

**INTERNAL REVENUE SERVICE**  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM  
August 9, 2000

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Index (UIL) No.:1221.00-00; 1222.00-00; 1231.00-00  
CASE MIS No.: TAM-105212-00/CC:ITA:B3

District Director,

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No:  
Years Involved:  
Date of Conference:

LEGEND:

Taxpayer	=
Utility	=
Power Marketer	=
Company	=
State	=
Year 1	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
X units	=
Y units	=
a	=
b	=
c	=
d	=

ISSUE:

What is the character of proceeds received in return for the transfer to a power marketer of a long-term power supply contract with a utility, as part of a larger transaction in which the original contract is cancelled and a new contract entered into between the power marketer and the utility?

**CONCLUSION:**

On these particular facts, the consideration received qualifies as gain from the sale or exchange of property, within the meaning of §§ 1221, 1222, and 1231.

**FACTS:**

Taxpayer, a partnership, was formed to construct and operate a power plant for the generation of electricity. Taxpayer had a lease to operate a power plant owned by Company.

The power plant was a "qualifying small power production facility" (a "QF") under the Public Utility Regulatory Policies Act of 1978 ("PURPA"), P.L. 95-617, 92 Stat. 3117. Under PURPA, public utilities are required to purchase excess power generated by QF's in their area at a price equal to the utility's "avoided cost"; that is, the cost avoided by the utility by substituting power generated by the QF. In general, at the time the contract at issue was entered into, the amounts paid to QF's for power under these statutorily-mandated contracts consisted of (1) energy payments, and (2) capacity payments. Energy payments are based on the costs of producing electricity, such as fuel costs and operating and maintenance expenses, that are avoided by substituting power generated by a QF. Capacity payments are based on generating plant construction costs that are avoided by relying on a QF's generating plant. Capacity payments are made regardless of whether the QF delivers electricity to the utility. The implementation of PURPA created a new class of non-utility generating companies and a significant market for electric power produced by non-utilities.

Taxpayer sold electricity to Utility pursuant to a PURPA power purchase agreement ("PPA 1") dated Date 1. Under the terms of PPA 1, Utility was obligated to purchase the total output of electric energy and capacity of the power plant. The capacity of the power plant is X units. Utility was to pay Taxpayer monthly for dispatched power in an amount made up of an energy payment and a capacity payment. PPA 1 was terminable by Utility on Date 5, resulting in an original term of approximately 25 years. PPA 1 was assignable with Utility's written consent, which could not be unreasonably withheld.

After the enactment of PURPA, the cost of fuel in the United States declined, which led to a reduction in utilities' costs of producing electric power. In addition, since the early 1990's the electric utility industry has been undergoing deregulation, which has led to increased competition in the industry and a reduction in the price of electricity. As a consequence of these and other factors, many PURPA contracts, including the PPA in the present case, contained rates that were significantly above market.

For several years, Utility paid Taxpayer shutdown fees under a suspension agreement pursuant to which Taxpayer agreed not to operate the plant. However, early in Year 1,

Taxpayer notified Utility that it intended to resume operation and deliveries to Utility under PPA 1.

Under deregulation legislation enacted by State in Year 1, Utility was required to

Pursuant to this policy and in an attempt to reduce its costs, Utility terminated or restructured a number of above-market contracts with QF's. Utility entered into negotiations with Taxpayer to terminate PPA 1, but could not reach mutually agreeable terms.

Power marketers generally are intermediaries engaged in the business of buying electricity from traditional utilities and other sources and reselling electricity at wholesale prices. Power Marketer was able to buy and resell power at a rate that was lower than the rate contained in PPA 1.

In Year 1, Power Marketer entered into negotiations with Taxpayer and Utility. Power Marketer negotiated with Taxpayer for the purchase of Taxpayer's interests in PPA 1. Power Marketer also negotiated with Utility either to supply power to Utility under the PPA to be purchased from Taxpayer, or to purchase and terminate PPA 1 and enter into a replacement agreement with Utility.

On Date 2, the negotiations between Power Marketer and Utility resulted in the signing of a Memorandum of Agreement ("MOA"). Under the MOA, Power Marketer would purchase Taxpayer's interests in PPA 1, immediately terminate PPA 1, and enter into a replacement PPA with Utility ("PPA 2"), making an additional payment to Utility of \$a. Taxpayer would retain the power plant, free of the financing lease with Company, and could operate it as a merchant power plant. Under the MOA, Taxpayer's approval of the restructuring was a condition precedent to the execution of PPA 2.

PPA 2, as described in the MOA and subsequently entered into between Power Marketer and Utility, provided that Power Marketer would deliver to Utility an amount of electric energy equal to the deliveries expected under PPA 1, based on historical averages, for the term remaining under PPA 1, approximately 19 years. PPA 2 also obligated Power Marketer to deliver X plus Y units of capacity to Utility (30% more than the capacity provided for in PPA 1). The rates under PPA 2, while still above market,

were lower than those set forth in PPA 1. Under both PPA 1 and PPA 2, rates were subject to an adjustment for inflation. Unlike PPA 1, which contained constant rates for electricity and for capacity throughout a given year, the rates in PPA 2 differentiated between on-peak and off-peak periods for each year.

