Stolen Money Taxable-Disallowed Theft Loss Rule Stings Scammed Couple

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Overview

Casualty and theft losses are important because of the exposure of farm property to the elements as well as exposure to those who might steal. Casualty and theft losses are deductible regardless of whether the property is used in the trade or business, held for the production of income or held for personal purposes although the rules differ slightly on how the loss is calculated. But a rule change that took effector for tax years beginning after 2017 and before 2026 has changed the landscape for deducting casualty and theft losses. In a recent case a couple discovered how unfortunate that disallowance rule can be for a theft loss based on an egregious set of facts.

Extent of Deduction

For property held for nonbusiness use, the first $100 of casualty or theft loss attributable to each item is not deductible. The deduction is also limited to the excess of aggregate losses over 10 percent of adjusted gross income. Since 1983, nonbusiness losses have been deductible only to the extent total nonbusiness casualty and theft losses exceed 10 percent of the taxpayer's adjusted gross income. However, each casualty or theft loss of nonbusiness property continues to be deductible only to the extent the loss exceeds $100. These personal casualty gains and losses (from non-business property) are netted against each other. If the losses exceed the gains, all gains and losses are ordinary. Losses to the extent of gains are allowed in full. Losses in excess of gains are subject to the 10 percent adjusted gross income floor. All personal casualty losses are subject to the $100 floor before netting. If the personal gains for any taxable year exceed the personal casualty losses for the year, all gains and losses are treated as capital gains and losses.

TCJA Limitation

The Tax Cuts and Jobs Act (TCJA), for tax years 2018-2025, disallows an itemized deduction for personal casualty and theft losses, except for casualty losses attributable to a federally declared disaster. *I.R.C. §165(h)(5).* The loss is normally deductible in the year the casualty is incurred, but an election can be made to deduct such a loss in the tax year preceding the year in which the disaster occurred. *I.R.C. §165(i).*

"Casualty" Defined

A casualty loss is the complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected or unusual nature. The issue in a particular case comes down to drawing a line. In this instance, the line is between what is a casualty and what is ordinary wear and tear. If, for

example, a farmer or rancher failed to screw the drain plug into a crankcase and loses all of the oil, or failed to put any oil in the crankcase after draining it and starts down the road, is that a casualty loss or is that ordinary wear and tear when the engine is ruined?

In the farm and ranch setting, there are numerous cases involving the improper use of herbicides, flood, frost and freezing, insect damage, drought, fire and wind, all of which are examples of casualty where damage was caused. If the taxpayer can successfully demonstrate that such losses were sudden, unexpected and unusual, the losses will be deductible. To be deductible, the loss must not be caused as the result of willful negligence. *See, e.g., Rohrs v. Comr., T.C. Sum. Op. 2009-199.* Losses because of disease or termite damage, for example, are generally not eligible for casualty loss treatment because the loss is progressive rather than sudden. For example, Dutch Elm disease has been repeatedly rejected as a cause of a casualty loss along with most other tree diseases as well.

"Theft" Defined

Theft, on the other hand, is the criminal misappropriation of property. Theft includes larceny, robbery and embezzlement. In one case, an individual purchased a farm, under a sale contract which specified that the well on the premises was a "good producing water well." Shortly after the buyer obtained possession of the premises, the well went dry. The buyer argued in court that he had suffered a theft loss because the seller misrepresented the well. The court rejected the buyer's argument, ruling that no theft had occurred. The court ruled that there may have been fraud or misrepresentation but not theft giving rise to a deduction. It is usually quite difficult for an event to be considered a theft unless there has been a criminal taking of property as determined by state law. However, one court has allowed a theft loss deduction for investors who were defrauded in a real estate investment scheme.

Timing of theft loss deduction

Theft losses are only deductible in the year of discovery rather than the year that the theft occurred. This fact has proved to be one of the major stumbling blocks in the ability to deduct for losses attributable to theft. Many times, people wait around thinking they will find the item that has come up missing, or that it will be returned, only to discover too late that the property was stolen and is not now deductible. Casualty losses, alternatively, are deductible only in the year the damage occurred.

Calculating the Deduction

The amount of the itemized deduction for both casualty and theft losses is the lesser of (1) the difference between the fair market value before the casualty or theft and the fair market value afterwards and (2) the amount of the adjusted income tax basis for purposes of determining loss. *See, e.g., McClune v. Comr., T.C. Memo. 2005-47.* Obviously, with theft, the item is gone, so the fair market value afterward is zero. Thus, the deductible theft loss is equivalent to the fair market value of the item immediately preceding the time of the theft. However, the deduction can never exceed the basis in the item. Hence, the loss attributable to theft or casualty is the lesser of the difference of the fair market value before and after or the basis in the item. In effect, the measure of the loss is the economic loss suffered limited by the basis.

