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## *Tax treatment of an individual resident's foreign expropriation losses: An analysis*

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*When a taxpayer's property is expropriated outside the U.S. (a situation which now arises more frequently), he faces difficult problems in trying to deduct these losses. The authors discuss key factors in the timing and character of such losses.*

DEDUCTION OF LOSSES from expropriation of property by foreign governments is governed by the general U. S. tax rules relating to loss deductions, but the fact patterns underlying these transactions create unusual problems and issues as well as some planning opportunities.

While the law governing the deduction of expropriation losses is quite old, a surprising number of important issues remains unresolved. Among these (considered in more detail below) are (1) the relationship between Section 483 and the character of securities received as consideration for seizures; (2) the computation of basis under Section 1016 and related sections; (3) the anomalous treatment of losses of assets and losses of shares; (4) the definition of a taxable year for purposes of claiming a worthless security loss; (5) the unusual and largely unsupported view taken by the Service in *Rev. Rul.* 80-17; and (6) the apparently unintended and disastrous effect of Section 1231 on the carryover of certain capital losses.

### *General considerations*

A taxpayer may deduct losses from expropriation of property, subject to the usual limits governing losses of individuals (Sections 165(c) and 1211). The loss transactions may be described and further regulated as a worthless security (Section 165(g)) or a bad debt (Section 166). Certain losses from expropriation by involuntary conversion of capital assets may be recharacterized as ordinary losses (Section 1231).

Losses treated as business losses may become part of the taxpayer's overall net operating loss carryover (Section 172) or may be treated separately as an expropriation loss carryover (Sections 172(b) and (d)).

One should also consider the problems of presentation of financial evidence prepared according to a system which is unfamiliar to U. S. courts, preservation of testimony in the form of records or affidavits and prosecution of claims for compensation or insurance.

Taxpayers have frequently suffered from an inability to provide adequate documentation relating to their lost property, and while the facts of these cases may have often evoked comments of sympathy from courts, decisions have not been particularly favorable to the taxpayer. In general, well-prepared and well-researched cases have the best chance of success.

There are examples of leniency by courts to taxpayers. In *Mikolajczyk*, TCM 1955-165, it may have been attributable to the taxpayer having been a Polish war hero, Prime Minister of the Polish government in exile and a Deputy Prime Minister in the provisional government established by the Yalta agreement before he was declared a traitor by the Communist government, stripped of his citizenship and expelled.

In *Rev. Rul.* 64-149, 1964-1 (Part 1) CB 233, the taxpayer had entered the U. S. in April, 1960 on a visitor's visa (the only type then obtainable). During the year of arrival, he made three trips out of the U. S. and then took part in the Bay of Pigs invasion in April, 1961 which resulted in his imprisonment in Cuba until December, 1962. His properties were confiscated either in October, 1960 or December, 1961 (the Ruling does not decide which is relevant for the purpose of fixing the date of loss). The Service ruled that the taxpayer had become a U. S. resident in April, 1960 and had not lost that status thereafter.

In sharp contrast, recent *Rev. Rul.* 80-17, IRB 1980-3, 5, discussed in more detail below, describes a taxpayer in roughly similar circumstances to those in *Rev. Rul.* 64-149 but takes a much harder position concerning the date of the loss and the time when the taxpayer became a U. S. resident. If, as one might assume, the Ruling relates to facts drawn from the Iranian situation, it is altogether consistent with the scant sympathy felt by Congress and the American public for Iranian refugees, as compared with the sympathy for Cuban refugees, who benefited from special legislation and reasonably liberal Service Rulings.

On the whole, however, the cases and Rulings have been reasonably consistent.

### *Nature of property; timing*

*Definition of loss property.* Most, but not all, expropriation losses occur from seizure, physical or administrative, by governmental authorities of the following types of property: securities, business assets, real property, debts and personal and household effects. Determination of the precise nature of the lost property is often a difficult process in this context. The most serious tax issues arise when a taxpayer loses a business that has been operating under the ownership of a separate legal entity.

Let us assume that the People's Republic of Tarzana has physically seized a roller skate manufacturing plant run by the taxpayer's company.

If the taxpayer's company is not a corporation by U. S. standards, he may be able to claim a loss incurred in his trade or business, deductible against ordinary income and available for carryover under Section 172.

If the company, whether U. S. or Tarzanian, is a corporation by U. S. standards and the result of the seizure is that the shares become worthless, the taxpayer may claim only a worthless security deduction under Section 165(g).[1] Establishing such a loss may be a hard task in practice. The roller skate company may have unexpropriated assets (whether in Tarzana or elsewhere) which exceed liabilities not excused by the seizure.[2] The assets not expropriated may include tax refund claims in jurisdictions outside Tarzana.[3] Also, the shares of the roller skate company may have some value if the company's expropriation losses are deductible in other jurisdictions, such as the United Kingdom, where tax loss companies have significant ascertainable market value.

Had the Tarzanian government nationalized the shares rather than the assets of the roller skate company (again assuming the company is a corporation by U. S. standards), the seizure would be treated as an involuntary conversion.[4]

If the roller skate company was not incorporated in Tarzana, it may be difficult for the government effectively to expropriate the shares, especially if the stock certificates are not physically located in Tarzana, or if the stock could be recovered in a court proceeding outside Tarzana.[5] In such a case, the expropriation would be treated as a seizure of assets and control of the business, notwithstanding the label attached to the action of the Tarzanian government.

The practitioner must examine early in the process what sort of entity has been affected and for this purpose may look to a substantial body of case and administrative law that has received considerable recent attention.[6]

*Expropriation by stages.* One pattern of expropriation has involved the compulsory exchange of the taxpayer's property for compensation which is deferred, of dubious value, or blocked. This compensation may be shown to be worthless or may be the subject of a separate seizure. The effect of this compensation may be to alter not merely the timing but also the character of the loss. For example, in *Alvarez*, 431 F.2d 1261 (CA-5, 1970), *cert. den.*,[7] the taxpayer, while a Cuban resident, was given noninterest-bearing securities in return for his apartment building. Upon leaving Cuba for the U. S., the rights were lost under a Cuban law deeming the rights in the securities abandoned if he stayed away more than 29 days. The Fifth Circuit ruled that he had lost his compensation rights, not the apartment building. Since the rights were noninterest-bearing, the court ruled that they were not held for profit and the taxpayer was allowed no deduction (Section 165(c)(2)).

