Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201002035**
Release Date: 1/15/2010

CC:ITA:B01:
POSTF-114404-09

UILC: 165.00-00, 741.00-00, 1231.00-00

date: September 25, 2009

to: Supervisory Internal Revenue Agent
Natural Resources & Construction
Large and Mid-Size Business Division

from: Chief, Branch 1
Associate Chief Counsel (Income Tax & Accounting)

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subject:

POSTF-114404-09

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=	
Subsidiary 1	=	
Subsidiary 2	=	
Years 1 - 11	=	
Country	=	
Region	=	
Region Bureau	=	
Region Power	=	
Region Commission	=	
Partnership	=	
State	=	
Foreign Region	=	
Company	=	
Product	=	
a%	=	
b%	=	

c%	=	
d%	=	
$M	=	

ISSUE

Whether the loss sustained with respect to taxpayer's partnership interest was a "seizure" by Region or Country, within the meaning of § 1231(a)(4), thus resulting in an involuntary conversion and an ordinary loss.[1]

CONCLUSION

Taxpayer's partnership interest was not seized by Region or Country within the meaning of § 1231.

FACTS

Taxpayer, through its related companies, supplies power to the State electric utility market. Prior to Year 1, facing a relatively slow economy, Taxpayer began looking for new growth avenues. As a result, Taxpayer formed Subsidiary 1, which was charged with expanding Taxpayer's power generation operations into the international market and the Foreign Region in particular.

Company is a state-owned producer of Product located in Region in Country. Company wanted to build a power plant to supply its energy needs. In Year 1, Company and a group of investors entered into a contract providing for formation of a joint venture company, Partnership, with the investor group owning *a%* and Company owning *b%*, to construct and operate a power plant (the Project) in Region. In Year 2, Taxpayer entered into a preliminary agreement to purchase a majority interest in the Project through Subsidiaries 1 and 2. By Year 3, Taxpayer effectively owned a *c%* interest in Partnership; an investor group owned *d%* and Company continued to own b%.

Under Country law, the joint venture was required to pass through an approval process involving both regional and national government authorities. Final approval was obtained in Year 2.

In Year 3 Partnership and Company also executed a power purchase contract (the PPC). This agreement obligated Company to purchase specified electric energy exclusively from the Partnership, at retail prices, and required that Company buy a

[1] The taxpayer argues, in the alternative, that it sustained an ordinary loss because either its partnership interest—or the partnership assets within the partnership—became worthless or were abandoned for salvage value. *See* Rev. Rul. 93-80, 1993-2 C.B. 239; *Equity Planning Corp. v. Commissioner*, T.C. Memo 1983-57. This memorandum addresses only the § 1231 issue; we express no opinion with respect to this alternative argument.

substantial minimum quantity from the Partnership each year, regardless of whether Company needed all of it. Under the PPC, Company was responsible for all interfaces with the Region power grid.

As a result of Taxpayer's involvement, it was necessary to seek reapproval of the joint venture, which was granted in Year 3.

In order for the Project to be operational, however, an interconnection agreement with the Region power grid was needed.

Shortly after Taxpayer invested in the Project in Year 3, there were significant organizational changes in the regulation and operation of Region's power grid. Prior to these changes, Region Bureau had been responsible for control and operation of the grid and, in addition, had had governmental regulatory authority over electric power in Region. As a result of a reorganization in Year 3, however: (i) Region Bureau's regulatory function was transferred to Region Commission; (ii) Region Bureau's responsibility for control and operation of the grid was transferred to a new entity named Region Power; and (iii) Region Bureau ceased to exist. Thus, Region Power emerged in Year 3 as a state-owned commercial entity which was without regulatory power but which had responsibility for electric power in Region from a commercial, business perspective.

When the Project was first conceived and for a number of years thereafter, Region experienced a shortage of reliable power. By Year 3, however, the market had shifted and Region faced excess power capacity. This left Region Power in a difficult position with regard to the Project since Region Power was responsible for the business aspects of Region power and since the oversupply of power meant that the Project would be supplying Company with power which Region Power would have liked to sell to Company. Region Power was soon expressing positions adverse to the Project.

