INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 26, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200722013**
Release Date: 6/1/2007

Index (UIL) No.: 1033.01-00, 1033.02-00, 1033.03-00
CASE-MIS No.: TAM-111757-06

Director

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Sub-U	=
State	=
Year 1	=
Year 2	=
Year 3	=
Year A	=
Year B	=
Year C	=
Year D	=
Year E	=
Year F	=

Year G =
Year M =
Date 1 =
Date 2 =

$A =
$B =
$C =
$D =
$E =
Buyer 1 =
$F =
$G =
$H =
Buyer 2 =
$J =
$K =
SPUC =
Decision =

Act =
Act 2 =
Plant =

ISSUE(S):

1. Were Taxpayer's "monopoly franchise" (hereafter referred to as "franchise"), access easements to its transmission system, and six power plants involuntarily converted by State for purposes of § 1033 of the Internal Revenue Code?

2. If the franchise was involuntarily converted, were the Competition Transition Charges (CTCs) received by Taxpayer in Year C and Year D proceeds for the involuntary conversion of the franchise as required by § 1033?

3. If an involuntary conversion occurred, did Taxpayer purchase its designated replacement property with the intent to replace the converted property as required by § 1033?

4. Assuming the other requirements of § 1033 were met, is the designated replacement property acquired to replace the converted property "similar or related in service or use" to the property so converted as required by § 1033?

CONCLUSION(S):

1. Taxpayer's franchise, access easements, and six power plants were not involuntarily converted by State for purposes of § 1033.

2. The CTCs received by Taxpayer were not proceeds for the involuntary conversion of franchise and receipt of the CTCs did not give rise to gain potentially subject to deferral under § 1033.

3. Except as otherwise provided in this memorandum, Taxpayer did not purchase designated replacement property with the intent to replace the converted property as required by § 1033.

4. Except as otherwise provided in this memorandum, the designated replacement property is not "similar or related in service or use" to the converted property as required by § 1033.

FACTS:

Taxpayer, in a refund claim for Year C and Year D, made an election under § 1033(a)(2) on behalf of its wholly-owned subsidiary, Sub-U. Sub-U, is an investor owned utility (IOU)[1] regulated by the State Public Utilities Commission (SPUC). SPUC is an agency of State with broad powers to determine rates and regulate utilities. Taxpayer asserts that in those years State involuntarily converted Taxpayer's franchise, access easements pertaining to its power transmission system, and six power plants. Taxpayer now seeks deferral of the gain realized from these events pursuant to § 1033(a)(2).[2]

These involuntary conversion claims arise from SPUC's restructuring of State's electric utility industry from a regulated to a competitive market pursuant to the enactment of the Act. As part of the restructuring, SPUC ordered Taxpayer to submit a plan to voluntarily divest at least 50 percent of its fossil fuel generating assets. Taxpayer complied. Following SPUC approval, Taxpayer sold three power plants in Year C and three power plants in Year D. In Part I of each Claim for Refund, Taxpayer seeks nonrecognition of $A and $B in net gain previously recognized in Year C and Year D, respectively. In Part II of each Claim for Refund, Taxpayer seeks nonrecognition of CTC revenue received in Year C and Year D and previously reported in the amounts of $C and $D, respectively. The CTC consisted of revenue derived from ratepayers to fund Taxpayer's recovery of

[1] For convenience, references to Sub-U or to its parent, Taxpayer, will hereafter be made by use of the common term, "Taxpayer."

[2] In its original Year C and Year D returns filed on September 15, Year D and September 15, Year E, respectively, Taxpayer did not elect § 1033 or identify any replacement property.

"uneconomic" transition costs of generation related assets and obligations pursuant to the Act and decisions of SPUC, as further described below.

State Electric Utility Industry Restructuring

State's early efforts to restructure the electric industry are reflected in a report (the "Report") issued in February of Year 1 by SPUC. The restructuring evolved through the regulatory and political process over a period of years. The utilities within State and other interested parties were active participants in this process. Following the Report, significant restructuring milestones included the following: First, in April of Year 2, SPUC issued an "Order Instituting Rulemaking and Investigation on Restructuring [State's] Electric Services Industry and Reforming Regulation" (the "Order"). Second, in December of Year 3, SPUC issued the "Decision." Third, the State legislature enacted the Act on September 23, Year A, effective January Year C. Finally, SPUC instituted regulatory proceedings and issued decisions implementing the Act.

Restructuring was intended to lower the retail cost of electricity without sacrificing the financial integrity of State's IOUs. In the Report, the Order, and the Decision, SPUC acknowledged the existence of an arrangement between State and IOUs within State, sometimes referred to as the "regulatory compact" with the IOUs. The Report stated:

> Building on the compact's legal and economic foundations, the actions of this Commission, [State's] Legislature, the courts, state and federal agencies, and Congress have combined to form four oft-cited elements of what has come to be referred to as the "traditional regulatory compact." Under that compact an investor owned public utility in [State] was granted 1) an exclusive retail franchise to serve a specific geographic region; 2) an opportunity to recover prudently incurred expenses; 3) an opportunity to earn a reasonable return on investment; and 4) powers of eminent domain. In return for these privileges, the utility was subject to cost and price regulation by the Commission, and required to provide safe and reliable service to all customers in its service area on a nondiscriminatory basis. This latter feature of the compact is commonly called the utility's "duty," or "obligation" to serve (footnote omitted).
>
> The Commission fulfills its obligations under the compact through a [decision-making] process which attempts to balance the interest of current and future consumers and the financial interest of the utility accepting the duty to serve.

During the beginning of the restructuring process, Taxpayer opposed complete restructuring and advocated limited reform. Throughout the process, Taxpayer was particularly concerned about its ability to fully recover costs that might become unrecoverable or "stranded" in a competitive marketplace. Taxpayer argued that it had

a legal right to recover all costs that may become stranded due to industry restructuring. In so doing, Taxpayer stressed its "rights" under the regulatory compact and argued that failure to fully compensate it was an unconstitutional taking. In addition, Taxpayer asserted that requiring divestiture was a taking and that SPUC lacked authority to order divestiture.

The Act, which significantly restructured State's electric utility industry, was intended to promote competition in the electric generation market and to lower rates for electricity in State. The new law acknowledged prior SPUC proceedings concerning restructuring. It also built on and endorsed many aspects of SPUC's recent Decision, including SPUC's approach to transition costs. As noted by the Legislature, SPUC found that state and ratepayer interests would best be met by moving from the current framework "in which retail electricity service is provided principally by electrical corporations subject to an obligation to provide ultimate consumers in exclusive service territories with reliable electric service at regulated rates," to a new, competitive framework in which customers could choose their electric power supplier.

