CFC is Now the Place to Be for Theft Losses, Worthless Losses, and Other Section 165 Losses

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The Federal Circuit recently issued a taxpayer-favorable opinion on a section 165 loss issue. Taxpayers considering filing suit on a theft loss or other section 165 loss, such as a loss for worthless securities, should consider filing a refund suit in the Court of Federal Claims because of the binding Federal Circuit precedent in *Adkins*. The opinion is available here. Other courts may continue to apply the "unknowable" standard, which would delay when the loss may be deducted.

Background

Section 165(c)(3) allows noncorporate taxpayers to deduct certain losses arising from theft in the year in which the theft is discovered. However, if the taxpayer has a claim for reimbursement for which a reasonable prospect of recovery exists, no portion of the loss is deductible until the tax year that the reimbursement amount can be determined with reasonable certainty.[1]

Between 1997 and 2002, Charles and Jane Adkins (the "Taxpayers") invested in securities with Otto Kozak and his brokerage firm (collectively, the "Brokers"). Unbeknownst to the Taxpayers, the Brokers were operating a "pump-and-dump" scheme that diminished nearly the entire value of the Taxpayers' original multi-million dollar investment portfolio. In 2006, when arbitration and criminal proceedings against the Brokers became stagnant, the Taxpayers filed a refund claim for their 2004 tax year claiming a multi-million dollar theft loss deduction. The IRS disallowed the refund claim, and the Taxpayers filed suit in the United States Court of Federal Claims.

Court of Federal Claims' Decision

The Court of Federal Claims held that the Taxpayers could not establish that they were entitled to the theft loss in 2004 because the reasonable prospect of recovering their losses was simply unknowable by the end of 2004. The Court of Federal Claims pointed to evidence showing three different pending avenues of recovery in 2004—two arbitration claims and criminal restitution. The Court of Federal Claims required objective evidence to show that the Taxpayers had no reasonable prospect of recovering their losses in 2004. The Taxpayers presented only their subjective belief that the criminal proceedings in 2004 eliminated their avenues of recovery.[2]

Federal Circuit's Decision

On appeal, the Federal Circuit found that the Court of Federal Claims misconstrued the legal standard in assessing the Taxpayers' reasonable prospect of recovery.[3] The Federal Circuit disagreed that a taxpayer cannot establish the lack of a reasonable prospect of recovery when it is "unknowable" at the time of the loss deduction. The applicable Treasury regulation requires only that a taxpayer have "no reasonable prospect of recovery," not affirmative proof that that the loss would never be recovered.[4] Further, the Federal Circuit found no requirement that a taxpayer

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exhaust every possible avenue of recovery, regardless of cost or the likelihood of success, and reasoned that such a requirement would be contrary to the regulations allowing abandonment of a claim.[5] In addition, the taxpayer, with the assistance of counsel, is in the best position to evaluate the claims worth pursuing. After reviewing the evidence, the Federal Circuit concluded that the Court of Federal Claims clearly erred in holding that the Taxpayers failed to prove they had no reasonable prospect of recovery in 2004 and remanded the case for a calculation of the Taxpayers' refund.

Implications

The Federal Circuit's rejection of the "unknowability" standard provides relief for taxpayers claiming a theft loss deduction while claims against the wrongdoers remain pending. Additionally, the Federal Circuit's reasonable-prospect-of-recovery analysis may offer favorable authority in the context of the "closed transaction" requirement for establishing other loss deductions.

For example, section 165(g) provides taxpayers a worthless securities loss deduction for the tax year that the securities become completely worthless. A security generally becomes worthless when there is no reasonable expectation that the security will have any current or future value, which is often evidenced by an identifiable event.[6] As stated in *Morton v. Commissioner* (the case often examined in analyzing the existence of worthlessness), "identifiable events" include such occurrences as bankruptcy, cessation of business, liquidation of the corporation, or the appointment of a receiver.[7]

Even though a singular event may not definitely establish worthlessness,[8] identifiable events are afforded significant weight in establishing the lack of future value of a security. For example, in *Delk v. Commissioner,*[9] the Ninth Circuit found that the cancellation of original shares of a bankrupt company pursuant to a plan of reorganization was an identifiable event where a shareholder contributed capital to acquire new shares in the reorganized company and realized a loss on the old shares. Additionally, in TAM 9223001, the IRS held that the decision to discontinue a subsidiary's operations was an identifiable event indicating that the subsidiary's stock became worthless during the tax year, even though the subsidiary continued to fulfill existing commitments.

