Internal Revenue Service

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Department of the Treasury

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JUL 22 1999

Taxpayer:

Taxpayer's EIN:

Taxpayer's Address:

Legend:

X	=
State	=
City	=
State Act	=
State Statute	=
Agreement	=
q	=
r	=
Proposal	=
m	=
n	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=

This responds to Taxpayer's request for a private letter ruling dated March 4, 1998. Specifically, Taxpayer has requested a ruling that the termination of Taxpayer's power purchase agreement ("PPA") pursuant to the Agreement constitutes a "compulsory or involuntary conversion" of its PPA within the meaning of §§ 1033 and 1231 of the Internal Revenue Code ("Code"). Taxpayer has also requested rulings that the restated contracts constitute "property similar or related in service or use" to its PPA for purposes of § 1033(a)(1) and that the amount of any gain (or loss) required to be recognized by Taxpayer in connection with the conversion of its PPA is a § 1231 gain or § 1231 loss.

CONCLUSIONS

(1) The termination of the PPA pursuant to the Agreement constitutes a "compulsory or involuntary conversion" of the PPA within the meaning of §§ 1033 and 1231.

(2) The restated contracts constitute "property similar or related in service or use" to Taxpayer's PPA for purposes of § 1033(a)(1).

(3) The amount of any gain (or loss) required to be recognized by Taxpayer in connection with the conversion of its PPA will be treated as a "§ 1231 gain" or "§ 1231 loss" in accordance with the provisions of § 1231.

FACTS

X is a regulated public utility furnishing electricity to various parts of State. Taxpayer is an independent power producer ("IPP") that was organized in Year 2 for purposes of developing, financing, constructing, and operating a q megawatt natural gas-fired combined cycle cogeneration facility ("facility") at City in State. The facility was placed in service in December, Year 4 and is certified as a Qualifying Facility ("QF") under the Public Utility Regulatory Policies Act of 1978, 16 U.S.C. § 824a, as amended ("PURPA"), and the implementing FERC regulations (18 C.F.R. § 292.207).

PURPA requires electric utilities to purchase electricity from, and enter into legally enforceable obligations with, QFs. In addition, State enacted parallel provisions to PURPA that obligated regulated public utilities, such as X, to enter into long-term contracts to purchase electricity from, and granted additional rights to, entities such as Taxpayer that qualified under the State Act as co-generation facilities or alternate energy production facilities.

The prices paid for electricity under these statutorily-mandated contracts were based upon projections of the costs that the regulated public utility otherwise would incur to meet its service requirements ("avoided costs"). These avoided costs were composed of (1) in all cases, variable costs associated with producing electricity, and

(2) in some cases, fixed costs associated with developing and constructing a facility if the regulated public utility did not have the generation capacity to meet the demand for electricity.

In June, Year 1, the predecessor to Taxpayer entered into a PPA with X that was priced to reflect both the fixed and variable costs of producing electricity required to be purchased under the agreement. For the output of Taxpayer's facility, X was obligated to pay an amount determined by reference to the higher of (a) r¢ per kilowatt hour or (b) X's avoided costs as calculated at the time electricity is delivered. Taxpayer projected that the payments to be made to it under the PPA would cover both the fixed costs associated with the development, construction, maintenance, and operation of the facility, as well as certain other costs, such as fuel and fuel transportation costs and variable operation and maintenance costs associated with the production of electricity.

At the time that the PPA was executed, the price X was to pay for electricity was agreed to by Taxpayer and X and was believed to be a fair price based on X's projections of the costs it would otherwise have incurred over the term of the PPA. However, by mid-Year 3, X had projected that it had excess electric production capability and thus its new avoided costs rates (and accordingly the prices it was required to pay new projects for electricity) were substantially less than its Year 1 rates. Thus, the price paid by X pursuant to Taxpayer's PPA has for some time exceeded the State Public Service Commission's ("PSC") current approved rates.

