its franchise for transmission and distribution and retained its ability to generate power on a competitive basis. In addition, the legislation created new rights. Before the institution of deregulation, Taxpayer was permitted only to earn a rate of return for its investors as allowed by PUC and was required to return excess amounts to the ratepayers. Deregulation paved the way for potentially unlimited returns to the investors. Also, Taxpayer's potential area of operations was expanded to include all of State. Hence, the legislation contemplated benefits to both Taxpayer and ratepayers.

Public utilities are heavily regulated industries. As such, their reasonable expectations are limited insofar as freedom of action is concerned and the extent government cannot interfere with their rights and obligations.[6] One who does business in a regulated field cannot reasonably rely on the status quo because there is the foreseeable potential for regulatory change. *See, e.g.*, *Concrete Pipe & Products of California, Inc. v. Construction Laborers Pension Trust*, 508 U.S. 602, 645 (1993) (regulatory imposition of liability on pension plan sponsor upheld); *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1008-09 (1984) (stating that absent an express promise, there was no reasonable investment-backed expectation that its trade secret disclosed pursuant to government (EPA) regulation would remain a secret; and that disclosure was foreseeable in an industry that historically has been the focus of great public concern and significant regulation). The regulatory scheme in place at the time of the property acquisition helps shape the reasonableness of the expectations that the status quo will continue. *Palazzolo v. Rhode Island*, 533 U.S. 606, 633 (2001) (O'Connor J., concurring). To be reasonable, the expectation must be more than a "unilateral" or "abstract need." *Ruckelshaus* at 1005. The Supreme Court has consistently stated: "When one bargains with the state, nothing passes by implication and all promises are to be narrowly construed." *Charles River Bridge v. Warren Bridge*, 36 U.S. 420, 546 (1837). *See also US West Communications, Inc. v. Arizona Corporation Commission*, 3 P.3d 936, 941-42 (Ariz. Ct. App. 1999) (rejecting a utility's argument that a "regulatory compact" was a contract, stating: "Absent some clear indication that the legislature intends to bind itself contractually, the presumption is that 'a law is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise.'" (Citations omitted)).[7]

In this case, State did not commit to bear the risk of regulatory change. Taxpayer has not identified any such explicit and unambiguous promise in statutes, regulations, and decisions existing at the time it invested in assets prior to deregulation. Absent such a commitment by State, Taxpayer's expectation appears to be unilateral.[8] Absent a

---

[6] *See Duquesne*, *supra*, at 308, where the Court noted that utility property is partly public in that its assets are employed in the public interest to provide consumers with power but also private in that private investors own and operate them. This dual status created its own set of questions under the "Takings Clause."

[7] *Compare, e.g., New Orleans Gas-light Co. v. Louisiana Light & Heat Prod. & Mfg. Co.*, 115 U.S. 650, 670-72 (1885), where the utility had such an explicit right granted by charter for a fixed period.

[8] Some commentators observe that traditional rate regulation may have led to overinvestment in power generation facilities as utilities strategically used the rate process to ensure revenue streams. Thus, putting the burden entirely on the government "oversimplifies the dynamic nature of the regulatory process." Jim Rossi, *The Irony of Deregulatory Takings*, 77 Tex. L. Rev. 297, 316 (1998) (citations omitted). *See also* Oliver E. Williamson, *Deregulatory Takings and Breach of the Regulatory Contract: Some Precautions*, 71 N.Y.U. L. Rev. 1007, 1012-14 (1996); Herbert Hoverkamp, *Book Review: The Takings Clause and Improvident Regulatory Bargains,* 108 Yale L.J. 801, 808-18, 821-28 (1999) (investment by utilities involves calculated risk taking rather than government compelled investment). *See also Energy Ass'n of N.Y. v. Public Service Commission of N.Y.*, 653 N.Y.S.2d 502, 513-16 (N.Y. Sup. Ct. 1996) (electric utility's "regulatory compact" did not entitle it to guaranteed total recovery of stranded costs under contract theory).

physical invasion, no taking occurs when governments legislate for the public welfare, except in the most extreme cases, as where the owner is deprived of "*all* economically beneficial uses" of the property. *See Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1019 (1992). (Emphasis in original.)

Under *Penn Central*, governments are allowed great latitude even when the government regulation results in an enormous diminution in value. As the Court noted in *Penn Central* at 131:

> . . . [T]he decisions sustaining other land-use regulations, which, like the New York City law, are reasonably related to the promotion of the general welfare, uniformly reject the proposition that diminution in property value, standing alone, can establish a "taking," see *Euclid v. Ambler Realty Co.,* 272 U.S. 365 (1926) (75 percent diminution in value caused by zoning law); *Hadacheck v. Sebastian*, 239 U.S. 394 (1915) (87 1/2 percent diminution in value); cf. *Eastlake v. Forest City Enterprises, Inc.,* 426 U.S. at 674 n. 8, and that the "taking" issue in these contexts is resolved by focusing on the uses the regulations permit.

