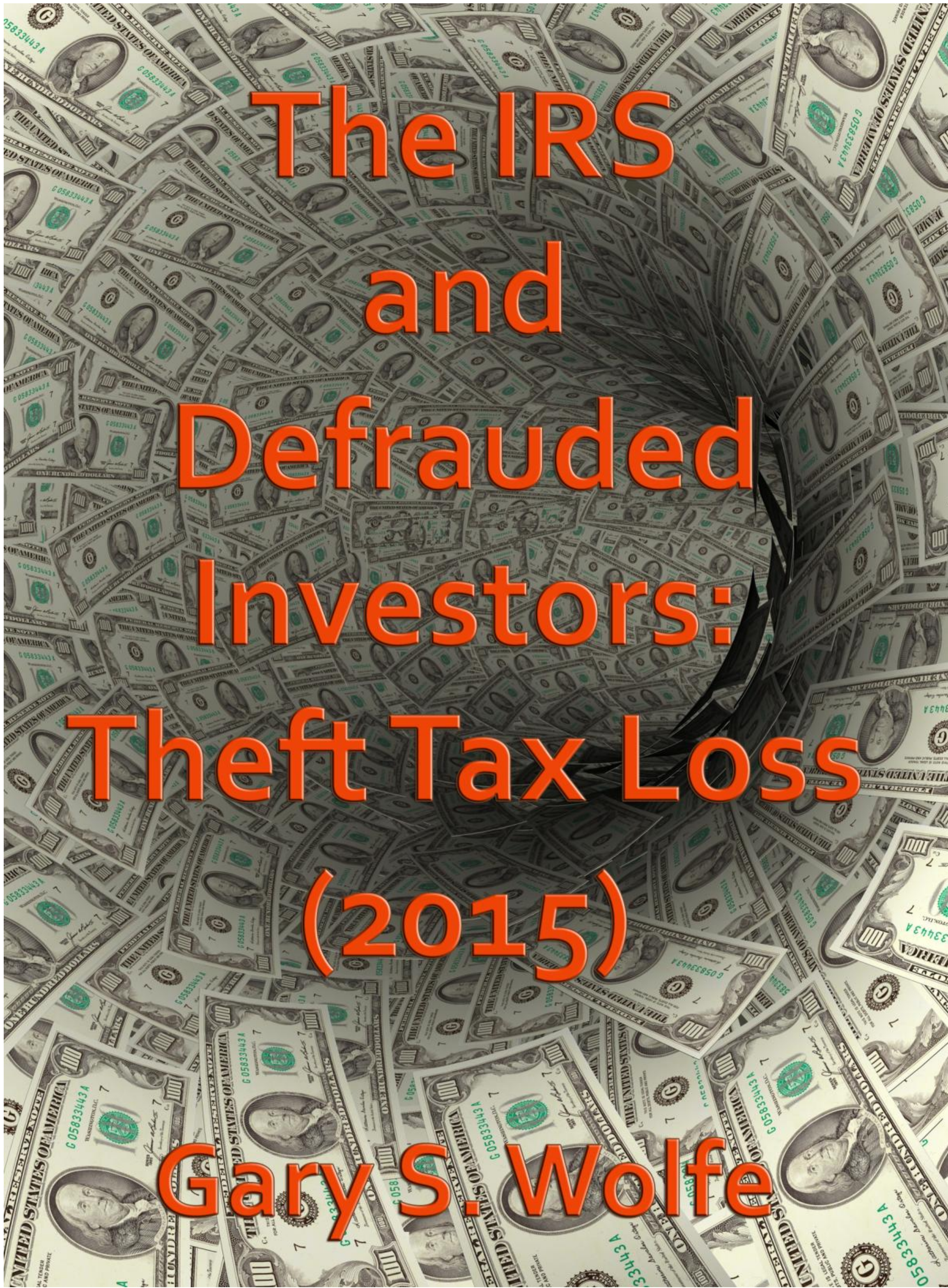
The IRS
and
Defrauded
Investors:
Theft Tax Loss
(2015)
Gary S. Wolfe

The IRS and Defrauded Investors: THEFT TAX LOSS (2015)

By

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Chapter 1 – Introduction

<u>Theft Loss – IRC Sec 165</u>

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):

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

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.

Chapter 5 – Statement of Law (IRC Sec 165)

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."

The "theft loss," which only includes losses to property not connected with the taxpayer's trade or business or for-profit transactions, and is further restricted by rules denying the deduction for the first $500 (2009)of loss from each casualty and allowing losses above this floor only to the extent they exceed 10 percent (10%) of adjusted gross income (IRC §165(h)). The courts have found a further limitation implicit in Section 165(a) – that a casualty loss is not allowable in any part if the deduction would frustrate well-defined public policy.

(See, Blackman v. CIR, 88 TC 677, 682 (1987) – taxpayer intentionally set fire to wife's clothes and negligently allowed fire to spread to entire house; held no casualty loss deduction because deduction "would severely and immediately frustrate the articulated public policy … against arson and burning," even though taxpayer never charged with crime; Mazzei v. CIR, 61 TC 497 (1974) – taxpayer defrauded by co-conspirators in scheme to counterfeit U.S. currency; held, theft loss of participant in criminal activity not deductible; Rev. Rul. 82-74, 1982-1 CB 110 (where taxpayer, in order to collect insurance, paid another to burn down taxpayer's building, public policy, precludes amount paid from being taken into account in determining gain on building's conversion). However, see, Hossbach v. CIR, 42 TCM (CCH) 80 (1981) [public policy not offended by allowing deduction for destruction by explosion of building used by taxpayer to manufacture illegal drugs]. IRC § 641(b) rules make § 165(c) apply to trusts and estates.)

Since losses attributable to business and profit-oriented property are deductible regardless of cause, the principal significance of the deduction allowed by § 165(c)(3) for casualty losses is that it encompasses personal residences, private automobiles, jewelry, home furnishings, and other property owned and used for personal purposes. Property of this type does not qualify for depreciation deductions while the taxpayer owns it, and losses on sales of such property are also nondeductible. (Reg. § 1.165-9(a).) If the property is damaged or destroyed by casualty, however, the resulting loss may be deducted under § 165 (c)(3).)

(IRC §165(c)(2)(3))

Under IRC §165, an individual may deduct losses arising from "fire, storm, shipwreck, or other casualty or from theft."

Under IRC §165(c)(2), an individual may deduct theft losses involving a transaction entered into for profit.

Under IRC §165(c)(3), an individual may deduct losses due to theft (which is defined to include fraud under California's Penal Code Section 484(a)) (see Treas. Reg. Section 1.165-8(d)).

A loss arising from theft is treated as sustained during the taxable year in which the Taxpayer discovers the loss (IRC §165(e)(1)).

The deductible amount is the lesser of the fair market value or basis of the property stolen (Treas. Reg. §1.165-8(c)), IRC §165(b).

An individual is permitted to deduct losses to her property arising from "fire, storm, shipwreck, or other casualty, or from theft." The term "other casualty" defined as a sudden, unexpected event that is unusual in nature and beyond the control of the taxpayer.

A theft loss technically is not a casualty loss, but theft losses are aggregated with casualty losses for most purposes. The first $500 (2009) of each personal casualty or theft loss is not deductible, and personal casualty and theft losses are generally deductible only to the extent they exceed 10 percent of the taxpayer's AGI.

Casualty and theft losses that arise in a trade or business or activity engaged in for profit are deductible (as are other losses arising in these activities) and may qualify for beneficial treatment under Code Section 1231.

The portion of a loss that is reimbursed by insurance is not deductible (Code Section 165(a)). A personal casualty or theft loss is deductible only if the taxpayer files a timely claim for any insurance covering the loss. Code Section 165 (h) (5) (E).

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.

Treas. Reg. § 1.165-1(b) ["Substance and not mere form shall govern in determining a deductible loss"].

Rev. Rul. 2009-9, I.R.B. 2009-9 ["... 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)."].

See generally Kaplan v. United States, 2008-1 U.S.T.C. ¶ 50,117 (M.D. Fla. 2007), in which the court, while acknowledging that there were different standards for determining whether a taxpayer is entitled to a theft loss deduction depending on the taxable year at issue, as well as that before a taxpayer may claim a deduction due to theft loss "the facts must show that as of the end of the tax year at issue, it was reasonably certain that the taxpayer had no reasonable prospect of recovering the amount of the loss that the taxpayer attempted to deduct," nonetheless seems to have disallowed a theft loss deduction because, as of the end of the year theft loss was discovered, the taxpayer could not reasonably ascertain the amount that they would ultimately recover.

See also Bubb, Jr. v. United States, 93-2 U.S.T.C. ¶ 50,572 (W.D. Pa. 1993), involving a taxpayer who attempted to claim a deduction for a portion of the theft loss in the year of discovery. The court concluded that "[b]ased upon an objective review of the totality of the facts and circumstances surrounding the losses as of the close of 1986, the taxable year for which the plaintiffs have claimed deductions [and the year in which the theft was discovered], the existence of a reasonable prospect of recovery beyond 5% of their investments did not exist"' and therefore the taxpayers were entitled to a deduction for 95 percent of their respective losses.

Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975) ["The standard is to be applied by foresight, and hence, we do not look at facts whose existence and production for use in later proceedings was not reasonably foreseeable as of the close of the particular year."]

Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811 (1971), aff'd, 521 F.2d 786 (4th Cir. 1975). See also Parmelee Transp. Co a United States, 351 F.2d 619, 628 (Fed. Cl. 1965) ["we stress that the mere existence of a "possible" claim or pending litigation will not alone warrant postponing loss recognition. There are many reasons for initiating lawsuits. In this case, taxpayer's antitrust claim for treble damages exceeded 19 million dollars. Where the stakes are so high, a suit may be "100% justified" even though the probability of recovery is minuscule. In short, although we offer no litmus paper test of "reasonable prospect of recovery," we note that the inquiry should be directed to the probability of recovery as opposed to the mere possibility. Analyzing the rule in percentage terms, we would consider a 40 to 50 percent or better chance of recovery as being "reasonable". A lawsuit might well be justified by a 10 percent chance."]; Premji v. Commissioner, 72 T.C.M. 16 (1996), aff'd, 139 F.3d 912 (10th Cir.

