INTERNAL REVENUE SERVICE
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CASE-MIS No.: TAM-152173-03/CC:ITA:B01

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Date 1 =
Date 2 =
Date 3 =
Date 4 =

Date 5 =
Date 6 =
Date 7 =
Date 8 =
Taxpayer =
Sub 1 =
Sub 2 =
Sub 3 =
Sub 4 =
Partnership =

Year 1 =
Month 1 =
State =

X	=
Y	=
Z	=
Company	=
$a	=
$b	=

ISSUE:

What is the character of a payment received for the termination of a long-term power purchase agreement, under the circumstances described below?

CONCLUSION(S):

Where a payment is received for the termination of a long-term power purchase agreement that ceases to exist thereafter, the payment is ordinary income.

FACTS:

The transaction at issue here involves a power purchase contract between Sub 1 and Partnership. On Date 1, Taxpayer became a public utility holding company after a series of merger transactions that resulted in Taxpayer owning all of the stock of several first-tier subsidiaries, including Sub 1 and Sub 2. Sub 2 owned all of the stock of Sub 3 and Sub 4. Together, Sub 3 and Sub 4 held a 50% partnership interest in Partnership. The remaining 50% interest in Partnership was held by an unrelated third party.

The Public Utility Regulatory Policy Act of 1978 (“PURPA”), P.L. 95-617, 92 Stat. 3117, was intended to encourage the development of independently-owned power plants that used renewable energy sources, particularly energy-efficient technologies such as cogeneration. PURPA established a class of nonutility power suppliers, referred to as independent power producers, non-utility generators or qualifying small power production facilities (“QFs”). PURPA required electric utilities to purchase excess power from QFs at a price equal to the utility’s forecast of “avoided cost,” which is the cost avoided by the utility by substituting power generated by the QF. State utility commissions, including the State Board of Public Utilities (“the BPU”), are responsible for administering utilities’ compliance with their purchase obligations under PURPA.

Pursuant to PURPA, Sub 1 entered into long-term power purchase agreements with four QFs for the purchase of X units of capacity and energy. On Date 2, Sub 1 entered into a power purchase agreement (“the PPA”) with Company, the contractual predecessor of Partnership. Company was formed to construct and operate a power plant for the generation of electricity (“the Power Plant”). Under the terms of the PPA, Sub 1 was obligated to purchase from Company the Power Plant’s total output of electric energy and capacity. The capacity of the Power Plant was Y units, which was later increased to Z units. Sub 1 was required to pay Company monthly for dispatched power in an amount made up of an energy payment and a capacity payment. The PPA was to terminate 30 years after the date when commercial operation of the plant commenced. Nonmaterial amendments to the PPA were made between Date 3 and Date 4.

The PPA was assignable by Sub 1 or Company with the other party's prior written consent. The consent requirement did not apply to assignments made in connection with project financing or assignments to affiliates or wholly-owned subsidiaries of either party. In Month 1, Company assigned all of its rights in the PPA to Partnership. After the assignment, the Power Plant was operated by Partnership, and the PPA was modified to substitute Partnership for Company as a party.

After the enactment of PURPA, it was widely expected that fuel and plant construction costs would continue to escalate through the 1980s and 1990s. Accordingly, many utilities entered into long-term power purchase contracts based upon the utilities' forecasted long-range avoided costs, including avoided power plant construction costs and avoided fuel and operating costs. However, the cost of fuel in the United States declined after the enactment of PURPA, leading to a reduction in utilities' costs of producing electric power. In addition, beginning in the early 1990s, the electric utility industry was undergoing deregulation, which led to increased competition in the industry and a reduction in the price of electricity. As a consequence of these and other factors, many PURPA contracts, including the PPA, provided for rates that were significantly above market.

