INTERNAL REVENUE SERVICE
Index No.: 351.00-00
751.00-00
Number: **199903013**
Release Date:1/22/1999

CC:DOM:P&SI:1 - PLR-112598-98
October 22, 1998

LEGEND

Father =

Children =

Trusts =

Newco =

X =

Y =

Z =

Q =

R =

T =

U =

V =

PRS1 =

PRS2 =

PRS3 =

PRS4 =

PRS5 =

PRS6 =

PRS7 =

PRS8 =

PRS9 =

Sub1 =

Sub2 =

x% =

y% =

z% =

q% =

r% =

t% =

u% =

v% =

w% =

$x =

$y =

Utility1 =

Utility2 =

State1 =

State2 =

State3 =

State4 =

Country =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

Date6 =

Date7 =

Date8 =

Month1 =

Month2 =

Underwriter =

Dear :

This letter responds to a letter dated June 11, 1998, and prior correspondence submitted on behalf of PRS1 and requesting rulings under various sections of the Internal Revenue Code.

FACTS

You have represented that the facts are as follows. PRS1 is a State1 general partnership formed on Date1. PRS1's general partners are A, B, C, D, E, and F. PRS1 holds an x% limited partnership interest in PRS2, a State1 limited partnership formed on Date2 pursuant to an agreement between PRS1 as the limited partner and X as the general partner. X is a State1 corporation with no relationship to PRS1 or any partner of PRS1. The outstanding stock of X is owned by Family. Family includes Father, Children, and Trusts, which were set up by Father for Children and other of his offspring.

PRS2 is the sole general partner of PRS3, a State2 limited partnership formed on Date3. PRS3's sole limited partner is a trust company acting as trustee for a trust having no relationship to PRS1 or any of its partners.

PRS1 also holds an x% limited partnership interest in PRS4, a State2 limited partnership. PRS4 was formed on Date4 pursuant

to an agreement between PRS1 as limited partner and Y, a corporation with no relationship to PRS1 or any of its partners, as the general partner. PRS4 is the sole general partner of PRS5, a State2 limited partnership formed on Date5. PRS5's sole limited partner is a publicly held corporation with no other relationship to PRS1 or any of PRS1's partners.

The partners of PRS1 directly or indirectly own y% of the capital stock of Z, a State1 corporation. Z's principal assets is all of the capital stock of Q, a State2 corporation. Q's principal asset is a z% interest in PRS6, a State3 general partnership formed on Date6. PRS6's other partners are partnerships or corporation with no other relationship to PRS1 or any of PRS1's partners.

PRS1 also holds an x% limited partnership interest in PRS7, a State2 limited partnership. Family owns the remaining limited partnership interest. R, an S corporation incorporated in State1 and wholly-owned by Family, holds the q% general partnership interest. PRS7 owns all of the stock of U, a Country corporation electing to be taxed under § 953(d) as a domestic corporation for U.S. tax purposes.

PRS1 holds an r% limited partnership interest in PRS8, a State2 limited partnership. Family owns the remaining limited partnership interest. T, an S corporation incorporated in State1 and wholly-owned by Family, holds the q% general partnership interest. PRS8 owns a t% preferred limited partnership interest in PRS9, a partnership engaged in the cogeneration business. U, an S corporation incorporated in State1 and wholly-owned by Family, holds a q% preferred general partnership interest in PRS9. The remaining general and limited partnership interests are held by unrelated third parties.

Each of PRS3, PRS5, and PRS6 were formed to design, construct, own, and operate a combined cycle cogeneration power plant that produces electric power and steam. The electric power produced by the PRS3 plant is provided to Utility1 pursuant to a power purchase agreement (PPA1) dated Date 1. The electric power produced by the PRS5 plant is provided to Utility2 pursuant to a power purchase agreement (PPA2) dated Date 7.

PPA1 was entered into pursuant to the Public Utility Regulatory Policies Act of 1978 (PURPA) and State4's implementation thereof. PPA2 was entered into pursuant to PURPA and State3's implementation thereof. PURPA generally requires electric utilities to purchase power from qualifying cogeneration facilities unless the purchase would result in greater costs for the utility than if the utility itself had generated the power.

The base term of PPA1 is 25 years from the date of commencement of commercial operations, which occurred in Month1. PPA1 requires Utility1 to make certain payments to PRS3 in exchange for access to the capacity and electric output of the plant up to a certain number of megawatts.

The payments made by Utility1 consist of both variable and fixed portions. The fixed payments consist of the fixed component payment and the O & M component payments. The fixed payments are not based on the plant's variable operating costs. Instead, they are based on the formulas mentioned above. The fixed payments approximate the fixed costs of constructing, operating, and maintaining an electric generating plant that Utility1 was able to avoid by contracting with PRS3.