1998) [a theft loss deduction "need not be postponed where the financial condition of the party against whom the claim is filed is such that no recovery could be expected."].

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). See also Rev. Rul. 72-112, 1972-1 C.B. 60 (theft is any felonious taking of money or property by which a taxpayer sustains a loss, whether defined or punishable under the penal codes of the state as larceny, robbery, burglary, embezzlement, extortion, kidnapping for ransom, threats, or blackmail)).

A theft loss deduction does not depend on the existence of a crime of theft in the state in which the loss occurs. The leading case in this area stated that for tax purposes, theft is "a word of general and broad connotation, intended to cover and covering, 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, 232 F.2d 107 (5th Cir. 1956). The court added that the exact nature of the crime is not important, as long as it amounts to theft.

Although "theft" for tax purposes is not limited to the statutory crime of theft, the act resulting in the loss must be a crime under state law. (See MTS International, Inc. v. Commissioner, 169 F.3d 1018 (6th Cir. 1999); Luman v. Commissioner, 79 T.C. 846 (1982); Bodine v. Commissioner, T.C. Memo. 1984-143).

A taxpayer whose property was taken by another under a legal procedure, such as foreclosure, cannot claim a theft loss because no theft has occurred, even if the procedure was improperly used. (See, e.g., Johnson v. United States, 291 F.2d 908 (8th Cir. 1961); Vance v. Commissioner, 36 T.C. 547 (1961); Marlowe v. Commissioner, T.C. Memo. 1967-12; Zaccaria v. Commissioner, T.C. Memo. 1961-102; Johnson v. Commissioner, T.C. Memo. 2001-97).

In the case of misrepresentation, there must be an intent to defraud. A loss sustained when a taxpayer is the victim of a misunderstanding, or is simply outsmarted due to a misrepresentation that is not fraudulent, is not a theft loss. (See, e.g., Skoznik v. Commissioner, 55 T.C. 1055 (1971); Schacht v. Commissioner, 47 T.C. 552 (1967), acq. 1968-2 C.B. 2; Gibson v. Commisioner, T.C. Memo. 1982-374; Schonhoff v. Commissioner, T.C. Memo. 1963-213; Fuhrmann v. Commissioner, T.C. Memo. 1959-81).

A theft loss deduction will be allowed if obtaining money from another under false

misrepresentations or false pretenses constitutes fraud under state law. Rev. Rul. 71-381, 1971-2 C.B. 126, modified by Rev. Rul. 2009-9, 2009-14 I.R.B. 735. For example, where the officers of a legitimate mortgage lending business engaged in securities fraud that, in part, led to the bankruptcy of the company, the IRS held that it is a question of fact whether, and at what point, the investors' loans to the company were no longer bona fide debts and instead thefts of the investors. CCA 200811016.

In cases involving stock purchased on the open market, however, the courts have consistently disallowed theft loss deductions relating to a decline in the value of the stock that was attributable to corporate officers misrepresenting the financial condition of the corporation, even when the officers were indicted for securities fraud or other criminal violations. Paine v. Commissioner, 63 T.C. 736, aff'd without published opinion, 523 F.2d 1053 (5th Cir. 1975). The IRS will disallow theft loss deductions with respect to a decline in the market value of stock caused by the disclosure of accounting fraud or other illegal misconduct of the officers or directors of the corporation that issued the stock. Notice 2004-27, 2004-1 C.B. 782.

When a theft is related to a transaction entered into by the taxpayer for profit, such as when the taxpayer invests in a pyramid, or Ponzi, scheme, the taxpayer may be entitled to a deduction. Victims of Ponzi schemes may elect special rules to calculate their theft deduction.

If a taxpayer's activities in connection with a theft loss are contrary to public policy, a deduction for a theft loss may be denied. A theft loss could be denied if a taxpayer participated in a sham transaction intended to avoid federal income taxes. FSA 200305028. A theft loss deduction was also denied to investors who loaned money to a corporation in a Chapter 11 reorganization in exchange for a security interest in telephone equipment because the investors were not the victims of theft. There was no indication that the corporation was not a viable business, that the equipment sold did not exist, or that the corporation intentionally made false representations to the investors to induce them into making the investment. CCM 200406046.

A theft loss deduction may be prohibited by another Code provision. For example, in Rust Communications Group, Inc. v. United States, 90-1 U.S.T.C. 50,263 (Cl. Ct. 1990), a corporation tried to deduct a $60,000 penalty imposed for its failure to pay its 1980 corporate income tax on time, which was caused by an employee's embezzlement. A theft loss deduction was allowed for the money that was embezzled, but the deduction for the penalty was denied because of Code Section 162(f), which bars the deduction of fines and penalties even though the failure to pay was directly attributable to the embezzlement.

Proof of Theft

A taxpayer must establish that his property was stolen in order to claim a theft loss. Allen v. Commissioner, 16 T.C. 163 (1951). It is not sufficient for a taxpayer to show only that the property is missing, but it is sufficient to show that theft is the most plausible explanation for the disappearance of the property. (Jory v. Commissioner, 52 T.C. 288 (1969); Meyers v. Commissioner, T.C. Memo. 1959-39). It is not necessary to identify or convict the alleged thief. (Jones v. Commissioner, 24 T.C. 525 (1955), acq., 1955-2 C.B. 7; Wilson v. Commissioner, T.C. Memo. 1982-107).

The most common alternate explanation that a taxpayer must address is that the missing property was lost or misplaced. For example, when a taxpayer discovers a wallet [See, e.g., Bakewell v. Commissioner, 23 T.C. 803 (1955); Smith v. Commissioner, 10 T.C. 701 (1948); Gray v. Commissioner, T.C. Memo. 1954-225.] or jewelry [See, e.g., Allen v. Commissioner, 16 T.C. 163 (1951); Manahan v. Commisioner, 9 T.C.M. 1095 (1950).] missing after a brief trip, the possibility that it was lost is as plausible as theft, and a theft loss has been denied. On the other hand, theft was found to be the most plausible explanation for the disappearance of cash or jewelry from a hiding place or safe box when others had access to it. (See, e.g., Kennedy v. United States, 109 F. Supp. 509 (D.R.I. 1952); Jones v. Commissioner, 24 T.C. 525 (1955), acq., 1955-2 C.B. 7; Jungert v. Commissioner, T.C. Memo. 1968-116; Meyers v. Commissioner, T.C. Memo. 1959-39; Turner v. Commissioner, 9 T.C.M. 883 (1950).

While filing a police report will not, by itself, establish the occurrence of a theft [See, e.g., Lee v. Commissioner, T.C. Memo. 1982-35.], case law indicates that the failure to file a report is a negative factor. (See James v. Commissioner, 10 T.C.M. 440 (1951) (casualty loss deduction disallowed because the taxpayer did not report the theft).

Year and Amount of Theft Loss Deduction

Theft losses must be deducted in the year the theft is discovered. Reg. Section 1.165-8 (a)(2). The loss is not deductible in the year the theft occurred (unless it is the same as the year of discovery). Reg. Section 1.165-8(a)(2). The year of discovery is deemed to be the year a "reasonable person" would have discovered the loss. (Cramer v. Commissioner, 55 T.C. 1125 (1971), acq., 1971-2 C.B. 2; Elliott v.Commissioner, 40 T.C. 304 (1963), acq., 1964-1 C.B. 4; Puscas v. Commissioner, T.C. Memo. 1978-73).

Code Section 165(e) provides that the loss is deductible in the year that the taxpayer discovers it. This rule is especially helpful to a taxpayer after the statute of limitations has run for the year in which the theft occurred.

For theft losses, the amount of the loss is always the fair market value or the basis of the property stolen, because its value is zero after the theft. Reg. Section 1.165-8(c). The amount a theft loss deduction is determined in a manner consistent with the rules that are applied to casualty loss deductions. (Reg. Section 1.165-8(c).

If a taxpayer loses several items from one theft or if a husband and wife filing jointly suffer separate losses as a result of the same theft, only one $500 reduction is required.

Thefts Involving Transactions Entered Into for Profit

A loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss, not a capital loss, even though losses from an investment are normally capital losses. While 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. However, investors in fraudulent arrangements such as Ponzi schemes may make an election that provides a uniform manner for determining the theft losses. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

In a Ponzi scheme, the party perpetrating the fraud receives cash or property from investors, purports to earn income for the investors, reports to the investors income amounts that are wholly or partially fictitious, and criminally appropriates some or all of the investors' cash or property, and any payments of purported income or principal made to the investors are made from cash or property that other investors invested in the fraudulent arrangement.

Generally

Unlike other theft losses, 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 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). Further, theft losses are treated as a business deduction, and thus eligible individuals who sustain a 2008 theft loss may be able to elect the four or five year carryback period allowed to small businesses. Code Section 172(d)(4)(C).

Ponzi scheme (safe harbor rules)

Victims of fraudulent arrangements such as Ponzi schemes may elect to apply special rules to their theft losses. Rev. Proc. 2009-20, 2009-14 I.R.B. 749. This safe harbor allows investors to treat a loss as a theft loss deduction when certain conditions are met, and provides a uniform manner for determining the theft losses. The election is available for the tax year of the investor beginning after December 31, 2007, in which the indictment, information, or complaint is filed against the lead figure in the scheme.

This election avoids potentially difficult problems of proof in determining how much income reported in prior years is fictitious or a return of capital, and alleviates compliance and administrative burdens on both taxpayers and the IRS.

To make the election, the taxpayer must mark "Revenue Procedure 2009-20" at the top of Form 4684, Casualties and Thefts, for the tax year of the investor in which the indictment, information, or complaint is filed against the lead figure. The taxpayer must also complete and sign the statement provided in Appendix A of Rev. Proc. 2009-20, 2009-14 I.R.B. 749, and attach the statement to the taxpayer's return. If, before April 17, 2009, the taxpayer has filed a return (original or amended) that is inconsistent with the election, the taxpayer can file a corrected return on or before May 15, 2009, and indicate this fact on the statement attached to the corrected return.

If the taxpayer makes the election, the IRS will not challenge the taxpayer's treatment of the

loss as theft loss; the taxpayer's treatment of the year in which the theft was discovered (and in which the taxpayer is therefore allowed to claim the deduction) as the tax year of the investor in which the indictment, information, or complaint is filed against the lead figure; or the taxpayer's treatment of the amount of the deduction. Rev 2009-14 I.R.B. 749.

