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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR THOMAS G. SCHLEIER
ASSISTANT DISTRICT COUNSEL CC:WR:NCA:SF

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Qualification as replacement property under I.R.C. § 1033

This Field Service Advice responds to your memorandum dated February 1, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer:
Subsidiary:
Corporation 1:
Corporation 2:
Corporation 3:
Corporation 4:
Corporation 5:
A:
B:
C:
D:
E:
F:
G:
H:

LEGEND (cont'd)

Year 1:	a:
Year 2:	b:
Year 3:	c:
Year 4:	d:
Year 5:	e:
Location X:	f:
Location Y:	g:
Property 1:	h:
Date 1:	i:
Date 2:	j:
Date 3:	k:
Date 4:	l:
Date 5:	m:
Date 6:	n:
Date 7:	
Storm:	

ISSUES

(1) Whether G are property which is similar or related in service or use to C for purposes of deferring gain under I.R.C. § 1033.

(2) If the G do not qualify as similar property, whether the gain resulting from the involuntary conversion is taxable in the year the property was destroyed, in the year the insurance claim was settled, or in the years the insurance proceeds were received.

(3) If the G qualify as similar property, whether Subsidiary is required to reduce its basis, for purposes of computing depletion, by the amount of gain realized but not recognized from the involuntary conversion.

CONCLUSIONS

(1) We conclude the G are not property which is similar or related in service or use to C for purposes of deferring gain under section 1033. Accordingly, Subsidiary's acquisition of control of Corporation 5 does not qualify as replacement property under section 1033 and Subsidiary must recognize the gain from the conversion.

(2) The amount of taxable gain resulting from the involuntary conversion will have to be redetermined based on our conclusions on Issue 1. Subsidiary received a partial payment of insurance proceeds in Year 1, the year the property was destroyed. To the extent the insurance proceeds received in Year 1 exceeded the amount of taxable gain as redetermined, Subsidiary should be required to recognize the gain in Year 1. The remaining gain should be recognized in the year the insurance claim was settled. If the taxable gain does not exceed the portion of insurance proceeds received in Year 1, Subsidiary should be allowed to defer recognition of the gain until the year the insurance claim was settled.

(3) If it is determined that the principal property owned by Corporation 5 was in fact similar or related in service or use to Subsidiary's destroyed property, Subsidiary is required to reduce the basis of the stock, but not the basis of the property in accordance with the version of section 1033(b) in effect in Year 1, when the involuntary conversion occurred. However, because Taxpayer and Subsidiary played an integral part in structuring the transaction to reap the benefits of a stock purchase under section 1033, the Service can step the transaction together to reflect that Corporation 2 did not exchange Property 1 Corporation 5 stock in a valid section 351 exchange. The substance of the transaction reflects that Corporation 2 instead sold Property 1 directly to Subsidiary.

FACTS

Taxpayer is engaged on a worldwide basis in the exploration for, and the development, production, purchase, transportation and sale of A and B. Taxpayer is the common parent of an affiliated group of corporations that filed consolidated corporate income tax returns for Year 1 through Year 5, inclusive. Subsidiary is a member of the affiliated group.

On Date 5, Storm caused extensive damage to Subsidiary's property, including C, D and E located in Location X. Some of the property was toppled over and totally destroyed; some of the property suffered sufficient damage to be condemned; other damaged property was capable of being repaired. Subsidiary, however, was later able to access those resources by restoring some of the D. Subsidiary's adjusted basis in the destroyed property was f. The properties damaged by Storm were covered by insurance.

Subsidiary received insurance proceeds in the amount of c in Year 1; however, there was a delay in determining the full amount that Subsidiary was entitled to. On Date 1, Subsidiary settled its insurance claim for losses caused by Storm. The covered losses agreed upon totaled a. After reductions for the deductible and for amounts paid in Year 1, Subsidiary received insurance proceeds of d in Year 3. Accordingly, Subsidiary received insurance proceeds from this incident in the total amount of b.

Although Subsidiary made expenditures to restore access to its F in Location X, the cost of restoring the D and E was not treated as replacement property for purposes of section 1033. Instead, Subsidiary deducted these expenditures under section . In addition, Subsidiary acquired certain property as set forth below in an effort to take advantage of the benefits of section 1033.

Subsidiary decided to acquire Property 1 in Location Y.[1] Property 1, which produces B, was operated by Corporation 1 and the rights to the property were owned by Corporation 1, Corporation 2, Corporation 3 and Corporation 4 in a joint venture. None of the corporations was related to Taxpayer, Subsidiary, or to each other. Corporation 1, Corporation 2, Corporation 3 and Corporation 4 owned approximately 65% , 3%, 22% and 10% of Property 1, respectively. Property 1 consisted of equipment, facilities, agreements, easements and records, as well as D and G. However, it is our understanding that G comprised the bulk of the value of Property 1.

The information we have indicates that Taxpayer was originally involved in negotiations for the purchase of Property 1 with each of the corporations, individually. It appears that later Corporation 1 was primarily responsible for negotiating the terms of the sale on behalf of the sellers. The negotiations between Taxpayer and the individual corporations took place in July, August and early September of Year 3. Documents reflecting the substance of these negotiations do not suggest that it was originally contemplated that the acquisition of Property 1 would be a stock purchase. In fact, the determination to structure the deal as a stock purchase does not appear to have been made until late September in Year 3.