The following day, Utility filed a petition with the State Public Utilities Commission ("PUC") requesting approval of PPA 2. State's statutes generally prohibited electric utilities from entering into a supply contract for a period longer than three years, for more than a stated amount of electrical capacity, without obtaining a certificate of public convenience and necessity from the PUC. Although contracts with QF's such as PPA 1 were exempt from this requirement, approval of PPA 2 was required because Power Marketer is not a QF. In its petition, Utility stated:

Utility subsequently entered into a stipulation with State's Public Advocate approving the proposed transaction, which was described as follows:

The stipulation also recited that:

On Date 3, the State PUC entered an order approving the stipulation, on the ground that the restructuring would result in significant cost savings to Utility and its customers, as compared to the projected costs of purchasing energy and capacity from Taxpayer, under PPA 1, through Date 5. The order also approved Utility's request that

On Date 4, several agreements were signed, consistent with the MOA and the PUC order. Taxpayer and Power Marketer executed a purchase agreement, pursuant to which Power Marketer purchased Taxpayer's interests in PPA 1 for \$d, \$b of which was paid to Taxpayer and \$c of which was paid, on behalf of Taxpayer, to Company as payment for Company's interests in the power plant. Taxpayer and Company executed

a purchase agreement and facility lease termination, pursuant to which Taxpayer acquired ownership in the power plant. PPA 1 was terminated, and Power Marketer and Utility executed PPA 2.

The agreements signed on Date 4 were interrelated. The purchase agreement between Taxpayer and Power Marketer referenced, but did not discuss, PPA 2. Among the conditions precedent to the execution of PPA 2 were that Taxpayer and Power Marketer had to have entered into an agreement transferring ownership in PPA 1 to Power Marketer, and Power Marketer and Utility had to have entered into an agreement terminating PPA 1. Another condition precedent was that Taxpayer had to approve the "restructuring," defined to include the consummation by Utility, Power Marketer, Taxpayer, Company, and certain other parties of the termination of PPA 1 and the execution and delivery of PPA 2.

Incorporated as an exhibit to PPA 2 was a mutual release, executed by Taxpayer and Utility, which referenced Power Marketer's agreement to purchase PPA 1, and Utility's agreement to terminate PPA 1 and enter into PPA 2. The release provided, among other things, that Utility and Taxpayer released each other from "any and all claims ... arising out of or in connection with the execution, performance or nonperformance of [PPA 1] ... ."

According to Taxpayer's submission, all aspects of the transaction were coordinated and orchestrated with respect to when each leg of the transaction was executed and, at the time these documents were executed, Taxpayer, Power Marketer, and Utility knew that Power Marketer was not going to perform under the terms of PPA 1. However, according to Taxpayer, each party negotiated independently and had opposing interests.

Taxpayer subsequently entered into a new power supply contract with another utility.

Taxpayer reported the receipt of the \$d from Power Marketer as long-term capital gain. The revenue agent maintains that this amount is ordinary income.

#### LAW AND ANALYSIS:

In order for proceeds from the disposition of an asset to qualify as long-term capital gain, the asset must be a capital asset as defined by § 1221, the disposition must be a "sale or exchange," and the asset must have been held for more than one year. I.R.C. § 1222. Under § 1231, capital gain also may result from the sale or exchange of real or depreciable property used in the taxpayer's trade or business and held for more than one year, if section 1231 gains exceed section 1231 losses for the year.

In the present case, PPA 1 was an asset held by Taxpayer for more than one year. Whether the \$d received from Power Marketer was long-term capital gain therefore depends on two factors: the nature of the asset and the nature of the transaction.

Nature of the Asset: PPA as "Property"

Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of five listed exceptions: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in § 167 or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; and (5) certain publications of the United States Government.<sup>1</sup>

The term "section 1231 gain" includes the sale or exchange of property used in a taxpayer's trade or business, of a character which is subject to the allowance for depreciation under § 167, and that does not fall within certain exceptions generally equivalent to the exceptions in § 1221.

In the present case, PPA 1 was an asset used in the taxpayer's trade or business that does not fall within any of the listed exceptions to capital gain treatment in § 1221 or § 1231. We do not decide whether it was a capital asset or a section 1231 asset because, in either case, gain from the sale or exchange of such an asset would be capital gain for Taxpayer.

In order for either § 1221 or § 1231 to apply, however, the asset sold must constitute "property."<sup>2</sup> Although § 1221 appears to give broad meaning to this term, the Supreme Court has found it "evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions [of § 1221] qualifies as a capital asset"; rather, the term "capital asset" "is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time ... ." Commissioner v. Gillette Motor Co., 364 U.S. 130, 134 (1960) (compensation for temporary seizure of business facilities is ordinary income). Similarly, in Commissioner v. P.G. Lake, 356 U.S. 260, 265-67 (1958), the Court denied capital gain treatment on the disposition of certain mineral payments carved out of established oil and gas working interests, observing, "The lump-sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. ... In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property."

On this basis, capital gain or loss treatment has been denied for transactions involving payments in return for interests carved out of, or related to, an interest retained by the taxpayer, see, e.g., Gillette and P.G. Lake; interests related to compensation for

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<sup>1</sup> All references are to the statutes and regulations as in effect for the year at issue.

<sup>2</sup> The term has the same meaning under § 1221 as it has under § 1231. See Hollywood Baseball Assoc. v. Commissioner, 423 F.2d 494 (9th Cir.), cert. denied, 400 U.S. 848 (1970).

personal services rendered or to be rendered in the future, see, e.g., Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962) (interest in films to be produced by taxpayer); Vaaler v. United States, 454 F.2d 1120 (8th Cir. 1972) (agency contract with insurance company); Foote v. Commissioner, 81 T.C. 930 (1983) (tenure rights); and interests relating to income already earned or about to be earned, see, e.g., Rhode's Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (right to dividend that was already declared).

On the other hand, as the courts have noted, "Simply because the property transferred will produce ordinary income, and such income is a major factor in determining the value of the property, does not necessarily mean that the amount received for the property is essentially a lump-sum substitute for ordinary income."<sup>3</sup> In Guggenheim, the court focused on whether substantial investment risks involved in holding the asset that was the source of the income were transferred. See 46 T.C. at 569. In Dresser, the court distinguished between proceeds from "the present sale of the future right to earn income [capital gain] and the present sale of the future right to earned income [ordinary income]." 324 F.2d at 59. In Ferrer, the court distinguished between cases involving "an 'estate' in, or an 'encumbrance' on, or an option to acquire an interest in property which, if itself held, would be a capital asset" and "an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another, or by rendering services, or by virtue of ownership of a larger 'estate'." 304 F.2d at 130-131 (cited cases omitted). See generally Foy v. Commissioner, 84 T.C. 50, 70 (1985) (capital gain on transfer of franchise rights; summary of factors).