Initially, X was able to recover its costs for electricity produced by, and purchased from, Taxpayer and other IPPs under its State PSC-approved tariffs, which included a fuel adjustment clause. However, X's electricity rates are much higher than in other areas of the United States. Due to the disparity between actual market electricity prices and the price paid for electricity under Taxpayer's PPA and other PPAs, the State PSC and consumers pressured X to reduce its rates and move toward a competitive market. As early as March, Year 4, the State PSC began to investigate methods to create competitive opportunities for State electricity consumers, including X's customers, and requested that the utilities do the same. Pursuant to the State PSC's request, X commenced negotiations with Taxpayer and other IPPs to reduce its cost for electricity purchased under those PPAs. As of April, Year 5, X had renegotiated PPA agreements with 20 of 175 IPPs that had PPAs.

In an attempt to reduce its costs, X sought to have rules adopted by the State PSC which would permit X to curtail purchases of electricity from the IPPs. In April, Year 5, X petitioned the State PSC, suggesting that such rules were necessary and stating that the currently available settlement opportunities with the IPPs had been exhausted. Although the State PSC did not adopt a formal curtailment plan in Year 5, it continued its efforts to encourage regulated public utilities, including X, to develop a competitive electric market for State.

In response, in October, Year 6, X submitted a proposal entitled "Proposal" to the State PSC for reducing its electric rates to its customers. Stating that the differences with the IPPs had not been resolved, the Proposal set forth several alternative ways to restructure the PPAs, including the taking by eminent domain of the IPPs' electricity generating facilities and the curtailment of X's obligations to purchase electricity generated by the IPPs, emphasizing that it was essential to the creation of a competitive market that PPAs with a significant number of the unregulated IPPs be restructured such that those generating units become independent suppliers competing in the wholesale spot market or become suppliers to customers directly.

In the Proposal, X stated that if negotiations with the IPPs failed to produce the necessary cost savings, it proposed to utilize its power of eminent domain to acquire the generating units owned by the IPPs with which it has PPAs and subsequently resell them at auction in order to increase competition in the wholesale power market. It also stated that it would soon initiate the process necessary to exercise its power of eminent domain by filing a petition with the State PSC.[1]

Taxpayer believed that X would institute an eminent domain proceeding against the facility unless X was otherwise able to reduce its payments to a significant number of IPPs with which it had PPAs. After the Proposal was made public, X and certain of the IPPs entered into negotiations. X took no further action towards exercising its eminent domain powers because of progress with the negotiations with the IPPs. During these negotiations, X 's counsel stated to one of the IPPs that if the negotiations were not successful, X would have no way to restructure its markets and reduce its costs other than by commencing eminent domain proceedings.

In May, Year 6, the State PSC issued an order describing its goals and strategies for restructuring State's electric utility industry and stated that all possible efforts to reduce electric rates should be continued, including efforts to reduce utility commitments under IPPs contracts that include obligations for payments well above current wholesale prices. It further stated that if the parties were unwilling to restructure these contracts voluntarily, it would pursue policies to mitigate the impact of such contracts on rates. Subsequently, in July, Year 7, the State PSC stated publicly that the PPAs with the IPPs were a major hurdle to lowering electric rates in State and achieving a competitive electric market. Two weeks after this public statement, X made an offer to 44 IPPs to buy out their PPAs. Those IPPs retained an investment banking firm to evaluate X's offer.

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[1] The power of eminent domain was delegated to X pursuant to State Statute which provides that "[a]n electric corporation shall have the power and authority to acquire such real estate as may be necessary for its corporate purposes ... in the manner prescribed by the Eminent Domain Procedure Law."

Active negotiations between X and the IPPs continued until December, Year 7, when the negotiations stalled. In December, Year 7, the administrative law judge considering X's request for curtailment of purchases from the IPPs recommended that State utilities be allowed to curtail purchases. Taxpayer's PPA does not expressly prohibit X's curtailment of electricity purchases. In March, Year 8, Taxpayer and other IPPs made a counterproposal to the X's offer, which became the basis for further negotiations. In May, Year 8, the State PSC approved, but did not issue, a curtailment order, which allowed X to reduce the quantity of electricity that it was required to purchase from certain IPPs. The IPPs believed that the approval of the curtailment order was intended to place additional pressure on the negotiations with X.

In July, Year 8, Taxpayer and the other IPPs signed the Agreement, which was subsequently amended four times. In June, Year 9, the transaction was consummated in accordance with the terms of the amended Agreement. Pursuant to the amended Agreement, consideration in the aggregate of $ m cash and n shares of X common stock would be available for IPPs to elect from, and the PPAs of certain IPPs, including Taxpayer, would be amended and restated. The amendment and restatement of a PPA constitutes a termination of an IPP's original PPA.

Pursuant to the amended Agreement, Taxpayer received cash and shares of X common stock and entered into contracts amending and restating its PPA (the Restated Contracts). Although Taxpayer's PPA will be terminated and restated, it will have the right to maintain its status as a State QF, the right to wheel its output to third parties, and the right to have X act as an agent for sales of its electricity to the State electric power pool. Taxpayer has continued to own and operate the facility after the restructuring.

Taxpayer's Restated Contracts consist of two contracts: (i) an indexed electric rate swap contract that is structured as a "notional principal contract" within the meaning of § 1.446-3(c)(1) of the Income Tax Regulations and (ii) a put contract that gives Taxpayer the right to sell a defined quantity of electricity to X periodically until a power exchange is fully established and successfully functioning.

The swap contract provides for a series of monthly net cash payments over a ten-year period that are calculated by reference to the difference between (a) the market rate for electricity (the "market price") and (b) a rate for electricity as adjusted by an indexing formula (the "contract price"). If the contract price exceeds the market price for a given period, X will pay Taxpayer the difference between the contract price and the market price multiplied by the quantity of electricity specified in the contract (the "contract quantity"). Conversely, if the market price exceeds the contract price, Taxpayer will pay X the difference between the market price and the contract price multiplied by the contract quantity.

The swap contract is a financial instrument that does not provide for the purchase or sale of electricity. Taxpayer's payment obligations under this contract will

be adjusted to reflect changes in inflation and fuel prices, among other things, and will not be dependent on or determined by reference to Taxpayer's production or sale of electricity, if any. Subject to certain limitations, this contract may be assigned by Taxpayer.

The put contract, which is coterminous with the term of the swap contract, gives Taxpayer the right to sell to X an amount of electricity up to the contract quantity (as defined in the swap contract) at the "proxy market price," as defined below. As there is no current competitive liquid market for determining the price of electricity in State for the quantity of electricity contemplated under the swap contract, Taxpayer and X have adopted a mutually acceptable formulaic definition of market price (the "proxy market price") until a competitive power exchange is fully established and successfully functioning (the "proxy market price period"). The proxy market price is based on X's short-term avoided energy and fixed costs as stated in its tariff approved by the State PSC. Once the proxy market price period has ended, the market price will be determined by reference to the price established and published by the power exchange. Like the swap contract, the put contract is assignable to third parties subject to certain conditions.

It is the general view among the State regulators that, sometime within the next 10 years, possibly earlier, there will be an established independent system operator that will, among other things, oversee and regulate a power exchange that will function as an efficient market for the purchase and sale of electricity on a wholesale basis. An established, efficient power exchange would allow Taxpayer to sell its electrical output at the market rate and thus Taxpayer would not have to have a long-term power supply agreement such as the PPA to ensure that it would have buyers for its electrical output. However, absent the PPA and until the power exchange is efficient and large enough for Taxpayer to sell its electrical output at the market price, Taxpayer must have a transitional contract that will ensure that Taxpayer could produce electricity and have a buyer for its electricity. Despite being able to sell its power, Taxpayer nonetheless would be subject to the risk of price changes, and thus Taxpayer also needs a contract that would hedge against changes in electrical rates.