By the time the legislation was enacted, Taxpayer was a strong advocate for competition and supported the Act.[3] According to Taxpayer, the legislation had the support of virtually all participants in the political process, including the IOUs, SPUC, potential entrants into the new competitive market, and various consumer representatives. Through the Act, the Legislature intended to provide the foundation for State's transition to a more competitive market for the generation of electricity and allow for the opportunity of recovery of transition costs. The restructuring included the following key features:

1. Generation, Transmission and Distribution Services Are Unbundled

Historically, the IOUs owned and operated the three major functions of electric service: (1) generation - the production of energy through various types of generating facilities such as fossil fuel, hydro-electric, geothermal, and nuclear; (2) transmission - the delivery of that power to local networks through the transmission grid (wholesale transportation); and (3) distribution - delivery to consumers through local distribution lines (retail energy supply). Costs associated with these services were bundled together and billed to the consumer as one charge.

Restructuring involved separating these functions so that one company did not control all three. The rate charged for each function and other charges were separately itemized on the consumer's bill. Thus, the consumer could compare the energy cost of competing providers.

2. Consumer Choice of Electric Power Supplier (Direct Access)

[3] According to Taxpayer's Year C Annual Report, "[Taxpayer] has long been a strong advocate for choice."

Under the Act, beginning in Year C, most consumers were offered a choice between continuing to purchase electricity from their existing IOU or purchasing electricity from a non-utility electric service provider. The IOUs were obligated to continue to provide utility service to its customers who did not choose a different provider.

3. Transmission Grid Control Transferred from IOUs to Independent Service Provider (ISO)

Under the restructuring, transmission and distribution were not subject to competition but remained regulated monopoly functions. However, the IOUs were required to transfer control and operation (but not ownership) of their transmission grids to a newly-created nonprofit entity, the ISO. The ISO was to ensure reliability of electric service and efficient use of energy resources. It was also designed to create fair and open access to the transmission system to promote competition. If a utility did not transfer control of its transmission grid to the ISO, it could not collect any CTCs.

4. The Power Exchange and the Mandatory Buy-Sell Requirement

The Act provided for the creation of a second independent nonprofit entity, the Power Exchange (PX). The PX began operating in March of Year C and provided a wholesale auction for buying and selling electricity. During the transition period, the IOUs were required to sell and purchase all their power from the PX. Participation by others was voluntary. Purchases of wholesale power through the PX were subject to FERC jurisdiction. The PX was designed to promote price competition and draw new wholesale suppliers into State.

5. IOUs' Voluntary Divestiture of Fossil Fuel Generating Assets

Under the restructuring, the IOUs were expected to divest themselves of substantial parts of their generating assets and retain others. SPUC determined in its Decision that divestiture of 50 percent of fossil generating assets could mitigate market power concerns related to one entity retaining excessive concentration in generation. It required the IOUs to file plans to voluntarily divest themselves of at least 50 percent of their fossil fuel generation assets. After the Act became law, SPUC reconfirmed its position concerning divestiture.

6. IOUs' Opportunity to Recover Transition Costs During Transition Period

a. Prior Law – Cost of Service Based Rates

Under prior law, the regulated rates set by SPUC were based on a cost of service ratemaking mechanism. The rates that utilities charged to consumers included reimbursement for power plant construction costs and contractual obligations. Under

cost of service regulation, the utilities had the opportunity to recover construction costs over a plant's expected useful life plus a reasonable return on the undepreciated cost of the investment tied to risk, as long as the plant remained useful and used.

b. Definition of Transition or "Stranded" Costs

In the Act, the legislature acknowledged that the utilities' investment in generation facilities and other generation-related contracts and obligations might become unrecoverable or "stranded" in the competitive marketplace. In the Decision, SPUC similarly acknowledged that these investments might become stranded. As explained by the State Supreme Court:

> Because this competition among producers was expected to bring down wholesale prices, the utilities believed that some of their generating assets, which they had built or improved with PUC approval, would become "uneconomic," in that the costs of generation (and of certain long-term contracts between the utilities and other generators) would be higher than prevailing wholesale rates would support. The costs associated with these potentially uneconomic assets are also known as "stranded costs" or "transition costs." The Legislature, in [the Act], intended to allow for "[a]ccelerated, equitable, nonbypassable recovery of transition costs" and thereby to "provide the investors in these electrical corporations with a fair opportunity to fully recover the costs associated with commission approved generation-related assets and obligations."

In addition, the legislature set forth the following declaration:

> It is proper to allow electrical corporations an opportunity 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, prior to December 20, Year 3, had authorized for collection in rates and that may not be recoverable in market prices in a competitive generation market, and appropriate additions incurred after December 20, Year 3, for capital additions to generating facilities existing as of December 20, Year 3 that the commission determines are reasonable and should be recovered, provided that the costs are necessary to maintain those facilities through December 31, Year F.

c. Determination of Transition Costs

Under the Act, SPUC was to identify and quantify potentially uneconomic generation related costs. Utilities were required to propose cost recovery plans for recovery of uneconomic costs under the frozen rate level for the transition period (described below). SPUC was to approve the plans if they satisfied the criteria set forth by the statute. The

legislature cited Taxpayer's plan of June 12, Year A, as an example of an authorized plan.

Generation assets such as fossil fuel plants were defined as "uneconomic" and thus eligible to be recovered as transition costs if net book value exceeded market value. For generation assets subject to valuation, market value was to be determined by appraisal, sale or other divestiture completed no later that December 31, Year F. Thus, the true stranded cost of an asset depended in part on its market value.

d. Recovery of Transition Costs Through the Rate Freeze and Reduction

The transition costs or stranded costs were to be recoverable through rates frozen at the rate levels in effect on Date 1, subject to a ten percent rate reduction for residential and small commercial customers.[4] The ten percent reduction was effective from January 1, Year C through December 31, Year F. The rate freeze, effective January 1, Year B, would remain in effect until the earlier of Date 2 or the date on which the costs for uneconomic generation-related assets and obligations had been fully recovered, as determined by SPUC.[5] The recovery of uneconomic costs was generally not to extend beyond December 31, Year F. Although the intent was to provide the opportunity to recover transition costs, recovery was not guaranteed. Taxpayer acknowledged in its annual reports and SEC filings that there was a risk that it would not recover its transition costs.[6]

The theory was that the frozen rates would be higher than they would have otherwise been during the transition period, that utilities would continue to make a profit, and that there would be additional money from the revenue under the rate freeze to pay for transition costs. The expectation was that the utilities' ongoing operating costs,

---

[4] Rates, but not revenues, were frozen. Revenues received from retail customers depended on the amount of electricity purchased at the frozen rate levels.

