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I. INTRODUCTION

It took decades, but the Supreme Court ultimately decided that profits from illegal activities are included in the income of the wrongdoer. Unfortunately, the inclusion of illegal income was the only issue that was clearly settled. This Article discusses the federal tax laws as they apply to criminals and their victims, including many nontax legal and social issues.

Part II describes the history and evolution of the case law that resulted in the inclusion in income of profits from all types of illegal activities, including embezzlement and extortion. Initially, a determination must be made as to whether an activity or transaction constitutes theft for tax purposes. Are misappropriations with the immediate intent to repay a theft or transactions couched as loans or investment opportunities in reality fraudulent? With the inclusion of illegal income, criminals are required to file a tax return and report all illegal income on the return despite the Fifth Amendment privilege against self-incrimination. Questions also arise as to whether the tax laws should be used to punish criminals for other crimes and whether tax evaders can receive a fair trial with evidence of other crimes admitted at trial. Important to victims of theft is the section of the article exploring the priority of federal tax liens over the victim's claim for restitution from any money or property held by the wrongdoer. Next, Part II examines the various methods used by the Internal Revenue Service to detect unreported income. Special attention is given to penalties imposed on the nonfiling of tax returns or the nonreporting of income by criminals, ranging from negligence to fraud, both civil and criminal, and the possibility of prison sentences. Finally, as illegal activities are often businesses or activities engaged in for profit, the availability of deductions for expenses and losses incurred is an important consideration for criminals.

Part III explores the tax consequences to the victims of illegal

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activities. A detailed discussion follows as to the allowability and characterization of theft losses, whether of money or property, and the recognition and characterization of gains from the theft of property. A discussion of the amount and timing of theft losses allowed by I.R.C. section 165 and of bad debt deductions allowed by I.R.C. section 166 is also provided. Typically, a theft results in a loss deduction but, counterintuitively, a theft of property may result in a gain. The ability to defer gain realized pursuant to I.R.C. section 1033 is explored. The article examines the Tax Benefit Rule as it applies to the receipt of previously deducted theft losses and possible application of the net operating loss provisions. The tax treatment of theft loss and gain in the computation of taxable income of an individual is then discussed, focusing on the tax treatment of itemized deductions. The article ends with a detailed examination of tax treatment of losses from fraudulent investment schemes. Generally, taxpayers prefer a loss characterized as an ordinary theft loss as opposed to a restricted capital investment loss. In 2009, the Internal Revenue Service issued Revenue Ruling 2009-9 and Revenue Procedure 2009-20 that provide the tax treatment and guidelines for claiming theft losses from Ponzi schemes. A more difficult analysis is the tax treatment of losses produced by other types of fraudulent investment schemes.

II. TAXATION OF THIEVES

A. INCLUSION OF UNLAWFUL INCOME

The final determination that income from all types of criminal activity is included in gross income for federal tax purposes was reached "after a series of confusing and conflicting Supreme Court decisions."[1] The Revenue Act of 1913, enacted shortly after the passage of the Sixteenth Amendment,[2] taxed income from multiple sources, including "the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever."[3] Without comment, Congress eliminated the word "lawful" from the statute three years later.[4]

During Prohibition,[5] the Treasury Department relied on this

1. 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 6.4, at 6–27 (Warren, Gorham & Lamont 3d ed. 1999).

2. *See* U.S. CONST. amend. XVI (giving Congress the power to "lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration").

3. Revenue Act of 1913, ch. 16, § 2(b), 38 Stat. 114, 167.

4. Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757.

5. National Prohibition Act (Volstead Act), ch. 85, 41 Stat. 305 (1921), *repealed by* Cullen-Harrison Act, ch. 4, 48 Stat. 16 (1933).

unexplained change in the definition of "gross income" to prosecute bootleggers who failed to report income from their illegal traffic in liquor, arguing that the change manifested a legislative intent to tax the profits of unlawful as well as lawful activities.[6] However, the Supreme Court struggled for decades with the question of whether income from illegal activity is included in income for the purposes of federal income taxation.[7]

In *Sullivan v. United States*,[8] the taxpayer was a bootlegger who generated profit from the illegal sale of liquor.[9] In defense of not filing a tax return, the taxpayer contended: (1) unlawful gains are not within the meaning of income under the Internal Revenue Code;[10] and (2) in any event, the duty of filing a tax return violated the Fifth Amendment, providing that no person shall be compelled in any criminal case to be a witness against oneself.[11] The Fourth Circuit concluded that Congress did not intend to allow an individual unlawfully employed to avoid taxation and thereby increase the burdens of individuals lawfully employed.[12] Nevertheless, the Fourth Circuit held that to require a tax return "from one whose income is derived from a violation of criminal law is in conflict with the Fifth Amendment."[13]

The Supreme Court, in *Sullivan*,[14] agreed with the Fourth Circuit that the taxpayer's illegal income was subject to tax.[15] With regard to the Fourth Circuit's finding that the requirement of a tax return violated the privilege against self-incrimination granted by the Fifth Amendment, the Supreme Court stated: "It would be an extreme if not an extravagant application of the Fifth Amendment to say that it authorized a man to refuse to state the amount of his income because it had been made in crime."[16] The Supreme Court concluded that the taxpayer must raise the objection on the tax return but cannot refuse to file a tax return.[17]

6. BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS, ¶ 4.06, at 4-41 (Warren, Gorham & Lamont 3d ed. 2002).

7. *Id.*

8. Sullivan v. United States, 15 F.2d 809 (4th Cir. 1926) [hereinafter *Sullivan I*].

9. *Id.* at 810.

10. All references to the Internal Revenue Code (the "Code") are to the 1986 Internal Revenue Code, codified under Title 26 of the United States Code, as amended, or Treasury Regulations promulgated thereunder.

11. *Sullivan I*, 15 F.2d at 810.

12. *Id.*

13. *Id.*

14. United States v. Sullivan, 274 U.S. 259 (1927) [hereinafter *Sullivan II*].

15. *Id.* Justice Holmes stated, "We see no reason to doubt the interpretation of the Act, or any reason why the fact that a business is unlawful should exempt it from paying taxes that if lawful it would have to pay." *Id.*

16. *Id.* at 263–64.

17. *Id.* at 263.

1. Embezzlement and Extortion

In *Sullivan*, the income was obtained through unlawful conduct but not the type of unlawful conduct, such as embezzlement or extortion, resulting in a legal obligation under state law to make restitution. Almost twenty years later, in *Commissioner v. Wilcox*,[18] the Supreme Court held that embezzled funds are not included in gross income because, as in the case of a loan, the funds are received subject to an obligation of repayment.[19]

In *Wilcox*, the taxpayer was a bookkeeper who embezzled from his employer, losing most of the embezzled funds in gambling houses.[20] The Supreme Court noted that the inclusion of income is conditioned upon: (1) the presence of a claim of right; and (2) the absence of a definite, unconditional obligation to repay or return.[21] Accepting the loan analogy, the Supreme Court determined that embezzled funds do not constitute income because the taxpayer did not have a bona fide claim to the funds and had an unqualified obligation to repay the funds.[22] Even though the embezzler dissipated the funds, the Supreme Court asserted that recovery by the victim would be jeopardized if the embezzler were required to pay part of the embezzled funds to satisfy a tax liability.[23] To permit a tax would serve only to give the United States an unjustified preference to money that rightfully belongs to the taxpayer's employer.[24]

Six years later, in *Rutkin v. United States*,[25] the Supreme Court addressed whether money obtained by extortion is income.[26] The taxpayer extorted $250,000 from his former partner in a bootlegging business by threats to kill him and his family.[27] Although extortion resembles embezzlement in imposing an obligation to reimburse the victim, the Supreme Court held that the extorted funds were included in the extortionist's income.[28] Again applying a claim of right rational, the

18. Commissioner v. Wilcox, 327 U.S. 404 (1946).

19. *Id.* at 408–409.

20. *Id.* at 406.

21. *Id.* at 408 (citing N. Am. Oil Consol. v. Burnett, 286 U.S. 417 (1932)). *See N. Am. Oil*, 286 U.S. at 424 (defining the Claim of Right Doctrine as follows: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may be still be adjudge liable to restore its equivalent.").

22. *Wilcox*, 327 U.S. at 408.

23. *Id*. at 414.

24. *Id*. at 411.

25. Rutkin v. United States, 343 U.S. 130 (1952).

26. I*d.* at 131.

27. *Id*. at 134.

28. *Id*. at 138–39. *But see id.* at 139–40 (Black, J. dissenting) (arguing that like an embezzler, an extortionist has no legal or equitable claim to the money and is under a continuing obligation to return the money, therefore, has not received taxable income any more than if the extortionist borrowed the

Supreme Court noted that a taxpayer derives economic value from unlawful gain, as well as lawful gain, and, if the taxpayer has control over the funds, the taxpayer has the freedom to dispose of the funds at will.[29] Practically, a victim of extortion is more likely to be silent because of the fear of exposure or violence, making it less likely that the extortionist will be asked to make restitution.[30]

The distinction between embezzled funds and extorted funds for tax purposes lasted for nine years. Finally, in *James v. United States*,[31] the Supreme Court held that embezzled funds constituted income.[32] The taxpayer, a union official, embezzled more than $700,000 from his union and an insurance company doing business with his union.[33] The Supreme Court overruled its decision in *Wilcox* and held that income from illegal activity is taxable despite the legal obligation of the wrongdoer to make restitution.[34] The embezzler does not intend to honor the obligation to make restitution and, as a practical matter, has sufficient control over the funds to derive an economic benefit.[35] If restitution is made to the victim, the embezzler may deduct the amount repaid in the tax year in which repayment is made.[36]

2. Questionable Circumstances

With the *James* decision, gross income includes all illegal receipts, even if the type of crime subjects the wrongdoer to an obligation to repay or if the wrongdoer promises restitution.[37] Even a prompt promise to repay does not convert a taxable theft into a nontaxable loan.[38] Nevertheless, the

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money; but agreeing that the business profits from the criminal activity should be taxed the same manner as the profits from a lawful activity, if the criminal activity constituted a business).

29. *Id*. at 137. *Cf.* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (defining "gross income" as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.").

30. *Id*. at 138.

31. James v. United States, 366 U.S. 213 (1961). *See also* Treas. Reg. § 1.61-14(a) (as amended in 1993) (including illegal gains into gross income). *See generally* Fed. Tax Coordinator 2d (RIA) ¶ J-1601 (listing, with citations, cases in which income derived from questionable transactions or businesses was included, or not included, in income, including: bookmaking; bootleg liquor; bribes; campaign contributions in exchange for a politician's influence; drugs; embezzlement; espionage; extortion; fraudulent schemes; graft; illegal bonus to corporate director; kickbacks; profits from illegal use of corporate assets; prostitution and massage; skimming of receipts; slot machines; swindling; transactions in foreign currency obtained at illegal exchange rates; unlawful insurance policies; and usurious interest).

32. *James* 366 U.S. at 221–22.

33. *Id*. at 214.

34. *Id*. at 221.

35. *Id*. at 219.

36. *Id*. at 220.

37. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 4.06, at 4–42.

38. *See* Norman v. Commissioner, 27 T.C.M. (CCH) 181 (1968), *aff'd per curiam*, 407 F.2d 1337

Internal Revenue Service (Service) allows the netting of the amount of the repayment from the amount misappropriated when the misappropriation and the repayment occur in the same tax year.[39] If restitution is made to the victim, a deduction is allowed for the amount paid in the year of the repayment.[40] An exception to inclusion may have been carved out if there is a consensual recognition of the obligation to repay.[41]

In *Gilbert v. Commissioner*,[42] the taxpayer, who was president, principal stockholder, and director of a corporation, made unauthorized withdrawals of nearly $2,000,000 of corporate funds.[43] Believing that he was acting in the best interest of the corporation, the taxpayer withdrew the funds to facilitate the merger of another company into the corporation.[44] The taxpayer promptly informed several, but not all, of the corporate officers and directors of the withdrawals.[45] Within two weeks, the taxpayer made a complete accounting of the withdrawals to the corporation's directors, officers, and outside counsel, and signed demand notes secured by the assignment of property with a net value in excess of the amount withdrawn.[46] The Board of Directors accepted the notes and assignment but refused to ratify the unauthorized withdrawals.[47] In time, the Service filed tax liens against the taxpayer and the corporation, which failed to file the assignment, was subordinate in priority to the tax lien.[48] Finding no consensual recognition of the obligation to repay because the corporation was unaware of the withdrawals, the Tax Court concluded that the taxpayer realized income when he made the unauthorized withdrawals from the corporation and that his efforts at restitution did not entitle him to an offset

(3d Cir. 1969) (entering into a repayment agreement with the employer does not convert the receipt of embezzled funds into a loan); Quinn v. Commissioner, 524 F.2d 617 (7th Cir. 1975) (giving a promissory note to the victimized bank does not prevent the funds from being included in the embezzler's gross income); Taylor v. Commissioner, 74 T.C.M. (CCH) 1197 (1997) (executing a confession of judgement note to the victimized bank in the year of the check-kiting scheme does not convert the income from the check-kiting scheme into a loan). *But see* Gaddy v. Comm'r, 38 T.C. 943 (1962), reversed in part on other issues, 344 F.2d 460 (5th Cir. 1965) (holding that where the taxpayer mistakenly obtains funds and in the same year recognizes a fixed and definite obligation to repay and makes provision for repayment, the taxpayer is not required to include the amount obtained in income even though repayment occurred in a later year).

39. I.R.S. Field Serv. Adv. Mem. CC:TL-N-2502-94 (Apr. 8, 1994).

40. *See infra* text accompanying notes 280-306 (detailing the tax treatment of restitution payments).

41. Donald DePass, *Reconsidering the Classification of Illegal Income*, 66 TAX LAW. 771, 777 (2013).

42. Gilbert v. Commissioner, 552 F.2d 478 (2d Cir. 1977).

43. *Id*. at 479.

44. *Id*. at 481.

45. *Id*. at 479.

46. *Id*. at 481.

47. *Id*. at 480.

48. *Id*.

against his income.[49]

The Second Circuit reversed the Tax Court and held, based on the atypical facts of the case, that the funds withdrawn were not income to the taxpayer.[50] The Second Circuit did not interpret *James* to require the realization of income in every case of unlawful withdrawals by a taxpayer.[51] The Second Circuit stated:

> We conclude that where a taxpayer withdraws funds from a corporation which he fully intends to repay and which he expects with reasonable certainty he will be able to repay, where he believes that his withdrawals will be approved by the corporation, and where he makes a prompt assignment of assets sufficient to secure the amount owed, he does not realize income on the withdrawals under the James test. When Gilbert acquired the money, there was an express consensual recognition of his obligation to repay: the secretary of the corporation, who signed the checks, the officers and directors to whom Gilbert gave contemporaneous notification, and Gilbert himself were all aware that the transaction was in the nature of a loan.[52]

The theft-loan dichotomy may be relevant if the taxpayer is claiming to borrow money for legitimate business reasons but is actually engaged in swindling investors.[53] The proceeds from a bona fide loan are not included in income because the financial benefit is offset by a contemporaneously acknowledged obligation to repay.[54] Although whether a bona fide debtor-creditor relationship exists is a question of fact, an essential element is the intent of the recipient of the funds to repay and the intent of the person advancing the funds to require repayment.[55] However, a swindler is obtaining money through a false pretense or device; therefore, the amount of money obtained is included in the income of the swindler.[56]

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49. *Id.*

50. *Id.* at 481–82. *Cf.* Collins v. Commissioner, 3 F.3d 625 (2nd Cir. 1993) (distinguishing *Gilbert*, the court found that the larcenist had no reasonable expectation in his ability to repay, had no reason to believe his employer would approve his actions, and was not motivated by assisting his employer).

51. *Gilbert,* 552 F.2d at 481.

52. *Id.* at 481–82.

53. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 4.06, at 4-42–43.

54. Commissioner v. Tufts, 461 U.S. 300, 307 (1983).

55. Welch v. Commissioner, 204 F.3rd 1228, 1230 (9th Cir. 2000). Although no single factor is determinative, factors considered in determining whether a bona fide debtor-creditor relationship exists include: (1) whether the promise to repay is evidenced by a note or other instrument; (2) whether interest is charged; (3) whether a fixed schedule for repayments is made; (4) whether collateral is given to secure payment; (5) whether repayments are made; (6) whether the borrower has a reasonable prospect of repaying the loan and whether the lender has sufficient funds to advance the loan; and (7) whether the parties conduct themselves as if the transaction is a loan. *Id.*

56. Rollinger v. United States, 208 F2d 109, 112 (8th Cir. 1953).

In *In Re Diversifies Brokers Co., Inc.*,[57] the Eighth Circuit refused to follow the holding of the Supreme Court in *James.*[58] The principal source of income of the corporate taxpayer was cash received from lenders, who were promised high rates of interest and misled as to the taxpayer's business, in exchange for short-term notes issued by the taxpayer.[59] Before the maturity date of each note, the noteholder had the option to redeem the note for cash, or accept a new note for the face amount of the old note and receive accrued interest in either cash or an additional note.[60] In fact, the taxpayer was not engaged in any profitable business, and the corporate officers were illegally diverting a substantial portion of the corporate funds for their own use.[61] The activity of the taxpayer was a Ponzi-type scheme under which the corporation was obtaining more loans in order to pay off the previous loans.[62] Eventually, the officers were convicted of securities and mail fraud, and the corporation was put in receivership for violations of the Securities Exchange Act of 1933. In addition, the U.S. government filed a claim against the bankrupted corporation for unpaid income tax plus interest.[63]

The Bankruptcy Referee denied the government's claim that the amounts "borrowed" from investors by the corporation were income, finding: (1) the transactions were bona fide loans as between the taxpayer and the lenders; (2) the taxpayer honored all requests for repayment, made substantial repayments, and had a considerable bank balance at time of receivership; and (3) the taxpayer was a mere conduit and received no benefit from the receipt of the funds.[64] The Referee concluded that it would be 'unthinkable' to tax the bankrupted corporation on its receipts thereby substantially impairing the ability of the innocent lenders to recover their

57. Diversified Brokers Co. v. United States, 487 F.2d 355 (8th Cir. 1973). *See* Kreimer v. Commissioner, 47 T.C.M. (CCH) 260 (1983) (stating that the issue is not whether the taxpayers engaged in improper conduct but whether they intended to repay the funds, "a finding of fraudulent conduct does not in itself establish the lack of intent to repay"). *But see* Moore v. United States, 412 F.2d 975 (5th Cir. 1969) (finding that although the swindler had an intention and contractual obligation to make repayments, no agreement existed between the actual lender and borrower, establishing a "consensual recognition" of an obligation to repay and the exact conditions of repayment); O'Sheeran v. Commissioner, 47 T.C.M. (CCH) 405 (1983) (holding that funds borrowed from the corporation were includible in income because the taxpayer had total control over the funds, deposited the funds into a personal account, and used the funds to support himself without obligation or intention of repayment); United States v. Rochelle, 384 F.2d 748 (1967) (finding that the funds were included in the income of a confidence man even though the victims "lent" the money to the swindler).

