INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-134352-03, CC:ITA:4

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference: None

LEGEND:

Product A =
Product B =
Product C =
Country D =
F =
P =
Q =
QP =
R =
S =

T =

U =

V =

W =

Z =

Buyer 1 =
Buyer 2 =
Ingredient 1 =
Ingredient 2 =
Ingredient 3 =
Sub 1 =
Sub 2 =
Partner =
$aa =
$bb =
$cc =
$dd =
$ee =
$ff =
$gg =
$hh =
$jj =
Date 0 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =

ISSUE(S):

(1) Was the transfer of Z's Product A and Product B United States assets voluntary?

(2) Were Z’s Product A and Product B United States assets converted for purposes of § 1033(a) of the Internal Revenue Code?

CONCLUSION(S):

(1) The transfer of Z’s Product A and Product B United States assets was voluntary.

(2) Z’s Product A and Product B United States assets were not converted for purposes of § 1033(a).

FACTS:

General Background. For the tax year at issue, the taxpayer, Z, filed a consolidated return on behalf of its consolidated group. Z was a lower-tier subsidiary of the ultimate parent company, P, a publicly-held Country D corporation. Q was an unrelated Country D corporation, which was also the common parent of a large conglomerate of companies.

Merger of Q and P. On Date 1, the boards of both Q and P agreed to the terms of a proposed merger to form a new group, QP, which would become the world's leading R company. The proposed merger was to be effected by Q and P becoming wholly-owned subsidiaries of the newly formed company, QP. The agreement involved the complete merger of the world-wide organizations of both companies.

At the time of the proposed merger, the principal activities of P were S. The P group manufactures products in many countries and sells them in most countries throughout the world. At the same time, the Q group constituted a major global R group engaged in the T. It had operating companies, manufacturing operations, and sales operations in many countries.

Federal Trade Commission Investigation of Proposed Merger. The proposed merger was subject to certain conditions including clearance from the European Commission and the United States Federal Trade Commission (FTC). The merger could only be effective if all conditions of the merger were satisfied or waived, including receipt of all shareholder and court approvals and all other regulatory clearances. The FTC investigated the proposed merger and found violations of the Clayton Act and the Federal Trade Commission Act. According to the FTC's complaint, the transaction as originally proposed would have substantially lessened competition in several separate markets.

In settlement of the FTC's charges, Q and P entered into an Agreement Containing Consent Orders (Consent Agreement) with the FTC on Date 2. The FTC issued a separate Decision and Order (Order) on the same date. The Order required Q and P to make divestitures in six product markets, including U. In three markets where competitive overlaps existed due to existing agreements with other research and development firms, the consent order directed the transfer and surrender of assets connected with W.

P's Divestiture of Product A and Product B Assets. The FTC ordered Q and P to divest the Product A assets and Product B assets within 10 business days after the merger. These divestitures were made pursuant to FTC approved Asset Sale Agreements. On Date 3, P and its affiliates entered into agreements with Buyer 1 and Buyer 2 for the sale of the Product A assets and the Product B assets, respectively.

The Order defined Product A assets as referring to Ingredient 1 and the related trademark, patent, marketing, and distribution rights. Product A assets also included all rights necessary to manufacture, and market and distribute Product A, together with all patents, trademarks, logos, clinical data, and other significant intellectual property relating to Product A. Prior to the divestiture, Sub 1 owned the Product A United States assets, i.e., the trademark, the customer list, the right to market and distribute Product A in the United States, and V. Certain patents, trademarks, scientific, and regulatory material were owned by P or another Country D affiliate. Other affiliates owned the manufacturing know-how, supply agreements, and distribution rights for other territories.

The Order defined the term Product B assets as referring to Ingredients 2 and 3 and all related rights necessary to manufacture, market, and distribute, together with all patents, trademarks, logos, clinical data, and other significant intellectual property relating to Product B. Prior to the divestiture, Sub 1 owned the Product B United States assets, i.e., the right to market and distribute Product B in the United States, the customer list, and V. Certain patents, trademarks, and scientific and regulatory material were owned by P or another Country D affiliate. Other affiliates owned the manufacturing know-how, supply agreements, and distribution rights for other territories.

On Date 4, P announced that the process for divestiture of the Product A assets and Product B assets, as required for FTC approval for the merger, was under way. P and its affiliates had entered into agreements in principle, subject to FTC consent, with specific buyers. The agreements were conditional on the completion of the merger of Q and P.

