Ordinary Losses for Squeezed-out Shareholders

By Robert W. Wood and Christopher A. Karachale • Wood & Porter • San Francisco

If you're a shareholder in a closely held company, you know there's little more frustrating and expensive than a control fight. That's especially true if you end up on the losing end, not only losing control, but being squeezed out of the company in the process. You may end up selling your shares at a price you find unattractive.

Sometimes, though, you can't avoid it, as where a foreign government does the squeezing. When that happens, you may at least find it helpful that the IRS recently suggested ordinary loss treatment rather than capital loss treatment may apply. What's more, you may be able to claim such a loss even though you continue to dispute the forfeiture action and are pursuing legal recourse to get your shares back. After all, those actions seem on their face to be inconsistent, something that normally gives one pause.

In a series of six private letter rulings, LTR 201043009 through LTR 201043014 (July 21, 2010), the IRS considered minority shareholders who were squeezed out of a foreign company when the corporation was nationalized. The question of appropriation of assets by a foreign government appears to be a topic of continuing interest to the IRS. [*See* Karachale, *Sovereign Seizures*, M&A TAX REP., Apr. 2010, at 1.] That means we can expect further activity in this area. In this latest set of letter rulings, six investors, each being a trust, purchased stock in the foreign corporation.

The foreign government then passed financial stabilization legislation that established a fund and authorized the company to be nationalized. The legislation provided that the fund should buy up shares of the company. Provided that the fund acquired a requisite percentage of the shares, the fund could squeeze out minority shareholders. The fund took measures to acquire 100 percent of the company in which the investors owned stock.

Pursuant to court action on behalf of the foreign government, the fund was permitted to appropriate shares of minority shareholders, including the six investors. As part of that process, the six investors were squeezed out for cash in amounts less than their basis in their shares. Thus, each experienced a loss.

Smarting, the six investors brought suit against the company requesting that their shares be returned. They also sued the fund requesting additional compensation for their shares. In the series of rulings, the IRS first considered whether the lawsuits prevented the shareholders from claiming the losses.

Loss Deductions

Plainly, it was inconsistent for the investors to claim the losses based on a government seizure at the same time the investors were suing to have the seizure undone. The Treasury regulations make clear that a loss is only deductible under Code Sec. 165 where it is (1) evidenced by closed and completed transactions; (2) fixed by identifiable events; and (3) actually sustained during the tax year, except in the case of disaster losses. [Reg. §1.165-1(b).] Here it appeared that the investors wanted to have their cake and eat it too.

That is, they were suing the company and the fund, and, despite the pendency of their case, they were simultaneously claiming the loss deduction currently on their U.S. returns. Despite the apparent inconsistency, the IRS found support for this duality in cases and rulings.

In general, these authorities permit the taxpayer to claim a loss in the year of the seizure notwithstanding the existence of potential claims for reimbursement. The critical inquiry is whether there is a reasonable prospect of recovery of the loss. If a casualty or other event occurs that may result in a loss, and, in the year of such casualty or event, there exists a claim for reimbursement that is reasonably recoverable, then no loss deduction is allowed under Code Sec. 165. [Reg. §1.165-1(d)(2)(i).]

The most well-known authority on the line between deductible and not in this context is *L. Boehm,* SCt, 45-2 USTC ¶9448, 326 US 287 (1945). There, the taxpayer had filed suit against a corporation and its board of directors seeking a recovery of stock due to the large losses sustained by the company. In a later year, when the suit settled and the shareholder received a small recovery from the board, the shareholder sought to deduct the loss on the stock.

The Supreme Court denied the loss, observing that the stock had become worthless prior to the resolution of the lawsuit, and the loss should properly been taken into account then. The mere presence of the lawsuit did not create value that might represent a recoverable interest, suspending the available loss deduction.

In the six recent rulings, the IRS acknowledged that there are a number of cases supporting the investors' position with respect to Code Sec. 165. In general, where there is a seizure by a foreign government, a loss is permitted in the year of the seizure. This is true in spite of the existence of pending claims for reimbursement.

