Part I

Section 165.—Losses.

26 CFR: § 1.165-8: Theft losses.
(Also: §§ 63, 67, 68, 172, 1311, 1312, 1313, 1314, 1341)

Rev. Rul. 2009-9

ISSUES

(1) Is a loss from criminal fraud or embezzlement in a transaction entered into for profit a theft loss or a capital loss under § 165 of the Internal Revenue Code?

(2) Is such a loss subject to either the personal loss limits in § 165(h) or the limits on itemized deductions in §§ 67 and 68?

(3) In what year is such a loss deductible?

(4) How is the amount of such a loss determined?

(5) Can such a loss create or increase a net operating loss under § 172?

(6) Does such a loss qualify for the computation of tax provided by § 1341 for the restoration of an amount held under a claim of right?

(7) Does such a loss qualify for the application of §§ 1311-1314 to adjust tax liability in years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511?

FACTS

A is an individual who uses the cash receipts and disbursements method of accounting and files federal income tax returns on a calendar year basis. B holds himself out to the public as an investment advisor and securities broker.

In Year 1, A, in a transaction entered into for profit, opened an investment account with B, contributed $100x to the account, and provided B with power of attorney to use the $100x to purchase and sell securities on A's behalf. A instructed B to reinvest any income and gains earned on the investments. In Year 3, A contributed an additional $20x to the account.

B periodically issued account statements to A that reported the securities purchases and sales that B purportedly made in A's investment account and the balance of the account. B also issued tax reporting statements to A and to the Internal Revenue Service that reflected purported gains and losses on A's investment account. B also reported to A that no income was earned in Year 1 and that for each of the Years 2 through 7 the investments earned $10x of income (interest, dividends, and capital gains), which A included in gross income on A's federal income tax returns.

At all times prior to Year 8 and part way through Year 8, B was able to make distributions to investors who requested them. A took a single distribution of $30x from the account in Year 7.

In Year 8, it was discovered that B's purported investment advisory and brokerage activity was in fact a fraudulent investment arrangement known as a "Ponzi"

scheme. Under this scheme, B purported to invest cash or property on behalf of each investor, including A, in an account in the investor's name. For each investor's account, B reported investment activities and resulting income amounts that were partially or wholly fictitious. In some cases, in response to requests for withdrawal, B made payments of purported income or principal to investors. These payments were made, at least in part, from amounts that other investors had invested in the fraudulent arrangement.

When B's fraud was discovered in Year 8, B had only a small fraction of the funds that B reported on the account statements that B issued to A and other investors. A did not receive any reimbursement or other recovery for the loss in Year 8. The period of limitation on filing a claim for refund under § 6511 has not yet expired for Years 5 through 7, but has expired for Years 1 through 4.

B's actions constituted criminal fraud or embezzlement under the law of the jurisdiction in which the transactions occurred. At no time prior to the discovery did A know that B's activities were a fraudulent scheme. The fraudulent investment arrangement was not a tax shelter as defined in § 6662(d)(2)(C)(ii) with respect to A.

LAW AND ANALYSIS

Issue 1. Theft loss.

Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise. For individuals, § 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit, and § 165(c)(3) allows a deduction for certain losses not connected to a transaction entered into for

profit, including theft losses. Under § 165(e), a theft loss is sustained in the taxable year the taxpayer discovers the loss. Section 165(f) permits a deduction for capital losses only to the extent allowed in §§ 1211 and 1212. In certain circumstances, a theft loss may be taken into account in determining gains or losses for a taxable year under § 1231.

For federal income tax purposes, "theft" is a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and any other form of guile. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); see also § 1.165-8(d) of the Income Tax Regulations ("theft" includes larceny and embezzlement). A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. Rev. Rul. 72-112, 1972-1 C.B. 60. However, a taxpayer need not show a conviction for theft. Vietzke v. Commissioner, 37 T.C. 504, 510 (1961), acq., 1962-2 C.B. 6.

The character of an investor’s loss related to fraudulent activity depends, in part, on the nature of the investment. For example, a loss that is sustained on the worthlessness or disposition of stock acquired on the open market for investment is a capital loss, even if the decline in the value of the stock is attributable to fraudulent activities of the corporation’s officers or directors, because the officers or directors did not have the specific intent to deprive the shareholder of money or property. See Rev. Rul. 77-17, 1977-1 C.B. 44.