The base term of the PPA2 is 20 years from the date of commencement of commercial operations, which occurred in Month2. PPA2 requires Utility2 to make certain payments to PRS5 in exchange for exclusive access to all of the electricity the plant is capable of producing (subject to certain seasonal capacity limitations).

The payments made by Utility2 consist of both variable and fixed portions. The Fuel Component portion of the Monthly Energy Charge is the variable portion of the payment. It is a charge per kilowatt-hour delivered to Utility2 that will vary monthly depending upon the market cost of fuel.

The fixed payment consists of the fixed component portion of the Monthly Energy Charge, the GNP Deflator Component portion of the Monthly Energy Charge, and the Monthly Capacity Charge. The fixed component portion of the Monthly Energy Charge is equal to two cents per kilowatt-hour delivered to Utility2, and will remain unchanged over the 20 year term of PPA2. The GNP Deflator Component portion is a fixed formula payment based on an amount per kilowatt-hour delivered. The amount is adjusted annually based on a government-produced deflator number. The Monthly Capacity Charge consists of a seasonal fixed payment per kilowatt-hour delivered during certain months of the year. This payment increases by 5% per year.

The fixed payments are not based on the plant's variable operating costs. Instead, they are based on the formulas described above. The fixed payments approximate the fixed costs of constructing, operating, and maintaining an electric generating plant that Utility2 was able to avoid by contracting with PRS5.

Due to changes in the marketplace, utilities are no longer entering into long-term contracts that provide for payments like the fixed payments. As a result, the payments required under

PPA1 and PPA2 are substantially in excess of the current market value of electricity, thereby resulting in an above market value for both PPAs.

The partners of PRS1, Family, and the other shareholders of Z, would like to obtain access to public debt and equity markets to maximize current opportunities existing in the power generation business. Therefore, the owners propose to combine, directly or indirectly, the ownership of the cogeneration business in a new corporation ("Newco) in conjunction with a public offering of securities of Newco (the "Secondary Public Offering" or "SPO"). Accordingly, the following transaction has been proposed:

(i) Family and PRS1 will form Newco in exchange for u% and x% of the shares of Newco common stock, respectively. Newco was formed prior to the Closing solely to permit registration of its common stock with the Securities and Exchange Commission, to enable it to acquire all of the outstanding stock of X at the Closing, and to engage in other transactions as described herein. Except for activities incident to these actions, prior to the Closing Newco will have no activities and will carry on no business.

(ii) Family will enter into an agreement with Newco to transfer 100 percent of the stock of Y to Newco in exchange for shares of the common stock of Newco plus cash of approximately $1 million (Sale1).

(iii) Family and Newco will agree to make a § 338(h)(10) election with respect to the transfer of the Y stock to Newco.

(iv) PRS1 will enter into an agreement to transfer its x% partnership interest in PRS4 to Newco in exchange for shares of the common stock of Newco (Exchange1).

(v) X and PRS1 will enter into an agreement with Newco to transfer slightly less than 50 percent of their respective u% and x% partnership interests in PRS2 to Newco in exchange for shares of common stock of Newco (Exchange2).

(vi) Simultaneously with entering into their agreements to make these transfers to Newco, Family, X, and PRS1 will enter into a firm commitment underwriting agreement (the "Underwriting Agreement") with Underwriter as the lead managing underwriter of the SPO pursuant to which Family, X, and PRS1 will sell a substantial portion of

the Newco shares they will receive in Sale1, Exchange1, and Exchange2 in a SPO of such shares. There will be no initial public offering ("IPO") of Newco stock. That is, Newco itself will offer no shares of Newco stock to the public. The only Newco shares offered to the public will be the Newco shares offered through the SPO. The Underwriting Agreement will require Family, X, and PRS1 to sell a sufficient number of Newco shares so that, immediately after the SPO, (i) Family, X, and PRS1, along with PRS7 and I (both described and discussed below) will own, in the aggregate, significantly less than 80 percent of the total combined voting power of all classes of stock entitled to vote and 80 percent of the total number of shares of all other classes of stock of Newco and (ii) Family, X, PRS7, and I will own, in the aggregate, significantly less than 50 percent of the total combined voting power of all classes of stock entitled to vote and 50 percent of the total value of shares of all classes of stock of Newco (the "Committed Shares").

(vii) Family will transfer all of the stock of Y (and PRS1 will transfer all of its partnership interest in PRS4) to Newco. Family, X, PRS1, and Newco will then close Sale1, Exchange1, and Exchange2 (the "Closing"). Newco will contribute the stock of Y to a newly formed single member limited liability company. Newco will also transfer PRS1's partnership interest in PRS4 to a wholly-owned subsidiary of Newco.