An internal memorandum between Taxpayer and Subsidiary officers dated Date 6, discussed the negotiations for Property 1 between Taxpayer and Corporation 1. It also discussed that certain tax benefits under section 1033, yet to be arranged,

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[1]Documents indicate that Subsidiary first identified Property 1 as replacement property as early as Date 6. We do not know whether Subsidiary may have identified Property 1 as replacement property prior to Date 6.

could improve the net present value of the transaction as structured. According to the memorandum:

> Subsidiary requests your assistance in reporting to the Executive Committee the proposed acquisition of Property 1 from Corporation 1 and partners. We have reached agreement with Corporation 1 and partners to acquire their interests ... Finalization of the transaction is expected prior to year end with an effective date of Date 4....
>
> Additional value to Taxpayer may also be realized by deferring the gain on Storm settlement funds under Internal Revenue Code Section 1033 provisions. While the precise benefit we may realize will depend on items yet to be resolved such as the exact structure of the transaction and the financial position of the sellers the potential benefit to Taxpayer ranges from zero to approximately $25 million NPV [Net Present Value]. **To achieve this potential uplift the transaction will need to be structured so that the interests of the current owners are conveyed into an as yet undesignated corporation whose stock will subsequently be acquired by Subsidiary.** Corporation 1 has expressed a willingness to consider structuring the transaction in this manner, but specific details have not yet been addressed and no final agreement has been reached on this point. A further increase in purchase price of up to $5 million, dependent on the level of benefit gained, may be required to provide additional incentive to the sellers to accommodate our desires for the transaction structure.

(Emphasis added).

An internal memorandum in Subsidiary's records, dated Date 7, addressed additional reasons for structuring the acquisition of Property 1 as a stock purchase of a newly-formed subsidiary. The memorandum states the following:

> Given that there is not enough time available to perform a very thorough examination of the subject property ... and the fact that Subsidiary is acquiring this property from smaller, , it would be best if the ... sellers transfer their interests to a newly-formed company, the stock of which Subsidiary would buy. This new company, after being bought by Subsidiary, would continue to operate this property. In this fashion, all liabilities, if any, would remain with the newly-formed company, and would not become part of Subsidiary's liabilities.

> An additional benefit of handling this acquisition in the above fashion is that, by keeping it separate, we can monitor the performance of this acquisition as though it was a separate business opportunity, giving the team who will be managing it a sense of ownership and accountability. If Taxpayer decides to sell ... at some point in the future, it would be very easy to simply sell this newly-formed company.

On Date 2, Corporation 2 purchased the interests in Property 1 of Corporation 1, Corporation 3 and Corporation 4.[2] Corporation 2 then assigned its interest in the property to Corporation 5, a newly formed corporation, in exchange for all of the stock in Corporation 5. The agreement by which Corporation 2 assigned its interest in Property 1 to Corporation 5 was also executed on Date 2, although it purports to be effective as of Date 4. Also on Date 2, Subsidiary purchased all of the stock of Corporation 5 from Corporation 2 for e.

Corporation 5 is now a wholly-owned subsidiary of Subsidiary and a member of Taxpayer's consolidated group. At the time Subsidiary purchased Corporation 5's stock, the assets of Corporation 5 consisted of H valued at g and G valued at h.

Subsidiary argues it is entitled to defer the gain realized from the involuntary conversion of its assets under section 1033. It treats the Corporation 5 stock as qualified replacement property based on section 1033(a)(2)(A). In addition to the stock, Subsidiary purchased two C in Year 4 as replacement property. It is not clear what Subsidiary paid for the two C; however, Subsidiary allocated basis to the replacement property as follows:

Stock in Corporation 5	j
C	k

For depletion purposes, Subsidiary claims a basis of h in the Property 1 G. This represents the cost to Corporation 2 of acquiring the G. Subsidiary argues that, for the year in which the property was destroyed, the rules under section 1033(b), requiring adjustments to the basis of replacement property to reflect the gain or loss resulting from the involuntary conversion, apply to the stock rather than to the underlying assets.

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[2] We note that there is little to explain why Corporation 2, only a 3% owner in Property 1, was identified and selected as the company that would purchase the interests of the other joint venturers, exchange them for stock in Corporation 5 and sell the stock to Subsidiary.

On its consolidated returns for the Year 3, Year 4, and Year 5, Subsidiary deducted cost depletion with respect to the G owned by Corporation 5 in the following amounts:

YEAR	DEPLETION DEDUCTION
Year 3	l
Year 4	m
Year 5	n

LAW AND ANALYSIS

Section 1033(a)(2) provides the general rule that gain resulting from the compulsory or involuntary conversion of property as a result of its destruction in whole or in part, theft, seizure, requisition, or condemnation into money or into property that is not similar or related in use to the converted property, shall be recognized.

