Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Keith M. Jones
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(Large & Mid-Size Business)

from: William D. Alexander
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subject: Allocation under Sections 338 and 1060 to Assets in a Non-Qualified Nuclear Decommissioning Fund Purchased along with a Nuclear Power Plant

This memorandum responds to your request for legal advice. Several taxpayers have engaged in transactions substantially the same as that described in this memorandum.

ISSUE

Can a taxpayer that, prior to September 15, 2004, purchased a nuclear power plant and an associated non-qualified decommissioning fund obtain the allocation result provided for in § 1.338-6T(c)(5) of the Income Tax Regulations?

CONCLUSION

The taxpayer cannot obtain the allocation result provided for in § 1.338-6T(c)(5).

GENERIC FACTS

Prior to September 15, 2004, the taxpayer acquired a nuclear power plant, nuclear fuel, and the non-qualified decommissioning fund ("the fund") associated with the power plant, all for $1000 cash. The transaction constituted an applicable asset acquisition within the meaning of Section 1060. The fair market value of the plant and fuel was $1000, the value of the assets in the fund was $500, and the present value of the decommissioning obligation associated with the plant (in excess of any amounts

covered by qualified funds described in § 468A) was $500. The power plant and fuel were assets described in § 1.338-6(b)(2)(v) ("Class V assets"). The assets in the fund consisted of securities described in § 1.338-6(b)(2)(ii) ("Class II assets").

LAW AND ANALYSIS

Congress mandated creation of an allocation system to operate under Sections 338 and 1060, and gave the Service regulatory authority to design it. Section 1.338-6 is the heart of that allocation system. Section 1.338-6 also applies under section 1060, pursuant to §§ 1.1060-1(a)(1) and -1(c)(2). Since the time the Service created the allocation system two decades ago, it has amended the regulations establishing this residual method allocation system several times, but at all points in time (i) a full set of rules has been in place and (ii) it has been clear to taxpayers what set of rules applied.

Section 1.338-6, in determining the fair market value of a particular asset for purposes of allocation, does not offset the gross value of the asset by the amount of a liability associated with such asset. This clear rule is set forth in § 1.338-6(a)(2): "Generally, the fair market value of an asset is its gross fair market value (i.e., fair market value determined without regard to mortgages, liens, pledges, or other liabilities). However, for purposes of determining the amount of old target's deemed sale tax consequences, the fair market value of any property subject to a nonrecourse indebtedness will be treated as not being less than the amount of such indebtedness."

To illustrate the basic rule, it is clear that if a $100 building that is the subject of a sale under § 1060 is encumbered by a $50 liability, that building in the purchaser's hands draws an allocation not of $50 but of the full, unreduced $100. In other words, the building draws an allocation equal not to the building's value net of debt but instead equal to the building's gross value.

Similarly, where, on the facts described in this memorandum, the taxpayer prior to September 15, 2004, acquired the nuclear plant and fuel, together worth $1000, and the fund, the assets of which have a gross value of $500 but are subject to a $500 decommissioning obligation, with the taxpayer paying $1000 cash out of pocket in the transaction, the allocation is as follows. The consideration equals the $1000 cash. Allocation of the consideration is made first to the assets in the fund, because they are Class II assets. Those assets, with their $500 gross value, draw a $500 allocation. The plant and fuel, which are Class V assets, are then allocated the remaining $500 of the consideration. In other words, the allocation to the securities in the decommissioning fund equals their $500 gross value, not their zero net value.

After the date of the taxpayer's purchase, § 1.338-6T(c)(5) was added to § 1.338-6, effective for acquisitions of nuclear plants and associated non-qualified decommissioning funds occurring on or after September 15, 2004. Section 1.1060-1T(e)(1)(ii)(C) imports the same election, with the same effective date, into section 1060. The effect of an election under § 1.338-6T(c)(5) is to let a taxpayer purchasing

both a nuclear plant and a non-qualified decommissioning fund determine the fair market value of the assets in the fund net of the associated decommissioning obligation. The result is often that the assets in the fund draw little or no allocation, causing most or all of the allocation to go to the Class V assets, in other words, the nuclear plant and fuel.

Under the facts described in this memorandum, the taxpayer's purchase occurred before September 15, 2004. Section 1.338-6T(c)(5) is thus not available to the taxpayer.

The allocation rules applicable at the time of the taxpayer's transaction were comprehensive, there having been no gap in their provisions. The manner in which they operated was well known to participants in the nuclear power industry, which asked for different rules and ultimately obtained them on a prospective basis. We note that § 1.338-6T(c)(5) was proposed with a prospective effective date; while the members of the nuclear industry urged that § 1.338-6T(c)(5) be made available retroactively, the Service declined to do so. This choice is reasonable because transactions prior to September 15, 2004, would have been negotiated based on the rules of § 1.338-6.

In conclusion, as noted above, in the taxpayer's case $500 of the consideration is allocated to the assets in the fund and the remaining $500 of the consideration is allocated to the nuclear plant and fuel.

Please call Richard Starke at (202) 622-7790 if you have any further questions.

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