In Estate of Shea, a case particularly analogous to the present case, the court held that the transfer by the taxpayers' S corporation to a third party of a shipping charter, a contract to provide cargo space on the corporation's ships, was a sale of "property" under § 1231, resulting in capital gain. The corporation had originally acquired the shipping charter along with the ship to which it was subject, later substituted a different ship, and eventually sold the charter as a separate asset. In its holding, the court stressed that the shipping charter was not a contract to perform personal services, that the taxpayer had been required to capitalize the acquisition cost of the charter, and that the value of the charter was primarily determined by its rate as compared to prevailing market rates. Thus, the court observed, the difference between the amount paid for the charter and the amount received upon his disposition represented appreciation in value over time, due purely to the action of market forces. This, according to the court, was precisely the type of profit for which capital gain treatment is intended, citing Gillette. See 57 T.C. at 24-25.

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<sup>3</sup> Guggenheim v. Commissioner, 46 T.C. 559, 569 (1966), acq., 1967-2 C.B. 2 (sale of syndicated interests in a racehorse). See also United States v. Dresser Industries, 324 F.2d 56, 59 (5th Cir. 1963) (transfer of "exclusive" feature of a patent contract); Commissioner v. Ferrer, 304 F.2d 125, 132-33 (2d Cir. 1962) (various rights in a literary work); Estate of Shea v. Commissioner, 57 T.C. 15, 25 (1971), acq., 1973-2 C.B. 3 (shipping charter).

Based on the above, we conclude that the bundle of contract rights and obligations represented by PPA 1 in the present case was "property" within the meaning of §§ 1221 and 1231. The PPA did not represent a right to compensation for personal services rendered or to be rendered; rather, it involved the sale of a product—electricity. Nor was it a right to collect income already earned, as in Rhodes' Estate. Instead, like the "exclusive" feature of the right to practice the license at issue in Dresser, the PPA was itself an income-producing asset, a right to earn income in the future. As made clear by Dresser and Guggenheim, it is not dispositive that the income to be produced by the PPA would have been ordinary, nor that the value of the PPA was largely determined by the present value of that expected future income stream. Moreover, the PPA was not simply, in the words of the Ferrer court, "an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another." First, as a PURPA contract, mandated by federal and state statutes and regulations, the PPA reflected to some extent benefits created by governmental action, similar to other rights that have been treated as capital assets. See, e.g., Rev. Rul. 66-58, 1966-1 C.B. 186 (cotton acreage allotments); Rev. Rul. 70-644, 1970-2 C.B. 167 (milk allocation rights). Second, like the shipping charter at issue in Estate of Shea, the value of the PPA was largely determined by prevailing market rates and was subject to market fluctuations, outside of the control of Taxpayer, based on projections of economic factors over a significant period of time<sup>4</sup>. As stated in Gillette and Estate of Shea, such appreciation in value over time resulting from market fluctuations is the type of profit for which capital gain treatment is intended.<sup>5</sup>

We reach the conclusion that Taxpayer sold "property" within the meaning of §§ 1221 and 1231 regardless of whether Taxpayer had any ownership interest in the generating facility prior to the sale of PPA 1, and therefore might be viewed as transferring the contract while retaining an underlying, related income-producing asset. Cf. Gillette; P.G. Lake. As discussed above, while the PPA was clearly related to the power plant, it was transferable separate from the plant and, in the context of the regulatory environment in which the transaction occurred, was an income-producing asset in its own right, one that had a value independent of Taxpayer's plant. In this respect, it was similar to the shipping charter in Estate of Shea, which—while it was clearly related to a ship in a generic sense—was not linked to any specific ship; it could be, and was, transferred from ship to ship and sold as a separate asset. As noted above, unlike the charter in Estate of Shea, Taxpayer had not acquired PPA 1 through purchase and had no basis in the contract; however, the contract was certainly an asset as to which costs would have to be capitalized in appropriate circumstances, separate from the source of

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<sup>4</sup> In this connection, note the length of the contract—approximately 25 years, with 19 remaining at the time of the present transaction.

<sup>5</sup> Unlike the corporation in Estate of Shea, Taxpayer had no investment in PPA 1, in the sense that Taxpayer had no basis in the PPA at the time of the transfer. However, this is only one factor in the determination, see Foy, 84 T.C. at 70—one which, in our view, does not outweigh the other factors in this case. With respect to whether investment risks in the property were transferred—a factor cited in Guggenheim, Foy, and other cases—see p. 20 below.



the electricity that was the subject of the contract. Taxpayer transferred its entire interest in PPA 1 and, after the transaction, the operation of the power plant had no economic effect on PPA 1 or *vice versa*; in fact, Taxpayer subsequently entered into a new contract to sell the output of the power plant to a different utility.

#### Nature of the Transaction: “Sale or Exchange”

##### The “Sale or Exchange” Doctrine in General

Even though we conclude that PPA 1 was “property” within the meaning of §§ 1221 and 1231, in order for the proceeds received by Taxpayer to be capital gain they must result from the “sale or exchange” of PPA 1, within the meaning of §§ 1222 and 1231. The transaction was clearly a “disposition” of property, within the meaning of § 1001, since Taxpayer parted with all substantial rights and obligations in the contract in return for a cash payment<sup>6</sup>. However, under long-established case precedent, not all dispositions are a “sale or exchange” for purposes of the capital gains provisions.