In Year 4, Region Power formally announced its opposition to the Project and, most importantly, said it would not interconnect the Project to the grid on terms sought by Company. Both Company and Taxpayer wrote to the Region government stating that Region Power's position violated a prior commitment and asking the government to direct Region Power to enter into an interconnection agreement. Region and County government officials expressed their support of the Project.

In Year 4, Taxpayer bought out the investor group and increased its share in Partnership to *a*%.

Although Region Power initially seemed to retreat from its opposition, in Year 5 it issued a letter purporting to agree to interconnection, but with restrictions on pricing and Project operation hours. Company and Taxpayer again appealed to Region and Country officials.

Frustrated by Region Power's position, Taxpayer informed the Region government in Year 5 that it intended to withdraw from the Project. Taxpayer advised Company a few days later that it was withdrawing from the Project and that Company was in default under the PPC for failure to meet its obligation to secure interconnection.

Later in Year 5, at Taxpayer's suggestion, Company, the Partnership, and Region Power met several times to try to resolve the interconnection dispute, finally signing an agreement on principles, under which Region Power would serve some of Company's needs, while Partnership would serve new power load.

In a meeting in Year 6, however, Region Power asserted a definition of new power load that would have minimized the Project's participation. Later in Year 6, Company notified Taxpayer that since the new load issue had not been resolved it would buy power from Region Power. Taxpayer rejected this and reverted to the original PPC agreement, under which Company would buy exclusively from the Project. Region Power, in turn, reverted to its position that the Project could only sell to the grid, not to Company, at wholesale rates and in limited amounts. A planned meeting with Region government officials and the principals of Company, Region Power, and Taxpayer fell through.

After a few sporadic efforts to resuscitate the Project, in late Year 6 Taxpayer's board declared its foreign power operations a discontinued business. Taxpayer announced in a press release that it was exiting international business and wrote off its investment in Project on its financial statements.

In Year 3, Taxpayer had purchased political risk insurance for the Project. In Year 6, Taxpayer claimed reimbursement under the policy for the total loss of its investment in the Project. In Year 7, the insurance carrier denied Taxpayer's claim. In Year 8, Taxpayer sought arbitration.

In Year 9, Taxpayer transferred its interest in the Partnership to Company and a new foreign investor in exchange for $M. Taxpayer waived all claims against Company and the Region government.

Taxpayer's insurance claim was ultimately denied by the arbitration panel in Year 10. The panel ruled that while the lack of an interconnection agreement caused the end of the Project, there was no "expropriation" by a "host government" under the policy because Region Power acted as a commercial entity in control of the grid, not as a government entity with regulatory powers, and Region Commission's decision not to get directly involved in the controversy did not amount to a passive "expropriation" because, among other reasons, Region Commission was not legally obligated to intervene.

Taxpayer filed an amended return in Year 11 claiming an ordinary loss for tax Year 6.[2]

[2] Since in Year 6 Taxpayer was actively seeking recovery for its loss through insurance (and, by its own admission, considering possible legal action against Company and other parties), no loss deduction would be allowable under any theory in Year 6. *See* § 1.165-1(d)(2). In this memorandum, we assume

LAW AND ANALYSIS

Section 165(a) of the Internal Revenue Code provides that there is allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 1231(a)(1)(2) provides that if the section 1231 gains for a tax year exceed the section 1231 losses, those gains and losses are not treated as capital gains and losses. Under § 1231(a)(3), section 1231 losses include losses from the compulsory or involuntary conversion into other property or money (as a result of, among other events, seizure) of a capital asset that is held for more than one year in connection with a trade or business or a transaction entered into for profit. Section 1231(a)(4)(B) provides that an uncompensated loss on the seizure of a capital asset held for more than one year is treated as a loss from an involuntary conversion. *See also* § 1.1231-1(e)(1) of the Income Tax Regulations. A partnership interest in a going concern is a capital asset. *Commissioner v. Shapiro*, 125 F.2d 532 (6th Cir. 1942).

The sale of a partnership interest at a loss generally results in a capital loss. Section 741 provides that in the case of a sale or exchange of an interest in a partnership, the resulting gain or loss is considered as gain or loss from the sale or exchange of a capital asset, except as provided in § 751 (relating to unrealized receivables and inventory items).