[5] Once the rate freeze ended, the intent was that the prices consumers paid for power would reflect the utilities cost to buy it.

[6] For example, it its 8-K dated February 19, Year B, it noted that "…any transition costs not recovered during the transition period will be absorbed by Taxpayer." It further stated:

> [Taxpayer's] ability to recover its transition costs during the transition period will be dependent on several factors. These factors include: (1) the extent to which application of the current regulatory framework established by the restructuring legislation will continue to be applied, (2) the amount of transition costs approved by [SPUC], (3) the market value of [Taxpayer's] generation plants, (4) future sales levels, (5) fuel and operating costs, (6) market price of electricity, and (7) the ratemaking methodology adopted for [Plant]. Considering its current evaluation of these factors, Taxpayer believes it will recover its transition costs and that its owned generation plants are not impaired. However, a change in these factors could affect the probability of recovery of transition costs and result in a material loss.

including the costs of wholesale power, would decline and the difference between such costs and the frozen rates would contribute to the recovery of transition costs. Mechanisms for recovery of transition costs included Revenue Reduction Bonds (RRBs) and the CTCs, as described below.

7. Recovery of Transition Costs Facilitated and Accelerated Through RRBs

To help finance the ten percent rate reduction and facilitate and accelerate the recovery of transition costs prior to the transition period, the Act authorized the IOUs to issue RRBs. The Internal Revenue Service determined that the RRBs should be treated as loans for tax purposes. In connection with the RRB offering in Year B, Taxpayer received net loan proceeds of $E. The source of the repayment for the RRBs (principal, interest, and costs) was a non-bypassable charge to customers subject to the rate reduction. The charge, known as the fixed transition amount (FTA), appeared on consumer utility bills as the Trust Transfer Amount (TTA). The TTA did not increase rates during the transition period. According to Taxpayer, the TTA did not cover tax liabilities incurred by Taxpayer on receipt of the TTA revenues. The TTA was to continue for a ten-year period until Year M, the year in which all the bonds would be paid off. According to Taxpayer, because the TTA revenues were collected without a gross-up to pay tax liabilities, Taxpayer was required to "reserve" a portion of the principal amount of the borrowing to pay for future tax liabilities on the TTA revenues. These tax liabilities were incurred as the TTA revenues accrued over the ten year pay-back period. According to Taxpayer, the remainder of the borrowing (*i.e*., $E less the reserve for taxes) was used to recover transition costs dollar for dollar.

In its Year D Annual Report, the taxpayer explained that "the Utility refinanced [$E] (the expected revenue reduction from the rate decrease) of its transition costs with the proceeds from the rate reduction bonds. The bonds allow for the rate reduction by lowering the carrying cost on a portion of the transition costs and by deferring recovery of a portion of these transition costs until after the transition period."

8. Recovery of Transition Costs through the CTC

The CTC was a mechanism to allow the IOUs an opportunity to recover their uneconomic costs during the transition period from revenues received from consumers at the frozen rate level. The CTC rate component dedicated to transition cost recovery was a separately stated, non-bypassable charge (that is, paid to the IOUs whether the consumer bought power from the utility or from a generator in a direct transaction). As explained by SPUC, although the CTC appeared as a separate charge on electric bills, it was part of the frozen rate and not an additional charge. The CTC was the difference between the frozen rate level and the actual utility costs, including the PX price, the distribution rate, the transmission rate, the public purpose program charge, the TTA amount, and the nuclear decommissioning charge. As the cost of power purchased

from the PX varied, the amount of CTC, if any, varied and could not be determined in advance.

9. Regulatory Accounting for Transition Cost Recovery

SPUC implemented the cost recovery plan in part by creating for each utility two regulatory accounts. The first account was the Transition Revenue Account (TRA). The second account was the Transition Cost Balancing Account (TCBA). These accounts were used to track transition costs and the recovery thereof.

a. The TRA

The TRA was used to track a utility's operating costs and revenues. On a monthly basis, revenue from the monthly utility bills paid by consumers was entered into the TRA. Subtracted from this revenue were the authorized operating costs (such as costs for distribution, transmission, public purpose programs and nuclear decommissioning) and the TTA charges. Next, costs of purchasing energy from the PX were subtracted from the revenue. Any revenue remaining was called the "headroom" (or CTC) revenue. The CTC revenue was transferred to the TCBA on a monthly basis to reduce stranded costs.[7]

b. The TCBA

The TCBA was used to track all SPUC-identified stranded costs and the recovery thereof during the rate freeze period. If these costs were recovered prior to Date 2, then the rate freeze would end at that time.

Three sources of revenue flowed into the TCBA: (1) CTC revenue or headroom as determined in the TRA account; (2) net gain from the sale of generating assets; and (3) net revenue from generation assets owned or controlled by the utility. In addition, revenue from the RRBs was imputed to the TCBA. Thus, each of these sources offset transition costs.

Actual transition costs found eligible for transition cost recovery were debited into the TCBA as SPUC determined them. Costs accruing in the TCBA earned a reduced rate of return, as addressed below.

10. Rate of Return for Transition Costs

[7] Prior to SPUC's Accounting Decision of March 27, Year F, if the TRA balance was negative, it was carried over in the TRA to the next month and not transferred to the TCBA. In the Accounting Decision, SPUC referred to the past practice as an "accounting anomaly" and adopted a true-up, requiring that either the debit or credit balance in the TRA be recorded in the TCBA. It ordered Taxpayer to restate its TCBA and TRA account balances beginning with January 1, Year C. Restatement would affect the amount of transition costs recovered and potentially affect when the rate freeze ended.

As previously mentioned, under cost-of-service regulation, utilities had the opportunity to recover the construction costs of a plant over its useful life plus a reasonable return (on the undepreciated portion of this cost) tied to risk, as long as the plant remained used and useful. In the Decision, SPUC adopted a reduced rate of return for transition costs. It found that the utilities faced a reduced risk in that once an asset was market-valued, the risk that the plant would no longer be found used and useful was eliminated. The Legislature in the Act confirmed the reduced rate of return. In a decision subsequent to the Act, SPUC reconfirmed the reduced rate of return and set forth the overall rate of return for Taxpayer at 7.13%. In addition, SPUC noted that the rate freeze started on January 1, Year B, allowing the utility to accrue revenues and offset transition costs and that ratepayers might have otherwise had lower rates. As an incentive for voluntary divestiture of assets, the reduced rate of return on equity was increased by ten basis points for each ten percent of fossil fuel generating capacity divested.