In the present case, State enacted PUC's deregulation program with the intent to provide for the welfare of its residents by significantly reducing the cost of purchasing electricity. This action was an exercise of its constitutional police power prerogative for the public benefit. As we have seen, such an exercise, without more, cannot constitute an involuntary conversion.[9]

It is in this context that the *Penn Central* case becomes most relevant. To determine whether a government regulation is to be treated as tantamount to a physical (or per se) taking, *Penn Central* sets three criteria for analyzing the question: 1) the character of the government action; 2) the diminution in the value of the property; and 3) the interference with the property owner's distinct investment-backed expectations.

The first factor, the character of the government action, weighs against finding a taking in the present case. State's action was regulatory and did not constitute a physical invasion of the franchise. Also, State acted in the long-term interests of both the utilities and the ratepayers by attempting to encourage competition in the electric industry. In this connection, it should be remembered that Taxpayer heavily endorsed the policy.

Second, in the context of the putative franchise rights, we doubt the relevance of the diminution in the value of the property factor in light of our view that Taxpayer had no right or expectation of a continuation of the regulatory ratemaking regime. Taxpayer

---

[9] The "more" involves consideration of whether a government has overstepped its legal bounds in the exercise of its police power.

asserts that its “franchise rights” were adversely affected. However, even assuming such rights existed (and we do not believe they did), the economic effect of the legislation should be viewed in terms of the impact on the totality of Taxpayer’s business, as Taxpayer was granted a right not only to generate power but also to transmit and distribute power. Courts generally reject property owners’ attempts to view a single property in isolation. *See Penn Central*, at 130-131. Moreover, as suggested by Taxpayer’s endorsement of the deregulation itself, Taxpayer’s takings claim is mitigated by the rights gained by Taxpayer pursuant to the deregulation to charge market rates for its retained property. Even if it were true that Taxpayer lost a monopoly, it gained the right to potentially earn larger profits in an unregulated power generation industry.

Finally, as to the third factor concerning the interference with Taxpayer’s distinct investment-backed expectations, Taxpayer, as a member of a heavily regulated industry, should have had very limited expectations that State would not interfere with its structure and operations, apart from being guaranteed a reasonable rate of return. Moreover, by allowing transition cost recovery, State provided for minimal interference with Taxpayers’ investment-backed expectations.

To the contrary, Taxpayer argues that it has suffered an involuntary conversion of its monopoly franchise rights, based on the following rationale: The prior regulatory scheme resulted in a regulatory compact between it and State. Under the compact, Taxpayer was induced to make substantial investments in assets to satisfy its statutory duty to serve the public, subject to rate regulation. In return, State provided the utility the exclusive right to provide electricity within a geographical area and enabled the utility to recover the costs necessarily incurred to fulfill its duty to serve. Thus, according to Taxpayer, the regulatory bargain justifies the reasonable, investment-backed expectations of an investor in a regulated rather than a competitive market. When the bargain is broken, these expectations justify applying the “Takings Clause.”

We, however, disagree with Taxpayer’s arguments. In *Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002), the Supreme Court rejected the taxpayer’s theory that it held a property right in a monopoly franchise and its reliance on a state’s prior regulatory scheme. The Court reviewed a takings challenge to the methodology for access rates under the Telecommunications Act of 1996 (”the 1996 Telecom Act”), noting that regulation does not guarantee full recovery of embedded costs and that such a guarantee would exceed past assurances by the states. In the words of the Court, “[a]ny investor paying attention had to realize that he could not rely indefinitely on traditional ratemaking methods but would simply have to rely on the constitutional bar against confiscatory rates.” *Verizon* at 528. Thus the Court rejected the utility’s argument that it had an expectation that a “historically anchored cost of service method” would set the rates because “no such promise was made.”

The Court's reasoning in *Verizon* is applicable here because the 1996 Telecom Act, like the Act, is a deregulatory statute seeking competition rather than a ratemaking statute seeking better regulation. *See Verizon* at 543. State did not explicitly promise Taxpayer that it was entitled to be a monopoly forevermore. Nor did State guarantee Taxpayer that it would use a particular ratemaking method or allow full recovery of embedded costs. Thus, Taxpayer never held an interest in a monopoly franchise rising to the level of a property right existing in perpetuity. At most, what existed prior to the Act was a regulatory scheme subject to modification and change by State, providing for rates that were not confiscatory under *Duquesne*.

Further, Taxpayer analogizes its situation with that of the taxpayer described in Rev. Rul. 82-147, 1982-2 C.B. 190. In that ruling, the taxpayer owned a resort on a lake. Federal legislation was enacted restricting the horsepower of motors that could be used on the lake, which rendered the taxpayer's business no longer viable. These circumstances motivated the taxpayer to sell its resort property to the government. The ruling holds that an involuntary conversion had occurred.

