Originally published in the:
New York Law Journal *June 20, 2024*

Theft Loss Deductions Denied

By: Elliot Pisem and David E. Kahen

Tax consequences to an individual whose stock, securities, or other property lose value by reason of a crime may be significantly affected by whether the losses "arise . . . from theft" within the meaning of IRC section 165(c).

A loss not compensated for by insurance or otherwise is allowable, in general, as a deduction under section 165(a), but that rule is subject to numerous limitations. Among those limitations is that, if the loss is attributable to a capital asset, and realized through a sale or exchange, it will be a capital loss and therefore deductible (above a de minimis amount) only to the extent of capital gains.

A non-business loss of an individual (not realized through a sale of property) will generally be classified as an "itemized deduction" under IRC section 63(d) and -- if it does not qualify as a casualty or theft loss -- as a "miscellaneous itemized deduction" under IRC section 67(b). Miscellaneous itemized deductions are not allowable at all through 2025, and the deduction for a "personal casualty loss" -- that is, a casualty or theft loss of property not connected with a trade or business or a transaction entered into for profit -- is generally limited through 2025 to losses attributable to a "Federally declared disaster" (see IRC section 165(h)). By contrast, a theft loss incurred in a business or transaction entered into for profit can generally be used to offset ordinary income as well as capital gain.

In two recent Tax Court decisions discussed below, it was determined that, although there had been a loss in value attributable to activities ultimately determined to be crimes, no theft loss was allowable to the petitioners because no crime in the nature of theft had been committed against the petitioners themselves to deprive them of property that they owned.

Pascucci

In *Pascucci v. Commissioner* (TC Memo 2024-43), Mr. Pascucci owned flexible premium variable life insurance policies (the Policies) issued by two insurance companies. The Policies provided that premiums paid would be held in one or more separate accounts. The policy holder could allocate the premiums among various investment portfolios offered by the insurance company, and bore all investment risk with respect to those amounts. The assets held in the separate accounts were owned by the insurance company.

Each of the insurance companies permitted policy holders to cause their premium payments to be invested in Tremont Opportunity Fund III, LP (Tremont), and Mr. Pascucci made such an allocation. Tremont invested a portion of its funds in Rye Broad Market Series (Rye Broad), which in turn invested in Bernard L. Madoff Investment Securities (BLMIS). Bernard Madoff was arrested in December 2008 and ultimately convicted of numerous crimes. His thefts ultimately caused Rye Broad to become worthless, and reduced the value of Tremont's assets by approximately 22%.

The 2008 Form 1040 of Mr. Pascucci and his spouse (the Pascuccis) reported theft losses attributable to the diminution in value of the Policies, as well as deductions attributable to a direct investment made by the Pascuccis in BLMIS through a family partnership. The loss attributable to the direct investment was within the scope of a safe harbor established by Rev. Proc. 2009-20, and not challenged by the IRS. The Commissioner disallowed, however, the theft loss with respect to the Policies (which the Pascuccis conceded was not within the scope of the safe harbor), and asserted to the Tax Court that no such loss was allowable because the theft was not committed by Mr. Madoff against the Pascuccis.

The court ultimately agreed with the government that the petitioners were not entitled to a theft loss by reason of the diminution of the value of the Policies. The actual owners of the interests in Tremont that lost value by reason of the Madoff crimes were the insurance companies, not Mr. Pascucci. In fact, if the terms of the Policies had provided Mr. Pascucci with significant incidents of ownership with respect to the assets held in the separate accounts, the court concluded that he would not have benefited from the favorable tax treatment of inside build-up in value generally associated with variable life insurance policies. The lack of an ownership interest in those assets that was necessary to preserve the tax treatment desired for the Policies fatally undermined, in the court's view, the claim by the Pascuccis of a theft loss in respect of the Policies.

The Pascuccis cited, in support of their view that they had a sufficient ownership interest in the assets underlying the Policies to support a theft loss deduction, *Alphonso v. Commissioner* (708 F.3d 344 (2d Cir. 2013)), which had concluded that a shareholder of a cooperative housing corporation had a sufficient ownership interest in property of the corporation to support a casualty deduction attributable to damage to the corporation's property. The court found *Alphonso* distinguishable on the basis that the Pascuccis' rights under the Policies did not sufficiently resemble the rights of tenant-stockholders with respect to real property that was owned by a cooperative housing corporation and available for use by them as tenant-stockholders.