Pursuant to the Product A Asset Sale Agreement of Date 3, P and its affiliates entered into an agreement to sell all its rights to the Product A assets to Buyer 1. In exchange for these rights, P and its affiliates were to receive $dd in cash. Of this amount, approximately $ee of the proceeds were allocated by P to the sale of the Product A

United States assets by Sub 1. The sale of the Product A assets closed on Date 5. Sub 1 reported a net taxable gain of approximately $ff for the sale of its Product A United States assets on Z's Form 1120 for the year in issue.

Pursuant to the Product B Asset Sale Agreement of Date 3, P and its affiliates entered into an agreement to sell all its rights to the Product B assets to Buyer 2. In exchange or these rights, P and its affiliates were to receive $gg in cash. Of this amount, approximately $hh of the proceeds were allocated by P to the sale of Product B United States assets by Sub 1. The sale of the Product B assets closed on Date 6. Sub 1 reported a net taxable gain of approximately $jj for the sale of its Product B United States assets on Z's Form 1120 for the year in issue.

Sub 1's Acquisition of Product C. Sub 1 and Partner were parties to a Limited Partnership Agreement of Date 0 (Partnership Agreement) relating to the development, marketing, and sale of Product C in the United States. Pursuant to the Product C United States Agreement of Date 7, Sub 1 and Partner agreed to terminate the Partnership Agreement and dissolve the partnership. The parties further agreed that, following the dissolution of the Partnership, Sub 1 would purchase the exclusive rights to develop, market and sell Product C in the United States (Product C United States assets). Under the Product C United States Agreement, Sub 1 paid Partner $aa in cash for these rights. The purchase of the Product C United States assets closed on Date 5. The merger of Q and P concluded on Date 8.

Sub 1's Election to Defer Gain Pursuant to § 1033(a)(2)(a). In a statement attached to Z's consolidated Form 1120 for the year in issue, Sub 1 reported receiving proceeds (and realized gains) of $bb as a result of an involuntary conversion of property under § 1033(a)(2), and elected to defer part of the gain realized on the disposition by reducing its basis in qualified replacement property pursuant to § 1033(a)(2)(A). Accordingly, Z reduced its adjusted basis in the newly-acquired Product C assets from $aa to zero, and reduced its total realized gain on the disposition of the Product A and Product B assets from $bb to $cc.

LAW AND ANALYSIS:

Section 1033(a)(2) generally provides for the deferral of gain at the election of the taxpayer when property (as a result of its destruction, theft, seizure, requisition, or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money if the taxpayer purchases, within 2 years after the close of the first taxable year in which any gain from the conversion is realized, other property similar or related in service or use to the property so converted.

Section 1033 does not cover all situations in which taxpayers are deprived of property rights without their permission. It is limited to the property's involuntary destruction, theft, seizure, requisition or condemnation, or disposition under the threat or imminence of seizure, requisition, or condemnation. Only involuntary conversions resulting from one of the specified causes are entitled to nonrecognition treatment under § 1033.

A. Was the disposition voluntary as to Z?

Z argues that its entitlement to nonrecognition under § 1033 because its property rights in the Product A and Product B assets had been "involuntarily destroyed" by the actions of its parent company, P, and that this destruction constituted an involuntary conversion under § 1033, notwithstanding the parent-subsidiary relationship between P and Sub 1. The basis for this argument is that the actions of P in pursuing the merger with Q and executing the FTC Consent Agreement cannot be imputed to Sub 1.

In support of this position, Z made the following factual assertions: First, Sub 1 was not a party to the FTC Consent Agreement. Second, the negotiations and execution of the FTC Consent Agreement requiring the disposition of assets involved only Q and P, who agreed with the FTC to bind its controlled subsidiaries to the Order. When P signed the FTC Consent Agreement, it was not a voluntary act with respect to Sub 1.

We disagree with these assertions. First, Sub 1 was a party to the FTC Consent Agreement. While there is no signatory line on the Consent Agreement for Sub 1, it was a party to the FTC proceedings by virtue of the definition of P in the FTC Order incorporated by reference into the Consent Agreement. The FTC Order makes continual reference to P, a term defined to include "[P], its directors, officers, employees, agents, representatives, predecessors, successors, and assigns; its joint ventures, subsidiaries, divisions, groups and affiliates controlled by [P] (including, but not limited to, [Sub 1 and Sub 2]) and the respective directors, officers, employees, agents, representatives, successors, and assigns of each." The specific reference to Sub 1 in this definition indicates that Sub 1 was in fact a party in the FTC Consent Agreement through the incorporation by reference in the Order.