In the present situation, unlike the situation in Rev. Rul. 77-17, B specifically intended to, and did, deprive A of money by criminal acts. B's actions constituted a theft from A, as theft is defined for § 165 purposes. Accordingly, A's loss is a theft loss, not a capital loss.

Issue 2. Deduction limitations.

Section 165(h) imposes two limitations on casualty loss deductions, including theft loss deductions, for property not connected either with a trade or business or with a transaction entered into for profit.

Section 165(h)(1) provides that a deduction for a loss described in § 165(c)(3) (including a theft) is allowable only to the extent that the amount exceeds $100 ($500 for taxable years beginning in 2009 only).

Section 165(h)(2) provides that if personal casualty losses for any taxable year (including theft losses) exceed personal casualty gains for the taxable year, the losses are allowed only to the extent of the sum of the gains, plus so much of the excess as exceeds ten percent of the individual's adjusted gross income.

Rev. Rul. 71-381, 1971-2 C.B. 126, concludes that a taxpayer who loans money to a corporation in exchange for a note, relying on financial reports that are later discovered to be fraudulent, is entitled to a theft loss deduction under § 165(c)(3). However, § 165(c)(3) subsequently was amended to clarify that the limitations applicable to personal casualty and theft losses under § 165(c)(3) apply only to those losses that are not connected with a trade or business or a transaction entered into for profit. Tax Reform Act of 1984, Pub. L. No. 98-369, § 711 (1984). As a result, Rev.

Rul. 71-381 is obsolete to the extent that it holds that theft losses incurred in a transaction entered into for profit are deductible under § 165(c)(3), rather than under § 165(c)(2).

In opening an investment account with B, A entered into a transaction for profit. A's theft loss therefore is deductible under § 165(c)(2) and is not subject to the § 165(h) limitations.

Section 63(d) provides that itemized deductions for an individual are the allowable deductions other than those allowed in arriving at adjusted gross income (under § 62) and the deduction for personal exemptions. A theft loss is not allowable under § 62 and is therefore an itemized deduction.

Section 67(a) provides that miscellaneous itemized deductions may be deducted only to the extent the aggregate amount exceeds two percent of adjusted gross income. Under § 67(b)(3), losses deductible under § 165(c)(2) or (3) are excepted from the definition of miscellaneous itemized deductions.

Section 68 provides an overall limit on itemized deductions based on a percentage of adjusted gross income or total itemized deductions. Under § 68(c)(3), losses deductible under § 165(c)(2) or (3) are excepted from this limit.

Accordingly, A's theft loss is an itemized deduction that is not subject to the limits on itemized deductions in §§ 67 and 68.

Issue 3. Year of deduction.

Section 165(e) provides that any loss arising from theft is treated as sustained during the taxable year in which the taxpayer discovers the loss. Under §§ 1.165-

8(a)(2) and 1.165-1(d), however, if, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is sustained until the taxable year in which it can be ascertained with reasonable certainty whether or not the reimbursement will be received, for example, by a settlement, adjudication, or abandonment of the claim. Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances.

A may deduct the theft loss in Year 8, the year the theft loss is discovered, provided that the loss is not covered by a claim for reimbursement or other recovery as to which A has a reasonable prospect of recovery. To the extent that A's deduction is reduced by such a claim, recoveries on the claim in a later taxable year are not includible in A's gross income. If A recovers a greater amount in a later year, or an amount that initially was not covered by a claim as to which there was a reasonable prospect of recovery, the recovery is includible in A's gross income in the later year under the tax benefit rule, to the extent the earlier deduction reduced A's income tax. See § 111; § 1.165-1(d)(2)(iii). Finally, if A recovers less than the amount that was covered by a claim as to which there was a reasonable prospect of recovery that reduced the deduction for theft in Year 8, an additional deduction is allowed in the year the amount of recovery is ascertained with reasonable certainty.

Issue 4. Amount of deduction.

