Internal Revenue Service

Index No: 1033.00-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

199911048

Telephone Number:

Refer Reply to:
CC:DOM:IT&A:05 PLR-106088-98

Date: DEC 15

Taxpayer:

Taxpayer's EIN:

Taxpayer's Address:

State A =

Town =

Forest =

Act =

Agency =

Parent =

$x =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Month 1 =

Year 1 =

Year 2	=	1995
Year 3	=	1997
Year 4	=	1990

Dear

This letter responds to your request for a private letter ruling, dated March 2, 1998, submitted on behalf of Taxpayer. Taxpayer requests a ruling that, for federal income tax purposes, under the facts described below, Taxpayer may defer recognizing gain under § 1033 of the Internal Revenue Code.

ISSUES

1) Did enactment and implementation of the Act result in the involuntary conversion of Taxpayer's timber cutting contract with Agency within the meaning of § 1033 in Year 3?

2) Do timber cutting contracts to be acquired by Taxpayer from Parent and/or third parties constitute eligible replacement property under §1033(a)(2)(A)?

CONCLUSIONS

1) Enactment and implementation of the Act resulted in the involuntary conversion of Taxpayer's timber cutting contract with Agency within the meaning of § 1033 in Year 3.

2) The timber cutting contracts to be acquired by Taxpayer from Parent and/or third parties will constitute eligible replacement property under § 1033(a)(2)(A) provided such contracts are similar or related in use or service to the converted contract and provided further that the requirements of § 1033(i) are satisfied.

FACTS

Taxpayer is a forest products company that harvests standing timber and manufactures lumber products. Taxpayer historically has sold significant quantities of logs and cants on the open market to other forest products companies. Taxpayer has plants in Town, State A, and neighboring locations which have been supplied primarily with timber cut from the Forest under the terms of a long-term contract with the Agency. Taxpayer is a wholly owned subsidiary of Parent.

On Date 1, the Agency and Taxpayer entered into a 50-year contract under which Taxpayer agreed to purchase from the Agency certain merchantable timber within the Forest in State A. The Agency sought, by means of this agreement, to stimulate industrial development in State A. Recognizing that Taxpayer would need to make a substantial investment to build a pulpmill in Town, that the raw material for the production was almost exclusively located on Agency land, and that there were unusual risks associated with this business venture, the contract was for a 50-year life and included favorable pricing. As originally agreed, the contract provided Taxpayer with the right to cut timber until Date 2.

On Date 3, Congress enacted the Act. This federal legislation, which specifically cited Taxpayer's contract with Agency, required that specified unilateral changes to that contract be made within 90 days of the Act's enactment.

Many of the unilateral changes affected the price paid by Taxpayer for stumpage. The Agency advised Taxpayer in Month 1, that certain terms in the original contract which protected the competitive pricing of the timber were replaced by the Act, which set new standards for the price the Agency would charge for the timber. Taxpayer contended that the revised pricing methodology constituted a taking of rights that it held under the original contract.

Believing that numerous rights had been taken from it, in Year 1 and Year 2 Taxpayer filed a series of complaints in the United States Court of Federal Claims. On Date 4, a settlement was reached and Taxpayer received $x.

Taxpayer proposes to replace its contract with Agency with one or more timber cutting contracts with Parent and/or third parties. Although taxpayer has not identified specific new contracts, it anticipates that the replacement contracts will:

- Specifically describe the standing timber to be purchased by Taxpayer at agreed upon prices per unit of measurement (e.g., per thousand board feet (Doyle scale)) to be cut within a specified time frame. Prices may be adjustable, depending on the term and other conditions of the contract(s).

- Provide that timber that may not be harvested due to environmental restrictions and/or applicable forestry practices will be excluded.

- Provide that payment will be made to the timber owner as the timber is cut.

- Provide that title to the timber (and risk of loss) remains with the timber owner until the timber is severed from the land.

- Provide that Taxpayer will be afforded necessary rights of ingress to, and egress from, the land on which the timber is located

- Provide that upon expiration of the specified period allowed for cutting, all rights of Taxpayer terminate.

Taxpayer anticipates that the replacement contracts will have a term of not more than thirty years.

LAW & ANALYSIS

Section 1033(a)(2) mandates that if property, as a result of a condemnation, is compulsorily or involuntarily converted into money, the gain (if any) shall be recognized, except to the extent provided in § 1033(a)(2)(A).

Section 1033(a)(2)(A) provides that if property is compulsorily or involuntarily converted into money and the taxpayer during the period specified in § 1033(a)(2)(B) 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.

Section 1033(a)(2)(B) provides that the replacement period starts with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending not earlier than 2 years after the close of the first taxable year in which any part of the gain from the conversion is realized.

Section 1033(i) provides a general rule that § 1033(a) will not apply if the replacement property is acquired from a related person. However, the general rule of § 1033(i) does not apply if the related person acquired the replacement property from an unrelated person within the period described in § 1033(a)(2)(B). For purposes of § 1033(i) a person is related to another person if the person bears a relationship described in § 267(b) or § 707(b)(1).

Involuntary Conversion

Taxpayer asks whether changes in its contract with the Agency resulting from enactment and implementation of the Act resulted in the involuntary conversion of its property within the meaning of § 1033. For the reasons described below, enactment and implementation of the Act resulted in the involuntary conversion under § 1033 of Taxpayer's contract in Year 3.

Section 1033 concerns the federal income tax treatment of involuntary conversions. The general rule requires nonrecognition of any gain realized if property is compulsorily or involuntarily converted into property similar or related in service or use to the converted property. Section 1033(a)(1); section 1.1033(a)-2(b)

taxpayer may elect to recognize gain only to the extent the amount realized upon the conversion exceeds the cost of qualified property that is purchased as a replacement. Section 1033(a)(2); section 1.1033(a)-2(c). These rules apply, however, only if the involuntary conversion of the property is a result of its complete or partial destruction, theft, seizure, or requisition or condemnation or the threat thereof. Section 1033(a); section 1.1031(a)-2(c)(1).

Involuntary conversion, within the meaning of § 1033, means that a taxpayer's property, through some outside force or agency beyond the taxpayer's control, is no longer useful or available to the taxpayer for its purposes. One of the conversions specified in § 1033 is condemnation, which refers to the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation. See Rev. Rul. 82-147, 1987-2 C.B. 190; Rev. Rul. 76-69, 1976-1 C.B. 219; c.f., Hedstrom Lumber Co. V. United States, 7 Cl Ct. 16, 27 (1984) (cancellation of timber cutting contracts pursuant to the Boundary Waters Canoe Area Wilderness Act resulted in a claim for the taking of property). In this case, the Act made unilateral changes to Taxpayer's contract with the Agency. In particular, the quantity of timber that could be cut and the price of that timber was changed legislatively by Congress. Taxpayer received payment for these changes on Date 4. Enactment and implementation of the Act constituted an involuntary conversion of Taxpayer's contract rights in Year 3 when Taxpayer received compensation for the contract.[1]

Replacement Property

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[1] Taxpayer did not realize any amount upon enactment of the Act in Year 4 as a unilateral change to a contract by one party, without the payment of consideration, that reduces the value of the contract to the other party is not a §1001 event. See 2 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts § 40.8.1 (2d. ed. 1990), stating

> Is the modification of a contract ... a "disposition"... ? If so, gain or loss is realized in a wide range of business transactions, since taxpayers...in the ordinary course of business, frequently alter these rights in midstream.... Businessmen...feel in their bones that transactions of this type are not taxable events. Although laymen are stuffed with misinformation about tax matters, this is one area in which their instincts are correct.

This result is not changed by Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991). Further, the modified contract is not included as part of the consideration in determining the amount realized. Accordingly, [illegible]

Taxpayer also requests a ruling that Timber cutting contracts to be acquired by Taxpayer from Parent and/or third parties, constitute eligible replacement property under § 1033(a)(2)(A). For the reasons described below, the timber cutting contracts to be acquired by Taxpayer from Parent and/or third parties will constitute eligible replacement property under § 1033(a)(2)(A) provided such contracts are similar or related in use or service to the converted contract.

In applying § 1033(a) a functional use test is used to determine whether replacement property acquired by an owner-user (as distinguished from an investor) is similar or related in use to the converted property. Rev. Rul. 64-237, 1964-2 C.B. 319. Under that test, property is not considered similar or related in service or use to the converted property unless the physical characteristics and end uses of the converted and replacement properties are closely similar. For example, a taxpayer's light manufacturing plant is not considered to be similar or related in service or use to a wholesale grocery warehouse under this standard. Rev. Rul. 64-237, 1984-2 C.B. 319. Similarly, the replacement of a fish processing plant on shore with a fish processing plant in a ship does not satisfy the similar or related in service or use standard as the ship can move as the physical characteristics are not closely similar. Further, there are significant differences between activities at the land based plant and activities on the ship. Rev. Rul. 77-192, 1977-1 C.B. 249. But the processing equipment for the ship and land based plant are the same and § 1033 can be used to defer gain related to the equipment.

In this case, Taxpayer proposes to replace the converted Agency contract with one or more timber cutting contracts as described above. Taxpayer asserts that the replacement of the converted contract with such cutting contract(s) satisfies the functional use test. Taxpayer reasons that the converted and replacement properties will be similar, since they are cutting contracts and necessarily share many elements common to such contracts. Further, Taxpayer believes that the converted and replacement contract(s) will also be "related in service or use" within the meaning of § 1033(a)(2)(A) since the function of the converted contract was to provide Taxpayer with the right to cut timber (for a payment per unit of timber cut) for use in its trade or business and that is the function that the new cutting contract(s) will perform. In this case, Taxpayer's timber cutting contract with Agency was converted within the meaning of § 1033. For purposes of deferring gain under § 1033(a)(2)(A) it is appropriate to replace that contract with one or more other timber cutting contracts. However, as Taxpayer has not yet identified one or more specific replacement contracts, we can not determine whether any such contract will be similar or related in use or service to the converted contract.[2]

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[2] Taxpayer may, of course, request a determination from its District Director in accordance with § 6.01 of Rev. Proc. 98-1, 1998-1 I.R.B. 7 (January 5, 1998), once it has identified a specific replacement contract on whether such replacement contract

The above conclusion is premised on Taxpayer replacing the converted Agency contract with one or more timber cutting contracts. Accordingly, the replacement property consists of the replacement contract(s) and not the timber which the replacement contract(s) entitle Taxpayer to cut. Acquisition by Taxpayer of timber or real estate containing timber would not satisfy the functional use test of §1033.

Taxpayer's acquisition of a replacement timber cutting contract from its Parent will trigger the restrictions of § 1033(i) as Parent is a related person to Taxpayer within the meaning of § 1033 (i)(3). Accordingly, Taxpayer may not defer gain under § 1033(a) by acquiring replacement contracts from Parent unless Parent acquired those contracts from an unrelated person within the period described in § 1033(a)(2)(B).

Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of the above transactions under other provisions of the Code and regulations that may be applicable. No opinion is expressed as to the tax treatment of any conditions existing at the time of or effects resulting from the transaction that are not specifically covered by the above ruling. A copy of this letter ruling should be attached to the appropriate federal income tax returns for the taxable years in which the transactions described herein are consummated.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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