SECURITIES FRAUD AND THE TAX LOSS DEDUCTION: THE RISE AND (PERHAPS) FALL OF THE STOCKBROKER EXCLUSION

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I. INTRODUCTION

Recent financial frauds, and in particular Ponzi schemes, have prompted new tax clarifications to the theft loss rules. A revenue ruling and complementary revenue procedure (both issued in 2009) make deducting thefts from such recognized schemes on federal individual tax returns easier. These new rules are in contrast with the recent court decisions where a theft loss was denied, in part because the plaintiff had given his money to a broker to buy stock, rather than to the executives actually committing the fraud. The case law has stated that there is a need for direct privity between the person who is being defrauded and the person committing the fraud for a theft loss to be allowable. The new rules are silent on whether using an intermediary as an agent will disqualify a taxpayer from taking a theft loss.

This article explores the genesis of the judicially created rule that direct privity is needed. The privity requirement essentially eliminates the possibility of a theft loss deduction for any brokered securities transaction. Because most securities transactions involve an intermediary, there is often no recovery for these victims. Use of an intermediary does not make one less defrauded than one who was to purchase a security directly from an issuer. This article then shows that the need for direct privity should be eliminated so that more victims of security fraud would be able to avail themselves of a theft loss deduction. This can be done by expanding the new rules that were created to aid victims of Ponzi schemes to all securities transactions, subject to restrictions that would keep enforceability from becoming a hardship to the Internal Revenue Service (IRS).

II. CURRENT THEFT LOSS RULES

A theft loss is generally any criminal appropriation of another's property by "swindling, false pretenses or any other form of guile."[1] Thefts from blackmail, embezzlement and other frauds, as well as from extortion, kidnapping for ransom, larceny, robbery and threats are generally treated similarly to casualty losses.[2] A theft loss is an illegal taking as defined under the law of the state or foreign country where it

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[1] Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1956).

[2] Internal Revenue Code (IRC) §§ 162 (property used in a trade or business), 212 (income producing property such as that used by employees and investments), 165(c)(3) (personal use property including casualty losses relating to hobbies (§183)). See also Reg. §1.165-8(d).

occurred that is done with criminal intent.[3] Lost property is not a theft, nor is seizure or confiscation of property by a foreign government.[4] Losses on deposits from insolvent financial institutions may be treated as a casualty loss, an ordinary loss or as a non-business bad debt. The amount of the loss that is actually deductible on the tax return is reduced by insurance and other reimbursements, if any. Other reimbursements may include reimbursements specifically designated to compensate for the theft loss received from government agencies, and the amount collectible from court awards for damages, less necessary expenses (including attorneys' fees). Help in the form of unrestricted gifts from relatives and friends are excluded from the theft loss calculation.[5] However, funds from an employer to mitigate the loss would normally reduce the amount of casualty loss, because employers may not make excludable gifts to employees.[6]

To deduct a theft loss, the taxpayer must have something that can actually be taken, for example money invested to purchase shares in a company. In contrast, the mere (sometimes false) promise that an asset exists does not normally qualify as a theft loss. An indirect effect of casualty and theft, such as reduction in the resale value of property, would not normally produce a deductible casualty loss.[7]

Theft losses are deductible in the year the theft is discovered when there is no reasonable prospect of recovery.[8] However, what constitutes a "reasonable prospect" is a judgment call. Filing a lawsuit is itself an *indication* that the taxpayer believes there is a reasonable prospect for recovery.[9] However, filing a lawsuit in itself is not conclusive, as in the case where a perpetrator had no assets from which to recover.[10] Where a claim for reimbursement does have a reasonable prospect of recovery, the loss is sustained in "the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received."[11] A recovery may come from a third party, such as an insurer. As such, the taxpayer must make reasonable effort to recover the stolen property including filing for insurance reimbursements where the property is covered by insurance.[12] Deciding when the prospect for recovery is no longer reasonable is also a judgment call, and erring on the conservative side, where a "reasonable prospect" becomes a "near certainty," may delay deductions. In some cases, such a delay could cause theft loss claims to be barred altogether under the statute of limitations.[13] Further, if the IRS

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[3] For United States thefts requiring state law application, I Rev. Rul. 72-112. For foreign thefts, *see* First Chicago Corp .v. *Comm'r,* T.C. Memo 1995-109, 1995 Tax Ct. Memo LEXIS 112.
[4] *See* W. J. Powers, 36 T.C. 1191 (1961).
[5] Rev. Rul. 64-329, 1964-2 C.B. 58.
[6] IRC § 102(c).
[7] *See* Pulvers v. Comm'r, 407 F.2d 838 (9th Cir. 1969).
[8] *See* Reg. §1.165-1(d)(2)(i). *See also* Geisler v. Comm'r, 55 T.C.M. (CCH) 1734 (1988). The burden of proof for "no reasonable prospect" falls on the taxpayer. Gale v. Comm'r, 41 T.C. 269, 276 (1963).
[9] Huey v. Comm'r, 50 T.C.M. (CCH) 430 (1985). However, ministerial acts such as filing a proof of claim in bankruptcy is not a strong indicator of recovery. Jensen v. Comm'r, 66 T.C.M. (CCH) 543 (1993)).
[10] Schneider v. Comm'r, 49 T.C.M. 1032 (1985).
[11] Treas. Reg. § 1.165-1(d)(3); *see also* Jeppsen v. Comm'r, 128 F.3d 1410 (10th Cir. 1997).
[12] IRC § 165.
[13] *See* Johnson v. United States, 80 Fed. Cl. 96 (2008). However, the prospect need only be reasonable, not certain.

feels that there is an unreasonable delay beyond the three-year statute of limitations, that delay can be grounds for denying a deduction.[14] Where a taxpayer can show a reasonable expectation of only partial recovery, the taxpayer may be able to take (only) the unrecoverable portion as a deductible loss.[15]

Ponzi scheme victims, however, can avail themselves of Revenue Ruling 2009-9. In this ruling, a theft loss is claimed in the year of discovery. To figure the amount of the theft loss, previous dividend and capital gain income declared and reinvested (rather than received by the taxpayer) increases the amount of the basis and theft loss in the current year. Thus, the taxpayer avoids having to reverse that phantom, unreceived income by amending previous years' tax returns where the statute of limitations is still open, and losing the tax on the phantom income altogether for earlier years where running of the statute of limitations bars refund.

Net theft losses are estimated, but estimated reimbursements may be incorrect and occasionally subsequent recoveries occur. Where a casualty loss is deducted in one year and an unexpected insurance or property recovery is made in a later year, the taxability of the subsequent recovery depends on the tax benefits received on those losses to-date. If the taxpayer used a larger expected reimbursement in figuring his casualty loss, the amount that the casualty loss is understated should be included as a loss with other losses in the year that the taxpayer can reasonably expect no further reimbursement.[16] Where a (subsequent) recovery is more than originally estimated, the excess recovery over the original estimate is included in income, but only to the extent that the original casualty loss deduction reduced the taxpayer's tax in the earlier year. The earlier year's tax return is unaffected. If the amount of reimbursements received is more than the taxpayer's adjusted basis in the stolen property, a gain will result. The gain is included as ordinary income up to the amount of the deduction taken for the property in earlier years, and generally as a capital gain thereafter.

