Internal Revenue Service

Number: **200445004**
Release Date: 11/5/04
Index Number: 1033.03-00

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:4 – PLR-112462-04

Date:
July 16, 2004

In Re:

TIN:

DO: Industry Director, Natural Resources and Construction (LM:NR)
TY:

State X =
Agency =
LP =
Highway A =
Highway B =
City Y =
$z =
Month 1 =
Year 1 =

Dear

This responds to your request for a private letter ruling, dated February 25, 2004, regarding the application of § 1033 of the Internal Revenue Code to amounts received for the cost of relocating certain equipment.

STATEMENT OF FACTS:

Taxpayer is an operating public utility providing electric and gas service within State X. Its business includes the generation, purchase, transmission, distribution and sale of electricity and natural gas.

Agency is the State X agency responsible for the design, construction, operation, and maintenance of state highways and that portion of the federal interstate highway system located within State X.

LP is a private entity doing business as a limited partnership. As authorized by the State X legislature, Agency entered into a franchise agreement with LP. Pursuant to the franchise agreement, LP will finance and construct a toll road which will extend State X Highway A. The project also includes construction of a road connection of State X Highway A with State X Highway B. After completing this project, LP will operate the toll road portion of the project under a 35-year lease from Agency, charging tolls to recover its investment plus an agreed rate of return. Afterwards, the toll road will revert fully to the state.

Approximately half of the land needed for the Highway A project was donated to State X by City Y. State X will acquire the property rights needed for the remainder of the project directly from private owners. Where agreements are not possible, Agency will use its power of eminent domain to condemn the property for public use. A number of such actions have already commenced.

Agency sent Taxpayer a "notice of decision to appraise" in Month 1 of Year 1. This was a letter informing Taxpayer that the state will acquire the property on which Taxpayer's equipment is located to accommodate the project. The letter advised that the state had hired an appraiser to determine the value of Taxpayer's property. After completing the appraisal, the state will ask Taxpayer to deed the land to the state and sign a separate contract with LP and an individual acting as the "right of way agent for [State X]," setting the purchase price. This separate contract contains the following recital:

> [State X requires the land] for State Highway purposes, a public use for which Grantee (the state) has the authority to exercise the power of eminent domain. Grantor(s) is compelled to sell, and grantee is compelled to acquire the property. Both Grantor(s) and Grantee recognize the expense, time, effort and risk to both parties in determining the compensation for the property by eminent domain litigation. The compensation set forth herein for the property is in compromise and settlement, in lieu of such litigation.

As part of this condemnation, Taxpayer must move various power lines, gas mains, poles and related protective devices which it owns at a cost of approximately $z. Taxpayer has divided up the entire relocation work into 24 smaller jobs. For example, one of these jobs is already underway, consisting of the relocation of 1,500 meters of overhead line to a new alignment underground and the removal of six utility poles. This job also includes the relocation of power lines within a substation. The details of the other 23 relocation jobs that Taxpayer will undertake have not yet become final.

Taxpayer entered into a separate utility agreement which sets forth in detail what it must relocate and at what expected cost. The utility agreement also specifies how much the state will pay to replace the rights of way. In some cases, the state provides the new right of way itself over state land and over other private land acquired by condemnation.

The state will not pay for improvements to utility equipment. Agency's policy manual requires the amount spent on relocation to be reduced by the value of any "betterment or increase in capacity."

The amounts Taxpayer will receive from LP and from Agency for property rights and the cost of relocating its equipment are referred to below as "relocation payments."

RULING REQUESTED:

Taxpayer has requested a ruling that it will not have to report relocation payments as income because they are proceeds from an involuntary conversion within the meaning of § 1033, provided the amounts are reinvested in other property that is similar or related in service or use within the time period specified in § 1033(a)(2)(B) for reinvestment.

STATEMENT OF LAW:

Section 1033(a)(1) provides, in part, that if property (as a result of its condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain shall be recognized.

Section 1033(a)(2)(A) generally provides that if property is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, and if the taxpayer –

(i) during the period specified in subparagraph (B),
(ii) for the purpose of replacing the property so converted,
(iii) purchases other property similar or related in service or use to the property so converted,

then, at the election of the taxpayer, the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property.

Section 1033(a)(2)(B) generally provides that the replacement period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, and ending 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized.