By making the election the taxpayer can deduct as a theft loss 95 percent of the taxpayer's investment in the fraudulent arrangement, but only if the taxpayer does not pursue any potential third-party recovery. If the taxpayer does pursue such a recovery, the taxpayer can only deduct 75 percent of the taxpayer's investment. In either case, the deduction must be reduced by all actual or potential claims for reimbursement that, as of the last day of tax year of the investor in which the indictment, information, or complaint is filed against the lead figure, are attributable to insurance policies in the name of the investor, contractual arrangements other than insurance that guaranteed or otherwise protected against loss of the investment, or amounts payable from the Securities Investor Protection Corporation (SIPC) as advances for customer claims under 15 U.S.C. Section 78fff-3a (or by a similar entity under a similar provision). The deduction is not reduced by any other actual or potential claims for recovery, including claims against an individual or entity that conducted the fraudulent arrangement or claims against an entity established to recover assets for the benefit of investors or creditors. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

If the taxpayer receives an additional recovery in a later year, the taxpayer may have to include that amount in income in the year it is received. Similarly, if the recovery turns out to be less than expected, the additional loss is claimed in that later year. Req. Section 1.165-1(d)(2).

A taxpayer's investment in the fraudulent arrangement is the total amount of cash, or the basis of property, that the taxpayer invested in the arrangement in all years. The taxpayer's investment is increased by the total amount of net income with respect to the arrangement that, consistent with information received from the arrangement, the taxpayer included in income for federal tax purposes for all tax years (including years for which a refund is barred by the statute of limitations) prior to the tax year of the investor in which the indictment, information, or complaint is filed against the lead figure. The taxpayer's investment is decreased by the total amount of cash or property that the taxpayer withdrew in all years from the arrangement, wither designated as income or principal. The taxpayer's investment does not include: amounts borrowed from the arrangement and then reinvested in the arrangement, to the extent the amounts were not repaid at the time the theft was discovered; amounts such as fees that were paid to the arrangement and deducted for federal income tax purposes; amounts reported to the taxpayer as taxable income that were not included in gross income of the taxpayer's tax return; or cash or property that the taxpayer invested in a fund or other entity that invested in the fraudulent arrangement. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

Before an election can be made, the lead figure in the fraudulent arrangement (or one of the lead figures) must be charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement, or a similar crime that, if proven, would meet the definition of theft under Code Section 165 under the law of the jurisdiction in which the theft occurred. Alternatively, the election can be made if the lead figure was the subject of a state or federal complaint alleging the commission of a Ponzi scheme and either (1) the complaint alleged an admission by the lead figure or the execution of an affidavit by that person admitting the crime, or (2) a receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

To be eligible to make the election:

1. The taxpayer must be a U.S. taxpayer under Code Section 7701(a)(30), meaning that the taxpayer must be a U.S. citizen or resident, or a domestic partnership, corporation, estate, or trust;

2. The taxpayer must not have had actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public; and

3. The taxpayer must have directly transferred cash or property to the fraudulent arrangement; and

4. The investment arrangement must not have been a tax shelter. Rev. Proc. 2009¬20, 2009-14 I.R.B. 749.

Investors who invested solely in a fund or other entity (separate from the investor for federal tax purposes) that invested in the fraudulent arrangement are not eligible to make the election, but the fund or entity itself may make the election.

By making the election, the taxpayer agrees not to deduct more than allowed under the election; not file returns or amended returns to exclude or recharacterize income reported with respect to the fraudulent arrangement in years preceding the tax year of the investor in which the indictment, information, or complaint is filed against the lead figure; not to apply the alternative computation in Code Section 1341 for restorations of amounts held under a claim of right; and not to apply the doctrine of equitable recoupment or the mitigation provisions of Code Sections 1311, 1312, 1313, and 1314. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

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 "mislaid" 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].)

Chapter 7 – Casualty Loss (IRC Sec 165)(c)(3)

Theft losses may be deductible either under IRC §165(c)(2) or §165(c)(3).

Casualty Losses (Current Law)

Code Section 165(c)(3) permits a deduction for losses arising from "fire, storm, shipwreck, or other casualty, or from theft." (Casualty losses are also deductible for purposes of the alternative minimum tax (AMT). Code Section 56(b)(1)(A) provides that miscellaneous itemized deductions are not allowed for AMT purposes, but Code Section 67(b)(3) provides that the deductions for casualty and theft losses are not miscellaneous itemized deductions. In addition, a personal casualty or theft loss is deductible only if the taxpayer files a timely claim for any insurance covering the loss. Code Section 165(h)(4)(E).)

While losses attributable to fire, storm, and shipwreck are casualty losses, theft losses are not. (Treas. Reg. Sec. 1.165-7(a)(6).)

The definition of the remaining term, "other casualty" has been the subject of decades of litigation. The IRS, analogizing to fire, storm, and shipwreck, has taken the position that a casualty is "the complete or partial destruction or loss of the taxpayer's property resulting from an identifiable event that is sudden, unexpected and unusual in nature." (Rev. Rul. 72-592, 1972-2 C.B. 101. See also Martin Marietta Corp. v. United States, 83-2 U.S.T.C. para. 9607 (Cl. Ct. 1983); Maher v. Commissioner, 76 T.C. 593 (1981), aff'd, 680 F.2d 91 (11th Cir. 1982); Popa v. Commissioner, 73 T.C. 130 (1979); White v. Commissioner, 48 T.C. 430 (1967), acq., 1969-1 C.B. 21; Toten v. Commissioner, T.C. Memo. 1984-603,; Kielts v. Commissioner, T.C. Memo. 1981-329; Rev. Rul. 87-59, 1987-2 C.B. 59.)

Limitations on deductibility of amount of casualty loss

An individual taxpayer's non-business casualty or theft loss is deductible only to the extent the loss exceeds $100 ($500 in 2009), and only to the extent the losses for the year exceed 10 percent of adjusted gross income (AGI). Code Section 165(h).

$500 (2009) FLOOR: A non-business casualty or theft loss of an individual is deductible only to the extent it exceeds $500 (2009). Code Section 165(h)(1). The floor does not apply to business property. Each casualty is subject to the floor. If there is more than one casualty causing loss to the same property, the amount of each loss must be reduced by the amount of the floor. On the other hand, if a single casualty damages several items of the taxpayer's property, the floor applies only once. Similarly, if a single casualty causes losses in more than one year, the floor applies only once. Whether damage to property is the result of a single casualty or more than one casualty is a facts and circumstances determination. However, events that are closely related in origin generally give rise to a single casualty. For example, wind and flood damage from a hurricane would be the result of a single casualty. Reg. Section 1.165-7(b)(4)(ii).

Each joint owner of property is subject separately to the floor. Reg. Section 1.165-7(b)(4)(iii). A husband and wife filing a joint return are considered a single taxpayer to whom a single floor applies, but the floor applies separately to married taxpayers who file separate returns. Reg. Section 1.165-7(b)(4)(iii). The floor applies only to the personal use portion of property used for both business and personal use purposes. Reg. Section 1.165-7(b)(4)(iv).

The 10 Percent of Adjusted Gross Income (AGI) Floor

If personal casualty losses for any taxable year exceed personal casualty gains for such year, the excess is deductible only to the extent that it exceeds 10 percent of the taxpayer's AGI for the taxable year. This limitation applies only after the loss from each casualty is reduced by the $500 (2009) floor. (Code Section 165(h)(2)(A)(ii); Code Section 165(h)(3).) AGI is computed by deducting personal casualty losses to the extent of personal casualty gains. Code Section 165(h)(5)(A).

A personal casualty gain is the recognized gain from any involuntary conversion of non-business property arising from fire, storm, shipwreck, other casualty, or from theft. Code Section 165(h)(4)(A). A personal casualty loss is any loss of non-business property arising from the same types of events. Code Section 165(h)(4)(B).

If the personal casualty gains for any taxable year exceed the personal casualty losses for such taxable year, all gains and losses are treated as capital gains and losses. Code Section 165(h)(2)(B). In this event, the losses are not subject to the 10 percent AGI floor. (Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 987.)

Method of Valuation

The regulations provide two methods for determining the decline in fair market value of property damaged in a casualty (for both business and personal use property), the appraisal method and the cost of repairs method. Reg. Section 1.165-7(a)(2).

Appraisal

The first method that can be used to measure the amount of damage to property caused by a casualty is to obtain a competent appraisal of the fair market value of the property immediately before and immediately after the casualty. Reg. Section 1.165-7(a)(2)(i). The appraisal should consider the effect of a general market decline affecting the undamaged, as well as the damaged property, in order to isolate the actual loss resulting from the casualty. Reg. Section 1.165-7(a)(2)(i). The appraiser's knowledge of sales of comparable property, conditions in the area, familiarity with the taxpayer's property before and after the casualty, and the method he

uses in ascertaining the amount of loss are all important elements of the appraisal. Maduza v. Commissioner, T.C. Memo. 1961-249.

The purchase price of the property is not relevant in determining value, unless the property was purchased shortly before the casualty. Similarly, the sales price of property sold shortly after a casualty may be the best evidence of value after the casualty. Woods v. Commissioner, T.C. Memo. 1960-72. A court may also make its own estimate of value based on the taxpayer's testimony. (Kenerly v. Commissioner, T.C. Memo. 1975-139; Scharf v. Commissioner, T.C. Memo. 1973-272, aff'd without opinion, 535 F.2d 1250 (4th Cir. 1976).)

Cost of repairs

The second method used to measure the amount of damage to property caused by a casualty is the cost of repairing the property. Reg. Section 1.165-7(a)(2)(ii). This method can only be used when the property is actually repaired. The taxpayer must show that the repairs were necessary to restore the property to its condition immediately before the casualty and that the amount spent for the repairs is not excessive. The cost of repairs is taken into account only to the extent that the property is restored but not improved; the repairs should not increase the property's value compared to what it was immediately before the casualty. Reg. Section 1.165-7(a)(2)(ii).

The cost of repairs is not a limit on the amount of the loss; it is a basis for a computation of the amount of loss. The amount of the loss can be greater than the cost of repairs if the property is not restored to its value before the casualty. Brush v. Commissioner, T.C. Memo. 1962-124.