However, Taxpayer argues that it is entitled to an ordinary loss deduction pursuant to § 1231 because the actions of the local foreign governmental agents and instrumentalities—in particular Region Power and Region Commission—effectively deprived Taxpayer of the economically beneficial or productive use of its property, to the benefit of Region and Country, and thus resulted in a taking by Country, not a sale. In Taxpayer's view, § 741 does not apply because the $M that it received in Year 9 was not, in substance, consideration for the sale of its partnership interest to Company; rather, the purported sale was a means whereby Region, or Country, indirectly compensated Taxpayer for the involuntary conversion of Taxpayer's investment in Partnership and the Project.

The field counters that no identifiable property was expropriated by Region or Country; that Region Power and Company were acting in their capacities as commercial entities, not as instrumentalities of Region or Country; and that Taxpayer has not established as a factual matter that the Year 9 sale transaction was a disguised payment of compensation by Region or Country.

We conclude that Taxpayer has not established that its loss was a loss from the seizure of its interest in Partnership, primarily because Taxpayer has not shown that Region

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that the correct year of deduction was Year 10, when Taxpayer's insurance arbitration concluded, and address solely the capital or ordinary character of that loss.

Power, whose actions in refusing to enter into an interconnection agreement on terms acceptable to Taxpayer were the primary cause of Taxpayer's withdrawal from the Project, was exercising governmental powers or otherwise acting on behalf of the government of Region or Country. Rather, the facts indicate that Region Power was acting in its own economic interest, in its capacity as a commercial enterprise, because it wished to sell power to Company.

Generally, a "seizure," for federal tax purposes, occurs when a governmental authority enters into physical possession of property without authority of a court order with compensation to be determined later and is limited to the taking of property for public use. Rev. Rul. 79-269, 1979-2 C.B. 297. An act of confiscation, whether by way of seizure, intervention in, expropriation, or similar taking of property occurs when a foreign government deprives a taxpayer of ownership of property or the normal attributes of ownership, such as receipt of income and control over the operation or use of the property, with little or no chance of being compensated therefor. Rev. Rul. 62-197, 1962-2 C.B. 66, *clarified by* Rev. Rul. 64-149, 1964-1 C.B. 233, *modified by* Rev. Rul. 69-498, 1969-2 C.B. 31. The expropriation or confiscation of property by a foreign government is considered a loss under § 165 and an involuntary conversion for purposes of § 1231. *See* Rev. Rul. 72-1, 1972-1 C.B. 52; *see also* Rev. Rul. 62-197, *Situation (3)*.

At the outset, we note that Taxpayer and the field differ with respect to whether there was an asset that constituted property subject to possible seizure. Taxpayer argues that the Partnership held substantial rights in the PPC, in the Project rights that had been approved by the Region and Country officials, and in Partnership itself, and was effectively deprived of those rights by the actions of Region Power and Region Commission. The field, in contrast, argues that Taxpayer's interest in the PPC never rose to the level of a property interest that could be seized, since it was the continuing subject of negotiation, and points out that the government approvals were permissive, not mandatory, and did not amount to fixed rights that were then taken away. We find it unnecessary to resolve this dispute, because even if we assume that Taxpayer is correct and there existed property rights that *could* be seized, under these facts they were not. [3]

Taxpayer asserts several propositions in support of its position:

- First, since Region Power was a state-owned enterprise, it was an instrumentality of Region and Country, capable of an act of seizure for federal tax law purposes.

[3] Similarly, since we conclude that Taxpayer's property was not taken by government action, we do not reach the question whether, if so, the property was taken for "public use."

- Second, the findings of the insurance arbitration panel, that the loss did not result from an "expropriation" by a "host government" under the insurance policy, do not determine the federal tax consequences.

- Third, seizure need not involve a physical, tangible asset.

- Fourth, a seizure need not involve an official, direct act of expropriation whereby a government obtains, or a taxpayer is deprived of, legal title to property. Rather, a seizure may occur indirectly, when government actions effectively deprive a taxpayer of the beneficial attributes of ownership in an asset.

- Fifth, a purported sale may be in substance a means of compensating a taxpayer for a seizure.