58. *Diversified Brokers Co.*, 487 F.2d at 358. *See supra* text accompanying notes 31-38 (discussing the *James* decision in which Supreme Court rejected the theft-loan dichotomy).

59. *Id.* at 355.

60. *Id.* at 355–56.

61. *Id.* at 356.

62. *Id.* at 355.

63. *Id.* at 356–57.

64. *Id.* at 357.

loans."[65] The District Court affirmed the Referee's decision and adopted his opinion.[66] Although recognizing that the taxpayer was unable to repay all of the loans with interest because of the pyramiding nature of the scheme and the corporate officers' embezzlements, the Eighth Circuit agreed with the District Court that the *James* decisions was not controlling.[67] The record supported the Referee's findings that there was an express agreement to repay the loans with interest and many repayments were made, and the proceeds of the loans were used for the benefit of the officers and not the taxpayer.[68] The *James* decision applies to the corporate officers, requiring them to include the funds embezzled from the corporation in their income.[69] The Eighth Circuit also stated that the government's underlying reason for extending the *James* rational to this case and similar cases was, "[i]ts chances of gaining additional tax revenues at the expense of the defrauded lenders would be substantially increased."[70]

B. Fifth Amendment and Al Capone

The Fifth Amendment mandates "No person shall . . . be compelled in any criminal case to be a witness against himself. . . ."[71] As interpreted, a taxpayer may assert Fifth Amendment privilege against compulsory testimonial self-incrimination.[72] To claim the privilege, a defendant must be faced with a situation in which the hazards of self-incrimination are "real and appreciable" and not merely "imaginary and unsubstantial."[73] The privilege encompasses not only answers that would in themselves support a conviction but also "embraces those which would furnish a link in the chain of evidence needed to prosecute the claimant for a federal crime."[74] In tax matters, the Fifth Amendment may be asserted in civil or criminal investigations, litigation, and prosecutions.[75] The party seeking to deny access to evidence must establish the basis for the privilege.[76]

65. *Id.*
66. *Id.*
67. *Id.* at 358.
68. *Id.*
69. *Id.*
70. *Id.*
71. U.S. CONST. amend. V.
72. United States v. Hubbell, 530 U.S. 27, 34 (2000).
73. Marchetti v. United States, 390 U.S. 39, 48 (1968).
74. Hoffman v. United States, 341 U.S. 479, 486 (1951).
75. MICHAEL I. SALTZMAN & LESLIE BOOK, IRS PRACTICE AND PROCEDURE, ¶ 12.05[12][b][ii] (2nd ed. 1991). *See* Garner v. United States, 424 U.S. 648, 662–63 (1976) (finding that the privilege against self-incrimination is an absolute defense to Section 7203, penalty for willful failure to file a tax return). *See infra* text accompanying notes 195–200 (discussing the criminal fraud penalty provided in Section 7203, willful failure to file a return, supply information, or pay tax).
76. SALTZMAN & BOOK, *supra* note 75, ¶ 12.05[12][a].

As previously stated, the Supreme Court, in *Sullivan*, agreed with the Fourth Circuit that income from illegal bootlegging was taxable but disagreed with the Fourth Circuit's requirement that a tax return violated the bootlegger's Fifth Amendment privilege against self-incrimination.[77] The not filing of a tax return or the filing of an incomplete tax return is not protected by the Fifth Amendment privilege.[78] Thus, the taxpayer cannot make a blanket refusal to file a tax return or to furnish the information requested but must assert the Fifth Amendment privilege to the specific information required on the tax return.[79] With regard to criminal activity, the information required on the tax return that may be incriminating is the source of income, type of business, and amount of income.[80] Tax returns filed under penalties of perjury are a source of evidence for the government against taxpayers in an ongoing criminal investigation, in a civil tax audit with a potential for criminal referral, or with regard to illegal sources of income.[81]

As tax cases are often document cases, the taxpayer's ability to assert the Fifth Amendment privilege against the production of documents is critical.[82] The Supreme Court has held that documents not prepared under compulsion are not protected by the Fifth Amendment privilege.[83] For example, business records of a sole proprietorship are not privileged under the Fifth Amendment because the records are prepared voluntarily.[84] Similarly, as the privilege is personal to the taxpayer, business and tax records held by the taxpayer's accountant[85] or prepared by the taxpayer's accountant and transferred to the taxpayer's attorney[86] are not protected by the Fifth Amendment privilege. However, under the right circumstances, documents voluntarily prepared may fall under another privilege such as the attorney-client privilege.[87]

As a consequence of the inclusion of illegal income into income, the government has used the tax laws to punish a wrongdoer for the criminal

77. *Sullivan II*, 274 U.S. at 263. *See supra* text accompanying notes 8–17 (discussing the Supreme Court's holding, in *Sullivan II*, that the profits from a bootlegging operation were included in income).

78. *Id.* *But see Marchetti*, 390 U.S. at 41–42 (holding the defendant's assertion of the Fifth Amendment valid if the information required on the tax return is for general criminal conduct).

79. Garner v. United States, 501 F.2d 228, 240 (9th Cir. 1974), *aff'd*, Gardner v. United States, 424 U.S. 648 (1976). A tax return that does not contain the necessary information necessary to compute the taxpayer's tax liability is not a return within the meaning of the Code. United States v. Porth, 426 F.2d 519, 523 (10th Cir. 1970).

80. SALTZMAN & BOOK, *supra* note 75, ¶ 12.05[12][b][iii].

81. Stephen E. Silver, *The "Tax Crime Exception" to Taking the Fifth Does Not Exist*, 86 J. TAX'N 224, 224 (April 1997).

82. SALTZMAN & BOOK, *supra* note 75, ¶ 12.05[12][b][iv].

83. United States v. Hubbell, 530 U.S. 27, 34 (2000).

84. United States v. Doe, 465 U.S. 605, 610 (1984).

85. Couch v. United States, 409 U.S. 322, 329 (1973).

86. Fisher v. United States 425 U.S. 391 413–14, (1976).

87. SALTZMAN & BOOK, *supra* note 75, ¶ 12.05[12][b][iv].

conduct that generated the income and not to enforce the tax laws or penalize for the failure to comply with the tax laws.[88] In 1931, Alphonse Capone, a gangster during the Prohibition era, was prosecuted, convicted, and sentenced to eleven years imprisonment for tax evasion.[89] This selective enforcement of the tax laws against taxpayers with income from illegal sources is referred to as the "Al Capone syndrome."[90] The concern is using the tax laws to punish wrongdoers whose principal offense are other crimes, such as racketeering, black market activities, or giving or accepting bribes.[91] Conversely, if the wrongdoer is guilty of two crimes, the crime under the tax laws should not be ignored because the other more serious crime is not being prosecuted.[92] Selective prosecution raises an additional concern of whether the wrongdoer can receive a fair trial.[93] The evidence presented in a tax fraud case of the taxpayer's criminal history and associations may color the conclusions of the jury.[94]

C. RECONSTRUCTING INCOME

The scope of the Fifth Amendment privilege against self-incrimination, with respect to the inclusion of illegal income on tax returns, remains unclear.[95] If included, wrongdoers often supply a name, address, and net income, label the income "miscellaneous income" or "income from various sources," and leave the rest of the tax return blank.[96] Such tax returns invite scrutiny by the Service; however, taxpayers are rarely prosecuted for failure to supply complete information.[97] Instead, the Service attempts to verify the amounts of income listed on the tax return by

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88. Boris I. Bittker, *Taxing Income from Unlawful Activities*, 25 CASE W. RES. L. REV. 130, 131–32 (1974-75). *See generally id.*.at 130 (discussing the pros and cons of the inclusion of illegal income into gross income and the "Al Capone syndrome").

89. Bittker, *supra* note 88, at 130–31, 141. *See* Capone v. United States, 56 F.2d 927 (7th Cir. 1932) (upholding the conviction of Alphonse Gabriel Capone for willfully attempting to evade and defeat income tax). *See also* Capone v. United States, 51 f.2d 609 (7th Cir. 1931) (upholding the conviction of Raffaele (Ralph "Bottles") James Capone, mobster and older brother of Al Capone, for willfully failing to pay tax, resulting in a sentenced of three years imprisonment).

90. Bittker, *supra* note 88, at 141. *See id.* at 140 (discussing possible methods of discouraging discriminatory enforcement, including the exemption of unlawful income and the granting of tax immunity to any taxpayer whose return was selected for audit in an irregular manner).

91. 6 BORIS I. BITTKER & LAWRENCE LOKKEN, 6 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 114.9.1 at 114–80 (Warren, Gorham & Lamont 2nd ed. 2012).

92. *Id.*

93. Bittker, *supra* note 88, at 142–43.

94. *Id.* *See id.* (arguing that a tax evasion trial may require only minimal reference to the wrongdoer's illegal activities and that the judge in a criminal case can exert sufficient authority over the jury to insure a fair trial.)

95. Bittker, *supra* note 88, at 133.

96. *Id.*

97. *Id.*

examining the taxpayer's financial history.[98]

A taxpayer is under the obligation to "keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe."[99] If the taxpayer fails to file a return or files an inaccurate return, or did not keep records or kept inaccurate records, the Service is given "great latitude" in determining the taxpayer's taxable income.[100] The Service is not required to use any particular method of reconstructing income, but may use any method that clearly reflects the taxable income of the taxpayer.[101] Although the Service has the initial burden of proof, the Service's reconstruction of taxable income is presumed correct, and the taxpayer has the burden of proving that the deficiency notice is arbitrary, capricious, and excessive.[102] Finally, although courts do not require the computation to be exact, the Service must employ reasonable means and be relatively exact when determining the taxpayer's taxable income.[103]

The foundation for the calculation of assessments and penalties is taxable income.[104] Depending on the facts and circumstances of each investigation, a taxpayer's taxable income may be established by direct or several indirect methods of proof.[105] The method most preferred by the Service is the direct method, referred to as the specific item method.[106] The specific item method of reconstructing income uses a taxpayer's books and records in which transactions are contemporaneously recorded and then summarized on the tax return.[107] If a taxpayer fails to keep adequate books

98. *Id.*

99. I.R.C. § 6001 (West 2017). *See* Treas. Reg. § 1.6001-1(a) (as amended in 1990) (requiring taxpayers to "keep permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of tax or information").

100. Ramsey v. Commissioner, 39 T.C.M. (CCH) 1150 (T.C. 1980).

101. *Id.* The method used by the government to reconstruct income is not conclusive, allowing the taxpayer to present alternative methods that may be more accurate. Kikalos v. United States, 408 F.3d 900, 903 (7th Cir. 2005).

102. Elizabeth M. Rutherford, *Taxation of Drug Traffickers' Income: What the Drug Trafficker Profiteth the IRS Taketh Away*, 33 ARIZ. L. REV. 701, 716 (1991). Once the Service determines gross income, the taxpayer generally has the burden to prove deductions. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 43.01 at 43–2.

103. Rutherford, *supra* note 102, at 713–14.

104. *Id.* at 712. Generally, the term "taxable income" means a taxpayer's gross income minus deductions. I.R.C. § 63(a) (West 2017).

105. I.R.S. IRM § 9.5.9.2(4) (2012), *available at* https://www.irs.gov/irm/part9/irm_09-005-009.html#d0e70. Generally, the special agent will gather evidence to determine the amount of income that the taxpayer should on the tax return and compare that to the amount of income included on the tax return. *Id.* § 9.5.9.2.2(1).

106. *Id.* Even if the direct method is used to reconstruct taxable income, an indirect method may be used to determine the accuracy of the taxpayer's books and records. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 43.01, at 43–2.

107. I.R.S IRM 9.5.9.2.1(1) (2012), *available at* https://www.irs.gov/irm/part9/irm_09-005-009.html#d0e70. The three types of schemes suited for the use of the specific item method are: (1)

and records, an indirect method of reconstructing taxable income may be employed.[108] The indirect methods of proving income that the courts upheld are: (1) net worth method; (2) expenditures method; and (3) bank deposit method.[109] Courts have only sustained the findings of fraud if the taxpayer offers no adequate explanation for the discrepancies between the expenditures, bank deposits, and increases in net worth and the amount of income reported on the tax return.[110]

1. Net Worth Method

The net worth method measures the increase in net worth of the taxpayer calculated at the beginning and end of each tax year.[111] A legacy of the prohibition era, the net worth method is well suited to search out unreported income, particularly income from illegal sources.[112] This method of income reconstruction was used to prosecute such notorious crime figures as the Capones.[113] The net worth method is used by the Service if the taxpayer maintains no books and records or if the taxpayer's books and records are not available, inadequate, or withheld.[114] The assumption is that the taxpayer's increase in net worth, plus the taxpayer's nondeductible personal expenses, must have been financed by taxable and nontaxable income.[115] Generally, the difference in the taxpayer's net worth from the previous tax year is increased by the amount of personal living expenses, nondeductible losses, and gifts made, and decreased by any nontaxable sources of funds, such as gifts and inheritances.[116] The Service must establish an opening net worth with reasonable certainty and prove

understatement of income; (2) overstatement of expenses; and (3) fraudulent claims for credits or exemptions. *Id.* § 9.5.9.2.1(2). *See* Durland v. Commissioner, 112 T.C.M. (CCH) 37 (2016) (holding that stipulations that the taxpayer received certain payments and that he did not keep adequate records were sufficient to allow the presumption of correctness to attach to the Service's determinations and justified using the specific items method of reconstructing income).

108. Rutherford, *supra* note 102, at 712.

109. I.R.S. IRM 9.5.9.2.2(3) (2012), *available at* https://www.irs.gov/irm/part9/irm_09-005-009.html#d0e70. Two additional indirect methods used by the Service to prove income are the percentage markup method and the unit and volume method. *See id.* § 9.5.9.1(1).

110. *Id.* at § 9.5.9.2.2(3).

111. Ray A. Knight & Lee G. Knight, *How the IRS Reconstructs Income Without Records*, 42 TAX'N FOR ACCT. (Jan 1992). *See* Holland v. United States, 348 U.S. 121, 129 (1954) (sanctioning the use of the net worth method of reconstructing taxable income).

112. Linda S. Eads, *From Capone to Boesky: Tax Evasion, Insider Trading, and Problems of Proof*, 79 CAL. L. REV. 1421, 1426–27 (1991).

113. *See supra* text accompanying notes 88-94 (describing the "Al Capone syndrome").

114. I.R.S. IRM § 9.5.9.5.2(1) (2012), *available at* https://www.irs.gov/irm/ part9/irm_09-005-009.html#d0e70.

115. Knight & Knight, *supra* note 111.

116. *See generally* I.R.S. IRM § 9.5.9.5.8.1 (2012), *available at* https://www.irs.gov/irm/part9/irm_09-005-009.html#d0e70. *See also id.*, at § 9.5.9.5.8.1(3).

the unreported income came from a known and likely source.[117] The most common defense used by taxpayers is that the increase in net worth was caused by a substantial "hoard" of cash from previous years of saving.[118]

2. Expenditures Method

The expenditures method compares the taxpayer's expenditures with the taxpayer's receipt of income.[119] The assumption is that the amount by which the taxpayer's expenditures during the tax year exceeds know sources of income, if unexplained, represent unreported income.[120] This method is similar to the net worth method of reconstructing income.[121] The expenditures method of proof is used if the taxpayer's net worth has not substantially changed during the period under investigation or when significant extravagant living expenditures are apparent.[122] Thus, the taxpayer has spent substantial income on consumable goods and services, such as food, vacations, and gifts, as opposed to durable goods, such as stocks, bonds, and real estate.[123] Typically, taxpayers claim that expenditures and increased bank balances are the result of previously earned income, funds held for other parties, or nontaxable loans.[124]

3. Bank Deposit Method

The bank deposit method is a means of verifying the taxpayer's receipts and expenditures.[125] The premise is that the taxpayer's bank deposits represent income and, if not income, the taxpayer is in the best position to explain the nature of the deposits.[126] The bank deposit method requires an analysis of the taxpayer's bank account(s), which may reveal unreported income or provide leads to unreported income by tracing the deposits to their source.[127] The Service does not have to prove that the

117. Eads, *supra* note 112, at 1427–29. *See id.*, at 1429–48 (discussing, in detail, the difficulty in establishing a likely source of nontaxable income and an opening net worth, and the willingness of appellate courts to affirm convictions despite the government's inability to meet the burden of proof beyond a reasonable doubt).

118. Holland v. United States, 348 U.S. 121, 127 (1954).

119. Knight & Knight, *supra* note 111.

120. *Id. See* United States v. Johnson, 319 U.S. 503 (1943) (sanctioning the use of the expenditures method of reconstructing taxable income).

121. Knight & Knight, *supra* note 111.

122. I.R.S. IRM § 9.5.9.6.2(1) (2012), *available at* https://www.irs.gov/irm/part9/irm_09-005-009.html#d0e70.

123. *Id.*

124. Jim Swayze and John C. Zimmerman, *IRS Steps Up Indirect Methods of Establishing Income*, 52 TAX'N FOR ACCT. (Feb 1994).

125. *Id.*

126. Knight & Knight, *supra* note 111.

127. Rutherford, *supra* note 102, at 728.

bank deposits are income or establish a likely source of unreported income as the taxpayer has the burden of proving the deposits represent nontaxable income.[128] Bank deposit reconstructions are justified when the taxpayer has no or inadequate records or the Service has strong suspicion that the taxpayer has undisclosed income.[129] Again, defenses include undisclosed gifts, cash hoards, and funds belonging to other parties.[130]

D. Civil and Criminal Civil Penalties

Taxpayers engaged in unlawful activities are often liable for unpaid taxes and civil and criminal penalties. "Congress has imposed a variety of sanctions for the protection of the system and the revenues."[131] Civil fraud results in remedial action by the Service, such as assessing the correct tax and imposing civil penalties as additions to tax, which are assessed and collected administratively as part of the unpaid balance of assessment.[132] Criminal fraud results in punitive action with penalties consisting of fines and/or imprisonment, which are enforced only by prosecution and are intended to punish the taxpayer.[133] Criminal penalties serve as a deterrent to other taxpayers.[134]

1. Civil Penalties

The major difference between civil and criminal fraud is the degree of proof required by the government.[135] In civil cases, the government must present sufficient evidence to prove fraud by clear and convincing evidence while in criminal cases guilt must be proven beyond a reasonable doubt.[136] Generally, in civil court proceedings, the taxpayer bears the burden of proof until the taxpayer introduces credible evidence with respect to relevant factual issues.[137] Nevertheless, the Service has the initial burden to

128. Knight & Knight, *supra* note 111.

129. *Id.*

130. *Id.*

131. Spies v. United States, 317 U.S. 492, 495 (1943).

132. I.R.S. IRM § 25.1.1.2.3(1) (2014), *available at* https://www.irs.gov/irm/part25/irm_25-001-001.html#d0e119. If an addition to tax is assessed, the taxpayer also owes interest, compounded daily from the due date of the return, on both the underpayment and addition to tax. *See* I.R.C. § 6601(a), (e)(2) (West 2017); *see also* § 6621 (establishing the interest rate on underpayments as three percent over the federal short-term rate determined under Section 1274(d)); § 6622 (West 2017) (establishing that interest compounds daily); § 6665(a) (West 2017) (treating additions to tax in the same matter as the income tax).