If repairs restore the property to its original condition, no additional loss is allowed. For example, in Jenard v. Commissioner, T.C. Memo. 1961-70, the taxpayer argued the very occurrence of a fire decreased the fair market value of his building in an amount in excess of the repair cost due to the fear of a prospective buyer that there may have been latent structural weaknesses caused by the fire which were not repaired. The Tax Court, however, refused to take into account the "groundless fears" of prospective buyers.

The cost of replacement has also been used as evidence of the amount of the loss. (Rev. Rul. 66-303, 1966-2 C.B. 55. See also Clapp v. Commissioner, 321 F.2d 12 (9th Cir. 1963), acq., 1964-1 C.B. 4 (replacement cost used as evidence of fair market value prior to casualty); but see Hernandez v. Commissioner, 72 T.C. 1234 (1979) (replacement cost of an air conditioner rejected as evidence of amount of loss because taxpayer did not show that the cost of the replacement unit did not exceed the value of the unit destroyed).)

The actual amount of the loss may be greater than the cost of replacement property, such as when mature trees or plants are replaced with younger trees. Zardo v. Commissioner, T.C. Memo. 1982-94. The cost to remove debris and otherwise clean up a damaged property can also be used as evidence of the amount of the loss. (Waldrip v. Commissioner, 81-2 U.S.T.C.

9653 (N.D. Ga. 1981); Stuart v. Commissioner, T.C. Memo. 1961-186; Rev. Rul. 71-161, 1971-1 C.B. 76.)

Setoffs

A casualty loss (like any loss) is deductible only to the extent it is not compensated for by insurance or otherwise. Code Section 165(a). If the amount of reimbursements exceed the taxpayer's adjusted basis in the property, the taxpayer realizes a gain unless the gain can be excluded from income as the sale of a home or can be deferred as an involuntary conversion. (Code Section 1033 provides special treatment for gains from an involuntary conversion.)

If, in the year of the casualty, the taxpayer has a claim for reimbursement of the loss, and there is a reasonable prospect that she will be reimbursed for part or all of the loss, the taxpayer must subtract the expected reimbursement to compute the loss. Reg. Section 1.165-1(c)(4) and Reg. Section 1.165-1(d)(2)(ii). If the reimbursement in the later year turns out to be less than expected, the additional loss is claimed in that year. Reg. Section 1.165-1(d)(2)(ii). If the reimbursement exceeds the amount deducted, the taxpayer does not go back to the deduction year to recompute the loss. Instead, to the extent required under the tax benefit rule, the taxpayer includes it in income in the year it is received. Reg. Section 1.165-1(d)(2)(iii). The home sale exclusion and the involuntary conversion deferral do not apply to amounts subject to the tax benefit rule, but may apply to other portions of the reimbursed amount.

Insurance expenses that do not compensate for the casualty do not reduce the loss and are income. Accordingly, insurance payments for normal family living expenses, due to the loss of use of the family's income, are income. But payments for additional living expenses, such as for additional transportation expenses or for restaurant meals, need not be included in income. Code Section 123; Reg. Section 1.123-1.

An individual must show that a grant, award, gift, or loan with respect to a casualty was not a reimbursement to avoid a reduction in the amount of the loss. In addition to insurance, compensation can include condemnation awards, cancellations of federal relief loans, reimbursement under the Federal Disaster Relief Act, cash gifts to rehabilitate property, payments from an urban renewal agency and certain payments to businesses affected by the World Trade Center attacks made by the Empire State Development Corporation. (Rev. Rul. 71-160, 1971-1 C.B. 75; Rev. Rul. 71-161, 1971-1 C.B. 76; Rev. Rul. 76-144, 1976-1 C.B. 17; Notice 2003-18, 2003-1 C.B. 699. Grant payments made by the Empire State Development Corporation under the World Trade Center (WTC) Business Recovery Grant Program are reimbursements for casualty losses. Grant payments made under the WTC Small Firm Attraction and Retention Grant Program and the WTC Job Creation and Retention Program are not reimbursements for casualty losses.)

Year of the Casualty Loss Deduction

A casualty loss (like any loss) generally must be claimed in the year sustained. Reg. Section 1.165-7(a)(1). Usually, this is the year in which the casualty occurs. However, the loss may be deductible in a later year if the loss is not determinable until a later year. For example, in United States v. Barret, 202 F.2d 804 (5th Cir. 1953), the taxpayer's trees were damaged by a severe Florida freeze and the taxpayer attempted to salvage them during the next two years. When it became evident he could not, he claimed a casualty loss. The Fifth Circuit allowed the claim in the later year.

A casualty loss that is subject to a claim for insurance or other reimbursement for which there is a reasonable prospect of recovery is not allowed in the year of the casualty. These losses may only be deducted in the year in which the reasonable prospect of recovery no longer exists or in which compensation is received for less than the amount of the loss. Reg. Section 1.165-1(d)(2)(i). A taxpayer who properly deducts a loss in one year and receives reimbursement in a later year must include the reimbursement in his gross income, as provided in Code Section 111. (Reg. Section 1.165-1(d)(2)(iii). 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.)

If an estate suffers a casualty loss of property during settlement, the loss may be allowed as a deduction in computing the taxable income of the estate. Reg. Section 1.165-7(c). The deduction is only allowed if the loss was not allowed as a Code Section 2054 loss during administration in computing the taxable estate of the decedent and if a statement is filed in accordance with Reg. Section 1.642(g)-1.

There are two central facts about this election. First, the amount of the potential deduction for a personal casualty loss is greater under the estate tax than it is under the income tax, since there are no limitations. Second, if the deduction offsets an otherwise fully taxable portion of the estate, it will usually be worth more (on a dollar-for-dollar basis) as an estate deduction than it would be as an income tax deduction, since the applicable estate tax rate will generally be higher than the income tax rate.

The deduction can be split between the estate tax return and the income tax return. If the estate tax deduction has not been finally allowed and the appropriate statement is filed, claiming a deduction in computing the estate's income tax return is not barred on the estate tax return. Reg. Section 1.642(g)-2. Delay filing the statement until it is clear that an income tax deduction is preferable. Once filed, the statement precludes the right to claim an estate tax deduction for the loss.

Casualty and Theft Losses of Passive Activity Property

In general, a taxpayer is allowed to deduct passive activity deductions only to the extent of her passive activity gross income for the year. (Code Section 469(a); Reg. Section 1.469-2T(b)(1).) A

deduction is a passive activity deduction if it arises in connection with the conduct of a passive activity. Reg. Section 1.469-2T(d)(1). The regulations, however, exclude casualty and theft losses (as defined in Code Section 165(c)(3)) as deductions from characterization as a passive activity deduction. (Reg. Section 1.469-2(d)(2)(xi).) However, the exemption is inapplicable if losses that are similar in cause and severity occur regularly in the conduct of the activity. Reg. Section 1.469-2(d)(2)(xi).

Passive activity rules will not limit losses arising from a natural disaster, such as a hurricane, but may operate to disallow the shoplifting losses of a retail store or the accident losses of a car rental business. (The casualty exception applies to all taxpayers subject to the passive activity rules who sustain a loss during a tax year that begins after 1989. However, a taxpayer sustaining such losses during a pre-1990 tax year may elect to treat such losses as a non-passive deduction on a return or amended return for such year. Notice 90-21, 1990-1 C.B. 332. Although the regulations do not indicate how this election is to be made, taxpayers would be wise to indicate that they are making such election by attaching a statement to their return or amended return. Taxpayers filing amended returns to take advantage of the casualty loss exemption must also recompute and reallocate their disallowed passive activity loss and credit on amended returns for all other affected years for which returns have been filed. Notice 90-21, 1990-1 C.B. 332. The amount and allocation of the disallowed loss and credit for l989 and future years must reflect any change in the taxpayer's carryovers. See Reg. Section 1.469-1T for details on allocating the PAL loss and credit.)

Reimbursements of casualty losses from passive activities by insurance or otherwise, are also excluded from the definition of passive activity income. Reg. Section 1.469-2(c)(7)(vi). This exclusion applies only to casualty and theft loss reimbursements that are included in gross income under Reg. Section 1.165-1(d)(2)(iii) (relating to reimbursements of losses that the taxpayer deducted in a prior taxable year), and only if the deduction of the loss was not a passive activity deduction. Reg. Section 1.469-2(c)(7)(vi). It does not apply to any other current or prior year deductions, whether from the activity in which the lost or damaged property was used or from any other activity. This exclusion for casualty and theft reimbursements is provided because such reimbursements are included in gross income only to the extent necessary to offset the tax benefits of any deduction that the taxpayer claimed with respect to the loss. Applying this principle to the passive activity computation, the reimbursement amount included in gross income should not be treated as passive activity gross income if the deduction for the loss was excluded from passive activity deductions.

Under Code Section 469(g), losses from an activity are allowed without limitation if the taxpayer disposes of his entire interest in the activity to an unrelated person in a fully taxable transaction. This rule is inapplicable, however, unless all of the assets used or created in the activity, including land, are disposed of. Thus, a casualty or theft loss involving property used in an activity does not constitute a complete disposition of the taxpayer's interest in the activity unless the casualty or theft loss results in the loss or theft of all property used or created in the activity. Notice 90-21, 1990-1 C.B. 332.

This exclusion from the passive activity rules does not change the treatment of a casualty or theft loss for purposes other than Code Section 469. Notice 90-21, 1990-1 C.B. 332. For example, if a casualty totally destroys property used in a trade or business or held for the production of income and the property's fair market value immediately before the casualty is less than its adjusted basis, the amount of the loss taken into account under Code Section 165 is the property's adjusted basis. Reg. Section 1.165-7(b)(1)(ii). However, the loss must be determined by reference to a single, identifiable property damaged or destroyed. Reg. Section 1.165-7(b)(2)(i).

A casualty or theft loss incurred in a passive activity is not a personal casualty loss and, thus, is not subject to the limitation and other rules applicable to personal casualty losses. (Code Section 165(c)(3); Code Section 165(h).) Such a loss may be treated as a Code Section 1231 loss. However, the Code Section 1231 rules are inapplicable to involuntary conversions of property from fire, storm, shipwreck, or other casualty, or from theft, if the recognized losses from such conversions exceed the recognized gains. Code Section 1231(a)(4)(C).