A taxpayer might have multiple casualties in a tax year. When events are clearly separable, they are treated as separate casualties. When two or more taxpayers incur a loss from the same casualty, the casualty loss rules apply separately to the losses of each individual. Losses for two taxpayers filing jointly with each other are treated as one loss.[17] If the property is insured, the taxpayer must have filed a timely insurance claim for reimbursement; only the portion of the loss not covered by insurance is deductible.[18] Theft losses are not subject to itemized deduction phase-out rules.[19]

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[14] Woltman v. United States, 56 A.F.T.R.2d. (S.D. Ca. 1985). Alternatively, Woltman could have, but did not, file a formal disclaimer of any recovery in the year the theft was discovered and claimed the theft loss then. *See* Reg. §1.165-1(d)(2)(i).

[15] Bubb v. United States, 72 A.F.T.R.2d. (W.D. Pa. 1993). But see also Kaplan v. United States, 100 A.F.T.R.2d 5674 (M.D. Fla. 2007).

[16] If the $100 floor was applied to the casualty loss in a previous year, as would be the case of personal-use property for individuals, the corrected loss need not be reduced by the $100 ($500 in 2009) floor again. However, the revised loss is subject to the 10% limitation of the later year.

[17] If spouses file separately, however, each spouse is subject to a $100 ($500) floor for each casualty. Reg. § 1.165-7(b)(4)(iii).

[18] IRC § 165(h)(5)(E).

[19] IRC § 68.

A. Amount of the Loss

The amount of the casualty or theft loss is the lower of the decrease in fair market value (FMV) or the taxpayer's basis in the property. Fair market value is the price for which the property could be sold to a willing buyer when neither the buyer nor seller is compelled to transact the exchange and both know all the relevant facts. In the case of theft, the FMV after the property is stolen is zero. The cost of documenting a theft loss does not increase the amount of the theft loss, but is deductible as a miscellaneous itemized deduction subject to the 2% of adjusted gross income floor. Similarly, individuals' shares of legal and forensic accounting fees necessary to determine a taxpayer's tax liability are also subject to the 2% floor.[20] If reimbursements exceed losses, a taxpayer may actually have a casualty gain, but this is unusual in the case of investment fraud.[21]

Only the theft loss *net* of reimbursements and recoveries is deductible. Reimbursements include money plus the FMV of property received, less any expense incurred in obtaining reimbursement. If there is a subsequent recovery or reimbursement for property, the loss is refigured to be the lower of the adjusted basis or decrease in FMV from the time it was stolen until the time of recovery. If this revised loss is less than the original loss, the difference between the revised loss and original loss would be reported as income in the year of recovery to the extent that the loss was deducted in previous years.

B. Net Operating Losses

Where casualty or theft loss deductions for the year are more than income, a net operating loss (NOL) might result.[22] NOLs are normally carried back to lower taxes in earlier years, and then carried forward to reduce taxes in later years.[23] NOLs for casualty and theft losses are carried back three years, and any unused NOL is then carried forward for up to twenty years. However, eligible small businesses with average annual gross receipts of up to fifteen million dollars over a three-year period may elect to carry back an NOL for either three, four or five years beginning for tax years ending in 2008.[24] Recently, Revenue Ruling 2009-9 allows individual fraud victims not in a trade or business to use the eligible small business carryover provisions, provided that the taxpayer meets the fifteen million dollar rule; however, the ruling is unclear whether that is a gross income or adjusted gross income level.

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[20] IRC § 67.

[21] Where the taxpayer has a casualty gain, the taxpayer may be able to postpone reporting the gain. Note that no $100 ($500 for 2009) per incident floor applies to gains.

[22] IRC § 172(d)(4)(c).

[23] An election can be made to forego NOL carryback.

[24] IRC § 172(b)(1)(H).

C. *Safe Harbor for 2008 and Subsequent Tax Years*

Revenue Procedure 2009-20 provides optional safe harbor rules for qualified investors suffering a qualified loss, beginning for 2008. According to this procedure, a taxpayer who transferred funds to the "lead figure" who promoted a "specified fraudulent arrangement" that caused an investment loss may use special loss rules to deduct the loss in the year of discovery of the fraud. The specified fraudulent arrangement must be a fraudulent Ponzi scheme; other frauds are not specifically covered. However, no conviction is necessary to show fraud, provided the lead figure is indicted for fraud, embezzlement or a similar crime meeting the definition of a theft loss, or the lead figure is the subject of an ongoing state or federal criminal complaint and the complaint alleged an admission by the lead figure or the assets of the arrangement have been frozen or a receiver/trustee was appointed with respect to the assets of the fraudulent arrangement. The investor must have had no actual knowledge of the fraud but otherwise be allowed a theft loss under IRC §165 or Reg. §1.165-168 and the fraudulent tax shelter must not be a tax shelter.[25]

If the taxpayer elects to use the safe harbor rules instead of the normal rules, the taxpayer may deduct 95% of the investment loss in the case where the taxpayer agrees to pursue no recovery from a third party, or 75% of the loss if the taxpayer is intends to pursue recovery from a third party. A third party is anyone other than: 1) individuals who conducted the fraud; 2) investment vehicles or other entities that conducted the fraud (including its employees, officers or directors); 3) a liquidation, receivership, bankruptcy or similar estate established with respect to the individuals who committed the fraud; and 4) parties subject to claims brought by a trustee, receivership, bankruptcy or other estate described in number 3 above. The investment loss is net of any actual recovery from any party and any expected recovery from insurance companies of the Securities Investor Protection Corporation. Future recoveries in excess of the undeducted loss, if any, would be income in the year of recovery under the tax benefit rule.

The safe harbor only applies to Ponzi schemes where the lead figure: 1) receives cash or property from investors; 2) purports to earn income for the investors; 3) reports to investors income amounts that are at least partially fictitious; and 4) appropriates some or all of the investors' cash or property. The safe harbor rules do not apply to: 1) amounts borrowed by an investor from those responsible parties that have not been repaid; 2) fees paid to the responsible parties, to the extent those fees have been deducted on the taxpayers' tax returns; 3) amounts reported as income from the scheme that have not been declared as income on the taxpayers' tax return; and 4) cash or property invested in a fund or entity that in turn invested in the scheme.

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[25] The definition for tax shelters is found in IRC § 6662(d)(2)(c)(ii).

D. Capital Loss Contrasted with Theft Loss Tax Treatment

Corporations can only offset capital losses against capital gains; therefore, ordinary losses are preferred by corporations. Corporations can carry unused capital losses back three years and forward five years.[26] For individuals, capital losses first offset capital gains in the year a security is sold[27] or is totally worthless,[28] which if long-term, save taxes at the rate of 15%. The first $3,000 of excess capital losses over capital gains offset ordinary income,[29] with the rest being carried forward to future years. Because it can take a long time to recoup a large loss, this possibility may be the least attractive after considering the time value of money. However, casualty and theft losses (net of insurance reimbursement) are deductible at ordinary rates, and if the property is income producing property like investments, it is deductible without regard to the 10% of Adjusted Gross Income (AGI) and the $100 per incident floor ($500 beginning in 2009), provided the taxpayer itemizes deductions. If the theft loss is extensive, it may generate a net operating loss, which can be recouped against previous years. Consequently, for large losses, theft loss treatment is often financially more advantageous than capital loss treatment.

Even where a fraud is clear, it may not result in theft treatment. For example, in *Stolz*,[30] a taxpayer guaranteed a loan for a friend who misrepresented is ability to repay the loan. After repaying the loan resulting from state common law fraud, the taxpayer was allowed to deduct the loss, but as a non-business bad debt treated as a short-term capital loss,[31] not as a theft.

