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## Maximizing Ponzi Loss Deductions for Estate and Income Tax Purposes: Are Taxpayers Better Off Dead?

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MAXIMIZING PONZI LOSS DEDUCTIONS  
FOR ESTATE AND INCOME TAX PURPOSES:  
ARE TAXPAYERS BETTER OFF DEAD?

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ABSTRACT

*There is a long history of cases interpreting whether a theft loss deduction for securities fraud is allowable for personal income taxes. The cases require that for a theft loss to be actionable as such, it would have to meet the requirements of the common law definition of theft in the U.S. state in which it occurred. This generally requires direct privity between the person claiming the loss and the person who committed the theft. Because most securities transactions are brokered, the direct privity is lost and a theft loss deduction is denied in favor a capital loss. Recently, in a case of first impression, the Tax Court was presented with a similar issue involving the worth of assets for estate taxes. Instead of using the reasoning presented in income tax cases, the Tax Court allowed a theft loss deduction on estate taxes where a Ponzi scheme was uncovered while the estate owned a limited liability company. The sole assets of the company were shares of the security that was involved in the Ponzi scheme. This Article examines the history of the privity requirement for deducting a theft loss for income taxes and how that reasoning now differs from the tax treatment for estate taxes. The Article concludes that there should not be a difference in treatment and that direct privity should not be required for either income or estate taxes.*

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## INTRODUCTION

A 2016 Tax Court case, *Estate of James Heller v. Commissioner*,<sup>1</sup> examined whether a fraud loss from a Ponzi scheme investment is theft loss for estate tax returns in a case of first impression. And, viewed through a lens of the common meaning of fraud being a theft, combined with some indications that the position for denying a theft loss deduction to individuals in some cases is softening, this appears to be a fair and reasonable result. For income taxes, however, defrauded Ponzi scheme victims generally cannot take a deduction for theft loss on individual income tax returns, unless they were in direct privity with the party selling the Ponzi scheme investment.<sup>2</sup> Instead, for income tax purposes, fraud losses in the absence of privity are generally treated as capital losses, which are extinguished without carry-over beyond the taxpayer's final tax return.<sup>3</sup> This leads to an anomalous conclusion that, for theft loss deduction purposes only, the taxpayer, James Heller (Heller), may have been better off dead when the fraud was discovered.

This Article discusses the *Heller* case, Internal Revenue Code (Code) § 2054, and commonalities with case rulings and judicial comments where living individuals would also be allowed a theft loss after a fraud under Code § 165(c) and the impact of *Heller* on these.<sup>4</sup> It then discusses the difference in financial effect for Heller had the court interpreted § 2054 in a manner consistent with § 165(c) and the history of the § 165(c) tax treatment. It concludes with a recommendation in support of the *Heller* decision and in extending the court's reasoning to similar § 165(c) cases where the taxpayer is still alive.<sup>5</sup>

I. THE *HELLER* CASE AND THEFT LOSS FOR ESTATE TAXES

At the time of his death on January 31, 2008, Heller had a 99 percent interest in the James Heller Family LLC (JHF), the

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<sup>1</sup> *Estate of James Heller v. Comm'r*, 147 T.C. No. 11, at \*1 (2016).

<sup>2</sup> See I.R.C. § 165(e) (Supp. II 2012); see also *Adkins v. United States*, 113 Fed. Cl. 797, 804 (2013).

<sup>3</sup> I.R.C. § 165(g) (Supp. II 2012).

<sup>4</sup> See *infra* Part I.

<sup>5</sup> See *infra* Section II.B and Conclusion.

sole asset of which was an account with Madoff Securities.<sup>6</sup> Each of Heller's two children held a 0.5 percent interest, accounting for the remainder of the assets of JHF.<sup>7</sup> From 1999 through 2007, Heller personally contributed \$6,052,000 to the account and withdrew \$12,429,781.<sup>8</sup> On December 19, 2006, the LLC contributed an additional \$150,000 and on January 3, 2007, Heller transferred a balance shown of \$14,850,000 from his personal account to JHF.<sup>9</sup>

JHF withdrew \$11,500,000 from the securities account and distributed 99 percent of this amount (\$11,385,000) to the estate of James Heller (Estate), to pay its taxes and administrative expenses.<sup>10</sup> On December 11, 2008, Bernard Madoff (Madoff), the head of the securities firm, was arrested for, and later pled guilty to, securities fraud.<sup>11</sup> Madoff later admitted that Madoff Securities was a Ponzi scheme that was perpetuated by the fabrication of periodic account statements.<sup>12</sup> After the revelation of the Ponzi scheme, the approximately \$5,000,000 balance owned by JHF in the Madoff Securities fund, became worthless, thus making JHF worthless.<sup>13</sup> The Estate claimed that balance as a theft loss deduction on a timely filed federal estate tax return.<sup>14</sup> The return showed a gross estate of \$26,296,807, which included \$16,560,990 as the value of Heller's 99 percent stake in JHF, and claimed a \$5,175,990 theft loss related to the Ponzi scheme.<sup>15</sup> The deduction was calculated as the value of the Estate's interest in JHF as reported on the estate tax return minus the Estate's share of the amounts withdrawn from the account.<sup>16</sup> The IRS agreed that a fraud loss occurred but claimed that JHF was entitled to the theft loss, not the Estate.<sup>17</sup> The IRS disallowed the deduction on the basis that a theft was not perpetrated against

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<sup>6</sup> *Heller*, 147 T.C. No. 11 at \*1.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at \*1 n.3.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at \*1.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at \*2.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

the Estate and issued a notice of deficiency to the Estate for the tax on that deduction.<sup>18</sup> The Estate challenged that determination in tax court, moving for summary judgment.<sup>19</sup> Based on its assertion that JHF incurred the theft loss, not the Estate, the IRS filed an opposing motion for partial summary judgment.<sup>20</sup>

The sole issue in *Heller* was, given that JHF (which was 99 percent owned by the taxpayer) was the owner of the fraudulent account, whether the taxpayer was eligible for a theft loss deduction for the fraud loss suffered by the Estate as a result of the Ponzi scheme.<sup>21</sup> While similar cases of whether a fraud loss is a theft loss exist for federal individual income taxes,<sup>22</sup> the court noted that whether a fraud loss is a theft loss for estate tax purposes under § 2054 was a case of first impression.<sup>23</sup>

#### A. *The Estate Tax*

The estate tax is imposed on the taxable estate, which is the value of the net assets transferred to beneficiaries.<sup>24</sup> The estate tax does not tax income from those assets or other work, although to the extent that the estate's assets earn income in the period that the estate is open, that income may also be taxed.<sup>25</sup> Thus, the savings on income can essentially be taxed twice: once when earned as income, and again after what was saved is passed on to heirs.<sup>26</sup>

The taxable estate is the value of the gross estate<sup>27</sup> less allowable deductions,<sup>28</sup> which include funeral expenses, administrative expenses of the estate, estate indebtedness, and taxes.<sup>29</sup>

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at \*1.

<sup>22</sup> See *Vietzke v. Comm'r*, 37 T.C. 504, 512 (1961); see also *Jensen v. Comm'r*, 66 T.C.M. (CCH) 543, 546–47 (1993).

<sup>23</sup> *Heller*, 147 T.C. No. 11 at \*2.

<sup>24</sup> I.R.C. § 2001 (2012).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* § 641.

<sup>27</sup> *Id.* § 2031(a).

<sup>28</sup> *Id.* § 2051.

<sup>29</sup> *Id.* § 2053(a).