*Timing.* Determination of the time of actual loss is an issue that expropriation cases in some measure have in common with other loss transactions. There are, however, questions peculiar to the expropriation area. For example, assume that the revolutionary government of Covina seizes a candy store owned by the taxpayer. It does so by physical occupation on January 1, followed by administrative edict transferring ownership of the assets on June 1. If the physical occupation has the effect of denying the taxpayer control over or enjoyment of his assets, his loss will be considered to have taken place as of January 1. If the Covina government did no more than place an agent on the premises to prevent major transfers of funds out of the country but not to interfere in normal operations of the business, then for U. S. purposes the loss probably did not occur until June 1.[8]

As suggested in the example, a loss from the expropriation of assets will occur from:

1. Loss of control or enjoyment of the asset due to the intervention of a foreign government (or revolutionary body which later assumes control), or some person acting under color of governmental authority.

2. Transfer of legal title to the property pursuant to action by the de facto government or some person acting under apparent authority of that government (such as students, workers, vigilante groups and religious groups).

The general rule is that the date of the loss is whenever the earlier of these two types of expropriation occurs. Courts have always regarded loss of control of enjoyment of the property to be the primary indicator that expropriation has taken place,[9] but they agree that a legal expropriation is sufficient. In addition, loss of any effective enjoyment of the income may constitute a closed loss transaction. In some cases this factor has boomeranged against the taxpayer either because the loss occurred in a tax year already closed or he was a nonresident alien at the time of the loss.[10]

Minor variations can make the timing of the expropriation unclear. Suppose that in our example, on January 1 the Covina government installs its own managing director and on February 1 he orders that only card-carrying Heroes of the Covinian Revolution may shop there; otherwise there is no interference in the business. On March 1 the new director orders that the store must buy

[1] See *Rev. Rul.* 75-501, 1975-1 CB 69; see also *Rev. Rul.* 62-197, 1962-2 CB 66 (situations (2), (6), (7), (8) and (9)).

[2] See *Rev. Rul.* 75-501, *supra.*

[3] See *Rev. Rul.* 62-197, *supra* note 1 (situation (2)).

[4] *Rev. Rul.* 72-1, 1972-1 CB 53 (situation (2)), *clarified by Rev. Rul.* 75-501, *supra* note 1; *Garrigo*, 296 F.Supp. 1110 (DC Tex., 1968).

[5] In *Rev. Rul.* 75-121, 1975-1 CB 70, stock of U.S. subsidiary corporation was seized upon default by its U.S. parent in complying with foreign government's requirements exacted under threat of expropriation and secured by pledge of stock. The Service ruled that the stock was involuntarily converted. In *Rev. Rul.* 75-501, *supra* note 1, the assets of a U.S. subsidiary were nationalized by foreign government. The Service ruled that the subsidiary was entitled to a loss deduction. Since the subsidiary had other assets elsewhere and remained solvent after the expropriation, the parent was not entitled to worthless security deduction. Note also *Rev. Rul.* 76-41, 1976-1 CB 52, *clarifying Rev. Ruls.* 72-1, *supra*, 75-121 and 75-501, which states that stock of U.S. corporation cannot be considered as expropriated if the owner can reasonably expect to recover it in a U.S. court proceeding. Presumably, this also would apply if the corporation were incorporated in a third country and the owner could recover the stock in that country's courts. The IRS fails to explain what would happen if the fact of the stock's worthlessness were clear enough to make a proceeding in any court a valueless exercise.

[6] For a recent summary, see "Report on Foreign Entity Characterization for Federal Income Tax Purposes," the New York State Bar Association Tax Section, 35 *Tax L. Rev.* 167 (1980).

[7] See also *Bosch*, 448 F.2d 1026 (CA-5, 1971); *Beltran*, 441 F.2d 954 (CA-7, 1971);*Deviak*, TCM 1960-118; *Rev. Rul.* 72-1, *supra* note 4 (situation (3)).

[8] Compare *Rev. Rul.* 72-1, *supra* note 4 (situation (1)).

[9] *Ribas*, 54 TC 1347 (1970); *S. S. White Dental Manufacturing Co. of Pennsylvania*, 274 U.S. 398 (1927); *Korn*, TCM 1973-258, *aff'd* 524 F.2d 888 (CA-9, 1975); *Colish*, 48 TC 711 (1967). The Service agrees (see *Rev. Ruls.* 62-197, *supra* note 1 and 72-1, *supra* note 4 (situation (1)).

[10] *Braschich*, DC N.Y., 12/19/73; *Estate of Fuchs*, 413 F.2d 503 (CA-2, 1969).

[11] *E.g.*, *Franke*, TCM 4/7/53; *Estate of Fuchs*, *supra* (hope of compensation through U.S. Foreign Claims Settlement Commission (FCSC)—losses not postponed until claim settled); *Colish*, *supra* note 9 (hope of reimbursement by U.S.; the court held that the loss was not postponed); *Korn*, *supra* note 9 (hope of compensation by FCSC); see also *Deviak*, *supra* note 7 (lease of building by owner to government on such onerous terms as not to constitute continued commercial operation. The court held that expropriation occurred when the "lease" was entered into).

[12] See, *e.g.*, *Ribas*, *supra* note 9.

[13] See *Mikolajczyk*, TCM 1955-165.

[14] *E.g.*, *Rev. Rul.* 65-172, 1965-2 CB 49.

