Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SF:TL-N-5250-00
BAKranzthor

date: DEC 14 2000

to: Associate Chief Counsel (Procedure and Administration)
Attn: Docket & Records Section CC:PA:DR

from: Area Counsel, Communications, Technology and Media

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subject: **Nondocketed Significant Advice Review**
[redacted]
Application of Section 1033(a) to Merger Break-up Fee

The issue presented in this case was recently (in 2000) considered by the Office of Chief Counsel in response to a Field Service Advice request concerning [redacted] (formerly [redacted]), submitted by Jack Forsberg of the St. Paul office, considered by Russ Pirfo (and others) in the National Office. Although we have not been able to discover whether the Chief Counsel Advice prepared in that case has been published, Mr. Forsberg advised us that the Office of Chief Counsel agreed with his position. We did obtain a copy of Mr. Forsberg's Field Service Advice request, which we have borrowed liberally from below. Since the facts of our case are identical in all crucial respects to the facts in the [redacted] case, we orally advised the I.R.S. Team Leader that [redacted]s attempted election of section 1033(a) was not permissible.

ISSUE

Can [redacted] elect under I.R.C. § 1033(a)(2) to defer a $[redacted] break-up fee it received in [redacted] as a result of the termination of its merger agreement with [redacted]?

CONCLUSION

[redacted]'s gain on the $[redacted] break-up fee must be recognized in [redacted] because:

A. The transaction in issue is outside the intended scope of section 1033(a);
B. [redacted]'s property was not "compulsorily or involuntarily" converted;
C. [redacted]'s property was not converted by "destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof";
D. The breakup fees were not paid on account of the conversion of [redacted] property;
E. The [redacted] stock acquired by [redacted] does not constitute "property similar or

related in service or use" to the executory contract purportedly converted;
F. An executory contract does not constitute "property" for purposes of § 1033.

FACTS

[redacted] is a domestic corporation in the [redacted] mining business. On [redacted] and [redacted] entered into a merger agreement whereby [redacted] would be merged into [redacted]. The parties intended that the transaction would qualify for tax-free treatment under section 368(a). [redacted]'s purpose for the merger was to expand its operations, as [redacted] was also a [redacted] mining company.

Article VII of the merger agreement provided, basically, that if a party reneged on the deal it would pay the other party $[redacted]. The merger agreement called for the merger to be completed by [redacted]

Before [redacted] signed the merger agreement with [redacted], it had received a merger offer from [redacted]. The [redacted] stock bid was worth $[redacted] per share of [redacted] at then-prevailing stock prices. The merger agreement [redacted] signed with [redacted] amounted to $[redacted] per [redacted] share as of [redacted]. On [redacted], [redacted] raised its offer to $[redacted] per [redacted] share in [redacted] stock. On [redacted], [redacted] announced that [redacted] had terminated the [redacted] merger agreement with [redacted] and had paid to [redacted] the $[redacted] break-up fee specified in the merger agreement. [redacted] was later merged into [redacted].

[redacted] claimed to have incurred costs and expenses totaling $[redacted] related to the attempted acquisition of [redacted]. Accordingly, [redacted] realized gain of at least $[redacted] as a result of its receipt of the $[redacted] break-up fee, assuming all its claimed costs are allowable. [redacted] did not report any of this realized gain in income, instead attaching to its [redacted] return an "Election under Code Sec. 1033(a)(2) not to Recognize Gain from Compulsory or Involuntary Conversion." In this election [redacted] characterized [redacted]'s termination of the merger agreement as the "destruction of [redacted]'s contractual right" and stated its intention to meet the replacement property requirements of section 1033(a)(2)(B) and Treas. Reg. § 1.1033(a)-2(c)(3).

On [redacted], [redacted] and [redacted] signed a "Combination Implementation Agreement," under which [redacted] planned to acquire all the stock of [redacted] (an Australian corporation). [redacted] completed its plan by purchasing some shares of [redacted] in [redacted] and by exchanging [redacted] stock for the remaining [redacted] shares in [redacted]. [redacted] claimed that its acquisition of [redacted] satisfied the replacement property requirements of section 1033(a)(2)(B) and Treas. Reg. § 1.1033(a)-2(c)(3); therefore, it reported none of the gain it realized on the receipt of the $[redacted] break-up fee and it reduced its basis in the [redacted] stock it acquired by the $[redacted] unrecognized gain.

LAW

I.R.C. § 1033 provides, in part:

> (a) 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–
>
> > (2) Conversion into money.-- Into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:
> >
> > > (A) Nonrecognition of gain.-- If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary may by regulations prescribe . . . .