Under section 1033(a)(2)(A), a taxpayer may defer recognition of gain resulting from an involuntary conversion, if, during a specified period, the taxpayer, for the purpose of replacing the property so converted, purchases other property that is similar or related in service or use to the converted property. A taxpayer also has the option of purchasing stock in the acquisition of control of a corporation owning property that is similar or related in service or use to the converted property. In either case, the taxpayer must recognize gain from the conversion only to the extent that the amount realized on the conversion exceeds the cost of the replacement property or stock.

Section 1033(a)(2)(B) provides the periods within which the taxpayer must replace the converted property. In this case, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain is realized.

Section 1033(g)(1) provides that for purposes of section 1033(a), if real property held for productive use in a trade or business, or for investment is (as a result of its seizure, requisition or condemnation) compulsorily or involuntarily converted, property of a like kind shall be treated as property similar or related in service or use to the converted property. However, section 1033(g)(1) does not apply to property that is involuntarily converted as a result of its destruction. In addition,

section 1033(g)(1) does not apply to the purchase of stock in the acquisition of control of a corporation. I.R.C. § 1033(g)(2).

Section 1033 is intended to be a relief provision and, therefore, is entitled to liberal and realistic construction. See, e.g., Graphic Press, Inc. v. Commissioner, 523 F.2d 585, 589 (9th Cir. 1975); Asjes v. Commissioner, 74 T.C. 1005, 1014 (1980), acq. in result in part, 1982-2 C.B. 1; Masser v. Commissioner, 30 T.C. 741, 746-47 (1958), acq. 1959-2 C.B. 5; Massillon-Cleveland-Akron Sign Co. v. Commissioner, 15 T.C. 79, 83 (1950), acq. 1950-2 C.B. 3.

Issue 1: Whether G are property that is similar or related in service or use to C for purposes of deferring gain under I.R.C. § 1033.

In this case, Subsidiary owned C that were destroyed in a . Subsidiary purchased two C and stock in a corporation that primarily owned G as replacement property. The two C acquired in Year 4 should qualify as property that is similar or related in service or use to the destroyed C under the functional use test. However, it is unclear, based on the facts we have, whether the two C were acquired timely pursuant to section 1033(a)(2)(B), or whether Subsidiary or Taxpayer sought and received an extension of time for replacing the converted property. Accordingly, we do not opine on whether Subsidiary is entitled to defer gain from the conversion with respect to its acquisition of this property.

With respect to Subsidiary's acquisition of stock in Corporation 5, the determination of whether the stock constitutes replacement property for purposes of section 1033 hinges on whether the G owned by Corporation 5 are considered to be property that is similar or related in service or use to the C that were destroyed. Subsidiary is not entitled to determine whether G qualifies as replacement property using the like-kind standard set out in section 1033(g). Section 1033(g) applies only to real property used in a trade or business that is involuntarily converted as a result of seizure, requisition or condemnation. As Subsidiary's property was destroyed, section 1033(g) is inapplicable and Subsidiary may not rely on the like-kind test.

In Rev. Rul. 64-237, 1964-2 C.B. 319, the Service announced a modification of its position regarding the meaning of the phrase "similar or related in service or use" when applied to section 1033 replacement property. The Service announced that, for taxpayer-investors, the focus would be on the similarity in the relationship of the services or uses that the original and replacement properties had to the taxpayer-investor. In applying this test, the Service indicated it would consider whether the business risks associated with the properties and the demands on the taxpayer, in terms of providing management services, were sufficiently similar. If so, the replacement property would be considered similar or related in service or use,

regardless of whether the property had a close functional similarity to the converted property.

However, the Service emphasized in Rev. Rul. 64-237 that the announced modification only applied to taxpayer-investors. For taxpayers that used the converted property, the Service indicated it would continue to adhere to the functional use test, under which replacement property is not considered similar or related in service or use to converted property unless the physical characteristics and end uses of the converted and replacement properties are closely similar.

In Rev. Rul. 72-433, 1972-2 C.B. 470, the Service considered whether a taxpayer that retained legal title to the converted property was entitled to defer gain under section 1033. In that case, the taxpayer granted the Government a perpetual overflow easement that gave the Government the right to flood his farm when necessary. It was projected that the farm would be flooded once every six years. The taxpayer was restricted from building structures for human habitation on the property, but was allowed to continue to farm the land, except when it was flooded. The taxpayer used the condemnation proceeds to purchase other farm land.

The Service determined that, under these circumstances, the taxpayer was entitled to defer the gain under section 1033. The Service considered the fact that the taxpayer used the proceeds of the condemnation award to restore his farm to its production volume prior to granting the easement and determined that section 1033 did not require the taxpayer to be deprived of all beneficial rights in the converted property. See Rev. Rul. 54-575, 1954-2 C.B. 145.

In Rev. Rul. 76-319, 1976-2 C.B. 242, the owner of a recreational bowling center that was destroyed by fire, attempted to replace the property with a recreational billiard center. It was determined that bowling alleys and bowling equipment were insufficiently similar to billiard tables and billiard equipment for the billiard center to qualify as property similar or related in use to the converted bowling center. Similarly in Rev. Rul. 76-390, 1976-2 C.B. 243, it was determined that the physical characteristics and end uses of a motel were insufficiently similar to those of a mobile home park for the motel to qualify as property similar or related in service or use. Again, in Rev. Rul. 77-192, 1977-1 C.B. 249, it was determined that a floating vessel that was a self-contained fish processing plant was not similar or related in service or use to a land-based seafood processing plant because the physical characteristics of the destroyed plant and the replacement property were not closely similar and there were significant differences between the activities at the land-based plant compared with those on the vessel.