133. I.R.S. IRM § 25.1.1.2.3(2) (2014), *available at* https://www.irs.gov/irm/ part25/irm_25-001-001.html#d0e119.

134. *Id.*

135. *Id.* § 25.1.1.2.2(2).

136. *Id.*

137. I.R.C. § 7491(a) (West 2017).

produce evidence to impose a penalty, an addition to tax, or an additional amount imposed by the tax laws.[138]

It has been stated that the Internal Revenue Code contains "a mind-numbing assortment" of civil penalties.[139] The following are the civil tax penalties that commonly apply to taxpayers involved in illegal activities:

a. I.R.C. Section 6651—Failure to File a Tax Return or to Pay Tax

If a taxpayer fails to file a tax return or fails to pay the tax shown, or required to have been shown, on a tax return, a penalty is imposed unless the taxpayer shows that the delay resulted from a reasonable cause and not willful neglect.[140] The penalty for failure to file a return is five percent of the amount the taxpayer was required to show for the first month, plus an additional five percent for each month thereafter, not to exceed twenty-five percent.[141] If the failure to file is due to fraudulent intent, the penalty for failure to file a timely tax return increases to fifteen percent per month with a maximum of seventy-five percent.[142] The Service has the burden to prove the failure to file was with fraudulent intent in order to impose the penalty for fraud.[143] The penalty for failure to pay the tax in a timely manner is 0.5 percent of the amount shown on the tax return for the first month, plus an additional 0.5 percent for each month thereafter, not to exceed twenty-five percent.[144]

Generally, the Service will not impose the failure to file or pay penalty on any portion of an underpayment if the taxpayer can show a reasonable and good faith effort to comply.[145] Special circumstances that warrant relief include the following: (1) taxpayer exercised ordinary business care or prudence but due to circumstances beyond the taxpayer's control was unable to comply with the tax law; (2) death, serious injury, or unavoidable

138. § 7491(c).

139. Michael Asimow, *Civil Penalties for Inaccurate and Delinquent Tax Returns*, 23 UCLA L. REV. 637, 637 (1976).

140. I.R.C. § 6651(a) (West 2017).

141. § 6651(a)(1). If a timely return is not filed, the taxpayer will usually fail to pay the tax due and will therefore be subject to penalties for both failure to file and late payment; however, in such circumstance, the penalties will offset each other so that the net result will equal the failure to file penalty. § 6651(c)(1).

142. § 6651(f).

143. I.R.C. § 7454 (West 2017). *See infra* text accompanying notes 167-71 (listing the factors considered by the Service in establishing fraudulent intent).

144. I.R.C. § 6651(a)(2), (3).

145. I.R.S. IRM § 20.1.1.3.2.1 (2014), *available at* https://www.irs.gov/irm/part20/irm_20-001-001r.html. For relief from the failure to file or pay penalty, the taxpayer must make an affirmative showing of all facts alleged as a reasonable cause for the failure to file or pay. Treas. Reg. § 301.6651-1(c)(1) (as amended in 2004). The Supreme Court held that relief is warranted if a taxpayer relied on an attorney or accountant for advice on a matter of tax law but not if a taxpayer relied on a tax advisor to prepare and file a timely tax return. United States v. Boyle, 469 U.S. 241, 250–51 (1985).

absence of the taxpayer or the taxpayer's immediate family; (3) fire, casualty, natural disaster, or other disturbance; (4) inability to obtain records necessary to comply with a tax obligation; and (5) receipt of, and reliance on, erroneous tax advice.[146] Reasonable cause is shown for failure to pay tax if the taxpayer exercised ordinary business care and prudence but was unable to pay or would suffer undue hardship if payment was made on the due date.[147] Lavish or extravagant personal spending and speculative or illiquid investments are inconsistent with a showing of reasonable care and prudence.[148]

b. I.R.C. Section 6662—Accuracy Related Penalty on Underpayments

The accuracy related penalty on underpayments attaches to specified proscribed conduct, including: (1) negligence or disregard of tax rules and regulations;[149] and (2) a substantial underpayment of tax.[150] Generally, the accuracy related penalty will not be imposed on any portion of an underpayment if the taxpayer shows a reasonable and good faith effort to comply with the tax laws.[151] The penalty is twenty percent of the underpayment attributable to the proscribed conduct.[152]

With regard to the penalty for "negligence or disregard of rule or regulations," the term "negligence" includes any failure to make a reasonable attempt to comply with the tax laws, exercise ordinary care in tax return preparation, or keep adequate books and records.[153] The penalty for negligence will not apply if the taxpayer's position has a reasonable basis.[154] "Disregard" includes any careless, reckless, or intentional

146. I.R.S. IRM § 20.1.1.3.2.2 (2014), *available at* https://www.irs.gov/irm/part20/irm_20-001-001r.html; § 20.1.1.3.2.2(1); § 20.1.1.3.2.2(2); § 20.1.1.3.2.2(3); § 20.1.1.3.2.2(5).

147. Treas. Reg. § 301.6651-1(c)(1) (as amended in 2004). For purposes of an extension of the time for payment of tax, the term "undue hardship" means more than inconvenience but means substantial financial loss, e.g., sale of property at a sacrifice price, will result from payment on the due date. Treas. Reg. § 1.6161-1(b) (as amended in 1973).

148. Treas. Reg. § 301.6651-1(c)(1) (as amended in 2004).

149. I.R.C. § 6662(b)(1), (c) (West 2017).

150. § 6662(b)(2), (d). The additional proscribed conduct for which the accuracy related penalty imposed are: (1) any substantial valuation misstatement; (2) any substantial overstatement of pension liabilities; (3) any substantial estate or gift tax valuation understatement; and (4) transactions lacking economic substance. § 6662(b). The penalty is increased to forty percent in the case of nondisclosed noneconomic substance transactions. § 6662(i).

151. § 6664(c)(1).

152. § 6662(a). The maximum accuracy related penalty that will apply is twenty percent of the understatement even though the understatement is attributable to two or more of the proscribed conducts. Treas. Reg. § 1.6662-2(c) (as amended in 2003).

153. I.R.C. § 6662(c) (West 2017); *see also* I.R.S. IRM § 20.1.5.7.1(1) (2016), https://www.irs.gov/irm/part20/irm_20-001-005.html; Treas. Reg. § 1.6662-3 (as amended in 2003) (providing details of the statutory definition of "negligence").

154. I.R.S. IRM § 20.1.5.7.1(3) (2016), https://www.irs.gov/irm/part20/irm_20-001-005.html.

disregard of tax statutes and regulations.[155] The penalty for disregard of tax statutes and regulations does not apply if the taxpayer adequately discloses the position and the position represents a good faith challenge to the regulations.[156]

A "substantial understatement" of tax occurs if the amount of the understatement exceeds the greater of: (1) ten percent of the tax required to be shown on the return; or (2) $5,000.[157] The accuracy related penalty will not be imposed on any portion of an underpayment if the taxpayer shows a reasonable and good faith effort to comply with the tax laws.[158] The amount of the understatement is reduced by the portion attributed to: (1) substantial authority for the position taken; or (2) relevant facts adequately disclosed on the tax return and a reasonable basis for the tax treatment of the item.[159] The penalty imposed by I.R.C. section 6662 will not apply to any portion of an underpayment for which a fraud penalty is imposed by I.R.C. section 6663.[160]

c. I.R.C. Section 6663—Imposition of Civil Fraud Penalty

Typically, the civil fraud penalty is imposed on a taxpayer generating illegal income.[161] The amount of the penalty is seventy-five percent of the portion of the underpayment attributable to fraud.[162] The Service must prove by clear and convincing evidence that the taxpayer is guilty of fraudulent intent to evade taxes.[163] Once the Service establishes that any portion of the underpayment is attributable to fraud, the entire underpayment is so treated, except any portion of the underpayment that the taxpayer establishes, by a preponderance of the evidence, not to be attributable to fraud.[164] The fraud penalty is not imposed on any portion of the underpayment if the taxpayer shows a reasonable and good faith effort to comply with the tax laws.[165] I.R.C. section 6663 applies only to tax returns filed; nevertheless, pursuant to I.R.C. section 6651(f), a

155. I.R.C. § 6662(c).

156. I.R.S. IRM § 20.1.5.7.2.1(3) (2016), https://www.irs.gov/irm/part20/irm_20-001-005.html.

157. I.R.C. § 6662(d)(1)(A).

158. § 6664(c)(1) (West 2017).

159. I.R.C. § 6662(d)(2)(B). If any portion of the understatement is attributable to a tax shelter a more rigorous test is applied. § 6662(d)(2)(C).

160. § 6662(b).

161. Megan L. Brackney, *When Crime Doesn't Pay: The Tax Consequences of Criminal Conduct*, 103 J. TAX'N 303, 304 (Nov 2005).

162. I.R.C. § 6663(a) (West 2017). If a joint return is filed, the fraud penalty will not apply to a spouse unless some part of underpayment is due to the fraud of that spouse. § 6663(c).

163. DiLeo v. Commissioner, 96 T.C. 858, 873 (1991), *aff'd*, 959 F.2d 16 (2nd Cir. 1992).

164. I.R.C. § 6663(b).

165. I.R.C. § 6664(c)(1) (West 2017). Intent to evade is distinguished from "inadvertence, reliance on incorrect technical advice, sincerely held difference of opinion, negligence or carelessness." I.R.S. IRM § 25.1.6.1 (2016), *available at* https://www.irs.gov/irm/part25/irm_25-001-006.html.

corresponding seventy-five percent delinquency penalty is imposed for fraudulent failure to file a tax return. As to both I.R.C. sections 6663 and 6651(f), the Service must apply the same standards in proving fraudulent intent.[166]

As distinguished from negligence, fraud is always intentional.[167] Since direct proof of fraud is rarely available, the Service must prove fraud by circumstantial evidence and reasonable inferences.[168] Generally, fraud involves one or more of the following elements: deception; misrepresentation of material facts; false or altered documents; and evasion.[169] Although a determination of fraud is based on a taxpayer's entire course of action, some of the common indicators considered by the Service in evidencing an "intent to evade tax" are as follows: (1) understatement of income, e.g., omission of specific items or sources of income or substantial income; (2) fictitious or improper deductions, e.g., overstatement of expenses; (3) accounting irregularities, e.g., two sets of books and false entries; (4) obstructive actions of the taxpayer, e.g., false statements, destruction of records, transfer or concealment of assets, and failure to cooperate with the examiner; (5) consistent pattern of underreporting income; (6) implausible or inconsistent explanations; (7) engaging in illegal activities or attempting to conceal illegal activities; (8) inadequate records; (9) dealing in cash; (10) failure to file returns; and (11) education and experience.[170] Deficiencies resulting from the exercise of judgement, a good faith misunderstanding of the law or a good faith belief that the taxpayer is not violating the law, are seldom the basis for the fraud penalty.[171]

2. Criminal Penalties

Criminal tax penalties, which include fines and/or terms of imprisonment, may also be imposed on perpetrators of illegal activities. Unlike civil penalties, criminal penalties are not collected through the assessment procedures but are imposed after conviction in criminal proceedings.[172] Although criminal fraud provisions often encompass the

166. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 50.04[2], at 50-12. *See supra* text accompanying notes 140-48 (describing the failure to file penalty imposed by I.R.C. § 6651).

167. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 50.06, at 50-33. Tax fraud is an intentional wrongdoing with the specific purpose of evading a tax owed, requiring both a tax due and owing and fraudulent intent. I.R.S. IRM § 25.1.1.2 (2014), *available at* https://www.irs.gov/irm/part25/irm_25-001-001.html#d0e119.

168. I.R.S. IRM § 25.1.6.3(1) (2016), *available at* https://www.irs.gov/irm/part25/irm_25-001-006.html

169. *Id.*

170. *Id.* § 25.1.6.3(2).

171. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 50.06, at 50-34–35.

172. Spies v. United States, 317 U.S. 492, 495 (1943). The government must bring an indictment

same conduct as the civil fraud penalty,[173] the government must prove criminal fraud by the higher standard of beyond a reasonable doubt.[174] In any court proceeding involving the question of fraud with the intent to evade taxes, the burden of proof with respect to fraud is on the government.[175] The elements of the various criminal penalties also may overlap but all require the element of willfulness that is given the same interpretation for all of the criminal penalties.[176] Unlike the civil penalty, the criminal provisions apply to more than just the taxpayer, allowing the government to prosecute individuals aiding the taxpayer, including employees, accountants, lawyers, and tax preparers.[177]

a. I.R.C. Section 7201—Attempt to Evade Tax

A taxpayer who willfully attempts to evade or defeat any tax or the payment of any tax, in addition to other penalties provided by law,[178] is guilty of a felony and, upon conviction, will be fined not more than $100,000, or imprisoned not more than five years, or both, together with the costs of prosecution.[179] The Supreme Court described the criminal fraud penalty:

> [W]e consider this felony as the capstone of a system of sanctions which singly or in combination were calculated to induce prompt

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for a tax crime within three years after the commission of the offense. I.R.C. § 6531 (West 2017). Except that the statute of limitations is extended to six years for criminal penalties the result of the following activities: (1) offenses involving tax fraud; (2) willfully attempting to evade tax; (3) aiding or assisting the preparation of a fraudulent tax return; (4) willfully failing to pay tax; and (5) fraudulent and false statements and tax returns. § 6531.

173. *See supra* text accompanying notes 167-71 (discussing the elements of fraud and conduct indicative of fraud).

174. *Spies*, 317 U.S. at 495. Imposition of a civil penalty after a criminal prosecution does not constitute double jeopardy. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 50.06, at 50-36. A civil penalty may be imposed after an acquittal in a criminal prosecution as the Service's burden of proof in the former is clear and convincing evidence and in the latter is beyond a reasonable doubt. *Id.* at 50-36–37.

175. I.R.C. § 7454(a) (West 2017).

176. United States v. Bishop, 412 U.S. 346, 361 (1973).

177. 6 BITTKER & LOKKEN, *supra* note 91, ¶ 114.9.1, at 114-81–82. In the penalty chapter of the Internal Revenue Code, the term "person" includes officers and employees of corporations and members and employees of partnerships. I.R.C. § 7343 (West 2017); *see also* I.R.C. § 6694 (West 2017) (subjecting tax preparers to civil penalties for negligent or willful attempts to understate a client's tax liability); I.R.C. § 6701 (West 2017) (imposing civil penalties on persons who aid or abet the understatement of another person's tax liability); I.R.C. § 7206(2) (West 2017) (imposing criminal penalties on persons who willfully aid or assist in the preparation of a tax return, affidavit, claim, or other document that is fraudulent or false as any material matter).

178. The phrase "other penalties provided by law" includes the civil fraud penalty and other statutory fines and prison terms if prosecution does not constitute double jeopardy. BITTKER, MCMAHON & ZELENAK, *supra* note 6 ¶ 50.08[2], at 50-50. *See supra* text accompanying notes 161-66 (discussing the civil fraud penalty imposed by I.R.C. § 6663).

179. I.R.C. § 7201 (West 2017).

> and forthright fulfillment of every duty under the income tax law . . ..[180]

The three elements required by I.R.C. section 7201 are: (1) willfulness; (2) the existence of a tax deficiency; and (3) an affirmative act constituting an evasion, or attempted evasion, of tax.[181] With regard to the first requirement, the Supreme Court found that the term "willfulness" requires "a voluntary, intentional violation of a known duty."[182] Thus, willfulness does not include a "frank difference of opinion or innocent errors made despite the exercise of reasonable care."[183] For example, if the taxpayer, who failed to file a tax return for three years, acted in good faith on his belief that a tax return or payment of tax was not required because wages were not income, the element of willfulness is not present no matter how objectively unreasonable his belief.[184] Willfulness can also be refuted by the demonstration of a good faith reliance on a tax advisor if all relevant facts were disclosed by the taxpayer.[185] The element of willfulness can be inferred from facts and circumstances such as evidence of a consistent pattern of underreporting large amounts of income and the failure to include all income in books and records.[186]

The second requirement is the existence of a tax deficiency.[187] While a formal deficiency assessment is prima facie evidence of a deficiency, the taxpayer has the opportunity to prove that the assessment does not accurately reflect the existence of a tax deficiency.[188] The government need not establish the exact dollar amount of tax owed, only the existence of a substantial deficiency.[189] Sufficient is the allegation that the taxpayer knowingly and willfully attempted to evade income tax by the use of fraudulent devices, "resulting in many thousands of dollars of taxable but unreported income."[190]

The third requirement is an affirmative act constituting an evasion, or attempted evasion, of tax, which lifts the offense from a misdemeanor to a felony.[191] Congress did not define or limit methods by which a willful

180. *Spies*, 317 U.S. at 497.

181. Sansone v. United States, 380 U.S. 343, 351 (1965).

182. *Bishop*, 412 U.S. at 360.

183. *Spies*, 317 U.S. at 496.

184. Cheek v. United States, 498 U.S. 192, 203 (1991).

185. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 50.08[2], at 50-52–53.

186. Holland v. United States, 348 U.S. 121, 139 (1954).

187. The requirement of a tax deficiency is surprising as the language of the statute seemingly includes both successful and unsuccessful attempts to evade tax. 6 BORIS & LOKKEN, *supra* note 91, ¶ 114.9.2, at 114-88; *see id.* (discussing the uncertainty as to whether and to what extent this prerequisite to prosecution must be met).

188. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 50.08[2], at 50-54.

189. United States v. Bucker, 610 F.2d 570, 573 (9th Cir. 1979).

190. *Id.* at 574.

191. Spies v. United States, 317 U.S. 492, 497–98 (1943).

evasion or attempted evasion of tax may be accomplished.[192] Although the mere failure to file a tax return does not constitute an affirmative act of evasion,[193] the requirement of an affirmative act of evasion or attempted evasion of tax can be inferred from conduct, including

> [K]eeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal.[194]

b. I.R.C. Section 7203—Willful Failure to File Return, Supply Information, or Pay Tax

A willful failure to file a tax return, keep records, supply information, or pay tax at the time required constitutes a misdemeanor subject to a fine of not more than $25,000, or imprisonment of not more than one year, or both, plus the costs of prosecution.[195] Failure to file a return and pay tax, if the taxpayer knows the tax is due, is a willful omission and, as such, a misdemeanor.[196] Tax evasion, however, must be proven by an affirmative act, such as filing a false return.[197] Even if a taxpayer intends to file at a later date, a taxpayer that willfully fails to file will violate section 7203 because the required intent is the intentional disregard of a legal obligation, and not the intent to defraud the government.[198] A good faith belief that a tax return is not required is a defense to the charge of willful failure to file even if the belief is objectively unreasonable.[199] Additionally, a good faith belief that the filing of a tax return violates the taxpayer's privilege against self-incrimination is a defense to the charge of willful failure to file.[200]

c. I.R.C. Sections 7206 and 7207—Fraudulent and False Statements

Pursuant to I.R.C. section 7206, each of the following offenses constitutes a felony, punishable with a fine of not more than $100,000, or

192. *Id.* at 499.
193. *Id.* at 497–98.
194. *Id.* at 499. If tax evasion is a motive, the criminal fraud penalty may be imposed even though such conduct may also conceal other crimes.
195. I.R.C. § 7203 (West 2017).
196. *Spies*, 317 at 493.
197. *Id.* at 494.
198. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 50.08[5], at 50-57–58.
199. *Id.* at 50-58.
200. *Id.* *See supra* text accompanying notes 71-94 (discussing the application of the privilege against self-incrimination).

imprisonment of not more than three years, or both, plus the cost of prosecution: (1) willfully making a false declaration under penalty of perjury; (2) willfully aiding or assisting in the preparation of any return or other document, which is fraudulent or false as to any material matter; (3) willfully falsifying or fraudulently executing or signing any bond, permit, entry, or other document required by the tax laws; (4) willfully removing, depositing, or concealing property upon which tax is imposed, or levied, with intent to evade or defeat the assessment or collection of any tax; and (5) willfully concealing property or withholding, falsifying, or destroying records, or making any false statement in connection any compromise or closing agreement. A conviction under this section can be based on a willful omission of a material fact as well as on an affirmative false statement.[201] Although the defect must be material, the government does not have to prove that the Service relied on the false statement[202] or that there was a tax deficiency.[203] Pursuant to I.R.C. section 7207, a willful delivery or disclosure of fraudulent lists, records, accounts, statements, or other document is a misdemeanor, punishable by a fine of not more than $10,000, or imprisonment for not more than one year, or both. This section overlaps with I.R.C. sections 7201 and 7206(1)[204] but, unlike the latter, I.R.C. section 7207, does not require the false statement to be made under the penalty of perjury.[205]

The problem—epitomized by the crusader against organized crime who would indict a person for spitting on the sidewalk if the suspect's more heinous crimes could not be established by sufficient evidence—is more complex than ordinarily recognized.[206]

E. Priority of Claims

If a criminal is proven to have undeclared illegal income, the government's claim for the taxes owed on the unreported income is often in competition with the victim's claim for restitution.[207] Under the tax lien provisions,[208] the tax lien of the federal government may have priority over the lien of the victim.[209] Although the priority of federal tax liens was not at issue in *James*,[210] Justice Black, in his dissent, stated: "subjecting the

201. United States v. Tager, 479 F.2d 120, 122 (10th Cir. 1973).
202. United States v. Romanow, 509 F.2d 26, 28 (1st Cir. 1975).
203. United States v. Jernigan, 411 F.2d 471, 473 (5th Cir.1969), *cert. denied*, 396 U.S. 927 (1969).
204. Sansone v. United States, 380 U.S. 343, 349 (1965).
205. United States v. Levy, 533 F.2d 969, 974–75 (5th Cir. 1976).
206. 6 BORIS & LAWRENCE, *supra* note 91, ¶ 114.9.1, at 114-80.
207. PAUL R. MCDANIEL, MARTIN J. MCMAHON, JR., DANIEL L. SIMMONS & GREGG D. POLSKY, FEDERAL INCOME TAXATION 180 (Foundation Press 6th ed. 2008).
208. I.R.C. §§ 6320–6323 (West 2017).
209. MCDANIEL, MCMAHON, SIMMONS & POLSKY, *supra* note 207.
210. *See supra* text accompanying notes 31-38 (discussing the Supreme Court's opinion in James

embezzled funds to a tax would amount to allowing the United States a preferential claim for part of the dishonest gain, to the direct loss and detriment of those to whom it ought to be restored."[211]

If an individual fails to pay a tax liability after demand, I.R.C. section 6321 provides that the unpaid tax, including interest, penalties, and costs, "shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."[212] A tax lien takes effect retroactively as of the date of assessment and continues until the tax liability is satisfied or becomes unenforceable due to the lapse of time.[213] The Service must give the taxpayer notice of the assessment and demand payment as soon as practicable and within sixty days after making the assessment.[214] The Service may levy on the taxpayer's property if the taxpayer neglects or fails to pay the tax within ten days after notice and demand.[215] In addition to the ten-day period, the Service must give notice of its intention to levy at least thirty days before the levy is made.[216]

With regard to solvent taxpayers, the general rule is that "first in time" determines the priority of liens.[217] Generally, state law determines the legal interest of the taxpayer in the property to which the tax lien can attach, and federal law determines the priority of the competing liens asserted against the taxpayer's property or rights to property.[218] Although valid against some third parties, an unfiled tax lien is not effective against four classes of claimants: purchasers, holders of security interests, mechanic's lienors, and judgement lien creditors.[219] A tax lien does not attach to a purchaser of property if the purchase is for "adequate and full consideration in money

that income from illegal activity is income despite the wrongdoer's obligation to repay).

211. James v. United States, 366 U.S. 213, 227 (1961) (Black, J., dissenting).

212. I.R.C. §§ 6321. An assessment is the determination of the amount of taxes due, and a lien protects the government's rights as a creditor. 6 BORIS & LOKKEN, *supra* note 91, ¶ 111.6.4, at 111-157–58.

213. § 6322. The government has ten years from the date of assessment to collect unpaid taxes unless the ten-year period is suspended or extended by agreement. I.R.S. §§ 6502(a), 6503 (West 2017). Generally, a lien is a claim or charge on property for payment of debt; however, a transfer of property to satisfy a debt can only be effective by levy or seizer. SALTZMAN & BOOK, *supra* note 75, ¶ 14.04.

214. I.R.C. § 6303(a) (West 2017). Nevertheless, the Service's failure give notice within sixty days does not invalidate the notice. Treas. Reg. § 301.6303-1(a) (as amended in 2001).

215. I.R.C. § 6331(a) (2017). If the Service finds that collection is in jeopardy, the Service may give notice and demand for immediate payment and levy upon the taxpayer's property without regard to the ten-day period. *Id.*

216. § 6331(d).

217. United States v. New Britain, 347 U.S. 81, 85 (1954); SALTZMAN & BOOK, *supra* note 75, ¶ 16.01. *See generally* SALTZMAN & BOOK, *supra* note 75, ¶¶ 16.07-16 (discussing the priority of tax liens of insolvent debtors and debtors in bankruptcy).

218. Aguilino v. United States, 363 U.S. 509, 513–14 (1960); SALTZMAN & BOOK, *supra* note 75, ¶ 14.07[1][e].

219. I.R.C. § 6323(a) (West 2017). Even if filed, a tax lien is not valid against a class of "superpriority" interests listed in Section 6323(b). *See* § 6334 (exempting certain categories of property from levy).

and money's worth."[220] Thus, property subject to a bona fide sale prior to the filing of the tax lien is protected as the taxpayer no longer owns the property.[221] The Service may not immediately record a tax lien because the filing of a tax lien may adversely affect the taxpayer's ability to pay.[222] With regard to after acquired property, with few exceptions, a federal tax lien is always first in time. [223] A claimant, who under state law would have priority, may be subordinate to a subsequently filed tax lien if the claimant's lien is "inchoate," or unperfected, prior to the filing of the tax lien.[224]

It is well established that illegally obtained funds are includable in the income of a wrongdoer.[225] However, the question arises as to whether the government can levy upon specific property acquired with illegally obtained funds.[226] In *Dennis v. United States*,[227] the District Court found that a federal tax lien does not attach to property held by the embezzler and traceable to the victim.[228] The threshold question addressed by the District Court was the ownership of the property under state law as a tax lien only extends to the property belonging to the wrongdoer.[229] If under state law the ownership of embezzled funds do not pass to the embezzler, the government cannot levy upon property purchased with those funds.[230] Applying common law principles, the District Court found that the victims did not intend that the embezzler to acquire title to the property, therefore, the levy by the Service was null and void.[231]

An important treatise on federal income tax presents the practical application of the priority of claims involving criminal activity notes:

> If a victim can trace and identify his property, as in the case of a stolen work of art, he generally can get it back, even if the thief has nothing left with which to pay his taxes. Even if the property cannot be traced (e.g., cash

220. § 6223(h)(6); *see also* Treas. Reg. § 301.6323(h)-1(f) (as amended in 2011).

221. SALTZMAN & BOOK, *supra* note 75, ¶ 14.07[1][c].

222. *Id.* at ¶ 14.04.

223. *Id.* at ¶ 14.07[1][b].

224. United States v. Sec. Trust & Savings Bank, 340 U.S. 47, 113–14 (1950). *See supra* text accompanying notes 42-52 (finding by the Second Circuit, in *Gilbert*, that the corporation's claim was subordinate to the federal tax lien because the corporation failed to file the taxpayer's assignment of property).

225. *See supra* text accompanying notes 14-41 (describing the Supreme Court decisions resulting in the inclusion in income of receipts from all types of illegal activity).

226. MCDANIEL, MCMAHON, SIMMONS & POLSKY, *supra* note 207, at 181.

227. Dennis v. United States, 372 F.Supp. 563 (1974).

228. *Id.* at 566–68.

229. *Id.*

230. *Id.*

231. *Id.* *See* Altas, Inc. v. United States, 459 F.Supp. 1000 (1978) (holding that the tax lien of the government was not entitled to priority as the embezzler did not have beneficial ownership of the property purchased with the embezzled funds).

> whose serial numbers are not known), the victim will ordinarily be familiar with the facts sooner than the government, and this prior knowledge will usually enable him to establish an enforceable claim against any assets that can be discovered in the criminal's possession before the government's tax lien takes hold. Situations can be imagined in which the victim's right to reimbursement will be subordinate to the government's right to collect taxes on the unlawful income, but they are unusual, and a corrective for this injustice could be provided by Congress without going so far as to confer a blanket exemption on unlawful income.[232]

F. DEDUCTION OF EXPENSES, LOSSES, AND PAYMENTS

"We start with the proposition that the federal income tax is a tax on net income, not a sanction against wrong-doing."[233] The determination of the deductibility of expenses and losses incurred in an illegal activity begins with classification of the activity.[234] If the unlawful activity constitutes a business, the wrongdoer may deduct all ordinary and necessary business expenses[235] and all losses incurred in the business.[236] With regard to a nonbusiness, for-profit activity, a deduction is allowed for all ordinary and necessary expenses incurred in the production of income[237] and all losses incurred in any transaction entered into for profit. However, no deduction or credit is allowed for any amount paid if the business consists of trafficking in controlled substances prohibited by federal or state law.[238]

1. Deduction of Expenses Pursuant to I.R.C. Sections 162 and 212

In 1969, I.R.C. section 162, which allows a deduction for all ordinary and necessary business expenses, was amended to disallow deductions for specific categories of payments.[239] The amendments were necessary to provide clarity as to the deductibility of such payments as illegal payments

232. Bittker, *supra* note 88, at 147.
233. Commissioner v. Tellier, 383 U.S. 687, 691 (1966).
234. *See* Sullivan v. Commissioner, 356 U.S. 27 (1958) (allowing a deduction for rents and salaries paid in an illegal gambling enterprise as ordinary and necessary business expenses).
235. I.R.C. § 162(a) (West 2017).
236. I.R.C. § 165(c)(1) (West 2017).
237. I.R.C. § 212(1)-(2) (West 2017). In addition, Section 212 allows a deduction for the management, conservation, or maintenance of property held for the production of income and expenses incurred in connection with the determination, collection, or refund of any tax. § 212(2)-(3).
238. § 280E.
239. Tax Reform Act of 1960, Pub. L. 91-172.

and bribes.[240] The conflict was between the requirement of taxing only net income and the frustration of the public policy against encouraging unlawful conduct.[241] Pursuant to the Frustration of Public Policy Doctrine, a deduction is disallowed if a deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct."[242] The disallowance of a deduction requires a declared national or state policy and severe and immediate frustration of that policy.[243]

By amending I.R.C. section 162, Congress preempted the existing case law establishing the Frustration of Public Policy Doctrine, stating "public policy, in other circumstances, generally is not sufficiently clearly defined to justify disallowance of deductions."[244] Certain deductions disallowed for specific categories of payments are also disallowed for payments incurred for the production of income under I.R.C. section 212.[245]

a. I.R.C. Section 162(c)—Illegal Bribes, Kickbacks, and Other Payments

Pursuant to I.R.C. 162(c)(1), no deduction is allowed for direct or indirect payments to any governmental official or employee, or any agency or instrumentality of any government, if the payment is an illegal bribe or kickback.[246] I.R.C. section 162(c)(2) disallows a deduction for direct or indirect payments to any person if the payment constitutes an illegal bribe, illegal kickback under any federal or state law, which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business.[247] If a violation of state law, the deduction is only disallowed if

240. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 11.04[1], at 11-34.

241. *Id.* Arguably, the denial of a deduction for expenditures incurred in the production of illegal income could be viewed as the functional equivalent of the imposition of a tax penalty. MCDANIEL, MCMAHON, SIMMONS & POLSKY, *supra* note 207, at 399 .

242. Commissioner v. Tellier, 383 U.S. 687, 694 (1966).

243. *Id.*

244. S. REP. NO. 91-552 (1969) *as reprinted in* 1969-3 C.B. 423, 597; BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 11.04[1], at 11-34. Under I.R.C. § 162, deductions are also disallowed for certain lobbying and political expenditures (§ 162(e)) and treble-damage payments under the antitrust laws (§ 162(g)).

245. Treas. Reg. § 1.212-1(p) (as amended in 1975). Pursuant to Section 212 of the Internal Revenue Code, a deduction will not be allowed if the payment is incurred for the following: (1) illegal bribes, kickbacks, and other payments § 162(c)); (2) fines and penalties (Section 162(f)); and (3) treble damage payments under the antitrust laws (Section 162(g)). *See* Treas. Reg. § 1.212-1(p).

246. If an official or employee of a foreign government, a payment cannot be deducted if unlawful under the Foreign Corrupt Practices Act of 1977. I.R.C. § 162(c)(1) (West 2017). The government must prove by clear and convincing evidence that the payment is an illegal bribe or kickback or unlawful under the Foreign Corrupt Practices Act of 1977. §§ 162(c)(1), 7454; *see also* Treas. Reg. § 1.162-18(a)(5) (as amended in 1975).

247. The government must prove by clear and convincing evidence that the payment is an illegal bribe or kickback. I.R.C. §§ 162(c)(2), 7454; *see also* Treas. Reg. § 1.162-18(b)(4) (as amended in 1975).

the state law is generally enforced.[248] A kickback also includes a payment in consideration of the referral of a client, patient, or customer.[249] Finally, a deduction is disallowed, pursuant to I.R.C. section 162(c)(3), for kickbacks, rebates, or bribes by physicians and other providers of goods and services in connection with Medicare or Medicaid, including payments for referrals of clients, patients, or customers.

b. I.R.C. Section 162(f)—Fines and Penalties

A deduction is not allowed for "any fine or similar penalty paid to a government for the violation of any law."[250] The disallowance occurs whether the violation was deliberate or inadvertent.[251] The term "similar penalty" encompasses "payments of sanctions which are imposed under civil statutes but which in general terms serve the same purpose as a fine exacted under a criminal statute."[252] Pursuant to the Treasury Regulations, a fine or similar payment includes the following: (1) paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor); (2) paid as a civil penalty imposed by federal, state or local law, including additions to tax, additional amount, or assessable penalties imposed under the Internal Revenue Code; (3) paid in settlement of an actual or potential liability for a fine or penalty (federal or civil); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of a fine or penalty.[253] A fine or penalty does not include the following: (1) legal fees and related expenses made in defense of a prosecution or civil action arising from violation of the law; or (2) compensatory damages paid to a government.[254]

2. Deduction of Losses Pursuant to I.R.C. Section 165

I.R.C. section 165 allows a deduction for a loss sustained during the tax year and not compensated by insurance or otherwise.[255] In the case of an individual, the deduction is limited to: (1) losses incurred in a business;[256] (2) losses incurred in any transaction entered into for profit;[257]

248. I.R.C. § 162(c)(2).
249. § 162(c)(2).
250. § 162(f).
251. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 11.04[2], at 11-36.
252. S. REP. NO. 92-437, *reprinted in* 1972-1 C.B. 559, 600; BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 11.04[2], at 11-36.
253. Treas. Reg. § 1.162-21(b)(1) (as amended in 1975).
254. *Id.* at § 1.162-21(b)(2).
255. I.R.C. § 165(a) (West 2017). The deduction is allowed only to the extent of the taxpayer's basis in the property. § 165(b).
256. § 165(c)(1).
257. § 165(c)(2).

and (3) with regard to personal use property, casualty and theft losses sustained during the tax year.[258]

In 1969, I.R.C. section 162 was amended to disallow deductions for specific categories of otherwise ordinary and necessary business expenses.[259] The legislative intent was to preempt the long-established Frustration of Public Policy Doctrine.[260] Nevertheless, the Service has long maintained that the Frustration of Public Policy Doctrine applies to the allowability of loss deductions pursuant to I.R.C. section 165.[261] In Revenue Ruling 81-24,[262] the taxpayer set fire to a building to collect insurance proceeds.[263] After the arson was discovered, the insurance proceeds were not paid and the taxpayer was convicted of arson.[264] On his tax return, the taxpayer claimed a casualty loss deduction in the amount he paid for the building.[265] Since the taxpayer's knowing and willful act caused the loss, the loss did not qualify as a casualty pursuant to I.R.C. section 165(c)(3).[266] Further, because the taxpayer violated the applicable state law against committing arson and making a fraudulent insurance claim, a loss deduction pursuant to I.R.C. section 165(c)(1) or (c)(2) was disallowed on the grounds that a loss deduction would violate a sharply defined state declaration of public policy.[267] The Service also stated that a deduction was not allowed pursuant to I.R.C. sections 162 and 212 as the taxpayer sustained a theft loss and not an ordinary and necessary expense incurred in a business or a for-profit activity.[268]

3. Deduction of Legal Expenses

For taxpayers engaged in criminal conduct, the ability to deduct legal fees is of considerable importance. Costs incurred in defending criminal charges are deductible if incurred in a business or a for-profit activity, but

258. § 165(c)(3). *See infra* text accompanying notes 338–60 (explaining the allowability of, and limitations on, deductions for the casualty and theft of personal-use property).

259. I.R.C. § 162(c), (f), (g) (West 2017).

260. *See supra* text accompanying notes 239-44 (discussing the Frustration of Public Policy Doctrine and the amendments to I.R.C. section 162 that preempted the Frustration of Public Policy Doctrine).

261. *See* BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 16.01, at 16-4 n..8; s*ee* also Rev. Rul. 77-126, 1977-1 C.B. 47 (disallowing a loss deduction for the seizer of illegal coin-operated gambling devices as contrary to a sharply defined public policy); Mazzei v. Commissioner, 61 T.C. 497 (1974) (denying a theft loss claimed by the taxpayer because the taxpayer was defrauded while participating in a counterfeiting conspiracy and the allowance of the deduction would constitute an immediate and severe frustration of the clearly defined policy against counterfeiting U.S. currency).

262. Rev. Rul. 81-24, 1981-1 C.B. 79.

263. *Id.*

264. *Id.*

265. *Id.* at 79–80.

266. *Id.*

267. *Id.*

268. *Id.*

not a personal activity.[269] In deciding whether legal fees are personal, the Supreme Court established the origin-of-the-claim test.[270] The origin and character of the claim with respect to legal expenses determines deductibility and not the potential financial consequences to the taxpayer.[271]

Although a deduction for expenses incurred in an illegal activity might otherwise be disallowed, the disallowance does not extend to legal fees incurred in defense of prosecution or legal action if incurred in business or a for-profit activity.[272] In *Commissioner v. Tellier*,[273] the Supreme Court held that legal expenses incurred by a taxpayer in the unsuccessful defense of a criminal prosecution for securities and mail fraud were deductible as business expenses.[274] The Supreme Court found that the criminal charges against the taxpayer were the result of his business activities as a security dealer.[275] In *DiFronzo v. Commissioner*,[276] the taxpayer was a member of a Chicago organized crime family, who incurred legal fees in defending conspiracy and mail and wire fraud charges from his involvement in an illegal gambling operation.[277] The Tax Court allowed a business deduction for his legal fees because the criminal charges originated from his business activities as a member of an organized crime family.[278] The crime family obtained income through a variety of illegal activities, including bookmaking, loan sharking, extortion, illegal gambling, trafficking in stolen property, and fraud.[279]

4. Deduction of Payments in Restitution

In *Wilcox*, the Supreme Court held that funds were not included in income because the embezzler did not have an unqualified right to the funds and had an unconditional obligation to repay.[280] The Supreme Court, in *James*, overruled the *Wilcox* decision, holding that embezzled funds are

269. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 11.02[2][i], at 11-25. No deduction is allowed for "personal, living, or family expenses." I.R.C. § 262(a) (West 2017).

270. United States v. Gilmore, 372 U.S. 39, 49 (1963). In *Gilmore*, the Supreme Court held that attorney fees incurred by a husband successfully protecting assets from the claims of his wife in a divorce proceeding are nondeductible personal expenses. *Id.* at 52. *See also* United States v. Patrick, 372 U.S. 53 (1963) (holding that a husband could not deduct legal expenses incurred in negotiating a property settlement incident to a divorce proceeding).

271. *Gilmore*, 372 U.S. at 49.

272. Treas. Reg. §§ 1.162-21(b)(2) (as amended in 1975); 1.212-1(p) (as amended in 1975).

273. Commissioner v. Tellier, 383 U.S. 687 (1966).

274. *Id.* at 695 (1966). The Supreme Court found that the legal expenses were "ordinary" (not capital expenditures) and "necessary" (appropriate and helpful). *Id.* at 689–90.

275. *Id.* at 695.

276. DiFronzo v. Commissioner, T.C.M. (CCH) 1998-41 (1998).

277. *Id.* at 1998-41, 2.

278. *Id.* at 1998-41, 4.

279. *Id.* at 1998-41, 2.

280. *See supra* text accompanying notes 20-24 (discussing the rationale of the Supreme Court in *Wilcox*).

included in the income of the embezzler despite the legal obligation of the embezzler to make restitution.[281] The Supreme Court noted that if the embezzler makes restitution to the victim, the embezzler could deduct the amount paid in the tax year of the repayment:[282]

Just as the honest taxpayer may deduct any amount repaid in the year in which repayment is made, the Government points out that, "if, when, and to the extent that the victim recovers back the misappropriated funds, there is of course a reduction in the embezzler's income.[283]

The taxpayer, in *Stephens v. Commissioner*,[284] participated in a scheme by employees to defraud and embezzle funds from their employer (Raytheon).[285] The taxpayer was convicted of various federal crimes for which the trial judge imposed a $16,000 fine and sentenced the taxpayer to multiple terms of imprisonment.[286] The sentencing judge suspended one of the prison terms, substituting five years of probation, on the condition the taxpayer make restitution to Raytheon in the amount of $1,000,000 ($530,000 principal and $470,000 interest).[287] The taxpayer included the embezzled funds into income and sought to deduct the $530,000 payment in restitution.[288] The Tax Court held that the taxpayer was not entitled to a loss deduction, under I.R.C. section 165(c)(2),[289] on the ground that allowance of the deduction would frustrate public policy.[290]

On appeal, the Second Circuit found that the loss deduction would not "severely and immediately frustrate sharply defined state or national public policy."[291] In reaching its decision, the Second Circuit considered both the compensatory nature and the tax consequences of the payment.[292] The Second Circuit determined that the restitution payment was primarily remedial in nature to compensate Raytheon and not a fine or penalty, even

281. *See supra* text accompanying notes 31–38 (discussing the rationale of the Supreme Court in *James*).

282. *See supra* text accompanying notes 31–38 (discussing the rationale of the Supreme Court in *James*). Forfeiture (payment to the government as a punitive measure) and restitution (repayment to the victim of a crime) must be distinguished because payments of forfeitures are nondeductible and payments of restitution may be deductible. Brackney, *supra* note 161.

283. James v. United States, 366 U.S. 213, 220 (1961).

284. Stephens v. Commissioner, 905 F.2d 667 (1990). *See* Robert T. Manicke, *A Tax Deduction for Restitution Payments? Solving the Dilemma of the Thwarted Embezzler*, 1992 U. ILL. L. REV. 593 (1992) (arguing that a deduction should be allowed for payments of restitution in the interest of taxing only net income and the separation of the tax laws from the punitive functions of the government).

285. *Stephens*, 905 F.2d at 668.

286. *Id.* at 671.

287. *Id.* at 668.

288. *Id.* at 668–69.

289. Section 165(c)(2) of the Internal Revenue Code allows an individual a loss deduction for transactions entered into for profit.

290. *Stephens,* 905 F.2d at 669. *See supra* text accompanying notes 239-45 and 260-68 (discussing the Frustration of Public Policy Doctrine as it applies to Sections 162, 212, and 165).

291. *Stephens*, 905 F.2d at 670.

292. *Id.* at 672–74.

though the taxpayer repaid the embezzled funds as a condition of his probation.[293] The fact that the taxpayer's sentence consisted of a prison term, fines, and an order to make restitution supported the inference that the restitution payment was compensatory in nature and not in the nature of a fine or penalty.[294] In addition, if the deduction was disallowed, the Second Circuit reasoned that, because the he had already paid tax on the embezzled funds, the taxpayer would be paying tax on income that he did not retain.[295]

I.R.C. section 1341 provides relief from the application of different tax rates in the computation of tax where a taxpayer included income under a claim of right and was allowed a deduction in a subsequent tax year because the taxpayer was required to repay the amount previously included.[296] The amount included in the earlier year must have been included under a claim of right, meaning it appeared from all available facts that the taxpayer had an unrestricted right to the income.[297] The tax liability for the tax year of repayment is the lesser of: (1) the tax for the tax year with the deduction; or (2) the tax computed without the deduction minus the decrease in tax liability for the earlier tax year if the amount repaid had not been included in income.[298] The ability to utilize this provision is particularly important if the taxpayer is in a lower marginal rate of tax in the tax year of restitution.[299]

To utilize I.R.C. section 1341, the taxpayer must have an apparent unrestricted right to the income in the tax year of inclusion.[300] *In Yerkie v. Commissioner*,[301] an embezzler argued that the Supreme Court, in *James*,[302] expanded the Claim of Right Doctrine to include embezzled funds.[303] The Tax Court held that the taxpayer could not utilize I.R.C. section 1341 in computing his tax liability in the year of repayment because the embezzled funds were not received under a claim of right.[304] Noting the underlying purpose of the Supreme Court in the *James* decision was to avoid taxing legal income while exempting illegal income, the Tax Court found that distinction between legal and illegal income is significant for

293. *Id.* at 673–74.
294. *Id.* at 673.
295. *Id.* at 671.
296. I.R.C. § 1341(a)(1), (2) (West 2017). The amount of the deduction must exceed $3,000. § 1341(a)(3).
297. Treas. Reg. § 1.1341-1(a)(2) (as amended in 1996).
298. I.R.C. § 1341(a)(4), (5).
299. *See* BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 4.03[4].
300. I.R.C. § 1341(a)(1).
301. Yerkie v. Commissioner, 67 T.C. 388 (1976).
302. *See supra* text accompanying notes 31-38 (discussing the rationale of the Supreme Court in James).
303. *Yerkie*, 67 T.C. at 391.
304. *Id.*

determinations under other sections of the Internal Revenue Code.[305] The taxpayer misconstrued the meaning of term "unrestricted right" for the purposes of I.R.C. section 1341, stating: "The inclusion of embezzled funds as gross income and the concomitant right to a deduction upon repayment neither categorizes proceeds as income rightfully received nor bestows upon these funds the characteristics of income received under a claim of right."[306]

5. Treatment of Non-Business Deductions

The distinction between criminal activity that constitutes a business and criminal activity that is engaged in for profit is important in the computation of the wrongdoer's taxable income. Business deductions are fully deductible from gross income in computing the adjusted gross income of an individual;[307] however, most for-profit deductions are itemized deductions subject to limitations.[308] Thus, a pivotal question is whether the wrongdoer's illegal activities constitute a business.

In *Commissioner v. Groetzinger*,[309] the Supreme Court addressed the issue of whether a full-time gambler who made wagers solely for his own account was engaged in business within the meaning of I.R.C. sections 62(a)(1) and 162.[310] The taxpayer devoted sixty to eighty hours per week to pari-mutuel wagering, primarily on dog races, with intent to earn a living from such activities.[311] The taxpayer gambled solely for his own account and had no other employment.[312] The Supreme Court observed that not every income-producing and profit-making activity constitutes a business.[313] To be engaged in a business, the "taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit."[314] Applying a common sense concept of business,[315] the Supreme Court

305. *Id.* at 392.
306. *Id.*
307. I.R.C. § 62(a)(1) (West 2017).
308. I.R.C. § 63(d) (West 2017). The term "itemized deduction" means all deductions except those deductions allowed in computing adjusted gross income under Section 62 and personal exemptions under Sections 151-52. An individual may deduct a standard deduction or elect to itemize deductions. § 63 (b), (c).
309. Commissioner v. Groetzinger, 480 U.S. 23 (1987).
310. *Id.* at 24. Section 62(a)(1) of the Internal Revenue Code allows an individual to deduct business expenses, other than the business of the performing services as an employee, from gross income in arriving at adjusted gross income. With exceptions, Section 162 allows a deduction for ordinary and necessary business expenses.
311. *Groetzinger*, 480 U.S. at 24.
312. *Id.*
313. *Id.* at 35.
314. *Id.*
315. *Id.*

concluded, based on the particular facts of this case, that "if one's gambling activity is pursued full-time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business."[316]

An example with regard to criminal activity, the courts and the Service agree that embezzlement does not constitute a business even though the embezzlements are regular and systematic.[317] Thus, an embezzler must deduct any expense incurred for the production and conservation of income under I.R.C. section 212[318] and any loss incurred in a transaction entered into for profit under I.R.C. section 165(c)(2).[319] If restitution is made, the embezzler is allowed a deduction for restitution payments under I.R.C. section 165(c)(2).[320] These deductions are itemized deduction and, as such, deducted from an individuals adjusted gross income in computing taxable income.[321]

Deductions allowed pursuant to I.R.C. sections 212 and 165(c)(2) are also included in the definition of "miscellaneous itemized deductions."[322] Miscellaneous itemized deductions are only allowed to the extent total miscellaneous itemized deductions exceed two percent of the embezzler's adjusted gross income for the tax year.[323] If the embezzler's adjusted gross income exceeds a threshold amount, the allowable itemized deductions are subject to a further limitation.[324] Thus, deductions allowed to embezzlers for for-profit expenses and restitution are subject to the two percent of adjusted gross income limitation and the overall limitation on itemized deductions.[325] Finally, miscellaneous itemized deductions are not deductible for alternative minimum tax purposes[326] and non-business deductions are not included

316. *Id.* at 35.

317. *See* Yerkie v. Commissioner, 67 T.C. 388, 393 (1976); *see also* Rev. Rul. 65-254, 1965-2 C.B. 50; Hankins v. United States, 403 F.Supp. 257, 259 (1975) (holding that embezzlement is not a business even though the taxpayers embezzled his employer's funds in a regular and systemic manner).

318. I.R.C. § 212(1), (2) (West 2017).

319. § 165(c)(2).

320. *Yerkie*, 67 T.C. at 393–94; Rev. Rul. 65-254, 1965-2 C.B. 50.

321. I.R.C. § 63(a), (d) (West 2017); *see also* Rev. Rul. 65-254, 1965-2 C.B. 50.

322. I.R.C. § 67(b) (West 2017). The definition of "miscellaneous itemized deduction" includes itemized deductions other than certain listed deductions, including deductions for interest, taxes, casualty and theft losses, charitable contributions, and medical expenses. § 67(b)(1)–(5).

323. § 67(a).

324. I.R.C. § 68(a) (West 2017). The allowable itemized deductions are further reduced by the lesser of: (1) three percent of the excess, or (2) 80 percent of the otherwise allowable itemized deductions. *Id.*

325. *See* §§ 67, 68; *see also* Rev. Rul. 65-254, 1965-2 C.B. 50.

326. I.R.C. § 56(b)(1)(A)(i) (West 2017); *see also* I.R.C. §§ 55–57 (establishing an alternative tax, which is a separate system for computing income tax liability; Rev. Rul. 65-254, 1965-2 C.B. 50 (holding that the repayment of misappropriated funds is deductible pursuant to Section 165(a)(2) of the Internal Revenue Code; therefore, a miscellaneous itemized a deduction is not allowed for the purposes of computing alternative minimum tax income).

for the purposes of computing a net operating loss.[327]

III. VICTIMS

Victims of crime do not fare much better than the perpetrators of crime.[328] For tax purposes, the victims of thefts are generally treated similarly to the victims of casualty events. Whether the taxpayer is engaged in a business, for-profit activity, or personal pursuit, a casualty or theft may result in a deductible loss. Although counterintuitive, the casualty or theft of property may result in the realization and recognition of gain.

A. LOSS FROM THEFT

A theft results in the taxpayer suffering a loss of money or property. If a loss occurs, the question becomes whether the loss is a deductible loss and, if so, in which tax year is the deduction allowed.

Generally, I.R.C. section 165 allows a loss deduction for any loss sustained during the tax year and not compensated by insurance or otherwise.[329] A loss deduction is only allowed for the tax year in which the loss is sustained as evidenced by closed and completed transactions and as fixed by identifiable events.[330] A theft loss is treated as sustained in the tax year in which the theft is discovered[331] and is considered discovered when a reasonable person in similar circumstances would have realized the loss.[332]

If a claim for reimbursement exists in the tax year of discovery, a loss is not sustained until determined with reasonable certainty whether or not reimbursement will be received.[333] If a portion of the loss is covered by a claim for reimbursement only that portion of the loss is deductible during the tax year.[334] For example, if a solvent embezzler promises restitution, a current loss deduction may be denied because the debt obligation constitutes a reasonable prospect of recovery.[335] If the debt is subsequently

327. Yerkie v. Commissioner, 67 T.C. 388, 392–93 (1976); Hankins, v. United States, 403 F.Supp. 257, 259. *See infra* text accompanying notes 379-88 (detailing the computation of a net operating loss under I.R.C. § 172).

328. *See supra* text accompanying notes 207-32 (discussing the priority of federal tax liens over the claims of victims of crime for restitution).

329. I.R.C. § 165(a) (West 2017).

330. § 165(a); *see also* Treas. Reg. § 1.165–1(d)(1) (as amended in 1977).

331. I.R.C. § 165(e) (West 2017).

332. Cramer v. Comm'r, 55 T.C. 1125, 1133 (1971).

333. Treas. Reg. §§ 1.165–1(d)(2)(as amended in 1977), 1.165–8(a)(2) (as amended in 1964). Reasonable certainly maybe ascertained by the settlement, adjudication, or abandonment of a claim. §§ 1.165–1(d)(2)(i), 1.165–8(a)(2).

334. §§ 1.165–1(d)(2)(ii), 1.165–8(a)(2).

335. MCDANIEL, MCMAHON, SIMMONS & POLSKY, *supra* note 207, at 530.

not paid, a bad debt deduction may be allowed under I.R.C. section 166.[336]

Under I.R.C. section 165(c)(1) and (2), a loss deduction for an individual is limited to loss incurred in a business or any transaction entered into for profit.[337] I.R.C. section 165(c)(3) limits losses involving personal-use assets to losses arising from "fire, storm, shipwreck, or other casualty, or from theft."[338] The term "casualty" is defined as an accident, mishap, or sudden invasion by a hostile agency, excluding progressive deterioration of property through a steadily operating cause.[339] Analogous to fire, storm, or shipwreck, a casualty requires a complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected, and unusual nature.[340]

As originally enacted in 1913, the predecessor to I.R.C. section 165(c)(3) only referred only to a fire, storm, or shipwreck, but the provision was amended in 1916 to include loss from "other casualty, or from theft."[341] A theft is the unlawful taking of money or property of another, including, but not limited to, theft by swindle, false pretenses, larceny, embezzlement, and robbery.[342] The Fifth Circuit, in *Edwards v. Bromberg,*[343] found that "the word 'theft' is not like 'larceny,' a technical word of art with a narrowly defined meaning but is, on the contrary, a word of general and broad connotation, intended to cover 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."[344] The Fifth Circuit also stated that courts have well established that whether a theft occurs, "depends upon the law of the jurisdiction where it was sustained and that the exact nature of the crime, whether larceny or embezzlement, of obtaining money under false pretenses, swindling or other wrongful deprivations of the property of another, is of little importance so long as it amounts to theft."[345]

To claim a theft loss, the victim must establish that the loss of money or property resulted from theft under the law of the jurisdiction where the loss occurred.[346] In Revenue Ruling 72-112,[347] the Service addressed the

336. *Id. See* I.R.C. § 166 (West 2017) (allowing a deduction for any debt that becomes wholly or partially worthless during the tax year). Losses and bad debts are mutually exclusive. Spring City Foundry v. Commissioner, 292 U.S. 182 (1934).