Transfers to qualified charities<sup>30</sup> and to one's surviving spouse<sup>31</sup> are also deducted in arriving at the amount of the taxable estate. A unified credit is provided for all estates and lifetime taxable gifts, ensuring that small estates are not subject to the estate tax.<sup>32</sup> Currently, this credit translates to excluding the first \$5,000,000 of lifetime taxable gifts and estate value, indexed for inflation.<sup>33</sup>

In arriving at the taxable estate, § 2054 also allows for deductions from the gross estate of "losses incurred during the settlement of estates arising from fires, storms, shipwrecks, or other casualties; *or from theft*, when such losses are not compensated for by insurance or otherwise."<sup>34</sup> Using *Black's Law Dictionary* to define the term "loss," the court in *Heller* found that "[i]n that context, a loss refers to a reduction of the value of property held by an estate."<sup>35</sup>

#### B. Tax Court's Ruling in *Heller*

In summary judgment, the court upheld the theft loss deduction for the Estate under § 2054.<sup>36</sup> The court's reasoning was that, while the LLC incurred a loss of its sole asset due to fraud, the Estate also incurred a loss in the value of the gross estate because the fair market asset value of JHF declined.<sup>37</sup> The court reasoned that again, based on plain meaning, a theft loss deduction is allowed provided that there is a sufficient nexus between the theft and the estate's loss.<sup>38</sup> The court opined that there was an undisputed and direct nexus between the theft and the value of the estate's interest in JHF.<sup>39</sup> To make its assertion, the court relied on *White v. Commissioner*.<sup>40</sup> In *White*, the court found that

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<sup>30</sup> *Id.* § 2055(a).

<sup>31</sup> *Id.* § 2056(a).

<sup>32</sup> *Id.* § 2010(c)(3)(A).

<sup>33</sup> *Id.* In the year of *Heller*'s death, the estate tax rules were different, but the size of the gross estate and the unified credit for that year were not in dispute. See *Estate of James Heller v. Comm'r*, 147 T.C. No. 11, at \*2 (2016).

<sup>34</sup> I.R.C. § 2054 (2012) (emphasis added).

<sup>35</sup> *Heller*, 147 T.C. No. 11 at \*2.

<sup>36</sup> *Id.* at \*3.

<sup>37</sup> *Id.* at \*2.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* (citing *White v. Comm'r*, 48 T.C. 430, 435 (1967)).

where an “other casualty” arose from<sup>41</sup> direct and proximate damage, similar to that of casualties specifically enumerated in § 165(c)(3), the other casualty should receive casualty loss treatment.<sup>42</sup> Passing the stricter test of direct privity between the fraudster and the victim, as is commonly used for determining whether there is a deductible theft loss for income tax purposes, is not required.<sup>43</sup> The court reasoned that the deduction was “consistent with the overall statutory scheme of the estate tax”<sup>44</sup> because the purpose of the estate tax is to impose a tax on “the net estate, which is really what of value passes from the dead to the living.”<sup>45</sup>

## II. THE DIFFERENCE BETWEEN CAPITAL LOSS AND THEFT LOSS TREATMENT FOR INCOME TAXES

As a case of first impression, *Heller* does not contradict existing regulations or legislative history pertaining to § 2054. This decision recognizes that there was, for estate tax purposes, a decline in the *asset* value of the estate arising from a theft or other casualty.<sup>46</sup> Further, *Heller* does not directly contradict dissimilar rulings on what constitutes a theft for income tax purposes under § 165(c).<sup>47</sup> However, because the language of the two Code sections<sup>48</sup> is strikingly similar, the court could have used a line of cases interpreting § 165(c) as persuasive authority, which tends to eschew a plain reading of the statute. Instead, the court in *Heller* chose to do plain meaning analysis,<sup>49</sup> leaving what can be interpreted as differing standards between what is a theft loss for estate purposes and for income tax purposes,

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<sup>41</sup> *White v. Comm’r*, 48 T.C. 430, 435 (1967). The court further noted that the term “arising from” is a broad phrase that even encompasses casual connections. See *United States v. Bradford*, 433 F. Supp. 2d 1001, 1003 (N.D. Iowa 2006).

<sup>42</sup> *White*, 48 T.C. at 435.

<sup>43</sup> See, e.g., *Taghadoss v. Comm’r*, T.C. Summ. Op. 2008-44, at \*3 (2008); *Paine v. Comm’r*, 63 T.C. 736, 737, 742-43 (1975).

<sup>44</sup> *Heller*, 147 T.C. No. 11 at \*3.

<sup>45</sup> *Id.* (quoting *Jacobs v. Comm’r*, 34 B.T.A. 594, 597 (1936)).

<sup>46</sup> *Heller*, 147 T.C. No. 11 at \*2-3.

<sup>47</sup> See *Taghadoss*, T.C. Summ. Op. 2008-44 at \*3; see also *Paine v. Comm’r*, 63 T.C. 736, 741 (1975).

<sup>48</sup> I.R.C. § 165(c) (2012); *id.* § 2054.

<sup>49</sup> *Heller*, 147 T.C. No. 11 at \*2.



which could lead to confusion. Where a theft loss would be disallowed for income tax purposes, the tax treatment of the loss would receive long-term capital loss treatment resulting from worthless securities.<sup>50</sup> If that treatment were to be applied in *Heller*, the capital loss deduction would be limited to \$3,000 in excess of capital gains,<sup>51</sup> not \$5,175,990 as claimed by the Estate. This difference in deduction amounts would be substantial for most families.

#### A. *Capital Loss Treatment for Income Tax*

For individuals, capital losses offset capital gains on securities in the year of sale<sup>52</sup> or when the security becomes totally worthless, where they are treated as being sold for zero dollars on the last day of the tax year.<sup>53</sup> Where capital losses offset capital gains, the tax savings on those losses can be as high as 20 percent plus Net Investment Income Tax at a rate of 3.8 percent.<sup>54</sup> Each year, the first \$3,000 of capital losses in excess of capital gains, if any, offsets ordinary income at ordinary income tax rates,<sup>55</sup> with the remaining capital losses being carried forward until the earlier of their exhaustion or individual's final income tax return.<sup>56</sup> Estates are also limited by the \$3,000 per year constraint, but unused capital losses pass through to the heirs while maintaining their capital loss attributes.<sup>57</sup> Consequently, a large loss net of capital gains can take many years, or worse, may never be recouped.

#### B. *Theft Loss Treatment for Income Taxes*

The IRS and the courts traditionally rely on state law to define a theft, which bears little to no relation to the definition

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<sup>50</sup> I.R.C. § 165(g) (Supp. II 2012).

<sup>51</sup> *Id.* § 1211(b).

<sup>52</sup> A decline in fair market value of securities held does not qualify as a deductible capital loss (Treas. Reg. § 1.165-5(f) (2008)), except where a security becomes worthless. § 165(g).

<sup>53</sup> *Id.*

<sup>54</sup> *Id.* § 1411(a).

<sup>55</sup> *Id.* § 1211.

<sup>56</sup> Rev. Rul. 74-175, 1974-1 C.B. 52; *see also* I.R.C. § 1212(a)(1) (2012).

<sup>57</sup> Treas. Reg. § 1.642(h)-1 (2016).

of securities fraud used by the federal government. State laws differ, but most require direct privity or the intent to defraud on the part of the person taking a victim's money.<sup>58</sup> In *Heller*, had traditional state law reasoning been applied, it might be argued that Heller funded the Madoff account, and had the fraud been discovered while Heller owned the account, he could have taken a theft loss deduction on his individual income tax return.<sup>59</sup> However, Heller contributed that account to the formation of JHF, with no indication of economic loss, and therefore, no theft loss deduction at that time.<sup>60</sup> JHF sustained the fraud loss when the Ponzi scheme was uncovered.<sup>61</sup> JHF, however, would be ineligible for a theft loss under most state laws because there was not privity between JHF and Madoff.<sup>62</sup> There was privity between JHF and Heller, but Heller did not intend to permanently deprive JHF of its assets.<sup>63</sup> Further, since Heller was not the sole owner of JHF, JHF was a distinct entity, not a disregarded entity.<sup>64</sup> Thus, the fraud loss of \$5,175,990 would be treated as a long-term § 165(g) worthless security, capital loss until the estate is terminated, and then it would be passed to the beneficiaries, retaining its capital loss character.<sup>65</sup> Were the two children the two heirs of the Estate, they would each receive a capital loss flow-through of \$2,587,995 each. If the heirs had no other capital losses, they would take \$3,000 per year through the earlier of their final federal individual tax return (due to their own death) or 862 years, with \$1,995 taken in their 863rd year.<sup>66</sup> Should they die first, the unused capital loss carryforward is lost permanently.<sup>67</sup>

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<sup>58</sup> See *Adkins v. United States*, 113 Fed. Cl. 797, 804 (2013).

<sup>59</sup> See generally *id.* (hypothesizing that if the fraud was discovered while Heller owned and funded the Madoff account, privity would exist between Heller and Madoff, making a deduction proper).