Again, however, we disagree with Taxpayer's argument and do not believe that Rev. Rul. 82-147 is analogous to its facts. The taxpayer in the revenue ruling held a property interest that it could operate in a profitable business free from regulatory restriction until legislation made his property uneconomic. In the present case, as stated above, Taxpayer never had an interest in a monopoly franchise rising to the level of a property interest. Also, before the Act became law, Taxpayer was heavily regulated and had no legal basis for assuming that a change in the regulatory scheme of its industry would entitle it to compensation.

In summary, since all three *Penn Central* factors suggest that no regulatory taking occurred, we do not agree with Taxpayer's position that it owned a franchise right that was "requisitioned" or "condemned."

3. Takings Law Applied to the Sale of Power Plant

Taxpayer contends that the Act and PUC's orders implementing deregulation made the operation of its power plants uneconomic, thereby forcing it to sell the power plants to independent generators. Consequently, Taxpayer takes the position that the proceeds derived from the sale of Power Plant are subject to § 1033.

As discussed above, State considered the divestiture of some generation assets necessary to encourage competition in the electric utility industry. PUC's goal was to limit Taxpayer's market power and its ability to unduly influence the price of power. To accomplish this objective, however, State did not compel Taxpayer to sell any assets. The facts and circumstances related to the implementation of deregulation by State and, particularly, Taxpayer's response to State's actions weigh against the argument that State forced the sale of Power Plant.

First, while PUC required Taxpayer and other utilities to file a plan to voluntarily divest at least 50 percent of its fossil fuel power plants, it did not require Taxpayer to sell any assets. There was no deadline for the sale of assets, only for submitting a plan of divestiture. Second, PUC gave incentives for Taxpayer to divest itself of at least 50 percent of its fossil fuel power generating capacity, including the allowance of a rate of return on equity that was increased by ten basis points for each ten percent of fossil fuel generating capacity divested. Third, although PUC required Taxpayer to submit a plan to voluntarily divest at least 50 percent of its fossil fuel assets, Taxpayer sold all of its fossil fuel generating capacity, including Power Plant, a response that far exceeded the PUC's proposed objectives for divestiture. Finally, in its filings with the SEC, Taxpayer characterized its divestiture as voluntary. Such representations are particularly relevant because the SEC, the public, and Taxpayer's investors depend on the truthfulness of the representations made in these filings. In summary, these factors show that while State provided incentives to sell, its actions fell far short of compelling the sale of Power Plant. Further, Taxpayer had many business reasons for the sale and, as a result, ended up selling all of its fossil fuel generation plants.

As an alternative theory for its position that § 1033 applies in the present case, Taxpayer posits that Power Plant was sold under a threat of requisition or condemnation by State. For a threat or imminence of condemnation to exist, the property owner must be informed by a reliable source that an entity with authority to condemn has decided to acquire the property for public use. Also, reasonable grounds must exist to believe that the condemnation will, in fact, occur. *See, e.g., Tecumseh Corrugated Box Co. v. Commissioner,* 932 F.2d 526, 536 (6th Cir. 1991); Rev. Rul. 74-8, 1974-1 200. However, the mere making of an advantageous sale to a public or private buyer with encouragement by a governmental entity is not a disposition of property under the threat or imminence of condemnation. *Stone v. Commissioner*, T.C. Memo. 1973-26. In the present case, there are no facts showing that State ever uttered or implied a threat, or that State had a plan or intent to acquire Power Plant. The only factors weighing in favor of a determination that a threat had been made or implied was that Taxpayer was ordered to submit a plan for voluntary disposition of 50 percent of its fossil fuel generation capacity and was threatened by the loss of certain incentives if sales did not occur.[10] These facts and circumstances do not rise to the level of a threat or imminence of condemnation for purposes of § 1033.

As an additional alternative theory, Taxpayer asserts that gain from the sale of Power Plant is excludible under § 1033 because the fossil fuel generation assets and the

[10] Taxpayer represents that it initially proposed a 50 percent divestiture in its FERC and PUC filings. However, FERC found this proposal unsatisfactory and commented that if Taxpayer files a detailed plan for divestiture of 100 percent of its gas-fired generation plants, it may well mitigate the market power concerns FERC had with the 50 percent proposal. Accordingly, Taxpayer filed an application with PUC to divest, by auction, all of its gas-fired generating plants.

property rights in Taxpayer's franchise were part of the same economic unit. Taxpayer cites *Masser v. Commissioner*, 30 T.C. 741 (1958), as authority for this position. In *Masser*, the taxpayer operated a trucking business from a terminal building and adjacent parking lots. The taxpayer sold the parking lots to the city under threat of condemnation. Although the city never threatened to condemn the terminal building, it too was sold because the taxpayer could not economically operate its business from that building without the parking lots. The court held that where two properties are used by a taxpayer in its trade or business as one economic unit, and one is involuntarily converted and the other sold because continuation of its use is impractical, the transaction as a whole constitutes an involuntary conversion of one economic unit.[11] However, we do not accept that the economic unit theory is applicable in the present case because, as discussed above, Taxpayer had no property interest in an allegedly condemned franchise.