[15] In *Rev. Rul.* 62-197, *supra* note 1, situation (6), the assets of a U.S. subsidiary were seized, so that the U.S. parent sustained a worthless security loss under Section 165(g) (which was a capital loss because, in this case, the parent did not own more than 95% of all classes of stock of the sub.). In *Rev. Rul.* 75-501, *supra note* 1, the U.S. subsidiary lost all its operating assets but retained significant bank balances in U.S. banks. The Service ruled that the subsidiary could claim a deduction for the seized assets but the parent could not claim a worthless security loss.

[16] It is believed the foreign country in the fact pattern giving rise to the ruling was Iran, but the Service has declined to confirm this.

[17] *Ribas*, *supra* note 9, followed in *Biblioni*, TCM 1973-284; (1973); *Bello*, TCM 1974-174.

its inventory only from wholesalers who are themselves Heroes.

There is no precise formula in such a case for determining the exact date of the seizure, but it is a good rule of thumb that expropriation takes place when the effect of all the steps taken is to deny the taxpayer access to the business premises, control over the general management of the business, or the earnings and benefits of owning the business. In some cases, uncertainty about the effect of the foreign government's acts may make it possible to determine only the range of time during which the expropriation took place.

### *Special timing rules*

*The existence of a claim for compensation.* Possible reimbursement or a reasonable prospect of compensation may delay or bar a claim (Section 165(a)). If there is a reasonable prospect of compensation, the position will not be fixed until it is established with reasonable certainty whether the claim will be met. Thus, if insurance of $8,000 covers loss of property with an adjusted basis of $10,000, a loss of $2,000 will be sustained in the year of the loss. If, subsequently, the insurance claim is rejected or settled at a lower amount, the further loss will be allowed in the year the claim is finally adjudicated (Reg. 1.165-1(d)(2)).

Courts have generally taken a common sense approach as to what constitutes a "reasonable prospect" of recovery in the context of foreign expropriation. Vague promises of compensation, or hopes of recovery through the agency of the U. S. (except where based on a Federal insurance program) will not defer the time when the loss should have been recognized.[11] As the Supreme Court stated in *S. S. White Dental Mfg. Co. of Pennsylvania*, 274 U.S. 398 (1927), the only expropriation loss case it has considered: "The Taxing Act does not require the taxpayer to be an incorrigible optimist."

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Neither, however, is a taxpayer required to be an incurable pessimist about the loss of his property where local legislation provides that failure to return to the country within a set period after leaving results in confiscation[12]; nor does deprivation of citizenship entail a presumption of loss of property.[13]

*Bank accounts and receivables.* An indirect form of expropriation occurs when the government seizes or significantly restricts debtors, such as banks or obligors. If it becomes clear that the government has no intention of permitting the debtor to honor his commitments, this will normally be treated as giving rise to a loss by reason of the worthlessness of the debt, recognized by the taxpayer on the last day of his year.[14]

*Worthless securities.* Where a security, as defined by Section 165(g), becomes worthless, the loss is treated as having been sustained on the last day of the taxable year, even though the security in fact became worthless economically some time earlier. Taxpayers should be aware of the possible effect of this in analyzing the holding period of expropriated securities recently acquired.

Persons becoming U. S. tax residents during the year are required to file a bifurcated return (Reg. 1.6012-1(b)(2)(ii)). It is not clear how this affects the application of Section 165(g) respecting the timing of the loss on a worthless security. A strong argument based on the wording of the Regulation can be made, *viz.*, since there is only one U. S. taxable year, the worthless security loss therefore arises after the alien became a U. S. resident. The Regulation refers to a single return being completed for the taxable year, albeit requiring a separate schedule of income for the portion of the year in which the taxpayer was a nonresident alien. The apparent effect of Section 165(g) is that there is no closed transaction until the end of the taxable year since there is no reference either in the Regulation or in Section 165(g) to the creation of a dual-recognition trigger for such a year.

Where the security itself is confiscated or nationalized, the loss is sustained at the time of expropriation.

*Decline in value—requirement of closed transaction.* Except in the case of partially or wholly worthless debts, no loss is treated as incurred by reason of a mere decline in value. In an expropriation context, this is relevant where the government seizes corporate assets, but not the corporation itself, and the corporation continues to have assets outside the expropriator's reach. If the corporation is within the U. S. tax jurisdiction either because it is a domestic corporation, or because it is a foreign corporation whose income in the expropriating jurisdiction is effectively connected with a U. S. trade or business, it may suffer a deductible loss, but the stockholders of the corporation will incur no loss as long as there are any assets remaining.[15]

It follows from these rules that the taxpayer must plan the timing of his loss claim carefully. If he claims the loss too early, he might be found not to have become a U. S. resident; and if he delays his claim, hoping for recovery or compensation, he may find himself out of time.

## Revenue Ruling *80-17*

Although the law as stated above appeared fairly settled, an element of doubt has arisen because of *Rev. Rul.* 80-17.[16] A nonresident alien owned assets of a personal service business and corporate stock and left his home country on a limited exit visa. The country's policy was to prevent the enjoyment of property by those leaving on such visas and to confiscate the property on failure to return in time. The nonresident alien entered the U. S. and did not return to his home country. The Service held that because the taxpayer left basically to escape political conditions, his enjoyment of ownership rights terminated on departure, prior to his becoming a U. S. resident.

The reasoning in the Ruling is tendentious and self-serving, and does not accord with the case law. For example, several Cuban expropriation cases have held for taxpayers who left Cuba on limited exit visas where Cuban legislation provided for expropriation if the taxpayer did not return.[17] Furthermore, the case cited in the Ruling as authority that there be a reasonable expectation of profit from the venture (*Mercer*, 376 F.2d 708 (CA-9, 1967)), does not support the Service's specific interpretation that the expectation needs to be present at the time the taxpayer becomes a U. S. resident. The only requirement under the case law is to enter into the venture with a good faith (and in some circuits, reasonable) expectation of profit. To



hold otherwise would result in the conclusion that many business losses would not be allowable, since the expectation of profit frequently ceases some time prior to the accrual of the loss.

The Ruling, therefore, should be treated as a warning, but not as strict authority.