Taking all the above into account, the court concluded that Mr. Pascucci should not be viewed as the owner of an interest in Tremont or Rye Broad, but rather only as the owner of the Policies. The Policies were not stolen, although they did suffer a decrease in value by reason of the Madoff thefts. Taking into account Mr. Pascucci's continued ownership of the Policies, the decline in value of the Policies was not the result of a theft against Mr. Pascucci, and therefore no theft loss was allowable by reason of that decline.

Giambrone

Giambrone v. Commissioner involved a federal chartered savings and loan institution (Platinum) that invested in residential mortgage loans and packaged such loans for sale. Platinum was owned by a holding corporation (Holding) in which Michael Giambrone and his brother William Giambrone (the Giambrones) owned a controlling interest from the time of its incorporation in 1998.

Platinum was consistently unprofitable and, under pressure from its regulator, was required to raise additional capital at various times from 2001 through 2004. In 2007, changes in the secondary mortgage markets resulted in further losses for Platinum. Under increasing regulatory pressure, William Giambrone sought out various potential buyers to acquire the stock or assets of Holding.

Ultimately, a stock purchase agreement was signed in late 2007 with TBW, an entity controlled by Lee Bentley Farkas, under which TBW would transfer $10 million to provide additional capital for Platinum, and in doing so acquire a majority interest in Holding. To facilitate an immediate capital infusion, TBW first lent $4 million to William Giambrone, which he contributed to Holding in exchange for newly issued shares of stock in Holding. Following regulatory approval in June 2008 of TBW's application to purchase a controlling interest in Holding, Mr. Giambrone transferred the newly issued shares to TBW in satisfaction of the loan (as previously agreed), and TBW purchased additional Holding shares for $6 million. The transactions resulted in a decrease in the percentage ownership of the Giambrones in Holding from 54% to approximately 14%.

In 2009, Platinum engaged in certain transactions with TBW, the ultimate effects of which were to place Platinum in unsound condition and to cause its regulator to close Platinum and place it into receivership. Mr. Farkas was indicted in 2010 and ultimately convicted of numerous crimes involving bank, wire, and securities fraud. A forfeiture order and restitution judgment were ultimately entered against Mr. Farkas in 2011 in amounts in excess of $3.5 billion. Mr. Farkas's circumstances at that time allegedly made it clear that the likelihood of any significant recovery against Mr. Farkas by his victims was "practically nil."

The Giambrones claimed theft loss deductions on their 2012 federal income tax returns of 95% of the value of their investments in Platinum. The loss deductions were premised in the first instance on the safe harbor in Rev. Proc. 2009-20. However, it was determined by the Tax Court in earlier proceedings (TC Memo 2020-145), upon motion for partial summary judgment by the government, that the Giambrones did not qualify for the safe harbor, as they had not claimed the loss on their returns for the year in which the indictment was filed.

Thereafter, the Giambrones continued to pursue arguments that the losses were allowable under section 165 as a theft loss without regard to Rev. Proc. 2009-20. The court disagreed. It viewed the Giambrones as not having sold anything to Mr. Farkas, but rather as having permitted Holding to issue shares of its stock to TBCW for $10 million. To the extent that transaction was the product of fraudulent inducement, the court viewed the fraud as committed against Holding, possibly, but not the Giambrones.

It was undisputed that the stock issuance by Holding deprived the Giambrones of their controlling interest in Holding, and they apparently argued that their loss of control by reason of a fraudulently induced transaction should suffice to support the theft loss. The court, however, was unwilling to view their controlling interest as property separate from the stock owned by them (which they retained). The court further noted that the transaction effecting a transfer of control was intentionally entered into by the Giambrones to address regulatory pressures relating to Platinum, and concluded that the transfer of control was not the result of deception by Mr. Farkas.

The court also noted that, once a theft is discovered, the related loss must be claimed in the year of discovery (see IRC section 165(e)) or, if later, in the year in which it can be ascertained with reasonable certainty whether any reimbursement for the loss will be received. In this case, the court found that it was apparent by 2011 that there was no reasonable prospect of such reimbursement. Accordingly, no theft loss could be claimed for 2012.

Observations

Pascucci and *Giambrone* underscore the numerous potential pitfalls that must be avoided by a taxpayer considering a claim for a theft loss, including the need to substantiate that the loss arose from a crime that was committed against the taxpayer and with respect to property in which the taxpayer had an ownership interest. A theft committed against a business entity in which the taxpayer owns an interest may not suffice.

Elliot Pisem and David E. Kahen are partners of Roberts & Holland LLP.