4. Takings Law Applied to the Transferring of Control of Taxpayer's Transmission System to the ISO and Requiring Access by Competitors

Under the Act, Taxpayer continued to own its transmission lines but transferred control of its transmission system to the ISO. This transfer was made to ensure equal access to power lines. According to representations submitted, the ISO acts as an electronic auction house, coordinating transfer of electricity between wholesale buyers and sellers, making sure there is enough electricity to meet consumer demand, and determining how much power can flow along the transmission paths on the grid. As explained by PUC in the Decision, transfer of control to the ISO was necessary to lessen the potential of the investor-owned utilities favoring their own generation facilities in providing transmission access over facilities owned by others, while at the same time preserving reliability and reducing costs.

PUC rejected the contention that the mandate of access to the transmission system and transfer of its control to the ISO constituted a physical taking. Rather, PUC determined that its actions were legitimate exercises of its police power to regulate facilities dedicated to public use in order to promote competition and lower rates. In addition, as noted in the Decision, Taxpayer, along with the other investor-owned utilities operating in State, chose to participate in the development of new market structures and voluntarily agreed to support a consensus model based on transferring control over their transmission systems to the ISO.

The facts of the present case are distinguished from those in *Loretto v. Teleprompter Manhattan CATV Corp, supra*, which involved mandatory access by a cable company to

[11] In Rev. Rul. 59-361, 1959-2 C.B. 183, as later clarified by Rev. Rul. 78-377, 1978-2 C.B. 208, the Service announced it would follow *Masser*, stating, *inter alia*, that a substantial economic relationship exists where the property sold could not practically have been used without replacement of the converted property and such replacement is not practically available.

install cable in the owner's apartment building. The installation involved the direct physical attachment of plates, boxes, wires, bolts, and screws to the building, which occupied space immediately above and upon the roof and along the Building's exterior wall. The Supreme Court held that a permanent physical occupation of property authorized by the government is a per se taking. *Loretto* at 426.

Several lower federal courts have applied the *Loretto* physical takings analysis in the context of mandatory pole attachments. For example, in *Gulf Power Co. v. United States*, *supra*, the district court found a per se taking. The court reasoned that the 1996 amendment to the Pole Attachment Act, as codified at 47 U.S.C. §227(f), on its face required the utility to permit permanent occupation of its physical space on its poles, ducts, conduits, and rights-of-way. The Eleventh Circuit affirmed this holding, noting that under the 1996 Telecom Act, the utility had no choice but to permit permanent occupancy of physical space on its property. *Gulf Power Co. v. United States*, 187 F.3d 1324, 1328-29 (11th Cir. 1999).

In contrast to *Gulf Power*, the Federal Court of Claims found no per se *Loretto* taking in *Qwest v. United States*, 48 Fed. Cl. 672, 690-91 (2001). The alleged taking in *Qwest* was unrelated to pole attachments but involved another mandatory access provision in the 1996 Telecom Act. At issue were fourteen of Qwest's loops. Qwest provided telephone exchange service to customers by using, in general, copper wire loops to connect the customer to Qwest's switching office where the loops were connected to a switch and from there to Qwest's network. FCC orders implementing the 1996 Telecom Act, as applied by the state PUC, required Qwest to allow interconnection to its network. The bargain was that once Qwest opened its local market to competition, it could have access to the long distance market. Pursuant to the 1996 Telecom Act, a mandatory lease allowed a competitor of Qwest to switch fourteen of Qwest's loops to its competitor's network. This was done by a "lift and lay" procedure whereby a Qwest technician at Qwest's switching office lifted a loop from its connection to Qwest's switch and laid it on the competitor's equipment.

In *Qwest*, the court found no physical *Loretto* taking and distinguished *Gulf Power*, emphasizing that there was no physical invasion because Qwest's competitor did not affix the loops to Qwest's property, did not perform the lift and lay procedure, and did not own or service the loops. Qwest contended that: (1) a physical taking did not require placing an "unwanted physical structure" on the owner's property, and (2) its loops were invaded by electrons every time its competitor originated or terminated a call. The court disagreed, characterizing the electron theory as a "novel" physical taking theory and unpersuasive. *Qwest* at 694 and footnote 9.[12]

---

[12] In addition, state courts have considered mandatory access provisions enacted under state law. For example, in two cases courts found that requiring utilities to carry competitors' electricity to end users for a reasonable rate was not a taking under *Loretto*. *See In re Retail Wheeling Tariffs*, 575 N.W.2d 808, 815-16 (Mich. Ct. App. 1998), *rev'd on other grounds, Consumers Power Co. v. Michigan PSC*, 596 N.W.2d 126 (Mich. Sup. Ct. 1999) (distinguishing a public utility from a private landlord and noting that the

Based on the analysis in *Qwest*, there was no per se taking in the present case because, as in *Qwest*, this case involves the movement of power over Taxpayer's lines rather than a direct physical invasion. Before deregulation was instituted, Taxpayer was required to use its transmission and distribution lines to provide electricity to its customers. Also, its transmission and distribution businesses were subject to strict regulatory controls. Following deregulation, Taxpayer's transmission and distribution properties were still highly regulated, only now under the control of the ISO. Furthermore, Taxpayer was still required to use its lines for the same purpose, except that now its customers included competitors. However, Taxpayer was still afforded the right to collect rates for all such uses. So long as the standards of *Duquesne* are satisfied, there is no 5th Amendment taking. Increased rates would compensate for lost profits and not for lost assets.

