

Campbell Law Review

Volume 38
Issue 1 *National Issue*

Article 1

2016

After *Goeller v. United States*, Can the Theft Loss Treatment Now Be Applied to Investments When Corporate Deception Is Present?

Brian Elzweig

Valrie Chambers

Jud Stryker

Follow this and additional works at: <http://scholarship.law.campbell.edu/clr>

Recommended Citation

Brian Elzweig, Valrie Chambers, and Jud Stryker, *After Goeller v. United States, Can the Theft Loss Treatment Now Be Applied to Investments When Corporate Deception Is Present?*, 38 Campbell L. Rev. 1 (2016).

This Article is brought to you for free and open access by Scholarly Repository @ Campbell University School of Law. It has been accepted for inclusion in Campbell Law Review by an authorized administrator of Scholarly Repository @ Campbell University School of Law.

After *Goeller v. United States*, Can the Theft Loss Treatment Now Be Applied to Investments When Corporate Deception Is Present?

BRIAN ELZWEIG*
VALRIE CHAMBERS**
JUD STRYKER***

ABSTRACT

Traditionally, the theft loss deduction for Federal income tax was limited in several ways. The limitations included requiring that the theft be considered a theft under the state law in which the theft occurred and that there be direct privity between the person committing the theft and the person against whom the theft occurred. The restrictions have made it hard to use the theft loss deduction in most securities fraud cases. This Article examines the history of the theft loss deduction and recent changes that may show a relaxing of some of these restrictions, and how these changes may impact allowing for the theft loss deduction in securities fraud cases.

INTRODUCTION	2
I. THE TRADITIONAL APPLICATION OF THE THEFT LOSS DEDUCTION	3
A. <i>Calculating a Theft Loss</i>	6
B. <i>Examining Safe Harbor Provisions for Qualified Ponzi Scheme Victims</i>	7
C. <i>Evaluating Why There Would Be a Preference for Theft Loss Treatment over Capital Loss Treatment</i>	9
D. <i>Analyzing Theft Loss Versus Return of Capital</i>	11
II. THE TRADITIONAL ELEMENTS OF STATE LAW AND INTENT	12
A. <i>What Is a Theft Under State Law?</i>	12
B. <i>What Is Intent?</i>	16
C. <i>What Are the Exceptions to Privity?</i>	22

* Associate Professor of Business Law, Texas A&M University-Corpus Christi.

** Associate Professor of Accounting, Stetson University.

*** Professor of Accounting and the Eugene M. Lynn Chair of Business, Stetson University.

D. <i>What Are the Consequences?</i>	23
E. <i>Why Now?</i>	32
III. CASES SINCE <i>GOELLER</i>	33
CONCLUSION.....	40

INTRODUCTION

For a loss to be considered a theft to receive theft loss treatment for federal taxation, case law has traditionally held that two elements must be present. First, the loss must arise from an action that would meet the definition of “theft” in the state in which the theft loss occurred. The second element that traditionally must be present for the loss to be a “theft” is that there must be direct privity between the person claiming the theft loss and the person who committed the theft. Losses for investment fraud are generally precluded from theft loss treatment when the investor purchased the investment through a stockbroker, rather than directly from the perpetrator of the fraud. Despite being a violation of federal securities law, losses for investment fraud are precluded because usually they do not meet the state law definition of a theft, and the state common law definition of theft includes the requirement of direct privity.

A new development came in the form of a case recently decided in the United States Court of Federal Claims, *Goeller v. United States*, which permitted the use of the federal common law definition of theft to allow theft treatment of the investment loss, resulting in theft loss treatment.¹ *Goeller* was in contrast with state court and federal court decisions in which theft losses were denied because purchases were made through stockbrokers, and no direct privity with the fraudster existed under state law. Prior decisions required the use of state definitions of theft, and the examination of the law of the state in which the theft occurred.² Because these definitions required intent as an element, direct privity was seen as an element of a theft. However, the logic of the *Goeller* decision may allow for an easing of the privity rule in investment fraud cases, permitting the use of the theft loss deduction in cases in which an intermediary is used as well.

There are inherent inequities in the law as it stands now. Most securities transactions involve an intermediary, and there is often a minimal tax recovery for the victims. Additionally, *Goeller* may allow for differential treatment for a theft victim who chooses to have a district court,

1. *Goeller v. United States*, 109 Fed. Cl. 534, 540–41 (2013).

2. See e.g. *United States v. Selders*, 797 F. Supp. 2d 147, 150-51 (D. Mass. 2009).

rather than the Federal Claims Court, hear his or her case. This could lead to forum shopping by taxpayers.

This Article discusses the tax treatment anomaly where taxpayers who purchased securities directly from a company and fell victim to securities fraud may have better tax treatment than those who purchased securities through a broker. Part I explores the genesis of the judicially created state law requirement and the direct privity rule's application as to theft loss deductions. Part I-A discusses the process by which theft losses are calculated. In Part I-B, this Article examines safe harbor provisions for some victims, and in Part I-C the incentive to file for theft loss treatment over capital loss treatment is explained.

Part II presents the traditional elements of state law and probes the definition—and consequences thereof—of “theft” under state laws in Part II-A. Part II-B examines the meaning of intent. In Parts II-C and II-D, this Article examines the current direct privity requirement and its possible exceptions. Part II-E argues that victims of securities fraud who purchase securities through a third party broker suffer disparate harm and calls for a reexamination of the law. In Part III, this Article discusses cases that have been decided in the wake of *Goeller* and the inconsistencies that remain. Finally, this Article concludes with the recommendation that the law be clarified either by statute or through common law to formally allow victims of securities fraud to be allowed access to the theft loss treatment for federal income taxes.

I. THE TRADITIONAL APPLICATION OF THE THEFT LOSS DEDUCTION

Section 165(a) of the Internal Revenue Code (IRC or Code) allows a tax deduction for “any loss sustained during the taxable year and not compensated for by insurance or otherwise.”³ The deduction is further defined by section 165(c)(3) of the IRC which states that “[i]n the case of an individual, the deduction under subsection (a) shall be limited to— . . . losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from *theft*.”⁴ However, theft is not further defined under section 165(c)(3) of the Code, and has generally been interpreted judicially, using state laws.

*Edwards v. Bromberg*⁵ presents one example of judicial interpretation of a state law definition of theft. In *Edwards*, the court defined theft loss

3. I.R.C. § 165(a) (2012).

4. I.R.C. § 165(c)(3) (emphasis added).

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

broadly as any criminal appropriation of another's property by swindling, false pretenses, or any other form of guile.⁶ Thefts include blackmail, embezzlement and other frauds, extortion, kidnapping for ransom, larceny, robbery, and threats, and they are generally treated similarly to casualty losses for tax purposes.⁷ Traditionally, "theft loss" is defined under the law of the state or foreign country where it occurred as an illegal taking that is performed while possessing criminal intent.⁸ Thefts do not include lost property or seizure or confiscation of property by a foreign government.⁹

Sometimes, however, what constitutes a theft is less clear. For example, 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 tax-deductible amount of the loss is the lower of the change in fair market value (FMV) or the taxpayer's basis reduced by insurance and other reimbursements, if any.¹⁰ Other reimbursements may include money received from government agencies as compensation for the theft loss received, the amount collectible from court awards for damages net of necessary expenses including attorneys' fees, and funds from an employer to mitigate the loss.¹¹ Gifts from relatives and friends are also excluded from the theft loss calculation.¹²

To deduct a theft loss, the taxpayer must have property that can actually be taken, like investments. The mere promise that an asset exists is not property, and would not normally qualify for a theft loss. Similarly, an indirect effect of casualties and thefts, such as reduction in the resale value of property, would not normally produce a deductible casualty loss.¹³

Theft losses are deductible in the year the theft is discovered, or later, when there is no reasonable prospect of recovery after examining all facts

6. *Id.* at 110.

7. *See generally* I.R.C. § 162 (2012) (property used in a trade or business); I.R.C. § 212 (income producing property such as that used by employees and investments); I.R.C. § 165(c)(3) (casualty losses on personal use property); *see also* Treas. Reg. § 1.165-8(d) (2015).

8. *See* Rev. Rul. 72-112, 1972-1 C.B. 60, 61 for U.S. theft losses requiring application of state law. For foreign thefts, *see* First Chi. Corp. v. Comm'r, 69 T.C.M. (CCH) 2089, 2097 (1995). As discussed *infra*, the interpretation that for there to be a theft under section 165(c)(3) there has to be a theft as defined in the jurisdiction where the theft occurred has been called into question.

9. *Powers v. Comm'r*, 36 T.C. 1191, 1192-93 (1961).

10. Reimbursements are shown net of expenses to obtain reimbursement.

11. I.R.C. § 102(c) (2012).

12. Rev. Rul. 64-329, 1964-2 C.B. 58, 59.

13. *See Pulvers v. Comm'r*, 407 F.2d 838, 839 (9th Cir. 1969).

and circumstances.¹⁴ The court may consider subjective factors during its assessment, but a subjective factor “cannot be ‘the controlling or sole criterion.’”¹⁵ Objective factors may include the existence of a claim or litigation and the availability of restitution.¹⁶ Where there is 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.”¹⁷ A recovery may come from a third party, such as an insurer, and a taxpayer must make reasonable efforts to recover the stolen property including filing for appropriate insurance reimbursements.¹⁸ A prospect for recovery must be reevaluated each year to determine when that prospect is no longer reasonable.¹⁹ If, subsequent to the theft discovery, enough years pass with a reasonable prospect of recovery, bona fide theft loss claims may be barred under the statute of limitations.²⁰ Further, the Internal Revenue Service (IRS) can deny a deduction if it feels that there is an unreasonable delay beyond the three-year statute of limitations.²¹ Where only a partial recovery is reasonable, as where insurance recoveries are limited by contract, the taxpayer may take only the unrecoverable portion as a deductible loss.²²

Where the taxpayer used a larger than expected reimbursement in estimating a casualty loss, the amount that the loss understatement should

14. See Treas. Reg. § 1.165-1(d)(2)(i) (2015); see also *Geisler v. Comm’r*, 55 T.C.M. (CCH) 1734, 1736 (1988). The burden of proof for no “reasonable prospect of recovery” falls on the taxpayer. See *Gale v. Comm’r*, 41 T.C. 269, 276 (1963).

15. *Adkins v. United States*, 113 Fed. Cl. 797, 807 (2013) (quoting *Boehm v. Comm’r*, 326 U.S. 287, 292 (1945)).

16. See, e.g., *Huey v. Comm’r*, 50 T.C.M. (CCH) 430, 434 (1985). However, filing a proof of claim in bankruptcy and other ministerial acts are not a strong indicator of recovery. *Jensen v. Comm’r*, 66 T.C.M. (CCH) 543, 547 (1993); see also *Adkins*, 113 Fed. Cl. at 807. In *Schneider v. Commissioner*, a lawsuit was filed, but the perpetrator had no assets from which to recover. *Schneider v. Comm’r*, 49 T.C.M. (CCH) 1032, 1034 (1985). The court found the lack of assets more persuasive than the presence of a lawsuit. *Id.* at 1034–35.