In United Development Co. v. United States, 212 F.Supp. 664 (E.D. Mo. 1962), the taxpayer operated a cemetery. A portion of the taxpayer's land designated for future burial plots was involuntarily converted. The taxpayer replaced the land with a building, which it intended to use as an office building for its business. The issue was whether the building was similar or related in service or use to the land. In finding the nature and character of the properties to be different, the court emphasized that the new building was "not a replacement of [the taxpayer's] income producing asset, the burial land." Id. at 667.

In Maloof v. Commissioner, 65 T.C. 263 (1975), the taxpayer engaged in an import, export business in China. The taxpayer imported and exported textiles which he designed and obtained the raw materials for, but which were manufactured in China. As a result of World War II, the taxpayer's business was seized and he claimed a war loss. The major portion of the losses sustained by the taxpayer resulted from the seizure of his inventory.

Subsequently, the taxpayer received an award from the Government with respect to the lost business property. He determined that part of the award should be treated as gain from an involuntary conversion and set up a fund to replace his business. The taxpayer invested the funds in a new business that was primarily engaged in the manufacture of textiles.

The Service argued that the taxpayer was not entitled to defer gain under section 1033 because he had not reinvested the fund in property that was similar or related in service or use to the converted property under the functional use test. The Service contended that the test should be applied to the particular assets converted and that only the portion of the gain that was reinvested in inventory items should be entitled to nonrecognition. The taxpayer argued the functional use test was satisfied without reference to the nature of particular assets, if the general character of the new business was substantially the same as that of the old.

The Tax Court did not entirely agree with either party. The court viewed some rearrangement of the taxpayer's investment among depreciable real and personal property as tolerable, where the overall effect was to reproduce the converted facility as closely as changed conditions would permit. However, the court indicated that section 1033 required "a reasonable degree of continuity in the nature of the assets as well as in the general character of the business." Maloof, 65 T.C. at 271. The court was not persuaded that acquiring a manufacturing plant had the effect of reestablishing the taxpayer's old business. Accordingly, the court concluded that, except for the purchases of inventory, the taxpayer had not replaced his converted property with other property similar or related in service or use within the meaning of section 1033.

In the instant case, Subsidiary was an owner-user of the converted property, rather than an owner-investor. Accordingly, the determination of whether Corporation 5's property qualifies as property similar or related in service or use to Subsidiary's converted property must be made under the functional use test. Application of the existing authority to the facts here leads us to conclude that the G owned by Corporation 5 do not qualify as property that is similar or related in service or use to the C that were destroyed.

Although section 1033 is a relief provision, we believe the existing authority illustrates that the functional use test is fairly restrictive. The property must have similar physical characteristics as well as being used for the same purpose. Moreover, a showing that the general character of the business is unchanged is insufficient if the nature of the replacement property is sufficiently dissimilar to that of the converted property. Although the properties are not required to be identical, section 1033(a) does contemplate "a reasonable degree of continuity in the nature of the assets" and a close relationship between the converted property and the replacement property. Maloof, 65 T.C. at 271.

In this case, the G comprise an interest in real property for federal income tax purposes. In contrast, the C are physical structures, or permanent improvements to real estate.

(describing the nature of the improvements). The G cover property that is land based, while the C are located at sea. Accordingly, there are significant differences in the business risks attendant with the operation of the properties and, more specifically, Subsidiary's activities in operating the properties. In addition, the G provide rights to B, while the C provide a physical mechanism for of A and B. Overall, the physical characteristics and end uses of the properties are sufficiently dissimilar to disqualify the properties under the functional use test as articulated in the relevant revenue rulings and cases.

In addition, we have considered the fact that only C, D and E were damaged by Storm. In Woodall v. Commissioner, 964 F.2d 361 (5th Cir. 1992), the Fifth Circuit upheld the Tax Court's decision to deny the taxpayers relief under section 1033. In that case, the taxpayers' owned a nightclub that sustained fire damage. The taxpayers used the insurance proceeds to repair the nightclub and also to purchase the land, building and improvements at another location. The Service allowed deferral of the gain from the conversion to the extent amounts were used to repair and replace the converted property. However, the Service did not treat the purchase of the land and improvements at the second location as property that was similar or related in service or use to the converted property.

The taxpayers argued that the purchase of a building could be a replacement for an involuntarily converted leasehold. The Fifth Circuit agreed, but indicated that the taxpayers' reliance on this argument was misplaced because the taxpayers had not suffered an involuntary conversion of their leasehold: "The purchase of the building replaced no damaged property and the funds used for its purchase do not fall within § 1033." Id. at 364.