Treas. Reg. § 1.1033 (a)-1(a) provides, in part:

> Section 1033 applies to cases where property is compulsorily or involuntarily converted. An "involuntary conversion" may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property.

DISCUSSION

In the present case the taxpayer seeks nonrecognition treatment under I.R.C. § 1033(a) for the break-up fee it received from [redacted] in connection with the termination of the Merger Agreement. For the reasons set forth below, the nonrecognition provisions of section 1033 (a) do not apply under the facts of this case.

A. The transaction in issue is outside the intended scope of section 1033(a).

Section 1033(a), like its predecessors, is intended to provide relief to taxpayers who realize gains from involuntarily conversions and invest the proceeds therefrom in replacement property representing a continuation of their "prior commitment of capital."

Johnson v. Commissioner, 43 T.C. 736, 741 (1965), acq. 1965-2 C.B. 5. The nonrecognition provisions currently found in section 1033(a) were originally enacted as part of Revenue Act of 1921. The rational for nonrecognition of involuntary conversions was explained in the Senate Finance hearings as follows:

> This new deduction that is authorized here is a deduction in case an individual is forced to realize profits and proceeds immediately to put the profit back into the same kind of property. It became very important during the war. A man would have a boat which cost, say, $100,000, and had come to be worth $500,000 during the war; the boat would be submarined or burned up, and he would get $500,000 and there would be a gain of $400,000. It seemed a great hardship to tax the gain if that man wanted to put the proceeds back into another boat, and in a number of similar cases it is believed that if the taxpayer proceeds to put the money back into the same kind of property that no taxable gain should be recognized.

Hearings Before the Senate Finance Committee on H.R. 8245, 67th Cong. 55 (Sept. 1, 1921)(testimony of Dr. T.S. Adams, Tax Advisor, Treasury Department). The termination of an executory merger agreement resulting in the taxpayer's receipt of a break-up fee followed by the taxpayer's acquisition of the stock of another target, does not constitute the continuation of a prior investment of capital and is not the type of circumstance under which Congress intended to provide relief. Such circumstances do not give rise to the type of hardship with which Congress was concerned.

B. [redacted]'s property was not "compulsorily or involuntarily" converted.

Section 1033(a) provides for the nonrecognition of certain gains realized when property is "compulsorily or involuntarily converted" due to its destruction, theft, seizure, or condemnation. The conversion of property is compulsory or involuntary for purposes of section 1033(a) only where it is "wholly beyond control of the one whose property has been taken." Dear Publication & Radio, Inc. v. Commissioner, 274 F.2d 656, 660 (3d Cir. 1960). That economic, business, or personal reasons compel the sale or disposition of property does not make the sale or disposition an involuntary conversion. Hitke v. Commissioner, 296 F.2d 639, 644 (7th Cir. 1961). Thus, a taxpayer's demolition of a building based on a third-party's promise (never fulfilled) to secure financing for construction of a new building on the site of the old was held not to constitute an involuntary conversion. Wheeler v. Commissioner, 58 T.C. 459 (1972). Likewise, the sale of a damaged ship was held not to be an involuntary conversion where the ship could have been repaired. C.G. Willis, Inc. v. Commissioner, 41 T.C. 468 (1964), aff'd per curiam, 342 F.2d 996 (3d Cir. 1965). Sales and redemptions of stock in resolution of shareholder disputes have consistently been held not to constitute involuntary conversions. Dear Publication & Radio, Inc., 274 F.2d 656, 660-661 (3d Cir. 1960) (stock sold under competitive bidding agreement after state court had granted petition for corporate dissolution under state deadlock statute). See also, Hitke v. Commissioner, T.C. Memo. 1961-66, aff'd, 296 F.2d 639, 644 (7th Cir. 1961); Robins

v. Commissioner, 15 B.T.A. 1068 (1929). In this case, in essence, [redacted] was simply outbid by [redacted].

C. [redacted]'s property was not converted by "destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof."

Section 1033(a) provides for nonrecognition of gains realized due to the compulsory or involuntary conversion of property by "its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof." Not all compulsory and involuntary conversions come within the ambit of section 1033. To the contrary, the section only applies to the four types of conversions specifically enumerated therein: (1) the destruction of property in whole or in part; (2) the theft of property; (3) the seizure of property; and (4) the requisition or condemnation of property or the threat or imminence of requisition or condemnation. Hitke v. Commissioner, 296 F.2d 639, 644 (7th Cir. 1961) .

