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Update on Theft Losses: *McNely v. Commissioner*

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Although the Internal Revenue Code ("Code") has long allowed a deduction for losses attributable to theft and casualty, claims for the deduction of such losses are often challenged and sometimes disallowed. Even where it is undisputed that a theft occurred, and the amount of the loss is also clear, a deduction for theft under Code Section 165 may be disallowed if the loss was not claimed in the appropriate year. *McNely v. Commissioner* (TC Memo 2019-39), a recent Tax Court memorandum decision discussed below, sustained an IRS determination that no theft loss was allowable, and provides some useful lessons as to traps for the unwary in this context.

Facts in *McNely*

Donnovan McNely and Jeffrey McKay incorporated M & M Properties, Inc. ("M & M") in 2008 and each owned 50% of the stock of M & M, which was an S corporation for Federal tax purposes. M & M was initially involved in the real estate business in northern California exclusively, but then began to purchase distressed real estate properties in southern California, including six such properties in 2010.

The sales of southern California properties to M & M turned out to be part of a fraudulent scheme in which bank debt secured by each property that was supposed to be paid off in connection with each sale was not in fact paid, such that M & M lost its ownership of the property and entire investment therein when the bank holding the note foreclosed. Bona fide title insurance companies were involved in some transactions pursuant to the scheme, but other transactions involved fake title insurance companies created under the fraud scheme.

Mr. McKay received an e-mail from his cousin (who was the person who brought this investment "opportunity" to M & M) in February 2011 alerting Mr. McKay to possible issues with respect to the six southern California properties.

In or about May 2011, Mr. McKay went to southern California to attempt to speak to members of the group that perpetrated the fraud but was unable to locate them. Sometime thereafter, he did speak to one member of the group, but M & M never received any money from the fraudulent scheme.

Also in 2011, Mr. McKay met with an attorney to discuss what could be done to recoup the losses, and was told that the best possible result would be restitution after litigation. The attorney was not engaged and neither M & M nor its shareholders filed such a lawsuit. They also did not file title insurance claims, even though other persons injured in the fraud scheme were successful in recovering part or all of their investments through title insurance.

A criminal investigation by the FBI and then by local police commenced in 2011, and criminal indictments were filed in 2014. A police investigator interviewed Mr. McKay in 2015. During the interview Mr. McKay asked whether there was a chance that M & M would recover any of its investment, and was told that such a recovery was highly unlikely.

In the Tax Court proceedings, Mr. McNely testified that, in 2010, "we talked to an attorney" who advised that it would cost several hundred thousand dollars to fight the fraud scheme, and that M & M would not recover its money. Mr. McNely also testified that an accountant confirmed to him in 2010 that there was no prospect of recovery, and that Mr. McNely filed a police report in late 2010 (without providing evidence of such a report). Apart from Mr. McNely's testimony, there was no other evidence in the record that he ever spoke to any attorney on this matter.

As previously noted, the only taxable year at issue before the court was 2011. With respect to that year, the M & M corporate return, filed on September 6, 2012, did not claim a theft loss deduction.

Mr. McNely's personal income tax return for 2011 (apparently filed jointly with his spouse) was filed untimely in 2014 and claimed a theft loss on Schedule A of slightly more than $400,000 attributable to the six southern California properties. Presumably the loss claimed

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was determined by reference to the portion of the loss of M & M that would have passed through to Mr. McNely as a 50% shareholder of an S corporation if the corporation had reported the loss, but the computation of the loss amount claimed was not discussed in the decision.

The decision notes that no explanation was provided to the court as to the origin of the apparent inconsistency between the McNelys' reporting of the theft loss as a deduction in 2011 attributable to M & M, and the failure of M & M to claim such a deduction on its 2011 return.

The IRS in its notice of deficiency disallowed the deduction for the theft loss claimed by the McNelys. In the ensuing proceedings before the Tax Court, the Commissioner conceded that M & M incurred a theft loss but argued that the McNelys had failed to prove that the loss was incurred during 2011.