<sup>60</sup> *Estate of James Heller v. Comm'r*, 147 T.C. No. 11, at \*1 (2016).

<sup>61</sup> *Id.* at \*2.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* at \*1.

<sup>64</sup> *Id.*

<sup>65</sup> I.R.C. § 165(g) (Supp. II 2012).

<sup>66</sup> You can deduct capital losses up to the amount of your capital gains plus \$3,000. The carryforward would take 863 years because \$2,587,995, divided by \$3,000 per year, equals 862 years, plus the \$1,995 in year 863. I.R.S. Instructions for Schedule D, Cat. No. 24331I (Oct. 19, 2016).

<sup>67</sup> *Id.*

1. *History of § 165(c)(3)*

Section 165 of the Internal Revenue Code allows individuals to deduct “any loss sustained during the taxable year and not compensated for by insurance or otherwise ...<sup>68</sup> [that] shall be limited to ... losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.”<sup>69</sup> Theft is defined in *Black’s Law Dictionary*,<sup>70</sup> but it is not defined in the Code. Courts have historically relied on state laws to define theft under Revenue Ruling 72-112.<sup>71</sup> *Edwards v. Bromberg*<sup>72</sup> broadly defines theft loss as any criminal appropriation of another’s property, including swindling, false pretenses or any other form of guile including blackmail, embezzlement and other frauds, extortion, kidnapping for ransom, larceny, robbery, and threats.<sup>73</sup> The laws of the location of the incident determine whether a taking is a theft. To be a theft, the taking must be illegal and done with criminal intent.<sup>74</sup> Generally, the tax treatment of theft losses parallels that of casualty losses.<sup>75</sup> Government seizures and confiscations, lost property,<sup>76</sup> and reduction in the resale value of property<sup>77</sup> are not thefts.

Theft losses are deductible in the later of the year of discovery or when there is no reasonable prospect of recovery.<sup>78</sup>

<sup>68</sup> I.R.C. § 165(a).

<sup>69</sup> *Id.* § 165(c)(3).

<sup>70</sup> The term “theft” means the fraudulent taking of personal property belonging to another, from his possession of some person holding the same from him, without his consent, with intent to deprive the owner of the value of the same, and to appropriate it to the use or benefit of the person taking. *Theft*, BLACK’S LAW DICTIONARY, 1477 (6th ed. 1990).

<sup>71</sup> Rev. Rul. 72-112, 1972-1 C.B. 60.

<sup>72</sup> *Edwards v. Bromberg*, 232 F.2d 107, 110 (5th Cir. 1956).

<sup>73</sup> *Id.*

<sup>74</sup> See Rev. Rul. 72-112 1972-1 C.B. 60 for U.S. theft losses requiring application of state law. For foreign thefts, see *First Chi. Corp. v. Comm’r*, 69 T.C.M. (CCH) 2089, 2097 (1995).

<sup>75</sup> See I.R.C. § 162 for losses on property used in a trade or business, § 212 for income producing activities of individuals, and § 165(c)(3) for losses on personal use property. See also Treas. Reg. § 1.165-8(d) (as amended in 1964).

<sup>76</sup> See *Powers v. Comm’r*, 36 T.C. 1191, 1193 (1961).

<sup>77</sup> See *Pulvers v. Comm’r*, 407 F.2d 838, 839 (1967).

<sup>78</sup> See Treas. Reg. § 1.165-1(d)(2)(i) (as amended in 1977); see also *Geisler v. Comm’r*, 55 T.C.M. (CCH) 1734, 1736 (1988). The taxpayer has the burden

Where there is a reasonable prospect of recovery, the loss is sustained in the year when one can reasonably determine whether a recovery will be received.<sup>79</sup> A taxpayer must make reasonable efforts to recover stolen property and seek reimbursements from insurers.<sup>80</sup> Each tax year that recovery is sought, the prospects for recovery must be re-evaluated, and, where prospects for recovery remain long enough, the statute of limitations for deducting a theft loss may actually bar recovery.<sup>81</sup> Deduction can be denied where there is an unreasonable delay beyond the three-year statute of limitations.<sup>82</sup> Objective factors in determining the year of the theft loss include the existence of litigation of a claim and the availability of restitution.<sup>83</sup> A subjective factor may be considered but cannot be the controlling or sole criterion.<sup>84</sup>

Theft losses on investments are deductible at ordinary income tax rates without regard to the 10 percent of adjusted gross income and the \$100 per incident floors, provided taxpayers itemize deductions.<sup>85</sup> Theft loss deductions are not subject to itemized deduction phase-out.<sup>86</sup>

Relatively large theft losses can create a net operating loss (NOL),<sup>87</sup> which is normally carried back to offset taxes paid

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of proof for what is “no reasonable prospect.” *Gale v. Comm’r*, 41 T.C. 269, 276 (1963).

<sup>79</sup> Treas. Reg. § 1.165-1(d)(3); *see also* *Jeppsen v. Comm’r*, 128 F.3d 1410, 1414 (10th Cir. 1997). Such a recovery could come from an insurer, the Securities Investor Protection Corporation, or a net collectible amount of damages from court awards. *See id.*

<sup>80</sup> I.R.C. § 165(h)(4)(E) (Supp. II 2012).

<sup>81</sup> *Woltman v. United States*, 56 A.F.T.R.2d. (RIA) 5860, 5863 (S.D. Cal. 1985).

<sup>82</sup> *Id.* *Woltman* could have filed a formal disclaimer of any recovery in the year the theft was discovered, allowing him to claim the theft loss then. *See* Treas. Reg. § 1.165-1(d)(2)(i).

<sup>83</sup> *Huey v. Comm’r*, 50 T.C.M. (CCH) 430, 434 (1985). Merely filing a proof of claim in bankruptcy and other ministerial acts, however, is not a strong indicator of recovery. *Jensen v. Comm’r*, 66 T.C.M. (CCH) 543, 547 (1993); *see* *Adkins v. United States*, 113 Fed. Cl. 797, 807 (2013). All facts and circumstances must be considered. For example, in *Schneider v. Comm’r*, 49 T.C.M. (CCH) 1032, 1033–34 (1985), the taxpayer filed a lawsuit but the perpetrator had no assets from which to recover. The court found the lack of assets more persuasive than the presence of a lawsuit. *Id.*

<sup>84</sup> *Adkins*, 113 Fed. Cl. at 807.

<sup>85</sup> I.R.C. § 165(c)–(h) (Supp. II 2012).

<sup>86</sup> *Id.* § 68(c)(3).

<sup>87</sup> *Id.* § 172(d)(4)(c).

in the last two years and then carried forward for up to twenty years.<sup>88</sup> However, to the extent that an NOL arises from theft losses, the carryback period is three years.<sup>89</sup> An election can be made to forego NOL carryback.<sup>90</sup>

Fraud may be treated as a nonbusiness bad debt which receives short-term capital loss treatment<sup>91</sup> rather than as a theft, as in the case of *Stoltz v. United States*,<sup>92</sup> where a taxpayer guaranteed a loan for a friend who misrepresented his ability to repay. Fraud losses may be split between capital losses and amending previous tax returns, as in the case of *Kaplan v. United States*,<sup>93</sup> where a couple invested in a Ponzi scheme, declaring fictitious income as reported on false statements before the fraud was discovered.<sup>94</sup> The initial investment was treated as capital loss, and the bogus income was corrected on previous returns where the statute of limitations had not yet barred.<sup>95</sup> Fraud loss may be split between capital loss and theft loss<sup>96</sup> where a company began to engage in fraud after having operated legitimately.<sup>97</sup> Investments made before the fraud received capital loss treatment and investments made after the fraud had started were treated as theft losses.<sup>98</sup>

## 2. Safe Harbor Provisions for Qualified Ponzi Scheme Victims

Victims of a Ponzi scheme have relief available from Revenue Ruling 2009-9, which allows victims to claim an estimated theft loss in the year of discovery without regard to whether a partial recovery might result.<sup>99</sup> The amount of the theft loss is equal to the original basis plus previously declared dividend and capital gain income that was reinvested in the scheme, less money

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<sup>88</sup> *Id.* § 172(b)(1)(A).

<sup>89</sup> *Id.* § 172(b)(1)(F).