Similarly in Templeton v. Commissioner, 66 T.C. 509 (1976), the Tax Court concluded that section 1033 requires a showing that the proceeds from the condemnation are used "'for the purpose of replacing the property so converted.'" Id. at 513 (quoting Feinberg v. Commissioner, 45 T.C. 635, 641-642 (1966), aff'd., 377 F.2d 21 (8th Cir. 1967)). If the proceeds of the conversion are not used to purchase property to replace the converted property, the benefits under section 1033 do not accrue. Id. at 615.

As in Woodall, Subsidiary retained its underlying rights to the A and the other F located on the property and was able to restore the property to full productivity. Thus, unlike the situation in Rev. Rul. 72-433, the property at Location Y did not replace the destroyed property and restore Subsidiary's productivity to pre-conversion levels. Instead, it augmented and expanded Subsidiary's investments in B. Because the acquisition of Corporation 5 did not replace damaged property, we conclude the stock purchase falls outside the scope of section 1033(a).

On the issue of whether Subsidiary may be entitled to defer recognition of gain under section 1033 to the extent that the investment in the stock of Corporation 5 represented an investment in equipment similar or related in service or use to destroyed equipment, you should be aware of the following authority.

After the decision in Templeton v. Commissioner, 66 T.C. 509, the taxpayer filed a motion to vacate the decision and for reconsideration based on a misunderstanding as to two paragraphs in the stipulation of facts. The Tax Court agreed to reconsider its opinion based on modified facts in Templeton v. Commissioner, 67 T.C. 518 (1976), aff'd, 573 F.2d 886 (4th Cir. 1978). The modified stipulation of facts indicated that the primary asset owned by the corporation at the time the taxpayer acquired control was an investment in the amount of $321,000 in Ford Motor Creditor Co. revolving notes. However, the parties agreed that certain assets owned by the corporation would qualify as similar or related in service or use to the unimproved land that had been condemned.

On these facts, the court remained unpersuaded that the taxpayer was entitled to section 1033 relief. The court distinguished Templeton from other cases where taxpayers had qualified under section 1033 by acquiring corporate stock. The court

determined that, although the corporation owned some property similar to the property that had been condemned, such property was not its principal asset after the taxpayer acquired his controlling interest. The court concluded that "[u]nder section 1033, a taxpayer's acquisition of stock qualifies only if he thereby acquires control of a corporation **whose assets consist principally** of similar property not owned by him immediately before the acquisition." Templeton, 67 T.C. at 521 (emphasis added).

This conclusion was affirmed by the court more recently in Kahl v. Commissioner, T.C. Memo. 1986-240, where the court concluded that, because the proceeds advanced to the corporation were not invested in assets consisting principally of similar property, the taxpayer did not purchase stock in the acquisition of control of a corporation owning such other property within the meaning of section 1033.

As we understand the facts of this case, at the time Corporation 5 was acquired by Subsidiary, its assets did not consist principally of property similar or related in service or use to Subsidiary's converted property. Assuming that position is sustained, there is authority under Templeton and Kahl to argue that no part of the investment in Corporation 5 qualifies as replacement property under section 1033.

Issue 2: If the G do not qualify as similar property, whether the gain resulting from the involuntary conversion is taxable in the year the property was destroyed, in the year the insurance claim was settled, or in the years the insurance proceeds were received.

The taxpayer computes taxable income using an accrual method of accounting. We agree that for an accrual basis taxpayer the gain should be recognized in part in Year 1, when the two partial payments were made, and in part in Year 3, when the claim was settled.

In Curtis Electro Lighting, Inc. v. Commissioner, 60 T.C. 633 (1973), vacated without op., 532 F.2d 756 (7th Cir. 1976), the taxpayer sustained a substantial fire loss in 1960. The taxpayer carried insurance to cover for business interruption as well as for losses from damage to inventory and other property. The taxpayer received approximately $12,000 in insurance proceeds in 1960 as a result of damage to inventory. However, the taxpayer and its insurer did not immediately agree on the extent of the losses from business interruption. Both the taxpayer and the insurance company submitted various proposals for computing the loss and agreement was not reached as to the extent of the losses until 1961. The taxpayer included the insurance recovery from the business interruption insurance in income in 1961.

The Service disputed the treatment of the business interruption insurance. The Service argued that all events fixing the taxpayer's right to receive the insurance proceeds occurred in 1960. The Tax Court disagreed, reasoning that the insurance company did not acknowledge liability for the taxpayer's business losses until 1961. Thus, in the court's view, the taxpayer's right to receive the income was not fixed until 1961. In addition, the court was not persuaded that all factors from which the amount of the loss was computed were known to the parties in 1960. Accordingly, the court concluded that the amount of income to which the taxpayer was entitled could not be determined with reasonable accuracy until 1961.

The decision in Curtis Electro was eventually vacated because of a dispute related to the recomputation of the deficiency; however, the Service acquiesced in the result set forth in the court's opinion. 1975 AOD LEXIS 148. Although the Service disagreed that it was necessary for the insurance company to expressly admit liability before the insurance proceeds could accrue as income to the taxpayer, the Service conceded that evidence in the record supported the finding that the amount to be received could not be ascertained with reasonable accuracy in 1960.

