

**CALIFORNIA LAWYERS ASSOCIATION TAXATION SECTION  
TAX PROCEDURE AND LITIGATION COMMITTEE**

**IMPROVING IRS GUIDANCE ON THEFT LOSSES UNDER IRC SECTION 165(c)  
AND (e): CLARIFYING PROFIT MOTIVE, PROVIDING CLEARER PARTIAL LOSS  
STANDARDS, AND ESTABLISHING SAFE HARBORS FOR RECOVERY EFFORTS  
AND RETIREMENT DISTRIBUTIONS**

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## **EXECUTIVE SUMMARY**

Scams are on the rise, with the FBI's Internet Crime Complaint Center reporting an alarming surge in losses—from \$3.5 billion in 2019 to \$12.5 billion in 2023. Beyond immediate financial harm, victims often incur additional expenses in recovery attempts, such as investigative services and legal fees, with little success in recovering their funds. Rapid technological advances continue to fuel new scams that fall outside existing IRS guidelines, creating uncertainty around tax consequences. While the Internal Revenue Code ("Code" or "IRC") permits a deduction for theft losses for profit-seeking activity, ambiguity about whether and when scam-related losses are deductible and the burden on victims to justify such deductions exacerbate their financial hardships.

Under current law, IRC section 165(c) and (e) permit taxpayers to deduct theft losses related to profit-seeking activities in the year they discover the loss. Treasury Regulations section 1.165-1(d)(3) clarifies that no deduction is allowed for a year where there exists a claim for reimbursement of which there is a reasonable prospect of recovery. Treasury Regulations section 1.165-1(d)(2)(ii) offers an example permitting a partial theft loss deduction if the facts and circumstances demonstrate that part of the loss is definitively unrecoverable.

Applying these rules in practice often leads to three distinct tax challenges. First, a taxpayer who claims a theft loss deduction in the year of discovery risks disallowance if the IRS determines there was a reasonable prospect of recovery. Second, a taxpayer who delays claiming the deduction until recovery efforts conclude may be challenged for waiting too long when no reasonable prospect existed. Third, a taxpayer who seeks a partial deduction while pursuing further recovery may have the deduction challenged on the ground that a full recovery was still reasonably possible. Additionally, despite recent IRS Chief Counsel Memorandum, it remains unclear when a theft loss is sufficiently related to profit-seeking activities to qualify for deduction. In addition, the Memorandum confirms that the taxpayer bears the burden of a theft loss that involved the distribution of funds from retirement account..

This paper explains that current rules lack clarity, forcing taxpayers to rely on debatable interpretations of the law and often triggering the need for costly tax advice and potential for litigation. Because recovery efforts can extend over multiple tax years, taxpayers and the IRS may face the burden of repeated audits and multiple actual or protective refund claims, resulting in administrative inefficiency. To address these challenges, the paper proposes (1) clarifying that certain transfers are deductible even though the profit-motive may be unclear; (2) adopting a safe harbor to permit partial theft loss deductions based on objective evidence of unrecoverable amounts without requiring full exhaustion of recovery efforts; (3) creating a de minimis procedural simplification exception for small loss claims, eliminating the need to prove the absence of recovery prospects for amounts involved are within certain range; and (4) introducing a conduit safe harbor for retirement account withdrawals made under fraudulent circumstances to prevent inappropriate income recognition on stolen funds. These proposals should reduce hardship on victims of scams and streamline tax administration for taxpayers and the IRS alike.

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## **DISCUSSION**

### **I. Introduction**

In recent years, financial scams targeting individual taxpayers have become increasingly complex, sophisticated, and widespread.<sup>1</sup> These schemes often leave victims with devastating financial losses as well as difficult and often unfavorable tax consequences that exacerbate the financial burden. Under current law, a taxpayer's ability to deduct a theft loss is severely limited by outdated rules that do not fully account for the nature of modern fraud or the realities faced by victims.

The Internal Revenue Code ("Code" or "IRC")<sup>2</sup> and accompanying Treasury Regulations provide some guidance for claiming theft loss deductions, but the framework rests heavily on standards that are not clearly defined, which could lead to uncertain tax reporting positions, inappropriate penalties, and costly litigation. Additionally, the law commonly known as "the 2017 Tax Cuts and Jobs Act" ("the 2017 Act") further restricted net operating loss carryback as well as disallowing personal theft loss deductions unless the loss is attributable to a federally declared disaster. The IRS has recently issued further guidance, such as Chief Counsel Memorandum 202511015, but the guidance is still narrow and does not reduce taxpayers' uncertainty about their theft loss-related tax consequences.