17. Treas. Reg. § 1.165-1(d)(3); see also *Jeppsen v. Comm’r*, 128 F.3d 1410, 1414 (10th Cir. 1997).

18. I.R.C. § 165(h)(4)(E) (2012).

19. Treas. Reg. § 1.165-1(d)(2).

20. See *Wagon v. State Farm Fire & Cas. Co.*, 146 F.3d 764 (10th Cir. 1998).

21. *Woltman v. United States*, 56 A.F.T.R.2d. (RIA) 5860, 5862–63 (S.D. Cal. 1985). *Woltman* could have avoided this result by filing a formal disclaimer of any recovery in the year the theft was discovered and claimed the theft loss then. *Id.* at 5863; see also Treas. Reg. § 1.165-1(d)(2)(i) (2015).

22. *Bubb v. United States*, 93-2 U.S. Tax Cas. (CCH) ¶ 50,572 at 89,81719 (W.D. Pa. 1993). *But see Kaplan v. United States*, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,117, at 83,136–37 (M.D. Fla. 2007).

be included with other losses in the year that the taxpayer can reasonably expect no further reimbursement.²³ Where an estimated net 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 is limited to the tax benefits received on those losses to-date and the earlier year's tax return is unaffected. If the amount of the reimbursements received is more than the taxpayer's adjusted basis in the stolen property, a gain will be included as ordinary income up to the amount of the loss taken for the property in earlier years, and the rest will generally be a capital gain, but this situation is unusual in investment fraud.²⁴

Where a taxpayer has multiple casualties in a tax year, and those casualties 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, except where the taxpayers are filing jointly, in which case the loss is treated as one loss.²⁵ Theft losses are not subject to itemized deduction phase-out rules.²⁶

A. Calculating a Theft Loss

The amount of the theft loss is the lower of the decrease in FMV or the taxpayer's basis in the property.²⁷ FMV is "[t]he amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts."²⁸ In the case of theft, there is generally no FMV after the property is stolen. The costs of documenting a theft loss and determining the taxpayer's tax liability from the theft do not increase the amount of the theft loss, but are deductible as a miscellaneous itemized deduction subject to the 2% of Adjusted Gross Income (AGI) floor.²⁹

23. 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 \$100 floor again, but would be subject to the 10% limitation of the later year. I.R.C. § 165(h)(2)(A)(ii).

24. I.R.C. § 165(h)(2)(b) (2012). Where the taxpayer has a casualty gain, the taxpayer may be able to postpone reporting the gain by reinvesting the proceeds. Note that no \$100 per incident floor applies to gains. *Id.*

25. If spouses file separately, *each* spouse is subject to a \$100 floor for each casualty. Treas. Reg. § 1.165-7(b)(4)(iii) (2015).

26. I.R.C. § 68(c)(3) (2012).

27. Treas. Reg. § 1.165-7(b)(1)(i).

28. *Fair Market Value*, BLACK'S LAW DICTIONARY (6th ed. 1990).

29. I.R.C. § 67(b)(3) (2012).

A net operating loss (NOL) might result where a theft loss deduction for the year is more than income.³⁰ NOLs for individuals are normally carried back to offset taxes paid in the last two years and then carried forward to reduce taxes for up to twenty years.³¹ However, individuals may elect to forego carryback.³²

B. Examining Safe Harbor Provisions for Qualified Ponzi Scheme Victims

Ponzi scheme victims have additional help from Revenue Ruling 2009-9,³³ where a theft loss is claimed in the year of discovery, regardless of whether a partial recovery might result. Under this ruling, the amount of the theft loss is equal to the amount of the original basis plus the previous dividend and capital gain income declared and reinvested in the scheme, less the amount recovered to date.³⁴ This ruling simplifies accounting for the loss because the taxpayer avoids having to amend previous years' tax returns for the phantom dividend and capital gain income where the statute of limitations is still open. The taxpayer also avoids losing the tax on the phantom income where the statute of limitations for the refund has already been barred.³⁵ It also does not delay the theft loss for ongoing investigations that might produce minimal recoveries.

Revenue Procedure 2009-20 provides an optional safe harbor for qualified investors suffering a loss that arose under a Ponzi scheme.³⁶ A qualified investor is a taxpayer who transferred funds to the "lead figure" who promoted a "specified fraudulent arrangement" which caused an investment loss.³⁷ These investors may deduct their losses in the year of the discovery of the fraud, without regard to whether any of the investment may ultimately be recoverable.³⁸ The specified fraudulent arrangement must be a Ponzi scheme; other frauds do not qualify.³⁹ Conviction of a crime is not necessary to show fraud, provided the lead figure is: (1) indicted for fraud, embezzlement, or other theft loss; or (2) the subject of an ongoing state or federal criminal complaint where that complaint: (a)

30. I.R.C. § 172(d)(4)(C) (2012).

31. I.R.C. § 172(b).

32. Rev. Rul. 2009-9, 2009-14 I.R.B. 735, 736.

33. *Id.*

34. *Id.*

35. *Id.*

36. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

37. *Id.* § 4.03, at 750.

38. *Id.* § 5.01(2), at 751.

39. *Id.* § 2, at 749.

alleged an admission by the lead figure; (b) the assets of the arrangement have been frozen; or (c) a receiver/trustee was appointed with respect to the assets of the fraudulent arrangement.⁴⁰ Additionally, the investor must have had no actual knowledge of the fraud and otherwise be allowed a theft loss under IRC section 165 or under Regulations sections 1.165 to .168.⁴¹ Further, the fraudulent investment must not be a tax shelter.⁴²

The safe harbor applies to Ponzi schemes only where the lead figure: (1) receives cash or property from investors; (2) purports to earn income for the investors; (3) reports at least partially fictitious income to investors; and (4) misappropriates at least some of the investors' cash or property.⁴³ The safe harbor rules do not apply to: (1) unpaid loans of an investor from fraudsters; (2) fees paid to the responsible parties that have been deducted on the taxpayers' tax returns; (3) fraudulent income not declared as income on the taxpayers' tax return; and (4) indirectly invested cash or property paid to a fund or entity that in turn invested in the scheme.⁴⁴

Under the safe harbor rules, the taxpayer may deduct either 95% of the net investment loss if the taxpayer agrees to pursue no recovery from a third party, or 75% of the net loss if the taxpayer intends to pursue recovery from a third party.⁴⁵ Third parties do not include: (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.⁴⁶ Actual recoveries from any party and expected recoveries from insurance companies of the Securities Investor Protection Corporation are netted against the fraud loss.⁴⁷ Recoveries in excess of the remaining 5% or 25% loss are income to the taxpayer in the year of recovery under the tax benefit rule.⁴⁸ The safe harbor does not allow for the use of the theft loss deduction where there is not a Ponzi scheme nor does it allow its use for victims of fraud where there is no

40. *Id.* § 4.02, at 750.

41. *Id.* § 4.03(1) and (2), at 750.

42. *Id.* § 4.03(3), at 750. The definition for tax shelters is found in section 6662(d)(2)(C)(ii) of the Internal Revenue Code. I.R.C. § 6662(d)(2)(C)(ii) (2012).

43. Rev. Proc. 2009-20, 2009-14 I.R.B. 749, § 4.01, at 750.

44. *Id.* § 4.06(2), at 750.

45. *Id.* § 5.02(1), at 751.

46. *Id.* § 4.05, at 750.

47. *Id.* § 5.03, at 751; *see also* Treas. Reg. § 1.165-1(d) (2015); Rev. Rul. 2009-9, 2009-14 I.R.B. 735, 736-37.

48. Treas. Reg. § 1.165-1(d).

criminal charge against the perpetrator.⁴⁹ The focus of this Article is on using the theft loss deduction in cases where this safe harbor does not apply.

C. Evaluating Why There Would Be a Preference for Theft Loss Treatment over Capital Loss Treatment

Corporations prefer ordinary losses over capital losses because capital losses can only be offset by capital gains, with unused capital losses generally being carried back three years and forward five years.⁵⁰ For individuals, capital losses either offset capital gains in the year a security is sold or they become totally worthless.⁵¹ Where capital losses offset long-term capital gains, the tax savings can be as high as 20% plus Net Investment Income Tax at a rate of 3.8%.⁵² The first \$3,000 of excess capital losses over capital gains offset ordinary income,⁵³ and the remainder is carried forward to future years until used. A large loss net of capital gains can take many years to recoup, and the application of the loss amount does not consider the time value of money or inflation. Since a capital gain is only experienced when there is a sale or gain on property, they “are less likely to be recurring income. Thus, there is the potential that these losses may never be utilized in the investor’s lifetime.”⁵⁴

In addition, theft losses net of insurance reimbursement are deductible at higher, ordinary income tax rates, and if the property is an investment, they are deductible without regard to the 10% of AGI and the \$100 per incident floors for taxpayers who itemize deductions.⁵⁵ If the theft loss exceeds ordinary income for the year, a net operating loss may result⁵⁶ which can be carried back and applied to income from previous years at

49. Claire H. Taylor, *Helping Defrauded Investors Recoup Losses with the Tax Code: Advice for Litigators*, 21 PIABA B.J. 225, 225–26 (2014).

50. I.R.C. § 1212 (2012).

51. 26 C.F.R. 1.165-1. A mere decline in fair market value of securities held does not qualify as a deductible capital loss, Treas. Reg. § 1.165-5(f), unless the fair market value makes a security worthless. I.R.C. § 165(g). One might be tempted to conclude that since I.R.C. § 165(g) allows for individuals to have tax relief for securities becoming worthless, that it is not necessary to apply I.R.C. § 165(c) to securities frauds perpetrated on all individuals. However, courts have regularly applied the theft loss deduction in cases of securities fraud in which the privity between the purchaser and seller of the security was not broken. See *Vietzke v. Comm’r*, 37 T.C. 504 (1961).

52. I.R.C. § 1411 (2012).

53. I.R.C. § 1211 (2012).

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

55. I.R.C. § 165(h) (2012); Treas. Reg. § 1.165-7 (2015).

56. I.R.C. § 172 (2012).

ordinary tax rates.⁵⁷ This makes theft loss treatment more advantageous than capital loss treatment because more of the loss is recoverable for tax purposes immediately, and the remainder is generally recoverable at a faster rate under theft loss rules than under capital loss rules.⁵⁸

The existence of investment fraud however is insufficient to result in theft treatment. For example, in *Stoltz v. United States*,⁵⁹ fraud was confirmed when a taxpayer guaranteed a loan for a friend who misrepresented his ability to repay the loan.⁶⁰ While the friend's misrepresentation was fraudulent under state common law, the taxpayer was required to deduct the loss as a non-business bad debt, which is treated as a short-term capital loss.⁶¹ In another case, *Kaplan v. United States*,⁶² a couple unknowingly invested in a Ponzi scheme and declared fictitious income as represented on the false statements they received on their income tax returns for eight years before discovering they were being defrauded.⁶³ The couple was allowed a capital loss for their initial investment and directed to amend the income on their tax returns where the statute of limitations had not barred reducing the bogus income.⁶⁴ However, they were not allowed a casualty loss for the taxes paid on bogus income for which the statute was otherwise barred.⁶⁵

Chief Counsel Advice Memorandum 200811016 addresses a situation where a loss should be split between capital and theft losses.⁶⁶ Where a company begins to engage in fraud after operating legitimately, taxpayers who invested before the fraud was perpetrated receive capital loss treatment, whereas those relying on fraudulent statements and investing afterward would have a theft loss.⁶⁷ Where a taxpayer invested both before

57. Brian Elzweig & Valrie Chambers, *Modernizing the Theft Loss Deduction for Victims of Securities Frauds and Ponzi Schemes*, BANKING & FIN. SERVS. POL'Y REP., Sept. 2011, at 1, 7.

