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INTERNAL REVENUE SERVICE NATIONAL OFFICE

TECHNICAL ADVICE MEMORANDUM

March 26, 2001

Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN:

Year Involved:

Taxpayer =

Product X =

State =

Product Y =
Product Z =

Agency 1 =
Agency 2 =

Plant 1 =
Plant 2 =

Agreement =

$ =
$$ =
$$$ =

Date 1 =
Date 2 =
Date 3 =

Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Date 12 =
Date 13 =
Date 14 =
Date 15 =
Date 16 =

Year 1 =

ISSUES:

1. Was Taxpayer eligible for section 1033(a) involuntary conversion treatment of the settlement proceeds?

2. What were the beginning and ending dates for the initial replacement period for the converted property under section 1033(a)(2)(B)(i)?

3. What is an appropriate extension of the replacement period under section 1033(a)(2)(B)(ii)?

CONCLUSIONS

1. Taxpayer is eligible for section 1033(a) involuntary conversion treatment of the settlement proceeds.

2. The beginning of the replacement period was Date 7 and the ending date was two years after the close of Taxpayer's fiscal year ending on Date 15.

3. Under the extremely unusual circumstances in this case, it is appropriate to grant Taxpayer sufficient additional time as may be necessary to purchase Product Z for consumption in the normal course of its manufacturing operations.

FACTS

Taxpayer is a manufacturer of Product X and has manufacturing plants located in State. Agency 1 contacted Taxpayer and encouraged Taxpayer to use Product Y in its manufacturing process instead of using Product Z. Prior to Year 1, Taxpayer used Product Z in its manufacturing process. Taxpayer had on occasion purchased Product Z from Agency 1. Taxpayer was interested in using Product Y as it had a longer life than Product Z. As a result

of Agency 1's offer, Taxpayer expended $ to convert Plant 1 so it could utilize Product Y in its manufacturing process.

On Date 1, Taxpayer executed a lease with Agency 1 for Product Y to be used at Plant 1. The lease was for a 10-year period with Taxpayer having the option to renew for two additional 10-year periods. Taxpayer received Product Y from Agency 1 on Date 2 and commenced operations with Product Y on Date 3.

On Date 4, Taxpayer applied to Agency 2 for renewal of its existing license to possess and use Product Y and Product Z. On Date 5 Agency 2 notified Taxpayer in writing that depending on the outcome of Agency 2's investigation of the causes of an accident involving Product Y at another location, Agency 2 may require Taxpayer to return Product Y to Agency 1. Agency 2 also suggested that Taxpayer consider contingency plans for the removal and replacement of Product Y. On Date 6, Agency 2 sent a letter to Taxpayer indicating that based on information provided by Agency 1 and its contractors, Agency 2 lacked confidence that Product Y could be safely used in commercial facilities and requested to meet with the Taxpayer.

On Date 7 representatives from Agency 2 and Taxpayer met to discuss the use of Product Y at Taxpayer's plant. At the meeting representatives from Agency 2 indicated they had concluded that Product Y could not be suitably used at Taxpayer's plant. In addition the representatives from Agency 2 indicated that other companies that were using Product Y also would have to return it. Agency 2 stated it wanted all of Product Y returned by the end of the following year. On Date 8, Agency 1 offered to take back at its expense all of Product Y from Taxpayer.

On Date 9, Agency 2 withdrew its approval of the commercial use of Product Y and mandated the removal of all of Taxpayer's Product Y. On Date 10, Taxpayer submitted a revised license renewal application to Agency 2 to possess and use Product Y and Product Z at its State facility. Taxpayer also requested permission to use Product Y and Product Z in a new facility being built at Plant 2.

Agency 2 denied Taxpayer's request to renew its license at Taxpayer's existing plant but allowed Taxpayer to continue operating under its old license pending Agency 1's removal of Product Y. On Date 11, Agency 2 granted Taxpayer's license application for its new facility, but only authorized use of Product Z.

On Date 12, Taxpayer filed an administrative claim for breach of contract with Agency 1 based on the recall of Product Y. Agency 1's decision regarding the claim recited the Agency's position that there had been no breach of Taxpayer's lease and that Taxpayer was entitled to recover no more than $$ even if a breach had taken place.

As a result of the actions taken by both Agencies, Taxpayer was required to convert Plant 1 so that it could use Product Z and redesign Plant 2 which was under construction. Product Y has a much longer useful life than Product Z.

On Date 13 in a telephone conference representatives from the Taxpayer and Agency 2 discussed Taxpayer's failure to allow removal of Product Y. Taxpayer indicated it had filed a claim against Agency 1 and Taxpayer had been unable to arrive at a settlement with Agency 1. A representative from Agency 2 indicated it would have to consider its options to have Product Y returned, including denying Taxpayer's license renewal and issuing a binding order to return Product Y.

