

Where Have All the Theft Losses Gone?

By Joshua D. Smeltzer and Matthew Roberts*

Introduction

Regrettably, theft losses are on the rise. According to the federal government, senior citizens lost almost \$1 billion in Internet and other scams in 2020.¹ In 2022, the federal government reported that theft losses had increased 84% year-over-year from 2021 to 2022, with an estimated \$3.1 billion of total losses reported to the Federal Bureau of Investigation's (FBI's) Internet Crime Complaint Center (IC3).² The Federal Trade Commission (FTC) has also reported that \$1 billion has been lost since 2021 in scams involving cryptocurrencies.³

Naturally, theft loss victims have questions when they prepare their income tax returns. Prior to the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA), theft loss issues were relatively simple. Taxpayers could claim the theft losses, subject to some restrictions. However, the TCJA has made this formerly simple process much more complicated for theft loss claims that arise from 2018 through 2025.

This article addresses the ambiguity in the law associated with claiming theft losses after the passage of the TCJA. It first discusses the general requirements to claim a theft loss. Then, it discusses the TCJA and its revisions to Code Sec. 165 or the provision in the Code that relates to theft losses. Finally, it provides arguments advanced for and against claiming theft losses after the passage of the TCJA.

Theft Losses Generally

Code Sec. 165 of the Code permits taxpayers to claim losses, including theft losses. Under existing federal case law, a taxpayer may claim a theft loss if the taxpayer can show (1) the occurrence of a theft, (2) the amount of the theft loss, and (3) the date the taxpayer discovered the theft.⁴ Additionally, the taxpayer must show that a third party (*e.g.*, insurance company) will not compensate or reimburse the taxpayer for the theft loss.⁵ As with any deduction, the taxpayer bears the burden of proof in showing satisfaction of all of these elements.⁶

Occurrence of a Theft

To qualify for the theft loss deduction, the taxpayer must first show the actual occurrence of a theft. Under the regulations, theft is “deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery.”⁷ Thus, under federal case law:

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[T]o qualify for a ‘theft’ loss within the meaning of section 165[] of the Code, 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, and that the taking was done with criminal intent.⁸

Amount of Theft Loss

Taxpayers bear the burden of proving the amount of a claimed theft loss. For these purposes, a theft loss is limited to the lesser of (1) the property’s fair market value immediately before the theft and (2) the property’s adjusted basis.⁹ To determine fair market value, the governing regulations assume a deemed sale where the “fair market value of the property immediately after the theft [is] considered zero.”¹⁰

Timing of the Theft Loss Deduction

To support a theft loss deduction, the taxpayer must show the proper tax year in which the loss occurred.¹¹ Moreover, to the extent the taxpayer satisfies this burden, the taxpayer must further show that there is no reasonable prospect of recovery in the year in which the theft loss deduction is claimed.¹² If there is a reasonable prospect of recovery in the year of the discovery, the timing of the deduction is delayed until the prospect of recovery no longer exists.¹³

Generally, the year of the discovery is the year in which a reasonable person in similar circumstances would have discovered the theft.¹⁴ Moreover, “[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.”¹⁵

The Tax Cuts and Jobs Act of 2017

On December 22, 2017, then President Donald Trump signed into law the TCJA. As discussed below, the TCJA modified and added restrictions to certain losses under Code Sec. 165 and also eliminated the ability of taxpayers to claim miscellaneous itemized deductions. These revisions apply to tax years 2018–2025.

Under the TCJA, a taxpayer may only claim a “personal casualty loss” under Code Sec. 165(a) to the extent the loss is attributable to a federally declared disaster area.¹⁶ Also, under the TCJA, “no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.”¹⁷

The Gomas Decision

On July 17, 2023, the federal district court in the Middle District of Florida issued a decision related to an elderly couple’s loss of their retirement savings.¹⁸ In that case, the Gomases had retired and liquidated their business. However, their daughter participated in a fraudulent scheme where she advised the Gomases that Mr. Gomas could be arrested if he failed to settle certain open accounts related to the business. The Gomases withdrew taxable funds from their retirement account and transferred those funds to their daughter. Later, the Gomases discovered the fraud in 2019, and their daughter was arrested and sentenced to a prison term.

For their 2017 tax year, the Gomases filed an amended tax return claiming a deduction related to the funds that were fraudulently transferred to their daughter. The Internal Revenue Service (IRS) refused to issue the refund, and the Gomases filed a refund suit. In the refund suit, the Gomases made two contentions for why they were entitled to a refund. *First*, the Gomases argued that they should not be taxable on the retirement distribution in 2017 because they did not receive or enjoy any benefit from the withdrawn funds. The court disagreed, concluding that the Gomases “authorized and directed each stock sale from Mr. Gomas’s IRA account and each wire transfer to their personal ... account.” According to the court, these activities showed that the Gomases had sufficient control and benefit over the distributions to render them taxable.

Second, the Gomases contended that they should be entitled to deduct the funds that were transferred to their daughter as an ordinary and necessary business expense. Specifically, they contended that they were led to believe by their own daughter that she was using the funds to pay for legal services to resolve fictitious legal matters associated with their closed business. The court also rejected this argument, finding that the Gomases were not engaged in any for-profit business activity because they had already retired.

Interestingly, although not apparently raised by the Gomases, the court acknowledged that the Gomases were victims of theft but that, “Congress suspended the theft loss deduction for the 2018 through 2025 tax years” under Code Sec. 165(h).¹⁹

Can Taxpayers Claim a Theft Loss in 2018–2025?

Given the changes in the law under the TCJA and the recent *Gomas* decision, taxpayers may be skeptical that

they can claim a theft loss at all during their 2018–2025 tax years. However, as with most things involving the Internal Revenue Code, the answer is not entirely clear. The remainder of this article addresses this issue.

Arguments for Claiming a Theft Loss

Proponents of claiming a theft loss would contend that the statutory language and prior IRS guidance support their view that *certain* theft losses may be claimed after the TCJA.

Code Sec. 165 provides the general rule that “[t]here shall be allowed as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise.” Notwithstanding this general rule, Code Sec. 165(c) breaks down losses claimed by an individual into three categories. *First*, Code Sec. 165(c)(1) permits individuals to claim losses related to a trade or business. *Second*, Code Sec. 165(c)(2) permits individuals to claim losses incurred in a transaction entered into for profit, though not connected to a trade or business. And *third*, Code Sec. 165(c)(3) permits individuals to claim losses not connected with a trade or business or a transaction entered into for profit related to “fire, storm, shipwreck, or other casualty, or from theft.”

As mentioned above, the TCJA enacted revisions to Code Sec. 165, particularly those related to “personal casualty losses.” Relevant here, Code Sec. 165(h)(5) provides that “any personal casualty loss which (but for this paragraph) would be deductible in a taxable year beginning after December 31, 2017, and before January 1, 2026, shall be allowed as a deduction under ... [Code Sec. 165(a)] only to the extent that is attributable to a Federally declared disaster area” Code Sec. 165(h)(3)(B) defines “personal casualty loss” as any loss described in Code Sec. 165(c)(3).

Based on the revisions made in the TCJA to Code Sec. 165(h), it appears clear that taxpayers may not claim theft losses under Code Sec. 165(c)(3) unless they are, among other things, attributable to the federally declared disaster area. But this begs the question: can theft losses be claimed under Code Sec. 165(c)(1) or Code Sec. 165(c)(2)? IRS guidance issued prior to the TCJA claims that it can.

For example, in Rev. Rul. 66-93,²⁰ two limited partners formed a limited partnership and engaged in brokerage services. One of the general partners embezzled funds from the partnership, resulting in the partnership becoming insolvent and subject to receivership. As a result of the embezzlement, the limited partners sustained a loss, which could not be recovered from the general partner because the general partner was also insolvent. On these facts, the IRS held that the loss incurred by the partnership

(*i.e.*, the theft loss) was an “ordinary loss under the provisions of section 165(a) and (c)(1) of the Internal Revenue Code of 1954.” In other words, the IRS held that a theft loss could occur outside the context of Code Sec. 165(c)(3).

In more recent guidance, the IRS has also concluded that taxpayers may claim theft losses under Code Sec. 165(c)(2), provided the theft occurred in an activity entered into by the taxpayer for profit, although not rising to the level of a trade or business. Specifically, in Rev. Rul. 2009-9,²¹ the IRS explicitly held that victims of a Ponzi scheme could claim theft losses under Code Sec. 165(c)(2) because such losses were not appropriately characterized as Code Sec. 165(c)(3) losses. Treasury regulations also seemingly support the view that theft losses can fall within Code Sec. 165(c)(1), 165(c)(2), or 165(c)(3), depending on the activity surrounding the theft.²² Therefore, the facts and circumstances of each case must be evaluated in order to determine if unique facts might save an otherwise non-deductible theft loss.

Notably, Rev. Rul. 2009-9 went further in also concluding that theft losses under Code Sec. 165(c)(2) were not miscellaneous itemized deductions or subject to the limitations of Code Sec. 165(h). This ruling applies to traditional assets; however, it might also apply to digital assets to allow victims of recent cryptocurrency fraud to take advantage of those losses to the extent that a capital loss does not provide full relief.²³ A recent Chief Counsel Advice Memorandum discussing abandonment and worthlessness losses for cryptocurrency specifically stated that theft losses involving individual taxpayers are treated differently.²⁴ The IRS’ contention that theft losses under Code Sec. 165(c)(2) do not constitute a miscellaneous itemized deduction warrants additional explanation, particularly in light of a general perception that all theft losses should be characterized as these types of deductions.

