Claiming Ordinary Theft Loss Deductions for Stock Investments

by Andy Torosyan

Andy Torosyan explains the circumstances in which it might be possible to claim a section 165 theft loss deduction for the loss in value of stock investments.

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I. Summary

Many investors in the 1990s lost money after investing in companies that turned out to have serious accounting problems -- such as accounting fraud perpetrated by corporate officers -- that, when uncovered, resulted in dramatic stock price declines. Generally, taxpayers purchased stock in those companies on the open market through their brokers (whether by phone or online). Some of those investors did minimal research before buying. When they invested, stocks were only increasing in value and they didn't want to miss a "once-in-a-lifetime opportunity."[1] As it became clear in the following years that some stocks whose values had declined were not going to rebound quickly, if ever, many investors sold their positions and recovered as much of their money as they could.

In general, the sale of stock at a loss results in a capital loss for federal income tax purposes.[2] Corporate taxpayers can use capital losses only to offset capital gains.[3] Excess capital losses can be carried back to each of the three tax years preceding the loss year or carried forward to each of the five tax years succeeding the loss year.[4] Unused capital losses can expire unused. Individuals, however, may deduct capital losses to the extent of capital gains plus $3,000 (limited to the amount of the actual loss)[5] and carry forward unused capital losses indefinitely.

Some investors, however, did not sell their stock and instead bought more as the price was declining. Many companies ended up in bankruptcy, some were liquidated, and a few actually survived. Some taxpayers apparently have been advised that they "may be able to deduct as a theft loss the decline in market value of stock caused by disclosure of accounting fraud or other illegal misconduct of the officers or directors of the corporation that issued the stock."[6] In response, on March 25, 2004, the IRS and Treasury Department issued Notice 2004-27, 2004-1 C.B. 782, to advise taxpayers that the IRS will disallow (and may impose penalties) for theft losses claimed by taxpayers for the decline in market value of their stock caused by disclosure of accounting fraud or other illegal misconduct of the officers or directors of the corporation that issued the stock. However, what Notice 2004-27 does *not* discuss is the authority that actually allows a taxpayer to claim a theft loss on a stock investment in some circumstances.

A theft loss deduction may indeed be available to individuals, corporations, partnerships, and other entities that purchased stock (or other property) that subsequently diminished in value, but *only if* the investment was from a seller that committed fraud under a local law. Consistent with Notice 2004-27, a theft loss deduction is *not* available to persons who purchase stock on the open market, because most local law definitions of theft require the taxpayer to demonstrate that the perpetrator of the fraud intended to defraud the taxpayer of its property. In other words, there must be a direct connection between the person buying the stock and the person committing the fraud. In most open market transactions, the seller of the stock is not the one committing the fraud -- it is the corporation's officers. However, as discussed in this article, when a person made a direct investment with the perpetrator of the fraud, a theft loss deduction may be available.

Before we move on, note that taxpayers who have worthless stock or debt investments may have alternative methods for claiming their losses (for example, abandonment and worthlessness).[7] Also, taxpayers may be eligible to claim an ordinary loss on stock that qualifies as small-business stock under section 1244.

II. Claiming an Ordinary Theft Loss Deduction

A. General Rule Under Section 165

Deductions for theft losses are governed by section 165(a), which provides that there shall be allowed as a deduction any loss sustained during the tax year that is not compensated by insurance or otherwise.

Section 165(e) specifies that any loss arising from "theft" shall be treated as *sustained* during the tax year in which the taxpayer *discovers* the loss (that is, a disposition is *not* required).[8] In general, the taxpayer does not have to prove when the loss actually occurred. Indeed, reg. section 1.165-8(a)(2) provides that a theft loss is not deductible in the year in which the theft occurs unless that is also the year the taxpayer discovers the loss.

To be deductible under section 165, a loss must be both a bona fide loss and must be sustained by the taxpayer as a result of a theft.[9]

In dealing with claimed theft losses, courts "do not consider whether an asset would have produced capital or ordinary gain or loss. Instead, the focus is upon the fact that a taxpayer parted with consideration because of trickery and deceit (theft)."[10] Moreover, reg. section 1.1223-1(e)(3) provides that a theft loss is not a section 1231 loss but an ordinary loss.

Taking advantage of that ordinary loss is quite complicated -- a common theme in our current tax system. The remainder of the article discusses the many hurdles taxpayers have to overcome to claim a theft loss deduction for a stock investment. Two critical requirements that must be satisfied to claim a theft loss are: (1) the amount of the loss claimed must exceed the amount of any claim for reimbursement for which there is a reasonable prospect of recovery[11] and (2) the amount of the loss claimed cannot be attributable to a fluctuation in the value of the stock due to market conditions -- it must be attributable to theft (or fraud).[12]

B. Definition of a Theft

The threshold question that must be answered in claiming a theft loss is whether the definition of a theft is satisfied. Reg. section 1.165-8(d) provides that theft is "deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery." The seminal case is *Edwards v. Bromberg*,[13] which defines a theft broadly to encompass any criminal appropriation of another's property:

> The word "theft" is not like "larceny", a technical word of art with a narrowly defined meaning but is, on the contrary, a word of general and broad connotation, intended to cover and covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile. [Footnote omitted.] [I]t has been long and well established that whether a loss from theft occurs within the purview of [the predecessor of section 165] depends upon the *law of the jurisdiction where it was sustained* and that the exact nature of the crime, whether larceny or embezzlement, of obtaining money under false pretenses, swindling or other wrongful deprivations of the property of another, is of little importance so long as it amounts to theft. [Emphasis added.]

That definition of theft is widely accepted by both the IRS and the courts.[14] Notably, it supports a broad definition of theft based on the law of the jurisdiction where it was sustained, which in most cases determines the jurisdiction under which the taxpayer can make a claim against the perpetrator.[15] Because the definition is based on local law, a local attorney should be consulted regarding the availability of a theft loss. However, note that a claim against the perpetrator is not necessary in claiming a theft loss.

1. Perpetrator's intent to defraud the taxpayer of its property.

a. Purchase on open market -- no theft. Based on case law analyzing local statutes that define theft, a common requirement is for the taxpayer to demonstrate that the perpetrator had intent to defraud the taxpayer of its property. That is generally why it is not possible to claim a theft loss for the purchase of stock on the open market.

In *Bellis v. Commissioner*,[16] the Tax Court held that it is not enough that there be a crime under state law. There must be criminal intent to defraud the taxpayer to qualify as a theft for purposes of California law. Accordingly, the theft loss deduction under section 165 was not allowed because the taxpayer could not provide evidence demonstrating that the perpetrator had intent to defraud the taxpayer. The Ninth Circuit Court of Appeals agreed with the Tax Court, holding:

> [a]lthough felonious intent is not an essential ingredient in every crime it is a necessary element of theft as defined in Section 484 of the California Penal Code. Therefore, while the sale of securities may have been a crime under California Corporations Code § 26104, it does not amount to *theft under California law* absent a showing of criminal intent to deprive appellants permanently of their property. The Tax Court correctly concluded that "without evidence of guilty knowledge or intent on Jansen's part petitioners . . . do not reach the threshold point of our broad definition of theft." [Emphasis added.]

For example, in *Paine*, the taxpayer purchased publicly traded stock. The corporation's officers and employees were later convicted of securities fraud and trading in the corporation's stock was suspended for several years. The company was then reorganized and the taxpayer was given stock in the reorganized corporation. The Tax Court held that the taxpayer failed to provide evidence demonstrating that he relied on misrepresentations when purchasing the stock of a publicly traded corporation.

Also, the Tax Court held that under the Texas Penal Code, a common element to theft requires the taxpayer to demonstrate that misrepresentations were made by the corporate officers with the intent of "obtaining, acquiring, or securing any property or valuable right from petitioner and with the specific intent of criminally appropriating petitioner's property or right, or destroying petitioner's right of enjoyment." The taxpayer was not able to present evidence that the owners of the stock purchased by the taxpayer participated or were even aware of the misrepresentations of the officers at the time of purchase. The taxpayer was also unable to present evidence that the misrepresentations by the officers were intended to defraud the taxpayer. Accordingly, the taxpayer was denied a theft loss under section 165.[17]

b. Direct purchase from perpetrator -- theft. So when is it possible to claim a theft loss on the purchase of stock? I now turn to a discussion of authorities that support the ability of a taxpayer to claim a theft loss for an investment in stock or securities.

In *First Chicago Corp.*, the taxpayer who purchased 44.5 percent of Denasa, a Brazilian investment bank, for $14.6 million was able to claim a theft loss based on the Brazilian law definition of a theft. The taxpayer demonstrated that Mr. Padilha, the president of Denasa, was aware that the financial statements provided to the taxpayer when negotiating the purchase (as well as subsequent financial statements) did not present the true financial status of Denasa. Further, Padilha was aware of information regarding proceedings by the Central Bank of Brazil regarding pending violations and did not disclose that to the taxpayer at the time of the agreement. The court found that Padilha withheld information from the taxpayer to gain an illicit advantage for himself and others to the prejudice of the taxpayer. In the court's opinion, that satisfied the Brazilian law definition of a theft. Accordingly, the taxpayer was entitled to a theft loss for its $14.6 million investment in Denasa in the year of discovery.

Furthermore, in Rev. Rul. 71-381, 1971-2 C.B. 126, the taxpayer's decision to loan money to a New Jersey corporation was based on a review of the financial reports issued by the corporation. A court later convicted the president of the corporation of violating New Jersey securities law by issuing false and misleading financial documents. The president of the corporation knowingly, with intent to defraud, obtained money by means of false representations and was found guilty under New Jersey statutes of a misdemeanor. Accordingly, the ruling concludes that the taxpayer was entitled to a theft loss deduction under section 165(c)(3).

In *Vietzke v. Commissioner*,[18] the taxpayer had purchased stock in a new corporation that was supposed to be licensed to sell insurance. The record provided evidence that the perpetrators parted the taxpayer from his money "by deceit and trick amounting to a criminal appropriation with felonious intent and that by so doing a theft occurred both within the meaning of Indiana law and section 165(e)." Accordingly, the taxpayer was allowed a theft loss.[19]

In *DeFusco*, the taxpayer was a stockholder and an employee in a corporation. He purchased stock in the corporation both on the open market and through the employee stock option plan. At the time of investment, the taxpayer relied on fraudulent financial information presented by the company and sales pitches made by corporate officers that included gross misstatements. It was later discovered that there had been fraud and misconduct designed to inflate the stock price to defraud investors. The corporation had recorded income and assets that did not exist and understated liabilities. The Tax Court disallowed the taxpayer's claim for a theft loss on the stock purchased on the open market because the seller had not been involved in the fraud. However, the Tax Court held (and the IRS then agreed -- see discussion of Rev. Rul. 77-18 below) that the taxpayer had suffered a theft regarding the stock acquired through the employee stock option plan. The corporation, through its officers, intended to deprive the taxpayer of property and obtained property from the taxpayer by making false representations regarding the value of the stock. Nevertheless, the theft loss deduction was disallowed because the taxpayer had a reasonable prospect of recovery through the bankruptcy reorganization and the taxpayer could have brought suit against the officers directly.[20] In other words, if the taxpayer did not have a reasonable prospect of recovery, a theft loss would be available. As will be discussed later, it is possible to deduct a theft loss to the extent the loss exceeds the expected claim for recovery.