Example:

Assume a rancher has five Hereford cows and one Hereford bull under a tree one June morning when lightning strikes and kills them all. The cows were raised and have a basis of $0.00 and a fair market value of $4,500. The bull, which was purchased for $5,000, had a fair market value of $6,000 at the time of death. The casualty, if all of the animals are struck dead on the spot, is calculated as follows: The difference in the fair market value before and after the loss is $10,500 ($10,500 - $0.00). However, the total basis in all of the animals is only $5,000 - the basis of the bull. Since the deductible loss can never exceed the basis, the amount of the deduction is limited to $5,000.

A similar principle applies for crops lost immediately before harvesting due to a catastrophic event. If the taxpayer deducted the cost of raising the crop, the income tax basis in the crop is zero and the deductible loss is zero. The part that has been through the tax mill once cannot be run through a second time. Thus, returning to the example, only the bull would have a basis. In addition, any loss must be reduced by any insurance recovery. Thus, returning to the example, if we assume that $4,500 of insurance was collected, the deductible loss would be limited to $500.

Recent Case

The harshness of the TCJA limitation on deducting a theft loss was recently borne out in *Gomas v. United States, No. 8:22-cv-1271-TPB-TGW, 2023 U.S. Dist. LEXIS 122729 (M.D. Fla. Jul. 17, 2023).* In the case, a couple was scammed out of almost $2 million by their daughter/stepdaughter ("Anderson"). The couple retired in 2016 and turned their pet food business over to Anderson. About a year later, Anderson caused them to believe that former employees had misused the business' credit card processing account to scam customers, and that they should hire legal counsel to protect their rights. There was some support for Anderson's claim, at least in the couple's mind, because there had been a problem with a former employee who was fired in 2014. Anderson suggested an attorney they could hire, and they sent her about $140,000 to retain him. But that was a ruse. The attorney didn't exist. Anderson always acted as the go-between and even set up a fake email address posing as the attorney along with forging various legal and business documents. Via her scheme, Anderson got the couple to send her more money on the claim that the funds would settle their legal troubles. Eventually friends of the couple (who Anderson had also stolen from) tried to reach the "attorney" and in the process uncovered Anderson's scheme. The couple was informed of the fraud in 2019 and the police opened an investigation at that time. Anderson was arrested, pleaded guilty and was sentenced in late 2022.

While the scheme was being perpetrated, the couple withdrew funds from their retirement accounts. During 2017, they withdrew over $1.1 million from an IRA, giving about $700,000 of that amount to Anderson in over 100 transactions. The couple was over age 59 and ½ so there was no 10 percent penalty for early withdrawal, but their 2017 return included $1,174,020 in pension and IRA distributions and a tax liability of $410,841, which they paid. In early 2020, they filed an amended 2017 return seeking a refund based on claiming a deduction of the $1,174,020 they received from their IRA and pension accounts based on the theft. The IRS disallowed the deduction in full, and the IRS appeals

office upheld the IRS determination. The couple then filed suit seeking a refund of the tax paid. The IRS moved for summary judgment.

The court, agreeing with the IRS, granted its summary judgment motion. The court noted that the couple received the distributions from the retirement accounts. Anderson only received the funds by later transfer from the couple. Anderson had not forged their signatures, which would have led to a different tax outcome. Accordingly, the couple was the "payee" of the account funds within the meaning of I.R.C. §408(d)(1). Anderson's later theft did not change the couple's status as the taxable distribute of the funds. Thus, the funds were properly taxable in 2017 and because the theft wasn't discovered until 2019, a theft loss deduction was not available that year due to the TCJA provision.

The couple tried another tact. They claimed that the funds were deductible in 2017 as an ordinary and necessary business expense because Anderson led them to believe that the funds were being used to pay for legal services tied to legal matters associated with the business they used to own and operate. But the court rejected this argument because the couple had already retired from the business before 2017. The expenses were not associated with any business-related activity of the couple. In any event, the expenses, the court noted, would have been nondeductible personal expenses and they never reported the payments as such on any tax return as they were incurred.

Conclusion

Certainly, the Congress did not contemplate the TCJA provision curtailing a theft loss deduction as playing out the way that it did in *Gomas*. Indeed, the court indicated that the fact that the couple had to pay tax on the stolen funds was unjust. But that was the result of the applicable law for the tax years at issue and the "kinder, gentler IRS" was unwilling to exercise discretion and excuse payment of taxes on the stolen funds.

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