58. *Id.*

59. *Stoltz v. United States*, 410 F. Supp. 2d 734 (S.D. Ind. 2006).

60. *Id.* at 735.

61. *Id.* at 744; *see also* I.R.C. § 166 (2012).

62. *Kaplan v. United States*, 2008-1 U.S. Tax Cas. (CCH) ¶ 50,117 (M.D. Fla. 2007).

63. *Id.* at 83,133-34.

64. *Id.* at 83,135.

65. *Id.*

66. I.R.S. Chief Couns. Adv. Mem. 200811016 (June 22, 2007). In this Chief Counsel Advice Memorandum (CCA), the victims of the loss purchased investments directly from the company perpetrating the fraud. *Id.* This CCA does not directly address a situation where a taxpayer used an intermediary. *Id.*

67. *Id.*

and after the fraud, the loss would be bifurcated, causing an arbitrage of losses across differing tax rates.⁶⁸

D. Analyzing Theft Loss Versus Return of Capital

Taxpayers have argued that previously declared income from Ponzi schemes are not interest or dividend income as originally declared; instead they are a return of capital. However, if the fraud is not found to be timely, the statute of limitations may bar filing amended returns for previous years that correctly omitted fictitious income thought to be earned under the Ponzi scheme.⁶⁹ And, courts are divided on whether a reclassification is valid at all. In *Premji v. Commissioner*,⁷⁰ a taxpayer loaned money to a Ponzi scheme and received interest checks.⁷¹ The principal however was not fully paid, and the taxpayer attempted to reclassify the interest income that was declared as return of principal.⁷² In this case, the court denied the reclassification request.⁷³

However, there have been instances in which courts have granted taxpayers' requests for reclassification. In *Taylor v. United States*,⁷⁴ a taxpayer loaned money to a Ponzi scheme, receiving and declaring interest checks, but the principal was not entirely repaid.⁷⁵ Taylor was allowed to reclassify the interest income as principal because the broker/promoter never made any promises of return on investments.⁷⁶ Similarly, in *Kooyers v. Commissioner*,⁷⁷ a taxpayer loaned money in a Ponzi scheme, receiving interest checks, but lost principal in the scheme, then wanted to reclassify interest income as return of capital.⁷⁸ Here too, the reclassification was allowed, but for a different reason. The court looked to the promoter's intent, which was not to make interest payments but was instead to conceal fraud.⁷⁹ Further, early investors who could have viably recovered their

68. John C. Zimmerman, *Deducting Losses for Defrauded Investors*, TAX ADVISER, July 2009, at 442, 445 (discussing this arbitration).

69. See *Johnson v. United States*, 74 Fed. Cl. 360, 362–63 (2006).

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

71. *Id.* at 17.

72. *Id.* at 26.

73. *Id.*

74. *Taylor v. United States*, 98-1 U.S. Tax Cas. (CCH) ¶ 50,354, at 83,927 (E.D. Tenn. 1998).

75. *Taylor*, 98-1 U.S. Tax Cas. (CCH) ¶ 50,354 at 83,927.

76. *Id.* at 83,929–30.

77. *Kooyers v. Comm'r*, 88 T.C.M. (CCH) 605 (2004).

78. *Kooyers*, 88 T.C.M. (CCH) at 606–09.

79. *Id.* at 614.

investment were to be treated differently than later investors who had no viable chance of recovery. Only the later victims could reclassify previously declared income as return of capital.

This solution ignores the statute of limitations problem early investors may have. For these early victims, the safe harbor rules of Revenue Procedure 2009-20 are more appealing. In essence, since theft losses are not subject to the same limitations as capital losses and allow the taxpayer to deduct the full amount of the loss, in most cases they would be more advantageous to a taxpayer than the capital loss.

II. THE TRADITIONAL ELEMENTS OF STATE LAW AND INTENT

A. *What Is a Theft Under State Law?*

In order to be considered a theft for purposes of the theft loss deduction, it has been generally held that “a taxpayer must establish that a ‘theft’ occurred by showing that the taking is illegal under the law of the state in which it occurred . . . and that it was done with criminal intent.”⁸⁰ The notion that the theft has to be a violation of law of the state where it occurred is usually traced back to the often-cited *Edwards v. Bromberg* case, which was decided in 1956.⁸¹ In *Edwards*, the taxpayer was defrauded into giving a third party over \$50,000 to bet on a horse race.⁸² The race was supposedly rigged so that the taxpayer’s money was not at risk.⁸³ The third party, however, embezzled the money instead of betting it.⁸⁴ The government argued that the taxpayer was swindled, but the swindle did not meet the definition of a statutory theft in Georgia where the swindle occurred.⁸⁵ The Fifth Circuit rejected this argument stating that “theft” is not a term of art, “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.”⁸⁶ In determining this, the court used precedent showing that other previous interpretations of the theft loss did not require that the loss occur because of a violation of a criminal statute, but instead noted:

80. Taylor, *supra* note 49, at 229.

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

82. *Id.* at 109 n.3.

83. *Id.*

84. *Id.*

85. *Id.* at 110.

86. *Id.* (emphasis added).

[u]nder this line of decisions it has been long and well established that whether a loss from theft occurs within the purview of [the theft loss deduction statute] 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, 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.⁸⁷

Thus, *Edwards* has become the seminal case in determining that for a theft to be deductible as a loss, the theft must meet the definition of theft within the jurisdiction in which it occurred.

This determination was questioned recently in *Goeller v. United States*.⁸⁸ In *Goeller*, the taxpayers, who were located in California, had invested in an Ohio company that was buying and selling real estate.⁸⁹ There was a dispute over whether the company had filed certain mortgages and why the properties were no longer listed on the company's financial statements.⁹⁰ The taxpayers, with the help of Tobias Elsass and the Fraud Recovery Group (who also represented the company) filed amended tax returns claiming that the losses were due to theft and a refund should be given.⁹¹ The court noted that “[b]oth parties cite authority for the proposition that whether a ‘theft’ has occurred, for purposes of section 165(c)(3) of the Code, depends upon whether a theft has occurred under state law.”⁹² However, the parties disputed which state's law should apply: Ohio, where the company was located, or California, where the taxpayers resided.⁹³

The court noted that this required a determination similar to that of a conflict of laws to decide whether Ohio or California law would be determinative.⁹⁴ Instead, the judge thought the federal common law of theft could be used as well as appropriate state law.⁹⁵ The court examined the history of the associated rulings with previous rulings relying on state law to determine whether a theft occurred.⁹⁶ It was noted that the court in *Edwards* made the statement that whether or not there is a theft depends on

87. *Id.* at 111 (emphasis added).

88. *Goeller v. United States*, 109 Fed. Cl. 534 (2013).

89. *Id.* at 536.

90. *Id.* at 537.

91. *Id.* at 537–38.

92. *Id.* at 539.

93. *Id.*

94. *Id.*

95. *Id.* at 543.

96. *Id.*

the law of the jurisdiction where it was sustained.⁹⁷ The court noted that many cases then get into lengthy discussions about whether or not a theft meets the definition of theft within a particular jurisdiction.⁹⁸ Further, the court stated that “[n]either *Edwards* nor any of its progeny, however, explain why state law should control the definition of what is a ‘theft’—most opinions are satisfied to treat the sentence from *Edwards* quoted above as axiomatic.”⁹⁹ The judge opined that it is paradoxical to think that Congress would intend a state law reading for theft losses when other triggering events under section 165 of the IRC (including fire, storm, shipwreck and casualty) are given their plain meanings in determining whether there is a deductible loss.¹⁰⁰ The court noted that a fundamental principle that controls the construction of federal statutes is that the “plain meaning . . . should be conclusive,”¹⁰¹ and there is no reason to apply theft losses differently. The court noted:

The key word in the statute—“theft”—has a long-standing and well-accepted meaning. Familiar lexicons mark this path. Thus, [*Black’s Law Dictionary*] defines that term as “[t]he fraudulent taking of corporeal personal property belonging to another, from his possession, or from the possession of some person holding the same for him, without his consent, with intent to deprive the owner of the value of the same, and to appropriate it to the use or benefit of the person taking.” At least by the time the 1954 Code was enacted, it also was well-accepted that the definition of “theft” includes a crime in which one “obtains possession of property by lawful means and thereafter appropriates the property to the taker’s own use.”¹⁰²

The court stated that since nothing in the legislative history of IRC section 165 suggested otherwise, the longstanding rules of statutory interpretation require that the plain meaning must be used.¹⁰³ By using the words “or from the possession of some person holding the same for him,” *Black’s Law Dictionary* implies the use of an intermediary would not negate a theft loss.¹⁰⁴

97. *Id.* at 540.

98. *Id.*; see also *Alioto v. Comm’r*, 699 F.3d 948, 955 (6th Cir. 2012); *Estate of Meriano v. Comm’r*, 142 F.3d 651, 658 (3d Cir. 1998); *Bellis v. Comm’r*, 540 F.2d 448, 449 (9th Cir. 1976); *Stoltz v. United States*, 410 F. Supp. 2d 734, 740–41 (S.D. Ind. 2006). The court noted that these were just a sampling of many cases that cite *Edwards* for this authority.

99. *Goeller*, 109 Fed. Cl. at 540.

100. *Id.*

101. *Id.*

102. *Id.* at 542 (citations omitted).

103. *Id.*

104. *Theft*, BLACK’S LAW DICTIONARY (5th ed. 1979).

In examining the legislative intent, the court questioned why Congress would have intended the word theft to include “content independent from state law,”¹⁰⁵ but limit its use to the laws of the jurisdiction in which the theft occurred.¹⁰⁶ The court asserted that this would require federal trial courts to preside over mini-trials to determine if the precise and sometimes complicated elements of state criminal laws (oftentimes involving *mens rea* requirements) are violated to resolve the deductibility of a theft loss under federal law.¹⁰⁷ It questioned why Congress would not use the “plethora of Federal statutes that criminalize ‘thefts’ [including] various forms of larceny, embezzlement, fraud, and robbery; as well as money laundering, wire fraud, and other conduct associated with such crimes.”¹⁰⁸ The court noted that there were instances in which the courts have stated that a federal statute may be the basis for a plaintiff to take the theft loss deduction, but the plaintiff still has to “gauge the deductibility of his losses by hypothetically applying a state criminal law,”¹⁰⁹ rather than rely on the influence of federal statutes to outweigh specific state laws. The court noted the concerns of commentators that “the victims of securities fraud crimes prosecuted under Federal law might not qualify for deductions under section 165(c)(3) because their losses would not be viewed as resulting from thefts under state law.”¹¹⁰ Arguably, allowing a federal definition of theft would allow for the common application of the federal statute nationwide, simplifying multi-state cases such as *Goeller*, and streamlining federal tax results among taxpayers from different states.

After examining the legislative history and likely intent of Congress, the court stated that the *Edwards* reasoning has become a “shibboleth”¹¹¹ and that it has only become embedded in the jurisprudence of IRC section 165 because of its constant repetition. Since there is no basis in the history

105. *Goeller*, 109 Fed. Cl. at 545.