In an effort to reduce its costs, Sub 1 attempted to end its obligations under the PPA. On Date 5, Sub 1 signed a letter of intent with Partnership relating to a transaction that would have, in exchange for a payment by Sub 1 to Partnership, terminated the PPA and substituted a long-term power contract between Partnership and an unrelated third party. Sub 1 and Partnership received proposals from various prospective third parties but were unable to establish mutually-agreeable terms to proceed with the transaction. Thereafter, Sub 1 did not transfer any of its rights and obligations under the PPA to any third party.

On Date 6, Sub 1 and Partnership entered into an agreement to terminate the PPA ("the Termination Agreement"), which required Sub 1 to pay Partnership $a ("the Termination Payment"). Specifically, section 2.02 of the Termination Agreement provides that Sub 1 is to pay the Termination Payment, "the PPA shall terminate and shall be of no further force and effect," and "thereafter neither [Partnership] nor [Sub 1] shall have any existing, accrued, or continuing rights, duties or obligations to each other under the PPA." On Date 7, the BPU entered an order approving the Termination Agreement and providing that Sub 1 was entitled to recover from customers the Termination Payment, together with reasonable and prudently-incurred transaction costs and interim financing costs. The BPU order also provided that the Termination Payment and related transaction costs were eligible for long-term financing through the issuance of transition bonds. Sub 1 did not enter into any new long-term contracts with Partnership.

On Date 8, Sub 1 paid the Termination Payment to Partnership pursuant to the Termination Agreement. Partnership reported the receipt of the Termination Payment as long-term capital gain and allocated 50% of the long-term capital gain (approximately $b) to Sub 3 and Sub 4. Ultimately, approximately $b of flow-through income from Partnership was reported on Taxpayer's Year 1 Consolidated Tax Return as a long-term capital gain. Taxpayer deducted the entire Termination Payment as an expense on the same return.[1] The revenue agent disagrees with Taxpayer's treatment of the termination payment as capital gain, instead maintaining that it is ordinary income.

LAW AND ANALYSIS:

In order for proceeds from the disposition of an asset to qualify as long-term capital gain, the asset must be a capital asset as defined by § 1221 of the Internal Revenue Code, the disposition must be a "sale or exchange," and the asset must have been held for more than one year. Section 1222. Under § 1231, capital gain also may result from the sale or exchange of real or depreciable property used in the taxpayer's trade or business and held for more than one year, if section 1231 gains exceed section 1231 losses for the year.

In the present case, Taxpayer and the revenue agent have agreed that the PPA was property and a capital asset held for more than one year. This memorandum focuses on whether the termination transaction resulted in a "sale or exchange" of the rights under the PPA.

<u>The "Sale or Exchange" Doctrine in General</u>

In order for the portion of the Termination Payment received by Taxpayer to qualify for capital gain treatment, it must result from the "sale or exchange" of the PPA within the meaning of §§ 1222 and 1231. The transaction was a "disposition" of property, within the meaning of § 1001, since Taxpayer parted with all substantial rights and obligations in the PPA in return for a cash payment. <u>See</u> <u>Bailey v. Commissioner</u>, 90 T.C. 558, 607-14 (1988), <u>aff'd in part and vacated in part on a different issue</u>, 912 F.2d 44 (2d Cir. 1990); <u>cf.</u> <u>Grodt & McKay Realty, Inc. v. Commissioner</u>, 77 T.C. 1221 (1981). However, under long-established case precedent, not every disposition qualifies as a "sale or exchange" for purposes of the capital gains provisions.

In <u>Fairbanks v. United States</u>, 306 U.S. 436 (1939), for example, the Supreme Court applied the commonly-accepted meaning of the term "sale or exchange" in holding that the redemption by a corporation of its bonds did not fall within the meaning of that term

[1] The deduction is not at issue in this memorandum.

and thus resulted in ordinary income to the bondholder. Similarly, in Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941), the Court held that insurance received as compensation for the loss of business assets was not capital gain because of the lack of a sale or exchange. Over the years, Congress has enacted numerous statutory provisions that override this general doctrine and provide capital gain or loss treatment by deeming certain transactions to be sales or exchanges. See, e.g., §§ 165(g) (worthless securities), 166(d)(1)(B) (worthless nonbusiness debt), 1038 (foreclosures), 1231(a)(3)(A)(ii) (involuntary conversions; overruling Flaccus Leather), 1233 (short sales), 1234 (option expirations), 1234A (certain contract cancellations), 1241 (cancellation of leases and certain distributorships), & 1271 (debt retirements; overruling Fairbanks). However, none of these statutory provisions covers the present case.