In *Michael Kaplan and Anita Kaplan, Plaintiffs v. United States of America, Defendant*,[32] a couple unknowingly invested in a Ponzi scheme and declared the non-existent income on the federal tax returns for eight years before learning that their investment adviser was defrauding them. The investment adviser took their principal and produced false statements until their investment adviser's bankruptcy filing.[33] The couple was allowed a capital loss for their initial investment and allowed to amend the returns to reduce the bogus income where the statute of limitations had not barred the loss, but they were not allowed a casualty loss for the taxes paid on bogus income for which the loss was otherwise barred.[34]

In some cases, a loss may be split between capital and theft losses. Chief Counsel Advice 200811016 [35] addresses a case where a company begins to engage in fraud after operating legitimately. Taxpayers who invested before the fraud was perpetrated apparently receive capital loss treatment, whereas those investing

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[26] IRC § 1212.
[27] A mere decline in fair market value does not qualify as a deductible capital loss. § 1.165-5(f).
[28] IRC § 165(g).
[29] IRC § 1211.
[30] Stoltz v. United States, 410 F. Supp. 2d 734 (S.D. Ind. 2006).
[31] IRC § 166.
[32] *Id.,* footnote 12.
[33] *Id.* at 736-39.
[34] *Id.* at 739, 745.
[35] CCA 200811016 (3/14/08).

afterward who also relied on fraudulent statements would have a theft loss. It is possible that continuous investors may have to bifurcate losses across both categories, causing an arbitrage of items across differing tax rates.[36]

E. Return of Capital

Additionally, one could argue that previously declared income from Ponzi schemes represent classification errors, and that they are not interest or dividend income as originally declared, rather they represent a return of capital. The problems with this argument are two-fold: first, for early investors, the statute of limitations may bar refunds for the early years and second, the courts are divided on the issue.

In *Premji,*[37] a taxpayer loaned money in a Ponzi scheme and received and cashed interest checks. Eventually however, the taxpayer lost principal in the scheme, and then wanted to reclassify interest as return of capital. The reclassification request was denied by the court. However, in *Taylor,*[38] a taxpayer who loaned money to a Ponzi scheme, received and cashed interest checks, but lost principal in the scheme, then wanted to reclassify interest as a return of capital. This reclassification was allowed as return of capital because the broker/promoter never made the promised investments.

In *Kooyers*[39] a taxpayer who loaned money in a Ponzi scheme, received and cashed interest checks, but lost principal in the scheme, then wanted to reclassify interest as a return of capital. Again, the reclassification was allowed as a return of capital because the promoter's intent was not to pay for the use of money but to conceal fraud. The court made a further distinction: early investors who had a viable chance of recovering their investment are treated differently than later investors with no viable chance of recovery. Later victims could reclassify previously declared income as return of capital; earlier victims could not. However, the statute of limitations problem with early investors is not addressed, making the safe harbor rules of Rev. Proc. 2009-20 more appealing to many of today's victims.

In *Greenberg,*[40] a taxpayer who loaned money to a Ponzi scheme, received and cashed interest checks, but lost principal in the scheme, then wanted to reclassify interest as a return of capital. The reclassification was allowed as a return of capital because the promoter's intent was not to pay for the use of money, but to conceal fraud.

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[36] For an excellent discussion of this arbitrage, *see* John C. Zimmerman, *Deducting losses for Defrauded Investors*, TAX ADVISER 442 (July 2009).

[37] Premji v. Comm'r, 72 T.C.M. 16 (1996), *aff'd*, 139 F. 3d 912 (10th Cir. 1998).

[38] Taylor v. United States, 81 A.F.T.R.2d 1683 (E.D. Tenn. 1998). *See also* Johnson v. United States, 80 Fed. Cl. 96, (2008).

[39] Kooyers v. Comm'r, T.C.M. (RIA) 2004-281 (2004).

[40] Greenberg v. Comm'r, T.C. Memo 1996-281, 1996 Tax Ct. Memo LEXIS 306, 71 T.C.M. 3191, T.C.M. ¶96281 (T.C. 1996).

III. INTENT: THE CRITICAL COMPONENT

Intent is critical to distinguishing whether a loss is a theft or a capital loss. A party must intentionally intend to permanently deprive another of their property or commit intentional misconduct or severe recklessness for theft to be indicated.[41]

How intent is viewed is well-illustrated in *Krahmer v. United States*.[42] In this case, the plaintiff purchased two paintings from an art dealer. Both of the paintings turned out to be falsely attributed to famous artists by the art dealer, and the plaintiff tried to establish that that should be allowed a theft loss deduction under IRC §165(c).[43] The United States Claims Court focused on whether there was intent to defraud to decide whether the plaintiff was eligible to claim the theft loss deduction. One painting had a counterfeit signature attributable to a famous artist named W.M. Chase. The other was unsigned but an affidavit accompanying the bill of sale stated that the art dealer "had examined the painting, that it was by Nicolas Poussin and that its appraised value was $75,000."[44] Both of the paintings turned out not to be genuine as to the artist that they were attributed and the plaintiff sold both for much less than he paid for them.

The court held differently for the two paintings: the theft loss deduction was disallowed for the unsigned painting because the dealer had not "schemed to defraud [the plaintiff] on the purchase"[45] of the unsigned painting. The dealer could "honestly err in his judgment as to the attribution of an unsigned work...[and the dealer's] written statement to plaintiff makes it clear that [he] was only rendering an opinion."[46] The court, however, did allow the theft deduction for the signed painting, stating that the "plaintiff suffered a loss at the hands of a forger, however distant in time and privity was the forger's act. Plaintiff need not know the identity of the forger. He need only prove that forgery was the cause of his loss."[47] However, the allowance of the theft loss deduction was overturned on appeal.[48] The United States Court of Appeals for the Federal Circuit stated that:

> [t]he lower court's holding that the mere existence of the forged signature on the painting was sufficient to prove a theft by false pretenses… The court cannot presume a theft occurred based solely on the on the presence of a forged signature on the painting. [The] taxpayer must still prove that the seller defrauded him by knowingly and intentionally misattributing the painting to the artist.[49]

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[41] *See* Ottmann v. Hanger Orthopedic Group,Inc., 353 F.3d 338 (4th Cir. Md. 2003).
[42] 9 Cl. Ct. 49 (1985).
[43] *Id,* at 51.
[44] *Id.*
[45] *Id,* at 57.
[46] *Id,* at 54.
[47] *Id,* at 53.
[48] Krahmer v. United States*,* 810 F.2d 1145 (Fed. Cir. 1987).
[49] *Id,* at 1147.

That is, the Federal Circuit essentially required privity between the perpetrator of the fraud and the taxpayer who claims the theft loss deduction. The idea that there has to be privity between the person who committed the theft and the person who was the victim of the theft arises out of state laws which require intent as an element of theft. Case law is divided into categories based on the interpretation of intent.

A. Buying Directly from the Market or Other Party: Deduction Depends on Seller's Intent

When buying directly from another party (including on the market), whether a theft loss is allowed after a fraud depends in part on the intent of the seller. In Revenue Ruling 77-17, a theft loss deduction was denied to a taxpayer who purchased a publicly traded corporate stock from a stockbroker. Although trading of the stock was subsequently suspended due to irregularities, the fraud perpetrators at the company did not specifically intend to defraud the taxpayer, nor did the company obtain possession to the taxpayer's property as was required under the definition of state law of the state with jurisdiction. Nor was it proven that the broker was fraudulent.

In *Paine*,[50] a theft loss deduction was disallowed where, relying on fraudulent statements issued by corporate officials to inflate the stock price, the taxpayer purchased stock through a public stock exchange. State law[51] required a direct purchase by the victim from the perpetrators to qualify as a theft. Having bought the stock on the open market from sellers who were unaware of the wrongdoing (rather than through the persons making the misrepresentations) disqualified Paine from theft loss treatment due to the lack of privity.