Taxpayers who sustain losses attributable to a disaster occurring in an area later determined to warrant assistance from the Federal government may elect to deduct the loss for the tax year immediately preceding the tax year of the disaster. (See Code Section 165(i).) Under Notice 90-21, 1990-1 C.B. 332, this throwback election may apply to casualty losses excluded from passive activity deductions.

Chapter 8 – Casualty/Theft Loss: Deductible Loss

To determine the amount of the casualty loss deduction, it is necessary to:

1. Measure the taxpayer's loss;
2. Take account of any insurance recovery, other compensation, or salvage value; and
3. Apply the non-deductible floors.

Measuring Taxpayer's Loss:

The basis for determining the amount of any loss (including casualty losses) is the adjusted basis used in determining the taxpayer's loss on a sale or other disposition of the property (IRC § 165(b)). In the case of a personal residence, automobile, or other item held exclusively for personal use, the adjusted basis is ordinarily cost, with adjustments for improvements, prior casualty deductions, and some other receipts, expenses and tax allowances. If there is a difference between the asset's basis for computing gain and its basis for computing loss (e.g., under § 1015(a), relating to property acquired by gift), the latter must be used, even if the property is held solely for personal use so that any loss on sale would be nondeductible. (Reg. § 1.165-7(b)(1)(ii). See, Pickering v. CIR, 37 TCM (CCH) 1765 (1978), aff'd, 79-2 USTC ¶ 9616 (2nd Cir. 1979), cert. denied, 444 US 1008 (1980) [failure of proof on issue of basis sometimes overlooked to permit allowance of small casualty loss if court can infer that deduction does not exceed basis].)

For example, if an uninsured painting costing $1,000 but worth $5,000 is totally destroyed by fire, the loss is $1,000. Since the unrealized appreciation has not been taken into income, it does not figure into the computation of the deduction. Indeed, if the taxpayer recovered $5,000 from an insurance company or tort-feasor, there would be a gain of $4,000.

If the painting was held solely for personal pleasure and was worth only $750 at the time of the fire, the casualty loss is only $750. The full-adjusted basis of $1,000 is not allowed in this case because the pre-fire decline in value of $250 is not attributable to the casualty. Under Helvering v. Owens, decided by the Supreme Court in 1939, the loss from casualty is the lesser of the property's adjusted basis and its value immediately before the casualty (Helvering v. Owens, 305 US 468 (1939); see, Reg. § 1-165-7 (b)(1)(ii)).

The *Owens* principle does not apply to property used in the taxpayer's trade or business or held for the production of income. When such property is destroyed by casualty, the casualty closes out a loss equal to the full amount of the property's adjusted basis, all of which is sustained in a business or profit-oriented activity (Reg. § 1.165-7(b)(1) (last sentence). If property is converted from personal to business or income-producing uses, the lower of its value or adjusted basis at the time of conversion is used in computing a casualty loss, with adjustments for post-conversion events; see, Reg. § 1-165-7(a)(5)). In this instance, the casualty is merely

the event that marks recognition of the loss, and the deduction is not limited to the loss caused by the casualty.

In computing the casualty loss when several integrally related assets (e.g., land and improvements) are involved, the regulations distinguish property held for personal use from property used for business or income-producing purposes. In the latter situation, the loss is computed by reference to each "single, identifiable property" that is damaged or destroyed. (Cox v. US, 371 F.Supp. 1257, 1261 (ND Cal. 1973) [loss of "unexpected and unrealized appreciation collateral to [taxpayer's] original investment" not deductible], vacated and remanded, 537 F.2d 1066 (9th Cir. 1976). The appellate court relied in part on Regulation § 1.165-7(b)(3), Example 2 (ornamental shrubs), although there the adjusted basis of the damaged property exceeded its value after the casualty. Reg. § 1-165-7 (b)(2)(i); see, Weyerhaeuser Co. v. US, 92 F.3d 1148 (Fed. Cir. 1996) [volcanic eruption of Mt. St. Helens caused damage to taxpayer's timber holdings, including timber stands, logging road systems, and railroad; held, each of seven road systems, entire railroad, and each "subdivision of [the] taxpayer's forest holdings [aggregated for purposes of] tracking the adjusted basis in the timber' was single, identifiable property]; Westvaco Corp. v. US, 639 F.2d 700 (Ct. Cl. 1908) [taxpayer's timber damaged by storms and fires; held, all standing timber in district directly affected by each casualty was single, identifiable property); Carloate Indus., Inc. v. US, 354 F.2d 814 (5th Cir. 1966) [citrus grove land and trees not treated as single unit]; Keefer v. CIR, 63 TC 596 (1975) [office building and land separate units]; see also, Rosenthal v. CIR, 416 F.2d 491 (2nd Cir. 1969) [allocation of basis of timber tract to trees damaged in ice storm].)

According to the regulations, in determining the amount of a casualty loss, a property's fair market value immediately before and after the casualty shall "generally be ascertained by competent appraisal." (Reg. § 1.165-7(a)(2)(i).)

Supplemental instructions issued by the IRS stress the importance of the appraiser's knowledge of the conditions in the area and familiarity with the taxpayer's property, the value of photographs, and industry "bluebooks" for automobiles. (IRS Pub. No. 547, "Casualties, Disasters, and Thefts (Business and Non-business)" 4 (1998); see also, IRS Pub. No. 561, "Determining the Value of Donated Property" 4-6 (1996) [listing several sources of information on valuing particular items, including books, art objects and stamps]; Bowers v. CIR, 42 TCM (CCH) 1659 (1981) [computation of loss attributable to destruction by tornado of ornamental trees around taxpayer's home; analysis of relevant factors].)

The cost of repairs is "acceptable evidence" of the loss in value if the repairs are necessary to restore the property to its pre-casualty condition, are not excessive in amount, and are confined to the casualty damage, and if the property's value after the repairs does not exceed its pre-casualty value. (Reg. §1.165-7(a)(2)(ii).)

The latter condition is easily satisfied in some circumstances (e.g., the replacement of a broken window), but some repairs almost inevitably add value to the property. (See, Bailey v. CIR, 47

TCM (CCH) 321 (1983) [loss from sudden subsidence of soil did not include cost of new retaining walls, which greatly reduced precasualty subsidence]; Root v. CIR, 42 TCM (CCH) 241 (1981) [full cost of repairs not deductible because they put properties in better condition than before casualty].)

The loss may exceed repair costs if repairs cannot restore the property to its pre-casualty value. (See, Finkbohner v. US, 788 F.2d 723 (11th Cir. 1986) [flood caused minimal physical damage to taxpayer's property but substantially diminished fair market value because extensive damage to neighboring property made prospective buyers wary of neighborhood; held, loss is full decline in fair market value, including portion resulting from buyer resistance, and is not limited to cost of repairs]; Conner v. US, 439 F.2d 974 (5th Cir. 1971) [decline in market value fully deductible, even though in excess of repair costs]; Thornton v. CIR, 47 TC 1, 6 (1966) ["in some cases fair market value of damaged property will decline to a far greater extent than can be measured by the yardstick of the cost of repair; once damaged, some property cannot regain its former fair market value no matter how carefully, painstakingly, or expensively repaired"].)

Section 165(k) sometimes allows a casualty loss deduction to a taxpayer ordered to relocate a residence as a result of a presidentially declared disaster. The measure of this loss is the difference between the residence's value before the disaster and its value after the disaster but before the relocation or, if less, the taxpayer's adjusted basis. (Staff of Joint Comm. on Taxation, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1166 (Comm. Print 1984).)

Appraiser's fees and other expenses incurred to establish a deductible loss are not part of the casualty loss itself, but they may be deducted under § 212(3) (expenses of establishing a tax liability) if the taxpayer itemizes deductions.

Chapter 9 – Insurance Recoveries & Other Compensations

Amounts paid by *tort-feasors* are not casualty losses as to them, but they may be deducted under § 162 or § 212 if incurred in a trade or business or a profit-seeking activity. See, Dosher v. US, 730 F.2d 375, 377 (5th Cir. 1984) (no deduction for payment to owner of home that taxpayer negligently drove into; taxpayer's money is lost by casualty only if "the actual currency or coinage is physically damaged or destroyed"); Tarsey v. CIR, 56 TC 553 (1971).

Section 165(a) permits losses to be deducted only if "not compensated for by insurance or otherwise." Expenses incurred in obtaining reimbursement for a casualty loss are part of the loss or an offset against the recovery. (See, Spectre v. CIR, 25 TCM (CCH) 519 (1966) [loss fully covered by insurance, but taxpayer's legal fees deductible]; Jeffrey v. CIR, 12 TCM (CCH) 534 (1953).)

If compensation for the loss or the property's salvage value is collected in the year of the casualty, these offsets are taken into account at that time in computing the uncompensated loss, if any. Conversely, if there is no reasonable prospect of a recovery, the entire loss is taken into account when sustained, and any unexpected subsequent recovery is taken into income when received, subject to the tax benefit doctrine. (See, Reg. §§ 1.165-1(d)(2)(ii), 1.165-1(d)(2)(iii); Montgomery v. CIR, 65 TC 511 (1975) [insurance recovery taxed when received, in view of earlier deduction with tax benefit].)

In the intermediate situation, where the taxpayer has "a claim for reimbursement with respect to which there is a reasonable prospect of recovery," but this claim is not settled during the year of the casualty, "no portion of the loss" that may be reimbursed by this claim is deductible "until it can be ascertained with reasonable certainly whether or not such reimbursement will be received. (Reg. § 1.165-1(d)(2)(i); but see, Hensler, Inc. v. CIR, 73 TC 168 (1979) (acq. in result) [business expense deduction allowed for repairs to business property damaged by casualty, despite possibility of insurance recovery].)

According to the Tax Court, in the case of Ramsay Scarlett & Co. v. CIR, 651 TC 795, 811-812 (974), aff'd, 521 F.2d 786 (4th Cir. 1975):

A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor…. The standard for making this determination is an objective one, under which this Court must determine what was a "reasonable expectation" as of the close of the taxable year for which the deduction is claimed…. The standard is to be applied by foresight, and hence, we do not look at facts whose existence and production for use in later proceedings was not reasonably foreseeable as of the close of the particular year. Nor does the fact of a future settlement or favorable judicial action on the claim control our determination, if we find that as of the close of the particular year, no reasonable prospect of recovery existed.