For example, in the old chestnut *S.S. White Dental Mfg. Co.*, SCt, 1 USTC ¶235, 274 US 398 (1927), the Supreme Court held that taxpayers were allowed to take a loss deduction for tax year 1918, when the German government seized a corporation in which they were stockholders. The deduction was available despite the fact the German government assured the taxpayers they would be repaid for their seized property. Similarly, in *F. Fuchs Est.*, CA-2, 69-2 USTC ¶9505, 413 F2d 503 (1969), taxpayers were allowed a loss deduction in 1953 when their rental properties in Czechoslovakia were seized. This was true even though the U.S. government subsequently compensated the taxpayers for their losses.

Beware Representations

In the six recent rulings, these investors had represented in their ruling requests that they had *no* reasonable prospect of recovering their shares in their legal action. They went on to say that the goal of the legal action was to give the fund an incentive to offer additional compensation for the seized stock. Based on this representation, the IRS considered it appropriate to consider the loss sustained at the time the stock was transferred to the fund pursuant to the forced sale.

The fact that such representations were made, though, is interesting. What if there are varying assessments made of the litigation, ranging from "we will win" to "we have no hope"? One could easily imagine a case in which correspondence and internal memoranda could be revealing.

However, such items would presumably be protected by attorney-client privilege or work product protections, although it is interesting to contemplate this, as well as any potential waivers. In any case, since different assessments of the likelihood of success in litigation are sometimes made for different purposes, it may be worth surveying them.

Ordinary Not Capital

The IRS also considered the type of loss sustained by the investors. Selling shares is usually a capital transaction. Thus, your first reaction to this might be that it was simply a sale like any other, to be treated as such for tax purposes. However, the fact this was a government seizure put it squarely within the involuntary conversion authorities.

That made it privy to the ordinary loss character provided by Code Sec. 1231. The authorities regarding nationalization of stock in a foreign company generally distinguish between seizures and forced sales of stock where there is a government order (generally treated as an involuntary conversion) and forced sales of stock without it. A seizure or forced sale of stock because of government action is viewed differently (and more favorably) than other forced sales.

A foreign government may deprive a taxpayer of ownership of property with little or no chance of compensating the owner. That is a seizure or act of confiscation for purposes of the involuntary conversion rules of Code Sec. 1231. For example, Rev. Rul. 72-1, 1972-1 CB 52, provides that a taxpayer may deduct the loss caused by the nationalization stock of a foreign company as ordinary where there was no reasonable prospect for payment of such appropriation.

In one of the situations discussed in Rev. Rul. 72-1, a taxpayer formed a domestic subsidiary to own and operate property in a foreign country. The company was occupied by the government of the foreign country, contingent upon the investment of capital improvements by the taxpayer. The taxpayer agreed to make the investment, but later determined such investment to be unfeasible, and so notified the foreign government.

Thereafter, the foreign government declared the stock of the subsidiary to be forfeited, but provided certain compensation to the taxpayer. The ruling concludes that the taxpayer's loss qualifies under Code Sec. 1231. Importantly, the IRS does distinguish between different types of forced sales of stock in the ruling.

A forced sale of stock outside the government seizure context does not involve a public purpose. If another private party acquires the stock, that is simply different. Where, for example, there is a sale of stock by one of two 50-percent shareholders under a state "deadlock" statute, this does not constitute a forced sale for purposes of the involuntary conversion rules under Code Sec. 1231. [*See Dear Publication & Radio, Inc.*, CA-3, 60-1 USTC ¶9263, 274 F2d 656 (1960).]

Regarding the investors described in the six recent letter rulings, the IRS ruled that the forced sale of the six investors' shares was an involuntary conversion. The sale resulted in the acquisition of the stock by the fund, an instrumentality of the foreign government, for a public purpose. Therefore, even though the shareholders received compensation for their shares, the forced sale could be treated as an involuntary conversion through seizure or confiscation. That meant the shareholders could treat the loss as ordinary under Code Sec. 1231.

Conclusion

No one likes the prospect of losing foreign investments through government confiscation. Moreover, the world, in the words of Thomas Friedman, is now flat. U.S. investors in the global economy now often look abroad for opportunities. Although there are risks in foreign investments, the IRS's guidance in these six private letter rulings helps to assure taxpayers that if they do run into trouble with their foreign investments, the tax consequences may be mitigated by Code Sec. 165 and the ordinary loss rules of Code Sec.1231.