<sup>90</sup> *Id.* § 172(b)(3).

<sup>91</sup> *Id.* § 166(d).

<sup>92</sup> *Stoltz v. United States*, 410 F. Supp. 2d 734, 739 (S.D. Ind. 2006).

<sup>93</sup> *Kaplan v. United States*, 100 A.F.T.R.2d (RIA) 5674, 5678 (M.D. Fla. 2007).

<sup>94</sup> *Id.* at 5675.

<sup>95</sup> *Id.* at 5682.

<sup>96</sup> I.R.S. Chief Couns. Mem. 200811016 (Mar. 14, 2008).

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

recovered to date.<sup>100</sup> No amendments of previous tax returns are required, eliminating the danger that the statute of limitations on the loss may bar before the potential for recovery is determined with reasonable certainty.

A taxpayer qualifies for this relief if the taxpayer is a qualified investor who, unaware of the fraud, transferred funds to the “lead figure”<sup>101</sup> who promoted a “specified fraudulent arrangement”<sup>102</sup> resulting in an investment loss. A fraud conviction is not necessary, but the lead figure must be: (1) indicted for fraud, embezzlement or other theft loss; or (2) the subject of an ongoing state or federal criminal complaint where that complaint: (a) alleged an admission by the lead figure; (b) the assets of the arrangement have been frozen; or (c) a receiver/trustee was appointed with respect to the assets of the fraudulent arrangement.<sup>103</sup> The taxpayer must otherwise be allowed a theft loss under § 165<sup>104</sup> or Regulation 1.165-1<sup>105</sup> and the fraudulent investment must not be a tax shelter.<sup>106</sup>

Safe harbor relief only applies to Ponzi schemes where the lead figure: (1) receives property or cash from investors; (2) purports to earn investor income; (3) reports at least partially fictitious investor income; and (4) misappropriates some of the investors’ cash or property.<sup>107</sup> No safe harbor relief is available for: (1) unpaid loans from fraudsters to an investor; (2) investment fee deductions paid to the fraudsters; (3) undeclared fraudulent income; and (4) indirect investments in Ponzi schemes where cash or property was paid to a non-fraudulent fund or entity that in turn invested in the scheme.<sup>108</sup>

Revenue Procedure 2009-20 provides that the taxpayer may deduct either 95 percent of the net investment loss where the taxpayer agrees to pursue no recovery from a third party, or 75 percent

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<sup>100</sup> *Id.*

<sup>101</sup> Claire H. Taylor, *Helping Defrauded Investors Recoup Losses with the Tax Code: Advice for Litigators*, 21 No.2 PIABA B.J. 225, 240 (2014).

<sup>102</sup> *Id.* at 240–41.

<sup>103</sup> *Id.*

<sup>104</sup> I.R.C. § 165(c) (Supp. II 2012).

<sup>105</sup> Treas. Reg. § 1.165-1 (as amended in 1977).

<sup>106</sup> For a definition of a tax shelter, see I.R.C. § 6662(d)(2)(c)(ii) (2012).

<sup>107</sup> Taylor, *supra* note 101, at 226.

<sup>108</sup> Brian Elzweig, Valrie Chambers & Jud Stryker, *After Goeller v. United States, Can the Theft Loss Treatment Now Be Applied to Investments When Corporate Deception Is Present?*, 38 CAMPBELL L. REV. 1, 8 (2016).

of the net loss where the taxpayer intends to pursue recovery from a third party.<sup>109</sup> However, specified third parties do not include: (1) the individual perpetrators of the fraud; (2) the investment vehicles or other entities that perpetrated the fraud, including its employees, officers, and directors; (3) a liquidation, receivership, bankruptcy, or similar estate established with respect to the individuals who perpetrated the fraud; and (4) parties subject to claims brought by a trustee, receivership, bankruptcy, or other estate described in (3) above.<sup>110</sup> Actual and expected recoveries from third parties reduce the fraud loss, and recoveries in excess of the remaining 5 percent or 25 percent loss are declared as income in the year of recovery under the tax benefit rule.<sup>111</sup>

### 3. State Law Definition of Theft

Relying on the precedent set by the 1956 *Edwards* case,<sup>112</sup> a taxpayer must generally establish that a theft has occurred as defined by state law to deduct a theft loss on a federal income tax return.<sup>113</sup> In *Edwards*, the taxpayer gave a third party over \$50,000 to bet on a rigged horse race in Georgia.<sup>114</sup> That third party embezzled the money instead of betting it.<sup>115</sup> The government argued that the taxpayer's loss did not meet the definition of a theft under Georgia state law.<sup>116</sup> The Fifth Circuit rejected the government's argument, stating that the term "theft" should be construed broadly, 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"<sup>117</sup> as interpreted under "the law of the jurisdiction where it was sustained."<sup>118</sup>

Many potential theft case rulings involve lengthy discussions about whether a theft met the state definition,<sup>119</sup> but, other than

<sup>109</sup> Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

<sup>110</sup> Elzweig et al., *supra* note 108, at 8.

<sup>111</sup> *Id.*

<sup>112</sup> *Edwards v. Bromberg*, 232 F.2d 107, 111 (5th Cir. 1956).

<sup>113</sup> *See Taylor*, *supra* note 101, at 229.

<sup>114</sup> *Edwards*, 232 F.2d at 109.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 110.

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at 111.

<sup>119</sup> *See Goeller v. United States*, 109 Fed. Cl. 534, 540 (2013) (citing, *e.g.*, *Alioto v. Comm'r*, 699 F.3d 948, 955 (6th Cir. 2012); *Estate of Meriano v. Comm'r*,

an axiomatic reliance on that one sentence from the *Edwards* ruling, they omit an explanation justifying why state law definitions should be given higher weight than the federal definition of “theft.”<sup>120</sup>

#### 4. *Intent and Privity*

The IRS has been able to successfully argue under most state laws that the use of an intermediary, like a stockbroker, generally disqualifies the taxpayer from claiming the theft loss because there is no direct privity<sup>121</sup> between the perpetrator and the victim. For example, in *Taghadoss v. Commissioner*, the taxpayer purchased stock and exercised options through WorldCom’s employee stock purchase plan and 401(k), which while set up by WorldCom, was technically a different corporation than WorldCom itself.<sup>122</sup> It was later discovered that WorldCom’s financial statements were fraudulent, and WorldCom filed for bankruptcy.<sup>123</sup> The taxpayer claimed a theft loss, reasoning that the false financial statements from a related corporation amounted to a fraud, and thus a theft, against investors.<sup>124</sup> The IRS denied Taghadoss’s theft loss deduction, arguing that while WorldCom executives committed fraud, Virginia law required privity, which the taxpayer did not have since he did not buy the stock directly from the corporation.<sup>125</sup> In doing so, the court stated that “a corporation is a taxable entity separate from its shareholders. Consequently, shareholders generally cannot claim a deduction for a theft loss where the corporation itself was the victim of the theft.”<sup>126</sup> Similarly, the court sided with the IRS, relying on *Paine v. Commissioner*.<sup>127</sup> In *Paine*, the court reasoned that since the stock of a company was purchased from the open market,

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142 F.3d 651, 658 (3d Cir. 1998); *Bellis v. Comm’r*, 540 F.2d 448, 449 (9th Cir. 1976); *Stoltz v. United States*, 410 F. Supp. 2d 734, 740–41 (S.D. Ind. 2006)).

<sup>120</sup> *Edwards*, 232 F.2d 107, 111 (5th Cir. 1956).

<sup>121</sup> The term “privity” means mutual or successive relationship to the same rights of property. *Privity*, BLACK’S LAW DICTIONARY, 1199 (6th ed. 1990).

<sup>122</sup> *Taghadoss v. Comm’r*, T.C. Summ. Op. 2008-44, at \*1 (2008).

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* at \*3.

<sup>126</sup> *Id.* at \*4.

<sup>127</sup> *See Paine v. Comm’r*, 63 T.C. 736, 736 (1975).



the taxpayer lacked evidence that anyone intended to directly deceive him as required under state law.<sup>128</sup> In *Willey v. Commissioner*, a taxpayer loaned money to three corporations which invested that money in fraudulent trust funds.<sup>129</sup> The corporations, as separate taxpayers, were allowed the theft loss, not the Willeys, who owned the corporations.<sup>130</sup> Contrast these results to that of *Vietzke v. Commissioner*,<sup>131</sup> in which a taxpayer purchased stock directly from the directors of the fraudulent corporation, where a loss may have been allowed because “a theft occurred both within the meaning of [state] law and of § 165(e) ....”<sup>132</sup> A theft loss was also allowed in *Jensen v. Commissioner*,<sup>133</sup> where the taxpayer was defrauded in a Ponzi scheme and the seller of the stock unknowingly acted as a feeder for the fraudulent company.<sup>134</sup> While there was privity in this case, the court implied that it should not be necessary for “an investor [to] have direct contact with the entity in which he is investing. It is not uncommon for investors to deal only with their brokers and never have direct contact with their investments. In such cases, the brokers act as conduits for the investors’ funds.”<sup>135</sup>

In *Goeller v. United States*, the Federal Claims Court opined that a narrow construction of whether a fraud is a theft loss solely under state law is “shibboleth,” and should be reconsidered.<sup>136</sup> In that case, California-based taxpayers had invested in an Ohio real estate company.<sup>137</sup> When irregularities in the reporting of certain mortgages and properties arose, the taxpayers

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<sup>128</sup> See *id.* at 741–42, 742 n.12.

<sup>129</sup> See *Willey v. Comm’r*, T.C.M. 1998-58, at \*1 (1998).

<sup>130</sup> See *id.* at \*2.

<sup>131</sup> See *Vietzke v. Comm’r*, 37 T.C. 504, 504 (1961).

<sup>132</sup> *Id.* at 504.

<sup>133</sup> See *Jensen v. Comm’r*, T.C.M. 1993-393, at \*5 (1993).

<sup>134</sup> See *id.* at \*4–5.

<sup>135</sup> *Id.* at \*5; Halvor N. Adams III, *Request for Legal Opinion*, 1995 FSA LEXIS 560 (Aug. 30, 1995) (original citations omitted) (Brokers are conduits “only if they have no control over the disposition of the assets and no potential benefit to be gained from the assets by holding them”); see also *Willey*, T.C.M. 1998-58 at \*1 (finding that when a taxpayer loaned money to three corporations, which invested that money in fraudulent trust funds, the corporations were allowed the theft loss but the taxpayer was limited to capital loss treatment).

<sup>136</sup> See *Goeller v. United States*, 109 Fed. Cl. 534 (2013).

<sup>137</sup> See *id.* at 536.

filed amended tax returns claiming theft loss deductions.<sup>138</sup> Both the IRS and the taxpayer cited state authority for the proposition of whether a “theft” had occurred, for purposes of § 165(c)(3).<sup>139</sup> However, they disputed whether the controlling law was that of Ohio or California.<sup>140</sup> Rather than determine which state law was definitive, the court noted that for the other § 165(c) events (fire, storm, shipwreck, and casualty), the plain meaning of the terms determines whether there is a loss that is deductible.<sup>141</sup> Per *Black’s Law Dictionary*, the plain meaning of “fraud” is a crime in which one “obtains possession of property by lawful means and thereafter appropriates the property to the taker’s own use.”<sup>142</sup> The court found no Congressional intent<sup>143</sup> to support the sole reliance on state law<sup>144</sup> but found a “plethora of Federal statutes that criminalized thefts; [including] various forms of larceny, embezzlement, fraud, and robbery; as well as money laundering, wire fraud, and other conduct associated with such crimes.”<sup>145</sup> Further, most “courts have refused to make the operation of federal statutes referring to crimes dependent on a specific state’s law.”<sup>146</sup> That is, reliance solely on state law definitions of fraud is, according to the court, “shibboleth.”<sup>147</sup> Allowing for the use of a federal common law definition of theft for federal tax administration would also be equitable because “the victims of securities fraud crimes prosecuted under Federal law might not

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<sup>138</sup> *See id.* at 537–38.

<sup>139</sup> *See id.* at 539.

<sup>140</sup> *See id.*

<sup>141</sup> *See id.* at 540. This reasoning predates, but is consistent with, the reasoning in *Estate of Heller v. Comm’r*, 147 T.C. No. 11, at \*3 (2016).

<sup>142</sup> *Goeller*, 109 Fed. Cl. at 542 (quoting *Theft*, BLACK’S LAW DICTIONARY 1648 (4th ed. 1951)).

<sup>143</sup> *See* H.R. REP. No. 99-841, at II-342-43 (1986) (Conf. Rep.); S. REP. No. 99-313 (1986); H.R. REP. No. 99-426, at 658 (1985); H.R. REP. No. 83-2543 (1954); S. REP. No. 83-1622, at 23, 198 (1954) (Conf. Rep.); H.R. REP. No. 83-1337, at 21, A46 (1954); H.R. REP. No. 64-1200 (1916); S. REP. No. 64-793 (1916); H.R. REP. No. 64-922 (1916).

<sup>144</sup> *Goeller*, 109 Fed. Cl. at 544–45.

<sup>145</sup> *Id.* at 545.

<sup>146</sup> *Id.* at 544.

<sup>147</sup> *See id.* at 540. A shibboleth is defined as an old idea, opinion, or saying that is commonly believed and repeated but that may be seen as old-fashioned or untrue. *Shibboleth*, MERRIAM-WEBSTER ONLINE DICTIONARY (2017), <http://www.merriam-webster.com/dictionary/shibboleth> [<https://perma.cc/WWN4-JS67>].

qualify for deductions under § 165(c)(3) because their losses would not be viewed as resulting from thefts under state law.”<sup>148</sup>

However, in *Adkins v. United States*,<sup>149</sup> the plaintiffs suffered an uncontested fraud loss that the IRS denied based on lack of privity.<sup>150</sup> The taxpayer’s main contention was that the loss on securities was a fraud loss because, while the transactions in question were brokered, they were purchased on the advice of the fraudster. The judge ruled that “the perpetrator must have had the specific intent to deprive the victim of his property,” citing *Goeller*<sup>151</sup> and noting:

Most courts analyzing whether a particular criminal act constitutes a theft for the purposes of I.R.C. § 165 refer to state law, but in a recent decision, the Honorable Francis M. Allegra of this court determined that the definition of theft should be derived from federal common law ... because plaintiffs purchased stock at the behest of one of [the fraudster’s] brokers ... third-party brokers may have acted merely as conduits for plaintiffs’ funds. *See Jensen v. Comm’r*, T.C. Memo 1993-393, 66 T.C.M 543, 546 (1993) (noting that “[t]here is no requirement that an investor have direct contact with the entity in which he is investing”), *aff’d*, 72 F.3d 135 (9th Cir. 1995).<sup>152</sup>

The judge noted that where the plaintiffs could demonstrate that they purchased stock from brokers who were controlled by the fraudsters, they may be able to establish privity.<sup>153</sup> However, where stock purchases were made solely on the *advice* of brokers, the judge ruled that there was no privity, granting the IRS’s request for summary judgment against taking a theft loss deduction.<sup>154</sup>

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<sup>148</sup> *Goeller*, 109 Fed. Cl. at 545 n.29 (citing Brian Elzweig & Valrie Chambers, *Modernizing the Theft Loss Deduction for Victims of Securities Frauds and Ponzi Schemes*, 30 No. 9 BANKING & FIN. SERVS. POL’Y REP. 1, 7 (Sept. 2011)).

<sup>149</sup> *See Adkins v. United States*, 113 Fed. Cl. 797, 804 (2013).

<sup>150</sup> *See id.* Or, if meeting the criteria for being a fraud loss, did not meet the requirements in the year the fraud loss was claimed. *Id.*

<sup>151</sup> *See Goeller*, 109 Fed. Cl. at 545.

<sup>152</sup> *Adkins*, 113 Fed. Cl. at 804 n.9.

<sup>153</sup> *See id.* at 805.

<sup>154</sup> *See id.* at 806. For further discussion on the history of the theft loss, see generally Elzweig et al., *supra* note 108.