Taxpayer's Sale of Assets

As previously mentioned, SPUC required Taxpayer to file a plan to voluntarily divest itself of at least 50 percent of its fossil fuel generating assets to resolve market power concerns. In its comments filed before SPUC on March 19, Year A, Taxpayer stated:

> The directive to consider some level of divestiture is consistent with [Taxpayer's] view of the future utility business. It was that view which prompted [Taxpayer] to decide several years ago not to build additional utility-owned generation in its service territory. Accordingly, as long as the objectives set forth in the [Decision] are realized, [Taxpayer] is willing to proceed with voluntary divestiture of at least 50 percent of its fossil-fueled generation assets.

Taxpayer's sales of fossil fuel generation assets proceeded in two stages. First, a sale of three plants in the Wave I sale in Year C, resulting in divestiture of about 42 percent of its fossil fuel generation assets. Second, a sale of three additional plants in the Wave II sale in Year D, resulting in divestiture for both years of about 91 percent of its total fossil fuel generation assets.[8] These sales are described below.

In addition, Taxpayer sold its geothermal facilities in Year D. In May of Year C, it announced its intent to divest its hydroelectric facilities but was precluded from so doing by a change in State law in Year F.

[8] Taxpayer's total fossil fuel capacity prior to divesture was 6,244 megawatts. In the Wave I sale, it sold plants with total megawatt capacity of 2,645. In the Wave II sale, Taxpayer sold plants with a 3,065 megawatt capacity.

1. Wave I Asset Sale

On October 16, Year A, Taxpayer's Board of Directors considered Management's plan to seek SPUC consent to divest 50 percent of Taxpayer's fossil generation assets.[9] Its reasons for the recommendation included (1) being responsive to SPUC's restructuring order and market power concerns, (2) a determination that a sale was the best way to determine market value, which was critical under the restructuring to recovery of full investment in generation, and (3) the belief that a marketing advantage could be achieved by a sale before other states implemented divesture.

Later that month, the Taxpayer's Board authorized divestiture as recommended. In an application dated November 15, Year A, as amended on June 25, Year B, Taxpayer sought SPUC authorization to sell three fossil fuel plants, known as "Wave 1 assets," in a competitive auction. As to Taxpayer's wish to sell Wave I assets, SPUC stated in an interim opinion:

> That wish is consistent with our Decision . . . , in which we required (the IOUs) to submit a plan to voluntarily divest itself of at least 50% of its fossil generating assets. . . . The three plants have a combined generating capacity of . . . approximately 45% of Taxpayer's fossil generation capacity.

In addition, SPUC stated:

> In view of Taxpayer's statements that it intends not to remain in the fossil-fuel generation business within its existing service territory, we would be surprised if Taxpayer attempted to retain any of the plants for which it had received bona fide bids. Therefore, should [Taxpayer] elect to retain any plant, the results of the auction may be evidence of but shall not determine, the valuation, and we shall determine the fair market value of such plants by other means for the purposes of our determination. . . . However, we will not convert our request for voluntary divestiture . . . into a mandatory requirement by requiring an absolute auction.

On December 16, Year B, SPUC approved the sale of Wave I assets. Taxpayer sold the Wave I assets to Buyer 1 as a bulk purchase for $F in Year C. The difference between the sale price and net book value of $G (after adjustments for tax and transaction costs) was credited to the TCBA. Taxpayer reported gain from the sale of Wave I assets of $H on its Year C federal income tax return.

2. Wave II Asset Sale

[9] Taxpayer owned eight fossil fuel plants in State powered by natural gas as well as hydroelectric, geothermal and nuclear generating assets.

On June 18, Year B, Taxpayer's Board considered a recommendation for the divestiture of Taxpayer's other fossil fuel and geothermal generation assets. The following considerations were cited for recommending divestiture: (1) the mitigation of market power; (2) the establishment of a true market value for the assets that would reduce the financial risk associated with regulatory asset valuation; (3) the maximization of the sales price if the assets were sold to non-regulated entities; (4) the elimination of assets that were expected to be subject to a SPUC-mandated rate-of-return reduction beginning in Year C and (5) the chance to reinvest sale proceeds at a higher rate of return.

In June Year B, Taxpayer announced the divesture of three additional fossil fuel plants. Taxpayer filed an application on January 14, Year C, as amended on July 17, Year C, to sell three fossil fuel plants known as "Wave II assets" through a competitive open auction process.

On April 1, Year D, SPUC approved the sale. Taxpayer sold the Wave II assets to Buyer 2 for $J. As before with the Wave I asset sale, net proceeds were credited to the TCBA. On its Year D federal income tax return, Taxpayer reported gain of $K from Wave II asset sales.
In summary, Taxpayer's recovery of its transition costs was accelerated and facilitated by the RRB transaction, the CTCs received during Year C and Year D, and the proceeds from asset sales. [10]

[10] Subsequent events after the tax years at issue impacted Taxpayer's recovery of CTC revenue. In the summer of Year E, wholesale electricity prices in State skyrocketed and there was no positive balance in the TRA. Taxpayer incurred huge debt buying electricity through the PX. The Legislature passed Act 2 in January, Year F, in response to the power crisis, amending several provisions of the Act. SPUC granted the utilities emergency rate relief in the form of surcharges. However, SPUC rejected Taxpayer's contention that the rate freeze ended in August, Year E, because it recovered all transition costs and continued to interpret the Act as requiring a rate freeze and no recovery of costs beyond the rate freeze period. In an Accounting Decision, SPUC modified the way the TCBA and TRA account balances were calculated. Shortly thereafter on April 6, Year F, Taxpayer filed for bankruptcy under Chapter 11. While Taxpayer was in bankruptcy, the State Supreme Court interpreted Act 2 as restoring SPUC's authority for cost of service ratemaking and found that recovery was no longer limited to the transition period. As noted by that Court, the true amount of transition costs could not be determined because retained generation assets were not market valued. Based on this decision, SPUC found it had authority to allow Taxpayer's recovery of its TCBA balance (which now reflected transition and power costs) after the rate-freeze period and entered into a settlement allowing such recovery. The Bankruptcy Court approved the settlement, Taxpayer agreed to dismiss the pending rate recovery litigation pursuant to the settlement, and Taxpayer emerged from bankruptcy.

Taxpayer's Taking Claims

1. Claims Before SPUC and the Federal and State Courts

On February 13, Year A, Taxpayer filed an application before SPUC for rehearing of the Decision. In the application, Taxpayer asserted that the provisions concerning the CTC resulted in an economic taking and that the provisions requiring transfer of control of its transmission grid to the ISO constituted a physical taking.