Discussion

In general, a loss is allowable in the year in which it is sustained (IRC § 165(a)). A loss arising from theft is generally treated as sustained in the year during which the taxpayer discovers the loss (IRC § 165(e)). However, if, in the year of the event resulting in the loss, there is a claim for reimbursement with respect to which there is a reasonable prospect of recovery, regulations under Section 165 provide that no portion of the loss is considered to be sustained until it can be ascertained "with reasonable certainty" whether or not such reimbursement will be received (Reg. §§ 1.165-1(d)(2)(i), 1.165-8(a)(2)).

The opinion discusses cases concluding that the test as to whether the taxpayer had a reasonable prospect of recovering a theft loss is "primarily an objective test," but that whether the taxpayer had a subjective belief that there was a reasonable prospect of recovery is also a factor. The opinion also stressed that the burden of proof was on the McNelys to show that, as of December 31, 2011, it could be ascertained with reasonable certainty that no reimbursement of the loss would be received.

The court did not find Mr. McNely's testimony credible, and inconsistencies in his testimony appeared to undermine his claim for a deduction in 2011. To begin with, there was at least some testimony appearing to indicate that the theft was discovered in 2010, not 2011.

Mr. McNely also testified that he did not file an insurance claim because he believed that all the titles were fake. No other evidence was provided to that effect, however, and the court concluded that Mr. McNely "had the opportunity to file a claim in 2011 with a prospect of recovery but chose not to do so." More generally, and taking into account that as of the end of 2011 M & M had not engaged an attorney or filed any insurance claim, the court concluded that M & M's prospect of recovery at that time "was simply unknowable and nothing more than speculation and conjecture."

Further undermining Mr. McNely's claim to the loss in 2011, in the view of the court, was Mr. McKay's question, in the context of being interviewed "on behalf of M & M" by a police investigator in 2015, as to whether there was any prospect of recovery. The court concluded that the question showed that M & M did not have a subjective belief that there was no prospect of recovery at that time. Although it was noted in the opinion that Mr. McKay was the primary point of contact for M & M's dealings with the fraud scheme, the opinion does not discuss whether the subjective opinion of Mr. McKay should be binding or even relevant to the allowance of the loss to another shareholder.

In sum, the court found that, at the end of 2011, "it would have been impossible for M & M to conclude . . . that there was no reasonable prospect of recovery," and upheld the IRS determination that the loss was not allowable for that year.

Observations

It is difficult to ascertain from the opinion whether Mr. McNely could have presented a stronger case that there was no reasonable prospect of recovery by the end of 2011, or chose not to present additional information to the court for other reasons. It can also be speculated that the issue received greater scrutiny from the IRS by reason of the divergence between M & M's and the McNelys' tax reporting positions for 2011. Mr. McNely's apparent reliance on the other shareholder to address the fraud, while understandable under the circumstances, may also have effectively undermined the McNelys' claim to a deductible loss.

More generally, the case underscores the need to consider, in evaluating the appropriate tax reporting for an apparent loss attributable to theft, whether a cohesive explanation backed by reasonable documentation exists for the position that all the requirements necessary to claim the loss as a deduction were met by the end of a specific year. Detailed records should be kept as to when the theft was discovered, the efforts made to investigate the theft, and prospects for recovery. If a decision is made not to file an insurance claim, the rationale for not doing so should be documented. In appropriate circumstances, consideration should be given to a protective claim of the loss as a deduction in one or more taxable periods other than the year in which it was apparently sustained.

Under the Code as amended in 2017 by P.L. 115-97, "personal casualty losses," defined to include losses of individuals from theft, fire, or other casualty that are not incurred in a trade or business or other transaction entered into for profit, are generally not deductible (apart from a special rule for losses attributable to a federally declared disaster) in taxable years beginning after 2017 and before 2026 (IRC Section 165(h)(5)). Loss deductions attributable to a business or investment activity (such as in *McNely*) will not be affected by this change.