B. Intermediary Buys on an Open Market or from Seller Who Does Not Know of Fraud: No Fraud Deduction

If using an intermediary, tax deductibility for fraud loss depends on the intermediary's role. If the buyer uses an intermediary who is not a party to the fraud, no fraud deduction is allowed. This rule applies sometimes even when the intermediary appears to be connected to, but is a separate legal entity from, the perpetrator. In *Mehdi Taghadoss v. Commissioner,*[52] a WorldCom Group employee purchased stock and exercised options through WorldCom's 401(k) and employee stock purchase plan. The company filed for Chapter 11 bankruptcy reorganization on July 21, 2002, due in part to effects of fraudulent actions taken by the chief executive officer and several other top company officials. In October 2003, a plan of reorganization was approved but by March of 2004, Taghadoss' 31,083 shares of stock were worth only $677.61, which

[50] Paine v. Comm'r, 63 T.C. 736 (1975)), *aff'd*, 523 F.2d 1053 (5th Cir. 1975).
[51] *Paine* was a Texas case. A similar result was upheld in California. *See* Singerman v. Comm'r, T.C. Summary Opinion 2005-4 (2005).
[52] Taghadoss v. Comm'r, T.C. Summary Opinion 2008-44 (2008).

was far less than he had paid.[53] As part of WorldCom's emergence from bankruptcy in April 2004, Taghadoss' junior interests were cancelled without action on Taghadoss' part[54] at that time. Taghadoss claimed a theft loss on his 2003 Form 1040 for $1,344,863. Because the company's pension and stock purchase plans were independent entities from the company itself and because neither of these entities defrauded him, his only case for theft was to argue that the false assurances of financial solvency of WorldCom executives resulted in a fraud against him. However, Taghadoss did not produce evidence that he relied upon WorldCom executives' assurances, and again, no theft loss due to WorldCom's actions was allowed.

Similarly, in *Electric Picture Solutions, Inc.,*[55] the Tax Court held that a taxpayer purchasing from a broker independent of the fraud must show that the broker was involved in the fraud in order for a theft loss to be allowed.

C. Intermediary Works as a Feeder to Fraudster: May Be Deductible

However, where the intermediary works directly to funnel funds to a perpetrator, the intermediary may be seen as a promoter, and theft losses may be deductible by the taxpayer. In *Jensen,*[56] the taxpayer used a broker who was unaware of the fraud but acted as a promoter for the fraudsters. However, the taxpayer knew that the broker was acting as an intermediary for the investment, which turned out to be fraudulent. A theft loss was allowed, with the Tax Court noting that "[i]t is not uncommon for investors to deal only with their brokers and never have direct contact with their investments. In such cases, the brokers act as conduits for the investors' funds." However, this law is not well-settled. The victims of Bernie Madoff who were unaware that their intermediaries were funneling money to Madoff might not prevail if they cannot show that the intermediaries, acting on their own judgment, were unaware of and, therefore, arguably did not intend to defraud the investor. The ruling appears to hinge on whether the intermediary was a feeder to the perpetrator, knowingly or not. Further, in some circumstances the feeder may be the legal victim of the fraud, especially where the intermediary is a fund or entity in its own right. Presumably, this would give the victims the right to then recover their losses through their intermediary, not the fund itself.

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[53] Because Taghadoss' holdings were not totally worthless in 2003, no worthless securities loss was allowed for that tax year. *See* § 165(g)(1) and §§165(b) and (c).

[54] The court found that this cancellation constituted abandonment of his securities. Had this happened after March 12, 2008, Revenue Regulation (§ 1.165-5 (i)(1)) would have applied allowing that worthless securities abandoned by the holder are eligible for worthless securities treatment. "A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor;" certainty of recovery is not required. Ramsay Scarlett & Co. Inc. v. Comm'r, 61 TC 795, 811 (1974)), *aff'd*, 521 F.2d 786 (4th Cir. 1975).

[55] Electric Picture Solutions, Inc. T.C. Memo 2008-212, 2008 Tax Ct. Memo LEXIS 208, 96 T.C.M. 146 (T.C. 2008). *See also* De Fusco v. Commissioner, T.C. Memo 1979-230, (T.C. 1979). This case is sometimes wrongly cited as *Electronic Picture Solutions Inc.*

[56] Jensen v. Comm'r, T.C. Memo 1993-393, (T.C. 1993), *aff'd,* 72 F.3d 135 (9th Cir. 1995).

D. *Intermediary Is an Investment Fund: Fund Gets Fraud Deduction, Taxpayer's Gain/Loss Is Capital*

Revenue Procedure 2009-20 states that a qualified investor "does not include a person that invested solely in a fund or other entity… that invested in the specified fraudulent arrangement." In *Willey,*[57] a taxpayer loaned money to three corporations. The corporations in turn invested in that money in fraudulent trust funds. The corporations were allowed the theft loss; the taxpayer was denied a theft loss, but not a capital loss.

IV. INTENT TO DEFRAUD AND THE REQUIREMENT OF PRIVITY IN SECURITIES FRAUD

There is an inherent unfairness of tax results when using an intermediary to purchase an asset and trying to claim a theft loss under IRC § 165. The use of an intermediary appears to disqualify the taxpayer from claiming the theft loss in almost all circumstances because to claim a theft loss deduction, there has to be an actionable theft under the state or country in which the theft occurred.[58] Because intent to permanently deprive another of their property (or at least intentional misconduct or severe recklessness) is required to prove the theft in most jurisdictions, there would generally have to be privity between the one perpetrating the fraud and the one who is defrauded.

A. *The Role of Privity*

The notion that there must be privity to form intent is especially problematic in security purchases. Privity ignores the fact that most publicly traded securities are bought through intermediaries such as brokers or broker-dealers and not directly from the company issuing the securities. The tax court in *Taghadoss*, applying Virginia larceny law, held that

> there is no evidence in the record establishing that WorldCom wrongfully took petitioner's money or property (i.e., the value of his securities) with the requisite intent to deprive him permanently thereof. Moreover, petitioner did not purchase his securities from WorldCom officials; rather his acquisitions were conducted through brokers on the open market, through WorldCom's 401(k) retirement plan, and through World Com's [employee stock purchase plan].[59]

The court in making its decision relied on *Paine v. Commissioner*.[60] The plaintiff in Paine had bought Westec securities on the open market.

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[57] Willey v. Comm'r*,* 75 T.C.M. (CCH) 1757 (1998).
[58] *See* note 2, *supra*.
[59] T.C. Summary opinion 2008-44, at 9.
[60] 63 T.C. 736 (1975).

> Investigation uncovered substantial misstatements and fraudulent statements as to the true earnings and profits of Westec; as to mineral discoveries that had been announced by Westec; as to acquisitions or sales of properties reported by Westec which had not occurred; as to false earnings projections; and as to other fraudulent statements and transactions that had been reported as being completed but had not occurred."[61]

The plaintiff stated that he relied on the fraudulent financial statements in his decision to purchase the securities. However, the court ruled that: "Petitioner did not purchase his stock from the persons who made the misrepresentations, but on the open market. There is no evidence that the previous owners of the stock participated in or were even aware of the misrepresentations of Westec's officers."[62]

The court in *Taghadoss* juxtaposed the *Paine* decision with *Vietzke v. Commissioner.*[63] In *Vietzke*, the petitioner had bought stock in a new insurance corporation. The corporation collapsed and the court held that the petitioner had been defrauded. In this case however, the petitioner had purchased his stock directly from the directors of the corporation.[64] Although the court held that it "need not determine the exact nature of the crime under Indiana law,"[65] the record showed that petitioner was defrauded "of 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."[66] Although the court was silent as to privity, it can be assumed that because the plaintiff dealt directly with the directors and the court found intent, that there was no reason to discuss the issues of privity. In *First Chicago Corp. v. Commissioner,*[67] a taxpayer similarly was allowed a theft loss deduction, where the taxpayer made an investment in a foreign company. Again, a material factor was that the shares were not bought on the open market, but were bought from the company itself.