Similarly to Curtis Electro, in the instant case the total amount Subsidiary was entitled to was not susceptible of accurate determination until the dispute with the insurance company was resolved. However, with respect to the proceeds actually received in Year 1, all events fixing Subsidiary's right to receive income in the amount received clearly had occurred. Consequently, the part of the gain attributable to the amounts received in Year 1 should be recognized in Year 1, with the balance being recognized in Year 3.

> Issue 3: If the G qualify as similar property, whether the taxpayer is required to reduce its basis, for purposes of computing depletion, by the amount of gain realized but not recognized from the involuntary conversion.

Although we have concluded that the stock in the instant case does not qualify as replacement property under section 1033(a)(2) because the G owned by Corporation 5 were not similar or related in service or use to the converted property, we assume for purposes of this issue that it has been determined that the G are similar or related in service or use to the C, D and E that were destroyed.

Section 1033(b) prescribes rules for the determination of the basis of property acquired through an involuntary conversion. Prior to amendment, section 1033(b) provided that the basis of property acquired in a transaction described in subsection (a)(2), which resulted in the nonrecognition of any part of the gain realized as the result of an involuntary conversion, would be the cost of such

property decreased in the amount of the gain not so recognized. If the property purchased consisted of more than one piece of property, the basis would be allocated to the purchased properties in proportion to their respective costs. This provision applied to involuntary conversions occurring before August 20, 1996.

For involuntary conversions occurring after August 20, 1996, section 1033(b) was amended to provide, among other things, that if the basis of stock in a corporation was decreased in the amount of nonrecognized gain, an amount equal to the decrease would also be applied to reduce the basis of property held by the corporation at the time the taxpayer acquired control.

In this case, the involuntary conversion occurred in Year 1. Thus, the determination of basis is covered by the provisions of section 1033(b), prior to amendment. Under these provisions, assuming the timing requirements were met, the C acquired by Subsidiary outside the stock transaction would be subject to a reduction in basis in an amount equal to the deferred gain resulting from the involuntary conversion. In addition, assuming the G qualify as property similar or related in service or use to the converted property, the stock of Corporation 5 would be subject to a reduction in basis to reflect the deferred gain. However, the G would not be subject to an adjustment to basis by reason of section 1033(b) unless it is determined that Subsidiary acquired the G directly rather than via a stock purchase.

In this case, Subsidiary takes the position that Corporation 2, having a 3% interest in Property 1, purchased the remaining 97% on Date 2. Corporation 2's acquisition established a cost basis for the property. On the very same day Corporation 2 formed Corporation 5 in a section 351 transaction[3] and exchanged the newly acquired G for 100% of Corporation 5's stock.[4] By virtue of this transaction,

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[3] IRC section 351(a) provides, generally, that no gain or loss is recognized when property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation, and immediately after the exchange such person or persons are in control of the transferee corporation. Control under section 368(c) means ownership of at least 80% of the then issued voting stock and at least 80% of the total number of shares of all other classes of then issued stock of the corporation.

[4] Under section 358(a), a transferor who transfers property to a corporation pursuant to section 351 takes as his or her basis in the stock received the same basis as he had in the property transferred, increased by any gain recognized on the exchange and decreased by any boot received.

Corporation 5 succeeded to Corporation 2's basis in the G.[5] Subsidiary then acquired all of Corporation 5's stock and, consistent with the provisions of section 1033(b) prior to its amendment, reduced its basis in the stock by the amount of gain realized, but not recognized by reason of section 1033(a). However, Subsidiary contends that the Property 1, including the G, are still owned by Corporation 5 and, consequently, retain the same cost basis at which they were acquired by Corporation 2.

You have asked whether, under the circumstances presented in this case, these transactions can be stepped together, with the result that Subsidiary is considered to have purchased Property 1 directly from the joint venturers. If so, Subsidiary would be required to reduce its basis in Property 1 under section 1033(b) and, as a participant in a section 351 exchange, would be viewed as exchanging Property 1 for 100% of the stock of Corporation 5.

The step transaction doctrine provides authority for arguing that certain economically meaningless steps of a transaction can be collapsed or ignored. Thus, the issue is whether the step transaction doctrine can be applied in this case to eliminate economically meaningless steps.

Courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine in a particular transaction. The tests applied are the "end result" test, the "mutual interdependence" test, and the "binding commitment" test. Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987). No one step transaction test is universally applied. Id. at 1429; Security Industrial Ins. Co. v. United States, 702 F.2d 1234, 1244 (5th Cir. 1983).

The less restrictive "end result test" links actions together if they are component parts of a single transaction intended from the outset to be executed for the purpose of reaching the ultimate result. See Penrod, 88 T.C. at 1429.

The "mutual interdependence test" inquires whether the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series of transactions. American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948), aff'd, 177 F.2d 513 (3d Cir. 1949).

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[5] Section 362(a) provides that the transferee corporation's basis in the properties received is the same as that in the hands of the transferor increased by the amount of any gain recognized by the transferor.

The emphasis under this test is on the relationship between the steps, rather than on the end result. See McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520, 524 (7th Cir. 1982). Therefore, it is especially proper to disregard the tax effects of individual steps where "it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts."

The "binding commitment" test, first articulated by the Supreme Court in Commissioner v. Gordon, 391 U.S. 83, 96 (1968), states that a series of actions by a taxpayer will only be treated as a single, integrated transaction if at the time the taxpayer took the first step he was under a binding commitment to take the later steps. See Security Indus., 702 F.2d at 1245.