Section 1.165-8(c) provides that the amount deductible in the case of a theft loss is determined consistently with the manner described in § 1.165-7 for determining the

amount of a casualty loss, considering the fair market value of the property immediately after the theft to be zero. Under these provisions, the amount of an investment theft loss is the basis of the property (or the amount of money) that was lost, less any reimbursement or other compensation.

The amount of a theft loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery. If an amount is reported to the investor as income in years prior to the year of discovery of the theft, the investor includes the amount in gross income, and the investor reinvests the amount in the arrangement, this amount increases the deductible theft loss.

Accordingly, the amount of A's theft loss for purposes of § 165 includes A's original Year 1 investment ($100x) and additional Year 3 investment ($20x). A's loss also includes the amounts that A reported as gross income on A's federal income tax returns for Years 2 through 7 ($60x). A's loss is reduced by the amount of money distributed to A in Year 7 ($30x). If A has a claim for reimbursement with respect to which there is a reasonable prospect of recovery, A may not deduct in Year 8 the portion of the loss that is covered by the claim.

Issue 5. Net operating loss.

Section 172(a) allows as a deduction for the taxable year the aggregate of the net operating loss carryovers and carrybacks to that year. In computing a net operating

loss under § 172(c) and (d)(4), nonbusiness deductions of noncorporate taxpayers are generally allowed only to the extent of nonbusiness income. For this purpose, however, any deduction for casualty or theft losses allowable under § 165(c)(2) or (3) is treated as a business deduction. Section 172(d)(4)(C).

Under § 172(b)(1)(A), a net operating loss generally may be carried back 2 years and forward 20 years. However, under § 172(b)(1)(F), the portion of an individual's net operating loss arising from casualty or theft may be carried back 3 years and forward 20 years.

Section 1211 of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (February 17, 2009), amends § 172(b)(1)(H) of the Internal Revenue Code to allow any taxpayer that is an eligible small business to elect either a 3, 4, or 5-year net operating loss carryback for an “applicable 2008 net operating loss.”

Section 172(b)(1)(H)(iv) provides that the term “eligible small business” has the same meaning given that term by § 172(b)(1)(F)(iii), except that § 448(c) is applied by substituting “$15 million” for “$5 million” in each place it appears. Section 172(b)(1)(F)(iii) provides that a small business is a corporation or partnership that meets the gross receipts test of § 448(c) for the taxable year in which the loss arose (or in the case of a sole proprietorship, that would meet such test if the proprietorship were a corporation).

Because § 172(d)(4)(C) treats any deduction for casualty or theft losses allowable under § 165(c)(2) or (3) as a business deduction, a casualty or theft loss an individual sustains after December 31, 2007, is considered a loss from a “sole

proprietorship" within the meaning of § 172(b)(1)(F)(iii). Accordingly, an individual may elect either a 3, 4, or 5-year net operating loss carryback for an applicable 2008 net operating loss, provided the gross receipts test provided in § 172(b)(1)(H)(iv) is satisfied. See Rev. Proc. 2009-19, 2009-14 I.R.B. (April 6, 2009).

To the extent A's theft loss deduction creates or increases a net operating loss in the year the loss is deducted, A may carry back up to 3 years and forward up to 20 years the portion of the net operating loss attributable to the theft loss. If A's loss is an applicable 2008 net operating loss and the gross receipts test in § 172(b)(1)(H)(iv) is met, A may elect either a 3, 4, or 5-year net operating loss carryback for the applicable 2008 net operating loss.

Issue 6. Restoration of amount held under claim of right.

Section 1341 provides an alternative tax computation formula intended to mitigate against unfavorable tax consequences that may arise as a result of including an item in gross income in a taxable year and taking a deduction for the item in a subsequent year when it is established that the taxpayer did not have a right to the item. Section 1341 requires that: (1) an item was included in gross income for a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to the item, (2) a deduction is allowable for the taxable year because it was established after the close of the prior taxable year or years that the taxpayer did not have a right to the item or to a portion of the item, and (3) the amount of the deduction exceeds $3,000. Section 1341(a)(1) and (3).