In *Jensen v. Commissioner*,[68] the court hinted that privity may not have been necessary for that court to rule in favor a theft loss deduction being taken. The court held that the petitioner was defrauded in a Ponzi scheme. The scheme involved an investment in a seafood company called Chacklan Enterprises, Inc. (Chacklan). The respondent bought stock from a person acting as a conduit for the fraudulent scheme, but the conduit had no knowledge of the fraud.[69] The court stated:

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[61] *Id.* at 737-38.
[62] *Id,*
[63] 37 T.C. 504 (1961).
[64] *Id.* at 509.
[65] *Id.* at 511.
[66] *Id.*
[67] 69 T.C.M. (CCH) 2089 (1995).
[68] 66 T.C. M. (CCH) 543 (1993).
[69] *Id.* at 10.

> We find, as a factual matter, that petitioners were investors in Chacklan. There is no requirement that an investor have direct contact with the entity in which he is investing. It is not uncommon for investors to deal only with their brokers and never have direct contact with their investments. In such cases, the brokers act as conduits for the investors' funds. The record in the case before us indicates that [the conduit's] role in the Chacklan investment was that of a broker; he clearly was acting as a conduit for his clients' funds.[70]

The key distinction in *Jensen* is that the person who brought the petitioner into the fraud was "act[ing] as a conduit through which investments passed from the investors to Chacklan and earnings passed from Chacklan to the investors."[71] A conduit is a means of conveying money in which the entity acting as a conduit has no control over the how the assets are disposed of and does not have the potential to benefit from the holding of the assets.[72]

A conduit relationship is different than a traditional broker relationship in that the conduit was acting as an agent for the company who was perpetrating the Ponzi scheme, not the buyer of the stock. The fact that the conduit did not know of the scam is irrelevant, he was still a part of the scheme itself. The court found that the conduit-broker was acting as an intermediary for the fraud.[73]

B. The Anomalous Boothe Decision

While most cases support a privity requirement, there is one case that seems to find that privity between the one perpetrating the fraud and the one who is defrauded is not needed in situations where the intermediary was not part of the fraud. In the 1960 case, *Boothe v. Commissioner*,[74] Mr. Boothe had sold land that he had purchased with Soldier's Additional Homestead Rights, which allowed the holder to receive fee simple interest in some federal lands. Boothe tried to exercise the rights and found that the federal land that he desired to attach was not available. Boothe then sold the rights to another person named Spoo. Spoo found that he could not exercise rights to the land because of an 1898 assignment of the rights known to neither Boothe nor Spoo.[75] Spoo obtained a judgment from Boothe for breach of warranty of title and Boothe tried to claim the amount of the judgment as a theft loss.[76]

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[70] *Id*. at 12-13.
[71] *Id,* at 5. Although the court discussion was not lengthy, and therefore this may not have had bearing on the court decision, it should be noted that the conduit described himself as a "procurement agent" for the Chacklan Investment. *Id.*
[72] *See, e.g,*. Webb v. IRS, 823 F. Supp. 29 (D. Mass. 1993; Kipperman v. Onex Corp. 411 B.R. 105 (Bankr. N.D. Ga. 2009).
[73] Zimmerman, *supra* note 34, at 444.
[74] Boothe v. Comm'r, 82 T.C. 804 (1984), *rev'd*, 768 F. 2d 1140 (9th Cir. 1985) (per curiam).
[75] *Id.* at 806.
[76] *Id.* at 807.

The tax court held that Boothe could claim a capital loss but not a theft loss because the origin-of-the-claim was in the sale of the sale of the property to Spoo.[77] The court did not take up the issue of privity stating that "[i]n view of our holding is based upon the origin-of-the-claim test it is unnecessary for us to decide whether a taxpayer who is not the direct victim of a theft is entitled to deduct a theft loss."[78]

There were two dissenting opinions filed with the majority opinion. On appeal, the Ninth Circuit adopted the first dissenting opinion (the Korner dissent) and replaced the majority decision with it.[79] In the Korner dissent, the loss was split into two parts. The court held that the original purchase should be considered a theft loss to Boothe because he purchased non-existing rights in the land. The court found that the

> petitioner was a victim of a loss arising from theft, *even though he was not the immediate purchaser from the fraudulent vendor*…; that his loss, and the cause therfor (sic), was not discovered until the lawsuit against petitioner by Mr. Spoo was concluded…; and he was therefore entitled to a theft loss deduction in that year.[80]

The loss on the sale subsequent sale of the property to Spoo was considered to be a capital loss.

The second dissent (the Hamblen dissent) deals more directly with the issue of privity. The Hamblen dissent argues that the statute on its face requires no privity, stating:

> The intended direct connection *between the taxpayer and the loss* is clearly expressed in the requirements of section 165(a). Section 165(c)(3) modifies section 165(a) only by requiring that there be a causal connection *between the loss and the theft*. There is, however, no legislative expression of any similar connection *between the taxpayer and the theft*, and we find no reason to infer such requirement. Therefore, petitioner need only prove that he has suffered a loss and that said loss arose from theft. Having carried this burden of proof, he need not demonstrate any direct relationship between himself and the act of theft.[81]

In essence it seems that the Ninth Circuit, by adopting the Korner dissent, has taken the approach that privity is not needed to claim a theft loss deduction. However, the opinion does take note that "[t]he unusual facts of this case created sharp differences of opinion in the Tax Court, with ten judges supporting the majority opinion and eight judges supporting two dissenting opinions."[82] These "unusual

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[77] *Id,* at 808.
[78] *Id.*
[79] 768 F. 2d at 1141. The case was then remanded for disposition consistent with that dissenting opinion.
[80] Boothe v. Comm'r, 82 T.C. 804, 809 (1984), *rev'd*, 768 F. 2d 1140 (9th Cir. 1985) (emphasis added).
[81] *Id,* at 817.
[82] 768 F. 2d at 1141

facts" however have led courts to largely ignore or marginalize the holding of the case. One commenter noted that "Boothe [is] very citable, but sharp differences in opinion noted by the Ninth Circuit persist."[83]

The claims court opinion in *Krahmer v. United States,*[84] which came out only two months after the *Boothe* appellate decision, relied on *Boothe* in deciding that privity between one perpetrating the fraud and the victim of the fraud need not exist. The claims court in *Krahmer*, citing *Boothe* for authority, noted:

> To deny plaintiff a deduction because [the seller] himself did not possess criminal intent would be to draw a distinction between victims that is not commanded by the statute and that is both unwarranted and inequitable. In a recent decision, the U.S. Court of Appeals for the Ninth Circuit approved precisely this interpretation of the statute.[85]

Surprisingly, because the claims court relied on *Boothe* for its position on privity, when the Eleventh Circuit overturned the decision in *Krahmer,* it did not distinguish, disagree with or even mention *Boothe* in its decision.[86] The court in *Jensen* relied on *Boothe* when it made its assertion that "there is no requirement that an investor have direct contact with the entity in which he is investing."[87] However, as one commenter noted on the court finding that the seller was dealing with the buyer through a conduit:

> Jensen is noteworthy because the Tax Court cited Boothe in the face of a pointed IRS argument that there was no direct contact between the taxpayer and the thief. However tempting it is to read Jensen as an endorsement by the Tax Court of Boothe's no-direct-contact-required, such an unqualified statement is unwarranted. [As a factual matter] the court found that the taxpayers were investors in Chacklan.[88]