In Fairbanks v. United States, 306 U.S. 436 (1939), for example, the Supreme Court applied the commonly accepted meaning of the term “sale or exchange” in holding that the redemption by a corporation of its bond did not fall within the meaning of that term and thus, resulted in ordinary income to the bondholder. Similarly, in Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941), the Court held that insurance received as compensation for the loss of business assets was not capital gain, reasoning that neither the term “sale” nor “exchange” was “appropriate to characterize the demolition of property and subsequent compensation for its loss by an insurance company.” 313 U.S. at 249. Over the years, Congress has enacted numerous “statutory sale or exchange” provisions, which override this general doctrine and provide for capital gain or loss in many situations<sup>7</sup>. However, none of these statutory provisions covers the present case.

##### Contract Rights and the “Extinguishment Doctrine”

One branch of the “sale or exchange” doctrine holds that, in certain circumstances, amounts received for the cancellation or termination of contractual or similar rights or claims do not qualify for capital gain or loss treatment because the rights are not sold to, or exchanged with, the payor; instead, they simply cease to exist. This doctrine—variously termed the “extinguishment,” “disappearing asset,” or “vanishing

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<sup>6</sup> See Bailey v. Commissioner, 90 T.C. 558, 607-14 (1988), aff’d in part and vacated in part on a different issue, 912 F.2d 44 (2d Cir. 1990); cf. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981).

<sup>7</sup> See, e.g., §§ 165(g), 166(d)(1)(B) (worthless securities); 1038 (foreclosures); 1231(a)(3) (involuntary conversions; overruling Flaccus Leather); 1233 (short sales); 1234 (option expirations); 1234A (certain contract cancellations); 1241 (leases and certain distributorships); 1271 (debt retirements; overruling Fairbanks).

asset” doctrine—is normally applied in two-party situations; however, there is precedent for applying it in a three-party situation, such as the present case, if the substance of the transaction is found to constitute a cancellation, rather than a sale. Some explanation of the historical development of the doctrine is useful in order to elucidate its current status and the factors that determine its application, especially in three-party situations. The development of the doctrine can be traced in a series of rulings and court opinions, many of which were issued by the Court of Appeals for the Second Circuit.

In an early case, Commissioner v. Starr Bros., Inc., 204 F.2d 673 (1953), the Second Circuit held that payment to a distributor for terminating its exclusive contract with a manufacturer was ordinary income. Drawing an analogy to a situation in which the holder of the note surrenders it to the maker for a payment, the court found that the payment and release “not only ended the promisor’s previously existing duty but also destroyed the promisee’s rights. They were not transferred to the promisor; they merely came to an end and vanished.” 204 F.2d at 674.

Another early case, General Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir. 1953), aff’g 17 T.C. 1517 (1952), cert. denied, 346 U.S. 866 (1953), dealt with a three-party situation. In General Artists, the taxpayer, a booking agent, had entered into contracts with Frank Sinatra entitling the taxpayer to represent Sinatra exclusively and receive a percentage of Sinatra’s earnings. The taxpayer purported to sell the contracts to another booking agent, MCA, under an agreement, endorsed by Sinatra, that provided that MCA would enter into new contracts with Sinatra. Shortly after, the new contracts were signed and General Artists later received a payment from MCA, which it treated as capital gain. Although the Tax Court relied in part on a finding that the taxpayer had not parted with “property,” the sole basis of the Second Circuit’s affirming opinion was that, while the transaction was a sale in form, in substance it was a cancellation:

It might be suggested that the instant case differs from that of Starr Bros. because the latter involved a release of a binding negative covenant to the obligor, whereas here there was a transfer to a third person of the rights under the covenant. But we think the correct view is that here there was a release to the obligor [i.e., Sinatra, the counterparty] of a negative covenant in order to allow a new covenant to be made with the third party [MCA]. ... The agreement provided that such new contracts should be made and "be deemed to supersede, cancel, and take the place of" taxpayer’s contracts with the singer.

205 F.2d at 361.

During the same period, the courts also distinguished between cancellations of such so-called “naked” contract rights and cancellations of another class of rights—primarily rights connected with real estate or other more traditional forms of property—that were viewed as sufficiently “substantial” to survive termination or cancellation, thereby

resulting in capital gain or loss<sup>8</sup>. In Rev. Rul. 56-531, 1956-2 C.B. 983, clarified, Rev. Rul. 72-85, 1972-1 C.B. 234, the Service recognized this distinction and acquiesced in these cases (now largely governed by § 1241, a statutory sale or exchange provision enacted in 1954). However, citing Starr and General Artists, the ruling made clear that the Service “will continue to regard the relinquishment of simple contract rights as not involving the sale or exchange of a capital asset ... and will treat amounts received in consideration of such relinquishment as constituting ordinary income ... .” 1956-2 C.B. at 983-84.

Two influential cases decided in 1958 are significant for present purposes because they involve long-term supply contracts. In Commissioner v. Pittston, 252 F.2d 344 (2d Cir.), rev'g 26 T.C. 967 (1956), nonacq., 1957-2 C.B. 8, cert. denied, 357 U.S. 919 (1958), the taxpayer, a coal company, received a lump-sum payment in return for cancellation of its exclusive contract to purchase the output of a coal mine. Upholding the Commissioner’s determination that the payment was ordinary income, the Second Circuit rejected the Tax Court’s rationale—that the counterparty to the contract, by making the cancellation payment, had reacquired “the right to sell its coal to whomsoever it chose at whatever terms it could arrange.” 26 T.C. at 970. According to the Second Circuit, “It would be more in accord with common understanding to say that the payment is solely for the termination of the right-duty relationship between the two parties to the agreement.” 252 F.2d at 347.