(viii) Concurrently with the Closing, the shareholders of Z will cause Z to merge pursuant to state law with a subsidiary of Newco solely in exchange for Newco stock (the "Z Merger").

(ix) Immediately after the Closing and the Z Merger, Family, X, and PRS1 will sell the Committed Shares in the SPO pursuant to the terms of the Underwriting Agreement.

(x) The interests of X and PRS1 remaining in PRS2 following Exchange2 will be redeemed by PRS2 (Redemption1) in consideration of a distribution to X and PRS1 of PRS2's note receivable from PRS7 and cash in an amount equal to the excess of the value of the redeemed partnership interests over the value of the distributed note receivable.

As part of the consolidation of the cogeneration business, Family and PRS1 will enter into the following related transactions. These transactions essentially consist of transfers of interests in various entities to Newco.

Family also owns 100 percent of the stock of R, an S corporation. R holds a g% general partnership interest in PRS7. The limited partnership interests are held v% and x% by Family and PRS1, respectively. PRS7 holds 100 percent of the stock of V, a Country corporation electing to be taxed under § 953(d) as a domestic corporation for U.S. tax purposes. PRS7 will transfer 100 percent of the stock of V to Newco, either directly or pursuant to a reverse subsidiary merger, solely in exchange for common stock of Newco (the "V Exchange") in a transaction intended to qualify as a non-taxable reorganization under § 368(a).

Family also holds 100 percent of the stock of T, an S corporation. T holds a q% general partnership interest in PRS8, a State3 limited partnership. The limited partnership interests are held w% and r% by Family and PRS1, respectively. PRS8 owns a t% preferred limited partnership interest in PRS9, an operating partnership engaged in the cogeneration business. The remaining limited partnership interests are held by unrelated third parties. T, Family, and PRS1 will transfer their respective partnership interests in PRS8 to Newco in exchange for common stock of Newco. Newco will transfer the general partnership interest in PRS8 to a newly formed subsidiary of Newco, Sub1. Newco will transfer the limited partnership interests in PRS8 to a newly formed subsidiary of Newco, Sub2.

The following representations have also been made in connection with the proposed transaction:

> Pursuant to the Underwriting Agreement, Family, X, and PRS1 will sell a sufficient number of Newco shares so that, immediately after the SPO, (i) Family, X, PRS1, PRS7, and T will own in the aggregate significantly less than 80 percent of the total combined voting power of all classes of stock entitled to vote and 80 percent of the total number of shares of all other classes of stock of Newco and (ii) Family, X, PRS7, and T will own in the aggregate significantly less than 50 percent of the total combined voting power of all classes of stock entitled to vote and 50 percent of the total value of shares of all classes of stock of Newco.

RULINGS REQUESTED

Based on the information submitted and the facts as represented above, you have requested that we rule as follows:

(1) PPA1 and PPA2 are not unrealized receivables for purposes of § 751(a)(1);

(2) PPA1 and PPA2 are not inventory items for purposes of § 751(a)(2); and

(3) Exchange1 and Exchange2 are not transfers described in § 351(a).

LAW AND ANALYSIS

Section 741 provides that gain or loss recognized by a transferor partner upon the sale or exchange of an interest in a partnership is, except as otherwise provided in § 751, gain or loss from the sale or exchange of a capital asset.

Section 751(a) provides that the amount of money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in a partnership attributable to (1) unrealized receivables or (2) inventory items of the partnership is considered an amount realized from the sale or exchange of property other than a capital asset.

Under § 751(b), certain distributions are treated as sales or exchanges. Section 751(b)(1) provides that, to the extent a partner receives a distribution of unrealized receivables or inventory items that have appreciated substantially in value from the partnership in exchange for all or a part of his interest in partnership property, or the partner receives money or other property of the partnership in exchange for his interest in partnership unrealized receivables or substantially appreciated inventory, the transaction may, as provided in regulations, be treated as a sale or exchange. This provision does not apply to a distribution of property that the distributee contributed to the partnership, or to payments to a retiring partner or successor in interest of a deceased partner described in § 736(a).

Section 751(c) defines "unrealized receivables" as including any rights to payment for (1) goods delivered or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered or to be rendered. Both types of rights are unrealized receivables only to the extent not previously includible in income under the partnership's method of accounting.