Perhaps the most peculiar treatment of the *Boothe* decision was in the more recent *Electric Picture Solutions*[89] case. The taxpayer in *Electric Picture Solutions* had its principal office California;[90] therefore the Ninth Circuit opinion in *Boothe*

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[83] Rhodes, Anne-Marie, *On Art Theft, Tax, and Time: Triangulating Ownership Disputes through the Tax Code*, 43 SAN DIEGO L. REV. 495, 516 (2006).
[84] 9 Cl. Ct. 49 (1985).
[85] *Id.* at 53 (citing Boothe v. Comm'r, 768 F. 2d 1140 (9th Cir. 1985)).
[86] *See* Rhodes, *supra* note 83, at 518.
[87] Jensen v. Comm'r, 66 T.C.M. (CCH) 543, 546 (1993). *See* discussion *supra* note 56 and accompanying text.
[88] Rhodes, *supra* note 83, at 518 n.99. (original citations omitted).
[89] *Electric Picture Solutions, Inc. v. Comm'r*, 96 T.C.M. (CCH) 146 (2008).
[90] *Id.* at 1.

would be mandatory authority on the case. In *Electric Picture Solutions*, the taxpayer purchased shares of stock in Novatek International Inc. (Novatek), through a stockbroker.[91] Novatek was alleged to have committed fraud and they filed for bankruptcy leaving the taxpayer no market in which to sell his shares.[92] The taxpayer alleged that the stockbroker was complicit in the fraud and had defrauded the taxpayer by "making claims about the company in order to sell its stock,"[93] and by "breach[ing] the stockbroker's duty of truth and fitness for his customer's portfolio."[94] The court held that there was inadequate evidence that the stockbroker had the intent to deceive the taxpayer. Therefore, the court found that there was "no privity between the perpetrator [Novatek] and the victim [the taxpayer]."[95] This appears to directly contradict the Boothe decision. The court, only mentioned *Boothe* in a footnote, interpreting as having a narrow holding by stating:

> In certain narrow circumstances a theft loss deduction has been allowed where the taxpayer suffered a loss which arose indirectly from a theft between other parties. See *Boothe v. Commissioner*, 768 F.2d 1140 (9th Cir. 1985) (allowing a theft loss deduction with respect to the taxpayer's purchase of nonexistent rights to land, even though the taxpayer was not the immediate purchaser from the fraudulent vendor), revg. 82 T.C. 804 (1984). Petitioner has not alleged or established that it suffered a loss which arose from a theft between other parties.[96]

V. APPLYING THE CASE LAW AND SUGGESTING A NEW LAW FOR STOCK PURCHASERS

Under the current interpretation of IRC section 165, "generally, a taxpayer who purchases securities on the open market cannot support a claim of theft under California [and other states] because there is no privity between the perpetrator and the victim."[97] IRB 2004-27 states that:

> In cases involving stock purchased on the open market the courts have consistently disallowed theft loss deductions relating to a decline in value of the stock that was attributable to corporate officers misrepresenting the financial condition of the corporation, even when the officers were indicted for securities fraud or other

[91] *Id.*
[92] *Id,* at 2.
[93] *Id,* at 8.
[94] *Id.*
[95] *Id,* at 7.
[96] *Id.* at 6 n.6.
[97] *Id.* at 7. *See also* Marr v. Comm'r, 69 T.C. M. (CCH) 2837 (1995); Crowell v. Comm'r, 51 T.C. M. (CCH) 1556 (1986); De Fusco v. Comm'r, 38 T.C. M. (CCH) 920 (1979).

> criminal violations…. Accordingly, the Service will disallow a deduction for theft loss… relating to a decline in the value of the stock that was acquired on the open market for investment. If the stock is sold or exchanged or becomes wholly worthless, any resulting loss is a capital loss.[98]

There are very few times that there is privity between the corporation issuing stock and the stockholder who is the ultimate purchaser, except when purchasing through a broker who was part of the theft itself (with or without knowledge of a fraudulent scheme by the broker).[99] One commentator noted that "[w]orthless stock is not theft even though it may feel like it."[100] While this comment is accurate with regard to recent interpretations of IRC §165, this strict requirement of privity is bad policy because most victims of theft of money in a security transaction purchased their securities through a broker. Another commentator noted that securities fraud is a theft:

> Section 10(b), [which is the] heart of securities fraud [requires the fraudster]: "To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance."[101]
>
> This provision is fleshed out in SEC regulations, particularly Rule 10b-5. This rule specifies that in connection with the purchase or sale of any security, it is unlawful to "employ any device, scheme, or artifice to defraud," to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading," or to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[102]
>
> At the core of these provisions is the prohibition against obtaining money (inflated purchase price of a security) or property (the security without sufficient payment) by use of a fraudulent statement or a deception. … The wording of the provision likens security fraud to theft, specifically the historical crime of theft by false pretenses in

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[98] IRB 2004-16, Notice 2004-27 Loss Deductions for Diminution in Value of Stock Attributable to Corporate Misconduct (drafted by Norma Rotunno).
[99] Jensen v. Comm'r, 66 T.C.M. (CCH) 543 (1993).
[100] Martin McMahon, Jr., Ira B. Shepard, & Daniel L. Simmons, *Recent Developments In Federal Income Taxation The Year 2008*, 9 FLA. TAX REV. 275, 318 (2009).
[101] Christine Hurt, *Symposium: Corporate, Criminality Legal, Ethical, and Managerial Implication: Regulation Through Criminalization: Of Breaches of the Peace, Home Invasions, and Securities Fraud*, 44 AM. CRIM. L. REV. 1365, 1371 (2007)(citing 15 U.S.C. § 78j(b) (2006)).
[102] *Id.*, citing 17 C.F.R. § 10b-5 (2007).

> which a person tells lies to gain both possession of and title to another's property. In theory, when a corporation creates a false impression that the company is doing well and worth more per share than the company really is, the market reacts by buying shares of the company and increasing the market price of the company's shares to the level of the impression created. This false picture induces investors to purchase shares in the company that otherwise they may not have or at least to purchase shares in the company at a price that they would not have. This fraudulent inducement is similar to a theft of that purchase price or at least of that portion of the price that is inflated. If and when the false picture is corrected, either by internal revelations or external criticisms, the stock price will then decline and shareholders will recognize the loss created by that inflated purchase price.

Because securities fraud is essentially a theft, Congress should clarify its intent; Congress should allow theft losses on private and publicly traded corporations "that have declined significantly in value to a diminimus (sic) amount … or that have been delisted" due to fraud.[103]

The question of why the courts require direct contact between the thief and the taxpayer was addressed in a commentary by Professor Rhodes. Professor Rhodes opines that there are three justifications for requiring privity. The first "may be nothing more than an unexamined historic imperative, the traditional section 165(c)(3) suddenness requirement,… [and] distinguishing theft from mistake."[104] The second rationale is that the tax system would become an insurer against securities loss. Thirdly, Professor Rhodes opines that the lines between personal losses and business losses would become blurred.

A. Exploring the Historical Imperative

The first point that Professor Rhodes raises is:

> that section 165(c) limits an individual's nonbusiness, nonprofitseeking losses to those losses arising "from fire, storm, shipwreck, or other casualty, *or from theft*." In interpreting "other casualty," courts adopted the principle of *ejusdem generis*, that is, interpret the phrase in light of the surrounding terms. Consequently, deductible losses from "other casualty" require an identifiable event that is "sudden, cataclysmic, and devastating," or "of a sudden, unusual or unexpected nature" put most simply, "only sudden events can be deductible casualties." If the tincture of time

[103] *See* similar logic proposing clearer criteria for the application of worthless securities deductions: Andrew J. Judd, *Substantiating the Worthless Securities Deduction*, 6 J. LEGAL TAX RES. 1 (2008).
[104] Rhodes, *supra* note 83, at 518.