### III. ESTATE TAX AND INCOME TAX CODE SECTIONS NEED NOT BE INTERPRETED CONSISTENTLY

The court was correct in asserting that *Heller* was a case of first impression and that no regulation or legislative history regarding § 2054 discusses whether an estate is entitled to a loss due to a theft that occurred during the settlement of an estate.<sup>155</sup> However, the opinion does not address why the court chose to have its analysis “begin[ ] and end[ ] with the statute.”<sup>156</sup> When construing a statute in a case of first impression, a court does look to the language of the statute itself first and, secondly, to the legislative history.<sup>157</sup> If there is no legislative intent to the contrary, the plain meaning of the words used controls.<sup>158</sup> However, if the language of a statute is ambiguous, the court may resolve this ambiguity using secondary sources to interpret congressional intent.<sup>159</sup> In cases involving administrative agencies, the statute’s administering agency provides an interpretation of congressional intent.<sup>160</sup> If the statute is silent or ambiguous with respect to the specific issue, the court must decide whether the agency’s answer is based on a permissible construction of the statute.<sup>161</sup>

By having the analysis begin and end with the statute, the tax court is implicitly stating that § 2054 is unambiguous as to its meaning. Section 2054 reads, in relevant part, “the value of the taxable estate shall be determined by deducting from the value of the gross estate losses incurred during the settlement of estates arising from fires, storms, shipwrecks, or other casualties; or from theft, when such losses are not compensated for by insurance or otherwise.”<sup>162</sup> In *Heller*, the IRS argued Madoff Securities committed a fraud; it was perpetrated against JHF, not the Estate, and therefore, the Estate was not the victim of the fraud.<sup>163</sup> JHF, even though owned mostly by the Estate, was

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<sup>155</sup> See *Estate of Heller v. Comm’r*, 147 T.C. No. 11, at \*2 (2016).

<sup>156</sup> *Id.*

<sup>157</sup> See *North Dakota v. United States*, 460 U.S. 300, 312 (1983).

<sup>158</sup> See *Heckler v. Turner*, 470 U.S. 184, 211–12 (1985).

<sup>159</sup> See, e.g., *In re Baron*, 165 F. Supp. 186, 187 (1958).

<sup>160</sup> See *Chevron v. Nat. Res. Def. Council*, 467 U.S. 837, 843 (1984).

<sup>161</sup> See *id.*

<sup>162</sup> I.R.C. § 2054 (2012).

<sup>163</sup> See *Estate of Heller v. Comm’r*, 147 T.C. No. 11, at \*2 (2016).

an entity separate from the Estate. In addition, as not being wholly owned by the Estate, it would not be considered a disregarded entity for tax purposes.<sup>164</sup> This is important, because it is similar to another line of cases,<sup>165</sup> such that if the court had found § 2054 ambiguous in its plain reading, the court may have interpreted this case differently.

Section 2054 is substantially similar in its structure to § 165(c), which describes the casualty losses (including losses derived from theft) deduction for individuals.<sup>166</sup> Section 165(c) allows for a deduction for “losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.”<sup>167</sup> Both statutes permit that losses are deductible when they arise from theft. In *Heller*, the court noted that the term “loss” means “the disappearance or diminution of value.”<sup>168</sup> Although both sides agreed in *Heller* that there was a loss because JHF lost its sole asset in the Ponzi scheme, there was disagreement between the parties regarding who actually incurred the loss.<sup>169</sup> The IRS claimed that the loss belonged JHF, not the Estate, because under New York law, JHF, as an entity separate from the Estate, was the victim of the theft.<sup>170</sup> The Estate claimed that it too was a victim, because the value of the Estate was diminished by the amount of money that was lost when the value of JHF fell in tandem with its sole asset, the investment in the Ponzi scheme.<sup>171</sup> The court, again using a plain reading interpretation, sided with the Estate by looking at the “arising from” language in § 2054.<sup>172</sup> The court sided with the Estate and allowed for a broad nexus between the theft and the incurred loss, stating that “‘arise’ is generally defined as ‘to originate from a

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<sup>164</sup> Treas. Reg. § 301.7701-2 (as amended in 2016).

<sup>165</sup> See *Heller*, 147 T.C. No. 11 at \*2.

<sup>166</sup> Compare I.R.C. § 165(c)(3) (Supp. II 2012), with I.R.C. § 2054 (2012).

<sup>167</sup> *Id.* § 165(c)(3).

<sup>168</sup> See *Heller*, 147 T.C. No. 11 at \*2 (citing *Loss*, BLACK’S LAW DICTIONARY 1087 (10th ed. 2014)).

<sup>169</sup> See *id.*

<sup>170</sup> See *id.*

<sup>171</sup> See *id.*

<sup>172</sup> See *id.*

source.”<sup>173</sup> Further, the court stated “[t]he loss suffered by the estate relates directly to its JHF interest, the worthlessness of which *arose from* the theft.”<sup>174</sup>

This plain reading interpretation of § 2054 is at odds with the interpretation of the similar provisions in § 165(c)(3).<sup>175</sup> Starting with *Edwards*, most decisions on what constitutes a theft loss require that there must be a theft under the law of the state in which the theft occurred.<sup>176</sup> In order for there to be a theft under state law, there must have been intent to deprive the person claiming the theft.<sup>177</sup> Cases under § 165(c)(3) have consistently required that there be a direct nexus between the thief and the taxpayer in order to claim a theft loss deduction.<sup>178</sup> In *Edwards* and its progeny, this nexus has been construed narrowly, requiring direct privity between the thief and the victim.<sup>179</sup> Any break in the privity, such as a brokered securities transaction, would disallow the deduction based on theft.<sup>180</sup> In *Heller*, the IRS suggests that the privity requirement under § 165(c)(3) should apply to § 2054 by arguing that JHF incurred the loss instead of the Estate.<sup>181</sup> In *Heller*, the court, instead of requiring the nexus between the thief and the taxpayer, only required a nexus between the loss and the Estate (which is the taxpayer).<sup>182</sup>

The court in *Heller*, if it decided to use case law under § 165(c)(3), could easily have used an analysis similar to the one used in *Taghadoss* and determined that the Estate and the LLC were separate entities. Under that reasoning, with only JHF and not the Estate being in privity with Madoff Securities, the Estate could have been denied the theft loss. Instead, the only

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<sup>173</sup> *Id.* (quoting *Arise*, MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 62 (10th ed. 2001)).

<sup>174</sup> *Id.* (emphasis in original).

<sup>175</sup> I.R.C. § 165(c)(3) (Supp. II 2012); *id.* § 2054 (2012).

<sup>176</sup> See *Edwards v. Bromberg*, 232 F.2d 107, 111 (5th Cir. 1956).

<sup>177</sup> See, e.g., *Taghadoss v. Comm'r*, T.C. Summ. Op. 2008-44, at \*3 (2008).

<sup>178</sup> Anne-Marie Rhodes, *On Art Theft, Tax, and Time: Triangulating Ownership Disputes Through the Tax Code*, 43 SAN DIEGO L. REV. 495, 525 (2006); see also discussion *supra* Section II.A.4.

<sup>179</sup> See, e.g., *Taghadoss*, T.C. Summ. Op. 2008-44 at \*4.

<sup>180</sup> See *Edwards*, 232 F.2d at 111.

<sup>181</sup> See *Estate of Heller v. Comm'r*, 147 T.C. No. 11, at \*2 (2016).

<sup>182</sup> *Id.* at \*2.

case that the Tax Court did cite under § 165(c)(3) was *White*.<sup>183</sup> *White* centered on a diamond that was lost from a ring as a result of the owner's hand being slammed in a door.<sup>184</sup> The owner of the diamond claimed that the loss was an uninsured casualty loss under § 165(c)(3).<sup>185</sup> The court held that the loss was the direct result of an "other casualty" under § 165(c)(3).<sup>186</sup> The *Heller* court used this case to determine that all that was needed to establish a casualty was a nexus between the loss and the casualty itself.<sup>187</sup> In doing so, the Court addressed neither the cases under § 165(c)(3) dealing with theft, nor the issue of privity.<sup>188</sup>

Instead of appealing the decision in *Heller*, the IRS let it stand. There are several reasons the IRS may have decided not to appeal. The first reason is that this decision will not have much precedential value as it is a rare occurrence. Section 2054 was originally adopted in 1954.<sup>189</sup> Since *Heller* was a case of first impression, and it occurred sixty-two years after the adoption of the statute, the IRS could find that there would not be long-term benefits in executing an appeal. Also, the facts in *Heller* are peculiar. To have precedential value in future interpretations of § 2054, it could be argued that *Heller* would be limited to a case in which there is an estate that owns another entity, such as an LLC and when a theft of the assets of the entity occurred between the time of the death of the owner of the entity and the distribution of the entity by the estate.