ANALYSIS:

In Rev. Rul. 58-396, 1958-2 C.B. 403, a taxpayer's residence was condemned to make way for a highway. Under the terms of the condemnation award, the taxpayer, in addition to a monetary award, was permitted to remove the residence from the condemned property and move it to a lot purchased by the taxpayer following the condemnation. The taxpayer also purchased a second residential property with the proceeds of the condemnation. The cost of the two new properties plus the cost of moving the house from the condemned property to the new property were in excess of the monetary condemnation award received by the taxpayer. Rev. Rul. 58-396 holds that the costs incurred in purchasing the new properties and in moving the old house to one of the new properties constitute a replacement, within the meaning of § 1033, of the property involuntarily converted. Thus, because the cost of the replacement property, including the cost of moving the old residence to the new property, was in excess of the condemnation award, the gain on the condemned property did not have to be recognized.

In *Graphic Press, Inc. v. Commissioner*, 523 F.2d 585 (9th Cir. 1975), the Ninth Circuit held that a condemnation award that included the cost of moving heavy equipment qualified for deferral under § 1033. As part of its rationale for the decision, the Court stated as follows:

> Section 1033 is a relief provision. Its purpose is "to aid the taxpayer where he in good faith quickly transforms everything he received into property 'similar or related in . . . use.'" *Commissioner v. Babcock,* 259 F.2d 689, 692 (9th Cir. 1958) (interpreting predecessor to § 1033). *See also, Winter Realty & Construction Co. v. Commissioner*, 149 F.2d 567, 569-70 (2d Cir.), *Cert. denied* 326 U.S. 754(1945). It is a legislative recognition that condemnation is not an appropriate time for recognition of gain if there has been no substantial change in form and productive use of an investment and appreciation has not resulted in liquid assets available to pay taxes. Accordingly, unless reimbursement is being made for lost profits, the cases have not scrutinized the source of condemnation proceeds as closely as the taxpayer's reinvestment.

> We believe compensation in excess of land and building payments in this case qualifies for § 1033 treatment. From the taxpayer's viewpoint, he is being compensated for a loss due to the condemnation of his property. Whatever payment the taxpayer receives is attributable to the involuntary

> conversion. Where, as here, a payment is made for relocation costs in addition to land costs, as long as Taxpayer reinvests the total award into other property similar or related in service or use within the statutory period, both the language and spirit of the statute are met.

*Graphic Press, 5*23 F.2d at 589.

As in *Graphic Press*, the present case involves a conversion that includes an award (or multiple awards) for moving costs, in addition to awards for land and rights-of-way taken by condemnation, or the threat or imminence thereof. Taxpayer will use the proceeds from the conversion to achieve the same economic position it enjoyed before with respect to the affected property.[1] In the present case, the language and spirit of the statute are met because the form, nature or use of Taxpayer's business property resulting from the conversion and reinvestment will remain substantially the same.

RULING:

Taxpayer may elect to defer gain under § 1033 on the relocation payments it receives provided the amounts are reinvested in other property similar or related in service or use to the property converted and for relocation of affected property or equipment within the period specified in § 1033(a)(2)(B).

DISCLAIMER(S):

The above ruling is conditioned on Taxpayer neither deducting nor capitalizing the relocation costs incurred by Taxpayer to the extent such costs are attributable to award amounts received from LP or from Agency. *Glendinning, McLeish & Co. v. Commissioner*, 61 F.2d 950, (2d Cir. 1932); *Patchen v. Commissioner*, 27 T.C. 592 (1956); *Flowers v. Commissioner*, 61 T.C. 140, 152 (1973); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977). Except as specifically provided above, no opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Code or regulations or under other principles of federal income taxation.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code

[1] The court in *Graphic Press* cited, as one of the justifications for deferral of gain from an involuntary conversion, the fact that the taxpayer who fully invests the proceeds in similar property would not have liquid assets available for payment of taxes on the gain realized. This would also be true of Taxpayer in the present case. Of course, any amount received by Taxpayer and not reinvested in similar property or for "relocation payments" as described in the facts of this case is subject to gain recognition, and not eligible for deferral under § 1033.

provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under § 6110. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel

(Income Tax & Accounting)

Enclosures

cc: