

Excerpt from eBook

The IRS and Defrauded Investors - Theft Tax Loss

Introduction

Recent Cases

Taxpayer Theft Loss: Deduction Summary

Federal/California Law (Theft)

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Gary S. Wolfe has over 34 years of experience, specializing in IRS Tax Audits and International Tax Matters including: International Tax Planning/Tax Compliance, and International Asset Protection.

As of July 2016, Gary Wolfe has internationally published 15 books and 28 articles. Gary has received 14 international tax awards from five different Global expert societies in LONDON/UK including being voted one of the 100 leading world's law firms with votes from over 150,000 voters in over 160 countries with the following award: Global 100 (2016) (KMH Media Group) - CA/US International Tax Planning Law Firm of the Year.

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Chapter 1 – Introduction

Theft Loss – IRC Sec 165

Introduction

US Taxpayers who lose funds due to “fraud” may declare an income tax deduction for their theft loss in the tax year they discover the theft loss (see: IRC sec. 165(a), 165(c)(3), 165 (e) (1). For IRS audits, it is not required that the affected Taxpayer recover their “fraud losses” only that they pursue collection of their lost funds (by lawsuit, or otherwise). Under IRC Sec. 111, in the event the Taxpayer recovers any of their lost funds they must declare the recovery as income in the tax year received.

As an income tax planning strategy, a “theft loss” may generate: tax savings, tax refunds, tax-free income:

- 1) In 2015, the maximum California/Federal “blended tax rate” is approximately 55%. So if the fraud loss is \$10m, the income tax savings may be as high as \$5.5m;
- 2) Tax Refunds: Under IRC Sec. 172 (b) (1) (F), the theft tax loss may be “carried back” for 3 years (by filing form 1040x for those tax years) with any income taxes paid (during the 3 prior carry back years) subject to refund;
- 3) Tax-free Income: The Tax Loss for theft may be carried forward for up to 20 years under IRC Sec. 172, offsetting any taxable income, creating tax-free income up to the amount of the theft loss.

Theft Defined

Theft is the illegal taking of money or property with the intent to deprive the owner of it. (W. LaFave, Criminal Law section 8.5, at 721 (2d Ed. 1986)). Theft includes, but is not limited to, larceny, embezzlement, and robbery. (Reg. Section 1.165-8(d)).

California Penal Code Section 484(a)

Taxpayer is a resident of the State of California. Under State Law, California Penal Code Section 484(a) theft is defined to include fraud:

Every person who shall feloniously steal, take, carry, lead, or drive away the personal property of another, or who shall fraudulently appropriate property which has been entrusted to him or her, or who shall knowingly and designed by, any false or fraudulent representation or pretense, defraud any other person of money, labor or real or personal property, or who causes or procures others to report falsely of his or her wealth or mercantile character and by thus

imposing upon any person, obtains credit and thereby fraudulently gets or obtains possession of money, or property or obtains the labor or service of another, is guilty of theft.

Federal Law

Gerstell v. Commissioner of IRS (Federal Law)

In the case of Gerstell (Petitioner) v. Commissioner of Internal Revenue (Respondent) 46 T.C. 161 (Docket No. 4299-64, filed May 4, 1966) (Exhibit “2”), the Tax Court States (at Page 7):

Section 165 of the Internal Revenue Code of 1954 provides for the deduction of losses arising from theft. The term Theft . . . converting 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.

Edwards v. Bromberg (C.A. 5) 232 F. 2d 107, Perry A. Nichols, 43 T.C. 842 (appeal dismissed C.A. 5) See also Sec. 1.165-8(d), Income Tax Regs. The parties are not at odds on this respect. Indeed, the Respondent concedes on brief that losses sustained by reason of criminally false pretenses are deductible under Section 165 of the Code.

Whether a loss arises from theft depends upon the law of the jurisdiction where the loss was sustained. Edwards v. Bromberg, supra.

And it has been held that a criminal conviction is not a necessary element in a Taxpayer’s proof that a theft loss has been sustained.

See: Michele Montelone 34 T.C. 688, Paul C.F. Vietzke 37 T.C. 504

Statement of Law: Theft Losses (Summary)

IRC § 165(a) provides as a general rule that “any loss sustained during the taxable year” may be deducted if it is not compensated for by insurance or otherwise. Section 165(a), however, limits this broad rule by restricting an individual’s deductions to:

1. Losses incurred in a trade or business or a transaction entered into for profit; and
2. Losses “from fire, storm, shipwreck, or other casualty, or from theft.”