> underlies deductibility for "fire, storm, shipwreck, or other casualty," it may, consciously or not, also color the interpretation of "or from theft."[105] (Emphasis added.)

The unexplained historical imperative seems to have its genesis in the often cited 1956 case of *Edwards v. Bromberg*.[106] In discussing what constituted a deductible theft loss, the Fifth Circuit noted that the line of cases where it had been allowed the cases followed the law of the jurisdiction in which the loss occurred to determine if there was a theft. The court noted:

> Under this line of decisions it has been long and well established that whether a loss from theft occurs within the purview of [a predecessor statute to IRC § 165] and the corresponding provisions of prior acts, depends upon the law of the jurisdiction where it was sustained and that the exact nature of the crime… is of little importance so long as it amounts to theft.[107]

Essentially, the proposition that an examination of the local jurisdiction's theft laws (and therefore the requirement of privity) determines whether or not a theft loss deduction may be taken under IRC §165, is a judicial creation. The requirement did not come from the statute itself. Importantly, when deciding that the state jurisdiction be used, the court only analyzed the cases that had been previously decided and those were based solely on interpretation of state law. Nowhere does the *Edwards* decision specifically address one way or another, an act that would be a violation of Federal law.

When interpreting the statute itself, Professor Rhodes suggests the impetus for this requirement might be in the construct of the statute itself, and the legal maxim of *ejsudem generis*.[108] This argument is based is based on the fact that IRC § 165(c)(3) puts theft loss in the same subsection as casualty losses, which usually require suddenness of the occurrence. "If the tincture of time underlies deductibility for 'fire, storm, shipwreck, or other casualty it may, consciously or not, color the interpretation of 'or from theft.'"[109]

While courts may have used *ejsudem generis* while interpreting the need for suddenness (and therefore required privity between the one being defrauded and the fraudster), this is not the best interpretation of the statute. First, Revenue Regulation § 1.165-8 lists examples of theft, including embezzlement. Embezzlement has an element of an employment or agency relationship, and the property stolen comes in to

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[105] *Id.* at 519.
[106] 232 F.2d 107 (5th Cir. 1956). A LEXIS search shows 156 citations for this case primarily for the determination of the definition of a theft loss.
[107] *Id.,* at 111.
[108] Rhodes, *supra* note 83, at 519.
[109] *Id.*

the possession of the defendant by virtue of that relationship.[110] Such relationships (and some embezzlements) take place over an extended period of time. For example, in *Finkelstein v. Commissioner*, money was embezzled from an employer for at least five years before being discovered.[111] Second, the Hamblen dissent facially analyzes the statute as to why privity should not be a requirement. In harmonizing sections 165(a) and 165(c)(3) Judge Hamblin noted:

> The language of section 165(c)(3) itself requires that "losses *arise* * * * *from* theft." In the absence of any compelling reason to disregard the plain language of the statute or its logical result, the legislative mandate of Congress must be taken at its word. …
>
> It is true, of course, that in the overwhelming majority of cases, a taxpayer who suffers a theft loss will simultaneously be the victim of the theft from which the loss arises. In unusual circumstances, however, such as those which confront petitioner in this instance, dual victimization will not result. Where this is so, it must be borne in mind that the target of section 165 is treatment of losses, not treatment of thefts.
>
> The intended direct connection *between the taxpayer and the loss* is clearly expressed in the requirements of section 165(a). Section 165(c)(3) modifies section 165(a) only by requiring that there be a causal connection *between the loss and the theft*. There is, however, no legislative expression of any similar connection *between the taxpayer and the theft*, and we find no reason to infer such requirement. Therefore, petitioner need only prove that he has suffered a loss and that said loss arose from theft. Having carried this burden of proof, he need not demonstrate any direct relationship between himself and the act of theft.[112] (Emphasis in original).

This interpretation, although not followed, argues that Congress never intended privity to be a statutory requirement of theft; it appears that the plain reading of the statute shows that indeed there only needs to be a theft and that the taxpayer only needs to have a loss from that theft. The *Boothe* decision shows that the Ninth Circuit agrees with this interpretation at least in certain circumstances.

One of these circumstances should be for a fraud which occurs in violation of federal securities laws. In *Crowell v. Commissioner,*[113] the taxpayer had bought stock in Equity Funding Corporation of America (EFCA). All of the principals of EFCA either pleaded guilty or were found guilty of at least some federal or state

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[110] *Black's Law Dictionary*, 5th Ed.
[111] Finkelstein v. Comm'r, 57 T.C.M. (CCH) 1280 (1989).
[112] Boothe v. Comm'r, 82 T.C. 804, 816 (1984)(Hamblen, J., dissenting), *rev'd*, 768 F.2d 1140 (9th Cir. 1985).
[113] 51 T.C. M. (CCH) 1556 (1986).

securities fraud violations.[114] As a result, EFCA filed for bankruptcy and the taxpayer lost money. The taxpayer tried to claim this loss as a theft loss, but the court held that because he bought the stock on the open market, there was no privity and therefore no theft in accordance with California law.[115] The taxpayer's argument that the taxpayer suffered a theft under federal law was disposed of by the court stating that "it is well settled… that the law of the State where the loss was sustained determines whether or not a theft had occurred."[116]

The rationale behind the decision again seems to be the "historic imperative"[117] that Professor Rhodes proffered. This interpretation ignores reality. Webster defines a victim as "(2) one that is acted on and usually adversely affected by a force or agent… (a)(1): one that is injured, destroyed or sacrificed under any of various conditions (2): one that is subjected to oppression, hardship or mistreatment.[118] The taxpayer in the Crowell case and several others were victims of theft. In *Edwards v. Bromberg*,[119] when discussing what constitutes a theft, the judge noted:

> the word 'theft' [in the 1939 Code predecessor of § 165(c)] 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 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.

The requirement that securities need not be purchased on the open market effectively excludes the vast majority of securities purchasers. However, when there is a fraud perpetrated on the market and an innocent purchaser of the security gets defrauded by false financial statements, that person is no less a victim of the "criminal appropriation … by swindling, false pretenses, and any other form of guile" than if the person would have bought their security directly from the company. Because *Edwards v. Bromberg* does not require the specific elements of a crime be met, only that the elements of theft in a particular jurisdiction be met, it is not important to identify a particular statutory securities fraud.