Contract Rights and the "Extinguishment Doctrine"

In certain circumstances, payments received for the cancellation or termination of contractual or similar rights do not qualify for capital gain or loss treatment because the rights are not sold to, or exchanged with, the payor; instead, they simply cease to exist. Some explanation of the historical development of this doctrine (commonly referred to as the "extinguishment doctrine") is useful to elucidate its current status and the factors that determine its application.

In Commissioner v. Starr Bros., Inc., 204 F.2d 673 (2d Cir. 1953), the Second Circuit held that a payment to a distributor for terminating its exclusive contract with a manufacturer was ordinary income. Drawing an analogy to a situation in which the holder of a note surrenders it to the maker for a payment, the court found that the payment and release "not only ended the promisor's previously existing duty but also destroyed the promisee's rights. They were not transferred to the promisor; they merely came to an end and vanished." 204 F.2d at 674.

Another early case, General Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir. 1953), dealt with a three-party transaction. In General Artists, the taxpayer, a booking agent, had entered into contracts with Frank Sinatra entitling the taxpayer to represent Sinatra exclusively and receive a percentage of the singer's earnings. The taxpayer purported to sell the contracts to another booking agent, MCA, under an agreement, endorsed by Sinatra, that provided that MCA would enter into new contracts with Sinatra. Shortly thereafter, the new contracts were signed, and General Artists received a payment from MCA. The sole basis of the court's opinion was that, while the transaction was a sale in form, in substance it was a cancellation:

> It might be suggested that the instant case differs from that of Starr Bros. because the latter involved a release of a binding negative covenant to the obligor, whereas here there was a transfer to a third person of the rights under the covenant. But we think the correct view is that here there was a release to the obligor [Sinatra] of a negative covenant in order to allow a new covenant to be made with the third party [MCA].

Id. at 361.

Courts have differentiated cancellations of simple contract rights and cancellations of agreements with respect to more substantial property rights that survive the cancellation and are actually transferred to the other party, such as rights connected with real estate or other more traditional forms of property. See, e.g., Commissioner v. Goff, 212 F.2d 875 (3d Cir. 1954) (payment for cancellation of exclusive right to buy output of four machines from manufacturer was capital gain where taxpayer transferred to manufacturer both exclusive contract right and the machines); Commissioner v. McCue Bros. & Drummond, Inc., 210 F.2d 752 (2d Cir. 1954) (lease termination payment to lessee was capital gain); Commissioner v. Ray, 210 F.2d 390 (5th Cir. 1954) (payment to lessee for release of lease restriction was capital gain); Commissioner v. Golonsky, 200 F.2d 72 (3d Cir. 1952) (lease termination payment to lessee was capital gain); McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946) (payment to life tenant for transfer of life interest in trust to remainderman was capital gain); cf. Appalachian Elec. Power Co. v. United States, 158 F. Supp. 138, 141 (1958) (fee to cancel contract for exchange of energy supplies was ordinary income; distinguishing lease cases like Golonsky). The court in McCue distinguished the earlier Second Circuit cases, Starr and General Artists, by pointing out that, in those cases, "the contractual right was not transferred, but was released and merely vanished. However, we think the right of possession under a lease or otherwise, is a more substantial property right which does not lose its existence when it is transferred." 210 F.2d at 753. In Rev. Rul. 56-531, 1956-2 C.B. 983, clarified by Rev. Rul. 72-85, 1972-1 C.B. 234, the Internal Revenue Service recognized the distinction between leases and general contract rights and acquiesced in Golonsky, McCue, and Ray. However, citing Starr and General Artists, the ruling made clear that the Service "will continue to regard the relinquishment of simple contract rights as not involving the sale or exchange of a capital asset … and will treat amounts received in consideration of such relinquishment as constituting ordinary income … ." 1956-2 C.B. at 983-84.

