

Internal Revenue Service

Number: **200714002**

Release Date: 4/6/2007

Index Number: 1033.00-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

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PLR-112758-06

Date:

December 22, 2006

TY:

State A =

Corporation 1 =

Corporation 2 =

X# =

Y# =

Date 0 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

A# =

A time =

B time =

Stock Market =

Fund =

Account =

\$A =

\$B =

\$C =

Dear

This letter responds to your ruling request regarding certain of your common stock taken and sold by State A pursuant to State A unclaimed property law. Specifically, you request a ruling that any gain attributable to State A's sale of your common stock in either Corporation 1 or Corporation 2 pursuant to State A unclaimed property law is eligible for nonrecognition of gain under IRC section 1033(a). You request a ruling that the nonrecognition provisions of section 1033(a) will apply provided that you timely reinvest the proceeds from State A's sale of your stock in (1) shares of publicly traded common stock of United States companies, (2) shares of publicly traded preferred stock of United States companies, (3) shares of publicly traded preferred stock of United States companies convertible into shares of common stock, (4) shares of publicly traded common stock of non-United States companies, and/or (5) shares of publicly traded United States mutual funds.

FACTS

You were born on Date 0 which means that you were 90 years old or older during the events discussed in this ruling. Prior to Date 1, you held in certificate form X# shares of Corporation 1. On or about Date 1, State A took control of your Corporation 1 stock pursuant to State A unclaimed property law. On Date 2, State A sold the Corporation 1 stock for \$A. State A took control of the proceeds of such sale. Prior to Date 3, you held Y# shares of Corporation 2, stock that had been spun off from Corporation 1. On or about Date 3, State A took control of your Corporation 2 stock pursuant to State A unclaimed property law. On Date 4, State A sold the Corporation 2 stock for \$B. State A took control of the proceeds of such sale. At all relevant times the stock of both Corporation 1 and Corporation 2 could be bought and sold on Stock Market.

With the aid of your daughter, on or about Date 5 you filed a claim with State A seeking the return of your Corporation 1 and Corporation 2 stock or the proceeds from the sale of such stock. On or about Date 6, State A paid you the proceeds from the sale of your Corporation 1 stock. On or about Date 7, State A paid you the proceeds from the sale of your Corporation 2 stock.

LAW AND ANALYSIS

Overview

Section 61(a) indicates that, except as otherwise provided in the income tax provisions of the Code¹, gross income means all income from whatever source derived. Gains from dealings in property are included among the specifically listed items included in gross income. Section 61(a)(3).

Section 1033(a)(2)(A) allows a taxpayer to make an election to limit current recognition of gain with respect to property that (as a result of destruction, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money. The recognized gain is limited to the excess of the amount realized upon such conversion over the cost of other property (hereinafter referred to as qualified replacement property) similar or related in service or use to the converted property (or the cost of purchasing stock in the acquisition of control of a corporation owning such other property), purchased by the taxpayer within a specified period. Section 1033(a)(2)(B) generally requires the replacement property to be purchased during 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, whichever is the earlier, and ending 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized.

State A Escheat Scheme

Pursuant to State A law, if certain jurisdictional requirements are satisfied corporate common stock escheats to State A if the apparent owner of the stock, as determined from the corporate records, for more than A# years neither claims a dividend on the stock nor corresponds with the corporation or otherwise indicates an interest in the corporation as evidenced by a corporate record. In addition, for escheat to be required the corporation must not know the location of the owner at the end of the A# year period referred to in the preceding sentence.

¹ Unless specifically provided otherwise, references to the Code refer to the Internal Revenue Code of 1986 and references to sections refer to sections of the Internal Revenue Code of 1986.

The corporate issuer of the stock to be escheated (the issuer) must file a report with the State A controller (the controller) that identifies the stock to be escheated. If known to the issuer, the report must also contain the name and the last known address, if there is one, of the person or persons that appear from the corporate records to be the owners of the stock. State A law requires the issuer to transfer the escheated stock to the controller when the report is filed.

Prior to transferring the escheated stock to the controller, the issuer must make reasonable efforts to notify the apparent owner by mail of the impending escheat. State A law generally requires the issuer to transfer the stock to the controller by issuing a duplicate certificate (in the name of the controller if possible) to the controller. The duplicate certificate replaces the certificate issued to the apparent owner. Under certain circumstances, the stock transfer may be accomplished by registering the stock in the name of the controller rather than through the issuance of a duplicate stock certificate.

Within A time of receiving the escheated stock, State A law requires the controller to publish notice in a newspaper of general circulation determined by the controller to be most likely to give notice to the apparent owner of the escheated stock. However, the required notice is simply a general notice to all potential owners of unclaimed property. The notice does not have to identify the escheated property nor the apparent owner of the property. The notice is only required to contain a statement that information concerning the description or amount of escheated property held by the controller may be obtained by persons possessing an interest in such property by contacting the controller. Only if certain conditions are satisfied does State A law require the controller to attempt to mail a notice to the apparent owner of particular property escheated. But State A law does not specify what the mailed notice must contain.

