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Department of the Treasury

Washington, DC 20224

Person to Contact:

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CC:ITA:3 PLR-143906-01

Date:
January 14, 2002

Taxpayer =

Utility =

Purchaser =

State A =

Region =

Noteholder 1 =

Noteholder 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

a =

b =

c =

X =

Dear

This is in response to a letter dated August 16, 2001, submitted on behalf of Taxpayer requesting a ruling that consideration received for rights to sell power to an electric utility at above-market rates qualifies as gain from the sale or exchange of property within the meaning of §§ 1221**,** 1222, and 1231 of the Internal Revenue Code. The information submitted in that request and in later correspondence is summarized below.

FACTS

Taxpayer, an S corporation (as defined in § 1361(a)(1) of the Code)[1], owns an electrical generation facility (the "Facility"), which it operates for the production of electricity and steam. The Federal Energy Regulatory Commission ("FERC") has certified the Facility as a qualifying facility ("QF") under the Public Utility Regulatory Policies Act of 1978 ("PURPA"), P.L. 95-617, 92 Stat. 3117. Taxpayer uses the accrual method of accounting and files its federal income tax return on a fiscal year.

Congress enacted PURPA as part of the national energy plan and thereby sought to stimulate the development of the QF industry by requiring utilities to interconnect with QFs and purchase QFs' output pursuant to the ratemaking standard contained in PURPA. PURPA directed FERC to promulgate rules implementing the statute. PURPA also requires state public utility regulatory bodies to implement the statute's provisions and the FERC rules, including the requirement to set rates for the sale of QF output. Under PURPA, electric utilities are required to purchase the electrical output generated by interconnected QFs at a rate determined by the state public utility regulatory body equal to the utility's "avoided cost", that is, the cost the utility would have incurred had it produced or procured an equivalent amount of power. PURPA mandates the purchase of QF power either on an as-available basis (priced at short-term avoided cost rates) or for a specified term (usually priced at long-term avoided cost rates). Power from a QF in excess of the amount committed for sale at long-term rates can be sold on an as-available basis at short term rates or pursuant to any other power sales arrangement entered into by the QF and the purchaser.

On Date 1, the State A Public Utilities Commission (the "Commission"), as part of its PURPA implementation responsibilities, issued an order requiring a State A electric utility company (the "Utility") to purchase energy from Taxpayer at long-term rates specified by the order for a period of <u>a</u> years (the "Order"). These rates were predetermined and fixed for each year of the <u>a</u> year term starting on Date 1. The Order, as subsequently clarified by an agreement dated Date 2, executed by the Commission, Utility, and Taxpayer (the "Settlement Agreement"), obligates Utility to purchase from Taxpayer at the long-term rates established in the Order all energy

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[1] All references are to the statutes and regulations as in effect for the year at issue.

produced by Taxpayer up to a b kilowatt capacity level. Since Date 1, Taxpayer has been selling energy generated by the Facility to Utility pursuant to the Order.

The Order's long-term rates were based on certain 30-year forecasts of the Utility's energy prices created during Date 3. Due to a variety of factors, the rates fixed by the Order using those forecasts and assumptions are significantly above the energy price forecasts today, and the Order provides long-term rates for the sale of energy from the Facility that significantly exceed today's market prices for energy. Today, Taxpayer (or any other QF), could not obtain a Commission order or a contract for the sale of its energy from the Facility at the long-term rate levels contained in the Order.

From time to time, Taxpayer sells energy from the Facility in excess of the energy committed to the Utility by the Order. These sales may be to the Utility or to other purchasers and may be at the PURPA short-term avoided cost rate periodically set by the Commission or pursuant to such other rate as agreed to by the purchaser and Taxpayer.