Two influential cases decided in 1958 are particularly relevant here because they involve long-term supply contracts. In Commissioner v. Pittston, 252 F.2d 344 (2d Cir. 1958), rev'g 26 T.C. 967 (1956), nonacq., 1957-2 C.B. 8, the taxpayer, a coal company, received a lump-sum payment for cancellation of its exclusive contract to purchase the output of a coal mine. Upholding the Commissioner's determination that the payment was ordinary income, the Second Circuit rejected the Tax Court's rationale–that the counterparty to the contract, by making the cancellation payment, had reacquired "the right to sell its coal to whomsoever it chose at whatever terms it could arrange," 26 T.C. at 970. According to the Second Circuit:: "It would be more in accord with common understanding to say that the payment is solely for the termination of the right-duty relationship between the two parties to the agreement." 252 F.2d at 347.

In the second case, Leh v. Commissioner, 260 F.2d 489 (9th Cir. 1958), aff'g 27 T.C. 892 (1957), a corporation that held a long-term requirements contract with a supplier for the purchase of petroleum products entered into a similar arrangement with the taxpayer's partnership, reselling the products to the partnership at slightly higher prices. Subsequently, because of a shortage in the supply of gasoline, the partnership's contract right had substantial value, and the partnership accepted a payment from the counterparty in termination of the contract. The Tax Court held that the contract was "property used in the trade or business" in the partnership's hands, and the Ninth Circuit accepted this finding. However, both courts rejected the taxpayer's argument that the effect of the termination agreement was to resell the contract rights to the counterparty; rather, relying on the line of authority represented by Starr, Pittston, and General Artists, both courts held that the payment was ordinary income. The Ninth Circuit observed that the "principal object, result, and 'effect'" of the termination agreement was "to terminate rights, not continue them, nor transfer them—nor sell them—nor exchange them." 260 F.2d at 494.

In 1962, the Second Circuit, despite its role in developing the extinguishment doctrine, caused some to question its continuing validity in an often-cited case, Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962). In that case, the taxpayer, actor Jose Ferrer, had acquired from Pierre LaMure, the author of a novel, certain rights connected with the novel, including the stage rights and the right to prevent disposition of the movie rights. After the director John Huston expressed an interest in producing a movie based on the novel and starring Ferrer, a series of agreements were signed pursuant to which Ferrer surrendered his rights, Huston acquired the movie rights, and the taxpayer received a series of payments from Huston's company, Moulin, some of which Ferrer reported as capital gain.

Analyzing prior case law, the Ferrer court decided that more recent cases had "moved away from the distinction, relied upon to some extent in Starr Brothers and General Artists, between a sale to a third person that keeps the 'estate' or 'encumbrance' alive, and a release that results in its extinguishment." 304 F.2d at 131 (footnotes omitted). Describing this as a "formalistic distinction," the court continued:

> In the instant case we can see no sensible business basis for drawing a line between a release of Ferrer's rights to LaMure for a consideration paid by Moulin, and a sale of them, with LaMure's consent, to Moulin or to a stranger who would then release them. … Tax law is concerned with the substance, here the voluntary passing of "property" rights allegedly

> constituting “capital assets,” not with whether they are passed to a stranger or to a person already having a larger “estate.”

Id. Thus, the court focused its analysis on the nature of the rights conveyed. Following this approach, the court held that Ferrer received capital gain upon surrender of his right to produce a play and his right to prevent disposition of film rights, because they represented equitable interests, but ordinary income with respect to termination of his right to receive a stated percentage of film proceeds. The Court concluded that the holdings in cases such as Starr, General Artists, Pittston, and Leh could be justified because in each case the taxpayer had only “an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another,” which is not a capital asset. 304 F.2d at 130-31, 136 nn.3-4.