Based on *Adkins*, taxpayers should not be required to wait to deduct a worthless security loss because the future value of the security is "unknowable." Taxpayers also should not be required to show that they have exhausted every possible avenue of recouping their investment before taking the loss deduction. A taxpayer may prove that the stock of an operating company has become worthless by pointing to bleak business prospects, the need for capital infusions, significant operational changes, or reporting of discontinued operations.[10]

The lower court in *Adkins* relied on a majority opinion issued by the Tenth Circuit in *Jeppsen v. Commissioner*[11] for the argument that a taxpayer is not entitled to a loss deduction if the prospect of recovering such loss is unknowable.[12] The dissenting opinion in *Jeppsen* viewed such a standard as placing an "insurmountable barrier on the taxpayer" in proving that the loss would never be recovered.[13] After discussing the merits of both arguments, the Federal Circuit explicitly endorsed the reasoning of the dissent in *Jeppsen*. Accordingly, the Federal Circuit's favorable interpretation

of the loss regulations creates a circuit split with the Tenth Circuit.[14] In addition, an unpublished opinion in the Sixth Circuit cites *Jeppsen*'s "unknowable" standard.[15]

Taxpayers considering filing suit on a theft loss or other section 165 loss, such as a loss for worthless securities, should consider filing a refund suit in the Court of Federal Claims because of the binding Federal Circuit precedent in *Adkins*. Appeals from the Court of Federal Claims lie to the Court of Appeals for the Federal Circuit. The Court of Federal Claims is a court of national jurisdiction over refund suits and is bound by Federal Circuit precedent.[16] Decisions of the Tax Court[17] and judgments of a district court[18] are appealed to the court of appeals with venue over the taxpayer by reason of residence or principal place of business. Therefore, all taxpayers—and especially those taxpayers whose appeal would lie to the Tenth Circuit or Sixth Circuit—should consider filing a refund suit in the Court of Federal Claims to avoid the "unknowable" standard for deducting a theft loss, worthless loss, or other section 165 loss that other courts may apply.

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[1] *See* Treas. Reg. § 1.165-1(d)(2).
[2] *Adkins v. United States*, 140 Fed. Cl. 297 (2018).
[3] *Adkins v. United States*, 960 F.3d 1352 (Fed. Cir. 2020).
[4] Treas. Reg. §§ 1.165-1(d)(2)(i), (3).
[5] *Id.* § 1.165-1(d)(2)(i).
[6] *See Morton v. Commissioner*, 38 B.T.A. 1270, 1278-79 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940) (holding that "identifiable events" include bankruptcy, receivership, cessation of business, and liquidation of the company).
[7] *Id.*
[8] *See Murray v. Commissioner*, T.C. Memo 2000-262 (2000) (foreclosure not determinative); *Osborne v. Commissioner*, T.C. Memo 1995-353 (1995) aff'd 114 F.3d 1188 (6th Cir. 1997) (bankruptcy not determinative); *Schnurr v. Commissioner*, T.C. Memo 1989-275 (1989) (cessation of business and sale of the assets not determinative).
[9] 113 F.3d 984 (9th Cir. 1997).
[10] *See, e.g.*, *Steadman v. Commissioner*, 50 T.C. 369 (1968), *aff'd*, 424 F.2d 1 (6th Cir. 1970) (stock of operating corporation deemed worthless based on corporation incurring substantial net-operating loss that eliminated all shareholder's equity in the stock); Rev. Rul. 2003-125, 2003-2 C.B. 1243 (parent corporation was entitled to worthless stock deduction on the deemed liquidation of its insolvent foreign subsidiary pursuant to a check-the-box election because the FMV of the subsidiary's assets did not exceed the subsidiary's liabilities so that on the deemed liquidation of the subsidiary the shareholder received no payment on its stock); Rev. Rul. 70-489, 1970-2 C.B. 53 (parent corporation could claim worthless security deduction, despite parent continuing the business formerly conducted by subsidiary, where subsidiary had bona-fide indebtedness to parent that exceeded fair market value of its assets and the subsidiary transferred all of its assets to its parent in partial satisfaction of its indebtedness).
[11] *Jeppsen v. Commissioner*, 128 F.3d 1410 (10th Cir. 1997).
[12] *Adkins*, 140 Fed. Cl. at 313 (citing *Jeppsen*, 128 F.3d at 1418).
[13] *Jeppsen*, 128 F.3d at 1419–20 (Kelly, J., dissenting).
[14] *Id.* at 1410.
[15] *Vincentini v. Commissioner*, 429 Fed. Appx. 560, 564 (6th Cir. 2011).
[16] The Court of Federal Claims has jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress of any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort. 28 U.S.C. § 1491(a)(1). The Federal Circuit has exclusive jurisdiction over appeals from the Court of Federal Claims. 28 U.S.C. § 1295(a)(3).
[17] I.R.C. § 7482(a)(1), (b); *see Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).
[18] 28 U.S.C. §§ 1291, 1294, 1346.