If § 1341 applies, the tax for the taxable year is the lesser of: (1) the tax for the taxable year computed with the current deduction, or (2) the tax for the taxable year computed without the deduction, less the decrease in tax for the prior taxable year or years that would have occurred if the item or portion of the item had been excluded from gross income in the prior taxable year or years. Section 1341(a)(4) and (5).

To satisfy the requirements of § 1341(a)(2), a deduction must arise because the taxpayer is under an obligation to restore the income. Section 1.1341-1(a)(1)-(2); Alcoa, Inc. v. United States, 509 F.3d 173, 179 (3d Cir. 2007); Kappel v. United States, 437 F.2d 1222, 1226 (3d Cir.), cert. denied, 404 U.S. 830 (1971).

When A incurs a loss from criminal fraud or embezzlement by B in a transaction entered into for profit, any theft loss deduction to which A may be entitled does not arise from an obligation on A's part to restore income. Therefore, A is not entitled to the tax benefits of § 1341 with regard to A's theft loss deduction.

Issue 7. Mitigation provisions.

The mitigation provisions of §§ 1311-1314 permit the Service or a taxpayer in certain circumstances to correct an error made in a closed year by adjusting the tax liability in years that are otherwise barred by the statute of limitations. O'Brien v. United States, 766 F.2d 1038, 1041 (7th Cir. 1995). The party invoking these mitigation provisions has the burden of proof to show that the specific requirements are satisfied. Id. at 1042.

Section 1311(a) provides that if a determination (as defined in § 1313) is described in one or more of the paragraphs of § 1312 and, on the date of the

determination, correction of the effect of the error referred to in § 1312 is prevented by the operation of any law or rule of law (other than §§ 1311-1314 or § 7122), then the effect of the error is corrected by an adjustment made in the amount and in the manner specified in § 1314.

Section 1311(b)(1) provides in relevant part that an adjustment may be made under §§ 1311-1314 only if, in cases when the amount of the adjustment would be credited or refunded under § 1314, the determination adopts a position maintained by the Secretary that is inconsistent with the erroneous prior tax treatment referred to in § 1312.

A cannot use the mitigation provisions of §§ 1311-1314 to adjust tax liability in Years 2 through 4 because there is no inconsistency in the Service's position with respect to A's prior inclusion of income in Years 2 through 4. See § 1311(b)(1). The Service's position that A is entitled to an investment theft loss under § 165 in Year 8 (as computed in Issue 4, above), when the fraud loss is discovered, is consistent with the Service's position that A properly included in income the amounts credited to A's account in Years 2 through 4. See § 1311(b)(1)(A).

HOLDINGS

(1) A loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss, not a capital loss, under § 165.

(2) A theft loss in a transaction entered into for profit is deductible under § 165(c)(2), not § 165(c)(3), as an itemized deduction that is not subject to the personal loss limits in § 165(h), or the limits on itemized deductions in §§ 67 and 68.

(3) A theft loss in 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.

(4) The amount of a theft loss in a transaction entered into for profit is generally the amount invested in the arrangement, less amounts withdrawn, if any, reduced by reimbursements or recoveries, and reduced 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 arrangement 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 purportedly reinvested amount.

(5) A theft loss in a transaction entered into for profit may create or increase a net operating loss under § 172 that can be carried back up to 3 years and forward up to 20 years. An eligible small business may elect either a 3, 4, or 5-year net operating loss carryback for an applicable 2008 net operating loss.

(6) A theft loss in a transaction entered into for profit does not qualify for the computation of tax provided by § 1341.

(7) A theft loss in a transaction entered into for profit does not qualify for the application of §§ 1311-1314 to adjust tax liability in years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511.

DISCLOSURE OBLIGATION UNDER § 1.6011-4

A theft loss in a transaction entered into for profit that is deductible under § 165(c)(2) is not taken into account in determining whether a transaction is a loss transaction under § 1.6011-4(b)(5). See § 4.03(1) of Rev. Proc. 2004-66, 2004-2 C.B. 966.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 71-381 is obsoleted to the extent that it holds that a theft loss incurred in a transaction entered into for profit is deductible under § 165(c)(3) rather than § 165(c)(2).

DRAFTING INFORMATION

The principal author of this revenue ruling is Andrew M. Irving of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Irving at (202) 622-5020 (not a toll-free call.)