In the second case, Leh v. Commissioner, 260 F.2d 489 (9th Cir. 1958), aff'g 27 T.C. 892 (1957), a corporation that held a long-term requirements contract with a supplier for the purchase of petroleum products entered into a similar arrangement with the taxpayer’s partnership, reselling the products to the partnership at a slightly higher price. Subsequently, because of a shortage in the supply of gasoline, the partnership’s contract right had substantial value, see 27 T.C. at 897, and the partnership accepted a payment from the counterparty in termination of the contract. The Tax Court held that the contract was “property used in the trade or business” in the partnership’s hands, and the circuit court accepted this finding. However, both courts rejected the taxpayer’s argument that the effect of the termination agreement was to resell the contract rights to the counterparty; rather, relying on the line of authority represented by Starr, Pittston, and General Artists, both courts held that the payment was ordinary income. In the words of the circuit court, the “principal object, result, and ‘effect’” of the termination agreement was “to terminate rights, not continue them, nor transfer them—nor sell them—nor exchange them.” 260 F.2d at 494.

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<sup>8</sup> See, e.g., McCue Bros. & Drummond, Inc. v. Commissioner, 19 T.C. 667 (1953), acq. 1956-2 C.B. 7, aff'd, 210 F.2d 752 (2d Cir.), cert. denied, 348 U.S. 829 (1954) (lease termination); Ray v. Commissioner, 18 T.C. 438 (1952), acq., 1956-2 C.B. 8, aff'd, 210 F.2d 390 (5th Cir.), cert. denied, 348 U.S. 829 (1954) (lease restriction); Golonsky v. Commissioner, 16 T.C. 1450 (1951), acq., 1956-2 C.B. 6, aff'd, 200 F.2d 72 (3d Cir. 1952), cert. denied, 345 U.S. 939 (1953) (lease termination). See also McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947) (payment to life tenant for transfer of life interest in trust to remainderman was capital gain).

In 1962, the Second Circuit, despite its role in developing the extinguishment doctrine, cast doubt on its continuing validity in a often-cited case, Commissioner v. Ferrer, 304 F.2d 125, rev'g in part and remanding 35 T.C. 617 (1961), acq., 1961-2 C.B. 4. In that case, the taxpayer, actor Jose Ferrer, had acquired from Pierre LaMure, the author of a novel, certain rights connected with the novel, including the stage rights and the right to prevent disposition of the movie rights. After the director John Huston expressed an interest in producing a movie based on the novel and starring Ferrer, a series of agreements were signed pursuant to which Ferrer surrendered his rights, Huston acquired the movie rights, and the taxpayer received a series of payments from Huston's company, Moulin, some of which Ferrer reported as capital gain.

Analyzing prior case law, the Ferrer court decided that more recent cases had "moved away from the distinction, relied upon to some extent in Starr Brothers and General Artists, between a sale to a third person that keeps the 'estate' or 'encumbrance' alive, and a release that results in its extinguishment." 304 F.2d at 131 [footnotes omitted]. Describing this as a "formalistic distinction," the court continued:

In the instant case we can see no sensible business basis for drawing a line between a release of Ferrer's rights to LaMure for a consideration paid by Moulin, and a sale of them, with LaMure's consent, to Moulin or to a stranger who would then release them. ... Tax law is concerned with the substance, here the voluntary passing of "property" rights allegedly constituting "capital assets," not with whether they are passed to a stranger or to a person already having a larger "estate."

Focusing instead on the nature of the asset, the Court concluded that the holdings in cases such as Starr, General Artists, Pittston, and Leh, could be justified as involving assets that weren't "property," rather than on the basis of the extinguishment doctrine. 304 F.2d at 130-131. Following this approach, the court, "unbundling" the various rights given up by Ferrer, held that Ferrer received capital gain upon surrender of his right to produce a play and his negative rights to prevent disposition of film rights, because they represented equitable interests, but ordinary income with respect to termination of his rights to receive a stated percentage of film proceeds.

Two cases, one decided shortly before and one shortly after Ferrer, demonstrate opposite approaches to the application of the extinguishment doctrine in a three-party situation. In the first, Paul Small Artists, Ltd. v. Commissioner, 37 T.C. 223 (1961), the taxpayer held several agency contracts with a movie actor. It assigned the contracts, with the actor's agreement, to another company in return for a lump-sum payment. Without ruling on the nature of the assets (which could have been viewed as contracts for personal services), the court held that there was no sale or exchange, relying on General Artists:

In substance, what was accomplished in each case was the substitution of one agent for another, and we do not think that the form of the transaction, i.e., whether the old

contracts were to be canceled and new ones entered into, or whether the new agent simply stepped into the shoes of the old with the artist's consent, should lead to a result here different from that reached in General Artists.

37 T.C. at 227.

By contrast, in Bisbee-Baldwin Corporation v. Tomlinson, 320 F.2d 929 (5th Cir. 1963), the court employed a “substance over form” analysis to convert a two-party cancellation into a three-party sale, effectively reversing the approach in General Artists and Paul Small Artists. In Bisbee-Baldwin, the taxpayer assigned mortgages to investors who then employed the taxpayer to service those mortgages. Some of the investors later cancelled their contracts with the taxpayer and gave the business to other agents, over the taxpayer's objection. The investors paid the taxpayer a standard percentage termination fee, for which they were reimbursed by the new agents. The court, following Ferrer's “unbundling” approach, determined that a portion of each fee was allocable to capital assets. With respect to these amounts, the court held that in substance the rights had been sold to the new agents:

The investors were conduits: Bisbee-Baldwin received the payments; the transferee's paid through the investors. Something was transferred. What Bisbee-Baldwin transferred was a bundle of rights under its contracts to service certain mortgages. For a price, the transferees stepped into Bisbee-Baldwin's shoes. It is irrelevant that the investors' approval was required, ... and that instead of assignment the transfer was effected by termination of the old contracts and execution of new contracts.

