

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Neil G. Smuckler, Revenue Agent
(SBSE Examination, Southeast)

from: Nancy C. Carver
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(Small Business/Self-Employed)

subject: Theft Loss Advisory

This memorandum responds to your request for assistance dated April 11, 2005. This advice may not be used or cited as precedent.

LEGEND

T =
X =
Corporation Y =
Z =

ISSUES

Whether T's are entitled to claim a theft loss under I.R.C. § 165.

CONCLUSIONS

Based on the limited facts provided, we conclude the T's are not entitled to a theft loss deduction for their losses related to the exercise of stock options. The T's have provided no facts showing the losses were caused by theft.

FACTS

In support of their theft loss claim under I.R.C. § 165, T's have provided an eleven page Statement of Claim, submitted on behalf of T's in the Matter of the Arbitration Between _____ . T's claim against _____ (hereinafter "X"), is summarized on page one of this document, in paragraph A. 1, which states:

In the period from _____ through _____, X overconcentrated the CLAIMANTS' portfolio, made misrepresentations or material omissions of fact to CLAIMANTS, failed to implement a hedging strategy in the CLAIMANTS' portfolio and _____. Such wrongful conduct caused a severe decline in the value of CLAIMANTS' life savings.

Both of the T's were employees of Corporation Y. During all relevant periods, T's resided in _____. As employees of Corporation Y, the T's received and invested in numerous non-qualified employee stock options. The T's were directed to exercise their options through X, the plan administrator for Corporation Y. X was represented by a broker team of individuals at X's offices in _____. As stock option plan administrator, X facilitated the exercise of stock options and managed the T's portfolio.

Pursuant to advice of X, during the years _____ and _____, T's exercised their Corporation Y non-qualified employee stock options using margin to facilitate the transaction by a strategy commonly referred to as "buy and hold". According to T's, the total amount of margin used to facilitate the "buy and hold" strategy was \$ _____. This is the amount of the I.R.C. § 165 theft loss T's claim on their Amended 1040X, dated _____. The above-referenced eleven page Statement of Claim details the dates and amounts spent by T's exercising options and meeting margin calls during the years _____ and _____. The claim includes allegations that the brokers breached their fiduciary duty and engaged in constructive fraud by allowing T's accounts to be overconcentrated in Corporation Y stock, failing to inform T's of protective hedging strategies to reduce the risk to their investments, and failing to recommend suitable investment strategies. The value of T's Corporation Y stock declined dramatically due to _____. T's settled their case with X for \$ _____. The terms of the settlement have been kept confidential. In support of their position, T's have provided a Section 165 Tax Support Guide published by JK Harris, LLC, which provides a general overview of theft losses. T's have supplied no specific legal or factual argument supporting their position that a theft occurred. In alleging a "theft of investments", T's mention their reliance on their brokers' expertise to manage and to invest their funds. T's rely on the fact that X was sanctioned \$ _____ by _____ for _____.

LAW AND ANALYSIS

I.R.C. § 165(a) allows a deduction for any loss sustained during a taxable year and not compensated for by insurance or otherwise. I.R.C. § 165(c) limits the general rule in subsection (a) for individuals to, among other things, theft losses. I.R.C. § 165(e) specifies that any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss.

Although the term "theft" is not defined in the Internal Revenue Code, the regulations provide that the term "theft" , "shall be deemed to include, but shall not necessarily be limited to larceny, embezzlement, and robbery." Treas. Reg. § 1.165-8(d). The Fifth Circuit Court of Appeals, in Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1956) concluded that "theft", as used in the Internal Revenue Code, is not a technical word of art with a narrow definition, rather it was intended to cover any criminal appropriation of another's property to the use of the taker. The Edwards Court also stated that whether a loss from theft occurs depends upon the laws of the jurisdiction where the loss was sustained. Id. at 111. The Internal Revenue Service's position is in accord with Edwards, "Thus, to qualify as a 'theft' loss within the meaning of section 165(c)(3) 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". Rev. Rul. 72-112. See also, Paine v. Commissioner, 63 T.C. 736, 740 (1975), aff'd per curiam, 523 F.2d 1053 (5th Cir. 1975); Grothues v. Commissioner, T.C. Memo. 2002-287; Kloosterhouse v. Commissioner, T.C. Memo. 1981-481. While a criminal conviction in a state court may establish conclusively that a theft occurred, the deduction does not turn on whether the thief has been convicted or prosecuted. Vietzke v. Commissioner, 37 T.C. 504, 510 (1961); Monteleone v. Commisioner, 34 T.C. 688, 694 (1960).

T's are not the first to argue they are entitled to claim a theft loss deduction for investment losses due to fraud or other misconduct of their financial advisors. In Hart v. Commissioner, T.C. Memo. 1997-11, the taxpayer contended that he sustained a loss in his investment account stemming from a theft by his broker. As a result of a substantial decline in the stock market in October of 1987, the taxpayer's broker sold stock in the taxpayer's investment account to meet the taxpayer's margin requirement. The Tax Court concluded that the taxpayer did not produce any evidence to demonstrate that the broker stole his securities. The evidence showed that the taxpayer's losses resulted from the sale of his stock to satisfy the margin requirements.

The Tax Court allowed a theft loss deduction to taxpayers who relied on false representations by their investment company in Nichols v. Commissioner, 43 T.C. 842, 884-886 (1965). The investment company falsely represented that it would purchase certain bonds and notes with money that the taxpayers provided. The Court analyzed the applicable state statutes and concluded that the investment company obtained the taxpayer's money by false pretenses in violation of state criminal law.

Taxpayer alleged in Beaver v. Commissioner, T.C. Memo. 2003-129, entitlement to a theft loss deduction for losses in his investment in HPI stock based in part on an SEC finding that his brokers manipulated the market for the stock and an indictment under state law against the brokers for enterprise corruption and felony. The Court did not reach the question of whether the taxpayer was entitled to a theft loss deduction since it found that the taxpayer did not prove he had any basis in the stock.

T's appear to be alleging that the theft loss stemmed from the negligent misconduct of their brokers and not as a result of any misconduct of Corporation Y officers or directors. There is only one reported case wherein the petitioner purchased stock through an employee stock option plan and later claimed a theft loss. In De Fusco v. Commissioner, T.C. Memo. 1979-230, the petitioner owned 684 shares of EFCA stock. Of the 684 shares, 104 shares were purchased through a stock option plan. Petitioner obtained these shares when he was employed by Equity Funding Corporation of America ("EFCA") as a part-time agent. According to the facts recited in the opinion:

Petitioners' purchases were stimulated in large part by the glowing prospects portrayed to the salesmen at 'brainwashing' meetings in the company offices. At some meetings the sales pitch was delivered personally by EFCA officers who were subsequently indicted and convicted. Some of the statements made by the officers at such meetings constituted gross misrepresentations.

As to the stock shares purchased as part of the employee stock option plan, the De Fusco court found that the government conceded that a theft occurred due to a statement in the government's post trial brief. Apparently, the government stated in the brief that a theft may have occurred since EFCA had, through it's officers, the specific intent to deprive petitioners of their property and did, in fact, obtain property from petitioners by making false representations to them regarding the value of the stock. The brief cites to Rev. Rul. 71-381 and Rev. Rul. 77-18.

In the instant case, law must be examined to determine if a theft occurred¹. T's have not specified which state criminal statute has been violated. Under , the crime of theft includes all of the following crimes:

¹ During all relevant periods, Taxpayers resided and worked in . Presumably, Taxpayers' property was taken from them in . If more facts are developed, it is possible that or law could be applicable.

provisions, which provides: (as relevant) contains the general theft

While all these property crimes are now included in a
since there was no substantive change regarding the elements of the crime,
law under the former statutory scheme is helpful. To prove “
Taxpayers must show that X (or another individual or entity) willfully and deliberately
converted money entrusted to it and that there was a purposeful refusal, accompanied

by fraudulent intent, to return such money to petitioner.²

To find that money was taken by false pretenses, T's must show that X (or another individual or entity)

Cases have held that the intent to cheat or defraud is the essential element of the crime of false pretenses.

Many of the terms used in these theft provisions, such as “”, “”, and “”, are defined in

T's bear the burden of proving entitlement to a theft loss deduction. See Welch v. Commissioner, 290 U.S. 111 (1933); Grothues v. Commissioner, T.C. Memo 2002-287; MTS International, Inc. v. Commissioner, T.C. Memo. 1996-118. Based upon the information provided us, T's and their representatives have failed to specify any criminal appropriation of their property or allege any criminal intent. T's have not demonstrated that their money was obtained by false pretenses under law and have not demonstrated that any of the elements for "theft" under law have been met.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Finally, Treas. Reg. § 1.165-8(a)(2) provides that a deduction for theft loss may not be claimed if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery. See also, Treas. Reg. § 165-1(d)(3). Thus, no loss can be claimed for purposes of § 165 until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. As noted in the factual section above, T's have already recovered \$ from X. However, T's may also recover sums from other parties.

2

Thus, even if T's could prove that a theft occurred under _____ law, it must also be determined if T's have any reasonable chance of recovering any of their loss through

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Please call (202) 874-1671 if you have any further questions.

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