337. I.R.C. § 165(c)(1), (2).

338. § 165(c)(3).

339. Rev. Rul. 63–232, 1963-2 C.B. 97.

340. Rev. Rul. 72–592, 1972-2 C.B. 101.

341. 2 BITTKER & LOKKEN, *supra* note 1, ¶ 34.3, at 34-15.

342. Treas. Reg. § 1.165–8(d) (as amended in 1964). Embezzlement constitutes a theft whether or not connected with the taxpayer's business or for-profit activity. Miller v. Commissioner, 19 T.C. 1046 (1953).

343. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956).

344. *Id.*

345. *Id.* at 110.

346. Monteleone v. Commissioner, 34 T.C. 688, 692 (1960). The alleged perpetrator of the theft

issue of whether ransom paid to the kidnappers of a child was deductible as a theft loss even though the laws of the state where the kidnapping occurred distinguished the crimes of extortion and theft.[348] The Service stated: "[c]onsidering the broad general meaning of theft, it must be presumed that Congress used the term 'theft' so as to cover any theft, or felonious taking of money or property by which a taxpayer sustains a loss, whether defined and punishable under the penal codes of the states as larceny, robbery, burglary, embezzlement, extortion, kidnapping for ransom, threats, or blackmail."[349] Thus, despite the fact that the ransom payments did not constitute "theft" under state law, the ransom paid was deductible as a theft loss because the taking of taxpayer's money was illegal under the laws of the state where the kidnapping occurred and the taking was done with criminal intent.[350]

Notice 2004-27 was issued to inform taxpayers that a loss deduction equal to the decline in market value of stock is not allowed even though the decline may have been caused by fraudulent accounting practices or illegal misconduct of corporate officers.[351] To claim a theft loss, the taxpayer must prove that a loss resulted from a taking of property that is illegal and done with criminal intent.[352] The taxpayer must also prove that a loss was sustained, and a loss is not sustained if the stock merely declines in value.[353] In cases involving stock purchased on the open market, courts have consistently disallowed a theft loss for the decline in value of stock in circumstances in which the decline was attributable to misrepresentations by corporate officers who were indicted for securities fraud or other criminal violations.[354] A loss deduction is allowed only in the tax year the loss is sustained as a result of the sale or exchange of the stock or the stock becoming completely worthless.[355]

No loss deduction is allowed for the mere mysterious disappearance of property absent evidence of a theft.[356] The taxpayer has the burden of presenting evidence establishing a reasonable inference that the loss was the result of a theft.[357] For example, in *Mary Frances Allen v.*

need not be convicted of the crime. Vietzke v. Commissioner, 37 T.C.504, 510 (1961).

347. Rev. Rul. 72–112, 1972-1 C.B. 60.

348. *Id.*

349. *Id.* at 61.

350. *Id.*

351. I.R.S. Notice 2004-27, 2004-1 C.B. 782. With the facts as presented, the purpose of the notice is to advise taxpayers that the loss deduction will be disallowed and penalties under Section 6662 of the Internal Revenue Code may be imposed. *Id.*

352. *Id.*

353. *Id.* The decline in value is viewed as a fluctuation in market value of the stock.

354. *Id.* *See infra* text accompanying notes 510-28 (discussing the tax treatment of theft losses from fraudulent investment schemes that are not Ponzi schemes).

355. *Id.*

356. Mary Frances Allen v. Commissioner, 16 T.C. 163, 166 (1951).

357. *Id.*

Commissioner,[358] the taxpayer's diamond brooch was lost while visiting the Metropolitan Museum of Art in New York.[359] The Tax Court held that the burden of proof was on the taxpayer to prove that the brooch was stolen. The taxpayer was denied a loss deduction because all she could prove was that the brooch disappeared and was never found or returned. Although a loss deduction is not allowed for the mere mysterious disappearance of property, a loss deduction is allowed for property accidently and irretrievably lost as the result of a casualty event.[360]

1. Loss from the Theft of Property

If property is the subject of a casualty or theft, the amount of the loss deduction is limited to the unrecovered basis of any property involved.[361] The formula for computing the amount of the casualty or theft loss is the lesser of the reduction in value of the property or the basis of the property.[362] With regard to a theft loss, the value of the property after the theft is considered zero.[363]

If an individual incurs a casualty or theft of property in a business or for-profit activity, the amount of the loss deduction is only subject to the basis limitation.[364] With regard to personal-use property, the amount of deductible casualty and theft loss is subject to the basis limitation and two additional limitations.[365] First, a loss deduction is allowed only to the extent the amount of the loss from each casualty or theft exceeds $100.[366] Second, the amount of the casualty or theft loss is limited to the sum of personal casualty gain, plus the amount of any excess personal casualty loss that exceeds ten percent of the taxpayer's adjusted gross income.[367]

358. *Id.* at 163.

359. *Id.* at 163–64.

360. White v. Commissioner, 48 T.C. 430, 438 (1967); Rev. Rul. 72–592, 19722 C.B. 101.

361. I.R.C. § 165(b) (West 2017); Treas. Reg. § 1.165–1(c)(1) (as amended in 1977).

362. *See* Treas. Reg. §§ 1.165–7(b)(1) (as amended in 1977), 1.165–8(c) (as amended in 1964). However, if property that is used in a business or transaction entered into for profit is totally destroyed, and the basis of the property is greater than the value immediately before the casualty or theft, the amount of the loss is the basis of the property. §§ 1.165–7(b)(1), 1.165–8(c). Two methods can be employed to determine the reduction in value of property: (1) the appraised value of the property immediately before and immediately after the event; or (2) the cost of repairs to the property. § 1.165–7(a)(2).

363. Treas. Reg. § 1.165–8(c) (as amended in 1964).

364. I.R.C. § 165(b). *See* Rev. Rul. 87–59, 1987-2 C.B. 59 (holding that a business loss deduction is allowed even though the casualty event lacked the requisite suddenness to qualify as a casualty).

365. I.R.C. § 165(c)(3), (h).

366. §165(h)(1) (West 2017); Treas. Reg. § 1.165–7(b)(4)(i) (as amended in 1977). The $100 limitation applies separately to each individual who sustains a loss if the damaged or destroyed property is owned by two or more individuals. § 1.165–7(b)(4)(iii).

367. I.R.C. § 165(h)(2)(B). The terms "personal casualty losses" and "personal casualty gains" are defined as losses and gains arising from the casualty or theft of personal-use property. § 165(h)(4). If the taxpayer's personal-use property is insured, a casualty or theft loss deduction is only allowed if the

Example: Taxpayer enjoys collecting art for personal enjoyment. Taxpayer's adjusted gross income is $100,000. During the tax year, a sculpture was stolen from Taxpayer's home. The sculpture was purchased for $20,000 and had a value of $25,000. The sculpture was uninsured and never recovered. During the same burglary, a painting was also stolen. The painting was purchased for $10,000 and had a value of $20,000, and Taxpayer received $15,000 in insurance proceeds. As a result of the burglary, Taxpayer experienced a personal casualty loss with regard to the sculpture of $19,900 (lesser of reduction in value of $25,000 ($25,000 minus zero) or $20,000 ($20,000 basis) minus the $100 floor) and a personal casualty gain of $5,000 ($15,000 insurance proceeds minus $10,000 basis). Thus, pursuant to I.R.C. section 165(h), Taxpayer's allowable personal casualty loss deduction is $9,900 ($5,000 to the extent of the personal casualty gain plus $4,900 ($14,900 minus $10,000 ($100,000 adjusted gross income x 10%)).

2. Tax Benefit Rule

As a taxpayer's tax liability is based on the facts occurring within the tax year, the good faith deduction of payments or losses that are recovered in a subsequent tax year results in the inclusion into income of the amount recovered under the Tax Benefit Rule.[368] Thus, if a victim of theft properly claims a loss deduction or a bad debt deduction and subsequently recovers all or a portion of the amount deducted, the taxpayer must include in income the amount recovered in the subsequent tax year.[369] The amount included is subject to I.R.C. section 111 that requires the earlier deduction produced a tax benefit for the taxpayer.[370]

In *Alice Phelan Sullivan Corp. v. United States*,[371] the taxpayer claimed a deduction for the value of parcels of real property donated to a charity in 1939 and 1940.[372] In 1957, the charity reconveyed the parcels to the taxpayer.[373] Pursuant to the Tax Benefit Rule, the taxpayer was required to include in gross income the amount of the deductions taken in

taxpayer files a timely insurance claim. § 165(h)(5)(E).

368. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 3.07[1], at 3-22–23 (Warren Gorham & Lamont 3d ed. 2002). The Supreme Court has held that "a fundamentally inconsistent event," and not just an actual recovery, is necessary for the application of the Tax Benefit Rule. Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 383 (1983).

369. Treas. Reg. §§ 1.165–1(d)(2)(iii) (as amended in 1977), 1.166–1(f) (as amended in 1986).

370. I.R.C. § 111(a) (West 2017).

371. Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (1967).

372. *Id.*

373. *Id.* at 400.

the prior tax years.[374] In 1939 and 1940, the taxpayer's tax rates were eighteen and twenty-four percent, respectively, with the result that the deductions produced a combined tax savings of $1,877.49.[375] The taxpayer's tax rate in 1957 was fifty-two percent with the result that the inclusion produced a tax cost of $4,527.60.[376] The taxpayer argued that the increase in tax liability for 1957 should be limited to the original tax benefit of $1,877.49.[377] The U.S. Court of Claims held:

> Since the taxpayer in this case did obtain full tax benefit from its earlier deductions, those deductions were properly classified as income upon recoupment and must be taxed as such. This can mean nothing less than the application of that rate which is in effect during the year in which the recovered item is recognized as a factor of income.[378]

3. Net Operating Loss

Congress enacted I.R.C. section 172 to ameliorate the effect of the annual accounting period that requires a taxpayer's taxable income to be computed on the basis of the taxpayer's tax year.[379] The primary purpose of this provision is to treat businesses with fluctuating income in the same manner as businesses with a steady flow of income by allowing a net operating loss to be carried back and then carried forward.[380] The result is a type of income averaging for the taxpayer experiencing business losses in some years and business profits in other years.[381] Generally, a net operating loss (NOL) can be carried back and deducted against taxable income in the two tax years prior to the loss year.[382] Then, the NOL is carried forward and deducted against taxable income for up to twenty tax years subsequent to the loss year.[383]

374. *Id.* at 402.

375. *Id.* at 400.

376. *Id.*

377. *Id.*

378. *Id.* at 403. *See supra* text accompanying notes 296-306 (discussing the Claim of Right Doctrine and I.R.C. Section 1341 that mitigates the difference in tax rate between the tax year of inclusion and the tax year of deduction).

379. I.R.C. § 441(a); BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 19.02[1], at 19-6.
I.R.C. § 441(a) (West 2017); BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS, ¶ 19.02[1] (Warren Gorham & Lamont 3d ed. 2002).

380. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 19.02[1], at 19-6.

381. *Id.*

382. I.R.C. § 172(b)(1)(A) (West 2017).

383. § 172(b)(1)(A). The entire net operating loss deduction must be carried first to the earliest permissible year, and the remaining net operating loss deduction is then carried forward to each year in a chronological order until the net operating loss is fully absorbed. § 172(b)(2). If a taxpayer carries a net operating loss deduction to an earlier year, the deduction will require a recomputation of the tax liability for the earlier year, resulting in a refund or credit of any excess tax paid. Treas. Reg. § 1.172–1(d) (as amended in 1986).

In order to take advantage of I.R.C. section 172, an individual must be engaged in a business and the expenses incurred must relate to that business.[384] Generally, the NOL is the excess of business deductions over the taxpayer's gross income, subject to the following modifications: (1) personal and dependency exemptions are disallowed; (2) nonbusiness deductions are allowed only to the extent of nonbusiness income; (3) capital losses in excess of capital gains are not deductible; and (4) no exclusion of gain from the sale or exchange of qualified small business stock under I.R.C. section 1202.[385]

Losses from casualties and thefts incurred by an individual in a transaction entered into for profit or with regard to personal-use property are treated as attributable to a business.[386] With regard to personal-use property, only losses allowable under I.R.C. section 165(c)(3), subject to the I.R.C. section 165(h) limitations, are treated as business losses in computing the NOL.[387] In the case of an individual, the portion of the NOL attributable to a casualty or theft loss can be carried back three tax years.[388] Thus, greater tax relief is provided non-business casualty and theft losses by the extension of the carryback period, thereby, increasing the number of tax years over which the NOL can be absorbed.

B. Gain from the Theft of Property

Counterintuitively, a casualty or theft may result in taxable gain if the property involved is adequately insured.[389] Unless otherwise provided, gain or loss realized on the disposition of property is recognized for tax purposes.[390] I.R.C. section 1033 provides for the nonrecognition of gain realized on the involuntary conversion of property.[391] The purpose of the section is to relieve a taxpayer from unanticipated tax liability arising from

384. For purposes of the net operating loss deduction, employment constitutes a business. Lagreide v. Commissioner, 23 T.C. 508, 513 (1954).

385. I.R.C. § 172(c)–(d); *see also* Treas. Reg. § 1.172–3(a) (as amended in 1986); I.R.C. § 1202 (West 2017) (allowing an exclusion from income for fifty percent of the gain on the sale of qualified small business stock held for more than five years).

386. § 172(d)(4)(C); Treas. Reg. § 1.172–3(a)(3)(iii).

387. I.R.C. § 172(d)(4)(C); Treas. Reg. § 1.172–3(a)(3)(iii). *See supra* text accompanying notes 338–60 (discussing the meaning of the phrase "arise from fire, storm, shipwreck, and other casualty, or from theft" for the purposes of I.R.C. 165(c)(3)). *See supra* text accompanying notes 365-67 (detailing the limitations applicable to personal casualty loss deductions under I.R.C. section 165(h)).

388. I.R.C. § 172(b)(1)(E)(i), (ii)(I).

389. Gain is amount by which the proceeds on the disposition of the property exceed the cost of the property. I.R.C. §§ 61(a)(3), 1001(a) (West 2017). Loss is the amount by which the cost of the property exceeds the proceeds on the disposition of the property. § 1001(a). A loss represents the unrecovered cost of the property. § 1001(a). The "cost" of property is the basis of the property with adjustments. I.R.C. §§ 1011(a), 1016 (West 2017).

390. § 1001(c).

391. I.R.C. § 1033(a) (West 2017). Section 1033 does not apply to losses. Treas. Reg. § 1.1033(a)–1(a) (as amended in 1981).

the involuntary conversion of property to the extent the taxpayer reinvests the proceeds within the period required by statute without changing the nature of the investment.[392]

At the election of the taxpayer, gain realized on an involuntary conversion of property is not recognized if the money received by the taxpayer is reinvested in property similar or related in service or use to the converted property.[393] However, gain is recognized to the extent the money received on the conversion exceeds the cost of the replacement property.[394] I.R.C. section 1033 may be elected whether the converted property is used in a business, held for the production of income, or personal-use property.[395] Generally, the replacement period begins on the date of the conversion and ends two years after the close of the first tax year in which any part of the gain is realized.[396] The basis of the replacement property is the amount paid for the property reduced by any unrecognized gain.[397]

Example: Taxpayer's classic automobile was stolen. The automobile had a cost of $100,000. Within six months of the theft, Taxpayer received insurance proceeds of $150,000. Taxpayer immediately acquires a replacement classic automobile at a cost of $200,000. The replacement automobile qualifies as similar or related in service or use to the stolen automobile. As a result of the theft, Taxpayer realized $50,000 gain ($150,000 insurance proceeds minus $100,000 basis) but recognizes $0 gain because all of the insurance proceeds were reinvested. The basis of the replacement automobile is $150,000 ($200,000 cost of the replacement automobile minus $50,000 unrecognized gain). If Taxpayer acquired a replacement classic automobile at a cost of $125,000, Taxpayer realized $50,000 gain ($150,000 insurance proceeds minus $100,000 basis) and recognizes $25,000 gain ($150,000 insurance proceeds minus $125,000 cost of the replacement automobile). The basis of the replacement automobile is $100,000 ($125,000 cost of the replacement automobile minus $25,000 unrecognized gain).

392. Willamette Indus., Inc. v. Commissioner, 118 T.C. 126, 131 (2002).

393. I.R.C. § 1033(a)(2)(A). Section 1033 is mandatory if property is converted directly into property similar or related in service or use. § 1033(a)(1). Generally, the replacement property cannot be acquired from a related person if the gain realized on the involuntary conversion exceeds $100,000. § 1033(i).

394. 1033(a)(2)(A).

395. J. MARTIN BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME 966 (LexisNexis 10th ed. 2012).

396. I.R.C. § 1033(a)(2)(B); s*ee also* Treas. Reg. § 1.1033(a)–2(c)(2) (as amended in 1981) (providing detailed rules for the time and manner of making the election).

397. I.R.C. § 1033(b)(2); *see also* § 1223(1) (West 2017) (tacking the holding period of the converted property onto the holding period of the replacement property for purpose of characterizing gain or loss).

For I.R.C. section 1033 to apply, the compulsory or involuntary conversion of property must be the result of "destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof."[398] Within the meaning of I.R.C. section 1033, an involuntary conversion requires that the taxpayer's property is no longer useful or available to the taxpayer due to some outside force or agency.[399] The term "destruction" is equivalent to "casualty" in the sense of I.R.C. section 165(c)(3), only allowing a loss deduction with respect to personal-use property if the loss arises from "fire, storm, shipwreck, or other casualty or from theft."[400] In addition to casualty events, I.R.C. section 1033 specifically applies to the theft of property.[401] For the purposes of I.R.C. section 1033, the term "theft" is "a word of general and broad connotation intended to cover and covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile."[402]

To assure the continuation of investment, I.R.C. section 1033 requires that the converted property and replacement property be "similar or related in service or use."[403] Although the similar-or-related-in-service-or-use standard is not defined in the Internal Revenue Code or the Treasury Regulations, two tests have been established: (1) the functional test, and (2) the investor test.[404] The functional test looks at the functional similarities between the properties, requiring the physical characteristics and end uses of the converted and replacement properties to be closely similar.[405] The investor test focuses on the extent and type of the lessor's management activity, the amount and kind of services rendered by the lessor to the tenants, and the nature of the business risks associated with the

398. § 1033(a).

399. C.G. Willis, Inc. v. Commissioner, 41 T.C. 468, 476 (1964), *aff'd*, 342 F.2d 996 (3d Cir. 1965); *Willamette*, 118 T.C. at 132.