320 F.2d at 936.

After the issuance of Ferrer, language in the opinion led some observers and courts to conclude that the extinguishment doctrine was dead—that is, if one followed Ferrer then cases such as Starr, General Artists, Pittston, and Leh were correct, if at all, only because the assets in those cases were not “property,” not because of the extinguishment doctrine<sup>9</sup>. However, subsequent events have made clear that the extinguishment doctrine survived Ferrer, and has been applied by both the Service and the courts—including the Second Circuit.

In Rev. Rul. 75-527, 1975-1 C.B. 30, for example, the Service reaffirmed the position it had taken in Rev. Rul. 56-531 with respect to the extinguishment doctrine and contract rights. In Rev. Rul. 75-527, the taxpayer owned a building that was heated by a central hot water distribution plant, owned by a supplier who had a contract to furnish heat to the building. Because of the expense of maintaining the system, the supplier desired to

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<sup>9</sup> See, e.g., United States v. Dresser Industries, 324 F.2d 56, 60 (5th Cir. 1963) (“Starr Bros. ... has been repudiated by the Second Circuit in ... Ferrer”); 2 B. Bittker & L. Lokken, Federal Taxation of Income, Estates, and Gifts ¶ 52.1.5 (2d ed. 1989) (two-party/three-party distinction criticized in Ferrer “fast becoming a footnote to history”); but see id., ¶ 48.1.5 (3d ed. 2000) (“may have become a footnote to history”).

terminate the contract. The taxpayer accepted the supplier's offer to reimburse the taxpayer for the cost of converting to an individual heating system, in termination of the supply contract. Rev. Rul. 75-527 holds that the amount received by the taxpayer for conversion of the system is ordinary income, because there was no sale or exchange, in that the taxpayer's right to have the building heated by the central heating plant was extinguished and did not pass to the supplier. The ruling cites Rev. Rul. 56-531, Pittston, and Leh for the proposition that, in general, "the mutual relinquishment of simple contract rights and obligations does not give rise to a capital transaction," and the cancellation or release of a contract right "does not transfer the right to the transferee-payor and is therefore not a sale."

Similarly, in 1971, in Billy Rose's Diamond Horseshoe, Inc. v. United States, 448 F.2d 549, the Second Circuit held that a payment to a lessor for the cancellation of its right to have leased property restored was not a "sale or other disposition" within the meaning of § 453. In so holding, the court stated that the Second Circuit "has long held that cancellation or release of a contract right does not transfer the rights to the transferee-payor and thus is not a 'sale'." 448 F.2d at 551. The court then went on to state, "We do not agree that Ferrer overruled the General Artists and Starr Bros. cases. Ferrer is to be distinguished on the ground that it involved the release of motion picture production rights which could have been sold to any third person." Id. at 552.

Following Billy Rose, there was some question whether its holding was restricted to the § 453 context. See, e.g., Sirbo Holdings, Inc. v. Commissioner, 509 F.2d 1220, 1222-23 (2d Cir. 1975). In addition, in 1981 and again in 1997, the scope of the extinguishment doctrine was significantly restricted with the enactment and expansion of § 1234A. The committee report accompanying the 1997 changes severely criticized the extinguishment doctrine, which it characterized as "present law," citing, among other cases, Starr, General Artists, and Pittston. See S. Rep. No. 33, 105th Cong., 1st Sess. 132, 133 (1997).<sup>10</sup>

However, in Wolff v. Commissioner, 148 F.3d 186 (1998), rev'g and remanding Estate of Israel v. Commissioner, 108 T.C. 208 (1997), the Second Circuit made clear that, outside of "statutory sale or exchange" provisions such as § 1234A, the extinguishment doctrine still applies—not just under § 453, but in its original § 1222/§ 1231 context as well. Accepting the taxpayer's position—based on cases like Starr, General Artists, and Pittston, see 148 F.3d at 189—and citing the passage from Billy Rose quoted above, id. at 189-90, the court held that fees paid in connection with the cancellation of legs of commodity forward contracts (prior to the effective date of current § 1234A) were ordinary losses, for lack of a sale or exchange under § 1222—despite the fact that the

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<sup>10</sup> Section 1234A provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset. Note that the statute does not cover contracts related to section 1231 assets or, as in the present case, ordinary assets.

economic result achieved by cancellation was identical to that achieved by offsetting such contracts, a transaction resulting in capital gain or loss.

With respect to Ferrer, the Wolff court quoted from an earlier opinion, Stoller v. Commissioner, 994 F.2d 855 (1993), aff'g in part and rev'g in part T.C. Memo. 1990-659, in which the Court of Appeals for the D.C. Circuit had applied the same analysis to the same transactions as in Wolff:

After the cancellation of Ferrer's contract, there was still an extant contract for the movie rights with essentially the same terms but a different signatory. Therefore, the court held, the substance over form doctrine applied. See also Bisbee-Baldwin ... . Because the consideration for the cancellation [in Ferrer] came from a third party, it was in substance a sale. Here, however, the underlying contracts were cancelled in substance as well as in form. When a contract was cancelled, it did not merely change hands; it ceased to exist altogether.

994 F.2d at 857. See Wolff, 148 F.3d at 189. (Note the emphasis in the quoted passage on the fact that, in Ferrer, the rights were not merely transferable; rather, they were actually transferred to a third party for consideration from the third party.)<sup>11</sup>

Although in both Wolff and Stoller the Tax Court was reversed, the disagreement concerned the interpretation of Ferrer's "substance over form" approach; the Tax Court did not challenge the extinguishment doctrine itself. See Estate of Israel, 108 T.C. at 222-23 (distinguishing between "unexpected and true cancellations of commercial contracts," as in Pittston and Leh, and expected cancellations of commodity-type contracts). Consistent with this position, in a more recent case, Nahey v. Commissioner, 111 T.C. 256 (1998), aff'd, 196 F.3d 866 (7th Cir. 1999) (possibly on another ground), petition for cert. filed, 68 U.S.L.W. 3698 (U.S. Apr. 26, 2000) (No. 99-1731), the Tax Court based its decision on the extinguishment doctrine. Citing Leh, among other authorities, the court held that an S corporation's proceeds from the settlement of a purchased legal claim were ordinary income, due to lack of a "sale or exchange," because "the S corporations' rights in the lawsuit vanished both in form and substance upon the receipt of the settlement proceeds." 111 T.C. at 262, 264-265.