Under federal tax law, taxpayers are required to compute their income taxes based on “taxable income.”²⁵ To determine “taxable income,” taxpayers may either claim a standard deduction or alternatively may elect to itemize their deductions.²⁶ “Itemized deductions” are defined in the negative as any deductions permitted under Chapter 1 (*i.e.*, Code Secs. 1-1400Z-2) other than deductions allowed in arriving at adjusted gross income (*i.e.*, Code Sec. 62); the standard deduction (*i.e.*, Code Sec. 63(c)); the deduction for personal exemptions (*i.e.*, Code Sec. 151); the qualified business income deduction (*i.e.*, Code Sec. 199A); and certain charitable contribution deductions (*i.e.*, Code Sec. 170(p)).²⁷

But the Code further breaks down certain deductions into so-called “miscellaneous itemized deductions.”²⁸ And Code Sec. 67(b)(3) provides the list of miscellaneous

itemized deductions. Under that provision, a miscellaneous itemized deduction is any itemized deduction other than “the deduction under Code Sec. 165(a) for casualty or theft losses described in paragraph (2) or (3) of Code Sec. 165(c).” Thus, by statute, Code Secs. 165(c)(2) and 165(c)(3) deductions are not miscellaneous itemized deductions. Note, however, that Code Sec. 165(c)(3) theft losses would be limited under the TCJA to those incurred or associated with a federally declared disaster area, leaving the possibility to claim Code Sec. 165(c)(2) theft losses undisturbed by the TCJA’s ban on miscellaneous itemized deductions.

Accordingly, there is some support for the position that taxpayers may claim a theft loss even after the TCJA. However, what do we make of the decision in *Gomas*? As an initial matter, it should be pointed out that, at least according to the opinion, the taxpayers never raised the issue of theft losses under Code Sec. 165(c) because they were not claiming a theft loss, resulting in the court’s statement representing non-binding *dicta*.

Arguments Against Claiming a Theft Loss

Many tax professionals and taxpayers merely accepted the general notion that no theft loss deduction may be claimed after the TCJA. This position is a reasonable one, particularly because of the statutory text and the *Gomas* decision, which made a similar comment even though that issue was never presented.

Federal courts have generally found that “[t]he best evidence of Congress’s intent is the statutory text.”²⁹ Thus, the first step in statutory construction cases “is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case.”³⁰ The inquiry ceases “if the statutory language is unambiguous and the statutory scheme is coherent and consistent.”³¹

Here, the term “theft,” as used in Code Sec. 165, is located in three parts of the statute. *First*, the term “theft” is used only in Code Sec. 165(c)(3). It is notably absent from Code Secs. 165(c)(1) and 165(c)(2), which addresses other types of individual losses. *Second*, the term theft is

used in Code Sec. 165(e), or the provision that governs when a taxpayer may claim a theft loss. That provision does not refer to Code Sec. 165(c) at all—rather, it only mentions Code Sec. 165(a) and the general rule related to losses. *Third*, the term “theft” is used in Code Secs. 165(h)(1) and (h)(3). Code Sec. 165(h)(1) provides the dollar limitation applicable to “casualty gains and losses” and Code Sec. 165(h)(3) defines the term “personal casualty gain.” Accordingly, a reasonable interpretation of the statute suggests that Congress’s explicit usage of the term “theft,” particularly in Code Sec. 165(c)(3), means that theft losses can only occur in that context and not within Code Sec. 165(c)(1) or (c)(2).

Thus, proponents against claiming a theft loss in 2018–2025 would point to the statute itself as well as to the recent decision in *Gomas*, which appears to be the only decision opining on the theft loss issue after the enactment of the TCJA.

What Should Taxpayers Do if They Have a Theft Loss in 2018–2025?

Taxpayers who claim theft losses on a return between 2018 and 2025 are subject to risks in light of the ambiguity of the law and *Gomas*. These risks include substantial civil penalties that could be potentially reduced if the taxpayer seeks a tax opinion and properly discloses the theft loss position on the tax return. For example, a taxpayer may only claim a position on a return if, at a minimum, the taxpayer has a “reasonable basis” for the reporting position.³² In determining whether a taxpayer has a “reasonable basis,” taxpayers are entitled to rely upon, among other authorities, the statutory text, applicable regulations, and revenue rulings.³³ Although the revenue rulings discussed in this article were issued prior to the TCJA, they may provide sufficient support to claim a theft loss. As is common in federal tax matters, the particular facts and circumstances surrounding the purported theft loss will ultimately govern how strong of a case a taxpayer has in claiming a theft loss and whether the taxpayer can reach the reasonable basis standard.