Upon delivery to the controller, State A takes custody of the escheated stock and becomes responsible for its safekeeping. Dividends received by the controller or accrued on the escheated stock from the time of its receipt by the controller until the controller sells the escheated stock are credited, upon receipt by the controller, to the apparent owner's account. If the escheated stock is traded on an established stock exchange, State A law requires the controller to sell the escheated stock at the exchange price.

State A law requires the controller to deposit dividends on the escheated stock, as well as the net proceeds from the sale of such stock into Fund to the credit of Account. However, earnings on the deposited amounts do not accrue to the credit of the apparent owners of the escheated property. State A law also requires the controller to transfer Account funds in excess of \$C to the State A general fund. Consequently, State A uses the vast bulk of funds derived from the sale of escheated stock for State A expenditures.

State A provides for a system of escheat and permanent escheat². “Escheat” within the meaning of the State A statutes consists of a custodial taking of property rather than the transfer of all ownership rights to the state. The owner of property escheated to State A may file a claim for such property, or the net proceeds from the sale of such property, at any time. The controller is required to consider the claim within B time after it is filed. In doing this the controller may hold a hearing and receive evidence regarding the claim. If the controller denies a claim in whole or in part, or fails to make a decision on such claim within B time, the claimant may assert the claim in a State A court.

State A is not required to pay any interest on claims pertaining to escheated property. Consequently, State A obtains the use of funds derived from escheated property without any obligation to compensate the apparent owners of the escheated property for that use.

Seizure

Whether the taking of stock by State A pursuant to State A unclaimed property law falls within one of the specified actions within section 1033(a), namely, destruction, theft, seizure, requisition or condemnation or threat or imminence thereof, constitutes the first issue to be resolved. Seizure constitutes the only option that might apply to the facts of this case.

Section 1033 provides no definition of the term “seizure”. Section 1033’s roots extend back to the Revenue Act of 1921. Neither the legislative history to that act or to subsequent acts amending section 1033 or its predecessors provide any guidance regarding the meaning of the term “seizure”.

Black’s Law Dictionary 8th Ed. (2004) defines “seizure” in part as “[t]he act or an instance of taking possession of a person or property by legal right or process.” In *Anderson National Bank v. Lueckett*, 321 U.S. 233 (1931), a national bank challenged the constitutionality of a Kentucky statute requiring it to pay to the state of Kentucky, prior to any judicial determination of abandonment, the amount in certain inactive bank accounts that had been unclaimed for specified periods. Kentucky law required the bank to file a report with the state listing bank deposits presumed to be abandoned as of an earlier date. The state sent a copy of the list to the sheriff of the county of the deposit account holder. Kentucky law required the sheriff to post a copy of the list of presumptively abandoned accounts at the local courthouse or on a local bulletin board.

Kentucky law authorized the Kentucky state commissioner of revenue to bring a judicial proceeding to establish actual abandonment of funds in state custody attributable to presumptively abandoned bank accounts. A claim to property surrendered to the state

² Where the procedures to permanently escheat property have occurred, the owner of the property only has a limited time to file a claim for the property or the proceeds from its sale. Failure to file a timely claim vests all ownership rights to the property in State A.

could be brought at any time unless there had been a judicial determination of actual abandonment. Even in that case, a person not actually served with notice of the judicial abandonment proceeding and who did not appear and whose claim to the property was not considered during the proceeding could assert a claim to the property during the five year period following the proceeding. Thus, as in the instant case, transfer of the property to the state did not extinguish the owner's rights to the transferred property.

The bank contended that payment of the deposits to the state of Kentucky on the prescribed notice without a prior judicial proceeding deprived the bank and the depositors of property without due process of law. The bank was allowed to raise the due process rights of the depositors because in the absence of such process the bank's turn over of funds to the state would not extinguish the bank's obligations to its depositors.

In response to the bank's contention, the Court noted that the Kentucky statutes themselves, of which the depositors were required to take note, provided notice to all depositors of banks within the state of the conditions under which the balances of inactive accounts would be deemed to be abandoned and paid over to the state. Second, the Court concluded that posting notice on the court house door, an ancient and time honored tradition in Kentucky, regarding the pending transfer of depositors' funds to the state, provided constitutionally adequate notice to the depositors. The Court stated:

We cannot say that the positing of a notice on the door of the court house ... in the circumstances of this case ... is an inadequate means of giving notice of the summary taking into custody of the designated bank accounts by the state. This is the more so because in this case the notice is the immediate prelude to and accompanies the compulsory surrender of the bank balances to the state, unless the depositors in the meantime intervene as claimants. The statutory procedure, so far as it affects depositors, is in the nature of a proceeding in rem, in the course of which property, against which a claim is asserted, is **seized** [emphasis supplied] or sequestered, and held subject to the appearance and presentation of claims by all those who assert an adverse interest in it. In all such proceedings the **seizure** [emphasis supplied] of the property is in itself a form of notice of the claim asserted, to those who may claim an interest in the property.