### *Limitations on the loss*

Section 165(c) distinguishes only three categories of loss (trade or business, investment and casualty) and applies to expropriation losses as it does to all other types of losses of individuals. Losses of other property, personal belongings and household effects in particular, therefore are not deductible.[18]

Except in very unusual circumstances, an expropriation loss is not a casualty loss.[19] The difficulty of distinction is illustrated by the recent case of *Popa*, 73 TC No. 12, where the taxpayer was a U. S. citizen residing in Vietnam. In April, 1975 he left the country on a business trip, but was unable to return due to the sudden withdrawal of U. S. forces and the North Vietnamese takeover. Since the property in respect of which the taxpayer claimed a loss was all held for personal use, he had to claim a casualty loss under Section 165(c)(3), alleging that his property had been destroyed or looted in the chaotic last days in Saigon. The Tax Court trial judge (Judge Sterrett) allowed the deduction on the ground that the loss was an "other casualty" of the same kind as losses due to fire, storm and shipwreck. It was, the judge held, "a sudden cataclysmic and devastating loss—just the sort of loss Section 165(c)(3) was designed to address." The trial court's findings were sustained on review, despite a strong dissent by Judge Fay, in which Judges Tannenwald, Simpson and Nims joined.

At the same time, the Tax Court reviewed *Billman*, 73 TC No. 13, (a decision of Judge Tietjens) in which a U.S. taxpayer tried unsuccessfully to claim a casualty loss arising out of the sudden worthlessness of Vietnamese currency due in part to the U. S. withdrawal. *Popa* was distinguished on the grounds that the taxpayer had still retained possession of the currency: it had become worthless, but it had not been destroyed.

Although a loss from vandalism is a casualty loss,[20] the courts are reluctant to apply such treatment to damage done by revolutionary forces prior to the assumption of authority. In addition, no matter how oppressive the style of expropriation, a foreign expropriation loss is not a theft loss.[21]

As pointed out in the discussion of the *Alvarez* case above, the receipt of noninterest-bearing securities as compensation for a taking has been held effectively to change the character of an investment to a personal one, the loss of which is not deductible under Section 165.

The deemed-interest provision of Section 483 might conceivably permit taxpayers in an *Alvarez* situation to deduct their losses. Section 483 provides that certain portions of receipts from a debtor paid over a long period of time (six months or more) are taxable as ordinary income on the theory that they represent payments of interest. If a debtor, such as a foreign government, defaulted on ostensibly noninterest-bearing payments due as part of a long-term installment obligation (paid as compensation for seizure of property held for profit), the taxpayer might argue that because of Section 483 any security, by definition, will eventually bear interest and that it, therefore, has been acquired in a transaction entered into for profit. A note not otherwise falling within Sections 165(c)(1) or (2) would satisfy their requirements.

This position has not yet been tested in court, although some encouragement may be derived from recent *Ltr. Rul.* 8024002, where the Service reaffirmed its position, originally stated in *Rev. Rul.* 59-108, 1959-1 CB 72, that an involuntary conversion constitutes a sale or exchange for purposes of Section 483(a) and that Section 483 does apply to such obligations. Indeed, this follows logically from Reg. 1.483-1(b)(1), which states that, for the purposes of Section 483, "sale or exchange" includes any transaction treated as such for purposes of the Code. Involuntary conversions are, in effect, so treated by the Code.[22]

This would appear to support the view, implied above, that *Alvarez* is wrong in holding that noninterest-bearing rights to compensation in such cases are not held for profit. If the deferred compensation is payable over a period in excess of six months and has any value, it must be treated as interest bearing, and *ipso facto*, acquired in a transaction entered into for profit. If, alternatively, the compensation is considered to have had no value at all, the loss will have arisen on the original taking.

The taxpayer may have some difficulty if the compensation is payable over a period of less than six months, but if it is not paid, the taxpayer will be in a strong position to argue that it never

[18] See *Rev. Rul.* 62-197, *supra* note 1 (situation (1)).

[19] *Farcasanu*, 50 TC 881 (1968), *aff'd per cur.* CA-DC, 8/20/70. The court noted that its opinion was consistent with the Act of State doctrine as illustrated by *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1965), and that Congress found it necessary to enact Section 165(i) which deemed losses from expropriations by the Cuban government before 1965 to be within Section 165(c)(3). The court might have added that Congress had previously adopted this solution in Section 158 of the Revenue Act of 1942 which amended the predecessor of Section 165 in a similar manner to deal with wartime losses.

[20] *Davis*, 34 TC 586 (1960).

[21] *Powers*, 36 TC 1191 (1961).

[22] This is implicit in Section 1033 (which refers to the recognition of gains and losses in cases of involuntary conversions), and in Section 1231.

[23] Mechanically, Section 1231 is applied as follows: First, segregate any net loss arising from casualty to or theft of any property used in trade or business (see Section 1231(b)), or any capital asset held more than one year. Losses of property from expropriation are not normally treated as casualty or theft losses, but if there are any casualty or theft losses, however arising, they should be included in this calculation. The tax position of casualty gains and losses where there is a net loss is determined without applying Section 1231 and they should be excluded from the Section 1231 calculation. If there is a net gain arising from such casualty or theft transactions (due to receipt of insurance proceeds exceeding the adjusted basis), then the gains and losses therefrom are included in the Section 1231 calculation.

If the recognized losses from (1) sales or exchanges of property used in the trade or business and (2) the compulsory or involuntary conversion of (as a result of destruction, theft or expropriations of property used in the trade or business or capital assets held for more than one year exceed the recognized gains from such sales, exchanges and conversions, then such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets, and each gain or loss will therefore be treated as ordinary gains or losses. The result is that Section 1231 loses are treated as ordinary. Thus, the taxpayer may not avail himself of the carryover provision for capital losses. The ability to carry over or carry back the losses will therefore depend upon whether those losses qualify as net operating losses. Section 1231 applies to shares and to debts evidenced by a security, except if held as inventory or if held for less than one year. Section 1231 does not apply to other types of debt.

[24] *Cf. Garrigo, supra* note 4.