Effect of Prospect Recovery

Like any loss, a theft loss is not deductible while there is a reasonable prospect of recovery or reimbursement. Reg. Section 1.165-1(d)(3). Whether there is a reasonable prospect of recovery or reimbursement is a question of fact based on all facts and circumstances. Reg. Section 1.165-1(d)(2)(i). For example, where the thief was hopelessly insolvent in the year the theft was

discovered, the taxpayer had no reasonable prospect of recovery or reimbursement. *IRS v. Price*, No. 93-C-104-E (N.D. Okla. Mar. 10, 1994).

A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and there is a substantial possibility that such claims will be decided in his favor. *Ramsay Scarlett & Co. v. Commissioner*, 61 T.C. 795 (1974). Therefore, for example, where a contractor performed poor workmanship and this poor workmanship was a theft of the taxpayer under state law, the taxpayer had a reasonable prospect of recovery because the taxpayer could have withheld future contractual payments to the contractor, the taxpayer had the right to require the contractor to correct the poor workmanship, and the taxpayer could have sued the contractor. *Davis v. Commissioner*, T.C. Memo. 2005-160.

Claims for recovery whose potential for success are remote or nebulous will not lead to a postponement of the deduction. *Ramsay Scarlett & Co. v. Commissioner*, 61 T.C. 795 (1974).

For example, a lawsuit with a ten percent chance of recovery might be justified on grounds of principle, but that does not mean that the lawsuit provides a reasonable prospect of recovery; the inquiry should be directed to the probability of recovery as opposed to the mere possibility. *Jeppsen v. Commissioner*, 128 F.3d 1410 (10th Cir. 1997). Whether taxpayer later wins the lawsuit is not a factor, because the analysis is made in the year the theft is discovered. *Rainbow Inn v. IRS*, 433 F.2d 640 (3rd Cir. 1970).

In the year of discovery, a reasonable prospect of recovery or reimbursement delays the deduction only with respect to the portion of the loss for which there is a reasonable prospect of recovery or reimbursement. Any excess (i.e., the portion of the loss that does not have a reasonable prospect of recovery or reimbursement) is deductible in the year of discovery. Reg. Section 1.165-1(d)(2)(i).

A reasonable prospect of recovery or reimbursement postpones the deduction until the year in which it can be ascertained with reasonable certainty whether or not the recovery or reimbursement will be received. Reg. Section 1.165-1(d)(3). Therefore, the taxpayer must wait to take the theft loss deduction until the recovery process is finalized either through adjudication, a settlement, the taxpayer abandoning her collection efforts, or until the claim for reimbursement is resolved in some other way. (See *Johnson v. United States*, Nos. 01-428T, 03-2803T, 05-1265T (Fed. Cls. Dec. 21, 2006); *Cramer v. Commissioner*, 55 T.C. 1125 (1971), acq., 1971-2 C.B. 2). However, taxpayers not required to wait until the time when the total amount of recovery is determined; a theft loss deduction may be taken for any portion that the taxpayer is reasonably certain will not be recovered. *Johnson v. United States*, Nos. 01428T, 03-2803T, 05-1265T (Fed. Cls. January 9, 2008).

A taxpayer who properly claims a theft loss and subsequently receives reimbursement or recovers the stolen property must recognize income in the year of recovery, subject to limits of

the tax benefit rule of Code Section 111. Under the tax benefit rule of Code Section 111, a recovery is includible in income to the extent the prior loss deduction reduced taxable income.

Taxpayers claiming casualty and theft losses must file Form 4684, Casualties and Thefts, with their tax returns to claim the deduction. The IRS has also made available two workbooks, IRS Publication 584, Casualty, Disaster, and Theft Workbook, and IRS Publication 584B, Business Casualty, Disaster, and Theft Workbook, which contain schedules used to compute personal and business casualty and theft losses, respectively.

Chapter 2 – Recent Cases

1. The Urtis Case - Real Estate Fraud

Under the case Urtis, TC Memo. 2013-66, the taxpayer sued in support of their theft loss, which was granted by the U.S. Tax Court.

In Urtis, taxpayers were the victims of a builder's fraud. The taxpayers paid a builder \$400,000 to expand their residence. The builder didn't finish the work and used nearly half the funds for other jobs, before suddenly dying.

Taxpayers sued the builder to recoup their loss, but under his insurance they were only able to recover a small portion of it. The Tax Court ruled that the balance of their loss is deductible as a theft loss because "the contractor knowingly deceived them". In this case, the taxpayers' theft loss was established by the filing of a lawsuit (there is no IRS requirement that a lawsuit be filed to establish a theft loss).

The taxpayer must reduce the loss by \$500, and then they can deduct the balance on Schedule A to the extent it exceeds 10% of the AGI.

2. Theft Loss (2014)

In *Hawaii v Commr* T.C Memo 2011-134 (June 15, 2004), Taxpayer failure to timely sue defendant in the year of the theft loss (2005) precluded a tax deduction in the year of the loss (2005).

In 2005, Taxpayer instructed his lawyer to sue defendant for fraud on his investment. The complaint was never filed. Taxpayer did not sue until 2009.

The IRS position was that the lawsuit in 2009 precluded a tax loss in 2005 because the lawsuit was evidence that as late as 2009, there was a reasonable prospect of recovery, which postponed the theft loss deduction until the time the reasonable prospect of recovery no longer existed (2009).

Based on the ruling in the Hawaii case the theft loss deduction was not taken until 2009 (a 4 year delay from the year of the theft loss (2005)).

Chapter 3 – Taxpayer Theft Loss: Deduction Summary

Losses due to theft are generally deducted as a theft loss under Code Section 165(c)(3). Losses due to theft involving a transaction entered into for profit are instead deducted under Code Section 165(c)(2), which contains fewer limitations on the amount that may be deducted. Rev. Rul. 2009-9, 2009-14 I.R.B. 735, modifying Rev. Rul. 71-381, 1971-2 C.B. 126.

Like all theft losses, a theft loss involving a transaction entered into for profit is deductible in the year the loss is discovered, provided that the loss is not covered by a claim for reimbursement or recovery with respect to which there is a reasonable prospect of recovery.

The amount of the theft loss is generally the amount invested in the arrangement, reduced by amounts withdrawn, by reimbursements and recoveries, and by claims as to which there is a reasonable prospect of recovery.

Where an amount is reported to the investor as income prior to discovery of the theft and the investor includes that amount in gross income and reinvests this amount in the arrangement, the amount of the theft loss is increased by the reinvested amount. Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

IRC §165(c)(2) (Theft Loss)

Unlike other theft losses, IRC §165(c)(2) theft losses due to a transaction entered into for profit are not limited to losses that exceed \$500 (2009) or to losses that exceed 10 percent of the taxpayer's adjusted gross income. Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

Unlike other theft losses, theft losses due to a transaction entered into for profit are not subject to the 10% AGI limit for itemized deductions. Similarly, the losses are not subject to the 2-percent of adjusted gross income limit for miscellaneous itemized deductions. Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

Generally, a net operating loss (NOL) can be carried back up to two years and forward up to 20 years, but eligible small businesses can elect to carry back 2008 NOLs three, four, or five years. Code Section 172.

A special rule applicable to theft losses allows individuals to carry back the theft loss for up to three years. Code Section 172(b)(1) (F).

Theft losses must be deducted in the year the theft is discovered (Treas. Reg. Sec. 1.165-8(a)(2)).

Chapter 4 – Federal/California Law (Theft)

1. Gerstell v. Commissioner of IRS (Federal Law)

In the case of Gerstell (Petitioner) v. Commissioner of Internal Revenue (Respondent) 46 T.C. 161 (Docket No. 4299-64, filed May 4, 1966) (Exhibit “2”), the Tax Court States (at Page 7):

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And it has been held that a criminal conviction is not a necessary element in a Taxpayer’s proof that a theft loss has been sustained.

See: Michele Montelone 34 T.C. 688
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Rev. Rul. 72-112, 1972-1 C.B. 60: (“Thus, to qualify as a “theft” loss within the meaning of IRC §165(c)(3), the taxpayer needs only to prove that his loss resulted from a taking of property that is illegal under the law of the State where it occurred . . .”).

2. California Penal Code Section 484(a) (California Law)

Under State Law, California Penal Code Section 484(a) theft is defined to include fraud:

Every person who shall feloniously steal, take, carry, lead, or drive away the personal property of another, or who shall fraudulently appropriate property which has been entrusted to him or her, or who shall knowingly and designed by, any false or fraudulent representation or pretense, defraud any other person of money, labor or real or personal property, or who causes or procures others to report falsely of his or her wealth or mercantile character and by thus imposing upon any person, obtains credit and thereby fraudulently gets or obtains possession of money, or property or obtains the labor or service of another, is guilty of theft.