In Rev. Rul. 77-18, 1977-1 C.B. 46, an individual had purchased stock in corporation G during 1967. In 1973 G's board of directors approved a merger with corporation X. Under the merger agreement, X provided detailed information about its financial condition that was included in proxy statements sent to G shareholders for their vote. The agreement contained a specific warranty stating that the financial information did not contain any untrue statements of material fact and did not omit any material facts. Based on that information, the shareholders approved the transaction in 1973. In 1975, after release of information about irregular activities, open market trading of X stock was suspended. Later that year, X filed a petition for bankruptcy protection. The trustee concluded that X should be reorganized and should continue doing business as a new entity. The reorganization plan provided that shareholders of X would receive one share of G stock for each share of X stock.

The bankruptcy trustee reported that there was securities fraud, rather than theft or embezzlement of X's assets. The primary goal of the fraud participants was to inflate the market price of X's stock. That goal was achieved by reporting nonexistent income and assets on the corporation's books and failing to record liabilities. The trustee estimated that the fictitious income was greater than the net earnings for 1972 (the year financial activity was reported to G's shareholders).

Under the laws of state N, the state of the taxpayer's residence, a person who, by false pretenses, obtains from another person any chattel, money, or valuable security, with intent to defraud any person of the same, is guilty of a theft. The IRS found that in that case (1) false representations about the financial condition of X were made to G's stockholders with the *intent* to induce them to vote for the merger, (2) the responsible X officials knew of the falsity of the financial statements they issued, and (3) the stockholders of G relied on the false financial statements at the time they decided to exchange their stock for X stock, which was worth substantially less than was represented. Consequently, the IRS concluded that "[t]he exchange was a theft by false pretenses under the laws of State N and therefore, meets the definition of theft for Federal income tax purposes."

Nevertheless, the IRS ultimately concluded that "the taxpayer is not entitled to a theft loss deduction pursuant to section 165 of the Code since there exists a *reasonable prospect of recovery*." [Emphasis added.] In the ruling, the taxpayer had a claim for rescission and a claim in the bankruptcy reorganization. Note that reg. section 1.165-1(d)(2)(i) provides that:

> [i]f a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, *no portion of the loss with respect to which reimbursement may be received is sustained*, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. [Emphasis added.]

Accordingly, as discussed below, a theft loss can be split between the portion of the loss for which there is a claim and the portion of the loss for which there is no claim for recovery.

In CCA 200451030, the IRS concluded that "a theft loss deduction will be barred *to the extent* that a reasonable prospect of reimbursement exists. If a theft loss *exceeds* the claim for recovery, the excess would be deductible in the year the theft is discovered."[21] [Emphasis added.] A valuation may be helpful in that regard.

Based on the authorities discussed above, it appears to be difficult, but not impossible, for taxpayers to claim a theft loss. Establishing that a theft has occurred under local law is the first hurdle taxpayers must deal with to claim a theft loss. The following requirements also must be satisfied: The amount of the loss claimed exceeds the amount of any reasonable prospect of recovery, and the amount of the loss claimed must be due to theft and not general market fluctuations.

2. Reasonable prospect of recovery.

As discussed above, some valid theft losses have been denied because the taxpayer had a reasonable prospect of recovery, notwithstanding that a theft may have occurred. Reg. sections 1.165- 8(a)(2) and 1.165-1(d)(3) provide that no portion of a theft loss for which reimbursement may be received is sustained until it can be ascertained with reasonable certainty whether or not the reimbursement will be received.[22] That is generally determined based on the relevant facts and circumstances of each case.[23]

In *Geo. M. Still, Inc. v. Commissioner*,[24] the taxpayer could not claim a theft loss in the year of discovery because the perpetrators had promised to repay the misappropriated funds, retained their offices, and their promise was accepted as assurance by the taxpayer.[25] Incidentally, the funds were repaid in the following year.

Also, in *Lapin v. Commissioner*,[26] the court dismissed the taxpayer's claim for a theft loss because the taxpayer failed to prove that there was no reasonable prospect of recovery. The court also clarified that a loss is sustained under section 165 if it is evidenced by a closed and completed transaction. Generally, a transaction is not closed in the year of the loss *to the extent that* the taxpayer has a claim for reimbursement that provides for a reasonable prospect of recovery.[27]

In *First Chicago Corp.*, however, the subsidiary that the taxpayer purchased did not cease operations and continued to have residual value in some assets; but, the value was far less than the amount by which liabilities exceeded assets.[28] Accordingly, the court held that the taxpayer was entitled to claim a loss in the year of discovery. Furthermore, in *Gottlieb Realty Co. v. Commissioner*,[29] the court held that "[t]he mere possibility or the bare hope of a future development permitting recovery does not bar the deduction of a loss clearly sustained."[30]