Finally, Taxpayer and Agency 1 entered into an Agreement on Date 14, whereby Taxpayer agreed to accept $$$ in settlement of the claim based on the taking of Taxpayer's property by Agency 1. The $$$ amount was based on the estimated present value of the cost of replacing Product Y with Product Z purchased periodically over the 20-year term remaining on Taxpayer's lease. The physical removal of Product Y from Taxpayer's facility was delayed until Date 16.

Taxpayer elected to defer the recognition of the gain realized under the Agreement as an involuntary conversion under section 1033(a)(2) on its Form 1120 for the fiscal year presently under consideration.

LAW:

Section 1033(a) of the Internal Revenue Code provides 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 the taxpayer purchases other property similar or related in service or use to the property converted, during the period specified in section 1033(a)(2)(B), then the taxpayer may elect to have the gain from the conversion recognized only to the extent that the amount realized exceeds the cost of the replacement property.

Section 1033(a)(2)(B) states that the replacement period begins with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ends (i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized, or (ii) subject to such terms and conditions as may be specified by the Secretary, at the close of such later date as the Secretary may designate on application by the taxpayer.

Rev. Rul. 63-221, 1969-2 C.B. 332, states that for purposes of section 1033(a) of the Code, a threat or imminence of condemnation is generally considered to exist when a property owner is informed, either orally or in writing, by a representative of a governmental body or by a public official authorized to acquire property for public use, that such body or official has decided to acquire the property and the property owner has reasonable grounds to believe, from the information conveyed to him by such representative or official, that the necessary steps to condemn the property will be instituted if a voluntary sale is not arranged.

Rev. Rul. 69-303, 1969-1 C.B. 201, holds that a sale of property to a non-profit organization for resale to a U.S. Agency, following notification of the Agency's decision to

acquire it by condemnation if necessary, when funds became available, constitutes an involuntary conversion as a result of threat or imminence of condemnation.

Rev. Rul. 71-567, 1971-2 C.B. 309, holds that the enactment of a public law authorizing acquisition of a property was a sufficient threat or imminence of condemnation to qualify for treatment under section 1033 of the Code, notwithstanding the absence of an actual appropriation of funds necessary to acquire the property.

Rev. Rul. 82-147, 1982-2 C.B. 190, involved federal legislation that prohibited the use on a particular lake of motorboats with motors of greater than 25 horsepower. This effectively denied the taxpayer the economic use of resort property owned by the taxpayer adjacent to the lake. While the taxpayer could have retained possession of its property, the Service concluded that the property was no longer suitable for commercial use because of the restrictions and thus no longer useful or available to the taxpayer for the property's originally intended purpose. The legislation which gave the taxpayer the choice to keep or to sell the property to the government (pursuant to the legislation) effectively constituted a taking of the property, and the sale of the resort constituted an involuntary conversion within the meaning of section 1033 of the Code.

Rev. Rul. 83-70, 1983-1 C.B. 189, holds that a timely acquired fee simple property interest qualifies under section 1033(a) of the Code as replacement property similar or related in service or use to an involuntarily converted 15-year leasehold because the fee property is to be used in the same business and for the identical purposes as the condemned leasehold.

ANALYSIS

ISSUE 1

Taxpayer argues it should be entitled to defer the recognition of gain under section 1033 because either (1) Agency 1's cancellation of the lease and repossession of Product Y was a requisition or condemnation of property or (2) the cancellation and repossession was a destruction of the property.

Taxpayer argues that its case is similar to Rev. Rul. 89-2, 1989-1 C.B. 260, wherein a taxpayer owned property that it used in a trade or business and, through no fault of the taxpayer, dangerous chemicals were released into the property. A governmental agency subsequently determined that the property was unsafe for habitation and that the businesses and residents in the area should relocate. The Service concluded the chemical contamination constituted a destruction within the meaning of section 1033(a) because it was a result of an outside force beyond the Taxpayer's control, and the property was rendered useless for its intended purpose.

The courts have interpreted the term requisition or condemnation to mean the taking of property by a governmental authority that has the power to do so against the will of the owner and for the use of the taker. A section 1033 requisition or condemnation is a taking which requires the payment of just compensation under the Fifth Amendment. Behr- Manning Corp.

v. United States, 196 F. Supp. 129 (D. Mass. 1961); American Natural Gas Co. v. United States, 279 F.2d 220 (Ct. Cl. 1960).