Summarizing this often conflicting precedent, the extinguishment doctrine has faced considerable criticism over its half-century history, yet it remains a feature of the tax law; Congress has reduced the scope of the doctrine but has not, as yet, eliminated it altogether. When contract rights involve the provision of personal services, the doctrine

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<sup>11</sup> In both Wolff and Stoller, the courts' holdings were not affected by the fact that Congress had enacted specific legislation covering post-effective-date transactions similar to those at issue. See Wolff, 148 F.3d at 190; Stoller, 994 F.2d at 858. In this respect, although courts have occasionally cited the existence of statutory sale or exchange provisions as evidence of congressional disapproval of the "sale or exchange" doctrine in general, or the extinguishment doctrine in particular, see, e.g., Ferrer, 304 F.2d at 131, more often such provisions have been construed as confined to their stated scope. See, e.g., Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 251 (1941).

is no longer relevant: payment for the termination of such rights is now viewed as ordinary income on the ground that they are not “property,” regardless of the nature of the transaction. At the other extreme, the cancellation of certain rights traditionally viewed as “substantial”—such as leases and life estates—will always be treated as a sale or exchange, whether or not they are covered by statute, and whether or not they are actually re-transferred to third parties. Rev. Rul. 56-531.

With respect to other contract rights and interests, the Ferrer case, while undoubtedly influential, has led to varying interpretations. Some courts and commentators regard Ferrer as having eliminated the extinguishment doctrine altogether—leaving the nature of the asset as the only relevant inquiry. However, this does not appear to be the majority view, nor is it the position of the Service: the extinguishment doctrine in general, and cases such as Pittston and Leh in particular, continue to be cited as valid precedent, even by the court that decided Ferrer. See, e.g., Rev. Rul. 75-527; Stoller, 994 F.2d at 857 (taxpayer’s prevailing argument); Wolff, 148 F.3d at 189-90 (same); Estate of Israel, 108 T.C. at 222 (doctrine distinguished by court); Nahey, 111 T.C. at 262.

Although Ferrer did not eliminate the extinguishment doctrine altogether, it has ameliorated its impact to some extent. First, the case clearly shifted the primary thrust of the analysis away from the nature of the transaction and towards the nature of the asset. Second, and related to the first point, the Ferrer case has come to stand for a “substance over form” approach to the “sale or exchange” determination—exemplified by the Bisbee-Baldwin case—in which rights are more likely to be viewed as having, in substance, survived a transaction, even though the transaction took the form of a cancellation or termination.<sup>12</sup>

This “substance over form” aspect of Ferrer is sometimes applied in two-party situations, in which the fact that the rights in question could be transferred to a third party, coupled with other factors, is viewed as sufficient to regard the rights as surviving as separate assets in the counterparty’s hands<sup>13</sup>. Under this view, situations such as those in Rev. Rul. 75-527 (right to centralized hot water heat) and Sirbo Holdings (right to restoration of property on leased premises) are distinguishable because they involve the cancellation of rights that are not valuable assets, capable of transfer to a third party. This interpretation is difficult to reconcile with cases like Pittston and Leh, however, since there is no indication that the contract rights in those cases were not

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<sup>12</sup> For a similar example of the evolution of the “sale or exchange” doctrine, see the line of cases represented by Yarbro v. Commissioner, 737 F.2d 479 (5th Cir. 1984), cert. denied, 469 U.S. 1189 (1985), in which the courts found a “sale or exchange,” resulting in capital loss, in certain transactions traditionally viewed as lacking that element, such as abandonments of mortgaged properties.

<sup>13</sup> See, e.g., Dresser, 324 F.2d at 59; Anderson v. United States, 468 F. Supp. 1085, 1098 (D. Minn. 1979), aff’d without written opinion, 624 F.2d 1109 (8th Cir. 1980) (release of right of first refusal regarding motel franchise is a sale or exchange where release added to rights of grantor by removing obstacle to franchise operation by grantor or others.)



valuable, potentially transferable assets. However, Ferrer's "substance over form" approach is often applied more narrowly, in three-party situations in which—as in Bisbee-Baldwin, and in Ferrer itself—the consideration for the release of the contract rights comes from a third party, directly or indirectly, and the rights are not merely transferable to third parties in the abstract, but are in fact transferred and survive, in some form, in the hands of the third party.

In such three-party situations, the question then becomes whether there is a sufficient nexus and similarity—between the rights given up by the taxpayer and the rights acquired by a third party—to permit the conclusion that the rights survived, in substance, in the hands of the third party. The D.C. Circuit, in Stoller, acknowledged this aspect of Ferrer; however, it took a restrictive view of the circumstances in which it could be applied, interpreting Ferrer as involving "an extant contract for the movie rights with essentially the same terms but a different signatory." 994 F.2d at 857. This was a questionable reading of Ferrer—the terms of the agreement between Huston/Moulin and LaMure were significantly different from those in the Ferrer-LaMure agreement. See 304 F.2d at 127-28; 35 T.C. at 618-25. Moreover, other courts, as well as the Service, have recognized that the rights acquired by the third party or parties need not be identical to those given up, in order to be viewed as surviving the transaction. See, for example, the Service's position in Stoller—accepted by the Tax Court, but not the D.C. Circuit—to the effect that contract rights were not extinguished when, in part, they were replaced by contracts "between the same parties for the same commodities (albeit with new prices and delivery dates) ... ." 994 F.2d at 857. See also Estate of Israel, 108 T.C. at 223-24; Gladden v. Commissioner, 112 T.C. 209, 226 n. 3 (1999) (water rights did not vanish where they reverted to the government, survived, and "were reallocated to other users"). In this respect, the extinguishment doctrine has evolved since 1953, when the General Artists opinion was issued, and—while General Artists may still represent valid precedent for the general proposition that the extinguishment of simple contract rights is not a sale or exchange—after Ferrer, cases like General Artists and Paul Small Artists might well be decided differently, on their actual facts.<sup>14</sup>