This paper examines three key tax issues affecting scam victims who are most likely to need guidance when claiming theft losses, and this paper proposes targeted reforms to reduce taxpayer burdens and provide equitable relief within the scope of IRC section 165. First, this paper addresses the practical limitations of the profit-motive requirement IRC section 165(c) and proposes the adoption of a statutory clarification rule permitting theft losses in connection with fraudulently induced investments or

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<sup>1</sup> FBI Releases Annual Internet Crime Report, Federal Bureau of Investigation, Apr. 23, 2025, <https://www.fbi.gov/news/press-releases/fbi-releases-annual-internet-crime-report>.

<sup>2</sup> Unless otherwise indicated, references to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code" or "IRC") and all "Treas. Reg." references are to the Treasury regulations promulgated under the Code, all as in effect (or, in the case of proposed regulations which remain outstanding, as proposed) as of the date of this paper.

transfers made that may involved mixed-motives. Second, this paper advocates for a more workable standard for partial theft losses, especially in situations where a taxpayer can establish a portion of the loss that would not be recoverable, even while recovery efforts continue as well as a de minimis procedural simplification where the loss amounts are within a specified range. Third, it proposes a safe harbor to address unfair tax consequences resulting from retirement plan withdrawals made under deceptive circumstances where the taxpayer never received economic benefit. These proposals are discussed in turn herein.

## II. **Background**

Before addressing the proposed changes to section 165, it is essential to first understand the context in which these changes are being proposed. This backdrop will inform the discussion on how section 165 should be updated to offer clearer guidance for taxpayers who are victimized by fraudulent schemes.

Financial scams are on the rise, with the FBI's Internet Crime Complaint Center reporting an alarming surge in losses—from \$3.5 billion in 2019, \$12.5 billion in 2023, and \$16 billion in 2024.<sup>3</sup> Beyond immediate financial harm, victims often incur additional expenses in recovery attempts, such as investigative services and legal fees, with little success in recovering their funds. Rapid technological advances continue to fuel new scams that fall outside existing IRS guidelines, creating uncertainty around tax consequences.

Here are some of the most common types of scams:

- **Impersonation Scams:** Scammers pretend to be technical support, government officials, or business partners offering fake investment opportunities. They often use urgency or authority to pressure victims into sending money or disclosing sensitive information that can then be used to commit a theft.
- **Identity Theft:** Criminals steal personal information to carry out further scams or threaten victims directly.

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<sup>3</sup> *Federal Bureau of Investigation Internet Crime Report 2024*, Federal Bureau of Investigation (April 23, 2025), [https://www.ic3.gov/AnnualReport/Reports/2024\\_IC3Report.pdf](https://www.ic3.gov/AnnualReport/Reports/2024_IC3Report.pdf); *Federal Bureau of Investigation Internet Crime Report 2023*, Federal Bureau of Investigation (April 4, 2024), [https://www.ic3.gov/Media/PDF/AnnualReport/2023\\_IC3Report.pdf](https://www.ic3.gov/Media/PDF/AnnualReport/2023_IC3Report.pdf)

- **Phishing:** Fraudulent emails or messages trick recipients into clicking fake links that lead to look-alike websites designed to steal login credentials or financial data.
- **Romance Scams:** Scammers build fake relationships online and then manipulate victims into sending money by claiming emergencies, investment needs, or family crises.
- **Deepfake Scams:** Using AI-generated content—such as realistic videos or voice recordings—scammers convincingly impersonate someone familiar, like a well-known person or loved one. This deception is often combined with other scam tactics to persuade victims to transfer money under false pretenses.
- **Fraudulent Investment Schemes:** These go beyond traditional Ponzi schemes and may involve fake securities, cryptocurrency scams, or elaborate operations like so-called “pig-butcher” scams,<sup>4</sup> where victims are lured into long-term fake investments.

