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Sovereign Seizures

By Christopher A. Karachale • Wood & Porter • San Francisco

A recent chief counsel advice got us here at the M&A TAX REPORT thinking about transnational mergers and acquisitions. It also reminded us of the hot new player in the international finance world: the sovereign wealth fund (SWF).

SWF?

No, SWF does not stand for "single white female," and this is not a personal ad. An SWF is a broad investment vehicle established and controlled by a sovereign state. Such funds invest in a wide variety of equity and debt arrangements, including acquisitions in U.S.-based firms. Typically, these SWFs are funded with commodity export receipts, most often oil. Although SWFs have been around for a while, they have played an increasingly important role in international finance during the last 10 years.

And they are big, *really* big. The China Investment Corporation has assets of nearly $300 billion. The largest SWF, the Abu Dhabi Investment Authority, reputedly has between $500 billion and $850 billion in assets. The largest SWFs (with the exception of Norway's SWF) typically disclose few details of their U.S. equity holdings.

Furthermore, it is not clear that economic (rather than political) decisions dictate the investment strategies of these entities. For example, while he was SEC Chairman, Christopher Cox warned that both investors and regulators must ask themselves whether SWFs will always direct their affairs in furtherance of investment returns, or rather will use business resources in the pursuit of other government interests. [*See The Role of Government in the Markets,* speech at the John F. Kennedy School of Government, Harvard University, Oct. 24, 2007.]

But transparency and investment strategies of these SWFs may be changing. For example, the China Investment Corporation filed detailed disclosure of its U.S. holdings with the SEC in 2009,

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showing that it owns stock in a variety of domestic companies, including Apple, Coca-Cola, Johnson & Johnson, Motorola and Visa. Similarly, in March 20, 2008, the U.S. and the governments of Abu Dhabi and Singapore, as well as their respective SWFs, reached an agreement on principles for investment. [*See* U.S. Department of the Treasury, Press Release, March 30, 2008.]

The parties agreed that SWF investment decisions should be based solely on commercial grounds, rather than the advancement, directly or indirectly, of the geopolitical goals of the controlling government. In addition, they said, SWFs should make this statement formally as part of their basic investment management policies.

Transnational Takings

So what, you may be asking, do these SWFs have to do with the taxation of M&A transactions? The recently released CCA 201002035 (Sept. 25, 2009) is what. Although the machinations of the various parties are complicated, the issue in this chief counsel advice was whether the taxpayer, a U.S. power company, could deduct as an ordinary loss the conversion of its partnership interest in a foreign joint venture. The taxpayer entered into a Subchapter K partnership with a variety of investors, including a state-owned foreign company, to construct and operate a power plant in the foreign country.

After the market for power became less expensive, a state-owned commercial entity, which itself was in the business of supplying power to the region, refused to provide the necessary interconnection to the power grid for the new power plant. After a few years of negotiation, taxpayer's board declared its foreign power operations a discontinued business and taxpayer wrote off its investment in the joint venture. The taxpayer transferred its interest in the join venture to the state-owned foreign company as well as other new investors for certain consideration.

Seizing Power?

The taxpayer asserted that it was entitled to an ordinary loss deduction based on a compulsory or involuntary conversion under Code Sec. 1231. According to the taxpayer, the actions of the foreign governmental agents and instrumentalities deprived the taxpayer of its interest in the power plant. Thus, the taxpayer argued, the state-owned foreign company had effected a taking of its partnership interest. Furthermore, the taxpayer asserted that although it made a purported sale of its interest to the state-owned foreign company, this was just compensation for the involuntary conversion of the taxpayer's interest in the joint venture.

The IRS ruled that there was no seizure or involuntary conversion for federal tax purposes. Rather, the state-owned commercial entity was acting in its own economic interest as a commercial enterprise wishing to compete with the taxpayer's power plant. Interestingly, in discounting the taxpayer's respective arguments, the IRS offers a good blueprint of its legal analysis on questions of seizure or expropriation by a foreign government. Three of these bear mention.