With respect to the CTC provisions, Taxpayer asserted that: (1) limiting the recovery of the CTC to the transition period could result in a confiscatory taking; (2) limiting the recovery of various fossil fuel plant costs (fixed operating costs and post-transition incremental capital costs) was inadequate; and (3) reducing the return on equity on fossil generating assets to a rate 10 percent below the long term debt rate was a taking. With respect to the ISO provisions, Taxpayer asserted that the ISO framework required physical access to and integration with its transmission system, a physical invasion constituting a per se taking. SPUC rejected Taxpayer's taking claims on the merits and as moot in light of the passage of the Act.

Although Taxpayer raised taking claims based on deregulation in federal and state courts, these claims were apparently not addressed by the courts on the merits.[11]

2. Claims before the Internal Revenue Service

Taxpayer stated that the CTC income and asset sale gains for Year C and Year D were directly attributable to the taking of its franchise to supply power within its designated service territory. According to Taxpayer, there was a taking of its franchise because the State and SPUC: (1) "terminated its monopoly franchise to supply power within its designated service territory (allowing 'open access' to customers)"; (2) required it to turn over control of its transmission grid to the ISO; (3) ordered it to file a plan to divest one-half of its fossil-fuel generation assets; and (4) imposed conditions on its retention of non-nuclear generation, including a showing of no undue competitive advantage. Furthermore, Taxpayer stated that SPUC reduced Taxpayer's rate of return for its generation assets and put its cost of capital improvements at risk. According to

---

[11] In Year E and Year F, Taxpayer brought actions against SPUC in federal court alleging takings. The gist of Taxpayer's takings claims were based on SPUC's interpretation of the Act as precluding it from recovering in retail rates the full cost of its wholesale power and interstate transmission costs during or after the transition period. The federal court dismissed taxpayer's complaint without prejudice on May 2, Year F, on the ground that the claims were not yet ripe for review as SPUC orders were not yet final. In its order, the court noted that the state appellate and Supreme Court denied Taxpayer's petition for review of the SPUC decision denying Taxpayer's Application for Rehearing on an SPUC decision. (In that decision, SPUC found that the Act prohibited the carryover of TRA under-collection past the end of the rate freeze period.) Pursuant to the bankruptcy proceeding in which the bankruptcy court approved Taxpayer's settlement with SPUC, Taxpayer agreed to dismiss the pending rate recovery litigation.

Taxpayer, these and other actions set forth in its Claims effectively precluded Taxpayer from being an efficient owner of its generating facilities during the transition period.

Identification of Replacement Property

In Part 1 of its two Claims for Refund (pertaining to sales of power plants), Taxpayer identified its replacement property as assets used in the transmission and distribution of electricity for sale in Taxpayer's market territory. Taxpayer's identified replacement property in the claims was purchased prior to its making elections pursuant to § 1033. In Part 2 of its two Claims for Refund (pertaining to CTC income), Taxpayer identified its replacement property as assets used in its regulated energy businesses in its market territory.

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 asserted. Therefore, 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 or other property was received for the asserted 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 converted property.

Issue One: Were Taxpayer's franchise rights, access easements, and power plants, involuntarily converted 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 Fifth 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 Fifth Amendment provides, in part, that no "private property be taken for public use without just compensation."

Fifth Amendment takings commonly occur in three forms.[12] The first is a per se taking, where the government physically 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 a "franchise" is intangible property and the power plants were sold by Taxpayer to third parties rather than condemned as hereafter discussed. However, a per se taking may be relevant for consideration of the taking of "access easements" asserted 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*, 488 U.S. 299 (1989). 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.[13]

The third common form of government taking (referred to variously as "inverse condemnation" or "regulatory taking") is 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 unsuccessfully alleged that

---

[12] Other forms of governmental taking may indeed occur; but for purposes of analyzing the issues presented in this memo, the three discussed herein are sufficient.

[13] *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 currently taxable as such); *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); and Rev. Rul. 57-261, 1957-1 C.B. 262 (rent payments by the city and pursuant to a lease arrangement were taxable as ordinary income although the forced lease amounted to a condemnation). *See also* § 1.1033(a)-2(c)(8) of the Income Tax Regulations (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).

government regulation had effectively reduced the value of property to such an extent that the property was "taken" by the regulation.

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

Under its prior system of utility regulation, State granted licenses to IOUs to provide electrical services within specific geographical areas. These utilities *were* allowed to be monopolies. However, the IOUs had no vested right to be monopolies. Rather, such rights are within the province of government. State governments have lawful police power to regulate industries and commerce, and to determine whether it is best for a given business to operate in a monopolistic 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, acting for the greater public good. *See, e.g., Mugler v. Kansas*, 123 U.S. 627 (1887). Pursuant to this authority, 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; Rev. Rul. 57-314, 1957-2 C.B. 523); 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*; and SEC orders (*American Natural Gas Co. v. United States, supra*. Yet, these acts and limitations 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.[14]

In the present case, it is evident that deregulation of the electric utility industry in State is intended to promote the common public good. SPUC 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 some ability to generate power on a competitive basis. In addition, the legislation created new rights. Before the institution of deregulation,

[14] Taxpayer claims that qualified takings for § 1033 purposes are not limited to takings requiring compensation under the Fifth Amendment. It argues that even a taking pursuant to the exercise of police power by the government would, if compensated, be eligible for deferral under this provision. However, it cites no substantial authority, statutory, judicial or administrative to support this point, and we know of none. On the other hand, the Service has specifically stated that the type of taking that constitutes a condemnation for § 1033 purposes involves a public taking for public use, which is the hallmark of a Fifth Amendment taking. *See* Rev. Rul. 58-11. *See also* Rev. Rul. 82-147, 1982-2 C.B. 190 (defining condemnation for § 1033 purposes as the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation).

Taxpayer was permitted only to earn a rate of return for its investors as allowed by SPUC 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.

Historically, public utilities are heavily regulated industries. As such, their expectations to operate free of government interference or intervention are limited.[15] 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) (upholding regulatory imposition of liability on pension plan sponsor); *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 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)).[16]

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, or 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.[17] Absent a

---

[15] *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."

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

[17] 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).

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 SPUC'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 for the public benefit. Such an exercise, without more, cannot constitute an involuntary conversion unless the government has overstepped its legal bounds in the exercise of its police power.

In relation to Taxpayer's theory that its franchise was converted, the analysis presented in the *Penn Central* case is the most helpful because there was neither a physical nor a per se (Duquesne-like) taking of the franchise. To determine whether a government regulation is to be treated as tantamount to a physical taking, *Penn Central* sets three criteria: 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.

