Anthony P. Curatola, Editor
By Diane Riordan, CMA, and Michael Riordan

Theft Loss Deductibility

IRC §165(c)(3) allows taxpayers to take deductions for losses related to theft of their property. Recent events may have an effect on some of the situations under which an individual can claim a theft loss deduction.

Is there a deduction for a loss from theft in your future? The answer to this question is changing due to recent court decisions and IRS pronouncements.

Section 165(a) of the Internal Revenue Code of 1986, as amended, provides the general rule that "There shall be allowed as a deduction any loss sustained during the taxable year not compensated for by insurance or otherwise." IRC §165(c)(3) specifically includes losses of an individual's property due to theft.

In *Edwards v. Bromberg* [49 AFTR 856 (232 F. 2d 107) (1956)], the U.S. Court of Appeals for the Fifth Circuit described "theft" as a word with broad connotation, intended to cover "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." Regulation §1.165-8(d) provides that the term "theft" shall include but not be limited to larceny, embezzlement, and robbery.

In the case of ransom payments, the IRS has ruled that a taxpayer claiming a theft loss "needs only to prove that the loss resulted from a taking of property that is illegal under the law of the state in which it occurred and that the taking was done with criminal intent" (Revenue Ruling 72-112, 1972-1 C. B. 60). When localities fear a source of fraudulent behavior from providers of certain services, such as fortune telling and psychic advising, they may enact specific ordinances prohibiting these exchanges.

In 1990, a taxpayer was successful in securing a casualty theft loss deduction for payments to fortune tellers (Kreiner, George John TC Memo 1990-587). The taxpayer gave money to two advisors for information to solve his problems. At their urging, the petitioner also made contributions to a church to ward off evil spirits. In 1988, after watching a television program on the crime of fortune telling, the taxpayer complained to the State of New York Commission of Investigation. The taxpayer prevailed in his tax deduction claimed in an earlier year because fortune telling for profit constituted a misdemeanor under New York law. Of course, not all fortune tellers are engaged in thievery. Whether or not a theft has occurred is a question of whether the practice is specifically banned or whether the advisors take financial advantage of the client.

An Associated Press story from September 7, 2008, reported that there's a great deal of flux across the country in the enactment, enforcement, and repeal of various prohibitions related to fortune telling and psychic advising (*Washington Post*, p. A16). In 2008, St. Johnsbury, Vt., lifted an ordinance prohibiting certain services that attempted to reveal future events by psychic powers or to restore lost goods or relationships. Though the ordinance wasn't enforced, an opponent claimed it acted to outlaw her practice of *feng shui*, the Chinese art of harmonizing one's environment for health and financial benefits. Bans on psychics in Lincoln, Neb., and in Livingston Parish, La., were successfully challenged in federal courts of appeal for various reasons.

Taxpayers often charge misrepresentation after a loss from a bad business deal or investment. More often than not, however, bad business deals don't qualify for the casualty theft deduction. For example, in the case of George Klooster-house (TC Memo 1981-481), the Tax Court found that the taxpayer

failed to prove the crimes of obtaining property under false pretenses or larceny under Maryland law. The Court determined that the taxpayer had simply made a bad investment in an unprofitable business. In this case, the petitioner was allowed to treat the losses as having arisen from worthless stock and worthless nonbusiness debts as provided under IRC §§165(g) and 166.

In addition to the existence of fraudulent behavior, the character of an investor's loss—theft or capital loss—may depend on the nature of the investment. A loss that's sustained on the value of stock of a legitimate corporation acquired on the open market for investment is treated as a capital loss deduction even if the corporation's officers behaved fraudulently because the officers didn't have the intent to deprive the shareholder of money or property and didn't take possession of taxpayers' property (Revenue Ruling 77-17, 1977-1 C.B. 44). Under this rationale, an investor in Enron stock would be entitled to a capital loss deduction, not a theft deduction.

The issue of bad investments from misrepresentation has been highlighted in the facts surrounding the Bernie Madoff case. In Revenue Ruling 2009-9 [2009-14 IRB 735 (3/17/2009)], the IRS has ruled that taxpayers investing in "Ponzi-like" schemes suffer losses from theft and not from poor investments, and, because the transactions are entered into for profit, the losses sustained aren't subject to the limitations of IRC §165(h).

In the Ponzi scheme described in Revenue Ruling 2009-9, the advisor purported to invest cash or property on behalf of each investor in an account in the investor's name. For each investor's account, the advisor reported investment activities that were partially or wholly fictitious. In some cases, payments were made, at least in part, from amounts that other investors had invested in the fraudulent arrangement. The advisor's actions constituted criminal fraud or embezzlement under the laws of the jurisdiction in which the transactions occurred. The IRS therefore ruled that the loss from these investments is a theft loss.

In *James G. and Elaine A. Wanchek v. Commissioner* (TC Memo 2007-366), the Tax Court denied the taxpayers' deduction for a theft loss of $172,904 from their home construction contractor's alleged fraud and misrepresentations. The taxpayers, despite problems described as a "living nightmare," didn't prove the contractor acted with intent to commit a crime within the meaning of fraud under New Mexico law, which requires intentional misappropriation by means of fraudulent conduct. The Court stated that, in the few cases in which it has allowed theft loss deductions in connection with contract work, the contractors took money under false pretenses and then either absconded or ceased construction and used the money for other purposes—described by the court as "take the money and run" situations.

Other cases in which the taxpayer was successful can be described as the perpetrators having "taken the money and run." In the wagering scheme in *Edwards v. Bromberg, supra*, bets were never placed. In Paul C. F. Vietzke [37 TC 504], the dealers selling the investment weren't licensed, and the securities weren't registered. The victim was swindled in a scheme sufficient to constitute a theft under Indiana law.

In the case of a loss arising from theft, Reg. §§1.165-8(a)(2) and 1.165-1(d)(3) provide that, if during the year of discovery of the theft there exists a claim for reimbursement with a reasonable prospect for recovery, no portion of the loss for which reimbursement may be received is sustained until there's reasonable certainty that the reimbursement won't be received. This restriction may prohibit or postpone the loss deduction. In addition, for 2009 under §165(h), personal casualty losses described in IRC §165(c)(3) will be allowed to the extent they exceed $500. The offset is usually $100. This limit, as well as the 10% floor, won't apply in the case of theft resulting from Ponzi schemes because these investors entered into the transactions with a profit motive. In addition, Revenue Procedure 2009-20 (IRB 2009-14, April 6, 2009) provides specific guidance and safe harbors for the deduction of theft losses resulting from Ponzi-type schemes. **SF**

Diane Riordan, CMA, Ph.D., and Michael Riordan, Ph.D., are accounting professors at James Madison University's School of Accounting in Harrisonburg, Va. Diane is also a member of IMA's Virginia Skyline Chapter. Diane can be reached at riordada@jmu.edu, and Michael can be reached at riordamp@jmu.edu.