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*; see also *Brown Corp. of Ionia v. Comm’r*, 45 T.C.M. (CCH) 200, 213 (1982); *Nichols v. Comm’r*, 43 T.C. 842, 884–85 (1965).

110. *Goeller*, 109 Fed. Cl. at 545 n.29; see also Elzweig & Chambers, *supra* note 57, at 7.

111. *Goeller*, 109 Fed. Cl. at 540. A shibboleth is defined as “an old idea, opinion, or saying that is commonly believed and repeated but that may be seen as old-fashioned or untrue.” *Shibboleth*, MERRIAM-WEBSTER, <http://www.merriam-webster.com/dictionary/shibboleth> [https://perma.cc/TA8M-U343]. It comes from a story in the Hebrew Bible in which Gilead determined whether or not an Ephramite could cross the Jordan River. The language of the Ephramites had no “sh” sound so Gilead would tell them to say the word “shibboleth.” If a person pronounced it as Sibboleth, Gilead would know it was an Ephramite and would have the person slaughtered. *Judges* 12:6.

of the statute, and no legislative intent otherwise, the court maintained that the plain meaning should be used. This would include thefts as defined under federal common law.

B. What Is Intent?

It is important to note that in *Goeller*, at least in dicta, the court addressed the issue that securities fraud can rarely be the basis for the theft loss deduction. The analysis in *Goeller* is consistent with the definition of fraud for securities law as being equivalent to theft by false pretenses. One commentator noted: “Section 10(b), [which is the] heart of securities fraud [requires the fraudster]: ‘[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance.’”¹¹² This provision is further addressed in SEC Regulation Rule 10b-5.¹¹³ 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.’¹¹⁴

However, aside from requiring a state law definition of theft, securities fraud cannot usually be the basis for a theft loss deduction because the element of intent is often missing.¹¹⁵ Another often-cited requirement for use of the theft loss deduction is that there has to be intent to deprive the rightful owner of the property.¹¹⁶ The use of an intermediary appears to disqualify the taxpayer from claiming the theft loss except where the intermediary is acting as a feeder.¹¹⁷ Because intent to permanently deprive another of property is required to prove the theft in most jurisdictions, the IRS has argued that there needs to be direct privacy

112. Christine Hurt, *Regulation Through Criminalization: Of Breaches of the Peace, Home Invasions, and Securities Fraud*, 44 AM. CRIM. L. REV. 1365, 1371 (2007) (quoting 15 U.S.C. § 78j(b) (2006)).

113. *Id.*

114. *Id.* (quoting 17 C.F.R. § 240.10b-5 (2007)).

115. Valrie Chambers, Brian Elzweig, & Judson Stryker, *Unequal Tax Effects for Equivalent Stock Losses*, 148 TAX NOTES 447, 451 (2015).

116. *See, e.g.,* Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1956); Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

117. *See* Paine v. Comm’r, 63 T.C. 736, 737, 742 (1975); *see also* Jensen v. Comm’r, 66 T.C.M. (CCH) 543, 547 (1993).

between the one perpetrating the fraud and the one who is defrauded.¹¹⁸ *Black's Law Dictionary* defines “privity” as “mutual or successive relationships to the same right of property”¹¹⁹

In *Taghadoss v. Commissioner*,¹²⁰ the taxpayer purchased stock and exercised options through WorldCom’s 401(k) and employee stock purchase plan.¹²¹ WorldCom officials were convicted of releasing fraudulent financial statements, resulting in WorldCom filing for bankruptcy.¹²² The taxpayer argued that, while the company’s pension and stock purchase plans were legally independent entities from the company itself, the false financial statements from the WorldCom Corporation were a fraud against him as an investor.¹²³ However, Taghadoss did not produce evidence that he relied upon WorldCom executives’ assurances and no theft loss was allowed.¹²⁴ The IRS argued that while WorldCom executives committed fraud, under Virginia law the taxpayer was denied a theft loss on this stock because he technically did not purchase the stock directly from the corporation.¹²⁵ The IRS contended that there was no evidence WorldCom wrongfully and intentionally took the petitioner’s property with the objective to deprive him permanently thereof.¹²⁶ Further, the IRS argued that the petitioner had bought his securities not from WorldCom but through brokers.¹²⁷

In making its decision, the court relied on *Paine v. Commissioner*.¹²⁸ There, the court ruled that the “[p]etitioner 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 [the issuing company’s] officers.”¹²⁹ The court contrasted this position with that of *Vietzke v. Commissioner*,¹³⁰ where the taxpayer purchased stock in a new corporation directly from the directors of the corporation.¹³¹ The principals in the

118. See, e.g., *Goeller v. United States*, 109 Fed. Cl. 534, 549–50 (2013).

119. *Privity*, BLACK’S LAW DICTIONARY (6th ed. 1990).

120. *Taghadoss v. Comm’r*, T.C. Summary Op. 2008-44 (2008).

121. *Id.* at 2.

122. *Id.* at 2–3.

123. *Id.* at 7–8.

124. *Id.* at 8–10.

125. *Id.*

126. *Id.*

127. *Id.* at 9.

128. *Paine v. Comm’r*, 63 T.C. 736 (1975).

129. *Id.* at 742.

130. *Vietzke v. Comm’r*, 37 T.C. 504 (1961).

131. *Id.* at 505–06.

company withdrew large portions of the money and the Indiana state insurance commission halted further sale of the securities.¹³² The company was then put into receivership.¹³³ Although the court held that it “need not determine the exact nature of the crime under Indiana law,”¹³⁴ the court determined that the taxpayer had been defrauded of his money by a deception meeting the standard of a criminal appropriation with felonious intent, and thus meeting the meaning of “theft” under both Indiana law and section 165.¹³⁵ However, privity was not at issue here because the taxpayer dealt directly with the corporate officers who intended to defraud him. Similarly, in *First Chicago Corp. v. Commissioner*,¹³⁶ a taxpayer was allowed a theft loss deduction where the taxpayer made an investment in a foreign company from the company itself.¹³⁷

In *Jensen v. Commissioner*,¹³⁸ where the taxpayer was defrauded in a Ponzi scheme, the taxpayer purchased stock from a person unknowingly acting as a conduit for the fraudulent scheme.¹³⁹ There, the court hinted that privity could be indirect, stating:

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.¹⁴⁰

The key distinction in *Jensen* was not whether a broker was used, but what role the broker played in the investment. In this case, whether or not the broker knew of the fraud, the broker was ruled to be acting as a feeder for the corporation, rather than as a traditional broker working for the taxpayer.¹⁴¹ Some entities have been found to be conduits “only if they have no control over the disposition of the assets and no potential benefit to be gained from the assets by holding them.”¹⁴²

132. *Id.* at 507–08.

133. *Id.* at 508.

134. *Id.* at 511.

135. *Id.*

136. *First Chi. Corp. v. Comm’r*, 69 T.C.M. (CCH) 2089 (1995).

137. *Id.* at 2103.

138. *Jensen v. Comm’r*, 66 T.C.M. (CCH) 543 (1993).

139. *Id.* at 544–46.

140. *Id.* at 546.

141. Zimmerman, *supra* note 68, at 444.

142. I.R.S. Field Serv. Adv. Mem. CC:NA:MAN:TL-N-5745-95, 8 (Aug. 30, 1995) (citations omitted). In some circumstances the feeder may also be the victim of the fraud,

The 1960 case of *Boothe v. Commissioner*¹⁴³ went even further. In that case, Boothe owned a parcel of land that he had purchased with Soldier's Additional Homestead Rights, which allowed the holder to receive fee simple interest in some federal lands.¹⁴⁴ Boothe sold the rights to another party named Spoo, who was unable to exercise the rights due to an 1898 assignment of the rights known to neither Boothe nor Spoo.¹⁴⁵ Spoo sued Boothe, obtaining a judgment for breach of warranty of title; Boothe tried to claim the amount of the judgment as a theft loss.¹⁴⁶ The Tax Court held that the loss was a capital loss, not a theft loss because the origin of the claim was the sale of the property to Spoo.¹⁴⁷ Having held that the origin-of-the-claim argument was critical, the Tax Court then said in its majority opinion that "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."¹⁴⁸ There were two dissenting opinions filed.¹⁴⁹

However, the Ninth Circuit Court of Appeals sided with the first dissenting opinion (the Körner dissent), where the loss was split into two parts: the original purchase was to be considered a theft loss to Boothe because he purchased nonexistent rights in the land; and the loss on the subsequent sale of the property to Spoo was to be considered a capital loss.¹⁵⁰ Judge Körner noted that the "petitioner was the victim of a loss arising from theft, *even though he was not the immediate purchaser from the fraudulent vendor*" and that his loss entitled him to a theft loss deduction.¹⁵¹

In the second dissent (the Hamblen dissent), Judge Hamblen argued that the statute on its face required no privity, stating:

The language of section 165(c)(3) itself requires that "losses arise * * * from theft." In the absence of any compelling reason to

especially where the intermediary is a fund or entity in its own right. In *Willey v. Commissioner*, a taxpayer loaned money to three corporations who in turn invested in that money in fraudulent trust funds. *Willey v. Comm'r*, 75 T.C.M. (CCH) 1757, 1757 (1998). The corporations were allowed the theft loss; the taxpayer was denied a theft loss, but not a capital loss. *Id.* at 1758.

143. *Boothe v. Comm'r*, 82 T.C. 804 (1984), *rev'd per curiam*, 768 F.2d 1140 (9th Cir. 1985).

144. *Id.* at 805.

145. *Id.* at 806.

146. *Id.* at 807.

147. *Id.* at 809.

148. *Id.*

149. *See id.* at 809 (Körner, J., dissenting); *id.* at 812 (Hamblen, J., dissenting).

150. *Boothe v. Comm'r*, 768 F.2d 1140, 1140–41 (9th Cir. 1985). The case was then remanded for disposition consistent with that dissenting opinion. *Id.*

151. *Boothe*, 82 T.C. at 810 (Körner, J., dissenting) (emphasis added).

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.¹⁵²

That is, by adopting the view of the Körner dissent in a 10-8 decision, the Ninth Circuit has taken the very controversial approach that privity is not needed to claim a theft loss deduction.¹⁵³ With both the judicial controversy and the unusual facts of the case, most other courts have responded by marginalizing the holding of this case. One commentator observed that “*Boothe* [is] very citable, but the sharp differences in opinion noted by the Ninth Circuit persist.”¹⁵⁴ Two months later, the United States Court of Federal Claims relied on *Boothe* in *Krahmer v. United States*,¹⁵⁵ deciding that direct privity between the one perpetrating the fraud and the victim of the fraud was unnecessary.¹⁵⁶ Citing *Boothe*, the claims court in *Krahmer* stated that “[t]o 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.”¹⁵⁷

152. *Id.* at 816–17 (Hamblen, J., dissenting).

153. *Boothe*, 768 F.2d at 1140.

154. Anne-Marie Rhodes, *On Art Theft, Tax, and Time: Triangulating Ownership Disputes Through the Tax Code*, 43 SAN DIEGO L. REV. 495, 516 (2006).

155. *Krahmer v. United States*, 9 Cl. Ct. 49 (1985), *rev'd*, 810 F.2d 1145 (Fed Cir. 1987).

156. *Id.* at 52.