As noted above, PURPA also requires electric utilities to interconnect QFs to the utility's electric system, thus enabling the QF to sell electricity to the directly connected electric utility or to other indirectly connected electric utilities. The Order approved the form of an interconnection agreement between Taxpayer and Utility, permitting Taxpayer to interconnect the Facility with Utility's electric system, and ultimately, Taxpayer and Utility executed this agreement effective Date 1 (the "Interconnection Agreement"). The Interconnection Agreement includes long-term rates approved by the Order. The Interconnection Agreement also sets forth the method of billing by Taxpayer, payment by Utility for the sale of energy, and a study performed by Utility. This study describes the physical and operating requirements of the interconnection between the Facility and the Utility and identifies the metering and delivery points for the sale of energy from the Facility.

The Interconnection Agreement can be assigned by Taxpayer upon the receipt of written consent by the Utility, which consent cannot be unreasonably withheld. Utility cannot terminate the Interconnection Agreement during such time as its obligations set forth in PURPA remain unchanged and in force, unless Taxpayer fails to perform substantially in accordance with the terms of the Agreement. As a result, unless the Interconnection Agreement is terminated earlier by Taxpayer, the term of the Interconnection Agreement corresponds to the a year term of the rates approved by the Order.

On Date 4, Taxpayer and Purchaser entered into a purchase agreement (the "Purchase Agreement") by which, subject to Commission approval and certain other conditions not relevant to this letter, Taxpayer will sell and assign to Purchaser all of its rights, interests, and obligations under the Order, including the Interconnection Agreement, but excluding the Interconnection Agreement's study. The interconnection study and the Facility will remain the property of Taxpayer. Hereinafter, the Order and the Interconnection Agreement are referred to as the "Existing Power Agreement."

As a condition to closing the sale and assignment of Taxpayer's rights under the Order to Purchaser, Taxpayer and Utility each will deliver to the other a consent and mutual release, releasing each other from potential claims arising out of, or in connection with, the execution, performance or nonperformance, or assignment of the Existing Power Agreement, rate petition, and the sale of electric energy from the Facility.

In exchange for the sale and assignment of all of Taxpayer's rights, interests, and obligations under the Existing Power Agreement, Purchaser will pay $X (the "Purchase Price"), a lump sum, directly to Taxpayer at closing, and Taxpayer will no longer have the right to sell power to Utility under the Existing Power Agreement. The Purchase Price is the only consideration that Taxpayer will receive (either from Purchaser or any other person or entity) with respect to Purchaser's acquisition of the Taxpayer's rights. Interests, and obligations under the Existing Power Agreement. Purchaser has represented to Taxpayer that Purchaser intends to finance the Purchase Price from the sale of notes pursuant to note purchase agreements between Purchaser and anticipated Noteholder 1 and Noteholder 2 (the "Noteholders"). The Noteholders are independent third parties. The Purchaser intends to pledge all of its assets, including the rights to payment under the Amended and Restated Interconnection Agreement from Utility (as defined below), as security for its obligations to the Noteholders.

Simultaneous with Purchaser's acquisition of the Existing Power Agreement, Utility and Taxpayer will enter into a "Replacement Interconnection Agreement," which will provide for the continued interconnection and operation of the Facility with Utility's electrical system pursuant to the original Interconnection Agreement's interconnection study. The Replacement Interconnection Agreement will have the same terms and conditions as the Interconnection Agreement, except that sales will not be made pursuant to the Order and will not be at the long-term rates contained in the Order. Instead, these sales will occur under either the current avoided cost for obligatory purchases by Utility under PURPA or such other power sales arrangements as may be agreeable to Taxpayer and Utility. Future power sales may also occur from the Facility to purchasers other than Utility upon such terms as are agreed to by Taxpayer and such purchaser.

On or after the closing of the transaction under the Purchase Agreement, Taxpayer intends to liquidate and transfer all of its remaining assets and obligations (including the Facility) to a successor entity in a nontaxable transaction for federal income tax purposes. The successor entity will seek to operate the Facility under the Replacement Interconnection Agreement and market the Facility's electrical output under such arrangements for sale as are contained in the Replacement Interconnection Agreement or under such other arrangements it negotiates with purchasers. Purchaser, and parties affiliated with Purchaser, will not be the successor entity to Taxpayer.