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).

As to the second factor, Taxpayer asserts that its "franchise rights" were adversely affected. However, we believe this diminution in the value of the property factor is of limited relevance when, as in the present case, Taxpayer had no right or expectation of a continuation of the regulatory ratemaking system. 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. Taxpayer had 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 franchise, 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, had very limited expectations that State would not interfere with its structure and operations, apart from being guaranteed a reasonable rate of return. Moreover, the allowance of transition cost recovery minimized the degree of such interference.

To the contrary, Taxpayer argues that it has suffered an involuntary conversion of its 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" of the Fifth Amendment.

We disagree. 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 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." *Id.*

The Court's reasoning in *Verizon* is applicable here because the 1996 Telecom Act, like the Act, is a deregulatory statute seeking to promote 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 forever. 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 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*.

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 for boats 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.

We do not, however, believe that Rev. Rul. 82-147 is analogous to this case. The taxpayer in the revenue ruling held a property interest allowing it to operate in a profitable business free from regulatory restriction until legislation made the 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. However, regulations (including those of the electrical utility industry) are subject to change. Unlike the taxpayer described in the revenue ruling, this susceptibility to regulatory modification of Taxpayer's business, both before and after the Act, was an intrinsic aspect of the business climate in which it operated. Thus, Taxpayer had neither legal basis nor factual justification for assuming that the regulatory scheme of its industry was or ever would be static, or that a change in the regulatory structure affecting it economically would entitle it to compensation.

In summary, none of the three *Penn Central* factors apply to suggest that a regulatory taking occurred in this case. We disagree with Taxpayer's position that it owned a franchise right or that any such right, if one did exist, was "requisitioned" or "condemned."

3. Takings Law Applied to the Sale of Six Power Plants

Taxpayer contends that both the Act and SPUC's orders implementing deregulation have 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 six power plants may be deferred pursuant to its § 1033 election.

As discussed above, State considered the divestiture of some generation assets necessary to encourage competition in the electric utility industry. SPUC's goal was to limit Taxpayer's market power and its ability to unduly influence the price of electric 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 all weigh against the argument that the disposition of the six power plants was involuntary.

First, while SPUC 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, SPUC 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 SPUC required Taxpayer to submit a plan to voluntarily divest at least 50 percent of its fossil fuel assets, Taxpayer sold more than 90 percent of its fossil fuel generating capacity, a response that far exceeded the SPUC'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 the power plants. Further, Taxpayer had many business reasons for the sale and, as a result, sold six of its fossil fuel generation plants.

As an alternative theory for its position that § 1033 applies in the present case, Taxpayer posits that the power plants were 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. *See, e.g., 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 any of Taxpayer's power plants. 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. These facts and circumstances, however, do not rise to the level of a threat or imminence of condemnation for purposes of § 1033.

An additional theory for claiming that gain from the sale of the power plants may be deferred under § 1033 is that the fossil fuel generation assets and the property rights in Taxpayer's franchise were part of the same economic unit. *Masser v. Commissioner*, 30 T.C. 741 (1958). 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.[18] However, we do not accept the economic unit theory as applicable in the present case because, as discussed above, Taxpayer had no property interest in any condemned franchise.

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

Pursuant to the Act, Taxpayer continued to own its transmission system but transferred control of the system to the ISO. This transfer was made to ensure equal access to transmission lines. One source describes the ISO 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 SPUC in the Decision, transfer of control to the ISO was necessary to lessen the potential of the IOUs favoring their own generation facilities in providing transmission access over facilities owned by others, while at the same time preserving reliability and reducing costs.

SPUC rejected the contention that the mandate of access to the transmission system and transfer of control to the ISO constituted a physical taking. Rather, SPUC determined that its actions were the legitimate exercise 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 IOUs 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.

[18] 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.

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 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 physical taking. *Loretto,* 458 U.S. 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.,* 187 F.3d at 1328-29.

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 copper wire loops to connect the customer to Qwest's switching office. These 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 public utilities commission, required Qwest to allow interconnection to its network. There was a bargain involved in this requirement, 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 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.[19]

[19] In addition, state courts have considered other 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

Based on the analysis in *Qwest*, there was no per se or physical 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 Fifth Amendment taking (nor any other form of involuntary conversion) for § 1033 purposes. Increased rates would ensure reasonable compensation for power and services provided.

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

Taxpayer takes the position that the CTCs it received were compensation for its involuntarily converted property, and may be deferred as gain under § 1033. 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 not operative until the taxpayer:

(1) 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; and

(2) makes an election to defer gain from such compensation.

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).

N.W.2d 126 (Mich. Sup. Ct. 1999) (distinguishing a public utility from a private landlord and noting that the 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.

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. 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 it can demonstrate that the CTCs represent compensation for a taking of its property.

Effectively, CTCs were a charge to ratepayers that enabled Taxpayer to accelerate the amortization of generation assets. This charge to ratepayers was part of the rate structure prior to deregulation and was based on a slower amortization rate (one that exceeded 20 years, compared to the four-year transition period). 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. Also the rates they paid during the transition period remained at a static level.

The question whether the CTCs were intended to compensate Taxpayer for a taking of its franchise 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 SPUC 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 SPUC 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 and related contracts. 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 right to provide power within specific geographic areas, the ability to recover invested capital and a return thereon through rates is distinct from right to provide power.

Taxpayer's characterization of the CTCs as compensation for the taking of a 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 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 franchise right would actually have a negative value, because the utility could earn more money in a deregulated environment.[20] Even so, the utility would still be entitled to recover transition costs on its uneconomic asset according to State's deregulation plan.

The amount Taxpayer was able to recover as CTCs was not based on the value of Taxpayer's franchise 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. 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. In theory, the CTC mechanism enabled recovery of these same costs on an accelerated basis, with the expectation that they would be completely paid off. Once paid, Taxpayer would be permitted 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 an ancillary argument for treating CTCs as proceeds for an involuntary conversion, Taxpayer observes that the CTCs were not simply "rates" in the traditional sense, but were "non-bypassable" charges specifically tracked by the utility and itemized on bills. Unlike traditional rates for Taxpayer's generation, transmission and distribution services, the CTCs applied to consumers of electricity as of December 25 of Year 3, regardless of whether they used Taxpayer's services. This meant that even consumers who switched to another supplier, or consumers who were never Taxpayer's customers, would still pay CTCs allocable to Taxpayer if they reside in an area served by Taxpayer as of

[20] Taxpayer's characterization of deregulation as a taking of its franchise right or any of its other property does not consider the rights it gained through deregulation, namely the right to earn a rate of return higher that that previously allowed by SPUC.

