Treat as a Theft Loss or a Capital Loss?

By Anthony J. Cataldo

THE ENRON, TYCO, WORLDCOM, AND ANDERSEN cases, which led to criminal charges and convictions, have raised some interesting tax planning questions for those taxpayers realizing significant losses from these securities in their taxable portfolios. As the statute of limitations approaches (for those taxpayers who filed their 2000 calendar-year returns on extension), an aggressive tax planning option has surfaced that treats losses from these securities as being the result of theft rather than capital losses. (See Eva Rosenburg, "When are stock losses theft?" published by cbs.marketwatch.com, February 13, 2004, and "StockGate: Could Short Seller Victims File Theft Losses Instead of Capital Losses?" published by financial wire.net, February 17, 2004.) If a stock loss more clearly represents a theft loss—which allows the taxpayer to avoid the $3,000-per-year net capital loss (NCL) limitation—which taxpayers are likely to benefit, given the 10% adjusted gross income (AGI) exclusion for theft and casualty losses?

The implications of this issue may reach further than you might initially expect. More than 100 small- and micro-cap firms have filed complaints, alleging market maker manipulation and "naked shorting" of their firm's securities. (Naked shorting can be described as the sale of securities for which no offsetting long shares are available for the broker-dealer to borrow, effectively counterfeiting and selling a firm's securities.) If some of these naked shorting allegations are proved and result in criminal convictions similar to the Enron, WorldCom, etc., cases mentioned above, taxpayers may argue that these losses also represent theft. These complaints already have prompted the National Association of Securities Dealers to implement a new global affirmative-action rule (effective April 1, 2004), which stipulates that broker-dealers must ensure that shares in short-sale transactions can be delivered by settlement time three days later. At the same time, the Securities & Exchange Commission continues to be overwhelmed by public comments to its proposed Regulation SHO, which seeks to set new standards for short sales. Both measures are expected to contribute to the restoration of investor confidence.

Who Cares?

A preliminary examination provides some insight into just how many taxpayers might benefit from approaching the situation as a theft loss rather than as a capital loss. Though these estimates are just that—estimates—some percentage of these taxpayers are likely to benefit and, therefore, may choose to do the research necessary to support filing an amended return (or returns).

Table 1 provides a summary of individual taxpayers reporting short- and long-term capital losses for the 2001 calendar year, as broken down by mean AGI class (e.g., $2,500 is the mean, or average, of the $1 to $5,000 AGI class). The mean capital loss per return is also computed, and two alternatives are presented.

Taxpayers that itemize may deduct "casualty and theft" losses on their Form 1040, Schedule A, but these amounts are subject to a 10% AGI exclusion and a $100-per-item reduction. Alternative #1 represents the amount available to the taxpayer after the 10% AGI exclusion. At least three of the higher AGI classes wouldn't benefit, as negative

Table 1: Short- and Long-Term Capital Losses—2001

Mean AGI	Aggregate (billions)	# Returns (thousands)	per Return	Exclude 10% AGI	Alternative #1 10% Surplus	Alternative #2 Less: $3K	Note*
$ -0-	$ 29.95	772.25	$ 38,786	$ -0-	$ 38,786	$ 35,786	D
$ 2,500	$ 6.65	629.06	$ 10,571	$ 250	$ 10,321	$ 7,571	B
$ 7,500	$ 7.95	624.61	$ 12,734	$ 750	$ 11,984	$ 9,734	B
$ 12,500	$ 6.66	540.42	$ 12,333	$ 1,250	$ 11,083	$ 9,333	B
$ 17,500	$ 7.09	590.06	$ 12,019	$ 1,750	$ 10,269	$ 9,019	B
$ 22,500	$ 6.89	521.77	$ 13,207	$ 2,250	$ 10,957	$ 10,207	B
$ 27,500	$ 5.78	525.33	$ 11,012	$ 2,750	$ 8,262	$ 8,012	B
$ 35,000	$ 13.20	1,092.92	$ 12,073	$ 3,500	$ 8,573	$ 9,073	B
$ 45,000	$ 12.70	1,096.91	$ 11,582	$ 4,500	$ 7,082	$ 8,582	B
$ 62,500	$ 33.64	2,595.08	$ 12,964	$ 6,250	$ 6,714	$ 9,964	B
$ 87,500	$ 24.58	1,930.78	$ 12,728	$ 8,750	$ 3,978	$ 9,728	B
$ 150,000	$ 50.96	2,982.24	$ 17,089	$ 15,000	$ 2,089	$ 14,089	B
$ 350,000	$ 44.45	1,192.61	$ 37,272	$ 35,000	$ 2,272	$ 34,272	C
$ 750,000	$ 21.73	280.91	$ 77,369	$ 75,000	$ 2,369	$ 74,369	C
$1,250,000	$ 9.07	72.39	$ 125,366	$ 125,000	$ 366	$ 122,366	C
$1,750,000	$ 5.25	31.25	$ 168,093	$ 175,000	NEGATIVE	$ 165,093	A
$3,500,000	$ 11.34	44.65	$ 253,995	$ 350,000	NEGATIVE	$ 250,995	A
$7,500,000	$ 5.82	10.40	$ 559,662	$ 750,000	NEGATIVE	$ 556,662	A
over $10M	$ 11.83	5.52	$2,141,463	$1,000,000	$1,141,463	$2,138,463	D
Total	$315.57	15,539.17	$ 20,308				

Where:
Note A = negative NCL after the 10% AGI exclusion
Note B = less than $30,000 in NCLs
Note C = modest amounts of potential "theft" loss after the 10% AGI exclusion
Note D = likely beneficiaries from the "theft"-loss strategy.

Table adapted from D. Campbell, M. Parisi, IRS, *Statistics of Income Bulletin, Individual Income Tax Returns, 2001* (Publication 1136; Rev. 12-03), Fall 2003, pp. 25-26.

amounts would result after the exclusion (Note A). These taxpayers are likely to avoid the less traditional theft-loss approach.

Both itemizer and nonitemizer taxpayers may deduct a maximum of $3,000 NCLs per year. Alternative #2 represents the amount available to the taxpayer after the first year's $3,000 NCL deduction.

Many alternative simulations could be developed. Selecting $30,000 in NCL carry-forward as an arbitrary breakpoint provides the reader with some test of reasonableness of the theft-loss approach. For the purpose of this column, therefore, taxpayers with $30,000 or less in NCLs are presumed to be unlikely candidates for the more aggressive theft-loss deduction, so they probably will choose the less aggressive path of carrying forward and applying NCLs in future tax years (Note B). Furthermore, taxpayers with only modest NCLs after the 10% AGI exclusion for casualty and theft losses may also select the traditional option (Note C).

The greatest beneficiaries of the theft-loss strategy would appear to be taxpayers in the "zero" (or negative) and the "over $10 million" AGI classes (Note D). These groups represent slightly more than 5% (777,776) of the 2001 individual federal income tax returns filed with short- and long-term capital losses (772,253 in the "zero" AGI class and 5,523 in the "over $10 million" AGI class).

Table 1 ignores tax bracket differentials and only represents an approximation of the likely beneficiaries of the proposed departure from NCL carry-forward treatment and adoption of the casualty and theft loss strategy. This analysis should be helpful to both affected taxpayers and tax practitioners considering the aggressive casualty and theft deduction option…or its avoidance. ■

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