On Date 5, Purchaser and Utility entered into an "Execution Agreement" under which the parties agreed to amend and restate the Existing Power Agreement immediately upon Purchaser's acquisition of Taxpayer's rights and obligations under the Existing Power Agreement (the "Amended and Restated Interconnection Agreement"). Concurrent with the request for approval of the sale and assignment of the Order to Purchaser, Utility has submitted the Amended and Restated Interconnection Agreement to the Commission and requested approval of it to allow Purchaser to make wholesale sales of power to Utility.

The Amended and Restated Interconnection Agreement will provide for the purchase by Utility and the sale by Purchaser of energy at rates less than those contained in the Existing Power Agreement, but nonetheless greater than could be obtained by Purchaser if it entered into a power sales arrangement with Utility in the absence of Purchaser's acquisition of the rights under the Existing Power Agreement. This is the case because the Commission no longer issues orders for long-term avoided cost rates for Utility and instead allows Utility to competitively procure its power supply needs. Today's market prices for such power are significantly less than the long-term avoided costs rates approved by the Order.

Purchaser has represented to Taxpayer that under the Amended and Restated Interconnection Agreement:

(i) On an annual basis, Purchaser intends to sell a substantially similar amount of energy to Utility as historically received by Utility under the Existing Power Agreement. Purchaser intends to meets its power supply obligation under the Amended and Restated Interconnection Agreement from a wholesale supplier or from market purchases.

(ii) Purchaser has no present intent to sell, terminate, or extinguish the rights it will acquire from Taxpayer to sell energy to Utility, as modified by the Commission and set forth in the Amended and Restated Interconnection Agreement.

(iii) The term during which Purchaser will have the right to sell energy to Utility under the Amended and Restated Interconnection Agreement will be substantially similar to the term remaining under the Existing Power Agreement.

(iv) The rates at which Utility will be required to purchase energy from Purchaser under the Amended and Restated Interconnection Agreement are presently above-market.

(v) The amount of energy Purchaser will have the right to sell to Utility in the future under the Amended and Restated Interconnection Agreement will be substantially similar to the amount of energy Taxpayer had the right to sell under the Existing Power Agreement.

(vi) Purchaser has no intent of physically interconnecting to Utility's electric system, and, in fact, Purchaser is physically incapable of such interconnection; thus these aspects of the Interconnection Agreement have no market value to Purchaser. Power sold by Purchaser to Utility is expected to be delivered at various Region power pool transmission facilities' points. The Amended and Restated Interconnection Agreement covers the sale of wholesale power and does not provide for Purchaser to interconnect with Utility.

(vii) Purchaser will only be compensated under the Amended and Restated Interconnection Agreement for energy actually delivered to Utility.

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, 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 §1231 gains exceed § 1231 losses for the year.

In the present case, the Existing Power Agreement was an asset held by Taxpayer for more than one year. Whether the Purchase Price received from Purchaser was long-term capital gain therefore depends on two factors: the nature of the asset and the nature of the transaction.

Nature of the Asset: Existing Power Agreement as "Property"

Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of five listed exceptions: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in § 167 or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; and (5) certain publications of the United States Government.

The term "section 1231 gain" includes the sale or exchange of property used in a taxpayer's trade or business, of a character which is subject to the allowance for depreciation under § 167, and that does not fall within certain exceptions generally equivalent to the exceptions in § 1221.

In the present case, the Existing Power Agreement was an asset used in Taxpayer's trade or business that does not fall within any of the listed exceptions to capital gain treatment in § 1221 or § 1231. We do not decide whether it was a capital asset or a § 1231 asset because, in either case, gain from the sale or exchange of such an asset would be capital gain for Taxpayer.