400. Rev. Rul. 59–102, 1959–1 C.B. 200, 201. *See supra* text accompanying notes 338-60 (discussing the meaning of the phrase "arise from fire, storm, shipwreck, and other casualty, or from theft" for the purposes of Section 165(c)(3)). For purposes of Section 1033, as long as the cause of the destruction falls within the general concept of a casualty, the taxpayer does not have to satisfy the requirement of "suddenness" that must be satisfied to qualify for a casualty loss deduction under Section 165(c)(3). Rev. Rul. 59–102, 1959–1 C.B. 200.

401. I.R.C. § 1033(a).

402. Hope v. Commissioner, 55 T.C. 1020, 1033–1034 (1961), *aff'd*, 471 F.2d 738 (3rd Cir. 1973) (citing Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1956)); s*ee also* Rev. Rul. 66–355, 1966–2 C.B. 302 (holding the unauthorized pledging of the taxpayer's stock as collateral for the personal loan by a financial manager constituted a theft for the purposes of I.R.C. Section 1033).

403. I.R.C. § 1033(a)(1).

404. Liant Record, Inc. v. Commissioner, 303 F. 2d 326 (2d Cir. 1962); s*ee also* Rev. Rul. 64–237, 1964–2 C.B. 319. A taxpayer replacing rental property with property owned and occupied by the taxpayer does not satisfy the similar-or-related-in-service-or-use standard. Rev. Rul. 79–261, 1979–2 C.B. 295, 296.

405. Rev. Rul. 76–319, 1976–2 C.B. 242.

properties.[406] For example, a taxpayer, who owns and operates a light manufacturing plant on the converted property and then owns and operates a wholesale grocery warehouse on the replacement property, does not satisfy the functional test.[407] However, a taxpayer who owns and leases a light manufacturing plant on the converted property and then owns and leases a wholesale grocery warehouse on the replacement property, satisfies the investor test.[408]

C. CHARACTERIZATION OF THEFT GAIN AND LOSS

The characterization of theft gain and loss is complex but essential to the victims of crime. If a theft gain is characterized as ordinary gain, the gain is taxed at ordinary tax rates that range from 10 percent to 39.6 percent.[409] However, if a theft gain is characterized as capital gain, the gain is taxed at preferential rates of 15 percent or 20 percent.[410] With regard to a theft loss, ordinary loss is deductible against ordinary income,[411] while a capital loss may be restricted as to the tax year of deductibility.[412]

Although the statutory treatment of capital gains varied over the decades, the current preferential treatment for individual taxpayers is found in I.R.C. section 1(h), which provides an alternative tax formula in determining tax liability.[413] Depending on the type of asset that generated the gain, generally, long term capital gain is subject to three maximum rates of tax:[414] (1) 28 percent for collectible gain[415] and section 1202 gain;[416] (2) 25 percent for unrecaptured section 1250 gain;[417] and (3) 15

406. *Liant Record*, 303 F.2d at 329; *see also* Rev. Rul. 64–237, 1964–2 C.B. 319.

407. Rev. Rul. 64–237, 1964–2 C.B. 319.

408. *Id.*

409. I.R.C. § 1 (a)-(d), (i) (West 2017).

410. § 1(h). Currently, preferential tax treatment for capital gains is not available to corporate taxpayers. I.R.C. §§ 11, 1201(a) (West 2012).

411. I.R.C. §§ 62, 63 (West 2017).

412. I.R.C. §§ 1211, 1212 (West 2017).

413. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 31.01, at 31-3. For I.R.C. § 1(h) to apply, the taxpayer's activities for the tax year must generate net capital gain. I.R.C. § 1(h) (West 2017). The term "net capital gain" means the excess of net long term capital gain (long term capital gains minus long term capital losses) minus net short term capital loss (short term capital losses minus short term capital gains). I.R.C § 1222(11) (West 2017). Capital gains and losses are long term if the asset was held for more than one year and short term if the asset was held for not more than one year. § 1222(1)–(4) (West 2017). To determine the holding period of property, the day of acquisition is excluded and the day of disposition is included. Rev. Rul. 66–7, 1966–1 C.B. 188; *see also* I.R.C. § 1223(1) (West 2017) (tacking the holding period of the converted property onto the holding period of the property acquired for the purpose of characterizing gain or loss).

414. I.R.C. § 1(h).

415. I.R.C. §§ 1(h)(1)(F)(4)-(5), 408(m)(2) (West 2017). A "collectible" is defined to include any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or any other property specified by the Secretary of the Treasury. § 408(m)(2).

416. I.R.C. § 1(h)(1)(F)(4), (7). The term "section 1202 gain" means the gain on the sale of qualified small business stock in excess of the amount of gain excluded from gross income under

percent for adjusted net capital gain.[418] Adjusted net capital gain is residual long term capital gain plus qualified dividend income.[419] For the high-income taxpayers who are subject to the 39.6 percent tax rate, the tax rate on adjusted net capital gain increases to 20 percent.[420] Capital gains may also be subject to the 3.8 percent tax on net investment income under I.R.C. section 1411.[421]

Contrary to the preferential tax treatment for capital gains, capital loss is generally only deductible to the extent of capital gain.[422] For individual taxpayers, I.R.C. section 1211(b) limits the deduction of capital loss to the amount of capital gain with any capital loss in excess of capital gain deductible against ordinary income up to maximum of $3,000.[423] Any capital loss remaining is carried forward for into succeeding tax years, retaining its original character as either long term capital loss or short term capital loss.[424] The capital loss carryover is subject to the same limitations in the succeeding tax years until fully utilized.[425]

The general rule is that capital gain or loss is generated by the sale or exchange of a capital asset.[426] Unless character is statutorily provided, capital gain and loss only result from dispositions that qualify as a sale or exchange and property that qualifies as a capital asset.[427] In addition to the dispositions that are generally considered a sale or exchange, case law has

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Section 1202. § 1(h)(7).

417. § 1(h)(1)(E), (h)(6) (West 2017). The term "unrecaptured section 1250 gain" means the gain on the sale of depreciable real property attributable to depreciation deductions taken during the holding period of the property. § 1(h)(6)(A)(i).

418. § 1(h)(1)(D), (h)(3). To the extent adjusted net capital gain would have been taxed at 10% or 15%, the preferential rate of tax is zero. § 1(h)(1)(B).

419. § 1(h)(3). The term "adjusted net capital gain" means the long-term capital gain other than collectible gain, Section 1202 gain, and unrecaptured Section 1250 gain, plus qualified dividend income. § 1(h)(3). Generally, qualified dividends are dividends distributed by U.S. corporations and certain foreign corporations. § 1(h)(11)(B).

420. § 1(h)(1), (C), (D) (West 2017). The 39.6% bracket applies to individuals with taxable income above the following amounts: $450,000 for married taxpayers filing joint returns; $425,000 for heads of households; $400,000 for single taxpayers; and $225,000 for married taxpayers filing separately. § 1(i)(3). The threshold amounts are adjusted for inflation. § 1(i)(3)(C).

421. I.R.C. § 1411(a)(1), (c)(1) (West 2017). The net investment income tax is 3.8 percent of the lesser of: (1) net investment income, or (2) modified adjusted gross income, over the threshold amount. § 1411(a)(1). Net investment income includes interest, dividends, royalties, and rents if not derived in the ordinary course of business and net gain attributable to the disposition of property if the property is not held in the ordinary course of business. § 1411(c).

422. I.R.C. §§ 165(f), 1211, 1212 (West 2017).

423. I.R.C. §§ 165(f), 1211(b).

424. I.R.C. §§ 165(f), 1212(b).

425. I.R.C. §§ 165(f), 1211(b), 1212(b). The unused capital loss carryovers expire with the death of the taxpayer who sustained the losses. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 31.02[4], at 31-18. For corporation taxpayers, I.R.C. section 1211(a) limits the deduction of capital losses to the amount of capital gains, with any unused capital losses carried back for three years and then carried forward for five years as short term capital loss. I.R.C. §§ 165(f), 1211(a), 1212(a).

426. I.R.C. § 1222(1)–(4) (West 2017).

427. § 1222(1)–(4).

determined whether other types of dispositions also satisfy the sale or exchange requirement.[428] In *Helvering v. William Flaccus Oak Leather Co.*,[429] the Supreme Court held that the receipt of insurance proceeds as compensation for the destruction by fire of a business plant did not constitute a sale or exchange of property.[430] Presumably, this result would "also encompass losses from tortious or criminal conduct (e.g., negligence, theft, or embezzlement)."[431] Nevertheless, the sale or exchange requirement is often provided by statute.[432] For example, a loss resulting from the worthlessness of stock or securities is deemed a loss from the sale or exchange of a capital asset.[433]

I.R.C. section 1221 defines a "capital asset" as property held by the taxpayer whether or not connected with the taxpayer's business.[434] However, the definition of a capital asset contains eight broadly interpreted exceptions, including:[435] (1) inventory and property held primarily for sale to customers in the ordinary course of business; (2) depreciable property and real property used in business; and (3) copyright, literary, musical, or artistic composition, a letter, memorandum or similar property created by the taxpayer.[436] If property is held by the taxpayer as inventory[437] or primarily for sale to customers in the ordinary course of the taxpayer's business,[438] the disposition of the property always produces ordinary income and ordinary loss.[439] Self-created works of the taxpayer, such as a copyright, a literary, musical, or artistic composition, or a letter or

428. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 32.01[1], at 32–3.

429. Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 248–49 (1941).

430. *Id.* at 248–49, 251.

431. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 32.01[2], at 32–5.

432. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 32.01[1], at 32–4.

433. I.R.C. § 165(g)(1) (West 2017). The term "security" means: (1) stock of a corporation; (2) a right to subscribe for, or to receive, corporate stock; and (3) a bond, debenture, note, or certificate, or other evidence of indebtedness issued by a corporation or by a government, with interest coupons or in registered form.0 § 165(g)(2).

434. I.R.C. § 1221(a) (West 2017).

435. § 1221(a). Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960).

436. I.R.C. § 1221(a)(1)–(3). The exceptions also include: (1) accounts or notes received for the sale of inventory and performance of services; (2) publications of the U.S. government acquired other than by purchase; (3) commodities derivative financial instruments held by a dealer; (4) clearly identified hedging transactions; and (5) supplies regularly consumed in the ordinary course of business. § 1221(a)(4)–(8).

437. §§ 1221(a)(1), 1221(b)(1)(A). Inventory accounting must be used whenever "production, purchase, or sale of merchandise is an income-producing factor." Treas. Reg. § 1.471–1 (1960).

438. I.R.C. §§ 1221(a)(1), 1231(b)(1)(B). In determining whether the taxpayer holds the property primarily for sale to customers in the ordinary course of business, the factors weighed by the court include: the frequency and substantiality of the sales; extent of development activities and improvements; and solicitation and advertising efforts. Suburban Realty Co. v. United States, 615 F.2d. 171, 176 (5th Cir. 1980). With regard to property held for multiple purposes, the Supreme Court defined "primarily" to mean "principally" or "of first importance." Malat v. Riddell, 383 U.S. 569, 572 (1966).

439. I.R.C. §§ 1221 (a)(1), 1231(b)(1)(A), (B) (West 2017).

memorandum, also produce ordinary gain and loss.[440]

With regard to depreciable business property and real property used in the taxpayer's business excluded from the definition of capital asset,[441] I.R.C. section 1231 will determine the character of gain and loss if the property is sold or exchanged and held for more than one year.[442] Additionally, I.R.C. section 1231 will determine the character of gains and losses from the compulsory or involuntary conversion of property used in the taxpayer's business and nonpersonal-use capital assets held for more than one year.[443] Generally, if the taxpayer's aggregate gains exceed aggregate losses, the gains and losses are characterized as long term capital gains and losses.[444] However, if the aggregate gains do not exceed the aggregate losses, the gains and losses are ordinary.[445]

I.R.C. section 1231 affords special treatment to gain and loss arising from fire, storm, shipwreck, or other casualty or from theft of property used in the taxpayer's business and nonpersonal-use capital assets held for more than one year.[446] If the aggregate losses exceed the aggregate gains from such events, the losses and gains are ordinary.[447] However, if the aggregate losses do not exceed the aggregate gains, the character of the casualty and theft gains and losses is determined along with the other gains and losses characterized under I.R.C. section 1231.[448]

Example: Construction equipment used in Taxpayer's business was stolen and not recovered. The equipment was insured. Taxpayer incurred a $50,000 loss from the theft of a bulldozer and a $25,000 gain from the theft of an excavator. In an unrelated transaction, Taxpayer

440. §§ 1221(a)(3)(A), 1231(b)(1)(C). Property received with a transferred basis from the creator also falls within the exception, for example, property received by gift. I.R.C. §§ 1221(a)(3)(C), 1015(a) (West 2017). At the election of the taxpayer, the sale or exchange of musical compositions or copyrights in musical works will not be treated as a noncapital asset. I.R.C. § 1221(b)(3).

441. I.R.C. § 1221(a)(2).

442. I.R.C. § 1231(a)(1)–(3). Depreciable property or real property used in the taxpayer's business held for more than one year is termed "property used in the trade or business." § 1231(b)(1). "Property used in the trade or business" does not include: (1) inventory; (2) property held primarily for sale to customers in the ordinary course of business; (3) copyright, literary, musical, or artistic composition, a letter, memorandum or similar property created by the taxpayer; and (4) publications of the U.S. government acquired other than by purchase. § 1231(b)(1)(A)–(D).

443. § 1231(a)(3), (4)(C). *See supra* text accompanying notes 398-402 (defining the types of events that constitute a compulsory or involuntary conversion as the result of destruction, theft, or seizure, or an exercise of the power of requisition or condemnation or threat or imminence thereof).

444. I.R.C. § 1231(a)(1); *see also* § 1231(c) (providing recapture rules to prevent the manipulation of the netting rules in order to maximize capital gains and ordinary losses).

445. § 1231(a)(2).

446. § 1231(a)(4)(C). *See supra* text accompanying notes 338-60 (discussing the meaning of the phrase "arise from fire, storm, shipwreck, and other casualty, or from theft" for the purposes of I.R.C. 165(c)(3)).

447. I.R.C. § 1231(a)(4)(C).

448. § 1231(a)(3), (4)(C).

> experienced a $100,000 gain from the sale of a warehouse. All of the property was depreciable property or real property used in Taxpayer's business and all were held for more than one year. Since the theft loss of $50,000 exceeds the theft gain of $25,000, the loss and gain are ordinary. The $100,000 gain from the sale of the warehouse is long term capital gain. However, if the gain from the theft of the excavator was $75,000, the casualty gain exceeds the casualty loss of $50,000, and, therefore, the gain and loss are weighted with the gain of $100,000 from the sale of the warehouse. As the aggregate gain of $175,000 ($75,000 excavator plus $100,000 warehouse) exceeds the $50,000 loss (bulldozer), the gains are long term capital gain and the loss is a long term capital loss.

With regard to personal-use property, I.R.C. section 165 allows an individual a loss deduction only if the loss arises from fire, storm, shipwreck, or other casualty or from theft.[449] Pursuant to I.R.C. section 165(h), however, the amount of the personal casualty losses are allowed only to the extent that: (1) the personal casualty losses exceed $100 per event, and (2) if the aggregate personal casualty losses exceed the aggregate personal casualty gains, the net personal casualty loss exceeds ten percent of the taxpayer's adjusted gross income.[450] In addition to limiting the amount of deductible personal casualty losses, I.R.C. section 165(h) also determines the character of personal casualty gain and personal casualty loss.[451] If the aggregate personal casualty loss exceeds the aggregate personal casualty gain, the losses and gains are ordinary. [452] If the aggregate personal casualty gain exceeds the aggregate personal casualty loss, all of the personal casualty losses are deductible and the gains and losses are deemed to be gains and losses from the sale or exchange of capital assets.[453]

I R.C. section 166 provides for a deduction for partially or wholly worthless bad debts.[454] The section applies to all bona fide debts whether the origin of the obligation is the taxpayer's business or a for-profit or personal transaction.[455] A bona fide debt is an obligation arising "from a

449. I.R.C. § 165(c)(3) (West 2017). *See supra* text accompanying notes 338-60 (discussing the meaning of the phrase "arise from fire, storm, shipwreck, and other casualty, or from theft" for the purposes of I.R.C. 165(c)(3)).

450. I.R.C. § 165(h)(2)(A).

451. § 165(h)(2).

452. *See* Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 250–251 (1941) (holding that a casualty event is not a sale or exchange of property).

453. I.R.C. § 165(h)(2)(B). *See supra* text accompanying notes 364-67 (providing an example of the application of I.R.C. section 165(h)).

454. I.R.C. § 166(a) (West 2017). The amount of the bad debt deduction is limited to the basis of the obligation. § 166(b).

455. BITTKER, MCMAHON & ZELENAK, *supra* note 6, ¶ 17.01, at 17-2.

debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.[456] The worthlessness of a debt is determined considering all pertinent evidence, including the value of any collateral, if any, and the financial condition of the creditor.[457] As to the tax treatment of a bad debt deduction, a business bad debt is an ordinary deduction, while a nonbusiness bad debt is short term capital loss.[458]

In Revenue Ruling 77-383,[459] the taxpayer had a personal savings account at a bank.[460] An employee of the bank embezzled large sums of money from the bank, resulting in the bank becoming insolvent.[461] The Service found that the bank's money, not the taxpayer's money, was embezzled and that the taxpayer's loss only arose as an indirect result of the embezzlement.[462] The debtor-creditor relationship existed between the taxpayer and the bank and not the taxpayer and the bank's employee.[463] The Service held that the loss sustained by the taxpayer was a nonbusiness bad debt under I.R.C. section 166 and not a theft loss deductible under to I.R.C. section 165.[464] Thus, the deduction was a short term capital loss and not an ordinary loss deduction.[465]

D. Treatment of Theft Loss and Gain in the Computation of Taxable Income

In computing taxable income, a theft gain or loss may be treated very differently for tax purposes depending on the circumstances that generated the gain or loss. Income included in the victim's income pursuant to the Tax Benefit Rule is ordinary income taxed at regular tax rates.[466] A gain from theft of property is included in the victim's income unless excluded

456. Treas. Reg. § 1.166–1(c) (as amended in 1986). Proof of bona fide debt requires an affirmative showing of the existence, at the time of the transaction, of a real expectation of repayment and intent to enforce the collection of the indebtedness. Van Anda's Estate v. Commissioner, 12 T.C. 1158, 1162 (1949), *aff'd per curiam*, 192 F.2d 391 (2d Cir. 1951).

457. Treas. Reg. § 1.166–2(a) (as amended in 1993). Nevertheless, if the surrounding circumstances indicate that a debt is worthless and uncollectible, legal action to enforce payment is not necessary. § 1.166–2(b).

458. I.R.C. § 166(a), (d)(1); Treas. Reg. § 1.166–5(as amended in 1980). The term "nonbusiness debt" is defined as a debt other than: (1) a debt created or acquired in connection with the business of the taxpayer; and (2) a debt the loss from the worthlessness of which is incurred in the taxpayer's business. I.R.C. § 166(d)(2); Treas. Reg. § 1.166–5(b).