Second, the IRS may have assumed that JHF could be seen as the equivalent of a conduit to the Estate. This would be easier if JHF was 100 percent owned by the Estate, and therefore, a disregarded entity for federal taxation purposes.<sup>190</sup> In *Jensen v. Commissioner*, Jensen invested in a seafood importing business after being approached by a business associate named Howarter.<sup>191</sup>

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<sup>183</sup> *Id.*

<sup>184</sup> *White v. Comm'r*, 48 T.C. 430, 432 (1967).

<sup>185</sup> *Id.* at 432–33.

<sup>186</sup> *Id.* at 435.

<sup>187</sup> *Heller*, 147 T.C. No. 11 at \*2.

<sup>188</sup> *See id.*

<sup>189</sup> I.R.C. § 2054 (2012).

<sup>190</sup> *See* Treas. Reg. § 301.7701-2(c)(2) (as amended in 2016).

<sup>191</sup> *Jensen v. Comm'r*, 66 T.C.M. (CCH) 543, 544 (1993), *aff'd*, 72 F.3d 135 (9th Cir. 1995).

Howarter brokered the investment for Jensen, instead of Jensen dealing directly with the seafood business.<sup>192</sup> The business turned out to be a Ponzi scheme, and Jensen lost all of his investment.<sup>193</sup> The court held that even though Jensen did not deal directly with the business, he could deduct a loss for the theft in the transaction.<sup>194</sup> This was because the court determined that Jensen giving money to Howarter, as many other people did, for the sole purpose of investing in the business, established that Howarter was acting as a conduit for the business.<sup>195</sup> In *Heller*'s case, it could be argued that JHF was set up as a conduit solely for the owners to invest in Madoff Securities.<sup>196</sup> Upon the death of the decedent, JHF became ninety-nine percent owned by the Estate.<sup>197</sup> If JHF were seen as a conduit, then the Estate would have the same privity as JHF itself with Madoff Securities, and would therefore be likely to reap the same tax deductions.<sup>198</sup> This argument would be more likely to be successful, however, if the Estate owned one hundred percent of JHF. A solely owned LLC is considered a disregarded entity for federal income tax purposes, meaning that the LLC and the owner are considered to be a combined, single entity.<sup>199</sup>

Third, and perhaps most importantly, the IRS may be afraid that *Heller*, if confirmed on appeal, would be seen as precedential to weaken the nexus requirement under § 165(c)(3). The precedential value of cases under § 165(c)(3) was questioned in *Goeller*,<sup>200</sup> using much of the same argument, with the court implying that the plain meaning of the statute could allow it to be interpreted in ways other than *Edwards* and its progeny. The judge went so far as to call the requirement of using state law a shibboleth.<sup>201</sup> The further requirement of privity was not tested

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<sup>192</sup> *Id.* at 544–45.

<sup>193</sup> *Id.*

<sup>194</sup> *Id.* at 546.

<sup>195</sup> *Id.*

<sup>196</sup> This would be an extension of the brokerage argument in *Jensen*. *See id.*

<sup>197</sup> Estate of *Heller* v. Comm'r, 147 T.C. No. 11, at \*1 (2016).

<sup>198</sup> *See* discussion of *Jensen*, *supra* Part III.

<sup>199</sup> Treas. Reg. § 301.7701-2(c)(2) (as amended in 2016).

<sup>200</sup> *Goeller* v. United States, 109 Fed. Cl. 534, 540 (2013).

<sup>201</sup> *Id.*



in *Goeller*, but the same analysis that led to the state law requirement could logically be expanded to the privity requirement.<sup>202</sup> If an appellate court were to affirm the lack of need for a direct nexus under § 2054, then the same logic may be applied to theft losses under § 165.<sup>203</sup> This could allow for a great expansion of losses that might be considered thefts, including securities frauds where the securities were bought in a brokered transaction.<sup>204</sup> In *Goeller*, there was a direct investment between the taxpayer and a company called CPR.<sup>205</sup> CPR was supposed to buy property with the money that was being invested, but some of the property was never bought.<sup>206</sup> *Goeller* claimed this was a theft and took a deduction for the loss under § 165(c)(3) on his federal income taxes.<sup>207</sup> The court, in examining *Goeller's* claims, explained that *Edwards* and its progeny created a shibboleth by repeating that to have a theft loss, the theft incurred must meet the state law definition in the state where the theft occurred.<sup>208</sup> A shibboleth, the court explained, is something that is repeated so often that it becomes accepted as a truth even though it may be outmoded.<sup>209</sup> Instead of considering the state law requirement as axiomatic, the judge examined the legislative history of § 165.<sup>210</sup> Similar to Judge Foley's examination of the legislative history of § 2054 in *Heller*, the *Goeller* court determined that there was nothing compelling the court to rely on anything other than the plain

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<sup>202</sup> Elzweig et al., *supra* note 108, at 26.

<sup>203</sup> *See id.*

<sup>204</sup> For example, the court in *Taghadoss* might have held a lack of privity between the taxpayers and WorldCom unimportant, resulting in their ability to claim a theft loss deduction under § 165(c)(3). *Taghadoss v. Comm'r, T.C. Summ. Op. 2008-44, at \*3 (2008)*. This would have made the result in *Taghadoss* similar to that of *Vietzke*, in which privity was not an issue because the case involved securities purchased directly, without a broker, from the company in which a fraud occurred. *Vietzke v. Comm'r, 37 T.C. 504, 511 (1961)*. Therefore, a theft loss deduction was allowed. *Id.* For further discussion of *Taghadoss* and *Vietzke*, see *supra* Section II.B.4.

<sup>205</sup> *Goeller*, 109 Fed. Cl. at 536.

<sup>206</sup> *Id.*

<sup>207</sup> *Id.* at 538.

<sup>208</sup> *Id.* at 540.

<sup>209</sup> *Id.*

<sup>210</sup> *Id.* at 540-41.

meaning of the statute.<sup>211</sup> The court in *Goeller* then determined that the definitions of theft in both *Black's Law Dictionary* and *Webster's New International Dictionary* would suffice, and there was no reason to reference the crimes of a particular state to define theft.<sup>212</sup> Since there is nothing in the legislative history to require privity between the person committing a theft and the victim (which was not at issue in *Goeller*), presumably the *Goeller* court would have seen this requirement as a shibboleth as well.<sup>213</sup> The IRS in *Heller* claimed that under New York law, the theft occurred against JHF, not the Estate, and that this breaks the privity between the loss and the Estate.<sup>214</sup> Because § 165(c)(3) is substantially similar to § 2054,<sup>215</sup> it would seem that using the plain meaning to interpret one would allow for using the plain meaning to interpret the other. This may allow for future courts to apply a plain meaning reading to § 165(c)(3) and only require a nexus between the loss and the taxpayer. This could greatly expand the types of cases that are brought under § 165(c)(3) for theft losses, including cases of securities fraud where there were brokered transactions. Since the IRS has taken the position, and courts have agreed since the *Edwards* case in 1956, that to claim a theft there has to be a direct nexus between the taxpayer and the loss, this would be a major change.<sup>216</sup> To bolster its decision in *Heller*, the court noted that its interpretation is in line with the purpose of the estate tax which is “to ensure ‘that the tax is imposed on the net estate, which is really what of value passes from the dead to the living.’”<sup>217</sup> This assumes that the estate’s value is the net of what is passed to the estate, less any deduction during the administration of the estate, including any theft diminishing value of an asset of the estate during the administration, which then leaves the remainder passed to the heirs.<sup>218</sup> It would seem

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<sup>211</sup> *Id.* at 540.

<sup>212</sup> *Id.* at 542–43.

<sup>213</sup> See Elzweig et al., *supra* note 108, at 26.

<sup>214</sup> Estate of Heller v. Comm’r, 147 T.C. No. 11, at \*2 (2016).

<sup>215</sup> Compare I.R.C. § 165(c)(3) (2012), with I.R.C. § 2054 (2012).

<sup>216</sup> See *supra* Section II.B.4 for discussion of the privity requirement.