Issue Two: Whether CTCs received by Taxpayer were proceeds for the involuntary conversion of its property –

In the present case, as discussed above, Taxpayer takes the position that the CTCs it received were compensation for its involuntarily converted property. Taxpayer thus takes the position that § 1033 applies to the receipt of the CTCs.

Section 1033(a)(2) is applicable only when an asset has been converted into money or into property not similar or related in service or use to the converted property. Thus, even if a taxpayer's property has been involuntarily converted, § 1033(a)(2) is applicable only if the taxpayer receives compensation for the taking, whether in the form of a condemnation award, insurance proceeds, or some other receipt of cash or dissimilar property intended by the payor to compensate the taxpayer for the taking.

The Service and the courts use the origin of the claim doctrine to determine whether amounts received by a taxpayer represent compensation for the taxpayer's involuntary conversion of property. *Allen v. Commissioner*, TC Memo 1998-406 (1998), *citing Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997). In determining the nature of the claim and thus the taxability of the proceeds, the most important factor to consider is the intent of the payor, considering all the facts and circumstances. *Allen*, *citing Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir.

---

utility would be compensated); *Energy Ass'n of N.Y. v. Public Service Commission of N.Y.*, 653 N.Y.S.2d 502 (N.Y. Sup. Ct. 1996) (*dictum* stating that no *Loretto* taking had occurred because (1) there was no permanent physical occupation, and (2) utilities were of a quasi-public nature). In contrast, the Oregon Supreme Court found a physical taking under *Loretto* for a different type of access provision in *GTE Northwest, Inc. v. Public Utility Comm'n of Oregon*, 900 P.2d 495 (Sup. Ct. Ore. 1995). In *GTE*, the PUC rules required the local phone company to allow a competitor to physically "collocate" on its property, which required the placement of a customer's equipment, software and databases on its premises. The court found a physical invasion under *Loretto* because the rules required a direct physical attachment, the competitor owned the property, and collocation was mandatory.

1965), affg. T.C. Memo 1964-33. The essential question in such a case is: What is "the basic reason for the . . . payment," *Agar v. Commissioner*, 290 F.2d 283 (2d Cir. 1961); or phrased differently, what was "the intent of the payor as to the purpose in making the payment," *Knuckles, supra*. Although the belief of the payee is relevant to the inquiry, the character of the settlement payment hinges ultimately on the dominant reason of the payor in making that payment. *Jacobs v. Commissioner*, T.C. Memo 2000-59. Thus, in the present case, even if we accept Taxpayer's argument that its property was involuntarily converted by a government taking, Taxpayer may not defer its income derived from CTCs under § 1033 unless Taxpayer can demonstrate that the CTCs represent compensation for a taking of its property.

As discussed above, the CTCs were a charge to ratepayers to enable Taxpayer to accelerate the amortization of generation assets. This charge to ratepayers was part of the rate structure prior to deregulation, although it was based on a slower amortization rate. There is no indication that the CTCs Taxpayer received from ratepayers in any way relate to compensation for a taking of Taxpayer's transmission and distribution property. The ratepayers did not view the payment of CTCs as compensation for a government taking because the charge had always been a part of the ratepayer's rate and the rates they paid during the transition period remained at a static level. Indeed, State's public utility code indicates that Taxpayer (along with other public utilities within State) was entitled to collect a separate, equitable return on its transmission facilities, which it still owned, through the rate it charged ratepayers for transmission. Therefore, we do not believe that the CTCs represent compensation to Taxpayer for the taking of its property.

Moreover, the question of whether the CTCs were intended to compensate Taxpayer for a taking of its "monopoly franchise right" is answered by negative inference in the following passage in State's public utility code:

> [The CTCs were intended to allow State's public utilities to] *continue to recover, over a reasonable transition period, those costs and categories of costs for generation-related assets and obligations, including costs associated with any subsequent renegotiation or buyout of existing generation-related contracts,* that the commission . . . had authorized for collection in rates and that may not be recoverable in market prices in a competitive generation market. . . .

(Emphasis added). Citing *Duquesne Light Co. v. Barasch*, *supra*, the PUC described its responsibility with respect to transition cost recovery as follows:

> We note that we are not required to guarantee full transition cost recovery. We are required only to design a rate structure the total impact of which provides the utilities with the opportunity to earn a fair return on their investment.