ENDNOTES

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¹ Luke Barr, *Senior Citizens Lost Almost \$1 Billion in Scams Last Year: FBI*, available at abcnews.go.com/Politics/senior-citizens-lost-billions-scams-year-fbi/story?id=78356859 (last visited on August 4, 2023).

² Austin Eller, *FBI: Losses from Elder fraud cases rose 84% in 2022*, available at accesswdun.com/

[article/2023/4/118001/fbi-losses-from-elder-fraud-cases-rose-84-in-2022](https://accesswdun.com/article/2023/4/118001/fbi-losses-from-elder-fraud-cases-rose-84-in-2022) (last visited August 4, 2022).

³ Ramishah Maruf, *\$1 billion has been lost in cryptocurrency scams since 2021, FTC warns*, available at www.cnn.com/2022/06/04/business/cryptocurrency-scammers-ftc-warning/index.html.

⁴ See *R.S. Gerstell*, 46 TC 161, Dec. 27,937 (1966); *M. Monteleone*, 34 TC 688, Dec. 24,278; *J. H. McCinley*, 34 TC 59, Dec. 24,135 (1960).

⁵ See Code Sec. 165(a).

⁶ *Welch v. Helvering*, S.Ct., 3 USTC ¶1164, 290 US 111, 54 S.Ct 8 (1933); *M. Torres*, 121 TCM 1504, Dec. 61,876(M), TC Memo. 2021-66.

⁷ Reg. §1.165-8(d); see also *C.P. Littlejohn*, 119 TCM 1274, Dec. 61,650(M), TC Memo. 2020-42 (“As used in Code Sec. 165, the term ‘theft’ is a word of broad and general connotation, intended to cover any criminal appropriation of another’s property, including theft by larceny, embezzlement, obtaining money by false pretenses, and any other form of guile.”).

- ⁸ Rev. Rul. 72-112, 1972-1 CB 60; see also *Edwards v. Bromberg*, CA-5, 56-1 USTC ¶9448, 232 F2d 107 (1956); *B. P. Citron*, 97 TC 200, 207, Dec. 47,513 (1991) (“The law of the jurisdiction where the loss is sustained is applicable to determine whether a theft or embezzlement has occurred.”).
- ⁹ *G. Raifman*, 116 TCM 29, Dec. 61,212(M), TC Memo. 2018-101; Reg. §§1.165-7(b)(1) and 1.165-8(c).
- ¹⁰ Reg. §1.165-8(c).
- ¹¹ See Code Sec. 165(e).
- ¹² See Reg. §1.165-1(d)(3).
- ¹³ *Id.*
- ¹⁴ *V.M. Cramer*, 55 TC 1125, 1133, Dec. 30,697 (1971).
- ¹⁵ *Baum*, 121 TCM 1315, Dec. 61,856(M), TC Memo. 2021-46.
- ¹⁶ Code Sec. 165(h)(5)(A).
- ¹⁷ Code Sec. 67(g).
- ¹⁸ See *Gomas*, No. 8:22-cv-1271 (M.D. Fla. July 17, 2023).
- ¹⁹ The court noted that although the funds were stolen in 2017, the Gomases did not discover the theft until 2019. Because the theft loss is keyed to the year of discovery, as mentioned *supra*, the TCJA would apply to any potential theft loss deduction they claimed in 2019.
- ²⁰ 1966-1 CB 165.
- ²¹ 2009-14 IRB 735.
- ²² See also Reg. §1.165-8 (“A theft loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is discovered during the settlement of an estate ... shall be allowed as a deduction under Code Secs. 165(a) and 641(b).”).
- ²³ IRS Notice 2014-21, IRB 2014-16, 938 treats convertible cryptocurrency as property so the price becomes cost basis and if later sold is a capital gain or loss on the transaction. However, a capital loss must have sufficient capital gains to offset those losses or they are subject to limitations.
- ²⁴ See CCA 202302011 (January 13, 2023) at 3 and fn 2.
- ²⁵ Code Secs. 1 and 63.
- ²⁶ Code Secs. 63(a) and 63(b).
- ²⁷ Code Sec. 63(d).
- ²⁸ Code Sec. 67.
- ²⁹ *Am. Trucking Ass'ns*, S Ct, 310 US 534, 543, 60 S Ct 1059 (1940).
- ³⁰ *Barnhart v. Sigmon Coal Co.*, S Ct, 534 US 438, 450, 122 S Ct 941 (2002).
- ³¹ *Id.*
- ³² Code Sec. 6662(d)(2)(B); Reg. §§1.6662-3(a) and 1.6662-3(c); *Chemtech Royalty Assocs.*, CA-5, 2016-1 USTC ¶150,284, 823 F3d 282 (2016).
- ³³ Reg. §1.6662-4(d)(3)(iii).

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