

Office of Chief Counsel
Internal Revenue Service

Memorandum

Number: **20044102F**
Release Date: 10/08/04
CC:LM:CTM:SEA:POSTF-133935-04
UIL: 1033.00-00

date: August 27, 2004

to: LMSB Manager

from: LMSB Counsel, Seattle

subject: **Section 1033 Replacement Property ()**

Sub =
Date M =
Location X =
Year 1 =
Date N =
Date P =
Act =
\$A =
\$B =
Year 2 =
\$C =
\$D =
Year 3 =
Year 4 =
\$E =
contract # XX =

This responds to your request for advice on issues relating to § 1033 of the Internal Revenue Code. More specific comments relating to the draft Form 886-A will be set forth in a separate correspondence.

Issue

Has the taxpayer engaged in a valid purchase of replacement property, as described in § 1033(a)(2)(A), for an involuntarily converted timber cutting contract with the U.S. Forest Service.

Conclusion

Timber cutting contracts acquired by the taxpayer within the applicable replacement period will constitute § 1033 replacement property within the meaning of § 1033(a)(2)(A). However, amounts expended as advance royalties, for example, which are normally payable to a lessor as timber is cut, are not expenditures for replacement property. Further, any purchase after the close of the applicable replacement period cannot be taken into account in determining the amount of gain deferred under § 1033(a)(2)(A).

Factual Summary

A timber cutting contract between Sub, a wholly-owned subsidiary of the taxpayer, and the U.S. Forest Service was entered into on Date M. The timber was located in Location X.

In Year 1, the Forest Service unilaterally changed certain pricing and volume provisions of the contract pursuant to the Act. The changes were effective on Date N. The taxpayer sued and ultimately recovered, through a settlement with the U.S. government on Date P, compensation of \$A. In PLR 199911048, issued to the taxpayer, the IRS concluded that enactment and implementation of the Act resulted in the involuntary conversion of the contract.

The taxpayer originally reported \$B as eligible for deferral on its Year 2 federal income tax return. The taxpayer has agreed, however, that of this \$B amount, \$C is no longer eligible for deferral. Thus, the amount currently eligible for deferral is \$D.

In Year 4, the taxpayer acquired 72 timber cutting contracts which it contends qualify as replacement property under § 1033.¹ The taxpayer estimates that it will owe an additional amount of \$E as timber is cut over the lives of the contracts. Accordingly, the taxpayer argues that the \$D received by the taxpayer due to the involuntary conversion has been, or will be used to purchase other property similar or related in service or use to the converted property.

Discussion

Section 1033(a)(2)(A) provides, in part, that if a taxpayer, during the period specified for replacing the involuntary converted property, "purchases other property similar or

¹ Section 1033(a)(2)(B)(titled "Period Within Which Property Must be Replaced") generally provides a 2-year replacement period. In this case, the 2-year period expired at the end of Year 3. The applicable 2-year replacement period may be extended if special permission is obtained from the IRS. See §1033(a)(2)(B). We understand an extension was secured in this case allowing for purchase of the replacement property in Year 4.

related in service or use to the property so converted ... at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion ... exceeds the cost of such other property....” [Emphasis added.]

Section 1033(a)(2)(A)(ii) provides, in part, that a taxpayer is considered to have purchased property only if the unadjusted basis of such property would be its cost within the meaning of § 1012.

For property to be valid replacement property under § 1033(a)(2)(A), the property acquired must have a close functional similarity to the property converted. See Rev. Rul. 64-237, 1964-2 C.B. 319. Under this “functional use” test, properties are considered similar or related in service or use if the physical characteristics and end uses of the converted and replacement properties are closely similar.

Contract rights have been held to constitute “property.” See *Schneider v. Commissioner*, 65 T.C. 18 (1975); *Mitchcom v. United States*, 573 F.2d 58 (Ct. Cl. 1978). Thus, in the present case, the timber cutting contract pertaining to Location X is the converted property for purposes of § 1033. Only other timber cutting contracts constitute qualifying replacement property under these facts.² Thus, only those costs incurred to acquire such contracts should be taken into account in determining whether an eligible purchase or replacement property has occurred. In addition, costs incurred to acquire such contracts as replacement property may also include any premium paid to secure a contract with favorable terms. For example, section 8.1 of the sample contract you provided (contract #XX) allows for the sale of the contract rights by the taxpayer, subject to the owner’s approval. A premium paid for the inclusion of such provision would be taken into account in determining the cost of replacement property. However, an incurred cost does not qualify to the extent it constitutes an advance payment of a royalty for timber to be later harvested.

In addition, even if the cost of the timber and costs associated with cutting the timber could qualify as expenditures for property similar or related in service or use, some of these expenditures will be incurred after the close of the applicable replacement period. Section 1033 requires that replacement property be “purchased” within the applicable replacement period. See Rev. Rul. 55-517, 1955-2 C.B. 297; see also *Dettmers v. Commissioner*, 430 F.2d 1019, 1023 (6th Cir. 1970), *aff’g*, *Estate of Johnston v. Commissioner*, 51 T.C. 290 (1968). In general, a sale/purchase of property occurs for federal income tax purposes when the benefits and burdens of owning the property shift

² Regarding potential replacement property, PLR 199911048 issued to the taxpayer provides as follows:

[T]he timber cutting contracts to be acquired [by Taxpayer from Parent and/or third parties] will constitute eligible replacement property under § 1033(a)(2)(A) provided such contracts are similar or related in use or service to the converted contract....

[T]he replacement property [will consist] of the replacement contract(s) and not the timber which the replacement contracts entitle Taxpayer to cut. Acquisition by Taxpayer of timber or real estate containing timber would not satisfy the functional use test of § 1033.

[Emphasis added.]

from the seller to the buyer. See *Merrill v. Commissioner*, 40 T.C. 66 (1963), *aff'd*, 336 F.2d 771 (9th Cir. 1964). Consequently, a “purchase” under § 1033 contemplates, at a minimum, transfer of ownership of the pertinent property.

The contract you provided, #XX, generally obligates the taxpayer to cut and pay for a specified quantity of timber over a 10-year period. An “Advance Deposit” is required at the outset of each year to cover the price of a “Base Volume” to be harvested each year. Section 2.7 provides that “Owner shall retain ownership of the Timber until such time as Purchaser harvests the Timber pursuant to the Annual Harvest Plan.” Further, section 2.3 provides that “Owner will bear the risk of loss regarding the Timber until such time as the Timber is harvested.” Section 2.4 provides that “Owner will retain possession and control of the Timber” until harvested by the taxpayer. Thus, even if payments under the contracts for timber could qualify as eligible replacement “costs,” the replacement property (timber) is not “purchased” as contemplated by § 1033 until the timber is harvested. In this regard, we assume that all of the contracts are pay-as-cut contracts and that the bulk of the \$E in anticipated cutting costs relative to the 72 contracts will be made after the close of Year 4, which is after the applicable replacement period.

Litigation Hazards

Please do not hesitate to call if you have any questions regarding the foregoing comments and recommendations.

Sincerely,

William A. McCarthy
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