Thus, both the State statutory language and the statements by the PUC demonstrate that the CTCs were intended to allow Taxpayer to (1) charge a rate which would allow it to recover its prudently incurred expenses and (2) provide its investors with a reasonable return. In other words, the CTC system was a mechanism designed to enhance the ability of Taxpayer to recover its invested costs and earn income with respect to the demonopolized generation assets. As discussed above, a right to earn income is not the proper subject of a § 1033 election.

Although State had originally granted Taxpayer an exclusive license to provide power within specific geographic areas, the right to recover invested capital and a return thereon through rates is distinct from the right to have a monopoly or the right to be a monopoly. Prior to deregulation, public utilities did not enjoy the unfettered power of monopolists. Rather they were, and still are, highly regulated and allowed only a reasonable rate of return.

Taxpayer’s characterization of the CTCs as compensation for the taking of a monopoly or franchise right is inaccurate. Under the deregulation plan, Taxpayer is allowed to collect as transition costs only the anticipated decline in value of certain generation assets determined to be adversely affected by deregulation. This valuation could be worth significantly less or significantly more than the value of a regulated monopoly franchise, depending on market forces. Consider the case in which a utility has a vast portfolio of assets, only one of which is uneconomic and the rest of which are predicted to be even more profitable in a deregulated environment. In such a case, the utility’s “monopoly franchise right” would actually have a negative value, because the utility could earn more money in a deregulated environment. Even so, the utility would still be entitled to recover transition costs on its uneconomic asset according to State’s deregulation plan.

Also, Taxpayer’s characterization of deregulation as a taking does not consider the rights it gained through deregulation, namely the right to earn a rate of return higher than that previously allowed by PUC. Further, the amount Taxpayer was able to recover as CTCs was not based on the value of Taxpayer’s monopoly because the CTCs were not designed to take into account the total economic impact of deregulation on the value of the franchise. The CTCs were simply a rate mechanism by which utilities were to recover their transition costs, in theory on an accelerated basis, with the expectation that they would be completely paid off and able to charge market rates in a deregulated environment, rather than to continue to charge ratepayers for such costs over an extended period of time. As noted above, the charges were part of the rate charged to ratepayers prior to deregulation and Taxpayer included such amounts in its ordinary income.

Thus, we refuse to accept Taxpayer’s argument that an amount that was, prior to deregulation, part of the rate charged to ratepayers and included in ordinary income is now, following deregulation, still part of the rate charged to ratepayers but somehow a capital item received as compensation for an alleged taking of taxpayer's property. Accordingly, the CTCs represent part of Taxpayer's taxable rate charged to its customers, the structure and amortization of which were altered to accommodate the perceived needs of State's energy deregulation program. Even assuming that Taxpayer could show that a taking occurred of the alleged access easements and franchise rights, Taxpayer would not be eligible to defer gain recognition for the CTCs under § 1033. This conclusion is compelled by the fact that the CTCs compensate for neither the franchise nor the easements.[13]

Issue Three: Whether Taxpayer's replacement property was acquired with the intent to replace the franchise rights, access easements, and Power Plant –

Section 1033(a)(2) provides, in part, that replacement property must be acquired "for the purpose of replacing the property so [involuntarily] converted." Accordingly, where a taxpayer acquires property without the intent that it serve as replacement for property involuntarily converted within the meaning of § 1033, the new property does not qualify as replacement property. Lack of intent is indicated where a taxpayer, having acquired a replacement property, fails either to make an explicit election on its return for the year in which gain from the conversion is realized or to reduce its basis on the supposed replacement property. *Feinberg v. Commissioner*, 45 T.C. 635 (1966), *aff'd*, 377 F.2d 21 (8th Cir. 1967).

In *Feinberg*, the taxpayer purchased real estate in 1953, after a threat of condemnation. However, when the taxpayer received the compensation in 1957, the taxpayer did not make a § 1033 election and did not reduce the basis of the alleged replacement property purchased in 1953. The taxpayer later made its § 1033 election on an amended return. The Tax Court found that failing to make an election after receiving the compensation and failing to reduce the basis in the replacement properties established that the taxpayer did not really intend the property to be replacement property at the time it was purchased. Therefore, the property purchased by the taxpayer did not qualify as replacement property. In so holding the court stated:

> The obvious intendment of the statute is that petitioner must have *the* requisite intent during the specified period of time. He cannot (retroactively) simply pick out some property which he happened to purchase in the prescribed period and say "I chose this one!"

Feinberg at 642.

---

[13] This rationale, however, is not applicable to amounts received for the alleged conversion of Power Plant. Such proceeds were derived directly from the disposition of property. Thus, if Power Plant was involuntarily converted, the amounts received from the sale may be capital gains susceptible to deferral under § 1033. However, the remaining CTC derived directly from ratepayers themselves are not so connected.