157. *Id.* at 53.

The Eleventh Circuit overturned the claims court's decision without discussing the *Boothe* decision on which the initial decision was based.¹⁵⁸ Additionally, the court in *Jensen* referred to the *Boothe* decision when it asserted "there is no requirement that an investor have direct contact with the entity in which he is investing."¹⁵⁹ However, the *Jensen* decision did not rely on the principle that no direct contact was required, because *Jensen* had contact through the seller's conduit.¹⁶⁰

In the 2008 case of *Electric Picture Solutions v. Commissioner*,¹⁶¹ involving a California-based taxpayer, the decision generally followed the Ninth Circuit opinion in *Boothe*.¹⁶² In this case, the taxpayer purchased shares of stock in Novatek International Inc. (Novatek) through a stockbroker.¹⁶³ Under allegations of fraud, Novatek filed for bankruptcy leaving the taxpayer no market in which to sell his shares.¹⁶⁴ The taxpayer alleged that the stockbroker also acted fraudulently by "making claims about the company in order to sell its stock," and by "breach[ing] the stockbroker's duty of truth and fitness for his customer's portfolio."¹⁶⁵ The court held that there was inadequate evidence that the stockbroker had the intent to deceive the taxpayer, and ruled against the taxpayer because of lack of privity between Novatek and the taxpayer, contradicting the *Boothe* decision.¹⁶⁶ The court mentioned *Boothe* only in a footnote, narrowly interpreting the *Boothe* holding:

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.¹⁶⁷

158. *Krahmer v. United States*, 810 F.2d 1145, 1147 (Fed Cir. 1987); see also Rhodes, *supra* note 154, at 518.

159. *Jensen v. Comm'r*, 66 T.C.M. (CCH) 543, 546 (1993).

160. *Id.*

161. *Elec. Picture Solutions, Inc. v. Comm'r*, 96 T.C.M. (CCH) 146 (2008).

162. *Id.* at 148.

163. *Id.* at 146.

164. *Id.*

165. *Id.* at 147.

166. *Id.* at 147-48.

167. *Id.* at 147 n.6. This ruling is consistent with Revenue Ruling 77-17, where a theft loss deduction was denied to a taxpayer who purchased a publicly traded corporate stock from a stockbroker, even though corporate irregularities led to a suspension of stock trading.

The concept of direct privity arises out of state laws which require the specific intent to defraud the specific victim, as opposed to the specific intent to defraud any victim from whom a perpetrator can deceive and profit. The interpretation of intent results in various case law decisions.

When dealing with an intermediary, it is possible the intermediary intends to defraud the purchaser, in which case, all other tests for theft loss being met, the purchaser can deduct a theft loss for the fraud. Where the intermediary does not intend to defraud the purchaser, a theft loss is allowed where the relationship of the intermediary is that of a feeder to the perpetrator to the fraud. Arguably, if the intermediary was merely an agent or performing ministerial tasks for the buyer, a theft loss should be allowed for the theft loss under agency theory also.¹⁶⁸ However, where the intermediary is independent of both the purchaser and the seller, the results are somewhat muddled.

C. *What Are the Exceptions to Privity?*

For a loss to be a theft loss, a party must purposefully intend to permanently deprive another of their property, or commit intentional misconduct or severe recklessness.¹⁶⁹ For example, in *Krahmer*,¹⁷⁰ the plaintiff purchased two paintings from an art dealer that were subsequently determined to be falsely attributed to famous artists. The plaintiff claimed a theft loss deduction under IRC section 165(c).¹⁷¹ The claims court focused on whether there was intent to defraud on the part of the art dealer. One painting had a counterfeit signature attributable to famous artist W.M. Chase. The other was unsigned but was accompanied by the art dealer's affidavit stating that the art dealer "had examined the painting, that it was

Rev. Rul. 77-17, 1977-1 C.B. 44, 46. The rationale in Revenue Ruling 77-17 was that the perpetrators of the corporate fraud did not specifically intend to defraud that specific taxpayer, nor did the company obtain possession to the taxpayer's property as was required under the definition of state law with jurisdiction. *Id.* at 45. In the alternative, it was not proven that the broker was fraudulent. *Id.*

168. The seller of investments often considers the broker to be the buyer's agent. For example, in Allianz's Privacy and Security Statement, they say, "we may collect your information from the following sources: From you, either directly *or through your agent*," where the agent includes the stockbroker facilitating the purchase of the investment. ADMINISTRATIVE OFFICE, ALLIANZ LIFE INS. CO. OF N.Y., PRIVACY AND SECURITY STATEMENT 1 (2012) (emphasis added), <https://laserapp.orcasnet.com/pdfs/%7B22050829-499C-4537-B761-9EB76938613C%7D.pdf> [<https://perma.cc/B7PH-KNUY>].

169. See *Ottmann v. Hanger Orthopedic Grp. Inc.*, 353 F.3d 338, 343-44 (4th Cir. 2003).

170. *Krahmer v. United States*, 9 Cl. Ct. 49, 51 (1985), *rev'd*, 810 F.2d 1145 (Fed Cir. 1987).

171. *Id.* at 49.

by Nicolas Poussin, and that its appraised value was \$75,000.”¹⁷² Neither painting was created by the attributed artist, and consequently, the plaintiff sold both paintings below his basis.

The court disallowed the theft loss deduction for the unsigned painting because the dealer had not “schemed to defraud [the plaintiff] on the purchase” of the unsigned painting.¹⁷³ 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.”¹⁷⁴ The claims court allowed the theft deduction for the signed painting stating that the “plaintiff has suffered a loss at the hands of a forger, however distant in time or 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.”¹⁷⁵ However, the allowance of the theft loss deduction was overturned on appeal.¹⁷⁶ The Federal Circuit stated that “[t]he court cannot presume that a theft occurred based solely on the presence of a forged signature on the painting. [The] [t]axpayer still must prove that the seller defrauded him by knowingly and intentionally misattributing the painting to the artist.”¹⁷⁷ That is, the Federal Circuit essentially required direct privity between the perpetrator of the fraud and the taxpayer who claims the theft loss deduction, and that view is held by most states. By extension, the result is that taxpayers relying equally on fraudulent financial statements who incur equal losses may be treated unequally under the tax code if one purchased the investment directly from the company perpetrating the fraud and the other purchased an equal investment from a broker; in the first case the fraud loss would be treated as a theft loss, while in the second case the loss would be treated as a capital loss because the second investor lacked direct privity with the fraud perpetrator.

D. What Are the Consequences?

In situations where one buys securities not directly from the seller, and not from an intermediary who is either party to the fraud, or a feeder or a conduit, the theft loss deduction for securities fraud has not been

172. *Id.* at 51.

173. *Id.* at 57.

174. *Id.* at 54.

175. *Id.* at 53.

176. *Krahmer v. United States*, 810 F.2d 1145, 1148 (Fed Cir. 1987).

177. *Id.* at 1147.

allowed.¹⁷⁸ A question that was left unanswered in *Goeller* is whether a brokered transaction, where direct privity was broken, could still be the basis for one to claim a theft loss deduction. By mentioning that “[s]everal commentators have expressed concern that the victims of securities fraud crimes prosecuted under Federal law might not qualify for deductions under section 165(c)(3) because their losses would not be viewed as resulting from thefts under state law,”¹⁷⁹ perhaps the judge was alluding to allowance for broader inclusion of securities frauds for theft loss deductions. This was not an issue in the case itself because the plaintiff bought securities directly from the company which committed the fraud.

The judge in *Goeller* proffered that the well-cited ruling in *Edwards* was a shibboleth since there was nothing in the legislative history that would require that a plaintiff to show that there was a taking of property that was a under the state law of the jurisdiction in which the taking occurred in order to claim a theft loss deduction.¹⁸⁰ Instead this was created by the *Edwards* case and its progeny through repetition of citation.¹⁸¹

Perhaps the same could be said of the direct privity rule between the plaintiff and the person committing the fraud. Analyses of the privity rule have been done previously, but in light of *Goeller*, it should be reexamined.¹⁸² Nothing in the legislative history of the theft loss deduction statutes mention this requirement.¹⁸³ Instead, the progeny of this seems to arise from the *Edwards* case as well. That is, privity is sometimes out of step with the plain meaning of theft (which merely includes the intent to deceive); and, nothing in the statute or legislative history necessitates that the thief and the plaintiff have direct privity.¹⁸⁴

A logical explanation of section 165 would require that a loss occur by theft. It does not require that the taxpayer necessarily be in direct privity with the thief. Indeed there are many ways in which one would be a victim of a theft without having direct privity with the thief. Logically, if one

178. See, e.g., *Taghadoss v. Comm’r*, T.C. Summary Op. 2008-44, at 10 (2008); *Paine v. Comm’r*, 63 T.C. 736, 737, 742 (1975).

179. *Goeller v. United States*, 109 Fed. Cl. 534, 545 n.29 (2013).

180. *Id.* at 540.

181. *Id.*

182. See, e.g., *Elzweig & Chambers*, *supra* note 57.

183. See H.R. REP. NO. 99-841, at II-342 (1986) (Conf. Rep.); S. REP. NO. 99-313 (1986); H.R. REP. NO. 99-426, at 658 (1985); H.R. REP. NO. 83-2543 (1954) (Conf. Rep.); S. REP. NO. 83-1622, at 23, 198 (1954); H.R. REP. NO. 83-1337, at 21, A46 (1954); H.R. REP. NO. 64-1200 (1916) (Conf. Rep.); S. REP. NO. 64-793 (1916); H.R. REP. NO. 64-922 (1916).

184. See I.R.C. § 165 (2015); see also BLACK’S LAW DICTIONARY, *supra* note 104, for a similar definition of theft.

buys stock through a broker and there is a fraud that renders the stock worthless, that person is no less a victim of the theft than one who bought stock directly from a company. Yet that appears to be the current interpretation of the law. In *Vietzke v. Commissioner*,¹⁸⁵ the taxpayer was allowed to take a theft loss deduction because he had bought the stock directly from the company.¹⁸⁶ It seems anomalous to say that the taxpayer in *Vietzke* was victimized any more than another investor who may have bought the same securities through a broker.

The question of victimization was also addressed by a dissenting opinion in *Boothe*.¹⁸⁷ The first dissent, which was adopted on appeal, allowed for the taxpayer to take the theft loss for purchasing nonexistent rights in land even though he was not the immediate purchaser from a fraudulent vendor.¹⁸⁸ The inequity between the victims who purchased from brokers and those who purchased from a fraudulent vendor was discussed, and it was argued that the plain interpretation of the statutory language could easily be read as one that protects all victims of thefts. The Ninth Circuit adopted this opinion, but noted that this was based on unusual facts that created sharp differences within the Tax Court. Because there is no reason not to think of someone using a broker as a victim, this would give those taxpayers equal access to the theft loss deduction regardless of privity. Perhaps this dissenting opinion should be more widely considered and adopted.

It is established that securities fraud may be considered a theft for the theft loss deduction, but not in cases where the securities were bought on an open market. These transactions have consistently been held to lack intent and privity.¹⁸⁹ The question that needs to be answered is: why is privity required, or rather, why is victimhood not enough? Case law has not explored this issue, but it was examined in commentary.¹⁹⁰ Three reasons are put forth as to why the IRS is concerned with direct privity to use the theft loss deduction: it is an “unexamined historical imperative, the traditional section 165(c)(3) suddenness requirement, . . . and [problems with] distinguishing theft from mistake.”¹⁹¹ These three rationalizations need to be discussed in light of *Goeller*.