The present facts plainly do not give rise to any of the last three types of conversions enumerated in section 1033(a). "Theft" for purposes of the Code in general, and section 1033 in particular, is the criminal appropriation of another's property. Hope v.Commissioner, 55 T.C. 1020, 1033-1034 (1971), aff'd, 471 F.2d (3d Cir. 1973), cert. denied, 414 U.S. 824 (1973). Here there is no allegation that [redacted]'s property was taken by any means constituting a crime under any state or Federal criminal statute.

As used in section 1033, the phrase "requisition or condemnation or threat or imminence thereof" means a taking or threatened taking of a taxpayer's property for public purposes by a governmental or quasi-governmental entity under the power of eminent domain. Koziara v. Commissioner, 86 T.C. 999, 1006-1007 (1986), aff'd. 841 F.2d 1126 (6th Cir. 1988); Dorothy C. Thorpe Glass Mfg. Corp. v. Commissioner, 51 T.C. 300, 305 (1968); Dear Publication & Radio, Inc. v. Commissioner, 31 T.C. 1168, 1174 (1959), aff'd, 274 F.2d 656 (3d Cir. 1960). The term "seizure" also denotes a taking for public purposes by a governmental entity, but without prior court approval and compensation. Rev. Rul. 79-269, 1979-2 C.B. 297. See, Hutcheson v. Commissioner, T.C. Memo. 1996-127; Recio v. Commissioner, T.C. Memo. 1991-215; Hitke v. Commissioner, T.C. Memo. 1961-66, aff'd, 296 F.2d 639 (7th Cir. 1961). Clearly there was no seizure" or "requisition or condemnation or threat or imminence thereof" under the present facts as there was no taking or threatened taking by a governmental or quasi-governmental entity.

The only type of conversion enumerated in section 1033(a) which could arguably have occurred under the present facts is a conversion by "destruction in whole or in part." For purposes of section 1033(a), however, legislative history, case law, and administrative rulings have long equated the "destruction" of property to the property's loss from a casualty, something which did not occur in the present case.

The nonrecognition provisions currently found in section 1033(a) were originally enacted as sections 214(a)(12) and 234(a)(14) of the Revenue Act of 1921. Sections 214(a)(12) and 234 (a) (14)[1] provided for the nonrecognition of gains from the involuntary conversion of property "as a result of (A) its destruction in whole or in part, (B), theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof." The legislative history of the Revenue Act of 1921 indicates that the nonrecognition provisions were applicable where "property is involuntarily converted into cash as a result of fire, shipwreck, condemnation, or related causes". H.R. Rep. No. 350, 67th Cong., 1st Sess. 12 (1921) , 1939-1 C.B. Part 2, 177; S. Rep. No. 275, 67th Cong., 1st Sess. 15 (1921), 1939-1 C.B. Part 2, 181; H.R. Conf. Rep. No. 486, 67th Cong., 1st Sess. 26 (1921), 1939-1 C.B. Part 2, 215. The phrase "fire, shipwreck, condemnation, or related causes" used in the legislative history closely matches the phrase "fire, storm, shipwreck, or other casualty..." currently found in section 165(c)(3) and first used in the Code to describe the types of events giving rise to deductible casualty losses in the Revenue Act of 1916.

In Wheeler v. Commissioner, 58 T.C. 459 (1972), the Tax Court held that section 1033 (a) applies only to public takings and casualty-type conversions. The taxpayer in Wheeler had demolished a building he owned based on a third-party's agreement to secure financing for construction of a new building on the site of the old. When the third-party failed to secure the promised financing, the taxpayer sued under a promissory estoppel theory and was ultimately awarded a judgment equal to the value of the demolished building. The taxpayer failed to report the judgment claiming, inter alia, that the nonrecognition provisions of section 1033 applied. The Court, citing the legislative history of section 1033(a)'s predecessor, held that the conversion was not of the kind to which section 1033(a) applied, stating:

> Congress clearly intended to extend the benefits of section 1033 and its predecessors only to public takings and casualty-like conversions, and the limitation of its benefits to involuntary conversions i.e., those "wholly beyond control of the one whose property has been taken" - reflects that intent. Dear Publication & Radio, Inc. v. Commissioner, 274 F.2d 656, 660 (3d Cir. 1960), aff'g 31 T.C. 1168 (1959).
>
> In the instant case, petitioner deliberately and voluntarily demolished his building. This was not a casualty or an event similar to one. Consequently, we are unable to find that this transaction is within the purview of section 1033.

Id., at 463. See also, Carver v. Commissioner, T.C. Memo. 1985-454 (board coup not analogous to casualty). Wheeler is consistent with a series of earlier administrative rulings which hold that for purposes of section 1033(a) and its predecessors, the term

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[1]Sections 214 (a)(12) and 234(a)(14) applied to individuals and corporations, respectively.

"destruction" is equivalent to a "casualty" within the meaning of section 165(c)(3). I.T. 3696, 1944 C.B. 241; Rev. Rul. 54-395, 1954-2 C.B. 143; Rev. Rul. 59-102, C.B. 200; Rev. Rul. 66-334, 1966-2 C.B. 302.

The term "casualty" has been described as something which is "sudden, unexpected, violent and not due to deliberate or willful actions by the [taxpayer]." White v. Commissioner, 48 T.C. 430, 433-434 (1967). For at least two reasons, the termination of the [redacted] Merger Agreement did not constitute a casualty:

1. First and most significantly, the Courts have consistently limited the concept of a casualty to the physical destruction, loss, or damage of property due to physical forces such as shipwreck, storm, fire, or the like. Citizens Bank of Weston v. Commissioner, 28 T.C. 717 (1957), aff'd, 252 F. 2d 425 (4th Cir. 1958) ("We agree with the respondent that physical damage or destruction of property is an inherent prerequisite in showing a casualty loss"). Casualty loss claims have uniformly been rejected where taxpayers have suffered economic loss not caused by physical destruction, loss, or damage resulting from physical forces. Broido v. Commissioner, 36 T.C. 786, 793 ("[W]e have found no departure from the concept that the loss covered was that represented by physical damage of property, whether from the result was partial or complete destruction"). See also, Pulvers v. Commissioner, 407 F. 2d 838, 839 (9th Cir. 1969) (diminution in value of real estate due to landslide which destroyed nearby homes but did no physical damage to subject property); Billman v. Commissioner, 73 T.C. 139 (1979) (loss incurred when South Vietnamese currency became worthless upon the fall of the South Vietnamese government); Hart v. Commissioner, T.C. Memo. 1997-11, aff'd without published opinion, 135 F.3d 764 (3rd Cir. 1997) (loss incurred on stock sold to satisfy margin calls on "Black Monday" in 1987); Furer v. Commissioner, T.C. Memo. 1993-11, aff'd without published opinion, 33 F.3d 58 (9th Cir. 1997) (loss incurred on stock sold to satisfy margin calls on "Black Monday" in 1987); and Dubin v. Commissioner, T.C. Memo. 1976256 (loss of amounts already paid for room and board when taxpayer's son called to active duty). In the present case, plainly there was no physical destruction, loss, or damage of the taxpayer's property due to any physical force. The termination of the merger agreement therefore did not result from a casualty and, accordingly, there was no involuntary conversion due to the destruction of property.

2. To constitute a casualty an event must be "unexpected." White v. Commisioner, 48 T.C. 430, 433 (1967); Rev. Rul. 72-592, 1972-2 C.B. 101. The termination of the Merger Agreement, however, was a reasonably foreseeable event. At the time the Merger Agreement was entered into, the possibility that [redacted] would ultimately merge with [redacted] rather than [redacted] was not insubstantial. [redacted] had made a hostile merger proposal and there was certainly no assurance that [redacted] would give up in the face of the [redacted] agreement. The Merger Agreement itself explicitly provided for the merger's termination on the very grounds upon which the merger was ultimately terminated. Merger Agreement, Article VII. Further, wholly apart from the [redacted] proposal, the Merger Agreement

was subject to any number of contingencies which could have resulted in the agreement's termination. Thus, termination of the merger was not "unexpected" and cannot be considered to have resulted from a casualty.

D. The breakup fees were not paid on account of the conversion of [redacted] property.

Section 1033(a) provides that where "property . . . is . . . converted . . . [i]nto money or into property . . . the gain" shall not be recognized to the extent provided therein. It is clear from the face of the statute that nonrecognition is available only for those gains directly realized from converted property. In the present case, the $[redacted] in issue was not paid on account of the conversion of [redacted]'s executory contract or any other property right, but rather in satisfaction of the terms of the Merger Agreement.

The Merger Agreement included detailed provisions concerning terminations of the agreement under different situations, and the effects of such terminations. Under Section 7.01(b)(i), for example, either [redacted] or [redacted] could terminate the agreement if the approval of [redacted]'s shareholders was not obtained. The failure of [redacted]'s shareholders to approve the merger did not, however, automatically require [redacted] to pay [redacted] the $[redacted] break-up fee. Under Section 7.02(a), [redacted] would be liable for the $[redacted] break-up fee only if (1) [redacted]s Board of Director's failed to recommend approval of the merger, or (2) [redacted]s shareholders approved a merger with a different company.