Section 751(d) provides that the term "inventory items" means property of the partnership of the kind described in § 1221(1) (property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business); any

other property that, on sale or exchange by the partnership, would be considered property other than a capital asset and other than § 1231 property; any other property of the partnership that, if sold or exchanged by the partnership would result in gain taxable under § 1246(a) (relating to gain on foreign investment company stock); and any other property held by the partnership that, if held by the selling or distributee partner, would be considered property of the type described above.

Section 751(f) provides a special rule for tiered partnerships. In determining whether partnership property is § 751 property, a partnership is treated as owning its proportionate share of the property of any other partnership in which it is a partner.

The legislative history accompanying § 751(c) provides that the provisions was enacted "in order to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70 (1954) (house Report); S. Rep. No. 1622, 83d Cong., 2d Sess. 98 (1954) (Senate Report). Further, § 751(c) was "necessary to prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income." House Report at 71; Senate Report at 99.

The definition of unrealized receivable under § 751(c) does not include PPA1 and/or PPA2 because they are both long-term contracts for the sale of goods that confer rights that constitute property and not merely rights to receive future income for goods or services delivered or to be delivered. We reach this conclusion because a direct sale of the contracts by the partnership would be treated as the sale or exchange of property within the meaning of §§ 1221 or 1231.

Section 351(a) generally provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in the transferee corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the transferee corporation. Section 368(c) provides that the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation.

For purposes of nonrecognition treatment under § 351(a), even if stock constituting "control" of the transferee corporation is received by the transferor(s), the requirements of § 351(a) will not be satisfied if, pursuant to a binding agreement entered into prior to the transfer of property to the transferee corporation, the transferor obligates itself to

transfer an amount of stock to a third party (who does not transfer property to the transferee corporation in the transaction) that would cause the transferor no longer to be in control (within the meaning of § 368(c)) of the transferee corporation immediately after the transfer of such stock (the "Binding Commitment Doctrine"). See Hazeltine Corp. v. Commissioner, 89 F.2d 513 (3rd Cir. 1937); Intermountain Lumber, 65 T.C. 1025 (1976); Rev. Rul. 79-70, 1979-1 C.B. 144; and Rev. Rul. 70-522, 1970-2 C.B. 81. The Binding Commitment Doctrine has also been applied outside the § 351 context. See, e.g., Berry Petroleum Company v. Commissioner, 104 T.C. 584 (1995) (involving whether certain assets of a target corporation were business or nonbusiness assets "immediately after" an ownership change of the target corporation for purposes of § 382(l)(4)).

Pursuant to the terms of the Underwriting Agreement, X, Family, and PRS1 will be bound to sell immediately after the Closing a substantial portion of the Newco common stock they receive in such transaction to third parties who will not have also transferred property to Newco. As a result of and after such transfer, (i) Family, X, PRS1, PRS7, and T will own in the aggregate significantly less than 80 percent of the total combined voting power of all classes of stock entitled to vote and 80 percent of the total number of shares of all other classes of stock of Newco and (ii) Family, X, PRS7, and T will own in the aggregate significantly less than 50 percent of the total combined voting power of all classes of stock entitled to vote and 50 percent of the total value of shares of all classes of stock of Newco. Accordingly, X, the Family, and PRS1 will not have the requisite stock ownership needed to be considered in "control" of Newco immediately after the proposed transaction for purposes of § 351(a).

CONCLUSION

Based on the information submitted and the representations made, we have reached three conclusions requested by the taxpayer. These conclusions follow.

(1) The PPA is not an unrealized receivable for purposes of § 751(a)(1).

(2) The PPA is not an inventory item for purposes of § 751(a)(2);

(3) Exchange2 is not a transfer described in § 351(a); and

(4) Exchange2 is not a sale or exchange of property, directly or indirectly, between related persons for purposes of § 1239(a).

Except as shown immediately above, no opinion is rendered regarding the federal income tax effects of any of the transactions described above under other provisions of the Code or regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above rulings.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling letter have not yet been adopted. Therefore, the Service may modify or revoke this letter if temporary or final regulations as adopted are inconsistent with any conclusions herein. See § 11.04 of Rev. Proc. 98-1, 1998-1 I.R.B. 7, 47. However, when the criteria in § 11.05 of Rev. Proc. 98-1 are satisfied, the Service will not revoke or retroactively modify a ruling except in rare or unusual circumstances.

Determination of the taxpayer's liability will be made by the District Director when examining the taxpayer's return. The District Director will consider whether the conclusions stated in the ruling letter are properly reflected in the return, whether the representations upon which the ruling letter was based reflected an accurate statement of the material facts, whether the transaction was carried out substantially as proposed, and whether there has been any change in the law or regulations which applies to the period during which the transaction was consummated.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

DIANNA K. MIOSI
Branch Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures:
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cc: