**Office of Chief Counsel**
**Internal Revenue Service**
# memorandum

Number: **200315021**
Release Date: 4/11/2003
CC:ITA:4:POSTF-116629-02

**UILN:** 1033.00-00

date: January 6, 2003

to: Associate Area Counsel
(Large and Mid-Size Business)

from: James L. Atkinson
Associate Chief Counsel
(Income Tax & Accounting)

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subject:

This Chief Counsel Advice responds to your undated memorandum received by this office on October 15, 2002. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND:

Partnership =
Pcorp =
Sub =

LLC-1 =
Sub 1 =
Xcorp =
Sub X =
LLC-2 =
Sub A =
Sub B =
AB =
BigCorp =
Z =
Y =
$x =
$y =
$z =
Date 3 =
Year 0 =
Year 1 =

Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 7 =

ISSUES:

1. When does the period of limitations for assessment of a deficiency attributable to Partnership's gain on an involuntary conversion expire?

2. Does the special limitations period of § 1033(a)(2)(C) extend the period of limitations for assessment of a deficiency against Pcorp, the common parent of Sub 1, attributable to Partnership's gain on the involuntary conversion?

CONCLUSIONS:

1. The period for assessment of a deficiency attributable to Partnership's gain on the involuntary conversion expires on October 4, Year 7, pursuant to § 1033(a)(2)(C).

2. The special limitations period of § 1033(a)(2)(C) extends the period of limitations for assessment of a deficiency against Pcorp, the common parent of Sub 1, attributable to Partnership's gain on the involuntary conversion realized in Year 1.

FACTS:

Partnership was a limited partnership and the lessee, and later the owner and operator of an electrical power plant (the Z Facility). The electricity generated from the Partnership's Z Facility was sold to BigCorp pursuant to a Power Purchase Agreement (PPA). BigCorp is a regulated public utility possessing powers of eminent domain. During the term of the PPA, BigCorp was required to take and pay for 100 percent of Partnership's electrical generating capacity at an agreed rate. However, due to the decline in wholesale power costs, the price paid by BigCorp under the PPA far exceeded its approved rates. Accordingly, BigCorp approached Partnership to renegotiate the contract. The parties ultimately agreed to terminate the PPA after BigCorp threatened to condemn Partnership's Z Facility. BigCorp paid $x in cash and BigCorp stock to Partnership as consideration for terminating the PPA. Soon afterwards, Partnership sold the Z Facility to a third party for $y. Partnership received all of the proceeds in Year 1, realizing a gain from the dispositions. Under § 1033, Partnership had until December 31, Year 3, to purchase qualifying replacement property.

In a private letter ruling issued to Partnership in Year 2, the Internal Revenue Service determined that although BigCorp's threat of condemnation was made to Partnership's

Z Facility, because the facility and the PPA formed an economic unit, the termination of Partnership's PPA constituted an involuntary conversion for purposes of § 1033.

In Year 1, the partners in Partnership were Sub 1, a lower tier subsidiary of Pcorp, and Sub X, a subsidiary of Xcorp (a party otherwise unrelated to Pcorp's consolidated group). For Year 1, Pcorp filed a Form 1120 consolidated corporate income tax return on September 15, Year 2, which included Sub 1 as a member of the consolidated group. Pcorp did not report Sub 1's gain on the involuntary conversion of Partnership's Z Facility and PPA because Partnership had elected on its Year 1 Form 1065 federal partnership income tax return to defer the gain.

Two years prior to the sale of the Z Facility, Sub (a wholly owned subsidiary of Pcorp) filed a petition with the appropriate regulatory board in the state of Y for approval of plans to construct a new electric power plant (the Y Facility). Sub was the sole owner of LLC-1 and LLC-2. LLC-1 owned Sub 1, one of the partners in Partnership. LLC-2 was the sole owner of Sub A and Sub B, which were partners in Old AB, a limited partnership. Sub A and Sub B held 51 percent and 49 percent of Old AB respectively. Old AB was to construct the Y Facility.[1] The Y board approved construction of the new Y Facility in Year 0. Construction began in April Year 1, and its expected in-service date was to be during the third quarter Year 3.

In Year 3, attorneys representing Partnership, Old AB, and Sub filed an application with the Federal Energy Regulatory Commission (FERC) for an order approving an internal reorganization whereby Partnership would acquire Old AB. Since Old AB was already constructing the new Y Facility, Partnership proposed acquisition of the new Y Facility as replacement property for purposes of § 1033. In its FERC application, Partnership proposed using proceeds from the involuntary conversion to acquire Old AB. This application declared that the purpose of the reorganization was to transfer ownership of Old AB, including its assets, to Partnership "in order to capture certain tax benefits arising from an involuntary conversion of [Partnership's] assets in [Year 1]." In its application Partnership projected tax savings of about $z resulting from the reorganization and the deferral gain under § 1033. In Year 3, FERC authorized the proposed merger of Partnership with Old AB.

The merger occurred 2 days later through a series of transfers, acquisitions, and offsets. After the merger, Old AB ceased to exist. Partnership, as the continuing partnership, was renamed AB (New AB). (The details of the merger, including the incidental monetary transactions, are not relevant to the issues herein.) Partnership's Year 3 acquisition of the new Y Facility from Old AB as its replacement property is the

[1] Before being reorganized by merger with Partnership in Year 3, as explained below, AB is referred to here as "Old AB."

subject of a current examination by the Service. Although the Y Facility was scheduled to be completed and commercially operating by the end of Year 3, there were many delays to completing the project. The new Y Facility did not begin commercial operations until Date 3, Year 4.