One might argue that IRC § 165(g) already provides relief to people who are defrauded and their stock becomes worthless. IRC § 165(g) provides that "[i]f any security which is a capital asset becomes worthless during the taxable year, the loss therefrom shall… be treated for a loss from the sale or exchange…of capital asset."[120] However, in *Vietzke v. Commissioner*, the court allowed for the loss of stock

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[114] *Id* at 7.
[115] *Id.* at 8.
[116] *Id.* at 9.
[117] Rhodes, *supra* note 83, at 518.
[118] *Webster's Ninth New Collegiate Dictionary*.
[119] 232 F.2d 107, 110 (5th Cir. 1956).
[120] IRC § 165(g).

purchase as a theft loss rather than a capital loss.[121] This case was cited for that same proposition in *Taghadoss v. Commissioner*,[122] so it would appear that one who purchases securities from the company and is defrauded would have the option of taking the loss as a theft loss rather than a capital loss that is limited to $3,000 of losses in excess of capital gains each year. Requiring that securities *must* be bought directly from the person perpetrating a fraud for there to be an allowable theft loss deduction creates an artificial barrier for using the deduction. In modern trading this rarely happens. Many people purchase stocks using information other than from the broker-dealer in which they make the trade or use on-line and other brokerages as clerical services to place specific "buy" orders. Fraudulent information may never be communicated directly to the investor with an intent to deceive, but may drive the overall price of the security. If, for example, a company were to file fraudulent financial statements with the SEC, a fraud-on-the market would occur. False financial statements would temporarily increase the price of the stock; if the fraud were later discovered the investor may lose a substantial portion, if not all of their money. The investor would still lose the investment by "guile or false pretenses," as would be required by *Edwards v. Bromberg*. The broker-dealer who facilitates the transaction, unless recommending the stock, has no legal responsibility except to complete the transaction requested by the investor-buyer. In examining suitability claims by purchasers of securities, Gedicks noted:

> There seems to be widespread agreement among courts, regulators, and commentators, however, that a broker-dealer cannot incur liability on suitability grounds unless it first recommends a securities transaction to a customer. … It is widely believed that in the absence of a recommendation, broker-dealers owe their customers no more than prompt, fair, and effective execution of purchase orders as and when they are received. Accordingly, discount broker-dealers have long argued that they are necessarily immune from liability on suitability claims because they act as "order clerks" who merely execute unsolicited customer orders to purchase unrecommended securities…[123]

The role of the broker is essentially as a clerical agent unless the broker is recommending a security. The fraud on the market is passed directly to the purchasers, causing them direct injury. If the broker-dealer were to recommend a security and it turns out that there was a fraud perpetrated, the investor "may recover on federal and state law fraud, fiduciary duty, and negligence theories for such breaches."[124] Again, the ultimate victim of the fraud is the purchaser, and the theft

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[121] 37 T.C. 504, 510 (1961).
[122] T.C. Summary Opinion 2008-44, at 9 (2008).
[123] Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An agency Theory of Broker-Dealer Liability*, 37 ARIZONA ST. L.J. 535, 541 (2005)(original citations omitted).
[124] *Id.* at 543.

that occurred from the fraud-on-the-market should be allowed to be deducted. If the brokers themselves had been involved in the fraud, then the loss would be deductable as there was privity between the victim and the fraud.

B. IRS as Insurer, and Blurring the Lines between Business and Personal Losses

Professor Rhodes' second rationale for "the IRS insistence on a direct link between the thief and the taxpayer may be an institutional belief that defining theft in a hard edged way, making theft a fortress, best distinguishes theft from mere "loss.""[125]

Essentially she argues that lowering the threshold would allow for the theft loss deduction to be used by taxpayers who have made an error in judgment and not a theft, such that "[t]he U.S. tax system would then become an insurer of sorts not only for theft but mistakes in judgment as well, something Congress did not intend."[126]

Professor Rhodes' third rationale is for requiring "a nexus between thief and taxpayer is that to allow otherwise could ultimately blur the tax distinctions between generally deductible business losses and generally nondeductible personal losses, so that all losses become deductible."[127]

Both of these rationales seem to arise from fear of the provision being abused by taxpayers and creating hardship in enforcement by the IRS. It is true that if recovery were to be allowed as a theft loss for any securities transaction involving fraud that taxpayers would try to find fraud where there was none. While it is true that there is a possibility for abuse, protections can be put into place to curtail it. There is no requirement for a theft conviction for a theft loss deduction to be taken.[128]

However, to prevent abuse, Congress could require that an indictment for either a federal or state securities fraud be issued against the principals of the company issuing the security. This would eliminate use of the deduction by taxpayers who suffered ordinary market loss and then claim it was due to fraud and would minimize the risk of the deduction being used for "mistakes in judgment"[129] and therefore not make the IRS "an insurer of sorts"[130] of securities that decline. While not all victims of securities fraud should be able to take the theft loss deduction, the requirement that that loss must be a crime in the state should be removed in favor of also allowing deductions for federal frauds. Allowing losses only for state crimes, and therefore requiring privity, is a notion of judicial construct that leaves those who rely on fraudulent information and buy securities on the open market with no casualty loss tax relief (while still others buying directly from a fraud perpetrator get a full deduction). Some limits should apply: requiring that the stock value go to a *de minimus* amount, and requiring an indictment of the perpetrators for fraud or similar

[125] Rhodes, *supra* note 83, at 519.
[126] *Id.*
[127] *Id,* at 521.
[128] Vietzke v. Comm'r, 37 T.C. 504, 510 (1961).
[129] Rhodes, *supra* note 83, at 519.
[130] *Id.*

official securities investigation undertaken by a governmental agency for the theft loss to be taken for a loss to be deductible would define clearly the distinction between business and personal losses.

C. Extending the Trend

Recent IRS interpretations of law seem to be leaning toward increasing this inclusiveness for theft deductions for victims of fraud. In reaction to the exposure of several high-profile Ponzi schemes, the IRS has established safe harbor provisions for Ponzi scheme victims so that they may use the theft loss deduction, but they are unclear about the treatment for those investors who purchase from a scheme using a broker.[131] There are two different standards in determining whether a loss is qualified for the safe harbor. Section 4.02 of Revenue Procedure 2009-20 defines a qualified loss as one resulting from "a specified fraudulent arrangement in which, as a result of the conduct that caused the loss-

> (1) The lead figure (or one of the lead figures, if more than one) was charged by indictment or information (not withdrawn or dismissed) under state *or federal law (emphasis added)* with the commission of fraud, embezzlement or a similar crime that, if proven, would meet the definition of theft for purposes of § 165 of the Internal Revenue Code and § 1.165-8(d) of the Income Tax Regulations, under the law of the jurisdiction in which the theft occurred; or
>
> (2) The lead figure was the subject of a state *or federal (emphasis added)* criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in section 4.02(1) of this revenue procedure, and either –
>
>> (a) The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or
>>
>> (b) The receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen."[132]

The first change that this makes to the general concepts is that it allows for a federal crime to be the basis of the use of the theft loss provision. This is a notion that was specifically rejected in *Crowell v. Commissioner*.[133] However, when defining a

[131] Rev Proc. 2009-20 I.R.B. 2009-14 (March 17, 2009).
[132] *Id.*
[133] 51 T.C. M. (CCH) 1556, at 9 (1986).

qualified investor, the safe harbor only requires that one generally be qualified to deduct the theft losses under IRC § 165 and Regulation § 1.165-8. It is silent as to whether the notion of direct privity between the fraudster and the victim must be there. On one hand, privity appears to be required in the way the courts are currently interpreting IRC § 165; on the other hand, Section 5.02(1) provides for a two-pronged safe harbor deduction: "(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," indicating that a taxpayer who invested using a broker (and therefore may have a cause of recovery against the broker) may still deduct the theft loss. If the IRS can find safe harbor for recent high profile Ponzi schemes (with the amount of recent high profile securities frauds), Congress should give relief to these investors as well.

VI. CONCLUSION

Generally, the use of stockbrokers has historically been cause for the disallowance of theft losses in for tax purposes. However, courts are somewhat divided on this point. The IRS has responded to the division and external pressures with Revenue Ruling 2009-09 and Revenue Procedure 2009-20, which seem to soften the disallowance further. Through their silence and safe harbor provisions, these pronouncements indicate that victims of Ponzi schemes may take theft losses, without regard to whether or not they used a broker to purchase these investments. The authors suggest a further softening: where a stock becomes worthless due to fraud, a theft loss should be allowed for tax purposes to innocent victims, regardless of whether or not the stock was purchased directly from the fraudster, and regardless of whether or not a broker was used to facilitate the purchase.