Two cases, one decided shortly before and one shortly after Ferrer, demonstrate opposite approaches to the application of the extinguishment doctrine in a three-party situation. In the first, Paul Small Artists, Ltd. v. Commissioner, 37 T.C. 223 (1961), the taxpayer held several agency contracts with a movie actor. It assigned the contracts, with the actor’s agreement, to another company in return for a lump-sum payment. Without ruling on whether the contracts (which could have been viewed as contracts for personal services) were capital assets, the court held that there was no sale or exchange, relying on General Artists:

> In substance, what was accomplished in each case was the substitution of one agent for another, and we do not think that the form of the transaction, i.e., whether the old contracts were to be canceled and new ones entered into, or whether the new agent simply stepped into the shoes of the old with the artist’s consent, should lead to a result here different from that reached in General Artists.

37 T.C. at 227.

By contrast, in Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963), the court employed a “substance over form” analysis to convert what appeared to be a two-party cancellation into a three-party sale. In Bisbee-Baldwin, the taxpayer assigned mortgages to investors who then employed the taxpayer to service those mortgages. Some of the investors later cancelled their contracts with the taxpayer and gave the business to other agents, over the taxpayer’s objection. The investors paid the taxpayer a standard percentage termination fee, for which they were reimbursed by the new agents. The court, following Ferrer’s approach, determined that a portion of each fee was allocable to a capital asset. With respect to these amounts, the court held that in substance the rights had been sold to the new agents, reasoning that

> [t]he investors were conduits: Bisbee-Baldwin received the payments; the transferees paid through the investors. Something was transferred. What Bisbee-Baldwin transferred was a bundle of rights under its contracts to service certain mortgages. For a price, the transferees stepped into Bisbee-Baldwin's shoes. It is irrelevant that the investors' approval was required … and that instead of assignment the transfer was effected by termination of the old contracts and execution of new contracts.

320 F.2d at 936.

At one time, certain language in Ferrer, 304 F.2d at 131, was interpreted to suggest that the extinguishment doctrine was no longer followed and that income from a contract termination would be capital gain as long as the cancelled right was a capital asset. See United States v. Dresser Indus., 324 F.2d 56, 60 (5th Cir. 1963) ("[Starr] … has been repudiated by the Second Circuit in [Ferrer]."). However, both the Service and courts, including the Second Circuit, have applied the extinguishment doctrine since Ferrer.

In Rev. Rul. 75-527, 1975-2 C.B. 30, the Service reaffirms the holding of Rev. Rul. 56-531. In Rev. Rul. 75-527, the taxpayer owns a building that is heated by a central hot water distribution plant, which is owned by a supplier that has a contract to furnish heat to the building. Because of the expense of maintaining the system, the supplier desires to terminate the contract. The taxpayer accepts the supplier's offer to reimburse the taxpayer for the cost of converting to an individual heating system, in termination of the supply contract. The Service rules that the amount received by the taxpayer for conversion of the system is ordinary income, because there is no sale or exchange, in that the taxpayer's right to have the building heated by the central heating plant is extinguished and does not pass to the supplier. The ruling cites Rev. Rul. 56-531, Pittston, and Leh for the general principles that "the mutual relinquishment of simple contractual rights and obligations does not give rise to a capital transaction," and "the cancellation or release of a contract right does not transfer the right to the transferee-payor and is therefore not a sale." 1975-2 C.B. at 30-31.

Similarly, in Billy Rose's Diamond Horseshoe, Inc. v. United States, 448 F.2d 549 (2d Cir. 1971), the Second Circuit held that a payment to a lessor for the cancellation of its right to have leased property restored was not a "sale or other disposition" within the meaning of § 453. In so holding, the court stated that the Second Circuit "has long held that cancellation or release of a contract right does not transfer the rights to the transferee-payor and thus is not a 'sale'." 448 F.2d at 551. The court then went on to state: "We do not agree that Ferrer overruled the General Artists and Starr Bros. cases. Ferrer is to be distinguished on the ground that it involved the release of motion picture production rights which could have been sold to any third person." Id. at 552.