On October 4, Year 4, Partnership (now under the name of New AB) filed its partnership return for Year 3. Attached to the partnership return was a letter applying for an extension of time to replace its involuntarily converted property. The October 4, Year 4, letter was the first correspondence from Partnership to the Service in which it designated the new Y Facility as its replacement property for the involuntary conversion of the Z Facility and the PPA. The application for the extension of time was filed more than 9 months after the close of the replacement period.

LAW AND ANALYSIS:

Section 6501(a) prescribes the general period within which a tax must be assessed or be barred. The period is normally 3 years from the date on which the return in question was filed. However, the Internal Revenue Code provides for other periods applicable to certain specified situations. One such variation from the general rule applies when a taxpayer elects to defer gain on the involuntary conversion of property.

Section 1033(a)(2)(C)(i) provides that if a taxpayer has made the election provided in § 1033(a)(2)(A) (to defer the recognition of gain from the involuntary conversion of property into money or property not similar or related in service or use), then the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain on such conversion is realized, attributable to such gain shall not expire prior to the expiration of 3 taxable years from the date the Secretary is notified by the taxpayer of the replacement of the converted property or of an intention not to replace. Thus, § 1033(a)(2)(C) effectively operates to extend the general 3-year period of limitations under § 6501(a). *Vaira v. Commissioner*, 52 T.C. 986, 1003 (1969).

Here, Partnership gave express notice that it had replaced the PPA and the Z Facility with the Y Facility when it filed its Year 3 federal income tax return on October 4, Year 4, with a letter addressed to the Secretary, identifying the replacement property. Therefore, the limitations period for assessment of a deficiency attributable to Partnership's gain on the involuntary conversion extends to October 4, Year 7.

Section 703(b) generally provides (with exceptions noted but not applicable here) that any election affecting the computation of taxable income derived from a partnership shall be made by the partnership. A partnership is the only entity that can make the § 1033 election with respect to the partnership property replaced. *Demirjian v. Commissioner*, 457 F.2d 1, 5 (3rd Cir. 1972). Thus, the valid partnership election not only starts the running of the replacement period, it also tolls the statute of limitations for assessment of a deficiency until the expiration of 3 years after the Secretary is notified by the partnership of the replacement of the converted property or the intention not to replace.

Pursuant to §§ 701 and 702, a partnership is treated as a flow-through entity for purposes of federal income taxation. As such, a partnership's items of income, gain, loss, deduction, and credit pass through the entity to its partners. Consequently, Partnership's election to defer any part of its gain on the involuntary conversion for Year 1 will flow-through to all partners.

In the present case, Sub 1 was a member in Pcorp's consolidated group in Year 1. Therefore, any adjustment to Sub 1's income tax liability for Year 1 will affect Pcorp's consolidated return for Year 1. In addition, the period for assessment of a deficiency attributable to Partnership's gain on an involuntary conversion extends to October 4, Year 7, for both partners, Sub 1 and Sub X. Partnership's action also extended the statute of limitations for the same period as to Pcorp because Sub 1 was a member of Pcorp's consolidated group in Year 1. *Cf. Rosefsky v. Commissioner*, 599 F.2d 515 (2nd. Cir. 1979), *aff'g* 70 T.C. 909 (1978) (holding that election by partnership to defer gain recognition on condemnation of partnership property tolled general 3-year statute as to individual partners).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Two collateral issues are of some concern. The first is that Partnership's partners seem to have taken inconsistent positions with respect to their tax liability under an election by the partnership to defer gain under § 1033. Since the election must be made at the partnership level as noted above, no partner is entitled to recognize gain except to the extent of its portion of the amount received that was not expended in timely purchasing replacement property that is similar or related in service or use. In other words, when a partnership makes an election under § 1033, all partners are bound by that election and must account for the gain from the involuntary conversion in a manner consistent with that election. However, Sub X apparently attempted to opt out of the partnership election as to its share of the proceeds from the involuntary conversion. This is impermissible.

Our second concern is with the possible position that Partnership may take that by the close of the replacement period on December 31, Year 3, it had already expended all or most of the amount of the proceeds of the involuntary conversion in acquiring New AB-Partnership and constructing the Y Facility. For example, if by the end of the replacement period Partnership had already expended a sum in excess of the amount realized in the conversion, then arguably replacement was timely even without actual completion of the plant to operational status. On the other hand, it is also arguable that an incomplete and nonoperational plant is not similar or related in service or use to the converted Z Facility and PPA. Perhaps Partnership is of this latter view, as evidenced by the fact that it eventually requested an extension of time to make replacement of the converted property. This office knows of no case or other substantial authority directly on point to support either position. However, the “similar or related in service or use” standard sometimes yields some surprisingly taxpayer-adverse results. *See, e.g.,* Rev. Rul. 70-399, 1970-2 C.B. 164, (hotel held by the taxpayer as owner/lessor was not a valid replacement for a converted hotel held by the taxpayer as owner/operator); *Erickson v. Commissioner*, 598 F.2d 525 (9th Cir. 1979) (owner-occupied residence was not a valid replacement for residential or other property leased to tenants); §1.1033(a)-2(c)(9)(i) (improved real estate not valid as replacement of unimproved real estate); and Rev. Rul. 76-319, 1976-2 C.B. 242 (“billiard center” not valid as replacement for a “bowling center”).

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Please call                          if you have any questions.