[25] The Regulations refer to Section 172(b)(3)(C)(ii). However they have not yet been amended to reflect the repeal in the Revenue Act of 1978 of Sections 172(b)(3)(A) and (B) and the redesignation of subparagraph (C) as (A).

[26] In the case of individuals, only a business debt (*i.e.*, a debt created or acquired in connection with a trade or business of the taxpayer or a debt where the loss from its worthlessness is incurred in the taxpayer's trade or business) is treated as part of the foreign expropriation loss (Section 166(d)).

was intended to be paid and so was worthless from the beginning.

### *Deductibility and nature of loss*

*Section 1231.* Before characterizing expropriation losses as ordinary or capital, the possible application of Section 1231 should be considered. Section 1231 applies to losses from property used in a trade or business (defined, broadly, as depreciable property and real estate not includable in inventory) and from the involuntary conversion (such as by expropriation) of a capital asset held, or treated as held, for more than one year. If the losses exceed the gains from all such assets during the year, each gain and loss is treated as ordinary.[23]

Thus, if the taxpayer suffers a loss on the expropriation of property held as a capital asset, he is foreclosed from using the carryover provisions for capital losses.

*Debts.* A worthless debt may be deducted by an individual taxpayer as an ordinary loss if the obligation was a business debt, or as a short-term capital loss if it was a nonbusiness debt (Sections 166(a) and (d)).

Section 1231 treatment is applied to any security (debt or otherwise) held as a capital asset for more than one year which is the subject of involuntary conversion. However, the creation or existence of a state of worthlessness of a security does not constitute an involuntary conversion of the security itself.[24] Thus, if a debt security held as a capital asset becomes worthless during the taxable year, Section 1231 will not apply. Under Section 165(g) the resulting loss will be treated as if it arose from a sale or exchange on the last day of the taxable year.

*Carryovers.* Operating losses and transaction losses qualifying under one of the Section 165(c) tests are deductible from current income, subject to the restrictions on deductibility of capital losses.

Section 172 normally permits a net operating loss to be carried back and deducted against the income of the taxpayer in the three taxable years preceding the year of the loss and to be carried forward for seven years. Certain modifications are made to the amount of the income against which the losses may be set (Section 172(d)).

A taxpayer with a net operating loss attributable to foreign expropriation may instead carry it forward for ten years if the foreign expropriation loss exceeds 50% of the overall net operating loss for the taxable year and if the taxpayer elects to have the ten-year period apply instead of the three-year carryback/seven-year carryover (Sections 172(b)(3) and (f)). As a matter of practice, this election should almost always be made by newly-resident aliens whose property was expropriated close to the time of their arrival in the U.S.

Regs. 1.172-11(c)(1) and (3) provide that the election be made by attaching to the taxpayer's return for the year in which the loss is incurred a statement containing:

1. The name, address and taxpayer account number of the taxpayer.
2. A statement electing application of Section 172(b)(3)(A)(ii)[25] to take a ten-year carryover.
3. The amount of the net operating loss for the year.
4. The amount of the foreign expropriation loss for the taxable year, including a schedule showing the computation of the loss.

The return must be timely filed (including extensions of time).

Under Section 172(h)(1), a foreign expropriation loss for this purpose is the sum of the losses sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, and political subdivision thereof or any agency or instrumentality of the foregoing.

A debt becoming worthless as a result of expropriation is treated as a foreign expropriation loss.[26] The foreign expropriation loss for the year may not exceed the net operating loss for the year (Section 172(h)(2)).[27]

Where the election is made, Section 172(h)(2) provides that in calculating the amount of a foreign expropriation loss carryover, other kinds of loss are to be applied before the foreign expropriation loss.

Capital losses not used up in the current year are deductible by individuals in accordance with Section 1212(b), and there is no time limit for using up the loss.

*Effect of Section 1231 on carryovers.* Under Section 172(d)(4), if Section 1231 applies to turn a capital loss into an ordinary loss, any portion which is not a trade or business loss (such as a loss on shares or other investment property)[28] can be used only in the current year. To the extent that such nontrade or business income is not available, the loss is not a net operating loss and cannot be carried over or back. Furthermore, because the loss has been transformed by Section 1231 into an ordinary loss, it is not eligible for capital loss carryover as such.[29]

Rental property is generally considered property used in a trade or business for purposes of Section 1231 if the taxpayer takes some active steps to manage the property, either in person or through an agent. A loss from the expropriation of such property would be a business loss, and there would be no restriction on the loss as part of the net operating loss.[30] The loss from the confiscation of vacant lots is generally not considered incurred in business.[31]

The surprising effect of Section 1231 is graphically illustrated by *Garrigo*, 296 F.Supp. 1110 (DC Tex., 1968). Among the losses sustained by the taxpayer were a share in the Trust Company of Cuba and bonds issued by a Cuban government agency. Two Cuban laws, Numbers 851 and 890, enacted in July and October, 1960, confiscated the assets of a large number of named corporations which, the court found, did not include the Trust Company and the Cuban government agency. One law, Number 989 enacted December 5, 1961, confiscated without compensation all property owned by Cuban emigres. The court held that the share and the bonds had been seized under Law Number 989, and the taxpayer thus had sustained an ordinary loss under Section 1231. The result was a denial of carryover under either Section 172 or 1212(b). If the court had found that the earlier laws were effective to create the loss, the holding would have been that the taxpayer suffered a worthless security loss on the last day of the taxable year. This would have been a capital loss, available for carryover under Section 1212.

The result appears particularly absurd since Section 1231 was meant to be a relief provision. The predecessor of Section 1231 was introduced by Section 137 of the Revenue Act of 1942 along with other wartime relief measures such as Section 158 (wartime losses treated as casualties) and was designed to meet three different problems.

First, Congress had intended to relieve owners who disposed of certain business property at a loss by providing that gains and losses from sales and exchanges of such property be treated as ordinary income and loss.



Second, many taxpayers were realizing extraordinary gains on dispositions of business properties because depreciation allowances had reduced their basis. A similar result occurred when insurance proceeds from a casualty or theft exceeded adjusted basis.