December 25 of Year 3. Taxpayer states that this factor "*clearly* demonstrates that this was no traditional ratemaking recovery but qualified as a state-mandated form of compensation for a state-mandated taking under [§] 1033." [Emphasis added]. However, such a conclusion does not naturally follow from that premise. While it is accurate that the CTCs were non-bypassable, the fact remains that CTCs were designated to provide the opportunity for IOUs to recover what had been previously recovered in rates – the amortization of generation assets plus a reasonable return on investment -- at an accelerated pace.

Thus, we do not accept Taxpayer's argument that the CTCs which were, prior to deregulation, part of the rate charged to ratepayers and included in ordinary income are now, following deregulation, part of the rate charged to ratepayers but somehow a capital item received as compensation for an alleged taking of Taxpayer's property. 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. Accordingly, even assuming that Taxpayer could show that a taking of its franchise rights occurred, Taxpayer is not eligible to defer gain recognition for the CTCs under § 1033 because the CTCs are not compensation for the taking of a franchise.[21]

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

Section 1033(a)(2) provides, in part, that replacement property must be acquired "for the purpose of replacing the property so [involuntarily] converted." *See also* § 1.1033(a)-2(c)(1). Accordingly, where a taxpayer's election or non-election demonstrates that at the time it purchased the property it did not do so with the specific intention of replacing converted property, the asset does not qualify as a replacement asset. Whether a taxpayer has the requisite intent to replace at the time of purchase is a factual question. *Feinberg v. Commissioner*, 377 F.2d 21, 28 (8th Cir. 1967), *aff'g* 45 T.C. 635 (1966).

In *Feinberg*, the petitioner purchased one of five alleged replacement properties in 1953, after the threat of condemnation had occurred. However, when the petitioner received condemnation proceeds in 1957, he did not make a § 1033 election and did

[21] This rationale, is not applicable to amounts received for the alleged conversion of the six power plants. Such proceeds were derived directly from the disposition of property. Thus, if the six power plants were involuntarily converted, the amounts received from the sale are, to the extent they exceed the basis of the property sold, capital gains subject to deferral under § 1033. However, the remaining CTC derived directly from ratepayers are not so connected. Additionally, State's public utility code indicates that Taxpayer (along with other IOUs 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. This statement is still another reason for our position that the CTCs are not compensation for a taking of Taxpayer's property.

not reduce the basis of the alleged replacement property purchased in 1953. He included the gain realized from the condemnation proceeds in income in 1958. The petitioner later filed an amended 1958 return and made a § 1033 election, but still failed to reduce the basis of the claimed replacement real estate. In addition, his identification of the replacement properties varied from a list of three, to a later list of thirteen during the examination process, to his final list of five. Based on these factors, the Tax Court found that the petitioner did not really intend the acquired property to be replacement property at the time of purchase. In holding that the property purchased by the petitioner did not qualify as replacement property, 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!"

45 T.C. at 642.

In the present case, Taxpayer claims that it purchased replacement assets as follows:

- For the Year C asset sale proceeds, the proposed replacement property was purchased in Year E.
- For the Year C CTC proceeds, the proposed replacement property was purchased in Year C and Year D.
- For the Year D asset sale proceeds, the proposed replacement property was purchased in Year E and Year F.
- For the Year D CTC proceeds, the proposed replacement property was purchased in Year D and Year E.

As to the proceeds received in Year C for the asserted conversion, Taxpayer recognized the "proceeds" as income, did not elect deferral of gain under § 1033, and did not reduce the basis of the asserted replacement assets it purchased in Year C on its Year C return. Nor did it reduce the basis of asserted replacement assets on its Year D return. When Taxpayer made an election in December Year E, it may have formed the intent that property purchased in Year E be replacement property. Under *Feinberg*, the fact that Taxpayer's election was not made until late Year E may be considered an indication that it did not have the intent to make the election in Year C when funds were first received or in Year D. It also indicates that the claimed replacement property acquired in Year C and Year D was not acquired with the intent that it be replacement property.

Similarly, as to the proceeds received in Year D for the asserted conversion, Taxpayer recognized the "proceeds" as income, failed to elect deferral of gain under § 1033, and failed to reduce the basis of assets it purchased in Year D on its Year D return. Nor did it reduce the basis of these assets on its Year E return. When Taxpayer made the

election in December, Year F, it may have intended that the property purchased in that year be replacement property. However, under *Feinberg*, Taxpayer lacked the requisite intent as to property purchased in Year D and Year E.

Taxpayer cites *S. H. Kress & Co. v. Commissioner*, 40 T.C. 142 (1963), for the proposition that a failure of a taxpayer to disclose, in the year of acquisition, its intent to use the newly acquired property as replacement property will not invalidate a subsequent § 1033 election. In *Kress*, the threat of condemnation occurred in 1952, replacement properties were purchased between 1953 and 1958, and the conversion sale actually occurred in 1955. However, in that case the Commissioner based its position of lack of intent on the fact that the taxpayer was in an expansion mode and would have acquired the properties listed as replacement properties regardless of the conversion. The court rejected this argument by observing that the fulfillment of its expansion plans necessitates that taxpayer also acquire new property to replace property taken by involuntary conversion.

Kress is easily distinguished from the present case because, in the present case, expansion plans do not form the basis for our position that § 1033 does not apply. Rather, our position is that Taxpayer did not acquire the property it now claims to be replacement property with the intent of using such property as replacement property for involuntarily converted property. Taxpayer's lack of intent is demonstrated by Taxpayer's return position recognizing gain, notwithstanding the acquisition of the purported replacement property, and failure to reduce basis on such property.

Although a taxpayer can retroactively make a § 1033 election and purchase replacement assets at some future time within the replacement period, a taxpayer cannot, as *Feinberg* shows, retroactively form the intent as to assets already purchased. Notwithstanding Taxpayer's self-serving, after-the-fact claims to the contrary, all the facts we have reviewed indicate a lack of the requisite intent to purchase replacement property.[22] Without more, the facts presented so far seem to weigh against Taxpayer's claims as to its intent. Accordingly, assets purchased in Year C and Year D as to the Year C claim, and in Year D and Year E as to the Year D claim, are not replacement assets because Taxpayer lacked the requisite intent at the time of purchase.[23]

---

[22] Taxpayer explains that it acquired the property listed for the purpose of replacing the converted property, but did not commit itself to this position on the original returns for the years at issue because of concern about possible liability for interest and penalties if the election was rejected by the Service.

