

Part III -- Administrative, Procedural, and Miscellaneous

Loss Deductions for Diminution in Value of Stock Attributable to Corporate Misconduct

Notice 2004-27

The Internal Revenue Service and Treasury Department are aware that some taxpayers who acquired stock on the open market for investment have been advised that they may be able to deduct as a theft loss the decline in market value of their stock caused by disclosure of accounting fraud or other illegal misconduct of the officers or directors of the corporation that issued the stock. The purpose of this notice is to advise taxpayers that the Service intends to disallow such deductions and may impose penalties under § 6662.

Section 165(a) of the Internal Revenue Code allows a deduction for any loss sustained during the taxable year not compensated for by insurance or otherwise. Under § 165(c) losses for individuals are limited to (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business, and (3) 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. Section 1.165-1(b) of the Income Tax Regulations generally provides that, to be allowable as a deduction under section 165(a), a loss must be evidenced by a closed and completed transaction, fixed by an identifiable event or events, and actually sustained during the taxable year.

Section 1.165-4(a) provides that no deduction shall be allowed under § 165(a) solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or to another similar cause. However, a deduction is allowed under § 165(a) if the stock is worthless and has no recognizable value. A decline in the value of stock owned by the taxpayer is not allowed as a deduction under § 165(a) until the taxable year in which the loss is actually sustained as a result of the sale or exchange of the stock or the stock becoming wholly worthless.

Section 165(f) provides that losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212. Stock held for investment is a capital asset under section 1221. Sections 1211 and 1212 limit the amount that individual taxpayers may deduct for losses from sales or exchanges of capital assets and provide rules for carrying forward to subsequent years the amount of any excess capital loss.

Under § 165(g)(1), if any stock that is a capital asset in the hands of a taxpayer,

such as stock purchased as an investment, becomes worthless during a taxable year, the resulting loss is treated as a loss from the sale or exchange of a capital asset (*i.e.*, a capital loss). Section 1.165-5(c) explains that if the stock becomes wholly worthless during a taxable year, the resulting loss may be deducted under § 165(a) subject to the limitations imposed on capital losses under §§ 1211 and 1212 and the regulations thereunder.

Therefore, under § 165(a), subject to the limitations of §§ 1211 and 1212, a taxpayer who owns stock that was acquired on the open market for investment and that has declined in value is allowed a deduction for a capital loss in the taxable year in which the stock is sold or exchanged or becomes wholly worthless.

Sections 165(e) and 1.165-8(a)(2) provide that, in general, a loss arising from a theft shall be treated under § 165(a) as sustained during the taxable year in which the taxpayer discovers the loss. Section 1.165-1(d)(3) provides that if in the year of discovery there exists a claim for reimbursement with respect to which the taxpayer has a reasonable prospect of recovery, the portion of the loss that may be reimbursed is not treated as sustained until the tax year in which it can be ascertained with reasonable certainty that reimbursement will not be received.

Whether a loss constitutes a theft loss is determined by examining the law of the state where the alleged theft occurred. *Edwards v. Bromberg*, 232 F.2d 107, 111 (5th Cir. 1956); *Viehweg v. Commissioner*, 90 T.C. 1248, 1253 (1988). Thus, to claim a theft loss, the taxpayer must prove that the “loss resulted from a taking of property that is illegal under the law of the state where it occurred and that the taking was done with criminal intent.” Rev. Rul. 72-112, 1972-1 C.B. 60.

In cases involving stock purchased on the open market, the courts have consistently disallowed theft loss deductions relating to a decline in the value of the stock that was attributable to corporate officers misrepresenting the financial condition of the corporation, even when the officers were indicted for securities fraud or other criminal violations. In *Paine v. Commissioner*, 63 T.C. 736, *aff'd without published opinion*, 523 F.2d 1053 (5th Cir. 1975), the taxpayers claimed a theft loss deduction for a decline in value of stock stemming from misrepresentations of the financial status of the corporation by corporate officials. The court noted that the taxpayers did not purchase the stock from the corporate officers who made the misrepresentations, but on the open market. In *MTS International Inc. v. Commissioner*, 169 F.3d 1018 (6th Cir. 1999), an individual taxpayer sold at a loss stock that was acquired on a public stock exchange and argued that the substantial decline in value was due to criminal conduct by the corporation’s officers. The Sixth Circuit concluded that the loss was not a theft loss. *See also Crowell v. Commissioner*, T.C. Memo. 1986-314; *DeFusco v. Commissioner*, T.C. Memo. 1979-230; *Barry v. Commissioner*, T.C. Memo. 1978-215; and Rev. Rul. 77-17, 1977-1 C.B. 44.

Accordingly, the Service will disallow a deduction for a theft loss under § 165(a) relating to a decline in the value of stock that was acquired on the open market for

investment. If the stock is sold or exchanged or becomes wholly worthless, any resulting loss is a capital loss.

DRAFTING INFORMATION

The principal author of this notice is Norma Rotunno of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, please contact Ms. Rotunno on (202) 622-7900 (not a toll-free call).