#### Application to the Present Case

Taxpayer points to certain formal aspects of the transaction—chiefly the purchase agreement whereby Power Marketer purported to purchase Taxpayer's entire interest in PPA 1, in return for a cash payment—as evidence that the transaction was a sale of PPA 1 for capital gains purposes. Taxpayer also argues that its tax treatment should not depend on what Power Marketer chose to do, as a result of separate negotiations, after Power Marketer acquired PPA 1. However, as discussed above, there is ample

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<sup>14</sup> We express no opinion as to whether cases similar to Pittston and Leh—or perhaps the present case—might be decided differently under the new rules covering hedging transactions. See § 1221(a)(6)-(7), (b), generally effective for transactions entered into on or after December 17, 1999. In the present case, PPA 1 was not identified as a hedging transaction and is not otherwise covered by the current hedging regulations. See § 1.1221-2 of the Income Tax Regulations.

precedent in this context for looking beyond the form of the transaction. This is especially true when, as in the present case, the separate steps of the transaction are so clearly interrelated. Whether or not there were separate negotiations leading up to the transactions that were executed on Date 4, it is clear that on that date each step of the transaction was dependent on Taxpayer's approval, and that Taxpayer knew that Power Marketer had no intention of performing under PPA 1, and would terminate PPA 1 simultaneously with—not "after"—its acquisition from Taxpayer. By the same token, however, neither the execution of mutual releases as between Taxpayer and Utility—a common precaution in a complex legal transaction—nor the fact that the transaction was referred to in some contexts as a "buyout" of PPA 1 by Utility, necessarily establish that the transaction was a cancellation rather than a sale. See, e.g., Leh, 260 F.2d at 493, n. 5; Turzillo v. Commissioner, 346 F.2d 884, 889 (6th Cir. 1965). The tax consequences turn on the substance of the transaction.

Accordingly, the question to be decided is whether, under Ferrer's "substance over form" approach as applied in three-party cases such as Bisbee-Baldwin, the present transaction was, in substance, a sale of Taxpayer's rights in PPA 1 to Power Marketer. On these particular facts, we conclude that it was. First, as discussed above, the transaction was in form a sale of Taxpayer's interest in PPA 1 to a third party; as a matter of non-tax law, at least, Power Marketer succeeded to Taxpayer's rights and obligations in PPA 1, if only momentarily. And, under tax or non-tax law, the fact that a purchaser of an asset is under a pre-existing obligation to sell or otherwise dispose of the asset upon acquisition does not necessarily mean that the asset was not, in fact, purchased, or that the transaction must be recharacterized. Second, although as part of the integrated transaction PPA 1 was terminated and ceased to exist, this was not done, as in Leh or Rev. Rul. 75-527, because the payor—in this case, Power Marketer—simply wished to eliminate what had become a burdensome contract. Nor did Power Marketer, once it had acquired PPA 1, terminate PPA 1 in return for cash or debt from Utility—which might lead to the conclusion that, in substance, the transaction was an indirect means for Utility to eliminate the contract. Rather, the consideration for the acquisition of PPA 1 came from Power Marketer, not Utility, and Power Marketer acquired PPA 1—and paid an additional \$a to Utility—because by doing so it was able to satisfy the requirements set by both Utility and the regulatory authorities for entering into PPA 2, a long-term power supply contract.

Moreover, while PPA 2 was not identical to PPA 1, the two contracts were similar in several respects. First, the remaining term of PPA 2 was the same as that under PPA 1. Second, while the source of the electricity differed, the amount of energy to be furnished under PPA 2 was based on the historical amounts furnished under PPA 1, and the amount of capacity was similar. Finally—although Power Marketer was not a QF, and the price terms under PPA 2 were not as favorable to the supplier as under PPA 1—PPA 2 was accepted by both Utility and the regulatory authorities as a substitute for PPA 1, because PPA 2, while still a long-term contract at above-market rates, was more favorable to Utility and the ratepaying public than PPA 1. This was reflected not only in the fact of approval itself, but also in the manner in which,

. In this way, some of the statutory benefits of a PURPA contract like PPA 1 were effectively preserved and reflected in PPA 2. Similarly, to a significant extent the investment risks of such a contract—see the discussion of this factor in cases like Guggenheim and Foy, above—were not eliminated, but were effectively transferred from Taxpayer to Power Marketer.

In substance, therefore, Power Marketer's payment to Taxpayer was intended to, and did in fact result in the acquisition of valuable rights by Power Marketer, in the form of a long-term, above-market power supply contract, of a type no longer favored in the new, deregulated environment, and similar in many significant respects to the rights given up by Taxpayer in the transaction. In this sense, Power Marketer "stepped into the shoes" of Taxpayer. Under the more liberal interpretation of the "sale or exchange" doctrine represented in Ferrer, Bisbee-Baldwin, and subsequent cases—as opposed to earlier cases such as General Artists or Paul Small Artists—and taking into account all the factors discussed above, we conclude that the substance of Taxpayer's rights in PPA 1 survived the transaction.

Accordingly, the transaction was a sale or exchange of property, within the meaning of §§ 1221, 1222, and 1231.