(See, Jeppsen v. CIR, 128 F.3d 1410 (10th Cir. 1997) [taxpayer had reasonable prospect of recovering funds stolen by stock broker]; Dawn v. CIR, 675 F.2d 1077 (9th Cir. 1982) [later suit evidenced reasonable prospect of recovery]; Scofield's Est. v. CIR, 266 F.2d 154 (6th Cir. 1959) [loss from trustee's diversions, discovered in 1935, deductible in 1948 on conclusion of litigation by successor trustee]; Harwick v. CIR, 184 F.2d 835 (5th Cir. 1950) [insurance for shipwreck]; Johnson v. CIR, 41 TCM (CCH) 849 (1981) [deduction in year of fire, not when lawsuit was finally settled, since prospect for recovery was very uncertain]; Grace v. CIR, 34 TCM (CCH) 992 (1977) [deduction for loss of interest in credit union denied for 1971 to taxpayer filing claim in 1974 to participate in judicial distribution of debtor's assets].)

In a common situation – a reasonable prospect of reimbursement, falling short of certainty – the taxpayer can deduct the loss currently only if and to the extent it exceeds the potential recovery. For example, a deduction may be taken for the amount by which the loss exceeds the taxpayer's insurance policy limit if the insurance is the only possible source of reimbursement. The balance of the loss must be held in abeyance pending resolution of the uncertainty, to be deducted if it exceeds the amount collected or if the claim is abandoned. In the latter case, the taxpayer must show that the claim has in fact been abandoned (e.g., by the execution of a release) or that the abandonment did not serve an extraneous purpose. (Reg. § 1.165-1(d)(2)(i) ["objective evidence" of abandonment]).

The treatment of taxpayers, who refrain from pressing valid claims against their insurers, presumably to guard against cancellation of coverage or increased premiums, has a long history. Although the courts first denied the deduction, later decisions allowed a covered loss to be deducted if the taxpayer unequivocally waived the insurance claim.

(See, Hills v. CIR, 691 F.2d 997 (11th Cir. 1982) [after repeated burglaries, taxpayers did not file insurance claim, fearing non-renewal of policy; loss held not compensated for by insurance]; Miller v. CIR, 733 F.2d 399 (6th Cir. 1984) [same]; Grigsby v. CIR, 47 TCM (CCH) 620 (1982) [same].)

Congress intervened in 1986, denying the § 163(c)(3) deduction for any loss covered by insurance unless "the individual files a timely insurance claim with respect to such loss." (IRC § 165(h)(4)(E) [applicable to losses sustained in taxable years after 1986].)

Amounts received because of a casualty are not necessarily compensation for damage to or destruction of the taxpayer's property. For example, insurance proceeds compensating for loss of the use and occupancy of business property or for additional living expenses are not ordinarily considered compensation for property and, thus, do not reduce the taxpayer's casualty loss.

(Section 123 excludes insurance proceeds received for certain living expenses from gross income. Before § 123 was enacted in 1969, these amounts usually were gross income and did not reduce the casualty loss deduction. Millsap v. Cir, 387 F.2d 420 (8th Cir. 1968); Rev. Rul. 59-

360, 1959-2 CB 75, declared obsolete by Rev. Rul. 72-619, 1972-2 CB 650. But see, Conner v. US, 439 F.2d 974 (5th Cir. 1971) [insurance compensating for temporary living quarters not gross income but reduces casualty loss]. See also, Oppenheim's, Inc. v. Kavanagh, 90 F.Supp. 107 (ED Mich. 1950) [business interruption insurance included in gross income as compensation for loss of profits].)

Similarly, benefits paid to victims of disasters may or may not be allocable to damaged property. (See, Spak v. CIR, 76 TC 464 (1981) [public agency's payment equal to value of house destroyed in flood is compensation for loss, but relocation payment is not]; Rev. Rul. 71-161, 1971-1 CB 76 [federal disaster relief benefits reduce casualty loss]; Shanahan v. CIR, 63 TC 21 (1974) [same]; Rev. Rul. 76-144, 1976-1 CB 17 [disaster relief in excess of casualty loss is nontaxable general welfare receipt]; Rev. Rul. 75-28, 1975-1 CB 68 [disaster relief received after casualty deduction taken in earlier year]. See also, Rev. Rul. 73-408, 1973-2 CB 15 [agricultural benefits included in gross income to extent in excess of farmer's basis in damaged crops].)

Chapter 10 – The $100 and 10 Percent Floors

Section 165(h) imposed two floors on the casualty loss deduction of § 165(c)(3). Section 165(h)(1) disallowed the first $100 of the loss from each casualty or theft (increased in 2009 to $500). Under § 165(h)(2), the deduction for losses in excess of $100 per casualty or theft was limited to the amount by which the aggregate of these losses for the year (reduced by gains on insurance and other recoveries on account of casualties) exceeds 10 percent of the taxpayer's adjusted gross income.

The 10 percent rule only applies in taxable years after 1983. The $100 floor was enacted in 1964. Until 1982, the statutory language applied the $100 floor to all "property not connected with a trade or business," but the regulations also exempted property held for the production of income. Reg. §§ 1.165-1(c)(3), 1.165-7(b)(4)(i)(b). See, S. Rep. No. 830, 88th Cong., 2nd Sess., reprinted in 1964-1 CB (pt. 2) 505, 562 [$100 floor limits personal losses "as distinct from those associated with a trade or business or transactions entered into for profit"]. After amendment in 1982, § 165 (c)(3) applies only to "property not connected with a trade or business or a transaction entered into for profit," and the floors only apply to losses "described in § 165(c)(3)." IRC §§ 165(h)(1), 165(h)(3)(B).)

Under the $100 rule, if one item of property is damaged in two or more separate casualties in a single taxable year, the floor is applied independently to each casualty. If two or more assets are damaged in the same casualty, however, the rule only strips $100 from the entire loss. (Reg. § 1.165-7(b)(4)(ii) [whether damage is from single casualty or from two or more separate casualties is question of fact; events closely related in origin, such as winds and flood caused by hurricane, are one casualty].)

When jointly owned property is damaged or destroyed, each owner's loss is subject to the $100 floor unless the owners are husband and wife, in which event there is only one $100 disallowance if they file a joint return (IRC § 165(h)(4)(B); Reg. § 1.165-7(b)(4)(iii)).

If property serving both personal and business purposes is damaged by casualty, the floor applies only to the part of the loss allocable to the personal element. For example, if an automobile used one half for business and one half for pleasure suffers an otherwise deductible loss of $150, the $75 business loss is fully deductible, but the $75 personal loss is eliminated by the $100 floor (Reg. § 1.165-7(b)(4)(iv)).

The 10 percent floor applies to the personal casualty gains and losses of every individual. The limitation also applies to estates and trusts, even though these entities do not usually use the concept of adjusted gross. An estate's or trust's adjusted gross income is specially computed for this purpose in the same manner as it is computed for individuals, except that administration expenses (if not taken as an estate tax deduction) are allowed in computing adjusted gross income. (IRC §§ 165(h)(4)(C), 165(h)(4)(D).)

A “personal casualty loss” is an excess over $100 of an uncompensated loss resulting from casualty property that is “not connected with a trade or business or a transaction entered into for profit.” (IRC § 165(h) (3)(B). In applying these rules, a husband and wife filing a joint return are treated as one individual. IRC § 165(h)(4)(B).)

A personal casualty gain is realized, for example, if an insurance recovery exceeds the basis of property lost by casualty. Personal casualty gains and losses for the taxable year are aggregated.

If there is net loss:
1. The gains are included in gross income as ordinary income;

2. Losses are deductible to the extent of these gains; and

3. Losses in excess of gains are deductible only to the extent they exceed 10 percent of adjusted gross income.

(IRC § 165(h)(2)(A).) In this case, the gains and an amount of loss equal to the gains are included in determining adjusted gross income, with the consequence that personal casualty gains and losses neither increase nor decrease adjusted gross income. IRC § 165(h)(4)(A). An excess of losses over gains (to the extent deductible under the 10 percent rule) is an itemized deduction.

If there is net gain, each gain and loss is reported as capital gain or loss (IRC § 165(h)(2)(B)). In this situation, the gains and losses are included in computing adjusted gross income. (IRC § 62(a)(3).)

Chapter 11 – The Tax Benefit Rule
Generally, the full amount of any recovery of a previously deducted or credited amount must be included in gross income. However, under the tax benefit rule, a previously deducted or credited amount is not included in gross income to the extent the deduction or credit did not reduce the amount of tax imposed in the prior year. Code Section 111. In other words, taxpayers must include a recovery in income in the year the recovery is received, but only up to the amount by which the deduction or credit the taxpayer took for the recovered amount reduced the taxpayer's tax for the earlier year.

The total of all taxable recoveries are generally reported as other income on Form 1040. Form 1040A or Form 1040EZ may not be used. However, refunds of state and local income taxes must be reported separately on their own line on Form 1040.
A taxpayer who receives a state or local income tax refund of $10 or more will receive a payee statement during January of the following year on Form 1099-G, Certain Government Payments, reporting the refund. Code Section 6050E.

Taxpayers who recover an item from the same tax year are not required to include the recovery in income except to the extent it exceeds the amount of the item. For example, a taxpayer who receives a property tax rebate in the same year the taxes were paid is not required to include the rebate in gross income except to the extent that the rebate exceeds the real property tax paid by the taxpayer. The amount of the rebate, however, reduces the taxpayer's real property tax deduction. CCM 200721017.

Common recoveries include refunds, reimbursements, and rebates of itemized deductions, and may also include some non-itemized deductions (such as previously deducted bad debts) as well as items for which the taxpayer previously claimed a tax credit. See Reg. Section 1.111-1(a)(2). The reimbursement of a previously deducted casualty or theft loss may be a recovery of an itemized deduction. Reg. Section 1.165-1(d)(2)(iii).

Refunds of federal income taxes are never included in income because they are never allowed as a deduction from income.