<sup>217</sup> See *Heller*, 147 T.C. No. 11 at \*3 (quoting *Jacobs v. Comm’r*, 34 B.T.A. 594, 597 (1936)).

<sup>218</sup> See *id.* at \*2.

then that a theft of an asset of an individual would then lower the value of that individual's estate by the amount of the theft in that year.<sup>219</sup> This could lead the IRS to fear an appeal, which may overturn the precedent synonymous with its longstanding position regarding theft loss deductions under § 165(c)(3).

#### IV. WHAT IF THE FRAUD HAD BEEN DISCOVERED IN ANOTHER YEAR?

Currently in income tax cases, the verdicts generally rely on the definition of theft used by the courts before them, which in turn is based on varying state laws stemming from simpler times when tangible property resided in a single state until (and perhaps after) it was stolen.<sup>220</sup> On the surface, the LLC, as a presumably pass-through entity, would be entitled to a theft loss under the safe harbor rules and would pass that loss through to the estate for income tax purposes.<sup>221</sup> However, the LLC's fraud loss might not have been categorized as the estate's theft loss under § 165(c) for income tax purposes, because the plain meaning of § 165(c) is not used.<sup>222</sup> Instead, New York state law, which requires privity between the fraudster and the victim, might be interpreted to mean that the LLC or the estate was not entitled to a theft loss, but instead entitled to a capital loss, due to lack of privity by both parties.<sup>223</sup> The fraud loss *would* be a deductible theft loss in determining the taxable estate under § 2054.<sup>224</sup> Thus, we have divergent interpretations of different I.R.C. sections with very similar wording.

When Heller died, and how the fraud loss is treated for income tax purposes, are material factors in how the family is taxed. The effect of Heller's death immediately before the discovery of the fraud (center row) is contrasted against what would have happened had Heller died just one year earlier or later in the table below.

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<sup>219</sup> *Id.*

<sup>220</sup> Rev. Rul. 72-112, 1972-1 C.B. 60.

<sup>221</sup> See Rev. Proc. 2009-20 § 4.03(4), 2009-14 I.R.B. 749.

<sup>222</sup> For discussion regarding the interpretation of § 165(c), see *supra* Section II.B.1.

<sup>223</sup> See *supra* Section II.B.4 (the estate did not directly incur the loss, and the LLC did not directly invest in the Ponzi scheme).

<sup>224</sup> See I.R.C. § 2054 (2012); *Heller*, 147 T.C. No. 11 at \*2-3.

	Income Tax Treatment of \$5,175,990 Loss		Estate Tax Treatment
	Fraud Loss Is Treated as Capital Loss	Fraud Loss Is Treated as Theft Loss	Fraud Loss Is Treated as Theft Loss
What if Heller is alive when the fraud is discovered?	Heller gets a \$3,000 loss in the year before death, and \$3,000 in the year of death. Capital losses for personal individual income tax returns are limited to \$3,000 in excess of capital gains, if any, for the year. The remaining $(\$5,175,990 - \$3,000) = \$5,172,990$ capital loss carryforward to the following year, which is the year of death. That carryforward capital loss is again limited to \$3,000 in excess of capital gains, if any, for the year. The remaining $(\$5,172,990 - \$3,000) = \$5,169,990$ loss is permanently unused because capital loss carryforwards do not carry from a living individual to their estate at death. <sup>225</sup>	Heller takes \$5,175,990 as a loss against current income, possibly creating an NOL which can be carried back two years, with any excess carried forward to the next year. Remaining NOL, if any, is permanently unused because NOL carryforwards do not carry from a living individual to their estate at death. <sup>226</sup>	Fraud loss permanently reduces the size of the estate subject to tax. <sup>227</sup>
What if the estate is open when the fraud is discovered?	The estate gets a \$3,000 loss each year that the estate is open, which is usually one year. The remaining \$5,172,990 loss passes through to the heirs for their use at the rate of \$3,000 per year in excess of capital gains until the loss is exhausted or the heirs die. The unused balance at heirs' death is permanently lost. If Heller's adult heirs were to live fifty years more each and have no capital gains, they would use $(50 \times 2 \times \$3,000) = \$300,000$ , leaving \$4,872,990 permanently unused. <sup>228</sup>	The estate takes \$5,175,990 as a loss against current income. Any unused loss passes through to the heirs to use, possibly creating an NOL which can be carried back two years with any excess carried forward twenty years. <sup>229</sup>	Fraud loss permanently reduces the size of the estate subject to tax. <sup>230</sup>
What if the fraud is not discovered until after the estate is closed?	The heirs each get a \$3,000 per year in excess of capital gains until the loss is exhausted or the heirs die. The unused balance at heirs' death is permanently lost. If Heller's adult heirs were to live fifty years more each and have no capital gains, they would use $(50 \times 2 \times \$3,000) = \$300,000$ , leaving \$4,875,990 permanently unused. <sup>231</sup>	Heirs split the \$5,175,990 loss against current income, possibly creating an NOL which can be carried back two years with any excess carried forward for up to twenty years. <sup>232</sup>	Fraud loss permanently reduces the size of the heirs' estate subject to tax. <sup>233</sup>

<sup>225</sup> See § 1211(b); *id.* § 1212(b); I.R.S. Instructions for Schedule D, Cat. No. 243311 (Oct. 19, 2016).

<sup>226</sup> See I.R.C. § 172(b) (2012).

<sup>227</sup> See *Heller*, 147 T.C. No. 11 at \*3 (interpreting I.R.C. § 2054).

<sup>228</sup> See Treas. Reg. § 1.642(h)-1 (1978).

<sup>229</sup> See § 172(b)(1)(A).

<sup>230</sup> See *Heller*, 147 T.C. No. 11 at \*3 (interpreting I.R.C. § 2054).

<sup>231</sup> See I.R.C. § 1211(b)(1) (2012).

<sup>232</sup> See *id.* § 172(b)(1)(A).

<sup>233</sup> See *Heller*, 147 T.C. No. 11 at \*3 (interpreting I.R.C. § 2054).

Clearly, Heller's family is unaffected by when the fraud is discovered (Column 4) and better off if the plain meaning of theft loss is also used for income tax purposes (Column 3 vs. Column 2). Heller is worse off for income tax purposes if the fraud is discovered immediately before his death (Row 2 versus Rows 3 and 4). For purposes of the current income tax treatment of fraud losses only, Heller was better off dead than having lived just long enough for the fraud to be uncovered.

#### CONCLUSION

Saved income is taxed once under the income tax structure when earned, and again, to the extent it is saved, under the estate tax structure.<sup>234</sup> Both structures allow deductions arising from theft. However, there is a difference in courts' interpretations as to whether a securities fraud is deductible as a theft loss.<sup>235</sup> Individuals traditionally have had to show privity between themselves and the fraudster because theft is traditionally defined through state law, which required privity.<sup>236</sup> In the case of estates, the Tax Court placed reliance on the plain meaning of the statute, not the indirect logic of case history, which one judge called a shibboleth.<sup>237</sup> Indeed, for income tax purposes, the plain meaning of theft, and the absence of legislative requirement to use state law, may be more compelling than a footnote in a single court case, even if that court case is cited repeatedly.<sup>238</sup> In the meantime, the estate tax interpretation of whether a theft loss exists in the case of fraud is more victim-friendly than the current, most frequent, income tax interpretation of whether a theft loss exists for individuals. As such, for tax purposes, a victim of fraud, arguably, may be better off dead.

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<sup>234</sup> See I.R.C. § 2001(a) (2012).

<sup>235</sup> Under the line of cases interpreting I.R.C. § 165(c)(3), a theft loss is only deductible for income tax purposes if the state definition of theft is satisfied. See *supra* Section II.B.3–4. However, under *Heller*, 147 T.C. No. 11 at \*3, securities fraud would be deductible as a theft loss in the estate tax context.

<sup>236</sup> See *Taghadoss v. Comm'r*, T.C. Summ. Op. 2008-44, at \*3 (2008).

<sup>237</sup> See *Heller*, 147 T.C. No. 11 at \*2; *Goeller v. United States*, 109 Fed. Cl. 534, 540 (2013).

<sup>238</sup> See *Edwards v. Bromberg*, 232 F.2d 107, 111 (5th Cir. 1956).