- In connection with the last two points, Taxpayer cites authorities holding that, while a voluntary sale is not an involuntary conversion, in certain circumstances an involuntary conversion of one asset may result in an involuntary conversion of another asset that together form a single economic unit, even if the second asset is sold to a third party.

Although there is support for all these propositions, they do not establish that there was in fact a seizure on any given set of facts. We will discuss each proposition in turn, and their application to this specific situation.

In support of the proposition that Region Power was a government instrumentality, Taxpayer cites *The Shaw Group, Inc. v. Taiwan Power Company*, 276 B.R. 360 (2002), a contract dispute in which the parties conceded that for purposes of the Foreign Sovereign Immunities Act of 1976, 28 U.S.C. § 1602 *et seq*. (FSIA), the Taiwan Power Company was an agency or instrumentality of the Republic of China (Taiwan), as all of its shares were held on behalf of Taiwan's Ministry of Economic Affairs. We agree that in appropriate circumstances, actions by an entity such as Region Power may be construed as government actions. However, we do not agree that state ownership, by itself, necessarily converts all actions by a state-owned company into government actions; if a company is acting in its own commercial interest rather than as an agent of the government, the federal tax result should not differ based solely on who owns the company, or the economic system in which the transactions occur.[4] Thus the inquiry here is whether Region Power was acting in a governmental or commercial capacity.[5]

[4] Similarly, the fact that a utility or other company has control of a limited resource, such as a power grid, and is therefore subject to government regulation does not, in our view, render all its actions government actions.

[5] While the *Shaw Group* case cited by Taxpayer is of limited usefulness in interpreting federal tax law, we note that it illustrates this basic distinction: As the court observed, the FSIA provides for an exception to immunity if a foreign government or instrumentality is engaged in "essentially private commercial activities" that have an impact on the United States. *See* 276 B.R. at 364-65.

In the present case, the facts indicate that Region Power, in refusing to enter into an interconnection agreement on terms satisfactory to Taxpayer, was not exercising regulatory or other governmental powers or otherwise acting on behalf of Region or Country. Rather, as the insurance arbitration panel found, it was acting pursuant to its economic self-interest because it wished to sell power to Company itself. After the reorganization of Region Bureau, regulatory supervision was separated and vested in Region Commission; Region Power had the responsibility for electric power in Region solely from a commercial, business perspective. Region Power's role was to serve as a market-oriented, independent competitor. As such, Region Power's role was to act in its own commercial interest, thereby having autonomy over its own commercial operations and was responsible for its own profits and losses. Region Power was subject to suit for its actions and enjoyed commercial independence from governmental entities. Region Power's actions were motivated by the fact that it wished to sell to Company itself, because the market had shifted and Region faced excess power capacity.

With respect to the second point, Taxpayer asserts that the specific holdings of the insurance arbitration panel involve interpretation of the terms of an insurance contract, and are not determinative of the federal tax consequences. Of course this is true. However, the thorough analysis in the arbitration decision, based on a detailed and extensive record, generally supports the conclusion that Taxpayer's loss resulted from market forces, business setbacks, and parties acting in a commercial capacity, not government actions.

With respect to whether seizure is restricted to takings of physical assets, we agree that an involuntary conversion due to seizure does not necessarily involve the physical confiscation of a tangible asset, and that in appropriate circumstances there may be a seizure of an intangible asset such as corporate stock or a partnership interest. *See*, *e.g.*, Rev. Rul. 72-1, *Situation (2)* (seizure of stock); *see also* Rev. Ruls. 75-501 and 76-41 (stock); *cf. Colish v. Commissioner*, 48 T.C. 711 (1967) (interest in nationalized partnership). The Taxpayer has not established, however, that a nationalization or other government seizure, such as occurred in the cited rulings and cases, occurred here.