Finally, involuntary conversions such as condemnations of property for use in the war effort caused hardship where the property could not be replaced or a fund could not conveniently be set aside. The problems were exacerbated by the high rates of income and excess profits tax charged during the war. The solution to these problems was Section 1231.

Nothing in the legislative history indicates that Congress anticipated the result described above, or considered the effect of Section 1231 on carrybacks and carryovers.[32] If anything, the opposite is true. In 1954, Section 172(a)(4)(A) was introduced to permit taxpayers who sold a business or certain business assets to include any loss as part of its net operating loss. This was expressly designed to overrule decisions such as *Sic*, 177 F.2d 469 (CA-8, 1949), *cert. den.*, which held that a taxpayer who sold his business at a loss recognized a nonbusiness loss because he was not in the business of selling businesses.[33] The clear implication is that Congress intended Section 172(a)(4)(A) to permit taxpayers to carry over this type of loss, but in the context of expropriation losses, the combined effect of Sections 1231 and 172(d)(4)(A) is to frustrate that intent.

A "correction" may be accomplished by Congress' inserting into Section 172(d)(4) a new paragraph (E) as follows:

(E) Any gain or loss from the compulsory or involuntary conversion of a capital asset held for more than one year where such gain or loss is treated as not being a gain or loss on the sale or exchange of a capital asset by reason of the application of Section 1231 shall be treated as a gain or loss attributable to the taxpayer's trade or business.

The intended effect is to remove any limitation on the inclusion of losses by individuals sustained on the involuntary conversion of capital assets which are treated as ordinary losses because of Section 1231.

As a result of Section 1231, any taxpayer losing shares in a company might argue that, either according to local law or in fact, the company was more akin to a partnership than a corporation, or that the company held the expropriated property as trustee or agent for the shareholders. However, such a "substance-over-form" argument is generally available only to the IRS, and the cases have mostly gone against taxpayers seeking to disregard an apparent corporate entity to claim the benefit of losses.[34] Arguments about the effect of foreign law on determination under U.S. standards on the nature of business organizations are difficult at the best of times, and in the typical circumstances of expropriation, the necessary evidence and witnesses are often unavailable.

A more helpful tactic may be to argue that the underlying assets were effectively expropriated before or instead of the shares.

### *Adjusted basis*

In general, the amount of any loss in an expropriation setting is restricted to the adjusted basis of the property computed in accordance with standard accounting principles. Although the taxpayers have generally not been subject to U.S. taxation in the past, such assets must be depreciated or amortized over their useful life (Section 1016(a)(3)). There are several examples of this in the cases.[35]

The burden of proof is upon the taxpayer to establish his basis and, indeed, the ownership of the property, its market value, the date of loss and all other information required to establish the loss. Although the courts occasionally refer sympathetically to the difficulty of providing information in circumstances where the taxpayer has fled the country and perhaps has to present his case through an interpreter, they still expect as much detailed evidence as possible, and have rarely permitted the taxpayer to rely on the *Cohan* rule (see 39 F.2d 540 (CA-2, 1930)).[36] A more sympathetic attitude was evident in *Popa*, the court finding on somewhat uncertain grounds that the taxpayer lost his property in the destruction and looting which followed the American withdrawal from Vietnam and not as a result of any form of expropriation.

Preparation of expropriation loss cases should begin early. Newly-established resident aliens seldom appreciate the long term U.S. tax benefits which their losses can bring and they may be reluctant to expend efforts in gathering the necessary evidence and witnesses. However, the effort must be made.

Unless the expropriated property is effectively connected with a trade or business carried on by the taxpayer in the U.S., the taxpayer will be entitled to no deduction if the loss is incurred before he becomes a U.S. resident for tax purposes.[37] The relative timing of the loss and the taxpayer's taking up residence in the U.S. is therefore critical.

### *Residency and Section 6013 elections*

How a taxpayer becomes resident in the U.S. for income tax purposes is beyond the scope of this article. However, refugees, even those entering on nonimmigrant visas, stand a reasonable chance of being treated as U.S. residents from the moment of their arrival (see Regs. 1.871-2, -4 and -5).

The problem, therefore, is how to deal with a taxpayer whose property is expropriated either before his arrival in the U.S., or after his arrival but where there is difficulty in proving that he had

[27] The excess has been used in reducing the taxpayer's income to zero for the year in which the net operating loss arises.
[28] See Sections 172(d)(4)(A) and 1231(b).
[29] The authors have been unable to find any policy explanation for this strange result. The rule is cited in *Garrigo, supra* note 4.
[30] *Elek*, 30 TC 731 (1958) and *Rev. Rul.* 64-149, 1964-1 CB 233. For a full definition of a nonbusiness deduction, see Section 172(d)(4)(A). *Elek* has been followed in numerous subsequent cases such as *Feiks*, TCM 1958-120; *Lajtha*, TCM 1961-273; *Alvary*, 302 F.2d 790 (CA-2, 1962); *Pap*, TCM 1962-82.
[31] *Daniel*, TCM 1960-274.
[32] See H. Rep't No. 2333, 77th Cong., 1st Sess., Part I (1941) Section 24 and comments on Section 137 of the Bill; S. Rep't No. 1631, 77th Cong., 2nd Sess. (1942).
[33] H. Rep't 1337, 83rd Cong., 2d Sess., 4052 and 4193 (1954); S. Rep't No. 1622, 83d Cong., 2d Sess., 4663 and 4849 (1954).
[34] See *e.g., Watson*, 124 F.2d 437 (CA-2, 1942).
[35] *Benichou*, TCM 1970-263; *Pap, supra* note 30; *Bello, supra* note 17.
[36] For an exception, see *Rodriguez-Torres*, TCM 1970-76.
[37] *Rev. Rul.* 62-197, *supra* note 1, referred only to U.S. citizens and corporations; *Rev. Rul.*. 64-149, *supra* note 30, among other things, clarified this oversight, for the benefit of those who expect Revenue Rulings to make complete statements of the law. Presumably, the rules also apply to nonresident aliens and foreign corporations to the extent that their losses are effectively connected with the conduct of a trade or business in the U.S.
[38] This formulation appears to permit an indefinite extension for a taxpayer who neither files a return nor pays tax.
[39] For an unusual case, see *Estate of von Dattan*, 22 TC 850 (1954) (real estate lost in 1941, recovered in 1945, lost again in 1945).
[40] Section 111; *Rev. Rul.* 62-197, *supra* note 1. See Section 1351 for the election available to U.S. corporations in respect of foreign expropriation loss recoveries.
[41] *S. S. White Dental Mfg. Co. of Pennsylvania, supra* note 9; *Brown*, 54 F.2d 563 (CA-1, 1931) (Japanese bonds in German bank seized in 1918 and restored in 1920. The court held that the loss may be deducted for 1918).

established U.S. tax residence by the time of the expropriation.

There may be a solution for the taxpayer if he can make an election under Section 6013(g) or (h), introduced in the Tax Reform Act of 1976. Under Section 6013(g), a nonresident alien married to a citizen or resident of the U.S. can, jointly with his spouse, make an election to be treated as a U.S. resident for the entire taxable year. Under Section 6013(h), a nonresident who becomes resident during the year and at the close of the taxable year is married to a U.S. citizen or resident can elect to be treated as a resident for the entire taxable year. While the purpose is to permit the taxpayers to file a joint return, the effect is that the alien is treated as if he were a U.S. resident throughout the taxable year for various purposes of the Code.

The persons need only have been married on the last day of the taxable year for which the election is made. There appears to be no provision for an unmarried nonresident who becomes a resident during the year to elect to be treated as resident for the whole year.

Regs. 1.6013-6 and -7 were recently adopted describing the manner of election under Sections 6013(g) and (h). Some anomalies are caused because Reg. 1.6013-7, which implements Section 6013(h), requires the making of the election in accordance with the rules in Reg. 1.6013-6(a)(4), which deal with the election under Section 6013(g). However, the IRS has indicated informally that Reg. 1.6013-6(a)(4) is to be read as appropriately modified in the case of a Section 6013(h) election.

The Regulations require the election to be attached to a joint return. Neither Section 6013(g) nor (h) refers to the filing of a joint return, and the author of the Regulations conceded in a recent telephone conversation that the Regulations reflect what was the presumed intention of the legislation, based on its location in Section 6013. Nonetheless, if a case were to present itself, it appears that the Service may litigate the apparent requirement that a joint return is a condition to filing the election.

An election under Section 6013(g) continues until revoked in contrast to an election under Section 6013(h) which, by its nature, is a one-time election in the year residence changes. However, in later taxable years while the election under Section 6013(g) continues in effect, separate returns may be filed. (This is a concession from the treatment in the Proposed Regulations.) The election must contain:

1. A declaration that the election is being made and that it meets the requirements of Reg. 1.6013-6(c) (in the case of a Section 6013(g) election), or, presumably, Reg. 1.6013-7 (in the case of a Section 6013(h) election).

2. The name, address, and taxpayer account number of each spouse.

3. The signature of each spouse.

An election under Section 6013(h) appears to cover only one of the spouses (because of the odd drafting of Section 6013(h)) and, in any case where both individuals were nonresident aliens at the beginning of the year, a separate election should be made by both spouses (each signed by both of them).

The election must be made before the expiration of the period of limitation for filing a claim under Section 6511 (three years from the time a return was filed, or two years from the time the tax was paid, whichever is later).[38] If an election is not attached to a return, and the taxpayer desires to make an election after a return has been filed, the election should be filed at the same time as an amended return, since the Regulations require the election to be "attached . . . to a joint return."

Only one Section 6013(g) and Section 6013(h) election is permitted during a taxpayer's lifetime.

It is difficult to overstate the importance of the elections, in particular that of Section 6013(h), to newly-arrived refugees who have lost their property and would like to take advantage of the cushion which such loss could provide against U.S. tax liabilities in the early years of U.S. residence. Many such persons have difficulty proving when their loss occurred, or at least showing that it occurred after permanent U.S. residence was acquired. The election enables them effectively to extend their status as U.S. residents with certainty back to the beginning of the calendar year. There may even be scope for choosing a suitable fiscal year-end to look back as far as possible.

*Recoveries.* Occasionally, victims of expropriation make some recovery, due to regaining possession of their property at the end of a war, the payment of war damages or the settlement of claims through the Foreign Claims Settlement Commission.[39] Such recoveries are generally taxable in the year of receipt if the taxpayer took a deduction for the losses, unless the deduction did not bring about a reduction in his tax bill.[40] The later recovery does not affect the deductibility of the loss in the year it was sustained.[41]

### *Conclusion*

Taxpayers seeking to claim deductions for expropriation losses may anticipate a long and detailed preparation stage. In addition to dealing with the obvious problems of collecting, analyzing, and presenting the financial data, practitioners must work with a body of law that is at best not coordinated and at worst seemingly capricious. Not only are several critical aspects of the law either unclear or unfavorable to the taxpayer, but taxpayers might well find that their cases are treated with relatively less sympathy due to the current political events in the Middle East and Southeast Asia.

Finally, the success or failure of an expropriation claim may depend significantly on timely handling of the following:

1. Analysis of current financial data concerning value of the loss property.

2. Determination of whether any business entity lost by the taxpayer is a corporation by U.S. standards.

3. Determination of the actual date of seizure.

4. Examination of the history of the holding of the property in order to determine the taxpayer's adjusted basis.

5. Making an alternate carryforward election under Section 172 and a residence election under Section 6013. ☆

## IRS provides guidelines for valuation of "stapled stock"

*Rev. Rul* 80-213, 1980-32 IRB 7 sets forth factors that should be considered, in addition to those mentioned in *Rev. Rul.* 59-60, 1959-1 CB 237, in valuing the stock of a subsidiary distributed in a "stapled stock" arrangement. "Stapled", "paired", or "back-to-back" stock arrangements take many forms but generally follow this pattern:

1. An existing U.S. corporation organizes a subsidiary, often under the laws of a foreign country offering tax advantages.

