

Excerpt from eBook

The IRS and Defrauded Investors - Theft Tax Loss

Theft Losses History (IRC Sec 165)

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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.

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Chapter 6 – Theft Losses History (IRC Sec 165)

Under § 165(e), enacted in 1954, a loss from theft is deductible when “the taxpayer discovers such loss.” The pre-1954 regulations provided that a loss from theft or embezzlement was “ordinarily” deductible for the year in which it was “sustained.” Saying that “ordinarily does not mean always,” the Supreme Court allowed the taxpayer in *Alison v. United States*, decided in 1952, to deduct his loss in the year an embezzlement was discovered where he was unable, despite a painstaking investigation, to establish either the identity of the embezzler or the years of the defalcations. (*Alison v. US*, 344 US 167, 170 (1952).)

In a companion case, the Court held that a deduction in the year of discovery was also proper for a taxpayer whose discovery of the embezzlement came after the statute of limitations had run on filing amended returns for some of the years in which the funds had been taken. (*Stevenson-Chislett, Inc. v. US*, 344 US 167 (1952).)

Congress enacted § 165(e) to provide that a loss arising from “theft” shall be “treated as sustained during the taxable year in which the taxpayer discovers such loss.”

Theft losses are often discovered contemporaneously with the crime, but discovery may be long delayed, as in the case of embezzlement by a trusted employee. Although § 165(e) refers to when “the taxpayer” discovers the loss, a loss “is considered to be discovered when a reasonable man in similar circumstances would have realized the fact that he had suffered a theft loss. (*McComb v. CIR*, 36TCM(CCH) 725 (1977).)

A result of the 1954 Tax Act is that if income is not reported when received because it is embezzled, a deficiency can be assessed for the year of receipt that cannot be offset by a deduction for the theft, which must be taken for the later year, when the loss is discovered. (See, *Asphalt Indus., Inc. v. CIR*, 411 F.2d 13 (3rd Cir. 1969).)

Moreover, if the malefactor promises to make restitution, the loss is “compensated for” and a deduction is not permitted unless and until the commitment to repay is breached.

(*George M. Still, Inc. v. CIR*, 218 F.2d 639 (2nd Cir. 1955). See, *Scofield’s Est. v. CIR*, 266 F.2d 154 (6th Cir. 1959) [under pre-1954 law, litigation against embezzlers postponed deduction until year of settlement]. For treatment of the embezzler in this situation, see, *Mannette v. CIR*, 69 TC 990 (1978) [deduction allowed for repayment under § 165(c)(2) – transaction entered into for profit], but net operating loss carryback not permitted.)

When enacted in 1913, the statutory predecessor of § 165(c)(3) referred only to fire, storm, and shipwreck, but it was amended in 1916 to embrace loss from “other casualty, and from theft.” Under § 165(e), however, theft losses are deductible only when “discovered,” and some thefts (e.g., embezzlement by a trusted employee) are sometimes not discovered until long after the loss occurs. (See, *Marine v. CIR*, 92 TC 958 (1989) [investment through theft of

promoter/general partner, discovery occurred when taxpayers discovered loss resulted from theft rather than from promised tax shelter, not when tax shelter loss was deducted; discovery by general partner not imputed to limited partner]).

Under IRC §165(c) theft implies that fraud, misrepresentation, and similar commercial misconduct do not give rise to deductions under § 165(c)(3) unless sufficiently flagrant enough to be “theft.” (See, *MTS Int’l, Inc. v. CIR*, 169 F.3d 1018 (6th Cir. 1999) [loss on sale of publicly traded stock not deductible as theft loss merely because stock crashed on discovery of corporate fraud; no theft under governing Kentucky law because, among other things, corporate officers who perpetrated fraud were not parties to taxpayer’s purchase or sale]; *Krahmer v. US*, 810 F.2d 1145 (Fed. Cir. 1987 [of two paintings purchased from dealer, one was forged and other misattributed; held, no theft in absence of evidence that dealer intended to defraud]; *Hope v. CIR*, 471 F.2d 738 (3rd Cir. 1973) [allegations of fraud in stock sale amounting to criminal false pretenses under state law and mail fraud under federal law not proved]’ *Schonhoff v. CIR*, 22 TCM (CCH) 1072 (1963) [taxpayer paid \$8,825 to dancing studio on implied representation he could “date” instructors; held, no theft loss even though no dates].)

Treasury regulations construe theft to include (without necessarily being limited to) larceny, embezzlement, and robbery. (Reg. § 1.165-8(d). See, *Edwards v. Bromberg*, 232 F.2d 107, 110 (5th Cir. 1956) [“theft” not technical word of art but term of general and broad connotation “covering any criminal appropriation of another’s property to the use of the taker”]; *Farcasanu v. CIR*, 50 TC 881 (1968) (acq.), *aff’d per curiam*, 436 F.2d 146 (DC Cir. 1970) [“theft” does not include confiscation by foreign government, no matter how arbitrary or despotic].)

“Theft” includes any “felonious taking of money or property by which a taxpayer sustains a loss, whether defined and punishable under the penal codes of the states as larceny, robbery, burglary, embezzlement, extortion, kidnapping for ransom, threats, or blackmail. (Rev. Rul. 72-112, 1972-1 CB 60 [ransom extorted by kidnappers]; This ruling implicitly rejects the contrary holding of *Bonney v. CIR*, 247 F.2d 237 (2nd Cir.), *cert. denied*, 355 US 906 (1957) [payments to former wife to terminate derogatory accusations not deductible; “theft” does not include extortion].)

Rev. Rul. 72-112 excludes non-criminal fraud. (See, *Mullins v. CIR*, 33 TCM (CCH) 912 (1974) [alleged misconduct by warehouseman in selling stored goods without compliance with local civil statute not theft]; *Buck v. CIR*, 26 TCM (CCH) 147 (1967) [surrender of shares by corporate officer under pressure not loss by theft; no evidence of criminal act]; *Leet v. CIR*, 14 TCM (CCH) 39 (1955), *aff’d per curiam* on other grounds, 230 F.2d 845 (6th Cir. 1956) [alleged swindle and misrepresentation by automobile manufacturer not theft].)

Investors allegedly defrauded by promoters of tax avoidance schemes, for example, usually are not allowed to deduct their losses as theft losses. (See, *Melcher’s Est. v. CIR*, 476 F.2d 398 (9th Cir. 1973) [theft loss deduction denied for out-of-pocket cost of failed tax shelter; no evidence taxpayer was deceived about nature of transaction]; *Jones v. US*, 96-1 USTC ¶ 50,136 (ND Cal.

1996) [not officially reported] [same]; *Marine v. CIR*, 92 TC 958, 978 (1980) [tax shelter investors not theft victims because they “received exactly what they bargained for – title to a ... building with no down payments and claims to tax deductions greatly exceeding their cash investment”]; *Horn v. CIR*, 90 TC 908, 941 (1988) [same; taxpayer’s “greedy quest for tax write-offs is as much responsible for their predicament as is the unscrupulous action of the promoters and their tax advisors”]. *West v. CIR*, 88 TC 152 (197) [same]; *Luman v. CIR*, 79 TC 846 (1982) [no theft loss deduction for amounts paid for forms and assistance in establishing family trust].

In *Gerstell v. CIR*, 46 TC 161 (1966) [misrepresentation of value of contracts in connection with tax-avoidance scheme was cheating by false pretenses under state law, deductible as “theft”]. The issue of theft usually arises in these cases after the loss has been found ineligible for deduction under § 165(c)(2) for lack of a profit motive.)

Theft claims by securities investors claiming to have purchased in reliance on faulty financial statements also do not usually succeed. (Compare, *Paine v. Cir*, 63 TC 736, aff’d by unpublished opinion (5th Cir. 1975) [no theft from taxpayer who purchased shares on public exchange when price was inflated by fraudulent financial statements issued by corporate officers] and Rev. Rul. 77-18, 1977-1 CB 46 [theft loss where shareholders of acquired corporation were induced to vote for merger by acquiring corporation’s warranty of false financial statements]. See also, *Lombard Bros. V. US*, 893 F.2d 520 (2nd Cir. 1990) [no theft when investment manager made risky investments on taxpayer’s behalf and misrepresented losses]; *Bellis v. CIR*, 540 F.2d 448 (9th Cir. 1976) [sale of unregistered stock was criminal but not “theft” absent showing of intent to deprive purchasers of their property].)

Closely held corporations whose shareholders divert unreported corporate income to personal use sometimes try to establish a theft loss to offset the unreported income by claiming that the shareholders embezzled the funds, but these claims usually fail. (See, *Ulster Tool & Die Corp. v. US*, 529 F.Supp. 108 (SDNY 1981) [summary judgment denied on theft loss claimed for embezzlement by 50 percent shareholder because promise to repay raised factual issue of whether loss sustained]; *Brown Corp. v. CIR*, 45 TCM (CCH) 200 (1982) [taxpayer consented to sole shareholder’s use of funds]; *MJ Laputka & Sons, Inc. v. CIR*, 43 TCM (CCH) 177 (1981) [no theft loss because shareholders merely stole from themselves]; *Ace Tool & Eng’g, Inc. v. CIR*, 22 TC 833 (1954) [alleged embezzlement by controlling shareholders not established].)

A denial of a theft loss under § 165(c)(3) is not final because the taxpayer may be able to deduct the loss under § 165(c)(1) or § 165(c)(2) (losses in trade or business or in transactions entered into for profit) if it is evidenced by a closed transaction. The taxpayer may treat the misconduct as creating a debt from the malefactor, which can be deducted if and when it becomes worthless. (Bad debt losses arising in this fashion are usually short-term capital losses rather than deductions from ordinary income.)

If the taxpayer’s property disappears mysteriously, theft may be inferred if it is a more reasonable explanation for the loss than any other. (See, *Jacobson v. CIR*, 73 TC 610, 613 (1979)

[personal belongings disappeared from house after taxpayer left on separation from husband; “if the reasonable inferences from the evidence point to theft rather than mysterious disappearance, petitioner is entitled to a theft loss”]; *Jungert v. CIR*, 27 TCM (CCH) 555 (1968) [unexplained disappearance of \$36,000 cash left on seat of taxpayer’s auto]; *Jones v. CIR*, 24 TC 525 (1955) (acq.) [disappearance of jewelry from locked box to which taxpayer’s maid had access, where loss coincided with maid’s departure from employment]. See also, Rev. Rul. 72-592, 1972-2 CB 101 [“casualty” includes accidental and irretrievable loss of property, but “mislaidd” property is not necessarily permanently lost unless theft can be inferred]. But see, *Smith v. CIR*, 10 TC 701 (1948) [mere disappearance of thoroughbred bird dog is not sufficient evidence of theft]; *Sussel v. CIR*, 25 TCM (CCH) 1241 (1966) [theft not inferred where bracelet missing from luggage while staying at transient hotel where theft by hotel personnel was common].)

The Tax Court has held that a theft loss is deductible even though the thief’s efforts to cover up his tracks causes the taxpayer to inadvertently take some other allowance for the loss. In *B.C. Cook & Sons, Inc. v. CIR*, the taxpayer’s bookkeeper embezzled funds over a period of years and hid the theft by recording the embezzled amounts in the taxpayer’s books as costs of inventory purchases, causing an overstatement of costs of goods sold and a reduction of gross income. (*BC Cook & Sons, Inc. v. CIR*, 59 TC 516 (1972) [nonacq.])

The Tax Court held that this reduction did not bar the taxpayer from deducting the loss when discovered. The IRS could eliminate the double counting, the court held, only by restating gross income for the years of the theft and eliminating the fraudulent entries in computing the costs of goods sold. Since the statute of limitations can easily run on the years of the theft before the theft is discovered (see, *BC Cook & Sons, Inc. v. CIR*, 65 TC 422 (1975) [nonacq.], *aff’d per curiam*, 584 F.2d 53 (5th Cir. 1978) [statute of limitations not lifted by mitigation rules]), the IRS rejects the Tax Court’s approach, holding that the inclusion of the stolen amount in computing a tax allowance for the year of the theft, even if inadvertent and caused by the wrongdoer’s defalcations, bars a theft loss deduction. (Rev. Rul. 81-207, 1981-2 CB 57. See, *Stahl Specialty Co. v. US*, 551 F.Supp. 1237 (WD Mo. 1982) [following IRS position]. See also, Reg. §1.165-8(e) [theft loss provisions do “not apply to a theft loss reflected in the inventories of the taxpayer].)