While these are some of the most widespread scams today, countless other schemes continue to impact taxpayers and consumers across the country. Scams can have a profound financial impact on victims, leading to significant monetary losses that often extend beyond the initial amount stolen. Victims are not only left without their funds, but they frequently face additional expenses attempting recovery, such as hiring professionals to investigate the fraud, legal fees, and other associated costs. Unfortunately, many of these efforts are unsuccessful, adding further financial strain.

The federal income tax consequences to victims of financial scams can compound the problems that victims face. That adverse effect is primarily due to two reasons: first, people will often liquidate assets (such as assets held in brokerage or tax-favored retirement accounts) and use the cash proceeds to pay the perpetrators of the scam under the pretense of making a further investment or protecting assets. That liquidation is a realization event for income tax purposes, and if the assets are sold for an amount higher than their cost, the difference is generally gross income subject to tax. Second, it is possible that the victims are not able to claim a tax deduction for any of the

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<sup>4</sup> *Pig Butchering Scams*, Office of Inspect General, <https://www.fdicog.gov/pig-butcher-scams> (last visited Mar. 24, 2025).

losses associated with the scam. Even when a deduction is permitted, victims often need to spend time and money to prove to the IRS that their loss qualifies for a theft loss deduction under the Code or that recovery of the stolen funds is unlikely. This process is particularly challenging due to the lack of clear guidance, especially for those affected by newer or less recognized types of scams.

### **III. The First Issue – Adding Clarity to the Deductibility of Theft Losses When Profit-Motive May Not Be Clear**

#### **A. Current Law**

Section 165(a) of the Code generally allows a deduction for losses sustained during the taxable year, provided they are not compensated by insurance or other means. A loss is generally considered sustained in the year it occurs, as determined by completed and closed transactions and confirmed by identifiable events during that year.<sup>5</sup> A theft loss is considered sustained in the taxable year when the taxpayer discovers the loss.<sup>6</sup> However, the taxpayer may not claim the theft loss until the taxable year in which it can be established with reasonable certainty that no reimbursement will be received.<sup>7</sup> For individual taxpayers, IRC section 165(c) limits deductible losses to three categories: (1) losses incurred in a trade or business; (2) losses from transactions entered into for profit, even if not connected to a trade or business; and (3) personal losses from casualty or theft that are not related to business or profit-seeking activities.<sup>8</sup>

Prior to the 2017 Act, households who itemized their deductions could deduct their unreimbursed net personal losses that “arise from fire, storm, shipwreck, or other casualty, or from theft” (referred to often simply as “theft or casualty” losses).<sup>9</sup> Individuals whose theft or casualty loss deductions exceeded their taxable income (which is often the case in these scenarios, given that a deception-based theft may be discovered long after the taxpayer liquidated their financial account) were entitled to

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<sup>5</sup> Treas. Reg. section 1.165-1(d)(1).

<sup>6</sup> IRC section 165(e); Treas. Reg. section 1.165-1(d)(3).

<sup>7</sup> Treas. Reg. section 1.165-1(d)(3).

<sup>8</sup> IRC section 165(c).

<sup>9</sup> IRC section 165(c)(3). Under law prior to the 2017 Act, taxpayers claiming a personal casualty loss could only deduct such losses to the extent that each loss exceeded \$100, and their total loss exceeded 10% of the taxpayer’s adjusted gross income. IRC section 165(h)(1) and (2). See also IRS Publication 547, *Casualties, Disasters, and Thefts: For use in preparing 2017 Returns* (Mar. 5, 2018), available at <https://www.irs.gov/pub/irs-prior/p547--2017.pdf>.

carry forward the deduction to subsequent tax years or carry back the deduction to prior tax years.<sup>10</sup>

Under the 2017 Act, for tax years 2018 through 2025, individuals can no longer deduct personal casualty or theft losses unless the loss is attributable to a federally declared disaster.<sup>11</sup> In addition, the net operating loss arising in tax years after 2017 can only be carried forward.<sup>12</sup>

The IRS Office of Chief Counsel recently issued a memorandum (“CCM”) which further clarifies when a victim of a scam can claim a theft loss deduction.<sup>13</sup> The CCM identified five common type of scam scenarios and the general application of the law to those scams:

- **Compromised Account Scam:** Under scenario 1, a scammer posed as a “fraud specialist,” contacted a taxpayer of potential fraud, and convinced the taxpayer to grant access to their retirement account, which led to the scammer stealing the funds. The CCM concludes that the resulting theft loss may be deductible, as the taxpayer acted with the intent to protect their investment, but concluded that the taxpayer was still required to include in income any funds distributed from a retirement or non-retirement account used in the scam.
- **Pig Butchering Investment Scam:** Under scenario 2, a scammer lured a taxpayer into a fraudulent cryptocurrency scheme—commonly known as a “pig butchering” scam—in which the taxpayer was induced to take a relatively smaller distribution from a retirement account and “invest” that money in a nonexistent financial investment. The taxpayer was then presented with fictitious statements showing purported profits before being induced to make a significantly larger investment, after which all of the funds were stolen. The CCM concluded that the resulting loss may be deductible under IRC section 165(c)(2) due to the profit motive, but that the taxpayer must still include in gross income any funds

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<sup>10</sup> IRC section 172(d)(4) (treating personal theft or casualty losses as net operating losses subject to carryforward or carryback (for tax years prior to 2021));

<sup>11</sup> IRC section 165(h)(5).

<sup>12</sup> IRC section 172(a); Note that the CARES Act, P.L. 116-136, provided limited relief under IRC section 172(b)(1)(D) in allowing carryback for tax years 2018, 2019, and 2020.

<sup>13</sup> IRS CCM 202511015 (Mar. 14, 2025).



distributed from a retirement account and report gain or loss from the liquidation of non-retirement account assets.

- **Phishing Scam:** Under scenario 3, a scammer contacted a taxpayer through a fraudulent email link or phone number claiming there was an account issue, and the taxpayer unknowingly engaged and gave the scammer access to their account, leading to the theft of funds. The CCM concluded that the resulting loss may be deductible, provided that the stolen assets, such as those in retirement or nonretirement accounts, were tied to a profit-motivated investment and not for personal use.
- **Romance Scam:** Under scenario 4, a scammer built a fake romantic relationship over text and convinced a taxpayer to send money for supposed medical needs, and the funds were ultimately stolen. The CCM concluded that the resulting loss would not be deductible, as the transfer lacked a profit motive and was not connected to a federally declared disaster. Additionally, the CCM concluded that the taxpayer must include in gross income any funds distributed from a retirement account and report gain or loss from the liquidation of non-retirement account assets.
- **Kidnapping Scam:** Under scenario 5, a scammer contacted a taxpayer by telephone and text message, demanded ransom for a fabricated kidnapping of the taxpayer's grandson by using AI to clone the grandson's voice. The taxpayer was induced to transfer funds, unaware that the kidnapping was fake. The CCM concluded that the resulting loss would not be deductible, as the transfer lacked a profit motive and was not related to a federally declared disaster. Additionally, the CCM concluded that the taxpayer must recognize taxable income from retirement account distributions and report gain or loss from the liquidation of nonretirement account assets.

## **B. Problems with Current Law**

While the CCM has provided some helpful guidance, significant uncertainty remains—particularly regarding the profit-motive requirement under IRC section 165(c)(2). In many cases, the facts suggest mixed motives or ambiguous taxpayer

intent, making it difficult to determine whether a theft loss is deductible under current law.

One recent case highlighting the complexities of intent in the context of fraudulently induced distributions from retirement account assets is *Gomas v. United States*, 2023 U.S. Dist. LEXIS 122729 (M.D. Fla. July 17, 2023).

Dennis and Suzanne Gomas, aged 78 and 74,<sup>14</sup> respectively, operated a pet store from 2010 until 2016, at which point they closed the business and transferred any remaining assets to their daughter, who continued running it.<sup>15</sup> Sometime between 2016 and 2017, their daughter devised a scheme to defraud them. She falsely claimed that former employees had used the Gomases' personal information to create fraudulent accounts impersonating the business, potentially exposing them to criminal liability. She warned that unless they paid or retained legal representation, they could face prosecution. The daughter fabricated legal documents and created a fake email account to impersonate legal counsel to communicate and demand money from the Gomases, while secretly pocketing the funds.