Under different circumstances, no break-up fee would be paid. For example, if [redacted]'s shareholders did not approve the merger, even though [redacted]s Board of Directors recommended approval, and [redacted] did not merge with a different company, then under Section 7.02(c) [redacted] would be required to reimburse [redacted] for reasonable merger-related expenses (up to $[redacted]) but would not be liable for the $[redacted] break-up fee.

Accordingly, payment of the $[redacted] break-up fee was *in accordance* with the merger agreement, not on account of its conversion.

E. The [redacted] stock acquired by [redacted] does not constitute "property similar or related in service or use" to the executory contract purportedly converted.

Subparagraph (a) (2) (A) of section 1033 provides, in part, that where property has been involuntarily converted into money:

> If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, ... at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized

upon such conversion ... exceeds the cost of such other property or such stock.

Replacement property is not "similar or related in service or use" to converted property merely because it used in the same general business as was the converted property. Rather, section 1033 (a) requires "a reasonable degree of continuity in the nature of the assets as well as in the general character of the business." Maloof v. Commissioner, 65 T.C. 263, 271 (1975).

The taxpayer in the present case identifies the converted property as an executory contract for the merger of [redacted] and [redacted]. The taxpayer apparently does not argue that the property converted was the [redacted] stock or [redacted] assets underlying the Merger Agreement. Such an argument would fail in any event for at least two reasons. First, [redacted] never acquired an ownership interest in stock or assets of [redacted]. At most [redacted] acquired a right to merger with [redacted] which was subject to shareholder approval and various other contingencies. Second, neither the stock nor assets of [redacted] were destroyed by termination of the Merger Agreement. If the property interest in issue was either the [redacted] stock or the [redacted] assets, there was no conversion.

The property acquired by [redacted] as replacement property was the stock of [redacted], another mining company. Doubtless, the stock was purchased for use in the same general business for which [redacted] wished to acquire [redacted]. Stock, however, differs substantially in nature from an executory contract to merge. Stock conveys direct ownership of the corporation and indirect ownership of its business and assets. An executory contract to merge represents little more than an agreement to proceed towards a merger, especially where, as here, the agreement is subject to substantial contingencies such as shareholder approval, regulatory approval, and so forth.

We have not located any authority directly addressing the question of what constitutes "property similar or related in service or use" to a converted executory contract. However, with respect to an analogous issue, it has been held that an executory contract to acquire replacement property is not the equivalent of the property to be acquired under the contract. For instance, in Estate of Johnson v. Commissioner, 51 T.C. 290 (1968), aff'd sub nom., Dettmers v. Commissioner, 930 F. 2d 1019 (6'" Cir. 1970), the Tax Court held that a taxpayer failed to purchase replacement property within the statutory replacement period where prior to the expiration of the replacement period he entered into an executory contract for the purchase of replacement real estate but the sale did not close until after the expiration of the replacement period. Likewise, Rev. Rul. 56-543, 1956-2 C.B. 521, held that a taxpayer failed to purchase replacement property within statutory period where prior to the expiration of the replacement period he entered into an executory contract for the construction of replacement property, but the replacement property was not actually constructed until after the expiration of the replacement period. If property can only be replaced for purposes of section 1033(a) with similar property and not with an executory contract to

purchase similar property, it follows that an executory contract can only be replaced with another executory contract and not with the type of property which is the subject of the contract.

The executory contract conveyed no ownership interest in the subject corporation, its stock, or its assets, and was subject to numerous contingencies. In contrast, the stock purportedly purchased to replace the executory contract conveyed a direct ownership interest in the subject corporations and an indirect interest in their assets. The stock did not represent a "continuity in the nature of the assets" and was not similar or related in service or use to the Merger Agreement.

F. An executory contract does not constitute "property" for purposes of § 1033.

An executory contract to purchase an asset does not constitute "property" for purposes of section 1033(a). Such a contract conveys no ownership interest in the asset for Federal income tax purposes and that any damages awarded for the breach of such a contract represent lost profit. See, Beck v. Commissioner, T.C. Memo. 1987-359 (notwithstanding contract to sell, no ownership interest in cattle recognized for Federal income tax purposes as burdens and benefits of ownership had not passed to the purchaser). See also, Treas. Reg. § 1.1033(a)-2(c)(8)(proceeds from a use and occupancy insurance contract which insures against lost profits are not proceeds from involuntary conversion, but are income in the same manner as the profits they replace). Thus there was no conversion of property in the present case as the Merger Agreement was not property for purposes of section 1033(a).

James W. Clark
Area Counsel
Communications, Technology
and Media

By: _____
BRYCE A. KRANZTHOR
Attorney (LMSB)

Attachments

Exhibit A: Article VII of the Merger Agreement
Exhibit B: [redacted]'s Explanation of its Section 1033 Election