In *Rainbow Inn, Inc. v. Commissioner*,[31] an employee forged signatures of two officers of the company and embezzled funds. The loss was discovered in 1962 and the corporation claimed a theft loss deduction in that year for the embezzled funds. The corporation also filed a lawsuit against the bank that cashed the forged checks and was awarded judgment. However, in 1964 the suit against the bank was reversed. The Tax Court ruled that the taxpayer could not claim the theft loss until 1964 because the suit against the bank represented a "reasonable prospect of recovery." The Third Circuit reversed, citing *Parmelee Transportation Co. v. United States*.[32] The court in *Parmelee* wrote: "we offer no litmus paper test of 'reasonable prospect of recovery,' we note that the inquiry should be directed to the probability of recovery as opposed to the mere possibility. Analyzing the rule in percentage terms, we would consider a 40 to 50 percent or better chance of recovery as being 'reasonable.' A lawsuit might well be justified by a 10 percent chance." Accordingly, the Third Circuit allowed a theft loss deduction to the taxpayer in 1962 (the year of discovery) because there was only a "remote possibility rather than reasonable prospect of recovery. . . . No reasonable taxpayer could have anticipated that [state court] decision."[33]

Thus, to claim a theft loss deduction it is imperative to determine whether there is a reasonable prospect of recovery in the investment when the theft loss deduction is claimed. That determination must be made based on the facts of each case. Generally, if the taxpayer has a claim for a portion of the loss, there *may* be a reasonable prospect of recovery for that portion of the loss up to the maximum amount of the claim. Theft losses in excess of those claims may be deductible.

a. Existing claim by the taxpayer. As discussed earlier, reg. section 1.165-1(d)(2)(i) provides that "*no portion of the loss with respect to which reimbursement may be received is sustained*." [Emphasis added.] Accordingly, to the extent there is an outstanding claim, the IRS and the courts may allow a theft loss deduction in the year of discovery to the extent it can be established that the amount of the theft loss exceeds the claim for recovery.

In *Ramsay Scarlett & Co.*, the taxpayer discovered that the bookkeeper embezzled approximately $1.5 million from corporate funds. The taxpayer recovered $50,000 from insurance and claimed a theft loss in 1965 (the year of discovery) for the $1,450,000. In 1969 the taxpayer received a $475,000 settlement from the bank at which the checks were cashed and a $25,000 settlement from the accounting firm which worked on the corporate books. The Tax Court denied the theft loss deduction to the extent there was a claim representing a reasonable prospect of recovery in the year the theft loss was discovered (1965). However, a theft loss deduction was allowed in the year of discovery to the extent that the amount of the theft loss exceeded the claims for recovery. That decision was affirmed by the Fourth Circuit.[34]

Accordingly, when claiming a theft loss taxpayers must determine (1) if there is a reasonable prospect of recovery and (2) the amount by which the theft loss exceeds the amount recoverable.

3. Amount of the theft loss deduction.

In determining how much to claim as a theft loss, the regulations require that the amount be determined in the same manner as a casualty loss.[35] The amount claimed as a theft loss under section 165 is generally the amount that is not recoverable by the taxpayer. As a result, the regulations provide that the fair market value of the stolen/misappropriated property immediately after the theft shall be considered zero.[36]

a. Theft versus market fluctuation. A discussion of the amount of the loss claimed as a theft would not be complete without a discussion of reg. section 1.165-4, which provides that no deduction will be allowed under section 165(a) solely on account of a decline in the value of stock owned by a taxpayer when the decline is due to a fluctuation in the market price of the stock or to other similar causes. A mere shrinkage in value, no matter how extensive, does not give rise to a deduction under section 165(a) if the stock has any recognizable value. No loss for a decline in the value of stock owned by the taxpayer shall be allowed as a deduction except insofar as the loss is recognized under reg. section 1.1002-1 on the sale or exchange of the stock and except as otherwise provided in reg. section 1.165-5 for stock that becomes worthless during the year.

Reg. section 1.165-4 was promulgated with little explanation.[37] Under a liberal interpretation, the regulation would seem to deny every claim for an ordinary theft loss deduction on stock investments because the regulation requires a recognition event under reg. section 1.1002-1. That would also convert the character of the loss from ordinary to capital. However, it would be misleading to apply the regulation too broadly because it would override the statute itself, which provides for an ordinary deduction when a theft occurs. Furthermore, reg. section 1.165-8, which governs theft losses, has no cross-reference to reg. section 1.165-4. Indeed, the cases that allow for a theft loss also have not applied reg. section 1.165-4 to disallow the loss or convert the loss from ordinary to capital.[38]

In *Singerman,* the Tax Court stated:

> Generally a taxpayer is not entitled to a loss deduction solely on the account of a decline in the value of stock unless the stock is worthless or has no recognizable value or until the stock is sold. Sec. 165(g); sec. 1.165-4(a), Income Tax Regs. Section 165(e) however, provides that any loss arising from theft will be treated under section 165(a) as *sustained* during the taxable year in which the taxpayer discovers the loss. [Emphasis added.]

In other words, the taxpayer's discovery of a theft loss is the act of sustaining the loss for purposes of section 165(a), and that a theft occurred is enough to overcome reg. section 1.165-4. That is not inconsistent with other cases and IRS guidance.

For example, in *Paine,* the Tax Court held that the "specific portion of the decline attributable to the illegal activities of the corporate officers petitioner describes as 'theft,' as opposed to the decline that might be attributable to business risks, market decline, poor or derelict management, and other illegal acts clearly not comprising any of the elements of a theft. Thus, even if the evidence disclosed a theft, the record contains no evidence with respect to the amount of any theft loss."[39] In other words, the taxpayer must demonstrate that the loss in value is due to a theft as opposed to general market fluctuations. In *First Chicago Corp.*, the Tax Court allowed the taxpayer to claim a theft loss for its investment in a Brazilian corporation. The taxpayer was able to establish that a theft was committed under local, Brazilian law. Notwithstanding that the taxpayer was aware of financial difficulties at the corporation, the taxpayer was unaware that the corporation's financial statements were so misstated that rather than a positive net worth of $16 million, there was a negative net worth of $33 million. Although not explicitly stated, the decision of the court to allow a theft loss to the taxpayer demonstrates that the financial records were so misstated that the entire decline in value was attributable to theft. Thus it is possible to have an ordinary theft loss notwithstanding reg. section 1.165-4.[40]

As discussed earlier, in Rev. Rul. 77-18, shareholders that relied on fraudulent information when approving the merger were eligible to claim a theft loss deduction. However, the deduction was denied because there was a reasonable prospect of recovery through a rescission claim and participation in the bankruptcy reorganization. The facts indicate that the trustee of the company in bankruptcy reported that the primary goal of the fraud was to inflate the market price of the company's stock. That goal was achieved by reporting nonexistent income and assets on the books and failing to record liabilities. The trustee also estimated that the fictitious income was greater than the net earnings for the year. That was also the situation for many prior years. The ruling concludes that the taxpayers suffered a theft loss. However, as stated above, the loss was denied because of the claims for recovery. Based on the facts of the ruling it appears that the IRS was satisfied that the amount of the decline in value of the stock was attributable to theft and would not be disallowed by reg. section 1.165-4.[41]

Accordingly, it appears that notwithstanding reg. section 1.165- 4, when a taxpayer's stock declines in value as a result of theft (or accounting fraud), an ordinary theft loss deduction may be claimed. A valuation report can be very beneficial in most cases to help identify the decline in value attributable to theft.

C. Taxpayer Reliance on Fraudulent Information

Another common requirement under most state law definitions of a theft is that the taxpayer relied on the fraudulent information when parting with his property.[42] In other words, the taxpayer must show that he relied on the misrepresentation when he acquired property to qualify for a theft loss under section 165.

D. Substance Shall Govern

Consistent with the general provisions of tax law, the substance of the transaction will determine whether there was indeed a theft loss and who suffered that loss.[43]

In *Vietzke*, the IRS argued that, in form, the corporation was the victim of the theft as opposed to the individual shareholder. However, the Tax Court looked to the substance of the transaction and concluded that the corporation was a sham and was used merely as a device to route the subscribers' money into the pockets of the perpetrators. As a result, the taxpayer was allowed a theft loss deduction.

E. Frustration of Public Policy

In some cases, the courts have denied a theft loss deduction if it would frustrate public policy. For example, taxpayers involved in a criminal scheme (for example, purchasing counterfeit money) and were swindled in the process were disallowed a theft loss deduction under section 165 because of strong public policy against those schemes.[44] Further, in *Marine v. Commissioner*,[45] the taxpayer was denied a theft loss deduction for investing in a partnership that was involved in sham transactions because the taxpayer had full knowledge of the scheme at the time of investment.[46] In other words, there was no misrepresentation made to the taxpayer. Indeed, the taxpayer had full knowledge that the partnership was going to be involved in sham transactions.[47]

In *Bromberg*, however, the taxpayer was the victim of a criminal act and was not involved in any scheme. The court held that it was illogical to deny the taxpayer a theft deduction when the IRS had taxed the perpetrator of the theft on the stolen funds.

F. Taxpayer Due Diligence Not Required

In general, a theft loss deduction may be allowed even if the taxpayer performed insufficient due diligence when purchasing property. For example, in *First Chicago Corp.*, at the time of the transaction, the taxpayer was aware of some financial shortcomings of Denasa, but nevertheless proceeded with the transaction because it wanted to gain access to the local currency market. The court held that:

> [t]o the extent the taxpayer may have facilitated the theft due to negligence, however, it is not a bar to a theft loss deduction. . . . The fact that petitioner [taxpayer] did not follow usual procedures or perform due diligence regarding its investment in Denasa, standing alone, is not determinative. . . . In summary, petitioner was informed that Denasa's financial statements were likely, to some extent, overstated. Petitioner, however, was not aware that Denasa's financial statements were so misstated that rather than a positive net worth of $16 million, there was a negative net worth of about $33 million.

In *Earle v. Commissioner*,[48] the taxpayer had placed securities in a safe deposit box jointly held by the taxpayer and his son. The son took the taxpayer's securities without the consent of the taxpayer. In concluding that a theft loss was allowed to the taxpayer, the court stated that the possibility of negligence by the taxpayer does not change the fact that the taxpayer sustained a loss by theft.

In *Rainbow Inn, Inc.*, the corporation's officers did not take the elementary precaution of examining bank statements and checks when they had noticed hostility by one of the other officers. That precaution would have prevented the theft loss from occurring. Nevertheless, the Third Circuit allowed a theft loss deduction for the amount stolen by forged checks.

Accordingly, in most situations it may not be necessary to demonstrate that the taxpayer performed extensive due diligence at the time of investment when claiming a theft loss deduction.

G. Effort to Collect From Perpetrator Not Required

To claim a theft loss deduction, the taxpayer does not have to obtain a conviction against the perpetrator.[49] More importantly, the taxpayer does not have to try and recover the loss from the perpetrator even when the perpetrator is capable of satisfying the claim. Instead, "the factual existence of a theft is what brings section 165(e) into operation."[50]

In *Bromberg*, the Fifth Circuit ruled that, in the event of a theft, the taxpayer does not have to demonstrate that he has made an effort to and cannot obtain restitution because the statute does not make such a requirement.[51]

In *Earle*,[52] the taxpayer's son had taken his father's securities from their joint safe deposit box without the father's consent and used them as collateral. The taxpayer had to pay $38,840.50 to recover his property. The taxpayer claimed a theft loss for the amount of the payment on his tax return. The court allowed the theft loss deduction, holding that the statute does not require the taxpayer to show that the perpetrator is not financially capable of repaying the amount stolen. In other words, the taxpayer did not have to attempt to collect the stolen amount from his son.[53]

H. Limitations on Losses for Individual Taxpayers

Theft losses are further limited when the investor is an individual. Section 165(c) limits losses of individuals to (1) losses incurred in a trade or business; (2) losses incurred in a transaction entered into for profit; and (3) losses of property not connected with a trade or business or a transaction entered into for profit, if those losses arise from fire, storm, shipwreck, or other casualty or from theft.

While section 165(h) limits theft and casualty losses of individuals,[54] those limits apply only to "personal casualty losses" as defined in section 165(h)(3)(B). As a result, theft losses that are related to income-producing property (for example, stock investments) and trade or business property should not be subject to the limitations of section 165(h) and should be fully deductible under section 165(a).

More importantly, a theft loss relating to business or income- producing property is specifically excluded from the definition of miscellaneous itemized deductions under section 67(b).[55] As a result, the loss is not subject to the 2 percent adjusted gross income limitation. Instead, the loss should be reported in Section B of Form 4684. That amount then flows to Schedule A as a miscellaneous itemized deduction on line 27 (that is, it is not subject to the 2 percent AGI limitation). Furthermore, a theft loss deduction is generally not subject to the section 469 at-risk rules.[56]

I. Alternative Minimum Tax Consequences

There is nothing in section 56 that disallows a theft loss incurred on income-producing property or on trade or business property for alternative minimum tax purposes. As a result, a theft loss incurred on income-producing property or trade or business property should be allowed as a deduction for AMT purposes.

III. Conclusion

Although a theft loss cannot be claimed for a purchase of stock on the open market, an ordinary theft loss deduction may be claimed when the purchase was from a seller who committed fraud, if:

- the local law definition of a theft is satisfied;
- the taxpayer relied on the fraudulent information provided by the seller;
- the amount of the loss is greater than any claim for reimbursement for which there is a reasonable prospect of recovery;
- the loss was due to theft and not a fluctuation in value caused by market factors and business risk; and
- the taxpayer was not involved in the fraud.

Possible fact patterns that may qualify for a theft loss include:

- purchases of stock or securities directly from the corporation, including initial public offerings;
- shareholder approvals of mergers based on fraudulent financial statements; and
- reliance by employees on fraudulent financial information, leading to agreements to receive stock as compensation or the exercise of stock options.

FOOTNOTES

[1] For interesting reading on things that are "too good to be true" and the origin of the Ponzi scheme, see Mitchell Zukoff, *Ponzi's Scheme: The True Story of a Financial Legend*, (Random House 2005).

[2] For purposes of this article it is assumed that the taxpayers were not dealers in stock. State tax consequences are not discussed in this article.

[3] Section 1211(a). "Section" references are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated under the code, except as otherwise noted.

[4] Section 1212(a).

[5] Section 1211(b).

[6] *See* Notice 2004-27, 2004-1 C.B. 782, *Doc 2004- 6710* [**PDF**], *2004 TNT 59-4*.

[7] For discussion on worthless stock investments, see Jerred G. Blanchard Jr. and David C. Garlock, "Worthless Stock and Debt Losses," *TAXES - The Tax Magazine* (CCH, Mar. 2005).

[8] Reg. section 1.165-8(a)(2). Only in rare circumstances do the courts consider whether a theft loss is available in the year of occurrence instead of the year of discovery. *See Rod Warren Ink v. Commissioner*, 912 F.2d 325 (9th Cir. 1990). *See also River City Ranches #1, Ltd. v. Commissioner*, T.C. Memo. 2003-150, *Doc 2003-12978* [**PDF**], *2003 TNT 101-12*, *aff'd in part and rev'd in part*, 401 F.3d 1136, *Doc 2005- 6278* [**PDF**], *2005 TNT 58-6* (9th Cir. 2005).

[9] *See* Rev. Rul. 77-17, 1977-1 C.B. 44; Rev. Rul. 77- 18, 1977-1 C.B. 46.

[10] *First Chicago Corp. v. Commissioner*, T.C. Memo. 1995-109, *Doc 95-3062*, *95 TNT 55-15*.

[11] Reg. section 1.165-8(a)(2).

[12] *See* reg. section 1.165-4; *Singerman v. Commissioner*, T.C. Summ. Op. 2005-4, *Doc 2005-429* [**PDF**], *2005 TNT 4-9*.

[13] 232 F.2d 107 (5th Cir. 1956) at 110. There are hundreds of cases dealing with theft of property. The focus of this article will be limited to theft losses on stock investments.

[14] *See* Notice 2004-27, *supra* note 6; Rev. Rul. 77-18, *supra* note 9; Rev. Rul. 77-17, *supra* note 9; Rev. Rul. 72-112, 1972-1 C.B. 60; Rev. Rul. 71-381, 1971-2 C.B. 126; FAA 20055201F, *Doc 2006-22* [**PDF**], *2005 TNT 250-13*; *Singerman*, *supra* note 12; *U.S. v. Shoels*, 685 F.2d 379 (10th Cir. 1982); *Setauket Clothing Inc. v. North River Insurance Co.*, 1977 U.S. Dist. LEXIS 12260 (E.D.N.Y. 1977); *Paine v. Commissioner*, 63 T.C. 736 (1975), *aff'd*, *in unpublished opinion*, 523 F.2d 1053 (5th Cir. 1975); *Howard v. U.S.*, 497 F.2d 1270 (7th Cir. 1974); *Farcasanu v. Commissioner*, 436 F.2d 146 (U.S. App. D.C. 1970); *Dobyns- Taylor Hardware Co. v. U.S.*, 278 F. Supp. 538 (E.D. Tenn. 1967); *Norton v. Commissioner*, 333 F.2d 1005 (9th Cir. 1964).

[15] Other definitions of theft can be found in Rev. Rul. 72- 112, *supra* note 14 (under the laws of state X, extortion was illegal, but it did not meet the specific definition of a theft under the local law of state X; nevertheless, the IRS ruled that the taxpayer has to prove only that his loss resulted from the taking of property that is illegal under the law of the state where it occurred and that the taking was done with criminal intent); *Bagur v. Commissioner*, 603 F.2d 491 (5th Cir. 1979), *rem'g* 66 T.C. 817 (1976) (the Fifth Circuit used a broad definition of theft to hold that the non-income-earning spouse may claim a theft loss deduction for federal income tax purposes if it can be established that the income-earning spouse appropriated community income from the non-income-earning spouse for his personal use. The court explained that even though the income-earning spouse would not be prosecuted under the Louisiana statutes, courts have resorted to state law to define theft in determining whether a loss is deductible under the federal tax laws as a rule of convenience). *But see Crowell v. Commissioner,* T.C. Memo. 1986-314, in which

the court determined that the taxpayers failed to satisfy the California state law definition of a theft and disallowed the taxpayer's theft loss. The taxpayers then argued that they suffered the loss due to a federal criminal law violation. The court did *not* address whether a federal law definition of a theft was satisfied and disallowed the theft loss claim because the local law definition was not met. *Cf. First Chicago Corp.*, *supra* note 10 (Tax Court looked to the Brazilian law definition of a theft -- and not the Illinois state law definition -- when allowing the taxpayer to claim a theft loss).

[16] 61 T.C. 354 (1973), *aff'd*, 540 F.2d 448 (9th Cir. 1974). *See also Singerman*, *supra* note 12; *Crowell*, *supra* note 15.

[17] *See* Notice 2004-27, *supra* note 6; Rev. Rul. 77-17, *supra* note 9; *Crowell*, *supra* note 15; *De Fusco v. Commissioner*, T.C. Memo 1979-230; *Barry v. Commissioner*, T.C. Memo. 1978-215.

[18] 37 T.C. 504 (1961), *acq.* 1962-2 C.B. 6.

[19] *See also Russell v. United States,* 1976 U.S. Dist. LEXIS 12739 (D. Or. 1965), *rev'd on other grounds*, 592 F.2d 1069 (9th Cir. 1979), *cert. denied*, 444 US 946 (1979); *McComb v. Commissioner*, T.C. Memo. 1977-176.

[20] *See also* Rev. Rul. 77-18, *supra* note 9; FAA 20055201F, *supra* note 14.

[21] *See also* CCA 200305028, *Doc 2003-2828* [**PDF**], *2003 TNT 22-13*; *Ramsay Scarlett & Co. v. Commissioner*, 61 T.C. 795 (1974), *aff'd.* 521 F.2d 786 (4th Cir. 1975).

[22] *See also* Notice 90-21, 1990-1 C.B. 332. (Loss cannot be claimed under section 165 if a claim for reimbursement exists, such as an insurance claim. The loss cannot be deducted until there is no longer a reasonable prospect of recovery on the claim. If the taxpayer properly deducts a loss and later receives reimbursement, the taxpayer does not recompute tax for the year of the loss and instead includes the reimbursement in income for the year recovered.)

[23] Reg. section 1.165-1(d)(2)(i).

[24] 218 F.2d 639 (2d Cir. 1955).

[25] *See also* Rev. Rul. 77-18, *supra* note 9, in which a theft loss was disallowed because the taxpayer had a claim for rescission and a claim in the bankruptcy reorganization.

[26] T.C. Memo 1990-343, *aff'd*, 956 F.2d 1167 (9th Cir. 1992).

[27] *See also Ramsay Scarlett & Co.*, *supra* note 21; *Viehweg v. Commissioner*, 90 T.C. 1248 (1988); *Dawn v. Commissioner*, 675 F.2d 1077 (9th Cir. 1982).

[28] *See also Morton v. Commissioner*, 38 B.T.A. 1270 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940); *Textron, Inc. v. U.S.*, 561 F.2d 1023 (1st Cir. 1977); LTR 8528067. Those authorities address whether a taxpayer has a reasonable prospect of recovery in the context of determining whether a security has become worthless during the year for purposes of section 165.

[29] 28 B.T.A. 418 (1933), *acq.*, 1933-2 C.B. 6.

[30] *See also United States v. White Dental Mfg. Co.*, 274 U.S. 398 (1927); *Rudiger v. Commissioner*, 22 B.T.A. 204 (1931).

[31] 433 F.2d 640 (3d Cir. 1970).

[32] 351 F.2d 619 (Ct. Cl. 1965).

[33] This referred to the lower court decision, which awarded the taxpayer judgment against the bank. Indeed, judgment was awarded on a construction of New Jersey law, which defied the plain language of the statute. Accordingly, it was emphatically reversed by the Appellate Division. *Cf. Ramsay Scarlett & Co.*, *supra note 21*; *Dawn*, *supra* note 27.

[34] *See also* CCA 200451030, *Doc 2004- 23910* [**PDF**], *2004 TNT 244-55*, which concludes that "a theft loss deduction will be barred *to the extent* that a reasonable prospect of reimbursement exists. If a theft loss exceeds the claim for recovery, the *excess* would be deductible in the year the theft is discovered" (emphasis added); CCA 200305028, *supra* note 21, which concludes that "if the theft loss exceeds the claim for recovery, the excess would be deductible in the year the theft is discovered."

[35] Reg. section 1.165-8(c).

[36] *Id*. See the regulations for illustrative examples. *See also* IRS Publication 547 (2004).

[37] T.D. 6445, 1960-1 C.B. 93.

[38] *See also* Blanchard and Garlock, *supra* note 7.

[39] *See also Barry*, *supra* note 17. *Cf. J.J. Dix, Inc. v. Commissioner*, 223 F.2d 436 (2d Cir. 1955), *cert. denied*, 350 U.S. 894 (1955) (court denied taxpayer a deduction for amounts misappropriated because the taxpayer was unable to demonstrate the misappropriated amount).

[40] *See also Vietzke*, *supra* note 18; Rev. Rul. 71-381, *supra* note 14.

[41] *See also* CCA 200305028, *supra* note 21. (Investors were induced to lend money to entities that would loan money to title loan companies. Those investments turned out to be pyramid schemes. In concluding that a theft loss is allowed in the year of discovery to the extent the amount of the loss exceeds the claim for recovery, the IRS did not apply reg. section 1.165-4. It was enough that the loss was the result of theft.) *See also* CCA 200451030, *supra* note 34.

[42] *See Paine*, *supra* note 14; *MTS International, Inc. v. Commissioner*, 169 F.3d 1018, *Doc 1999- 9020*, *1999 TNT 44-64* (6th Cir. 1999); *Monteleone v. Commissioner*, 34 T.C. 688 (1960), *acq.* 1960-2 C.B. 6; *Nichols v. Commissioner*, 43 T.C. 842 (1965), *nonacq.*, 1970-2 C.B. xxi; *Morris Plan Co. of St. Joseph v. Commissioner*, 42 B.T.A. 1190 (1940), *acq.*, 1941-1 C.B. 8; Rev. Rul. 71-381, *supra* note 14; Rev. Rul. 77-18, *supra* note 9.

[43] *See also* reg. section 1.165-1(b); *Miles v. Livingstone*, 301 F.2d 99 (1st Cir. 1962).

[44] *See Richey v. Commissioner*, 33 T.C. 272 (1959); *Mazzei v. Commissioner*, 61 T.C. 497 (1974); *Lincoln v. Commissioner*, T.C. Memo. 1985-300.

[45] 92 T.C. 958 (1989), *aff'd*, 921 F.2d 280 (9th Cir. 1991).

[46] *See also* Rev. Rul. 70-333, 1970-1 C.B. 38; *Nichols*, *supra* note 42; *Viehweg*, *supra* note 27.

[47] *See also* CCA 200305028, *supra* note 21; CCA 200451030, *supra* note 34.

[48] 72 F.2d 366 (2d Cir. 1934).

[49] *Paine*, *supra* note 14; *Monteleone*, *supra* note 42; *First Chicago Corp.*, *supra* note 10.; *Vietzke*, *supra* note 18; *Franks v. Commissioner*, T.C. Memo. 1990-189; *MTS Int'l*, *supra* note 42; *Marr v. Commissioner*, T.C. Memo. 1995- 250, *Doc 95-5840*, *95 TNT 114-11*; *Jones v. Commissioner*, 24 T.C. 525 (1955), *acq.*, 1955-2 C.B. 7.

[50] *Vietzke*, *supra* note 18.

[51] *See also Denit v. U.S.*, 718 F.2d 1089 (4th Cir. 1983). In *Denit*, the Fourth Circuit reversed and remanded, without opinion, the decision in *Denit v. U.S.,* 544 F. Supp. 137 (D. Md. 1982), which had ruled that the taxpayer was not allowed a theft loss deduction because of her failure to pursue a remedy. Even though the opinion of the Fourth Circuit is unpublished, it appears that the reversal is a clear indication that a taxpayer is *not* required to pursue remedy against the perpetrator. Indeed, even the district court decision states that it is not a prerequisite to a deduction under section 165(c)(3) that the taxpayer proceed against the thief. However, the district court tried to create a new standard for the facts at issue and was reversed and remanded by the higher court on that issue.

[52] *But see Ander v. Commissioner*, 47 T.C. 592 (1967), *acq. in result only*, 1967-2 C.B. 1. *Cf. Bagur*, *supra* note 15.

[53] *Cf. Vesta Peak Denny (now Vesta Peak Maxwell) v. Commissioner*, 31 B.T.A. 894 (1934) (taxpayer could not claim a theft loss for property that the taxpayer had already abandoned); *Commissioner v. Kennedy*, 109 F.Supp. 509 (D.C. R.I. 1952) (*in dicta*, court evaluated whether the taxpayer had done "all that could [reasonably] have been required of him under the circumstances").

[54] In general, there is a $100 floor for personal theft losses. Also, the amount of the personal theft loss must exceed 10 percent of adjusted gross income.

[55] Also, a theft loss relating to section 165(c)(3) is excluded.

[56] *See* Notice 90-21, *supra* note 22.

END OF FOOTNOTES

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