2. The subsidiary issues the same number of shares as the parent corporation has outstanding.

3. The subsidiary's stock is "spun-off" ratably to the shareholders of the parent.

4. Pursuant to by-laws or otherwise, the shares of the two corporations are "stapled" or "paired" so that they can be transferred only as a unit.

5. The operations of the two corporations are ordinarily closely associated.

Pursuant to *Rev. Rul.* 54-140, 1954-1 CB 116, the IRS treats a stapled stock arrangement as an actual distribution of the subsidiary's stock to the parent's shareholders although the Tax Court held otherwise under the particular facts of *Wilkinson,* 29 TC 421 (1957), *nonacq.* If such a transaction is a distribution, it might be taxable as a dividend if undertaken with tax-avoidance motives, or it might qualify as a tax-free spin-off under Sections 355 and 311. More importantly, the Service's position suggests that a stapled stock arrangement creates a brother-sister relationship in which the original parent is no longer subject to tax or regulation through the activities of its former subsidiary although both are subject to long-term control by the same shareholders. Hence by decontrolling a foreign subsidiary in this way, a U.S. parent can apparently avoid both Subpart F taxation on its foreign income and liability for its participation in a foreign boycott. (See Fitzgerald, *Does Service's position on "stapled stock" open a loophole for foreign operations?,* 50 JTAX 354 (June, 1979).)

Recognizing that the subsidiary stock distributed in a stapled stock arrangement is often not publicly traded, the IRS has amplified the stock valuation provisions of *Rev. Rul.* 59-60 with the following considerations:

1. Because the future of the original parent and its former subsidiary will be closely associated by stapling their stock, the history and experience of the parent in conducting the same or similar business as the subsidiary is relevant.

2. The prior earnings of the subsidiary's business operated as either a division or a subsidiary. Adjustments must be made if the subsidiary is a foreign corporation not subject to U.S. income taxation.

3. If the subsidiary is a foreign corporation, consideration must also be given to the corporation laws and political stability of the host nation, possible changes in the exchange rate and any restrictions on the transfer of funds. It should be remembered that the management of the parent firm weighed these factors in choosing to incorporate a foreign subsidiary.

4. If the former subsidiary will carry on essentially the same business as existed prior to the distribution, consideration should be given to any management changes in the distributed subsidiary, the goodwill and going concern value developed by the former parent, and whether the expertise of the parent's personnel will be made available to the subsidiary.

5. Any financial assistance to the distributed subsidiary from the distributing parent in the form of direct loans, surety arrangements or performance guarantees.

6. Whether the former subsidiary is to assume any existing contracts or to be assigned contracts from particular customers or within a particular territory.

7. The enhanced marketability of the former subsidiary's stock if it meets stock exchange listing requirements solely by virtue of the stapling arrangement.

8. The value of the freely traded stock of corporations engaged in the same or a similar line of business. Adjustments must be made because the stock of the distributed subsidiary is not publicly traded.

Of course, no discount for lack of marketability is appropriate where the stock of the distributed subsidiary is registered prior to the distribution and can be publicly traded with the stock of the distributing parent afterwards. ☆

## New foreign decisions this month

***Regs. involving U.S. property finalized.*** *(Regs.)*

The Service has issued final Regulations relating to the exceptions to the definition of U.S. property under Section 956(b)(2) and affecting computation of the investment of earnings in U.S. property by controlled foreign corporations under Section 956(c). TD 7712, 8/6/80. Regs. 1.956-1, -2; 1.958-2.

***Exclusion from Subpart F income of certain earnings of insurance companies.*** *(Reg.)*

The Service has adopted a final Regulation providing an exclusion from foreign personal holding company income of a controlled foreign corporation that is an insurance company. TD 7704, 6/25/80; Reg. 1.954-2.

***Final Regs. on foreign government's income.*** *(Regs.)*

Final Regulations relating to the taxation of foreign governments on their income from commercial activities within the U.S. have been adopted. TD 7707, 7/17/80. Regs. 1.892-1, -2.

***Foreign tax credit limitation superseded by TRA 1976.*** *(Rev. Rul.)*

TRA 1976, which provides that the limitation on the foreign tax credit shall be computed using only the overall method, supersedes the foreign tax credit per-country limitation provided in U.S. income tax treaties. *Rev. Rul.* 80-201, IRB 1980-30.

***Tax implications of Taiwan Relations Act.*** *(Rev. Rul.)*

The Taiwan Relations Act provides that the laws of the U.S., including the Internal Revenue Code, treaties and conventions, shall apply with respect to Taiwan in the manner that they applied prior to 1979. The American Institute in Taiwan is exempt from tax except to the extent that FICA provisions apply to its employees. *Rev. Rul.* 80-208, IRB 1980-31.

***Passage-of-title test denies taxpayer Western Hemisphere trade corporation benefits.*** *(DC)*

The Commissioner held that taxpayer did not qualify for the special tax benefits that were applicable for pre-1976 years to Western Hemisphere trade corporations.

*Held:* For the Government. In more than 5% of taxpayer's sales, title to the merchandise passed while it was still in the U.S. The passage-of-title test is appropriate here. *Perry Group, Inc.,* DC N.J., 7/11/80.

***Effect of Section 482 allocation on the foreign tax credit.*** *(Rev. Rul.)*

The Ruling illustrates how the reduction in the amount of foreign income tax paid by a foreign subsidiary following a Section 482 income allocation affects its domestic parent's Section 902 deemed paid foreign tax credit. *Rev. Rul.* 80-231, IRB 1980-34.

***Income tax treaties superseded by Tax Reduction Act of 1975.*** *(Rev. Rul.)*

The enactment of Sections 901(f) and 907 by the Tax Reduction Act of 1975 supersedes inconsistent provisions of all income tax treaties with foreign countries entered into both prior to and after the enactment of these sections. *Rev. Rul.* 80-223, IRB 1980-33.