185. *Vietzke v. Comm’r*, 37 T.C. 504, 510 (1961).

186. *Id.* at 511.

187. *Boothe v. Comm’r*, 82 T.C. 804, 809–10 (1984).

188. *Id.* at 817.

189. Taylor, *supra* note 49, at 230.

190. For a general examination of the privity requirement under I.R.C. § 165, see generally Rhodes, *supra* note 154.

191. Rhodes, *supra* note 154, at 518.

The historical imperative rationale seems to arise from the *Edwards* case, which relied “upon the law of the jurisdiction where [the theft] was sustained.”¹⁹² After *Edwards*, its progeny often cited this clause, based on shibboleth¹⁹³ without much examination as to whether its application made sense. This has been used by many subsequent cases to substantiate that there must be privity for this intent to be formed. There is nothing in the legislative history to show that this was the intent of the statute. Perhaps this too is a shibboleth. It is perfectly logical to interpret the statute to state there must be intent to commit the theft, but there only needs to be a connection between the loss and the theft as was stated in the dissent in *Boothe*.¹⁹⁴ This would require only that an intentional theft take place, but would allow the use of the theft loss deduction regardless of privity. Since this taxpayer would still be a victim of the theft, it would seem fair to allow federal income tax theft loss treatment.

The second argument for why there is a privity requirement is that other casualties listed in section 165(c)(3) have a suddenness to them. It is proffered that the term “or of theft” may be interpreted using “*ejusdem generis*, that is, [to] interpret the phrase in the light of the surrounding terms.”¹⁹⁵ This is the case for how courts have interpreted the phrase “other casualty” in section 165(c)(3).¹⁹⁶ Using *ejusdem generis*, courts have interpreted “other casualty” to only include sudden unexpected or cataclysmic events.¹⁹⁷ If the tincture of time underlies deductibility for “fire, storm, shipwreck, or other casualty,” it may, consciously or not, also color the interpretation of “or from theft.”¹⁹⁸ This argument, however, seems to be in contradiction with embezzlements, which can happen over an extended period of time,¹⁹⁹ as well as with the logic used in *Goeller*. The judge in *Goeller*, when describing why he felt that federal law should

192. *Edwards v. Bromberg*, 232 F.2d 107, 111 (5th Cir. 1956).

193. *Goeller v. United States*, 109 Fed. Cl. 534, 540 (2013).

194. *Boothe v. Comm’r*, 82 T.C. 804, 816 (1984) (Hamblen, J., dissenting), *rev’d*, 768 F.2d 1140 (9th Cir. 1985).

195. *See Rhodes*, *supra* note 154, at 519.

196. *Id.*

197. *Id.*

198. *Id.*

199. *See generally* *United States v. Ciccolini*, 750 F. Supp. 2d 850 (N.D. Ohio 2010), *vacated*, 491 F. App’x 529 (6th Cir. 2012); *see also* *United States v. Ohle*, 678 F. Supp. 2d 215, 223 & n.6 (S.D.N.Y. 2010) (stating defendant’s embezzlement spanned at least 2000–2003). In *Ciccolini*, an ordained Catholic priest founded the Interval Brotherhood House, a drug rehabilitation center, and subsequently embezzled approximately \$5 million from the center. *Ciccolini*, 750 F. Supp. 2d at 852. While the exact amounts and time periods of embezzlement are unknown, the crime extended from at least 2000–2007, and possibly decades before discovery. *Id.* at 853.

apply as well as state law, noted that court cases relying on the state definition of theft have not explained why state law is superior to federal law, continuing:

As such, none of them begin to explain why Congress would want state-by-state variability in the treatment of theft losses for Federal income tax purposes, particularly via a provision in which all the other triggering events for deductible losses—fire, storm, shipwreck, or casualty—are defined not by state law, but by reference to their plain meanings.²⁰⁰

If one were to understand the plain meaning of the statute to involve a theft, and only require a causal connection between the theft and the loss, there would be no reason to use maxims of interpretation such as *ejusdem generis*. The plain meaning would apply over such maxims. Theft is a broad term. There are some thefts which occur quickly, but some may evolve over time due to complicated schemes. If a theft took longer to commit, such as long-term embezzlement, it is no less a theft than if a person is robbed at gunpoint.

In addition, this would aid in resolving one of the main issues raised in *Goeller*. The judge opined that it was problematic to use state law because state-by-state variability existed in the interpretation of the term “theft” which made the application of the statute inconsistent.²⁰¹ The judge’s rationale behind this was that states differ on definitions of the word “theft” and “often deal[] with complicated questions involving the elements or *mens rea* requirements of particular state crime.”²⁰² Even if the courts were to allow federal common law to determine whether or not there is a theft, presumably it would be in addition to still allowing for state law to apply as well. Eliminating the privity requirement would ease the courts’ burden of determining if there is intent under state laws, increasing the likelihood that a victim of the theft would have relief. This judicial burden, left unabated by a refusal to allow a federal interpretation of theft, could continue to multiply as investors from all states use online brokerage houses and multistate (or multinational) brokerages to conduct trades.

The third argument that has been put forth, that problems have arisen surrounding the determination between theft and mistake, can also be debunked using the logic in *Goeller*. The fear is that by eliminating a requirement that there be “a nexus between thief and taxpayer[,] . . . [it] could ultimately blur the tax distinctions between generally deductible business losses and generally nondeductible personal losses so that all

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

201. *Id.*

202. *Id.* at 545.

losses become deductible.”²⁰³ The *Goeller* holding allows for federal common law to be the basis for taking a theft loss deduction. When talking about federal crimes of larceny, embezzlement, fraud, robbery, money laundering, and wire fraud, the *Goeller* decision asked, “[c]an it be that when a conviction for theft is obtained under one of these Federal statutes, a taxpayer harmed by that conduct must still gauge the deductibility of his losses by hypothetically applying a state criminal law?”²⁰⁴ It seems that, at least in cases where there was a conviction of a federal theft crime, the judge in *Goeller* would allow for the theft loss deduction to be taken.

The question remains: would securities fraud, which victimizes a person as much as any of the crimes contemplated in *Goeller*, be a basis for the deduction? The fear is that the taxpayers would claim the theft deduction in transactions unrelated to theft. Thus, the tax system would then “become an insurer of sorts not only for theft but mistakes in judgment as well, something Congress did not intend.”²⁰⁵

There is certainly the potential for abuse as with any other tax deduction. But by claiming the theft loss deduction, “the taxpayer bears the burden of proof to establish that he or she is entitled to the deduction.”²⁰⁶ In fact, the IRS has collected evidence that many people improperly claim investment losses as theft losses.²⁰⁷ However, the fact that many more people would use a deduction that is in line with Congressional intent is not a reason to limit the deduction. That would be in the purview of Congress. Congress could limit the use of the deduction for securities fraud only to those cases where there was a conviction or an indictment if it so wished to limit the deduction. Until then it is incumbent on the IRS to enforce the law as it is written.

Recently the IRS has made an effort to scrutinize the use of securities losses as the basis of a theft loss. The Treasury Inspector General for Tax Administration has recommended that the IRS increase ways to target investment losses as that are being claimed to be theft losses.²⁰⁸ Tax practitioners are also being warned that the IRS may be scrutinizing closely taxpayer claims of theft loss for investment losses.²⁰⁹ This, however, may lead to more cases in which the courts will interpret section 165(c)(3),

203. Rhodes, *supra* note 154, at 520.

204. *Goeller*, 109 Fed. Cl. at 545.

205. Rhodes, *supra* note 154, at 520.

206. Taylor, *supra* note 49, at 236.

207. *Id.* at 243.

208. *Id.* at 244.

209. *Id.* at 243.

which could ultimately soften or eliminate the privity requirement in light of *Goeller*.

The shibboleth argument also has merit because prior to the twentieth century, the evolution of fraud and theft was very slow, if at all existent. At the beginning of the twentieth century, national organized stock markets emerged, providing both financial opportunities and additional opportunities to defraud investors. The number of companies choosing to be a separate legal entity (corporation) increased dramatically, and more professional managers were hired for salary and sometimes a performance bonus, generally based on corporate net income. Brokers, as a group, sold both valuable and specious investments to investors who were largely removed from the day-to-day operations of the company in which they invested. Some of the early problems with stock market abuses were cured by the Securities Acts of 1933 and 1934.²¹⁰

Over time, management compensation rose until Congress, incensed at the amount officers of public corporations were paid, limited the amount of officer compensation that a corporation could deduct to \$1,000,000 (not indexed to inflation), except to the extent that the excess compensation could be tied to corporate performance.²¹¹ To get around these rules, corporations began shifting the way they compensated managers from cash salary plus bonus (both of which were taxable to the corporate officer immediately at ordinary income tax rates) to a base cash salary plus corporate stock options.²¹² Corporations had found that by paying officers

210. Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77a (2012)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78a (2012)).

211. I.R.C. § 162(m) (2012).

212. I.R.C. § 422(b) (2012). This statute defines an incentive stock option as:

[A]n option granted to an individual for any reason connected with his employment by the employer corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

- (1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;
- (2) such option is granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;
- (3) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted;
- (4) the option price is not less than the fair market value of the stock at the time such option is granted;

in corporate stock as well as cash, corporate officers had a greater incentive to see not just profits rise, but corporate stock prices as well, which of course directly increased the wealth of all investors. Further, incentive stock options are taxed favorably for regular income tax purposes. Qualifying incentive stock options are not taxed when granted or exercised.²¹³ Income or loss is not reported until the stock is sold. If the stock is acquired by the exercise of the incentive stock options is held for more than one year after acquisition and more than two years after the incentive stock option is granted, there will be a long-term capital gain or loss on the sale equal to the difference between selling price of the stock in the option price paid when the incentive stock option is exercised. If the incentive stock option is sold before meeting the one-year and two-year holding period tests, a gain on the sale is generally treated as ordinary income to the extent of the excess of the value of the stock when incentive stock option is exercised over the option price. Any gain in excess of this “option spread” is reported as capital gain. Thus, executives could defer taxes on their compensation until the underlying stock was sold years later, and then they would be taxed at lower, long-term capital gains rates rather than at ordinary income tax rates. However, if the FMV of the stock for which incentive stock options may first be exercised in a particular year by an employee exceeds \$100,000, the excess is not considered a qualifying incentive stock option.²¹⁴ Incentive stock options might also possibly produce a substantial liability for alternative minimum tax.²¹⁵

Mathematically, this multiplied the incentive to produce fraudulent income statements. An officer who made a base salary plus a hefty 10% of net income performance bonus would, at a 45% ordinary federal and state tax rate, be left with an incentive equal to 5.5% of net income after tax for the year. An officer who made a base salary plus incentive stock options of

(5) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(6) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation.

Such term shall not include any option if (as of the time the option is granted) the terms of such option provide that it will not be treated as an incentive stock option.

Id.