Some of the factors considered in determining whether there is a step transaction are proximity in time between the steps, whether the steps are part of an integrated transaction, whether there is a binding commitment and whether the step is contemplated by the parties. See Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937).

As previously discussed, in order for there to be a valid section 351 transaction as contemplated by Subsidiary, the transferor, in this case, Corporation 2, would have to be in control of Corporation 5, as defined in section 368. Furthermore, a valid section 351 transfer requires that there be a valid business purpose for the exchange. See Caruth v. United States, 688 F. Supp. 1129, 1138-42 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989).

We conclude that the transaction reflects that Corporation 2 was never in control of Corporation 5, nor was there any business purpose with respect to the transactions between them.

According to the facts as we understand them, Taxpayer and Subsidiary had been negotiating with the independent owners of Property 1 during July, August and early September of Year 3. Nothing reflects that Taxpayer or Subsidiary intended the acquisition of the property to be consummated as a stock purchase at this time. However, it appears that by Date 6, Taxpayer and Subsidiary had decided it would be advantageous to arrange the transaction as a stock purchase for purposes of benefitting from section 1033. In fact, this appears to be a key element in setting up the purchase. Taxpayer’s subsequent Date 7 memorandum discloses other reasons for acquiring the property in the form of a stock purchase, such as to limit its environmental liabilities, to allow tracking of Corporation 5's performance, and to facilitate the potential disposition of Corporation 5's assets. However, we believe the chronological sequence of documents indicates that the primary purpose for

structuring the transaction as a stock purchase was to obtain tax benefits under section 1033.

It makes little sense for Corporation 2, all within the same day, to purchase the Property 1, transfer the acquired assets in a purported section 351 exchange for Corporation 5's stock and sell the stock to Subsidiary. Corporation 2 does not appear to have had a valid business purpose for the exchange. The series of agreements entered into by the parties in the transaction were all consummated in one day, which is a factor demonstrating the transaction should be stepped together. The documents also reflect that Taxpayer provided substantial incentives to the individual owners of the Property 1 in order to guarantee the transaction was arranged as a stock purchase and to ensure that it obtained a cost basis in Property 1.

In addition to not having a business purpose for entering into the transaction, at no time was Corporation 2 in control of Corporation 5 for purposes of section 351. Corporation 2 was merely a vehicle by which Taxpayer and Subsidiary arranged the purchase of Property 1. We believe it is significant that the President of Corporation 1, the owner of the largest interest in Property 1 prior to these transactions, did not have any understanding as to the structure of the transactions by which Property 1 was sold and that he indicated that the parties' tax attorneys were responsible for consummating the structure of the sale.

In sum, we conclude it was economically meaningless for Corporation 2 to acquire Property 1 prior to its sale to Subsidiary. Under either the mutual interdependence test or the end result test the series of transactions can be stepped together.

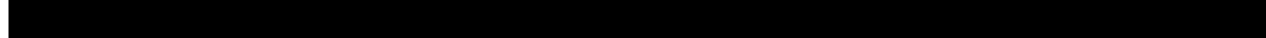
The Service can disregard the transactions between Corporation 2 and the other joint venturers and between Corporation 2 and Corporation 5 because it is unlikely that Corporation 2 would have purchased Property 1 and undertaken the section 351 transaction except for purposes of selling Corporation 5 to Subsidiary. Therefore, we believe the facts of this case support an argument that the mutual interdependence test is met. Furthermore, we also believe that the end result test is met because of Taxpayer's influence on the structure of these transactions and the fact that they were clearly part of an overall plan for Subsidiary and Taxpayer to receive a step up in basis. None of these meaningless steps would have been undertaken had it not been the strategy of Taxpayer and Subsidiary to acquire a step up in basis in the replacement properties.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Potential Litigating Hazards

First, we have found no case law specifically deciding the issue of whether G are property that is similar or related in service or use to C, D and E for purposes of section 1033.

Second, there is documentation, contrived or not, which suggests that there may have been valid business purposes, other than tax advantages, for setting up the transaction as a stock purchase . The internal memorandum dated Date 7, indicates that Taxpayer was concerned over exposure to environmental liabilities and supports an argument that this concern contributed to the decision to structure the transaction as a stock purchase instead of an asset purchase. It appears that



.[6] Thus, Taxpayer may assert it has a legitimate concern over the impact of environmental liabilities. Further, Taxpayer may argue that the

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Service is substituting its judgment for Taxpayer's in determining its exposure to risk as a result of the asset acquisition.[7]

In addition, we believe Taxpayer can argue that by enacting section 1033, Congress specifically approved transactions, such as those outlined in this case, where taxpayers set up their transactions to take advantage of the involuntary conversion provisions through the use of a stock purchase. The difference in the basis of replacement property for depreciation or depletion purposes that resulted from a stock acquisition compared with a direct asset purchase was eventually remedied by Congress in the Small Business Job Protection Act (SBJPA) of 1996, effective August 20, 1996. See Blue Book Joint Committee on Taxation 104th Congress, 2d Session; JCS-12-96 with respect to section 1610 of the SBJPA '96. However, the fact that a legislative fix was necessary, supports a possible assertion that the transaction, as consummated in Year 3, prior to the effective date of SBJPA '96, was nothing more than good tax planning as part of an overall strategy to acquire Property 1, limit Taxpayer's exposure with respect to environmental liabilities and secure the benefits under section 1033 of purchasing property through a stock purchase, rather than an asset purchase. See Gregory v. Helvering, 293 U.S. 465, at 469 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted").