[23] In its brief, Taxpayer argues that any taxpayer will be considered to have acquired replacement property for the purpose of replacement of converted assets so long as both the election and the acquisition of qualified replacement assets occur within the replacement period. We simply find no support for this claim. Indeed, if Taxpayer's theory is correct, there would be no need for the clause in the statute specifying that the property be acquired for the purpose of replacing the converted property. Further, if Taxpayer is correct, then the taxpayer in *Feinberg* would have prevailed.

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 or easements to its transmission system, and six power plants. A franchise is intangible property. The access easements are generally considered to be real property for state law purposes (and also for § 1033 purposes). The power plants are likely a combination of real and personal property consisting of multiple assets. Most of the properties identified as replacement property consist of distribution and transmission assets including land and personal property. For the asserted conversion of its franchise and access easements, Taxpayer also identified (as replacement property) power generation assets (including fossil fuel, steam, geothermal, hydro and nuclear power assets), communications equipment, computers, data handling equipment, furniture, transportation equipment, software, fixtures, gas transmission and distribution assets (including pipelines and storage) and land, in addition to electrical power distribution and transmission assets. All of these properties were placed in service between Year C through Year F.

Section 1033(a)(2) provides that property will qualify as replacement property if it is similar or related in service or use to the property so converted. Section 1033(g)(1) provides that 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, 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. All property at issue in this case is Taxpayer's trade or business property rather than investment property. Therefore, the more rigorous test of functional similarity, physical characteristics and end uses set forth in Rev. Rul. 56-347 applies.

Taxpayer seems to argue, however, 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. To bolster its argument, Taxpayer points out that § 1033 is a relief provision to be liberally construed to effectuate its purpose. It further argues 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 leased agricultural lands and 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 converted lands and fisheries and the replacement industrial park were investment properties leased to tenants rather than trade or business properties. The replacement property had relevant similarities to the converted properties, such as similar management demands and similar business risks. In the present case, the converted and replacement properties were business-use properties rather than investment properties. Thus, we believe that *Davis* is distinguishable.

With respect to Taxpayer's intangible franchise rights, replacement properties consisting of power lines and other tangible business assets that Taxpayer purchased do not meet the "similar or related in service or use" test. There are no matching functional similarities, physical characteristics or end uses. But, even if we applied Rev. Rul. 64-237 and *Davis* (and it is our position that they do not apply), there would still be no match. 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. The fact that replacement franchises were not available for reinvestment does not change this conclusion.

The taxpayer in *Maloof v. Commissioner*, 65 T.C. 263, 271-272 (1975), made an argument similar to that of Taxpayer when it cited an alleged difficulty of compliance due to advancing technology, making a former mode of operation impractical. In *Maloof*, the taxpayer was seeking to change its investment from inventory to fixed (manufacturing) assets because it was impractical to resume its former export/import merchandising enterprise. However, the Tax Court found that such circumstances do not override the plain requirements of § 1033 or make them inapplicable. Section 1033 requires a reasonable degree of continuity in the nature of the assets and the general character of the business. *See Maloof* at 271. Therefore, we do not accept Taxpayer's argument that it met this particular requirement of § 1033 because no similar or related in service or use property was available. Instead, we conclude that no replacement property acquired by Taxpayer is similar or related in service or use to the asserted franchise.

To the extent the power plants are real property, they 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). However, to the extent replacement assets consisted of personal property not connected with underlying real property (*i.e.*, components of nuclear, hydro, geothermal, or steam generation

plants, or components of transmission and distribution systems, structures, power lines, towers, poles, streetlights, etc., not connected as fixtures or land improvements), then the properties designated to replace the power plants are 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).

Similarly, there is no evident basis for Taxpayer's assertion that the purported replacement transmission and distribution assets are similar or related in service or use to the power plants, whether compared on the basis of functional similarity, physical characteristics or end uses. We do not believe that an entire operating fossil fuel power generation 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 transmission and distribution assets. 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 the access easements are real property under state law and if such easements were converted (and we still maintain as stated above that they were not 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. As stated previously, in the present case the purported replacement property consists primarily of electric transmission and distribution property, gas transmission and distribution property, and power generation assets.

Transmission and distribution are considered separate parts of a utility's business (or separate businesses entirely) 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 like-kind replacement property for access easements over transmission lines for purposes of § 1033(g).

Therefore, some of the property purchased by Taxpayer to replace 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, most of the purported replacement property for the asserted franchise or for the power plants does not qualify as replacement property for purposes of § 1033.

Granted, as Taxpayer asserts, § 1033 is a relief provision entitled to liberal and realistic construction. Taking this assertion one step further, Taxpayer also argues that any new investment in capital assets related to its business is close enough as a continuation of its old investment. However, application of the "relief provision" doctrine does not stretch § 1033 so far as to permit Taxpayer to "materially alter its type of business." *Maloof at* 270. There are limits to the extent change of investment is countenanced under § 1033. We think that Taxpayer exceeded those limits for many of the acquired properties proposed as replacement properties.[24]

V. SUMMARY AND CONCLUSION

In summary, it is our position that Taxpayer's claims under § 1033 must be denied because no involuntary conversion occurred meeting the requirements for deferral. No taking of Taxpayer's asserted franchise or access easements occurred because State acted within its police power to further the well-being of State's ratepayers by deregulation of the electrical utility industry. In addition, no taking occurred with respect to the six power plants.

Moreover, even if a taking occurred with respect to franchise rights, the CTCs received by Taxpayer were not compensation for the taking. The CTCs represent accelerated cost recovery for generation assets and supply contracts in order to implement State's deregulation plan, not compensation for a taking.

Also, the purported replacement property was not acquired with the intent to replace converted property, with the possible exception of property acquired in Year E and Year

[24] Taxpayer's submissions also argue against application of the prerequisites for § 1033 deferral because to do so would merely burden consumer ratepayers with the costs of "accelerated tax liabilities", which Taxpayer would simply pass along to them, thus frustrating State's policy objectives for instituting deregulation. However, even if this were true, we are not permitted to set aside federal statutory requirements for tax relief or to promulgate relief beyond what the statute provides to further the policy objectives of a state.

F, the years in which the elections for the tax years at issue (Year C and Year D) were first made.

With respect to whether the purported replacement property was like-kind or similar or related in service or use to the converted property, we have determined that (1) none of the asserted replacement property was similar in service or use to the franchise; (2) only like-kind real property components of transmission and distribution assets qualify as valid replacement of the real property components of the power plants; and (3) the property acquired to replace access easements may constitute property of like kind or similar or related in service or use.

CAVEAT(S):

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