459. Rev. Rul. 77–383, 1977–2 C.B. 66.

460. *Id.*

461. *Id.*

462. *Id.* at 67.

463. *Id.*

464. *Id.*

465. I.R.C. § 166(d) (West 2017).

466. *See supra* text accompanying notes 368-78 (discussing the inclusion and exclusion of income pursuant to the Tax Benefit Rule). *See* Arrowsmith v. Commissioner, 344 U.S. 6, 8 (1952) (allowing an examination of a prior tax year for the purpose of characterization).

pursuant to the nonrecognition provision I.R.C. section 1033.[467] Ordinarily, theft gain or loss generates ordinary income or an ordinary deduction because a theft does not satisfy the sale or exchange requirement for capital treatment; however, the sale or exchange requirement may be satisfied statutorily.[468] Includable theft gain may be characterized as long-term capital gain taxable at preferential tax rates, and a theft loss may be characterized as capital loss subject to the limitations provided in I.R.C. sections 1211 and 1212.[469] Non-business bad debts are treated as short term capital loss and subject to such limitations applicable to capital losses.[470]

For an individual, I.R.C. section 62 identifies which allowable deductions are deductible from gross income in computing adjusted gross income. A theft loss and bad debt deduction incurred in the victim's business are taken into account in computing the victim's adjusted gross income.[471] Also deductible from gross income in computing adjusted gross income are theft losses characterized as capital losses and deductions attributable to rents.[472] Further, personal casualty losses to the extent of personal casualty gains are deductible from gross income in computing adjusted gross income.[473]

A theft loss generated by a for-profit activity and net personal casualty loss are itemized deductions that reduce adjusted gross income in the computation of taxable income.[474] Fortunately, theft loss produced by a for-profit activity and net personal casualty loss are not miscellaneous itemized deductions, subject to the two percent of adjusted gross income floor.[475] Further, casualty and theft losses incurred in for-profit activities and personal casualty losses are not subject to the overall limitation on itemized deductions.[476] If a taxpayer elects the standard deduction instead

467. *See supra* text accompanying notes 389-408 (explaining the application of I.R.C. section 1033, allowing for the nonrecognition of realized gain as a result of the involuntary conversion of property).

468. *See supra* text accompanying notes 426-33 (discussing the characterization and treatment of gains and losses).

469. *See supra* text accompanying notes 409-25 (discussing the characterization and treatment of gains and losses).

470. I.R.C. § 166(d). *See supra* text accompanying notes 454-65 (discussing the characterization of bad debt deductions). *See supra* text accompanying notes 422-25 (discussing the characterization and treatment of gains and losses).

471. I.R.C. § 62(a)(1) (West 2017). With limited exceptions, the business cannot consist of the performance of services as an employee. *See* § 62(a) (listing twenty-two items deductible from gross income in computing adjusted gross income).

472. § 62(a)(3), (4).

473. I.R.C. § 165(h)(4)(A) (West 2017).

474. I.R.C. § 63(a), (d) (West 2017).

475. I.R.C. § 67(a), (b) (West 2017). Generally, miscellaneous itemized deductions are only allowed to the extent total miscellaneous itemized deductions exceed two percent of the embezzler's adjusted gross income for the tax year. §67(a).

476. I.R.C. § 68(a), (c) (West 2017). Generally, a taxpayer whose adjusted gross income exceeds a threshold amount must reduce the amount of allowable itemized deductions by the lesser of: (1) three

of itemizing deductions, a deduction for such theft losses incurred during the tax year cannot be claimed.[477]

E. FRAUDULENT INVESTMENT SCHEMES

From a tax perspective, the distinction between a loss from criminal fraud or embezzlement and an unsuccessful investment is critical. Whether an investor can claim a theft loss for an investment in a fraudulent scheme are factual determinations that are difficult to make with certainly.[478]

If an investment loss is the result of fraud or embezzlement, the taxpayer typically has an ordinary loss that is deductible from ordinary income[479] and may produce a NOL.[480] The theft of personal-use property produces a loss deduction pursuant to I.R.C. section 165(c)(3), but subject to characterization and limitations provided in I.R.C. 165(h).[481] However, a fraud or embezzlement occurring in a transaction entered into for profit produces an ordinary loss deduction pursuant to I.R.C. section 165(c)(2), not subject to I.R.C. section 165(h).

If a loss is not the result of fraud or embezzlement, an investment loss is characterized as a capital loss that is deductible only to the extent of capital gain with any excess capital loss limited to $3,000 for the tax year.[482] The taxpayer may carry forward any capital loss remaining to succeeding tax years, subject to the same limitations.[483] As capital gain is less likely than ordinary income to be recurring income, a substantial capital loss may never be fully deducted in the investor's lifetime.[484] If a transaction is treated as creating a debtor-creditor relationship, a nonbusiness bad debt is treated as a short term capital loss.[485] If a

percent of the excess of adjusted gross income over the threshold amount; or (2) 80 percent of the otherwise allowable itemized deductions. § 68(a), (b).

477. I.R.C. § 63(a), (b).

478. Rev. Proc. 2009–20, 2009–14 I.R.B. 749 § 2.03.

479. *See supra* text accompanying notes 422-25 (discussing the characterization and treatment of gains and losses). *See supra* text accompanying notes 365-67 (detailing the limitations applicable to personal casualty loss deductions under I.R.C. Section 165(h)).

480. *See supra* text accompanying notes 379-88 (describing the availability and application of the NOL provisions).

481. I.R.C. § 165(a), (c) (West 2017).

482. *See supra* text accompanying notes 422-25 (discussing the characterization and treatment of gains and losses).

483. *See supra* text accompanying notes 422-25 (discussing the characterization and treatment of gains and losses)

484. Jeffrey P. Coleman & Jennifer Newsom, *Can an Investment Become a Theft for Tax Purposes*?, 84 FLA. B. J. 27, 27 (2010).

485. Rev. Rul. 77–383, 1977–2 C.B. 66, 67; *see also* Rev. Rul. 69–458, 1969-2 C.B. 33 (holding that losses sustained on purchases of undelivered stock from a securities corporation that subsequently becomes bankrupt are deductible short term capital losses under I.R.C. section 166(d)); *Cf.* Morris Plan Co. of St. Joseph v. Commissioner, 42 B.T.A. 1190 (1940); McKinley v. Commissioner, 34 T.C. 59 (1960) (allowing a theft loss deduction if the "loan" was in fact a fraudulent transaction because no real

transaction qualifies as both a deductible loss and a bad debt, the deduction is treated as a bad debt deduction under I.R.C. section 166.[486]

1. Ponzi Schemes

In 2009, the Service issued Revenue Ruling 2009-9[487] and Revenue Procedure 2009-20[488] to provide guidance as to the tax treatment of loss incurred in a certain type of fraudulent investment commonly known as a "Ponzi" scheme. Revenue Ruling 2009-9 involves a taxpayer who invested funds with an individual who held himself out to the public as an investment advisor and security broker.[489] Based on positive investment reports, the taxpayer invested additional funds and reinvested any reported income, receiving a distribution only once during an eight-year period.[490] Ultimately, the purported advisory and brokerage activity was discovered to be a fraudulent investment arrangement.[491] The reported investment activities and resulting income amounts were fictitious and any payments to investors were made from amounts that other investors invested in the Ponzi scheme.[492] The individual's actions constituted criminal fraud or embezzlement under the law of the jurisdiction in which the transactions occurred.[493]

In Revenue Ruling 2009-9, the Service provides guidance as to the proper tax treatment of losses resulting from Ponzi schemes:[494]

> A loss from criminal fraud or embezzlement is a theft loss under I.R.C. section 165 and not a capital loss;
>
> A theft loss is deductible under I.R.C. section 165(c)(2), not I.R.C. section 165(c)(3), as an itemized deduction that is not subject to the personal loss limits in I.R.C. section 165(h), or the limits on itemized deductions in I.R.C. sections 67 and 68;
>
> A theft loss is deductible in the year the loss is discovered, provided that the loss is not covered by a claim for reimbursement or recovery with respect to which there is a reasonable prospect of recovery;
>
> The amount of a theft loss is generally the amount invested in the arrangement, less amounts withdrawn, if any,

debt was created).

486. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 187 (1934).
487. Rev. Rul. 2009–9, 2009–14 I.R.B. 735.
488. Rev. Proc. 2009–20, 2009–14 I.R.B. 749.
489. Rev. Rul. 2009–9, 2009–14 I.R.B. 735.
490. *Id.*
491. *Id.*
492. *Id.*
493. *Id.*
494. Rev. Proc. 2009–20, 2009–14 I.R.B. 749 § 2.02.

> reduced by reimbursements or recoveries, and reduced by claims as to which there is a reasonable prospect of recovery. Where an amount is reported to the investor as income prior to discovery of the fraudulent arrangement and the investor includes that amount in gross income and reinvests this amount in the arrangement, the amount of the theft loss is increased by the reinvested amount; and
> A theft loss may create or increase a net operating loss under I.R.C. section 172.[495]

Revenue Procedure 2009-20 establishes an optional "safe harbor" treatment for taxpayers that experience losses in a "specified fraudulent arrangements," often referred to as Ponzi schemes.[496] If certain conditions are met, Revenue Procedure 2009-20 provides: (1) a uniform manner for determining the taxpayer's theft losses; (2) a method to avoid potentially difficult problems of proof in determining the extent previously reported income was fictitious or a return of capital; and (3) alleviation from compliance and administrative burdens.[497] Generally, the taxpayer may elect the safe harbor if the following requirements are satisfied: (1) specified fraudulent arrangement; (2) qualified loss; (3) qualified investor; and (4) discovery year.[498] If the taxpayer elects the safe harbor the taxpayer's losses from the investment are treated as theft losses pursuant to Revenue Ruling 2009-9.[499]

Specified Fraudulent Arrangement—The "lead figure" perpetrating the fraud receives cash or property from investors; claims to earn income for the investors; reports to the investors income amounts that are fictitious; makes payments, if any, of purported income to some investors from amounts other investors invest; and appropriates some or all of the investor's cash or property.[500]

Qualified Investor—A qualified investor is a U.S. person who qualifies to deduct the theft loss; had no prior knowledge of the fraudulent nature of the investment arrangement; and transferred cash or property to a

495. Rev. Rul. 2009–9, 2009–14 I.R.B. 735, 738. The holding also provides: (6) a theft loss in a transaction entered into for profit does not qualify for the computation of tax provided by I.R.C. Section 1341; and (7) a theft loss in a transaction entered into for profit does not qualify for the application of I.R.C. Sections 1311–1314 to adjust tax liability in years that are otherwise barred by the statute of limitations. Rev. Rul. 2009–9, 2009–14 I.R.B. 735, 738.

496. Rev. Proc. 2009–20, 2009–14 I.R.B. 749 § 1. Revenue Procedure 2009–20 applies to losses for which the discovery year is a tax year beginning after December 31, 2007. Rev. Proc. 2009–20, 2009–14 I.R.B. 749 § 7.

497. Rev. Proc. 2009–20, 2009–14 I.R.B. 749 § 2.04.

498. *Id.* § 4.

499. *Id.* § 2.02.

500. *Id.* § 4.03.

specified fraudulent arrangement.[501]

Qualified Loss—A qualified loss is a loss resulting from a specified fraudulent arrangement causing the loss, if either: (a) the lead figure is charged by indictment or information (not withdrawn or dismissed) under state law or federal law with the commission of fraud, embezzlement, or similar crime; or (b) the lead figure is the subject of a state or federal criminal complaint (not withdrawn or dismissed) on similar grounds and either (i) the complaint alleged an admission of the crime by the lead figure; or (ii) a receiver or trustee was appointed.[502] In 2011, Revenue Procedure 2009-20 was modified to allow for the death of the lead figure that may foreclose criminal theft charges.[503]

Discovery Year—A qualified investor's discovery year is the taxable year of the investor in which the indictment, information, or complaint is filled.[504]

Pursuant to Revenue Procedure 2009-20, the deductible amount is calculated as follows: (1) multiply the amount of the qualified investment by (a) 95 percent, for a qualified investor that does not pursue any potential third-party recovery; or (b) 75 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery; minus (2) the sum of any actual recovery and any potential insurance recovery.[505] The qualified investor may have income or an additional deduction in a subsequent tax year depending on the actual amount of the loss that is eventually recovered.[506] Excluded from the definition of a qualified investment are cash or property that the investor invests in a fund or other entity that invested in a specific fraudulent arrangement.[507]

A taxpayer who does not elect the safe harbor option is subject to all the generally applicable provisions governing the deductibility of losses under I.R.C. section 165.[508]

For example, a taxpayer seeking a theft loss deduction must establish that the loss was from theft and that the theft was discovered in the year the taxpayer claims the deduction. The taxpayer must also establish that no claim for reimbursement of any portion of the loss exists with respect to which there is a reasonable prospect of recovery in the taxable year in which the taxpayer claims the loss.[509]

501. *Id.* § 4.03. In addition, the specified fraudulent arrangement cannot be a tax shelter. *Id.* § 2.03. Equity owners in a pass-through entity can elect safe harbor treatment to claim losses allocable to them as owners of the pass-through entity. I.R.S. CCA 201445009 (2014).

502. Rev. Proc. 2009–20, 2009–14 I.R.B. 749 § 4.02.

503. Rev. Proc. 2011–58, 2011–50 I.R.B. 849.

504. Rev. Proc. 2009–20, 2009–14 I.R.B. 749 § 4.04.

505. *Id.* § 5.02.

506. *Id.*

507. *Id.* § 4.06(2)(c).

508. *Id.* § 8.01.

509. *Id.*

2. Other Types of Fraudulent Investment Schemes

Not all fraudulent investment schemes are Ponzi-type schemes to which certainty and guidance is provided by Revenue Ruling 2009-9 and Revenue Procedure 2009-20. As to other types of fraudulent investment schemes, the difficult question remains as to whether an allowable loss is a theft loss producing an ordinary deduction or an investment loss producing a capital loss.

With regard to investments in stocks, direct privity between the wrongdoer and the investor is required for characterization as a theft loss, which is often problematic because investors must establish that the wrongdoer intended to deprive them of their funds.[510] In *Paine v. Commissioner*,[511] the taxpayer was a stockbroker who purchased stocks on the open market.[512] The decline in value of the stock was the result of the corporate officers engaging in fraudulent and illegal acts that artificially inflated the value at which the stock was traded.[513] The taxpayer was denied a theft loss because he failed to prove that, under state law, the misrepresentations by the corporate officers were made with the specific intent to criminally appropriate funds from the taxpayer.[514] The Tax Court noted that the taxpayer had not purchased the stock from the persons who made the misrepresentations but on the open market.[515]

However, if the requirement of privity between the buyer and seller is satisfied, a theft loss deduction is allowed. In Revenue Ruling 1977-18,[516] the Service concluded that a theft loss occurred under circumstances in which shareholders voted to merge their corporation into another on the basis of fraudulent financial statements.[517] Soon after the exchange, the acquiring corporation filed for bankruptcy and the shareholders of the target experiences substantial losses.[518] It was proven that the responsible

510. Brian Elzweig & Valerie Chambers, *Modernizing the Theft Loss Deduction for Victims of Securities Frauds and Ponzi Schemes*, 30 no. 9 BANKING & FIN. SERVICES POL'Y REP. 1, 3 (2011). *See* Bellis v. Commissioner, 61 T.C. 354, 358 (1973) (denying a theft loss deduction because at the time of the stock purchase the sellers did not misrepresent the financial condition of the corporation although it subsequently went into bankruptcy). *See* Lombard Bros., Inc. v. United States, 893 F.2d 520, 523 (2d Cir. 1990) (denying a theft loss deduction because, although the margin calls were conceded to be a wrongful taking, intent to deprive the taxpayer of funds was not shown).

511. Paine v. Commissioner, 63 T.C. 736 (1975).

512. *Id.* at 737.

513. *Id.* at 740 n.4.

514. *Id.* at 742. The taxpayer also failed to prove his reliance on the corporate officer's misrepresentations and the amount of any theft loss. *Id.*

515. *Id.* *See also* Rev. Rul. 77–17, 1977–1 C.B. 44 (holding that the taxpayer was not allowed a theft loss for stock purchased on the open market).

516. Rev. Rul. 77–18, 1977–1 C.B. 46.

517. *Id.*

518. *Id.*

officials knowingly made false representations to the shareholders of the merged corporation with the intent to induce them to vote for the merger and the shareholders of the merged corporation relied upon the false financial statements at the time they voted to exchange their stock.[519] The exchange was theft by false pretenses under state law.[520]

The Service also allowed a theft loss, in Revenue Ruling 71-381,[521] for amounts loaned to a corporation based upon information contained in fraudulent financial statements of the corporation provided by the corporation's president. The president of the corporation was later convicted of violating state securities law by issuing false and misleading financial documents.[522] In this case, the corporate president, "knowingly, with intent to defraud, obtained money by means of false representations, and was found guilty under New Jersey Statutes of a misdemeanor."[523]

In *Viezke v. Commissioner*,[524] the Tax Court upheld the taxpayer's theft loss for funds invested in what was purported to be an insurance company but was in reality a stock swindle.[525] The perpetrators were criminally indicted on charges of violating state securities law by selling unregistered securities through an unregistered agent.[526] The Tax Court stated that the fact the perpetrators were convicted of a crime other than theft does not exclude from consideration the existence of a theft.[527] "We need not determine the exact nature of the crime under Indiana law. . . . The record convinces us that Patterson and Zak parted petitioner from his money by deceit and trick amounting to a criminal appropriation with felonious intent and that by so doing a theft occurred both within the meaning of Indiana law and of section 165(e)."[528]

IV. CONCLUSION

The taxation of thieves and their victims presents many complex and unique issues. Any discussion of the taxation of thieves begins with the decision by the Supreme Court that illegal income, along with legal income, is includable in income. Not surprisingly, criminals do not file tax returns or report illegal income thereby incurring tax penalties both civil and criminal. For victims of theft, the involuntary loss of money or property is, to a limited extent, accommodated by the tax laws. The

519. *Id.* at 47.
520. *Id.*
521. Rev. Rul. 71–381, 1971–2 C.B. 126.
522. *Id.*
523. *Id.* at 127.
524. Vietzke v. Commissioner, 37 T.C. 504 (1961).
525. *Id. at* 510.
526. *Id.* at 509.
527. *Id.* at 510.
528. *Id.* at 511.

manner of accommodation and the factual distinctions made are often complicated and inequitable. However, the greatest disservice to victims of theft is the priority given the claims of the government for unpaid taxes, penalties, and interest over the claims of victims for restitution. The claims of victims of theft, who are often coping with emotional and financial distress, should never be subordinate to the claims of the government for unpaid taxes.