Finally, we bring John Richard Corp. v. Commissioner, 46 T.C. 41 (1966), nonacq., 1974-2 C.B. 5, withdrawing acq., 1967-2 C.B. 3, to your attention. In John Richard, the taxpayer's insured business property was destroyed by a fire. The insurance proceeds exceeded the taxpayer's adjusted basis in its property. The taxpayer decided to purchase a replacement facility in another state and, for various business reasons, decided to create a new company to purchase and operate the new facility. The taxpayer organized the new company and purchased a controlling interest in stock. Approximately five days later, the newly formed company purchased the replacement property. There was no dispute that the replacement property was similar or related in service or use to the destroyed property.

The Service argued that the acquisition of the newly formed company's stock did not comply with the requirements of section 1033 because the new company did not own the replacement property at the time the taxpayer acquired control. The Tax

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Court rejected this argument, concluding that it was not necessary for the new company to be in possession of the replacement property at the time the taxpayer acquired control. "The organization of the new corporation, the acquisition of its stock by [the taxpayer], and the purchase of the mill were merely steps in an integrated transaction having for its purpose the replacement of [the taxpayer's] involuntarily converted property." Id. at 47.

The Service has issued a nonacquiesce to the result in John Richard; however, the case has not been overruled. Presumably, a similar case tried in Tax Court would be controlled by its outcome. More importantly, we bring this case to your attention because it suggests that, at least when dealing with section 1033 issues, the court may show more than usual tolerance of transactions that are admittedly integrated.

Case Development

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Other Considerations

This case was coordinated with Passthroughs & Special Industries (P&SI). P&SI expressed concern with the statement in the incoming memorandum indicating that Taxpayer suffered no loss to the value of its F as a result of Storm. P&SI takes issue with this statement as a factual matter. According to P&SI, “it is axiomatic in the valuation of [F] that a fully equipped and operating [F] will have a higher value than a non-operating property without equipment (all other things being equal).” Thus, while it appears that Subsidiary suffered no reduction in the quantity of recoverable reserves as a result of Storm, Subsidiary nevertheless suffered a substantial decrease in the value of the F.

Although we do not believe the fact that Subsidiary may have suffered an economic loss to the value of its property alters our conclusions as to whether it is entitled to defer gain from an involuntary conversion under section 1033, we bring this matter to your attention so that any confusion as to the facts of this case and our position with respect to the valuation of F may be avoided.

In addition, in connection with Issue 3, we have considered the strength of your proposed agency argument and, on the whole, we do not believe an argument that Corporation 2 acted as the agent of Subsidiary is likely to be successful.

> Whether the corporation operates in the name and for the account of the principal; binds the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal.

Id. at 437.

As the Court indicated, the business purpose of the agent "must be the carrying on of the normal duties of an agent." Id.

In Commissioner v. Bollinger, 485 U.S. 340 (1988), the Court again considered whether a corporation was the agent of several partnerships owned by the taxpayers. In Bollinger, the Court affirmed the validity of the National Carbide factors and determined that a genuine agency relationship existed. However, in Bollinger, the Court's determination rested largely on a written agreement, which expressly indicated that the corporation was acting as the taxpayers' agent. Id. at 349-350.

In the instant case, although it is clear that Subsidiary, Corporation 1 and Corporation 2 were acting in concert and that the transactions were prearranged, it is not so clear that Corporation 1 and Corporation 2 were acting as the agents of Subsidiary. There was no direct relationship between either Taxpayer or Subsidiary and the two corporations, and the transactions benefitted all parties. Thus, it is not obvious from the facts that either Taxpayer or Subsidiary exercised control over Corporation 1 and Corporation 2. Further, as we understand the existing facts, they do not indicate that any of the National Carbide factors have been satisfied. For example, there is no indication that Subsidiary was bound by any actions of either Corporation 1 or Corporation 2, or that parties dealing with Corporation 1 and Corporation 2 believed they were dealing with Subsidiary.

In sum, we do not find your argument based on agency principles particularly persuasive. Unless further facts are developed indicating that Corporation 1 and/or Corporation 2 were controlled by Subsidiary or Taxpayer in these transactions, (such as facts to indicate the existence of a written agreement between the parties, facts showing the transaction was financed by Subsidiary or Taxpayer, or facts demonstrating that employees of Subsidiary or Taxpayer were involved in the

negotiations between the joint venturers), we would not recommend pursuing the argument that any members of the joint venture were agents of Subsidiary or Taxpayer.

DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL

/s/ *Clifford M. Harbourt*
By: ______________________________
CLIFFORD M. HARBOURT
Senior Technician Reviewer
Income Tax & Accounting Branch
Field Service Division