In the present case, Taxpayer contends that it purchased replacement assets each year from Year B through Year 3. However, Taxpayer received the "proceeds" from its alleged conversion beginning in Year 1, at which time Taxpayer recognized the alleged "proceeds" as income. Taxpayer failed to make a § 1033 election and failed to reduce the basis of assets it allegedly purchased in Year C and Year 1. When Taxpayer made an election in Year 2, it may have formed the intent that property purchased in Year 2 be replacement assets. However, as in *Feinberg*, the fact that Taxpayer's election wasn't made until Year 2 indicates it did not intend to make the election in Year 1 when funds were first received or when the alleged replacement assets, acquired before Year 2, were purchased. In the absence of countervailing facts, a factual conclusion that Taxpayer lacked the requisite purpose when it acquired those assets before Year 2 is justified and adequately supported.

The fact that Taxpayer filed amended returns for Year B though Year 1 designating over $1x in replacement assets does not change the analysis. Although a taxpayer can retroactively make a §1033 election in order to purchase replacement assets at some future time still within the replacement period, a taxpayer cannot, as the *Feinberg* case demonstrates, retroactively form an intent as to assets already purchased at an earlier time. Accordingly, assets purchased from Year B through Year 1 are disqualified from being considered replacement property. To this extent, the third requirement for a valid deferral under § 1033 is not satisfied.

Issue Four: Whether the claimed replacement properties are "similar or related in service or use" within the meaning of § 1033 –

In the present case, as mentioned before, Taxpayer contends that there was an involuntary conversion within the meaning of § 1033 of its franchise rights, access easements, and Power Plant. The franchise rights are intangible property. The access easements may be real property. Also, Power Plant is likely a combination of real and personal property consisting of multiple assets. Eighty-two percent of the property asserted as acquired as replacement property for the franchise rights and access easements consists of power lines and substations, with the remainder of the replacement property consisting of land, buildings, and capitalized remodeling costs. Identified as replacement property for Power Plant were components of nuclear, hydro and steam electrical generation plants placed in service from Year C through Year 3.

Section 1033(a)(2) provides that property will qualify as replacement property only if it is similar or related in service or use to the property so converted. Further, under § 1033(g)(1), a taxpayer may replace condemned real property held for productive use in a trade or business or for investment with other like-kind real property to be held for productive use in a trade or business or for investment. Section 1.1033(g)-1(a) adopts the rules set forth in § 1.1031(a)-1(b) for purposes of determining whether replacement property is of like kind to the converted property for § 1033 purposes.

To determine whether property is similar or related in service or use, the Service initially focused on whether the original and replacement properties have a close functional similarity, which means closely similar physical characteristics and end uses. *See, e.g.,* Rev. Rul. 56-347, 1956-2 C.B. 517. The Service later abandoned this functional test with respect to property held for investment, while continuing to hold that it applies where the property converted is used by the taxpayer in its business. Rev. Rul. 64-237, 1964-2 C.B. 319.

Taxpayer seems to argue that because of its difficulty in finding property similar or related in service or use to the converted property it should be permitted to replace the converted property with any property that is in anyway connected with its businesses of power generation, transmission and distribution. Taxpayer, to bolster its argument, observes that § 1033 is a relief provision to be liberally construed to effectuate its purpose and that a taxpayer's inability to replace the converted assets with similar property is relevant to the application of the functional use test. As authority for its arguments, Taxpayer cites *Davis v. United States*, 589 F.2d 446, 449 (9th Cir. 1979). In that case, when the taxpayer's fisheries were condemned by the state, the taxpayer was not permitted to invest in other fisheries and investment in other agricultural properties was considered impractical. The restrictions on private ownership of sea fisheries was a fact mentioned in the opinion and the court ultimately determined that reinvestment of conversion proceeds in an industrial park already owned by the taxpayer was a suitable replacement for purposes of § 1033(a). However, in *Davis* the replacement property had relevant similarities, such as similar management demands and similar business risks. Both the converted fisheries and the industrial park property that replaced them in *Davis* were held for investment and leased to tenants. In the present case, the only similarity between the property that Taxpayer contends was converted and the replacement property is that both are used in Taxpayer's business. Thus, we believe that *Davis* is distinguishable from the present case.

It is arguable, however, that *Davis* can be read to hold that the focus of "similar or related in service or use" should be on the relationship of the taxpayer to its converted and replacement properties rather than just on the character of the assets. In *Davis*, the court focused on the relationship the taxpayer had with the new and old investments that it held for lease and whether there was a sufficient continuity of investment. The test is whether, considering all the circumstances, Taxpayer has "achieved a sufficient continuity of investment to justify non-recognition of the gain, or whether the differences in the relationship of the taxpayer to the two investments compel the conclusion that he has taken advantage of the condemnation to alter the nature of his investment for his own purposes." *Davis,* at 449, *citing Filippini v. United States*, 318 F.2d 841 (9th Cir. 1962). A court may consider, for example, whether the replacement property requires a similar amount of attention from the taxpayer, and whether the business risks and management demands attendant to such property are similar. However, the replacements proposed by Taxpayer do not meet this standard.

With respect to Taxpayer's franchise rights, which is intangible property, replacement property consisting of power lines, substations, and other tangible business assets that Taxpayer purchased does not meet the similar or related in service or use" test. The amount of attention required, including business risks and management demands, for such divergent types of properties (tangible *vis-a'-vis* intangible) are not the same or similar. Therefore, no replacement property acquired by Taxpayer is similar or related in service or use to the alleged franchise rights.