In 1981 and 1997, the scope of the extinguishment doctrine was significantly limited with the enactment and expansion of § 1234A. The committee report accompanying the 1997 changes severely criticized the extinguishment doctrine, which it characterized as "present law," citing, among other cases, Starr, General Artists, and Pittston. See S. Rep. No. 33, 105th Cong., 1st Sess. 132, 133 (1997).[2]

However, in Wolff v. Commissioner, 148 F.3d 186 (2d. Cir. 1998), rev'g and remanding Estate of Israel v. Commissioner, 108 T.C. 208 (1997), the Second Circuit made clear that the extinguishment doctrine still applies in situations not covered by a statute specifically defining a transaction as a sale or exchange, such as § 1234A. The court, citing Starr, General Artists, Pittston, and Billy Rose, concluded that "[s]ince the asset simply vanishes, there can be no 'sale or exchange' and, thus, no capital gain or loss." 148 F.3d at 189. Thus, the court held that fees paid in connection with the cancellation of legs of commodity forward contracts (prior to the effective date of § 1234A) were ordinary losses, despite the fact that the economic result achieved by cancellation was identical to that achieved by offsetting such contracts, a transaction resulting in capital gain or loss.

With respect to Ferrer, the Wolff court adopted the analysis used by the D.C. Circuit in Stoller v. Commissioner, 994 F.2d 855 (D.C. Cir. 1993), which involved the same transactions as Wolff:

> After the cancellation of Ferrer's contract, there was still an extant contract for the movie rights with essentially the same terms but a different signatory. Therefore, the court held, the substance over form doctrine applied. See also Bisbee-Baldwin … . Because the consideration for the cancellation [in Ferrer] came from a third party, it was in substance a sale. Here, however, the underlying contracts were cancelled in substance as well as in form. When a contract was cancelled, it did not merely change hands; it ceased to exist altogether.

Stoller, 994 F.2d at 857; see Wolff, 148 F.3d at 189.

Although in both Wolff and Stoller the Tax Court was reversed, the disagreement concerned the interpretation of Ferrer's "substance over form" approach; the Tax Court had not challenged the extinguishment doctrine itself. See Estate of Israel, 108 T.C. at 222-23 (distinguishing between "unexpected and true cancellations of commercial contracts," as in Pittston and Leh, and expected cancellations of commodity-type

[2] Section 1234A provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset. This provision does not apply to this case.

contracts). Consistent with this position, in a more recent case, Nahey v. Commissioner, 111 T.C. 256 (1998), aff'd, 196 F.3d 866 (7th Cir. 1999), the Tax Court based its decision on the extinguishment doctrine. Citing Leh, among other authorities, and distinguishing Ferrer, the court held that an S corporation's proceeds from the settlement of a purchased legal claim were ordinary income, due to lack of a "sale or exchange," because "the S corporations' rights in the lawsuit vanished both in form and substance upon the receipt of the settlement proceeds." 111 T.C. at 262, 264-65.

To summarize this often-conflicting precedent, the extinguishment doctrine has faced considerable criticism over its half-century history, yet it remains a current feature of tax law. Congress has reduced the scope of the doctrine but has not eliminated it altogether. The extinguishment doctrine does not apply to the cancellation of certain rights traditionally viewed as substantial enough to survive the cancellation, such as leases and life estates. See Rev. Rul. 56-531. With respect to other contract rights and interests, the Ferrer case has led to varying interpretations. Some courts regard Ferrer as having eliminated the extinguishment doctrine altogether, leaving the nature of the terminated rights as the only relevant inquiry. See, e.g., Turzillo v. Commissioner, 346 F.2d 884, 890 (6th Cir. 1965); United States v. Dresser Indus., Inc., 324 F.2d 56, 59-60 (5th Cir. 1963). However, the position of the Service and several courts is that the extinguishment doctrine, as applied to the termination of contract rights similar to those in cases such as Pittston and Leh, continues to be a valid doctrine. See, e.g., Wolff, 148 F.3d at 189-90; Stoller, 994 F.2d at 857; Billy Rose, 448 F.2d at 552; Nahey, 111 T.C. at 262; Estate of Israel, 108 T.C. at 222 (doctrine distinguished by court); Rev. Rul. 75-527.