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Extraterritorial Expropriation

First, the IRS describes the circumstances in which an instrumentality of a foreign country is capable of an act of seizure for purposes of Code Sec. 1231 (creating a loss under Code Sec. 165). According to the chief counsel advice, state ownership by itself does not convert all actions by a state-owned company into government action.

Where a state-owned entity (1) has autonomy over its own commercial operations; (2) is responsible for its own profits and losses; and (3) is subject to suit for its actions, its economic activity probably will not result in a seizure that could create an ordinary loss for the owner of the expropriated property. The key appears to be whether the state-owned entity is exercising regulatory or other governmental power or is otherwise acting on behalf of the foreign entity.

Physical vs. Nonphysical?

Second, the chief counsel advice points out that an involuntary conversion due to seizure does not necessarily involve the physical confiscation of a tangible asset. Rather, in appropriate circumstances, intangible assets such as corporate stock or a partnership interest may be appropriated by a foreign entity. [*Citing to* Rev. Rul. 71-1, 1971-1 CB 59.]

Finally, the IRS concedes there could be an indirect, *de facto*, seizure of property by a foreign government or one of its instrumentalities, even though title to the property is not formally transferred to the government, and the transaction involves an apparently voluntary sale. The IRS also acknowledges that such a seizure could be passive or covert, provided that it involved the action of a governmental body.

Involuntary Conversions in Action

This brings us back to the character and role of SWFs. Suppose you partnered with a SWF to construct a power plant in the foreign country that owns the SWF. The deal goes south because of the recalcitrance of the directors of the SWF. They refuse to provide funding for the power plant and, through strong-arm tactics, including influencing the local workers, force a stop to the construction of the power plant.

Would this constitute a seizure of your partnership interest for purposes of Code Sec. 1231, creating an ordinary loss? It would certainly seem so. Despite the fact the SWF purportedly acts in its own commercial interest (Treasury Department principles notwithstanding), the SWF certainly is an instrumentality of the foreign nation (if not a part of the foreign nation itself). Plus, the SWF may well be acting *not* for commercial interests, but in the name of geopolitical hegemony. The IRS, approached with such facts, would be hard-pressed not to find the situation distinguishable from CCA 201002035.

Now take the hypothetical to the next step—instead of a tangible asset such as a power plant, suppose you invest (along with an SWF) in the stock of a foreign bank in the SWF's country. Let's say the SWF is able to force the value of the stock down through its investment in other competing banks and proxy battles. In the end, you are forced to sell your stock in the foreign bank to the SWF at a huge loss.

Looks Like a Seizure?

Is this a *de facto* seizure, even though you have received consideration for your shares of the stock? Could you receive ordinary loss treatment for this loss from your stock? It appears not to be outside the realm of possibility. Maybe you could show that the SWF was acting in a political, rather than economic capacity. Call it covert nationalization of the foreign country's banks, and you may already be halfway there.

Let's take this example to its final logical step. Suppose you've partnered with the SWF to design and build computer chips in the U.S (leave aside regulatory concerns). You will supply your specialized computer chip knowledge. In turn, the SWF will supply the vast bulk of the funding.

Again, the SWF balks at providing additional funding that is required. With the loss of funding, the computer chip company fails. A whistleblower emerges who has information suggesting that because of the increase in computer chip costs, the SWF pulled its funds so that computer chips from its own country could have a better shot at the U.S. market.

Has there been a seizure? Perhaps it is tenuous, but it might be possible to argue that you are entitled to an ordinary loss with respect to a partnership interest because the SWF was not acting based solely on commercial grounds. It may have been indirectly advancing the geopolitical goals of its government.

Conclusion

SWFs are interesting and unusual hybrids, a kind of cross-species combo of investment vehicle and foreign power. The immense size and transnational reach of these entities means that more and more taxpayers may end up investing with SWFs. The U.S. tax ramifications of dealing with these SWFs are largely untested.

Still, taxpayers should bear in mind the seizure rules, even if it's not a pleasant topic No one wants a deal to go south. Yet if you do find yourself in one of these pickles, you may be able to console yourself with an ordinary loss rather than a Craigslist posting with lots of funny acronyms.