In order for either § 1221 or § 1231 to apply, however, the asset sold must constitute "property."[2] Although § 1221 appears to give broad meaning to this term, the Supreme Court has found it "evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions [of § 1221] qualifies as a capital asset"; rather, the term "capital asset" "is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time ... . " Commissioner v. Gillette Motor Co., 364 U.S. 130, 134 (1960) (compensation for temporary seizure of business facilities is ordinary income). Similarly, in Commissioner v. P.G. Lake, 356 U.S. 260, 265-67 (1958), the Court denied capital gain treatment on the disposition of certain mineral payments carved out of established oil and gas working interests, observing, "The lump-sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. ... In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property."

On this basis, capital gain or loss treatment has been denied for transactions involving payments in return for interests carved out of, or related to, an interest retained by the taxpayer, see, e.g., Gillette and P.G. Lake; interests related to compensation for personal services rendered or to be rendered in the future, see, e.g., Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962) (interest in films to be produced by taxpayer); Vaaler v. United States, 454 F.2d 1120 (8th Cir. 1972) (agency contract with insurance company); Foote v. Commissioner, 81 T.C. 930 (1983) (tenure rights); and interests relating to income already earned or about to be earned, see, e.g., Rhode's Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (right to dividend that was already declared).

On the other hand, as the courts have noted, “[s]imply because the property transferred will produce ordinary income, and such income is a major factor in determining the value of the property, does not necessarily mean that the amount received for the property is essentially a lump-sum substitute for ordinary income.”[3] In Guggenheim, the court focused on whether substantial investment risks involved in

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[2] The term has the same meaning under § 1221 as it has under § 1231. See Hollywood Baseball Assoc. v. Commissioner, 423 F.2d 494 (9th Cir.), cert. denied, 400 U.S. 848 (1970).

[3] Guggenheim v. Commissioner, 46 T.C. 559, 569 (1966), acq., 1967-2 C.B. 2 (sale of syndicated interests in a racehorse). See also United States v. Dresser Industries, 324 F.2d 56, 59 (5th Cir. 1963) (transfer of “exclusive” feature of a patent contract); Commissioner v. Ferrer, 304 F.2d 125, 132-33 (2d Cir. 1962) (various rights in a literary work); Estate of Shea v. Commissioner, 57 T.C. 15 , 25 (1971), acq., 1973-2 C.B. 3 (shipping charter).

holding the asset that was the source of the income were transferred. See 46 T.C. at 569. In Dresser, the court distinguished between proceeds from “the present sale of the future right to earn income [capital gain] and the present sale of the future right to earned income [ordinary income].” 324 F.2d at 59. In Ferrer, the court distinguished between cases involving “an ‘estate’ in, or an ‘encumbrance’ on, or an option to acquire an interest in property which, if itself held, would be a capital asset” and “an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another, or by rendering services, or by virtue of ownership of a larger ‘estate’.” 304 F.2d at 130-131 (cited cases omitted). See generally Foy v. Commissioner, 84 T.C. 50, 70 (1985) (capital gain on transfer of franchise rights; summary of factors).

In Estate of Shea, a case particularly analogous to the present case, the court held that the transfer by the taxpayers’ S corporation to a third party of a shipping charter, a contract to provide cargo space on the corporation’s ships, was a sale of "property" under § 1231, resulting in capital gain. The corporation had originally acquired the shipping charter along with the ship to which it was subject, later substituted a different ship, and eventually sold the charter as a separate asset. In its holding, the court stressed that the shipping charter was not a contract to perform personal services, that the taxpayer had been required to capitalize the acquisition cost of the charter, and that the value of the charter was primarily determined by its rate as compared to prevailing market rates. Thus, the court observed, the difference between the amount paid for the charter and the amount received upon its disposition represented appreciation in value over time, due purely to the action of market forces. This, according to the court, was precisely the type of profit for which capital gain treatment is intended, citing Gillette. See 57 T.C. at 24-25.