213. I.R.C. § 421(a) (2012).

214. I.R.C. § 422(d).

215. I.R.C. § 56(b)(3) (2012).

similar projected net present value now would not be taxed on the stock options now and those stock options would not be an expense on the corporation's income statement. The stock price, which was loosely a multiplier of earnings per share (EPS), would rise faster without this performance compensation deduction. The value of the stock options would rise with the stock price, and tax on this increase was deferred until the stock option was exercised and the subsequent stock was sold. So, if that officer received a 10% bonus in incentive stock options, and the EPS was 25 times, and the tax rate was cut to 20% now, 20% in the future, the incentive to keep stock prices high was much greater than under the cash bonus option.

Further, during the 1990s and early 2000s, stock options were frequently equal to or exceeded the corporate officer's salary.²¹⁶ That is, rather than being paid primarily for a corporate officer's work input, the value of the corporate officer's compensation and net wealth was largely based on an increase in stock prices, of which the net income of the corporation was the primary factor under the corporate officer's control.²¹⁷ This created a new environment (not historically considered in the development of state theft law) where corporate officers whose corporate net income was otherwise not meeting market expectations would have an incentive, for their own personal gain and the gain of the corporation of which they were an agent, to produce fraudulent financial statements. The intent would be to deceive investors—all potential investors, not just specific investors—into paying more for the corporate stock so that the corporate officers' wealth increased. This increased wealth could be locked in with the sale of the stock at the officer's convenience, even where the officer had inside knowledge.

The intent was also to deceive brokers into feeding investments into the purchase of corporate stock, whether that stock be a new issuance or purchased from the open market, so long as the stock price remained (artificially) high so that officer wealth was maximized.²¹⁸ The strategy worked this way: the appearance of a strong company financial

216. See STEVEN BALSAM, ECON. POLICY INST., TAXES AND EXECUTIVE COMPENSATION 9–10 (2012), <http://www.epi.org/publication/taxes-executive-compensation/> [<http://perma.cc/9GHF-569X>].

217. See Steven Balsam & David Ryan, *The Effect of Internal Revenue Code Section 162(m) on the Issuance of Stock Options*, in 18 ADVANCES IN TAXATION 3, 3 (Suzanne Luttmann ed., 2008) (“The results of this study show that the propensity to issue stock options has increased for affected executives as a percentage of total compensation. Additional analysis suggests that this increase in stock-option compensation is substituting for lower increases in salary for affected executives . . .”).

218. ENRON: THE SMARTEST GUYS IN THE ROOM (Magnolia Home Entertainment 2005).

performance boosted stock prices in the open market, even if that appearance was inaccurate. All stockholders benefited while stock prices were high, including manager-stockholders; but, manager-stockholders had an advantage: they could issue fraudulent financial statements if they were disappointed in actual financial results, keeping the value of their company stock high, and they could sell their shares at the artificially high price and exit the market before the market discovered the fraud. Thus, manager-stockholders could profit from the fraud at the expense of other investors in the market who bought the stock at artificially inflated prices. These investors, individually and in the aggregate, would lose money upon the discovery of the manager-stockholders' fraudulent statements, regardless of whether they had purchased their stock from the company directly or from an intermediary, as management conspired to build their own wealth.

The law is settled that this circumstance is a fraud.²¹⁹ State laws have not yet evolved to recognize the sophisticated, twice-removed intent to deprive another of their property. Unlike a corporation defrauding an investor directly, a corporate officer in his capacity as an agent uses the corporation to deceive the market, with the intent to take property from investors to maintain an inflated market price for personal gain. The privity is not as direct, but it is there. And, it is time for the law to evolve with the circumstance for the purpose of furthering justice.

E. *Why Now?*

The recent convergence of at least three factors justifies a federal definition of theft from fraud for nationally and internationally traded securities. First, the size and sophistication of frauds perpetrated by companies increases the cost to society of not correcting the broker versus non-broker inequity.²²⁰ That is, the frauds appear to have gotten more complex over the last fifty years. Second, brokerages provide more convenient services than they historically have, which allows for wider use of brokerages.²²¹ It is often difficult for small investors to piecemeal a balanced portfolio by buying directly from publicly-traded companies. By buying through a brokerage, all stocks can be organized on one statement.

219. See, e.g., *United States v. Martoma*, 48 F. Supp. 3d 555 (S.D.N.Y. 2014).

220. *Keeping Up with Fraud Sophistication: How to Leverage Advanced Analytics*, SAS, <http://www.sas.com/reg/gen/corp/765251> [<http://perma.cc/PMJ3-BPJ5>] (last visited Mar. 11, 2016).

221. Selena Maranjian, *The Online Stock Broker: A Great Way to Invest*, MOTLEY FOOL (Feb. 10, 2014), <http://www.fool.com/investing/brokerage/2014/02/10/the-online-stock-broker-a-great-way-to-invest.aspx> [<https://perma.cc/5Y7Y-NHBY?type=source>].

Online brokerages make trading convenient, and brokerages must now generally provide tax basis as well as proceeds information to taxpayers when they sell their stock.²²² In short, the stockbrokers absorb some of the accounting for the stock, which is more convenient than having to independently obtain this information from (presumably multiple) corporations. Finally, securities law has evolved faster than its income tax theft loss counterpart.²²³ *Ceteris paribus*: these two sets of federal law should be largely harmonized. All of these factors had not evolved quickly enough to warrant a sense of immediacy until recently. Since the turn of this century the number and size of frauds should inspire the realization that there is an inequity in the tax treatment, and in action to correct this inequity.

III. CASES SINCE GOELLER

Pursuing a fraud loss through district courts may continue to produce a ruling contrary to this argument and that of the *Goeller* decision because district courts rely on the individual state definitions of theft, which in turn rely on privity (whereas federal or the plain meaning of theft do not). For example, in *Adkins v. United States*,²²⁴ the plaintiffs legitimately suffered an uncontested \$2,336,895.58 fraud loss from a pump-and-dump scheme through a local broker-dealer, Donald & Co. Securities, Inc. [Donald & Co.], but claimed an additional \$239,062.61 that the IRS disputed met the qualifications for a fraud loss.²²⁵ The IRS argued that there was a lack of privity between the fraudster and the investor, or, if meeting the criteria for being a fraud loss, it did not meet the requirements in the year the fraud loss was claimed.²²⁶ Adkins contended that \$194,062.61 of the \$239,062.61 loss on three securities (My Turn, Tera Computer Co., and Great Train Store Co.) was a fraud loss because, while the securities were purchased through a third party. They were purchased on the advice of Donald & Co.²²⁷ Adkins contended that the remaining \$45,000 was supposed to be a return of capital originally sent to an underwriter (thus not credited to Adkins' Donald & Co. account) for the purchase of a Vianet IPO stock issue that turned out to be oversubscribed and thus not

222. *Id.*

223. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S.C.).

224. *Adkins v. United States*, 113 Fed. Cl. 797 (2013).

225. *Id.* at 804.

226. *Id.*

227. *Id.*

purchased.²²⁸ Instead of being returned to Adkins by the underwriter, that \$45,000 was retained and a different \$45,000 check was mailed to Adkins and debited to the Donald & Co. account.²²⁹ Both parties sought summary judgments for their positions.²³⁰

In reaffirming that the “the perpetrator must have had the specific intent to deprive the victim of his property,”²³¹ Judge Sweeney cited *Goeller*, stating “[m]ost courts analyzing whether a particular criminal act constitutes a theft for the purposes of IRS Sc. 165 refer to state law, but in a recent decision, the Honorable Francis M. Allegra of this court determined that the definition of theft should be derived from federal common law.”²³² Judge Sweeney went on to state that direct privity between the perpetrator and the victim must be present for a fraud loss to be taken.²³³ While Donald & Co. manipulated the price of the stocks purchased by Adkins, the third-party brokers were not involved in the manipulation itself, and they were the party that received the funds from Adkins directly.²³⁴ Adkins asserted that since they were merely following the advice of a Donald & Co. broker when they purchased from the third-party brokers, and because Donald & Co. was the perpetrator of the pump-and-dump fraud, Donald & Co. affirmatively intended to deprive Adkins of the investment.²³⁵ Here, the judge refused to grant summary judgment, saying that there is no requirement that an investor have direct contact with the entity in which he is investing.²³⁶

The remaining two stock purchases, Tera Computer Co. and Great Train Store Co., were made solely on the advice of third-party brokers, and as such, the judge ruled that there was no privity between Adkins and Donald & Co. with respect to these purchases.²³⁷ Accordingly, the judge granted the IRS’ request for summary judgment against taking a theft loss for these purchases.²³⁸

228. *Id.* at 800.

229. *Id.* at 806.

230. *Id.*

231. *Id.* at 804.

232. *Id.* at 804 n.9.

233. *Id.* at 804.

234. *Id.* at 805.

235. *Id.*

236. *Id.*

237. *Id.* at 804–06.

238. *Id.* at 806.

There was conflicting evidence regarding the final \$45,000 for the IPO, for which summary judgment was denied.²³⁹ Ironically, on April 5, 2011, an appeals officer concluded that Adkins had sustained a theft loss of \$2,532,996.01—very close to the \$2,336,895.58 Adkins originally sought—but because Adkins had previously filed suit in the United States Court of Federal Claims on December 10, 2010, that decision was void.²⁴⁰ The opinion of the appeals officer, while not authoritative, may indicate a somewhat sympathetic interpretation for victims of fraud loss at a federal level that does not otherwise meet the definition of a fraud loss at a state level.

Another example was presented in *United States v. Elsass*,²⁴¹ in which the United States brought suit against a tax preparer and his companies to enjoin them from providing services to taxpayers on the grounds that defendants had frequently violated tax laws.²⁴² The defendant, Elsass, was an attorney whose law license was suspended in 1998.²⁴³ The suspension was in part because of “repeated acts of dishonesty, deceit, and failure to abide by [the Supreme Court of Ohio]’s orders.”²⁴⁴ Recognizing the added value of a theft loss for tax purposes over a capital loss, Elsass opened two wholly-owned companies that he promoted as having an expertise in theft loss, Fraud Recovery Group, Inc. (FRG) and Sensible Tax Services, Inc. (STS).²⁴⁵ Elsass and his companies marketed to investors that they were in the business of helping taxpayers claim tax refunds through tax deductions for theft losses arising from investment scams like Ponzi schemes.²⁴⁶ The business marketed to potential victims of investment fraud losses and assisted them in filing amended tax returns, taking approximately 15% of the resultant income tax refund.²⁴⁷ They were accused of attempting “to obtain theft-loss deductions for their customers in instances where doing so [was] improper or altogether groundless.”²⁴⁸ Generally, they took theft

239. *Principal Life Ins. Co. v. United States*, 116 Fed. Cl. 82, 108 (2014) (citing *Goeller v. United States*, 109 Fed. Cl. 534, 539 (2013)) (stating that a taxpayer must prove the existence and amount of a claimed loss under I.R.C. § 165). This is undisputed and tangential to this article.

240. *Adkins*, 113 Fed. Cl. at 803.

241. *United States v. Elsass*, 796 F.3d 390 (6th Cir. 2014).

242. *Id.* at 391.

243. *Columbus Bar Ass’n v. Elsass*, 713 N.E.2d 421, 421 (Ohio 1999). It should be noted that Elsass was the same person who represented the plaintiff in *Goeller*. *Goeller v. United States*, 109 Fed. Cl. 534, 538 (2013).

244. *Columbus Bar Ass’n*, 713 N.E.2d at 425.