A further indication of the Sub 1's involvement in the FTC proceedings and divestiture of Product A and Product B is that F, an employee and officer (Vice President and Associate General Counsel) of Sub 1, not only signed the FTC Consent Agreement on behalf of P, but also signed the Product A and Product B Asset Sale Agreements on behalf of all Z group entities that were parties to these agreements. Accordingly, Sub 1 was not involuntarily bound by the actions of its parent P . Rather, Sub 1 was a party and active participant in the FTC proceedings that led to the voluntary divestiture of the assets described.

However, Z argues that § 1033 is applied on a separate taxpayer basis even if the taxpayer is a member of an affiliated group or a closely held corporation. In support of this position Z cites *Murphy v. Commissioner*, T.C.M. 1996-59; *Hill v. Commissioner*, 66 T.C. 701 (1976); Rev. Rul. 73-72, 1973-1 C.B. 368; and Rev. Rul. 56-636, 1956-2 C.B. 522.

These cases and rulings all stand for the proposition that the same taxpayer that has suffered an involuntary conversion must be the one that acquires the replacement property in order to qualify for non-recognition treatment under § 1033. For example, in *Murphy*, the Tax Court did not allow § 1033 non-recognition treatment to a shareholder who had personally reinvested proceeds received from his liquidated closely-held corporation that had suffered an involuntary conversion. In so holding, the court stated: "In order to qualify for nonrecognition treatment ... the taxpayer must have owned the property that was involuntarily converted."

However, none of the authorities cited by Z resemble, even remotely, the situation presented here. Neither do they stand for Z's proposition that the actions of a parent company are not to be attributed to a subsidiary in determining the threshold question of whether the transfers were voluntary. In the present situation, the transactions were engaged in by Z through Sub 1 at the direction of the ultimate parent, P, in order to secure FTC approval of its proposed merger with Q. In fact, employees of Z (and Sub 1) participated actively in the merger and necessary dispositions.

The management of Z and the corporate group to which it belongs determined that it was beneficial for the collective Z group (including its shareholders) to merge with Q, notwithstanding the requirements of regulatory agencies that certain assets be divested due to anti-competitive concerns. The Z group was under no compulsion to enter into this merger transaction. Therefore, the transfers at issue must be deemed the voluntary actions of the entire group. Because the merger was intended to benefit the entire Z group, it is entirely appropriate to consider the group as an economic family for purposes of determining whether there has been an involuntary conversion for purposes of § 1033. Under these circumstances, there is no discernable legal or factual basis for the claim that any of these dispositions were anything other than voluntary as to Z, Sub 1, or P.

In *C.G. Willis, Inc. v. Commissioner*, 41 T.C. 468 (1964), *aff'd* 342 F.2d 996 (3d Cir. 1965), the United States Tax Court considered the application of § 1033 to the proceeds from the sale of a partially damaged ship. The ship was repairable; however, the owners chose to sell the ship (at a gain) rather than make the necessary repairs. The proceeds from the sale, along with the insurance proceeds for the repair cost, were invested in a barge that would cover the same ports and carry the same kind of cargo as the damaged ship. The ship owners claimed nonrecognition treatment for this transaction under the provisions of § 1033(a). In denying the claim for nonrecognition treatment, the court stated that "[i]nvoluntary conversion, within the meaning of [§]

1033(a), means that the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes." *Id. a*t 476. The court states further that it did not believe the damage to the vessel compelled the petitioner to sell the vessel "so that the whole transaction would amount to an involuntary conversion within the meaning of the statute." *Id.* at 475. Rather, the "sale was the result of a business decision by the owner that the money equivalent of the unrepaired ship would serve its business interests better." *Id.*

Similarly, Sub 1's dispositions of its Product A and Product B United States assets were entirely voluntary. The disposition of these assets emanated solely from business expediency, that is, P and Q's mutual desire to merge. P and its affiliates were under no compulsion to merge with Q. The merger was a voluntary act. So also, the transfers of Z's Product A and Product B United States assets were the voluntary acts of Z and its subsidiary, Sub 1.