To the extent Power Plant is real property, it may be validly replaced with other real property to be used in a trade or business or for investment, pursuant to § 1033(g), or with property similar or related in service or use under § 1033(a). If the replacement assets consisted solely of component parts of nuclear, hydro or steam generation plants, and no land, then the property designated to replace Power Plant is not of like kind. *See* Rev. Rul. 76-390, 1976-2 C.B. 243 (motel to be constructed on land already owned by the taxpayer is not a like-kind replacement of condemned mobile home park); and Rev. Rul. 67-255, 1967-2 C.B. 270 (office building constructed on land already owned by the taxpayer was not like-kind to condemned real estate).

Another problem with the replacement property designated for Power Plant is that Taxpayer failed to comply with § 1.1033(a)-2(c)(2). As noted above, Taxpayer designated nuclear, hydro and steam generation assets as replacement property. The values asserted as pertaining to the replacement property equals the total proceeds from the sale of Power Plant. However, Taxpayer has not set forth or described the precise nature of these replacement assets, but has provided only broad categories which are not in compliance with the requirements of the regulation. For example, Taxpayer has not demonstrated that it replaced Power Plant (which consisted of land and improvements) with other real estate. Without more information, we are not satisfied that the property that Taxpayer asserts replaced Power Plant was of like kind to Power Plant. Similarly, there is no evident factual basis for Taxpayer's assertion that the purported replacement nuclear, hydro and steam assets are similar or related in service or use to Power Plant. In addition, we do not believe that an entire operating fossil fuel power generation plant, such as Power Plant, which we understand to include land, improvements, accessory operating assets, and possibly some intangible property, is similar or related in service or use to random components of nuclear, hydro or steam generation plants. No authority has been cited to us for this proposition and we know of none.

With respect to access easements, however, the facts seem somewhat more favorable for Taxpayer. An access easement over a transmission system or a distribution system is probably an interest in real property for state law purposes, assuming that it includes an interest in the underlying real estate improved with fixtures (towers, poles and transmission or distribution lines). Therefore, if such easements were converted, replacement property may consist of either like-kind (real) property used in Taxpayer's trade or business or for investment, or property similar or related in service or use. In the present case, the purported replacement property consists entirely of transmission and distribution property (including buildings, substations, lines, land and rights and remodeling of the new properties).

Transmission and distribution are considered separate parts of a utility's business (or even as separate businesses) because the materials, technology, and general business functions of the two are distinct. A distribution system consists of local, lower voltage power lines and networks, whereas a transmission system is a network of high voltage lines and grids. Taxpayer's replacement of access easements over transmission lines with other transmission assets satisfies the similar or related in service or use test because of the likelihood that such acquisitions and improvements would be deemed as necessary for the continuance of Taxpayer's transmission business. See *Woodall v. Commissioner*, T.C. Memo 1991-15, *aff'd*, 964 F.2d 361 (5th Cir. 1992) (valid use of conversion proceeds to restore damaged nightclub); Rev. Rul. 271, 1953-2 C.B. 36 (use of severance damages to restore usability of farm); Rev. Rul. 60-69, 1960-1 C.B. 294 (use of conversion proceeds to preserve operating condition of plant); Rev. Rul. 67-254, 1967-2 C.B. 269 (rearrangement of plant facilities on remaining land).

On the other hand, distribution property designated by Taxpayer as replacement property is not similar or related in service or use to the easement over the transmission lines. However, to the extent that the distribution assets asserted as replacement property assets consist of real property used in Taxpayer's business, such property would be valid as like-kind replacement property for purposes of § 1033(g). Therefore, some of the property purchased by Taxpayer to replace of its access easements would be like-kind property or even property that is similar or related in service or use to such access easements. However, this is not true for most of the purported replacement property for franchise rights or Power Plant.

V. SUMMARY AND CONCLUSION

In summary, it is our position that no taking of Taxpayer's franchise rights or access easements occurred because State acted within its police power to further the well-being of State's ratepayers by deregulation of the power industry. In addition, no taking occurred with respect to Power Plant or transmission and distribution systems.

Moreover, even assuming that some sort of taking occurred with respect to the franchise rights and access easements, no compensation was received for the taking. The CTCs that Taxpayer received represent accelerated cost recovery for generation assets and supply contracts in order to implement the state's deregulation plan, not compensation for a taking. Also, the purported replacement property was not acquired with an intent to replace the property that Taxpayer contends was converted (with the possible exception of property acquired in Year 2). Finally, most of the purported replacement property is transmission and distribution property that is not similar or related in service or use to the franchise rights and Power Plant, but may be similar or related or of like kind to the access easements.

Under the facts presented, no involuntary conversion occurred meeting all the requirements for deferral. Therefore, Taxpayer's claims under § 1033 should be denied.

CAVEAT(S):

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