Not all refunds are treated as recoveries. For example, where a taxpayer claims a deduction under Code Section 164 for his real property taxes, and in the next year the taxpayer receives a state income tax credit against those real property taxes, the credit is not a taxable recovery of the real property taxes. Instead, the taxpayer's state income tax, which is also deductible under Code Section 164, is reduced. However, if the state income tax credit is refundable, the amount by which the credit exceeds the taxpayer's state income tax is includable in income as a recovery of real property taxes. CCA 200842002.

A recovery does not include the gain resulting from the receipt of an item which exceeds the deduction or credit previously allowed for such item. For example, if a $100 bond originally purchased for $40 and later deducted as worthless is collected on to the extent of $50, the $10

gain is not a recovery and cannot be excluded from income under the tax benefit rule. Reg. Section 1.111-1(a)(2). Similarly, if a recovery of state taxes paid exceeds the amount of tax actually paid, then the excess is not a recovery and is includable in gross income. CCM 200504027. Also, in the case of a recovery of a previously deducted charitable contribution, if the property returned by the qualified charitable organization has appreciated in value, the amount subject to the tax benefit rule is limited to the value of the property when it was originally contributed. (Rev. Rul. 76-150, 1976-1 C.B. 38; Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967)).

The addition of a carryover that has not expired by the year of recovery is treated as a tax benefit. Rosenburg v. Commissioner, 96 T.C. 451 (1991). Because the taxpayer received a tax benefit from the additional carryover, the carryover is treated for purposes of the tax benefit rule as decreasing the taxpayer's tax in the year the carryover was generated. Therefore, the recovery of the item that generated the carryover must be included in gross income in the year of recovery even though the carryover has not yet reduced any tax. Code Section 111(c). Similarly, if a bad debt arising from worthless securities or from certain non-business bad debts is treated as a loss from the sale of a capital asset, the recovery of the bad debt is subject to the tax benefit rule regardless of whether the bad debt generated capital losses or ordinary losses, or whether the loss was used as a deduction in the year the loss arose or was instead treated as a capital loss carryover. Reg. Section 1.111-1(a)(4). If the bad debt generated a capital loss, then the recovery amount is treated as capital gain. Likewise, the recovery of an ordinary loss would be treated as ordinary gain. (Deely v. Commissioner, 73 T.C. 1081 (1980); Arrowsmith v. Commissioner, 344 U.S. 6 (1952).)

The recovery of an itemized deduction is eligible for the tax benefit rule only if the taxpayer elected to itemize her deductions for the taxable year in which the deduction could be claimed, rather than taking the standard deduction. See Rev. Rul. 70-86, 1970-1 C.B. 23. Further, the recovery of an item that was previously claimed as an itemized deduction is includable in income under the tax benefit rule in an amount equal to the lesser of (1) the amount of the recovery or (2) the amount by which the itemized deductions exceeded the standard deduction. Rev. Rul. 92-91, 1992-2 C.B. 49.

A computation statement should be attached to the return to show why the income reported due to the tax refund is less than the amount shown on Form 1099-G, Certain Government Payments. IRS Publication 525, Taxable and Nontaxable Income.

Chapter 12 – Net Operating Losses

Carrybacks and Carryforwards - General Rule

After the statutory net operating loss for a taxable year has been determined, the amount of the NOL deduction for that year is calculated based on the amount of the statutory loss and any carrybacks and carryforwards of losses from other years. A loss may be carried only to certain years and must be carried to them in a specified order.

An NOL generally can be carried back to each of the two taxable years preceding the loss year (Code Section 172(b)(1)(A)(i)) and carried forward to each of the 20 taxable years following the loss year. Code Section 172(b)(1)(A)(ii). However, small businesses can elect to carry back any NOL for 2008 back three, four, or five years. See Section 48.3(b)(1). Similarly, any NOL for any taxable year ending during 2001 or 2002 may be carried back to each of the five taxable years preceding the loss year, although the taxpayer can elect not to have this provision apply.
NOLs arising in taxable years beginning before August 6, 1997 generally could be carried back three years and carried forward 15 years. (Reg. Section 1.172-4(a)(1)(ii); Young v. United States, 103 F. Supp. 12 (W.D. Ark. 1952), aff'd, 203 F.2d 686 (8th Cir. 1953).)

Exceptions

Small businesses can elect to carry back losses for 2008 tax years three, four, or five tax years. Similarly, a longer carryback period was available for NOLs arising in 2001 and 2002.

In addition to these rules applicable to specific periods, some types of losses are subject to special rules on carrybacks. Such rules apply with respect to certain losses resulting from casualties, specified liability losses, excess corporate equity reduction interest losses, and losses relating to REITs. (Code Section 172(b)(1) Taxpayer Relief Act of 1997, Pub. L. 105-34, Sections 1082(a)(1) and (2).)

Small Business Losses for 2008

In general, small businesses can elect to carry back 2008 NOLs three, four, or five years, instead of two years. Code Section 172(b)(1)(H). This election applies to the taxpayer's NOL for any tax year ending in 2008, or, at the taxpayer's election, any tax year beginning in 2008. Code Section 172(b)(1)(H)(ii). It can be made for only one tax year. Code Section 172(b)(1)(H)(iii).

A small business for this purpose is any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) the average annual gross receipts (as determined under Code Section 448(c)) of which are $15 million or less. Thus, the election can be made by small businesses, partners in partnerships that are small businesses, shareholders in S corporations that are small businesses, and sole proprietors. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

In determining whether a partnership, S corporation, or sole proprietorship qualifies as an eligible small business, the gross receipts test applies at the partnership, corporate, or sole proprietorship level. Rev. Proc. 2009-26, 2009-19 I.R.B. 935. See Section 503.3(a) for aggregation rules that apply.

A partner in a partnership can make the election for its distributive share of the qualifying partnership income, gain, loss, or deduction that is both allocable to the taxpayer and allowed in calculating the taxpayer's applicable 2008 NOL. Similarly, an S shareholder can make the election for its pro rate share of the qualifying S corporation income, gain, loss, and deduction that is allowed in calculating the shareholder's applicable 2008 NOL. An owner of a sole proprietorship can make the election for the qualifying sole proprietorship income, gain, loss, and deduction that is allowed in calculating the taxpayer's applicable 2008 NOL. The amount of the taxpayer's applicable 2008 NOL that the taxpayer can carry back is limited to the lesser of the taxpayer's items of income, gain, loss, or deduction that are allowed in calculating the taxpayer's applicable 2008 NOL and are from one or more partnerships, S corporations, or sole proprietorships that qualify as eligible small businesses, or the taxpayer's applicable 2008 NOL. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

This election generally must be made by the due date, including extensions, for filing the taxpayer's return for the tax year of the NOL. Code Section 172(b)(1)(H)(iii). However, in the case of a tax year ending before February 17, 2009, it can be made at any time before April 17, 2009. Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(d)(2). Once made, the election to use a carryback other than two years is irrevocable. Code Section 172(b)(1)(H)(iii).

A taxpayer can make the election either on an original return or by filing the appropriate form:

1. A taxpayer makes the election on an original return by attaching a statement to the taxpayer's timely filed federal income tax return for the tax year in which the applicable 2008 NOL arises. The statement must state that the taxpayer is making the election and specify the length of the NOL carryback period elected by the taxpayer (3, 4, or 5 years). If the taxpayer's tax year of the applicable 2008 NOL ends before February 17, 2009, the taxpayer must make the election on or before the later of the due date (including extensions of time) of the taxpayer's return for that taxable year or April 17, 2009.

2. A taxpayer that did not make the election on its original return can make the election by filing the appropriate form applying the NOL carryback period chosen by the taxpayer:

For corporations: Form 1139, Corporation Application for Tentative Refund, or Form 1120X,

Amended U.S. Corporation Income Tax Return.

For individuals: Form 1045, Application for Tentative Refund, or Form 1040X, Amended U.S. Individual Income Tax Return.

For estates or trusts: Form 1045, or amended Form 1041, U.S. Income Tax Return for Estates and Trusts.

A taxpayer that makes the election by filing an amended return must file the return for the earliest taxable year to which the taxpayer is carrying back the applicable 2008 NOL. The taxpayer should not file an amended return for the applicable 2008 NOL taxable year. The appropriate form must be filed on or before the later of the date that is 6 months after the due date (excluding extensions) for filing the taxpayer's return for the taxable year of the applicable 2008 NOL or April 17, 2009. No statement or label is required with the appropriate form. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

The procedures in (2) also apply for taxpayers that want to revoke a prior election to revoke an election to forego the carryback period. In addition, the taxpayer should type or print across the top of the appropriate form "Revocation of NOL Carryback Waiver Pursuant to Rev. Proc. 2009-19." The taxpayer must file the revocation and new election under ?172(b)(1)(H) on or before April 17, 2009. Rev. Proc. 2009-26, 2009-19 I.R.B. 935.

If a taxpayer makes this election, the special rule for losses from casualties does not apply for that year. Code Section 172(b)(1)(H)(i)(III).

The IRS is to prescribe anti-abuse rules, including anti-stuffing rules, anti-churning rules, including rules relating to sale-leasebacks, and wash sales rules. Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1121(c).

Losses Resulting from Casualties

NOLs of individuals arising from a fire, storm, shipwreck, other casualty, or theft, and NOLs of a small business or a taxpayer engaged in a farming business attributable to losses incurred in federally declared disaster areas, may be carried back for three years. Code Section 172(b)(1)(F). However, qualified disaster losses incurred in 2008 and 2009 can be carried back for five years. Code Section 172(b)(1)(J). In addition, these amounts may be deducted for alternative minimum tax purposes. Code Section 56(d)(3).

Qualified disaster losses are the lesser of the sum of the deductible casualty for the taxable year attributable to a federally declared disaster occurring before December 31, 2010, and occurring in a disaster area and the deduction for the taxable year for qualified disaster expenses, or the net operating loss. Taxpayers can elect not to have the five-year carryback apply. The election must be made by the due date, including extensions, of the taxpayer's return for the year, and once made is irrevocable. Code Section 172(j).

A small business is any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) the average annual gross receipts (as determined under Code Section 448(c)) of which are $5 million or less. A farming business is the trade or business of farming and includes the trade or business of operating a nursery or sod farm or raising or harvesting trees bearing fruit, nuts, or other crops, or other ornamental trees (other than an evergreen tree that is more than six years old at the time it is severed from the roots). Code Section 263A(e)(4).