Although Ferrer did not eliminate the extinguishment doctrine, in some cases the focus has shifted away from the nature of the transaction and towards the nature of the terminated rights. The Ferrer case also has come to stand for a "substance over form" approach to the sale or exchange determination, in which courts analyze whether rights have, in substance, survived a transaction, even though the transaction took the form of a cancellation or termination. Ferrer's "substance over form" approach has been applied in situations in which, as in Ferrer and Bisbee-Baldwin, the consideration for the release of the contract rights comes from a third party, directly or indirectly, and the rights are transferred and survive, in some form, in the hands of the third party. In such situations, rights are viewed as having survived, in substance, in the hands of the transferee if there is a sufficient nexus and similarity between the rights given up by the taxpayer and the rights acquired by the transferee. See, e.g., Gladden v. Commissioner, 112 T.C. 209, 226 n.3 (1999) (water rights did not vanish where they reverted to the government, survived, and "were reallocated to other users"), rev'd on other grounds and remanded, 262 F.3d 851 (9th Cir. 2001). In this respect, the extinguishment doctrine has evolved since General Artists.

It may be conceptually easier to analyze the application of the extinguishment doctrine in the context of the termination of contracts involving only two parties, such as this case, Pittston, and Leh. Consequently, in an effort to prevent its application, some courts have gone to great lengths to interpret what appears to be a two-party transaction as a three-party transaction. See Bisbee-Baldwin, 320 F.2d at 936.[3] However, the more recent cases have blended the extinguishment doctrine and the doctrine of substance over form in an effort to determine whether the rights at issue "vanished both in form and substance," Nahey, 111 T.C. at 265. In either a two-or three-party transaction, the true nature of the inquiry is whether the payment is to terminate rights or to pay for property that continues to exist.

Accordingly, the question to be decided here is whether the termination of the PPA pursuant to the Termination Agreement was, in substance, a sale or exchange by Partnership of its rights and obligations under the PPA or whether those rights vanished. An examination of both sides of the transaction makes it clear that there was no sale or exchange of the rights under the PPA.

Sub 1 did not receive any property in exchange for the Termination Payment. It paid the Termination Payment to terminate its obligation to purchase power from Partnership under the terms of the PPA, which had become burdensome to Sub 1 because of the above-market rates contained therein. The only "right" Sub 1 received in exchange for the Termination Payment was the negative "right" to be relieved from its obligation to purchase power from Partnership at the prices set forth in the PPA. This "right" is neither property nor is it the same as what Partnership gave up; clearly Partnership's right to sell power under the PPA did not pass to Sub 1. Consequently, Sub 1 did not receive any property in exchange for the Termination Payment.

Similarly, Partnership did not sell its rights and obligations under the PPA, either in substance or in form. No one "stepped into the shoes" of Partnership with respect to the PPA; no third party purchased Partnership's rights and obligations to sell power. As a result of the termination, Partnership was no longer bound by the terms of the PPA, and it was free to sell its electricity to another buyer or series of buyers under any terms it could arrange. However, the rights and obligations that were created in connection with any such other sales were new rights and obligations, not a continuation of the rights and obligations under the terminated PPA. In substance, Partnership did not sell its rights to sell power under the PPA to Sub 1 or any other party; those rights merely ceased to exist.

[3] The fact that the Fifth Circuit in Bisbee-Baldwin focused on whether the contract rights in substance survived the transaction suggests that the extinguishment doctrine remains viable; there would be no need for such an analysis if it were irrelevant whether contract rights survived in some form and passed to the transferee.

Therefore, the Termination Payment was not received by Partnership from a sale or exchange of property and is ordinary income.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.