Id. at 244-45. Thus, in a fact pattern very similar to the instance case, the Supreme Court viewed the custodial taking of property by a state for potential permanent escheat as constituting a seizure of the property.

Rev. Rul. 79-269, 1979-2 C.B. 297 further refines the meaning of the term "seizure" for section 1033 purposes. That ruling distinguishes the seizure of property from its requisition or condemnation as follows:

The courts have interpreted the term requisition or condemnation to mean the taking of property by a government authority that has the power to do so against the will of the owner and for the use of the taker. (citations omitted) This interpretation limits the definition of the term to the taking of property for public use.

A seizure occurs when a government authority enters into physical possession of property without authority of a court order with compensation to be determined later. This is different from a requisition or condemnation under which the government pays judicially determined compensation before it takes property, or it takes property under court order before the amount of compensation has been determined. See *United States v. Dow*, 357 U.S. 17 (1958). But a seizure is like a requisition or condemnation in that it is limited to the taking of property for public use.

Upon receipt of your corporate stock, State A was required to hold the stock and collect any dividends paid on the stock and credit such dividends to you. State A was not required to give you credit for any earnings on the dividends and if certain conditions were met State A could expend the dividends for State A purposes. It is not necessary for us to determine whether State A's ability to derive benefits from the dividends paid on your stock prior to its sale caused the stock to be held for public use. It is only necessary for us to determine whether the public use requirement was satisfied after State A sold your stock.

Upon the sale of your stock, State A law required the controller to deposit the proceeds into Fund. However, State A law also requires the controller to transfer Account funds in excess of \$C to the State A general fund. It is not possible to determine with certainty whether the funds from the sale of your stock were transferred from Fund to the State A general fund and expended for State A purposes. However, the total amount of presumed abandoned property that has come under the control of State A and the relatively small amount of such property that the controller is required to maintain in Fund makes it so likely that the funds from the sale of your stock were expended for State A purposes that we find it acceptable to treat the funds as so expended for purposes of this letter ruling. Moreover, State A was not required to pay you interest on the proceeds from the sale of your stock nor were you entitled to any earnings State A derived from such proceeds. We conclude that once State A converted your stock to cash and expended it for State A purposes, there was a seizure of your property within the meaning of section 1033(a).

Involuntary

Section 1033 only defers gains resulting from *compulsory or involuntary* conversions. The conversion into money or other property must occur from circumstances beyond the taxpayer's control. *C. G. Willis, Inc. v. Commissioner*, 41 T.C. 468, 474, (1964),

aff'd per curiam, 342 F.2d 996 (3d Cir. 1965). Thus, a taxpayer who, in an attempt to obtain insurance proceeds, commits arson by voluntarily paying a third party to burn down the taxpayer's building is not entitled to the benefits of section 1033. Rev. Rul. 82-74, 1982-1 C.B. 110. Likewise, in Rev. Rul. 69-654, 1969-2 C.B. 162, the Service concluded that a property owner who voluntarily consented to the subsequent conversion of part of his property for the purpose of constructing a school as a condition to receiving approval for the development of his remaining property was not entitled to the tax benefits of section 1033 with regard to the sale of the land on which the school would be constructed. Therefore, if a taxpayer takes voluntary action to cause the conversion of the taxpayer's property into other property or money, such a conversion does not constitute an involuntary conversion within the meaning of section 1033. You have represented that you did not intentionally fail to exercise ownership rights with regard to your stock for the purpose of having such stock transferred to and sold by the controller pursuant to State A unclaimed property law. Assuming that this representation is true, you would not be precluded from the tax benefits of section 1033 because you took voluntary action to have your stock taken and sold by State A.

The next question to be resolved is whether something less than voluntary action on your part could result in a failure of section 1033's involuntariness requirement. Specifically, the issue to be addressed is whether reckless, grossly negligent, or merely negligent, behavior on your part contributing to the transfer of your stock to State A and its subsequent sale would preclude the application of section 1033 to the sale. We have not found any authority that addresses this question in the context of seizures. However, the issue has been addressed regarding the destruction of property, another type of involuntary conversion covered by section 1033.