Taxpayer's Restated Contracts are not structured as a typical power supply agreement, as a standard agreement would not enable X or State to make the transition to a competitive marketplace for the sale of electricity. To make the transition to a competitive marketplace possible and at the same time allow Taxpayer to return to the position it was in prior to the restructuring (as closely as the changed market conditions will permit), the Restated Contracts were structured as a combination of the swap and put contracts.

Once a competitive power exchange is established and the right to put power under the put contract expires, Taxpayer expects to be able to sell the contract quantity of electricity at the market price in the power exchange.

The combination of the swap contract and the put contract serves the same business function to Taxpayer as its PPA: these contracts allow Taxpayer to sell its electricity to a customer in a monopsonistic market (a market where there is only one buyer) at a price that will allow Taxpayer to remain financially viable (i.e., to recover its estimated fixed and variable costs associated with producing the contract quantity of electricity).

Taxpayer represents that X had threatened, during negotiations, to pursue eminent domain actions against the IPPs' facilities, including Taxpayer's facility, if the restructuring negotiations were not successful. In November, Year 8, X informed the State PSC that it had not pursued the exercise of its power of eminent domain due to the progress in negotiations with the IPPs, but that it would take necessary measures, including exercise of its power of eminent domain, if the restructuring pursuant to the Agreement was not effected. Based on X's actions, Taxpayer states that it had a reasonable belief that a threat or imminence of condemnation existed against its facility.

Taxpayer further represents that if X had condemned its facility, the PPA would have been unenforceable and wholly worthless, and that it could not have sold electricity to X pursuant to the terms of the PPA. Taxpayer represents that the PPA was "site-specific" because that the PPA is limited to the purchase and sale of electricity produced and delivered by the facility referenced in the PPA. Thus, if Taxpayer's facility were taken by X pursuant to its eminent domain powers, Taxpayer could not sell electricity to X pursuant to the terms of the PPA, nor could it assign its PPA to a third party for value because the third party could not sell electricity to X pursuant to the terms of the PPA.

Taxpayer further represents that one of the requirements for QF status is that the facility must be owned by a person not primarily engaged in the generation or sale of electric power (other than electric power solely from cogeneration facilities or small power production facilities). Thus, once X (an electric utility) acquired the facility, the facility would lose its QF status, which is required by the PPA to be maintained. If the QF status is not maintained, X has the option of terminating the PPA, and it would have terminated the PPA. It is also represented that if X had acquired Taxpayer's facility, it would have auctioned the facility and the new owner of the facility could not have sold power to X pursuant to the PPA, but would have to abide by new pricing protocols in the competitive market.

Taxpayer's PPA has a term of 22 years, and requires X to take and pay for all of the electricity produced by Taxpayer's facility, although X may reduce its obligation to purchase the facility's output for a limited period of time each year. The PPA can be assigned to a third party by Taxpayer, without X's consent, upon prior written notification to X. Taxpayer has not treated the PPA as a separate and distinct asset on its books and records. Costs associated with acquiring the PPA, such as attorney's fees and other related costs, have been capitalized into a general asset category and amortized or depreciated accordingly.

LAW AND ANALYSIS

(1) Whether the termination of Taxpayer's PPA pursuant to the Agreement constitutes a "compulsory or involuntary conversion" of its PPA within the meaning of §§ 1033 and 1231.

Section 1033(a)(1) 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 property similar or related in service or use to the property so converted, no gain shall be recognized.

Section 1033(a)(2) provides in part 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, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph.

Section 1033(a)(2)(A) provides that if a taxpayer during the period specified in § 1033(a)(2)(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, then at the taxpayer's election, 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.

Section 1.1033-1(a) of the regulations provides in part that 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.

Rev. Rul. 63-221, 1963-2 C.B. 332, establishes the criteria necessary for the existence of a threat or imminence of condemnation based on the taxpayer's reasonable belief. Generally, the threat or imminence of condemnation exists when a property owner is informed, either orally or in writing, by a representative of a governmental body or public official authorized to acquire property for public use, that such body or official has decided to acquire the owner's property, and the owner has reasonable grounds to believe, from the information conveyed to him by such representative, that the necessary steps to condemn the property will be instituted if a voluntary sale is not arranged.

Rev. Rul. 74-8, 1974-1 C.B. 200, modifying Rev. Rul. 63-221, provides that a threat or imminence of condemnation may exist where the purchaser, a public utility, lacked actual condemnation authority prior to or at the time of the sale, but it generally could readily obtain the power to condemn by application to the appropriate state

official authority in the event that a voluntary sale was not arranged, and there was no reason to believe that such power to condemn the land purchased would be denied.

Rev. Rul. 59-361, 1959-2 C.B. 183, recognized the economic unit theory of Masser v. Commissioner, 30 T.C. 741 (1958), acq. 1959-2 C.B. 5. The taxpayer in Masser owned a freight terminal and the parking lots across the street from the terminal that were necessary for its operation. The parking lots were condemned and the taxpayer being unable to secure adequate replacement lots in the same vicinity sold the freight terminal. The proceeds of the sale of the freight terminal, together with the proceeds from the condemnation of the parking lots, were reinvested in a similar terminal and parking facilities suitable for the taxpayer's business. The court allowed involuntary conversion treatment for the terminal proceeds and the parking lot proceeds on the theory that the two properties were used as an economic unit. Accordingly, the Service stated that where all the facts and circumstances show a substantial economic relationship between the condemned property and the other property sold by the taxpayer, so that together they constituted one economic property unit, such as existed in the Masser case, involuntary conversion treatment for the proceeds of the voluntary sale will be permitted.

Rev. Rul. 82-147, 1982-2 C.B. 190, held that the sale of the taxpayer's fishing resort due to an act of Congress declaring the area in which it is located a Boundary Waters Canoe Area Wilderness constituted an involuntary conversion. The act prohibited the use of motorboats with motors of greater than 25 horsepower on the lake. The restriction on horsepower of motorboats effectively denied the taxpayer the former economic use of its resort. The act gave an affected resort owner the option to require the government to purchase the resort at its fair market value without regard to the restriction. The restriction together with the provision authorizing purchase effectively constituted a taking of the property upon payment of fair compensation.

The actions of the State PSC and X with regard to the establishment of a competitive electricity market for State provide notice to Taxpayer as well as a reasonable basis for Taxpayer to conclude that X would pursue its threat to condemn Taxpayer's facility if Taxpayer did not renegotiate its PPA. Further, it is clear that X had the authority under State Statute to commence eminent domain proceedings against Taxpayer's facility.

Taxpayer's representations regarding the relationship between its PPA and its facility establish that the property converted (the PPA) bears a "substantial economic relationship" to the threatened property (the facility) against which X has taken actions that constitute a threat or imminence of condemnation. Further, if X were to condemn the facility, this action would damage completely the value of the PPA to Taxpayer. Thus, although X's threat of condemnation was made to Taxpayer's facility, because the facility and the PPA form an economic unit, the termination of Taxpayer's PPA pursuant to the Agreement constitutes an involuntary conversion of the PPA made under a threat or imminence of condemnation by X.

2) Whether the Restated Contracts constitute "property similar or related in service or use" to Taxpayer's PPA for purposes of § 1033(a)(1).

Where a taxpayer has used converted property for the conduct of its business operations, a functional use test is applied to determine whether property received on conversion or subsequently acquired to replace the converted property is "similar or related in service or use" to the converted property. See Cotton Concentration Co. v. Commissioner, 4 B.T.A. 121, 125 (1926), acq., 1926-2 C.B. 1; Davis Regulator Co. v. Commissioner, 36 B.T.A. 437, 443 (1937), acq., 1937-2 C.B. 7.

In general, under the functional use test, property received on conversion of property used in a taxpayer's trade or business constitutes property that is "similar or related in service or use" unless the taxpayer's pre-conversion business is substantially changed and the use of the replacement property in the taxpayer's post-conversion business is very different than the use to which the taxpayer put the converted property in its pre-conversion business. The acquired property need not be identical to the converted property, but the taxpayer must use the acquired property to continue and preserve the nature of its pre-conversion business operations. See, e.g., Cotton Concentration Co. v. Commissioner (reinvestment of proceeds into a new storage shed that was slightly larger and had greater capacity than the two original sheds qualified as replacement property because taxpayer was not required to reconstruct destroyed property in exactly the same physical condition and sheds were both used for storage of baled cotton).

The Restated Contracts are designed to enable Taxpayer to maintain, as closely as possible, continuity of its business enterprise and use of its assets while making the transition to a competitive marketplace. The swap contract mirrors one function of the PPA to Taxpayer by hedging against fluctuations in the price of electricity. The put contract fulfills the other function of the PPA by providing a buyer for Taxpayer's electricity. Thus, after the restructuring, as before Taxpayer has a contractual arrangement that ensures that it will have a buyer for its electrical output and that the prices it receives for that electrical output are structured so that Taxpayer will be able to recover its fixed costs and variable costs. The flexible term of the put contract allows X to effect a transition to a competitive market in which purchases and sales of electricity would occur on an established exchange. Accordingly, the Restated Contracts are the functional equivalent of the PPA and constitute "property similar or related in service or use" for purposes of § 1033(a)(1).

(3) Whether the amount of any gain (or loss) required to be recognized by Taxpayer in connection with the conversion of its PPA is a § 1231 gain or § 1231 loss.

Section 1231(a) prescribes in part the treatment of certain gains from involuntary conversions. Section 1231(a)(3)(A)(ii) provides that the term § 1231 gain means any

recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of (1) property used in a trade or business, or (2) any capital asset which is held for more than one year and is held in connection with a trade or business or a transaction entered into for profit. See also § 1231(a)(3)(B) (losses). Under § 1231(a), if § 1231 gains for the year exceed § 1231 losses, they are treated as long-term capital gains and losses; if § 1231 losses exceed § 1231 gains, they are treated as ordinary gains and losses.

The provisions in § 1231 that deal with involuntary conversions provide a statutory sale or exchange for such transactions, so that they may qualify for potential capital gain treatment, depending on the netting of gains and losses under § 1231. These provisions were added by Congress in part to supplement what is now § 1033, and are generally interpreted in a similar manner. See H. Rep. No. 2333, 77th Cong., 2d Sess., 1942-2 C.B. 372, 415; Conf. Rep. No. 2586, 77th Cong., 2d Sess. 1942-2 C.B. 701, 708-9. Cf. Rev. Rul. 271, 1953-2 C.B. 36 (treatment of severance damages under § 1231). Accordingly, any gain (or loss) recognized by Taxpayer in connection with the conversion of its PPA will be treated as a "§ 1231 gain" or "§ 1231 loss."

* * * * *

Based on Taxpayer's representations and the above analysis, we rule as follows:

(1) The termination of the PPA pursuant to the Agreement constitutes a "compulsory or involuntary conversion" of the PPA within the meaning of §§ 1033 and 1231.

(2) The Restated Contracts constitute "property similar or related in service or use" to Taxpayer's PPA for purposes of § 1033(a)(1).

(3) The amount of any gain (or loss) required to be recognized by Taxpayer in connection with the conversion of its PPA will be treated as a "§ 1231 gain" or "§ 1231 loss" in accordance with the provisions of § 1231.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

By: Kelly Alton
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