245. *Elsass*, 796 F.3d at 390.

246. *Id.* at 392.

247. *Id.*

248. *United States v. Elsass*, 978 F. Supp. 2d 901, 907 (S.D. Ohio 2013).

losses where not all the criteria for doing so were met, or sometimes as a “for AGI” deduction where a “from AGI” deduction was indicated or where a capital loss was indicated instead of a theft loss.²⁴⁹

In one set of losses, Elsass deducted losses from investments in American Business Financial Services, which sold high-interest, subprime mortgage-backed securities.²⁵⁰ Fraud was never proven, and at the time Elsass deducted the losses, the amount of the expected recovery—including the possible recovery of all losses—was uncertain. The district court found that Elsass and FRG demonstrated reckless disregard for the criminality and distorted pertinent information on hundreds of returns by insisting that 2005 was the proper year of discovery.²⁵¹ This behavior continued after the IRS issued disallowances of this theft loss to individual taxpayers and/or FRG employees. As of December 2009, FRG had filed 168 theft loss claims after the first IRS notice of disallowance.²⁵² The IRS sent 137 notices of disallowance to FRG and its taxpayers overall.²⁵³ While it appeared as though FRG clung to 2005 dogmatically in filing theft losses for ABFS investors, they seemed to have been ethically negotiable; an internal FRG document discovered by the government listed ABFS losses as occurring in 2005 with a note that “Per Toby this can be put in ‘06 if it works better.”²⁵⁴ That is, whether the loss was a theft loss is questionable at best, but in any case, it was not a theft loss in the year(s) indicated by FRG.

In a second set of loss claims, FRG deducted losses from a documented Ponzi scheme, but willfully and/or recklessly filed the theft loss claims using 2004 as the year of discovery, which was several years before the amount of partial investor recovery was determinable.²⁵⁵ FRG continued to market 2004 as the year of the theft loss to potential clients even after the IRS determined that 2004 was premature for a determination that there would be no further recovery.²⁵⁶

In a third group of filings, FRG claimed theft losses where a mortgage broker used investors’ money for specific real property purchases in exchange for monthly interest payments.²⁵⁷ When the housing market failed, the mortgage broker declared bankruptcy and investors became

249. *Elsass*, 796 F.3d at 393.

250. *Id.* at 392–93.

251. *Id.* at 396.

252. *Elsass*, 978 F. Supp. 2d at 919–20.

253. *Id.* at 919.

254. *Id.* at 920.

255. *Id.* at 921.

256. *Id.* at 920–22.

257. *Id.* at 924.

owners through foreclosure of the properties in which they had invested.²⁵⁸ No criminal intent was proven, indicating that proper treatment of this investment was a capital loss.²⁵⁹

FRG's improper claims of theft losses were complicated by how the theft losses were claimed. Repeatedly, "when customers' losses could not be extended forward or backward, Elsass instructed employees . . . to use Form 4797 for the purpose of entitling the customer to additional deductions or state refunds through lowered AGI."²⁶⁰ The court called this "shopping' between claiming the theft loss above versus below the line."²⁶¹ In one instance, Elsass issued instructions to process a tax return "as a 4797 if its [sic] better,"²⁶² and in another instance claimed a "sold" date of November 30, 2005 on an ABFS investment to make an improper classification seem more proper. In a summary judgment, Elsass' sale of a material theft loss plan, consisting of fraudulent statements and misrepresentations on the tax return that he had reason to know were false or fraudulent, was determined to be an abusive tax shelter in violation of IRC section 6700.²⁶³

Elsass appealed, relying heavily on the *Goeller* decision challenging the district court's finding that the theft loss deductions were improper and that defendants were reckless in claiming them.²⁶⁴ Further, Elsass asserted that the district court should have relied on the federal claims court's definition of theft.²⁶⁵ The defendants did not dispute that they engaged in other prohibited practices, including inflating the tax refunds by taking casualty losses "above the line" that should be taken "below the line," claiming theft loss deductions for losses incurred by taxpayers' deceased relatives, negotiating taxpayer refund checks, misrepresenting his eligibility

258. *Id.*

259. *Id.* at 924–25.

260. *Id.* at 929.

261. *Id.*

262. *Id.*

263. *Id.* at 936. Additionally, Elsass and FRG employees negotiated at least 510 refund checks in violation of I.R.C. section 6695(f), and continued to negotiate checks after the lawsuit was filed against them in District Court. *Id.* at 931. Elsass misrepresented his eligibility to practice before the IRS as an attorney in good standing, and possibly committed perjury on several Form 2848 "Declaration of Representative" forms. *Id.* at 940. The court found that "FRG's use of contingent fees only amplifies [the risk of continuance], as it creates an incentive to aggressively pursue theft-loss claims regardless of the claims' underlying merits." *Id.* Correspondingly, the District Court issued permanent injunctive relief. *Id.* at 941.

264. *United States v. Elsass*, 769 F.3d 390, 394 (6th Cir. 2014).

265. Brief of Defendants-Appellants at 21–35, *United States v. Elsass*, 769 F.3d 390 (6th Cir. 2014) (No. 13-4358).

to practice before the Internal Revenue Service, and making false or fraudulent statements pertaining to the allowability of deductions, that in themselves would warrant an injunction.²⁶⁶ The appellate court thus upheld the injunction and declined to consider the propriety of the theft loss deductions as it pertained to propriety of the district court's injunction. "We note, however, that defendants' primary argument—that the district court applied an incorrect definition of 'theft'—is, in any event, meritless."²⁶⁷ The appellate court notes that the district court located in the Sixth Circuit relied on both the state law definition and also the Fifth Circuit's definition of theft as "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."²⁶⁸

Generally, one federal court of appeals is not bound to follow the decisions of other courts of appeals. Relying on previous circuit rulings—even where circuits themselves conflict—is consistent with stare decisis. The federal tax court, for example, will conform to the appellate court rulings of a particular jurisdiction even if it disagrees with the holding, under the *Golsen* rule.²⁶⁹ Thus, the judge in *Elsass* did not analyze whether federal law, as applied in the *Goeller* decision, could be the basis for use of the theft loss deduction. Four reasons for this were given. First, relying on *Alioto*,²⁷⁰ the appellate court asserted that under the established law of the Sixth Circuit, "[w]hether a 'theft' has occurred for purposes of Section 165 is determined by the law of the jurisdiction where the theft took place."²⁷¹ Second, the district court did not rely solely on the state law definition of theft, but also used the Fifth Circuit's broad definition of theft.²⁷² Third, the court ruled that by not stating any distinction between the federal and state definitions of theft, *Elsass* forfeited the argument that federal law should apply.²⁷³ Finally—and according to the court most importantly—even if the district court had relied on *Goeller*, "there [was] no indication that the outcome would have been any different"²⁷⁴ because in two of the three sets of losses, no criminal intent was found, and in the third, the presence of the theft loss was undisputed; it was the amount, timing and

266. *Id.*

267. *Elsass*, 769 F.3d at 392.

268. *Edwards v. Bromberg*, 232 F.2d 107, 110 (5th Cir. 1956).

269. *See Golsen v. Commissioner*, 54 T.C. 742, 756–57 (1970).

270. *Alioto v. Commissioner*, 699 F.3d 948, 955 (6th Cir. 2012).

271. *Elsass*, 769 F.3d at 397 (citing *Alioto*, 699 F.3d at 955).

272. *Id.*

273. *Id.*

274. *Id.*

placement of the theft loss that was in dispute.²⁷⁵ By finding that there was no basis in fact for adopting the argument, the court did not have to get into an analysis, similar to the one in the *Goeller* case, of whether federal law should apply.

Instead, the court relied on stare decisis within the Sixth Circuit. By pointing out that the “most important”²⁷⁶ reason for ruling the way it did was that the outcome would not have changed, perhaps the court was signaling that that analysis would be saved for a future case in which the federal definition of theft would conflict with the state’s, alternatively permitting or denying a theft loss claim. Until that time, litigants may be enticed by what appears to be an advantage to claiming a theft under federal law, resulting in an issue of forum shopping because the case may be brought in the United States Court of Federal Claims instead of the jurisdiction in which the loss occurred.

In *Greenberger v. United States*,²⁷⁷ a federal district judge denied a theft loss deduction in connection with a stock where the company’s former executives were convicted of a pump-and-dump securities fraud.²⁷⁸ The court noted that “theft, [as used in section 165], is a ‘word of general and broad connotation, intending to cover . . . any criminal appropriation of another’s property to the use of the taker, particularly including theft by swindling, false pretenses, and other forms of guile.’”²⁷⁹ Quoting *Elsass* as Sixth Circuit precedent, the court relied on the state law of Ohio, which was where the theft took place.²⁸⁰ The court found that in Ohio, “criminal theft statutes require privity between perpetrator and victim in order to establish that the perpetrator has a specific intent to deprive the particular victim.”²⁸¹ Because the taxpayers bought the shares on the open market rather than directly from the entity or wrongdoers, intent to take their property was not proven.²⁸²

The court then examined the state law definition of “theft offense.”²⁸³ While the Ohio Supreme Court has held that securities fraud is a theft offense, the district court found that the definition of “theft offense” was a

275. *Id.*

276. *Id.*

277. *Greenberger v. United States*, No. 1:14-CV-01041, 2015 U.S. Dist. LEXIS 80643 (N.D. Ohio June 19, 2015).

278. *Id.* at 4.

279. *Id.* at 14 (alteration in original) (quoting *Elsass*, 769 F.3d at 397 and *Edwards v. Bromberg*, 232 F.2d 107, 110 (5th Cir. 1956)).

280. *Id.*

281. *Id.* at 15–16 (quoting *Schroerlucke v. United States*, 100 Fed. Cl. 584, 598 (2011)).

282. *Id.* at 17.

283. *Id.* at 27–30.

term of convenience used in the Ohio Revised Code for a variety of purposes.²⁸⁴ Because the term “theft offense” is not itself a substantive crime, the district court rejected this term as a standard for theft loss because “almost any deceptive act or practice that has an effect in Ohio could be the basis for claiming a theft-loss deduction . . . [which] goes against the mandate that tax deductions are to be construed narrowly.”²⁸⁵

CONCLUSION

State laws have not evolved to recognize the refined and remote intent to deprive another of their property. Today, rather than corporations defrauding an investor directly, corporate officers in their capacity as agents use corporations to deceive the market with the intent to take property from investors to maintain an inflated market price for personal gain. The privity is not as direct, but, we argue, it is there.

Congress should allow a theft loss deduction in an amendment to IRC section 165(c) where a stockbroker or other intermediary was used, provided that all other provisions supporting a theft loss are met. Congress could also delegate the writing of a revenue regulation to the Internal Revenue Service. In the meantime, courts could give deliberate consideration in each case as to whether the federal common law serves as a better and more consistent basis than state law for the determination of theft losses where intermediaries are used. By applying a plain meaning to securities cases where an intermediary served as a conduit to the purchase of securities and the underlying corporation was committing fraud, greater equity among geographic victims and greater equity among investors (the smaller of whom often cannot easily buy stocks directly from a corporation) could be achieved, with the side benefit of a lesser administrative burden for the courts in multistate cases. Due to the inequities both in opportunity and in result, it is time for the law to evolve for the purpose of furthering justice.

284. *Id.* at 29.

285. *Id.* at 30.