"Destruction" in the sense of section 1033 is similar in meaning to the term "casualty" as used within section 165(c)(3). See Rev. Rul. 54-395, 1954-2 C.B. 143, 144, *as modified by*, Rev. Rul. 59-102, 1959-1 C.B. 200. That a taxpayer's own negligence contributed to a loss incurred by the taxpayer does not prevent the loss from being classified as a casualty loss for section 165 purposes. *Heyn v. Commissioner*, 46 T.C. 302, 308 (1966), *acq.*, 1967-2 C.B. 2. Treas. Reg. § 1.165-7(a)(3)(i) provides that an automobile may be the subject of a casualty loss when "[t]he damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the *willful act* [emphasis supplied] or *willful negligence* [emphasis supplied] of the taxpayer or of one acting in his behalf." See also Rev. Rul. 54-395 (discussing the possible impact of gross negligence on the characterization of a loss).

You have represented that to the best of your knowledge you did not receive a letter or other notification from either Corporation 1 or Corporation 2 informing you of the pending transfer of your stock prior to those corporations transferring your stock to State A. You have also represented that you did not receive any notice from State A that it had taken custody of your Corporation 1 and Corporation 2 stock prior to its sale, nor did State A notify you that it was going to sell such stock prior to its sale. Under these

circumstances an argument still might be made that you were negligent in not taking notice of the State A escheat provisions and in failing to take action to prevent the escheat of your stock. However, as in the case of destruction of property, negligence on your part, even if it existed, would not preclude the application of section 1033 to any gain from the sale of your stock by State A.

Replacement Period

Section 1033(a)(2)(B)(i) generally requires a taxpayer to purchase qualifying replacement property by the close of the period ending 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized. We believe the earliest possible time at which you might be required to realize gain would be upon State A's sale of your stock. Consequently, you will satisfy section 1033's timely replacement requirements provided you invest the proceeds from such sales in qualified replacement property within the period ending 2 years after the close of the taxable year in which State A sold your stock.

Qualified Replacement Property

Generally, replacement property does not qualify as "similar or related in service or use" unless its physical characteristics and end uses are similar to those of the converted property. When an investor owns property that is involuntarily converted, however, the inquiry shifts primarily to the similarity in the relationship of the services or uses which the converted and replacement properties have to the owner-investor. See Rev. Rul. 64-237, 1964-2 C.B. 319. Rev. Rul. 64-237 discusses several factors to consider in determining whether the replacement property is similar to the converted property of the owner-investor, including the nature of the business risks connected with the properties, and the extent and type of management activities the property requires of the owner. Thus, when an investor's property is involuntarily converted, the investor is entitled to consider the manner in which the converted property was held in determining whether the proposed replacement property will be similar or related in service or use.

The Service generally does not distinguish among various types of equity securities for purposes of section 1033. Rev. Rul. 66-355, 1966-2 C.B. 302, holds that a taxpayer can replace common stock that was involuntarily converted with common stock, preferred stock, or mutual fund shares and treat the replacement property as similar or related in service or use within the meaning of section 1033. Nor is foreign property outside the scope of the nonrecognition sections of the Code. Assuming that replacement property is otherwise of the same nature and character of the involuntarily converted property, the fact that it is not in the United States is not determinative. See Rev. Rul. 68-363, 1968-2 C.B. 336 (section 1031 of the Code imposes no qualification as to the place where either the property transferred or the property received is located, and no such qualification can be inferred).

You owned stock in Corporation 1 and Corporation 2 for investment purposes. The risks to and activities required of you with respect to stock in Corporation 1 and stock in Corporation 2 are comparable to the risks of investing in other publicly traded common and preferred stock and stock in publicly traded mutual funds. An investment in debt instruments, however, would not be similar or related in service or use to converted capital stock for purposes of section 1033.

Accordingly we rule as follows:

- (1) Pursuant to section 1033(a), you will not be required to recognize gain from State A's sale of your Corporation 1 stock provided you reinvest the proceeds from the sale of such stock in qualifying replacement property by the close of Date 8.
- (2) Pursuant to section 1033(a), you will not be required to recognize gain from State A's sale of your Corporation 2 stock provided you reinvest the proceeds from the sale of such stock in qualifying replacement property by the close of Date 9.
- (3) For purposes of rulings (1) and (2) the following types of property qualify as qualified replacement property:
 - (A) shares of publicly traded common stock of United States companies;
 - (B) shares of publicly traded preferred stock of United States companies;
 - (C) shares of publicly traded preferred stock of United States companies convertible into shares of common stock;
 - (D) shares of publicly traded common stock of non-United States companies; and/or
 - (E) shares of publicly traded United States mutual funds.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to you. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by the adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 11.04 of Rev. Proc. 2006-1, 2006-1 I.R.B. 1, 49. However, when the criteria in section 11.06 of Rev. Proc.

2006-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it may be relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by you and accompanied by a penalty of perjury statement. 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.

Sincerely,

William A. Jackson
Chief, Branch 05
(Income Tax & Accounting)