B. Was the disposition a conversion for purposes of § 1033(a)?

Z argues that Sub 1's interests in these assets were "destroyed" as the ground for application of § 1033(a).[1] In support of this position, Z cites *Willis* at 476 for the definition there given for the term "involuntary conversion" in the context of a destruction-type event, i.e., the rendering of "the taxpayer's property, through some outside force or agency beyond his control, [as] no longer useful or available to him for his purposes." 41 T.C. at 476. Using this broad language, Z attempts to extend the coverage of the term "destruction" to the factual circumstances presented here. We are not satisfied, however, that this language forms any basis for Z's contention.

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[1] Z apparently concedes that the FTC Order requiring the divestiture of Product A and Product B United States assets did not constitute a "seizure, or requisition or condemnation or threat or imminence thereof" under § 1033. We agree. A forced sale or exchange pursuant to government order does not constitute an involuntary conversion within the purview of § 1033 simply because of a taxpayer's unwillingness to part with the property involved. Courts have interpreted the term "seizure, or requisition or condemnation" to mean the taking of property by a governmental authority that has the power to do so against the will of the owner and for the use of the taker. *See, e.g., American Natural Gas Co. v. United States*, 279 F.2d 220 (Ct. Cl. 1960), *cert. denied*, 364 U.S. 900 (1960) (sale of stock resulting from a divestiture order issued by the Securities and Exchange Commission under the Public Utility Holding Company Act). *See also* Rev. Rul. 77-370, 1977-2 C.B. 306 (sale of real estate by a taxing authority to satisfy a lien for delinquent taxes); Rev. Rul. 56-420, 1956-2 C.B. 519 (sale of portion of city lot to pay a paving assessment for streets adjoining such property).

Historically, the term "destruction," in the context of § 1033(a), has been equated with the term "casualty." According to Rev. Rul. 59-102, 1959-1 C.B. 200, "casualty" denotes an accident, a mishap, or a sudden invasion by a hostile agency, but not progressive deterioration. The ruling further states that a casualty may proceed from an unknown cause or may be the unusual effect of a known cause and that, in either instance, a casualty occurs by chance or unexpectedly, but need not be a sudden occurrence. For other examples of loss by destruction within the meaning of § 1033, *see* Rev. Rul. 54-395, 1954-2 C.B. 143 (loss of cattle by accidental poisoning); Rev. Rul. 75-381, 1975-2 C.B. 25, (losses of honeybees from application of pesticides on nearby property); and Rev. Rul. 66-334, 1966-2 C.B. 302 (contamination of fresh water with salt water).

The statutory language referring to the "destruction in whole or in part" of property was originally enacted as part of § 214(a)(12) of the Revenue Act of 1921, 42 Stat. 241, the predecessor of § 1033. The congressional reports accompanying that Act explain that this language was intended to provide for the nonrecognition of gain "when property is involuntarily converted into cash as a result of fire, shipwreck, condemnation, or related causes" and later reinvested in similar property. S. Rep. No. 275, 67th Cong., 1st Sess. (1921), 1939-1 C.B. (Part 2) 191; H. Rep. No. 486, 67th Cong., 1st Sess. (1921), 1939-1 C.B. (Part 2) 209. Thus, the legislative history indicates that Congress intended to extend the benefits of § 1033 and its predecessors only to public takings and casualty-like conversions. The limitation of its benefits to involuntary conversions, i.e., those "wholly beyond control of the one whose property has been taken," reflects that intent. *Dear Publication & Radio, Inc. v. Commissioner*, 274 F.2d 656, 660 (3d Cir. 1960), *aff'g* 31 T.C. 1168 (1959).

Z cites no clear judicial or administrative precedent under § 1033 (and we have found none) for equating the sale of corporate assets in the furtherance of business objectives with destruction. Sub 1's sale of its Product A and Product B assets involves neither a public taking nor a casualty-like conversion. Rather, Sub 1's assets were sold to an unrelated third party for fair value, based upon a voluntary business decision to merge.

The legislative intent behind § 1033 and its predecessors did not contemplate relief for dispositions required by business necessity or expediency, such as what occurred here. Rather, it intended relief for taxpayers faced with the actual or threatened loss of their property to the government or a loss by casualty. In light of this legislative intent, it is inappropriate that Z should be allowed relief under § 1033 to defer gains on assets that were required to be sold as a result of a voluntary transaction entered into by the worldwide P group.

CAVEAT(S):

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.