Taxpayer's last three points are related, inasmuch as they bear on the possibility that the facts and circumstances in a given case may indicate that there is an indirect, *de facto* government seizure of property, even though title to property is not formally transferred to the government, and the transaction may involve a seemingly voluntary sale. We do not question this general proposition. *See, e.g.*, Rev. Rul. 82-147, 1982-2 C.B. 190 (federal designation of wilderness area, coupled with provision authorizing purchase of affected properties, resulted in taking of resort under § 1033 because resort

was no longer suitable for intended commercial use).[6] Similarly, where two properties form a single economic unit, a government taking of one may be an involuntary conversion of the other. *See Masser v. Commissioner*, 30 T.C. 741 (1958), *acq*., Rev. Rul. 59-361, 1959-2 C.B. 183. However, we believe that such an indirect seizure did not occur here and that the taxpayer's authorities and analogies are distinguishable.

For example, Rev. Rul. 82-147 is distinguishable because it involved the exercise of the federal government's power to legislate; in the present case, Taxpayer's loss was not the result of legislation or other regulatory or governmental action.

Taxpayer argues that the PPC in this case was crucial to the success of the joint venture, and that in certain circumstances the termination of a contract may result in an involuntary conversion for tax purposes, citing several private letter rulings that held that a state electric utility's threat to condemn a power generator's plant, unless the generator terminated a power purchase agreement, caused the termination of the contract and the sale of the plant to be an involuntary conversion. *See*, *e.g.*, PLR 200052010, 2000 PLR Lexis 1757. Under federal law, informal documents such as private letter rulings are without value as precedent. § 6110(k)(3). In any case, these documents are distinguishable, because the utilities in those cases were exercising the uniquely governmental power of eminent domain, which had been delegated to them by the state. *See*, *e.g.*, Rev. Rul. 74-8, 1974-1 C.B. 200. In the present case, by contrast, Region Power was not vested with regulatory or other governmental powers, and neither Region Commission nor any other Region or Country government body with such powers asserted them to thwart the Project; if anything, they expressed continuing support for the Project.

Taxpayer argues that expropriation or seizure can be covert, citing an arbitration decision under the North American Free Trade Agreement (NAFTA), *Metalclad Corporation v. The United Mexican States*, 40 I.L.M. 36 (2001), in which a Mexican municipality denied the claimant a landfill permit after the claimant had obtained all Mexican federal and state approvals for the project. The tribunal held that this action was an expropriation under NAFTA. Assuming that the *Metalclad* decision is useful precedent for the current question under federal tax law, we find it distinguishable, since it involved an action by a governmental body, a Mexican municipality. In the present case, Taxpayer has not demonstrated that its loss resulted from governmental action, covert or otherwise.

The approvals by Country officials allowed Partnership to undertake construction of the Project as a joint venture. These approvals, however, were permissive and not mandatory in nature and did not require or promise that Region Power would in fact enter into agreements that might be necessary for the Project to go forward, such as the

[6] In this discussion, we do not stress the distinctions between various forms of government action, such as "seizure," "taking," "condemnation," and "requisition," or the fact that certain tax provisions may be triggered by the threat of requisition or condemnation. These distinctions may be relevant in other contexts.

interconnection agreement with the Partnership. The governmental approvals simply authorized the parties to connect to the grid on commercial terms which, of course, would have to be worked out with and agreed to by Region Power. The parties negotiated about an agreement but an agreement was never reached. Taxpayer has not shown that Region or Country officials covertly revoked binding approvals they had issued. Similarly, the fact that Region Commission and other Region or Country officials did not force Region Power to interconnect did not amount to a "passive seizure," even assuming that such an event is possible under § 1231.

Taxpayer argues that the sale of its interest in Partnership should be treated as an involuntary conversion, rather than a § 741 capital loss, under one of two theories. First, it argues that under the "single economic unit" theory of *Masser* and Rev. Rul. 59-361, the seizure of the PPC rendered the sale of the Partnership part of an involuntary conversion. This theory fails, however, because, as discussed above, even if we assume that Taxpayer had property rights in the PPC, the PPC was not seized by a government body or instrumentality. Second, the taxpayer argues that the purported purchase was in fact a payment of compensation by Region or Country officials. However, Taxpayer has not shown this to be the case. Taxpayer points to evidence indicating that, in connection with the sale, Taxpayer waived certain rights and actions it may have had against Company, Region Power, and other parties. It is common, however, for parties who have negotiated a sale to waive rights of recovery and other potential actions with respect to the transferred property; such waivers do not typically convert the sale into something else for tax purposes.

Please call at if you have any further questions.