A seizure occurs when a governmental authority enters into physical possession of property without authority of a court order with compensation to be determined later. This is different from a requisition or condemnation under which the government pays judicially determined compensation before it takes property, or it takes property under court order before the amount of compensation had been determined. United States v. Dow, 357 U.S. 17 (1958). The word "requisition" is more often used in reference to the taking of personal property, and the word "condemnation" to the taking of real estate. Filbin Corp. v. United States, 266 F. 911 (E.D.S.C. 1920).

In Taxpayer's case representatives from Agency 2, on Date 7, specifically told Taxpayer that Product Y was no longer suitable for use and wanted all of Product Y returned to Agency 1 by the following year. Since the materials were not returned, Agency 2 again met with Taxpayer. Taxpayer indicated it had an unsettled claim filed against Agency 1 because of the possibility of the taking of Product Y. Agency 2 stated it had no interest in the settlement but would have to consider denying Taxpayer's license renewal and issuing a binding order requiring the return of Product Y.

The action taken by Agency 2 resulted in the property leased by Taxpayer under the lease agreement with Agency 1 being no longer suitable for commercial use, and Taxpayer was required to return the property. This created a situation similar to that presented in Rev. Rul. 82-147. Product Y was no longer suitable for its intended use because Agency 2 withdrew its approval for commercial use of the product. Since Taxpayer's leasehold interest was rendered useless, it filed a claim against Agency 1 for the loss of its rights under the contract. Compare Woodall v. Commissioner, 964 F.2d 361 (5th Cir. 1992), affg T.C. Memo. 1991-15 (court denied section 1033 non-recognition of gain for fire insurance proceeds received for destruction of improvements to leased property to the extent proceeds were reinvested in replacement property for the leasehold interest; leasehold interest itself was not involuntarily converted because it remained available for its intended use by repairing damage to the improvements).

Agency 1 entered into the Agreement with Taxpayer, which eventually terminated Taxpayer's rights under the original lease agreement. In considering all the facts in this case and the actions taken by Agency 1 and Agency 2, we conclude that Taxpayer's leasehold interest under the agreement with Agency 1 was requisitioned and involuntarily converted under section 1033 of the Code.

ISSUE 2. What were the beginning and ending dates for the initial replacement period for the converted property under section 1033(a)(2)(B)(i)?

Taxpayer argues that although it received the settlement proceeds on Date 15, the last day of its fiscal year, Product Y was not removed until Date 16. Taxpayer views this as the date of disposition of Product Y, and argues that the replacement period did not begin until that date.

It is clear under the statute that the replacement period begins at the earlier of the date of disposition of the converted property, or the earliest date of the threat or imminence of condemnation or requisition of the property. Thus, we believe that the replacement period began on Date 7 when Taxpayer was advised by Agency 2 that Product Y was no longer suitable for commercial use.

Under section 1033(a)(2)(B), the replacement period ends 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized. As an accrual method taxpayer, Taxpayer's right to the $$$ payment from Agency 1 became fixed on Date 14, the date on which the Agreement was entered into. Accordingly, the initial replacement period ended 2 years after the close of Taxpayer's fiscal year ending on Date 15.

3. What is an appropriate extension of the replacement period under section 1033(a)(2)(B)(ii)?

Before the end of the initial replacement period, Taxpayer requested an extension of the period pursuant to section 1.1033(a)-2(c)(3). That section provides that extensions shall be granted only if a taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

Taxpayer's facilities have been converted and/or designed for use of Product Z in its manufacturing operations. Agency 2 has approved Taxpayer's use of Product Z. Because of its useful life, Product Z cannot be purchased in advance of the period in which it must be consumed or it becomes useless. At any given point in time, the cost of the quantity of Product Z required by Taxpayer in the normal course of its manufacturing operations is significantly less than the $$$ realized under the Agreement.

Under these extremely unusual circumstances, we believe that Taxpayer has demonstrated reasonable cause for not being able to replace the converted property within the required period of time. Accordingly, we believe it is appropriate in this case to grant Taxpayer sufficient additional time as may be necessary to purchase Product Z[1] for consumption in the normal course of its manufacturing operations. We agree with Taxpayer's proposal to use a detailed schedule of projected future purchases of Product Z and periodically review those purchases in connection with the approval of consecutive extensions. The length of any particular extension can be determined by mutual agreement between Taxpayer and the appropriate field official.

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1 Although not addressed in the request for technical advice, we note that the purchase of Product Z as replacement property for Taxpayer's leasehold interest in Product Y appears to be the purchase of qualifying replacement property under the rationale of Rev. Rul. 83-70, 1983-1 C.B. 189, which holds that a fee simple property interest qualifies as replacement property similar or related in service or use to an involuntarily converted 15-year leasehold interest when the fee property is used by the taxpayer in the same business and for identical purposes as the converted leasehold.

CAVEAT

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

GEORGE WRIGHT