Based on the above, we conclude that the bundle of contract rights and obligations represented by the Existing Power Agreement in the present case was "property" within the meaning of §§ 1221 and 1231. The Existing Power Agreement did not represent a right to compensation for personal services rendered or to be rendered; rather, it involved the sale of a product—electricity. Nor was it a right to collect income already earned, as in Rhodes' Estate. Instead, like the "exclusive" feature of the right to practice under the license at issue in Dresser, the Existing Power Agreement was itself an income-producing asset, a right to earn income in the future. As made clear by Dresser and Guggenheim, it is not dispositive that the income to be produced by the Existing Power Agreement would have been ordinary, nor that the value of the Existing Power Agreement was largely determined by the present value of that expected future income stream. Moreover, the Existing Power Agreement was not simply, in the words of the Ferrer court, “an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another.” First, as a PURPA contract, mandated by federal and state statutes and regulations, the Existing Power Agreement reflected to some extent benefits created by governmental action, similar to other rights that have been treated as capital assets. See, e.g., Rev. Rul. 66-58, 1966-1 C.B. 186 (cotton acreage allotments); Rev. Rul. 70-644, 1970-2 C.B. 167 (milk allocation rights). Second, like the shipping charter at issue in Estate of Shea, the value of the Existing Power Agreement was largely determined by prevailing market rates and was subject to market fluctuations, outside of the control of Taxpayer, based on projections of economic factors over a significant period of time[4]. As stated in Gillette and Estate of Shea, such appreciation in value over time resulting from market fluctuations is the type of profit for which capital gain treatment is intended.

We reach the conclusion that Taxpayer sold "property" within the meaning of §§ 1221 and 1231 even though it retained its ownership of the Facility, and therefore might be viewed as transferring the contract while retaining an underlying, related income-producing asset. Cf. Gillette; P.G. Lake. As discussed above, while the Existing Power Agreement was clearly related to the Facility, it was separately transferable and, in the context of the regulatory environment in which the transaction occurred, was an income-producing asset in its own right, one that had a value independent of Taxpayer's Facility. In this respect, it was similar to the shipping charter in Estate of Shea, which—while it was clearly related to a ship in a generic sense—was not linked to any specific ship; it could be, and was, transferred from ship to ship and sold as a separate asset. As noted above, unlike the charter in Estate of Shea, Taxpayer had not acquired the Existing Power Agreement through purchase and had no basis in the contract; however, the contract was certainly an asset as to which costs would have to be capitalized in appropriate circumstances, separate from the source of the electricity that was the subject of the contract. Except for the inter-connection study, Taxpayer transferred its entire interest in the Existing Power Agreement and, after the transaction, the operation of the power plant had no economic effect on the Existing Power Agreement or *vice versa*; in fact, Taxpayer has retained the right to sell power to the Utility or other purchasers under such terms and arrangements as are agreed upon by such parties.

Nature of the Transaction: "Sale or Exchange"

The "Sale or Exchange" Doctrine in General

Even though we conclude that the Existing Power Agreement was "property" within the meaning of §§ 1221 and 1231, in order for the proceeds received by Taxpayer to be capital gain they must result from the "sale or exchange" of the Existing Power Agreement, within the meaning of §§ 1222 and 1231. The transaction was clearly a "disposition" of property, within the meaning of § 1001, since Taxpayer parted with all substantial rights and obligations in the contract in return for a cash payment[5].

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[4] In this connection, note the length of the contract—approximately a years, with c remaining at the time of the present transaction.

[5] See Bailey v. Commissioner, 90 T.C. 558, 607-14 (1988), aff'd in part and vacated in part on a different issue, 912 F.2d 44 (2d Cir. 1990); cf. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981).

Contract Rights and the “Extinguishment Doctrine”

One limitation on the “sale or exchange” doctrine holds that, in certain circumstances, amounts received for the cancellation or termination of contractual or similar rights or claims 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. This doctrine—variously termed the “extinguishment,” “disappearing asset,” or “vanishing asset” doctrine—is normally applied in two-party situations; however, there is precedent for applying it in a three-party situation, such as the present case, if the substance of the transaction is found to constitute a cancellation, rather than a sale.

In an early case, Commissioner v. Starr Bros., Inc., 204 F.2d 673 (2d Cir. 1953), the Second Circuit held that 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 the 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), aff'g 17 T.C. 1517 (1952), cert. denied, 346 U.S. 866 (1953), dealt with a three-party situation. 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 Sinatra'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 after, the new contracts were signed and General Artists later received a payment from MCA, which it treated as capital gain. Although the Tax Court relied in part on a finding that the taxpayer had not parted with “property,” the sole basis of the Second Circuit’s affirming 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 [i.e., Sinatra, the counterparty] of a negative covenant in order to allow a new covenant to be made with the third party [MCA]. ... The agreement provided that such new contracts should be made and "be deemed to supersede, cancel, and take the place of" taxpayer’s contracts with the singer.

205 F.2d at 361.

Two cases decided in 1958 are significant for present purposes 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, cert. denied, 357 U.S. 919 (1958), the taxpayer, a coal company, received a lump-sum payment in return 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 a slightly higher price. Subsequently, because of a shortage in the supply of gasoline, the partnership's contract right had substantial value, see 27 T.C. at 897, 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 circuit court 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. In the words of the circuit court, 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, cast doubt on its continuing validity in Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962), rev'g in part and remanding 35 T.C. 617 (1961), acq., 1961-2 C.B. 4. 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 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."

Focusing instead on the nature of the asset, the Court concluded that the holdings in cases such as Starr, General Artists, Pittston, and Leh, could be justified as involving assets that weren't "property," rather than on the basis of the extinguishment doctrine. 304 F.2d at 130-131. Following this approach, the court, "unbundling" the various rights given up by Ferrer, held that Ferrer received capital gain upon surrender of his right to produce a play and his negative rights to prevent disposition of film rights, because they represented equitable interests, but ordinary income with respect to termination of his rights to receive a stated percentage of film proceeds.

In Bisbee-Baldwin Corporation v. Tomlinson, 320 F.2d 929 (5th Cir. 1963), the court employed a "substance over form" analysis to convert a two-party cancellation into a three-party sale, effectively reversing the approach in General Artists. 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 "unbundling" approach, determined that a portion of each fee was allocable to capital assets. With respect to these amounts, the court held that in substance the rights had been sold to the new agents:

> The 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.

Although Ferrer did not eliminate the extinguishment doctrine altogether, it has ameliorated its impact to some extent. First, the case clearly shifted the primary thrust of the analysis away from the nature of the transaction and towards the nature of the asset. Second, and related to the first point, the Ferrer case has come to stand for a "substance over form" approach to the "sale or exchange" determination—exemplified by the Bisbee-Baldwin case—in which rights are more likely to be viewed as having, in substance, survived a transaction, even though the transaction took the form of a cancellation or termination.[6]

In transactions involving three parties, the question then becomes whether there is a sufficient nexus and similarity—between the rights given up by the taxpayer and the rights acquired by a third party—to permit the conclusion that the rights survived, in substance, in the hands of the third party. Courts, as well as the Service, have recognized that the rights acquired by the third party or parties need not be identical to those given up, in order to be viewed as surviving the transaction.

Application to the Present Case[7]

Taxpayer points to certain formal aspects of the transaction—chiefly the purchase agreement whereby Purchaser purported to purchase Taxpayer's entire interest in the Existing Power Agreement, in return for a cash payment—as evidence that the transaction was a sale of the Existing Power Agreement for capital gains purposes. Taxpayer also argues that its tax treatment should not depend on what Purchaser chose to do, as a result of separate negotiations, after Purchaser acquired the Existing Power Agreement. However, as discussed above, there is ample precedent in this context for looking beyond the form of the transaction. This is especially true when, as in the present case, the separate steps of the transaction are so clearly interrelated. Whether or not there were separate negotiations leading up to the transactions that were executed on Date 5, it is clear that on that date each step of the transaction was dependent on the others, and that Taxpayer knew that Purchaser had no intention of performing under the Existing Power Agreement, and would terminate the Existing Power Agreement simultaneously with—not "after"—its acquisition from Taxpayer. By the same token, however, the execution of mutual releases as between Taxpayer and Utility—a common precaution in a complex legal transaction---does not necessarily establish that the transaction was a cancellation rather than a sale. See, e.g., Leh, 260 F.2d at 493, n. 5; Turzillo v. Commissioner, 346 F.2d 884, 889 (6th Cir. 1965). The tax consequences turn on the substance of the transaction.

Accordingly, the question to be decided is whether the present transaction was, in substance, a sale of Taxpayer's rights in the Existing Power Agreement to the Purchaser. On these particular facts, we conclude that it was. Although as part of the integrated transaction the Existing Power Agreement was terminated and ceased to exist, this was not done directly, or indirectly, by Utility simply to eliminate what had become a burdensome contract. Nor did the Purchaser, once it had acquired the

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[6] For a similar example of the evolution of the "sale or exchange" doctrine, see the line of cases represented by Yarbro v. Commissioner, 737 F.2d 479 (5th Cir. 1984), cert. denied, 469 U.S. 1189 (1985), in which the courts found a "sale or exchange," resulting in capital loss, in certain transactions traditionally viewed as lacking that element, such as abandonments of mortgaged properties.

[7] Taxpayer represents that the hedging transaction regulations, under § 1.1221-2, do not apply to the Order, Supplemental Agreement, or Interconnection Agreement.

Existing Power Agreement, terminate it in return for cash or debt from Utility—which might lead to the conclusion that, in substance, the transaction was an indirect means for Utility to eliminate the contract. Rather, the consideration for the acquisition of the Existing Power Agreement came from the Purchaser, not Utility.

Moreover, while the Amended and Restated Interconnection Agreement was not identical to the Existing Power Agreement, the two contracts were similar in several respects. First, the remaining term of the Amended and Restated Interconnection Agreement will be substantially similar to the Existing Power Agreement. Second, while the source of the electricity differs, the amount of energy to be furnished under the Amended and Restated Interconnection Agreement will be based on the historical amounts furnished under the Existing Power Agreement. Finally—although the Purchaser is not a QF, and the price terms under the Amended and Restated Interconnection Agreement are not as favorable to the Purchaser as the terms under the Existing Power Agreement are to Taxpayer—the Amended and Restated Interconnection Agreement has been approved by the regulatory authorities as a substitute for the Existing Power Agreement, because the Amended and Restated Interconnection Agreement, while still a long-term contract at above-market rates, is more favorable to Utility and the ratepaying public than the Existing Power Agreement.

In substance, therefore, the Purchaser's payment to Taxpayer is intended to result in the acquisition of valuable rights by Purchaser, in the form of a long-term, above-market power supply contract, of a type no longer favored in the new, deregulated environment, and similar in many significant respects to the rights given up by Taxpayer in the transaction. In this sense, the Purchaser "stepped into the shoes" of Taxpayer. Thus, we conclude that the nature of the transaction is a sale or exchange of Taxpayer's rights in the Existing Power Agreement to Purchaser.

CONCLUSION

Accordingly, the consideration received by Taxpayer for its rights to sell power to Utility at above-market rates qualifies as gain from the sale or exchange of property, within the meaning of §§ 1221, 1222, and 1231.

This ruling is based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

We express no opinion about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings. In particular, we express no opinion as to the applicability of the hedging transactions regulations, under § 1.1221-2, to the proposed transaction.

Under the powers of attorney on file in this office, a copy of this ruling is being sent to your authorized representative.

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

Sincerely yours,
DOUGLAS FAHEY
Assistant to the Branch Chief, Branch 3
Office of the Associate Chief Counsel
(Income Tax and Accounting)