Procedure

Unless the carryback period is relinquished, an NOL must be carried to the earliest of the taxable years to which it can be applied. Code Section 172(b)(2).

Any excess is carried over to the other taxable years, in order. Thus, unless an earlier year is permitted under one of the exceptions, an NOL is first carried back to the second preceding taxable year. The portion of the loss that remains unabsorbed in the second preceding taxable year is then carried to each of the other taxable years in chronological order. A 2003 NOL is carried back first to 2001. Any unabsorbed amount is carried to 2002. Any still-unabsorbed amount is then carried forward.

A taxable year that is shorter than a full twelve-month year is counted as a full taxable year in determining the years to which the loss may be carried. (Taxpayer Relief Act of 1997, Pub. L. 105-34, Section 1082(c).) Years for which assessment is barred are also counted. Calumet Industries, Inc. v. Commissioner, 95 T.C. 257 (1990). Similarly, the IRS takes the position that years discharged in bankruptcy are counted. FSA 200039007.

An individual taxpayer carrying back an NOL files either Form 1045, Application for Tentative Refund, or Form 1040X, Amended U.S. Individual Income Tax Return. Estates and trusts not filing Form 1045 must file an amended Form 1041, U.S. Income Tax Return for Estates and Trusts, for each carryback year to which the NOL is applied. An individual taxpayer carrying forward an NOL lists the NOL deduction as a negative figure on the "other income" line of Form 1040.

A corporate taxpayer carrying back an NOL files either Form 1120X, Amended U.S. Corporation Income Tax Return, or Form 1139, Corporation Application for Tentative Refund. Form 1139 may not be filed before filing the return for the NOL year, but if used must be filed no later than one year after the NOL year. If Form 1120X is used, it must be filed within three years of the due date, including extensions, for filing the return for the year of the NOL. A corporate taxpayer carrying forward an NOL enters the amount on Form 1120, Schedule K, line 12.

Every taxpayer claiming an NOL must attach a statement showing all the important facts about the NOL, including a computation showing how the taxpayer figured the NOL deduction. Reg. Section 1.172-1(c).

In the case of consolidated groups, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset consolidated taxable income for the year, generally are absorbed on a pro rata basis. Reg. Section 1.1502-21T(b)(1).

If any part of a net operating loss is not absorbed by the end of the carryforward period, it is lost. Although the NOL provisions provide some measure of income averaging, they do not ensure that all losses are deductible. However, there are ways to ensure that an NOL carryforward is not lost.

Relinquishing the Carryback Period

A taxpayer may elect to relinquish the carryback period with respect to any net operating loss for any taxable year. Code Section 172(b)(3). If a taxpayer does not make this election and fails to carry back a loss to the earliest prior year, the amount of NOL that may be deducted in another year is reduced by the amount of the NOL that would have been absorbed in a prior year. (Eisenberg v. Commissioner, T.C. Memo. 1963-78; see Messina v. United States, 202 Ct. Cl. 155 (1973).)

Although carrying an NOL back to a preceding tax year typically results in an immediate refund, a taxpayer may wish to relinquish the carryback period if tax rates in the previous two years are lower than the rates expected in succeeding years. At higher tax rates, the same dollar amount of loss produces larger tax savings.

If an election to relinquish the carryback period is made, the entire carryback period must be relinquished. Code Section 172(b)(3). The taxpayer may not elect to forgo only certain years.

Under the special rules for NOLs arising in 2001 and 2002, however, a taxpayer may choose to carry losses back to the fifth preceding year or the second preceding year, or forego a carryback altogether.

Furthermore, the election, once made for any taxable year, is irrevocable for that year. (Code Section 172(b)(3). Because the election is irrevocable, a taxpayer cannot disregard an election based on a material mistake of fact. TAM 199937020. See also, Welch v. Commissioner, 204 F.3d 1228 (9th Cir. 2000) (when taxpayer did not properly make the election, he failed to establish that the alleged NOL had not already been absorbed).)

The IRS has provided a limited amount of relief from this rule for NOLs arising in 2001 and 2002 and for NOLS arising in 2008.

A bankruptcy trustee, however, has the authority to avoid a debtor's irrevocable election to carry NOLs forward as a fraudulent transfer. United States v. Sims, 218 F.3d 948 (9th Cir. 2000). Once an election has been avoided, it is as if it never happened, and the trustee can elect as he sees fit. Estate of Russell v. United States, 927 F.2d 413 (8th Cir. 1991). Where a trustee in bankruptcy is barred by the bankruptcy law's statute of limitations from exercising the avoidance power, however, the election made by the bankrupt to relinquish the carryback period may not be challenged. In re Home America T.V.-Appliance Audio, Inc., 232 F.3d 1046 (9th Cir. 2000).

The election to relinquish the carryback period must be made by the due date (including extensions) for filing the taxpayer's return for the taxable year in which the NOL for which the election is to be in effect was generated. (In TAM 9144043, the National Office advised that notations written in the margin on the taxpayer's returns that included the word "elect" were affirmative statements that provided enough information to allow the losses incurred to be carried forward in accordance with an election under Code Section 172(b)(3).) The IRS does not have the authority to grant an extension of time for making the election. (PLR 8333001; PLR 8107111; PLR 8229035; PLR 8339056; PLR 8549057. See also PLR 8405041 (reaffirms position taken in PLR 8339056).)

The election is made by attaching a statement to the return for the taxable year indicating the section under which the election is being made and setting forth the information to identify the election, the period for which it applies, and the taxpayer's basis for making the election. Reg. Section 301.9100-12T(d). An election to forgo the carryback may be made in an amended return only if the amended return is filed before the due date of the original return. Reg. Section 301.9100-12T(b)(1). Despite this rule, the IRS has provided limited relief for NOLS arising in 2001 and 2002, as discussed in Section 48.3(e).

In Young v. Commissioner (83 T.C. 831 (1984), aff'd, 783 F.2d 1201 (5th Cir. 1986). PLR 8929033; (the election to relinquish the carryback period cannot be made on an amended return filed after the due date for the loss year, even if the original return filed did not show a loss).), the Tax Court held that failure to make a timely election in the manner prescribed irrevocably deprived the taxpayer of the right to forgo the carryback period, even though, in other documents filed, that taxpayer did not manifest an intent to forgo such period. Thus, a taxpayer who fails to comply with the requirement that the return be accompanied by a separate statement with information identifying the election has not made a valid election. Klyce v. Commissioner, T.C. Memo. 1999-198. The Tax Court has held an election to be valid, however, where it met the standards prescribed in the regulations, but the taxpayer cited the incorrect Code section. (Powers v. Commissioner, T.C. Memo. 1986-494, reaff'd, T.C. Memo. 1993-125. See also Carlstedt Assn. v. Commissioner, T.C. Memo. 1989-27.)

If the original return has been timely filed (by the extended due date) the election can still be made on an amended return filed within six months of the due date, excluding extensions, of the original return. Reg. Section 301.9100-2.

Rules for 2001 and 2002 NOLs and Tax Years

NOLs arising during 2001 and 2002 can be carried back five years, rather than the normal two years. Code Section 172(b)(1)(H), prior to amendment by Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(a). A taxpayer may elect not to have the five-year carryback period apply. Code Section 172(k), prior to repeal by Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(b). In this case, the normal two-year carryback period, or, if eligible, a three-year carryback period, applies, unless the taxpayer elects to forgo the carryback period entirely.

In general, the election to forgo the five-year carryback must be made by the due date, including extensions, of the return for the taxable year of the NOL and once made is irrevocable for that year. Code Section 172(k), prior to repeal by Pub. L. 111-5, American Recovery and Reinvestment Tax Act of 2009, Section 1211(b). See Rev. Proc. 2002-40, 2002-1 C.B. 1096, for how to make this election.

Code Section 172(f)(1)(A) and (B). With respect to affiliated groups, the Supreme Court has held that an affiliated group's product liability loss must be figured on a consolidated, single-entity basis, not by aggregating product liability losses separately determined company by company. United Dominion Industries, Inc. v. United States, 532 U.S. 832 (S.Ct. 2001) rev'g 208 F.3d 452 (4th Cir. 2000).

See Sealy Corporation v. Commissioner, 171 F.3d 655 (9th Cir. 1999), affg, 107 T.C. 177 (1996)(relating to the deductibility of legal and accounting expenses); Host Marriott Corporation v. United States, 267 F.3d 363 (4th Cir. 2001), aff?g 113 F.Supp. 2d 790 (D. Md. 2000) (relating to the deductibility of interest accrued on federal tax deficiencies); Intermet Corporation & Subsidiaries v. Commissioner, 117 T.C. 133 (2001) (relating to the deductibility of state tax deficiencies and interest on federal and state tax deficiencies); United States v. Balsam Corporation, 232 B.R. 160 (E.D.Mo. 1997), aff?d, No. 98-1225EM (8th Cir. 1998) (relating to the deductibility of tort losses); Major Paint Company v. United States, 334 F.3d 1042 (Fed. Cir. 2003), affg sub nom. Standard Brands Liquidating Creditor Trust v. U.S., 53 Fed. Cl. 25 (Fed. Cl. 2002) (relating to the deductibility of capitalized bankruptcy costs).

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In 1997, Gary completed the Team Beverly Hills civic leadership training.

From 1997-1999 Gary was Vice-President and Member of the Board of Trustees of The Greystone Foundation, Beverly Hills, California.

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Articles by Gary S. Wolfe

EB-5 Investor Green Cards By Mark Ivener and Gary Wolfe
Offshore Investment (December 2014/January 2015 Edition)

EB-5 Investors & the Perils of U.S. Estate and Gift Taxes with Mark Ivener
EB-5 Investors Magazine (Winter/2014 Edition)

Self-Study Article: A Primer on Passive Foreign Investment Companies and Comparison to Controlled Foreign Corporations with Allen Walburn
California Tax Lawyer (Fall 2013)

EB-5 Investor Visa And U.S. Tax Issues with Mark Ivener
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2. IRS Closes In On Secret Caribbean Accounts by Eric Reiner
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Expatriation: The IRS & U.S. Taxes (2014)

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Asset Protection 2013: The Gathering Storm (2013)

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Offshore Tax Evasion: U.S. Tax & Foreign Entities (2013) with Allen B. Walburn, Esq.

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