To avoid the threatened legal consequences, the Gomases withdrew approximately \$1,133,250 from their retirement account and ultimately transferred about \$726,152.44 to their daughter to "fund" the legal defense. In 2019, they discovered the scam, and the daughter was later convicted of multiple theft and fraud charges.<sup>16</sup> On May 14, 2018, the Gomases filed their federal individual income tax return for the 2017 year reporting \$1,175,799 in income, which included the \$1,174,020 in pension and IRA distributions, resulting in a tax liability of \$410,841.<sup>17</sup> On February 24, 2020, the Gomases filed an amended return for the 2017 tax year, seeking a refund of income tax and penalty payment of \$412,259, plus interest.<sup>18</sup> The amended return sought to deduct from income the \$1,174,020 that the Gomases received from the IRA and pension accounts.<sup>19</sup> The IRS disallowed the Gomases' claimed for refund and stated

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<sup>14</sup> Brief of Appellant at 11, *Gomas v. United States*, USCA11 Case: 23-12423 (11th Cir. Oct. 25, 2023).

<sup>15</sup> *Gomas v. United States*, No. 8:22-cv-1271-TPB-TGW, 2023 U.S. Dist. LEXIS 122729, at \*3 (M.D. Fla. July 17, 2023).

<sup>16</sup> *Id.* at \*6.

<sup>17</sup> *Id.* at \*7.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

that the distributions must be included in income.<sup>20</sup> The District Court agreed with the IRS and disallowed the claim based on the following reason: (1) that the Gomases had to include in income the distribution as they were “distributes” within the meaning of the Code; and (2) the payments were personal in nature.<sup>21</sup>

Even so, the District Court commented on the unfortunate reality of this case: the Gomases attempted to recharacterize the facts — which in truth reflect a theft loss — into something else in an effort to obtain relief from their tax burden.<sup>22</sup> However, existing law favors the IRS.<sup>23</sup>

What happened to the Gomases was undeniably unfortunate, and made even more so by the fact that the law did not permit a theft loss deduction in this circumstances, as the District Court held the loss to be personal because they were retired and did not have a trade or business, as would be the case with many scam victims.<sup>24</sup> While the ultimate objective of scammers is to steal money, many schemes rely on a calculated blend of emotional manipulation and financial deception, whether through promises of investment returns or threats of harm. Scammers often spend weeks or months cultivating personal or professional relationships to build trust before defrauding their victims. These circumstances raise difficult questions about the taxpayer’s intent, specifically whether the transfer of funds was driven by emotional reliance or a genuine profit motive.<sup>25</sup> The Gomases relied on their trust in their daughter and transferred the funds without clearly verifying how the money would be used. This emotional reliance ultimately undermined their position, as the court found no evidence that the funds were connected to legitimate legal expenses associated with the business.<sup>26</sup> The proposal below seeks to provide relief in these circumstances.

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<sup>20</sup> *Id.* at \*8.

<sup>21</sup> *Id.* at \*11-13.

<sup>22</sup> *Id.* at \*14.

<sup>23</sup> *Id.* at \*14.

<sup>24</sup> *Id.* at \*13; FBI Releases Annual Internet Crime Report, Federal Bureau of Investigation, Apr. 23, 2025, <https://www.fbi.gov/news/press-releases/fbi-releases-annual-internet-crime-report> (people over the age of 60 suffered the most losses from scam).

<sup>25</sup> The Gomases argued that despite transferring funds due to threats and reliance on their daughter, the funds were nonetheless related to their business activities. See Brief of Appellant at 26, *Gomas v. United States*, USCA11 Case: 23-12423 (11th Cir. Oct. 25, 2023).

<sup>26</sup> *Gomas*, *supra* note 16 at \*13.

### **C. Proposed Changes**

Some theft cases highlight the complex emotional factors underlying a taxpayer's decision to transfer funds. While the taxpayer may intend for the funds, whether from a retirement account or non-retirement account, to grow as an investment, scams often exploit a mix of emotions, such as trust, fear, and greed. As a result, it can be difficult to determine the taxpayer's true motive for the transaction. This uncertainty complicates the application of current law, which often requires a clear, profit-driven purpose to allow a theft loss deduction. Greater guidance is needed to address how mixed motives should be treated in these cases.

To better address this gap, IRC section 165(c)(2) or the applicable regulations should be amended to provide that a transaction is treated as entered into for profit if the taxpayer's transfer of funds was induced by representations or circumstances involving an expectation of financial return, the acquisition of investment property, or the protection of financial interests — regardless of whether the transaction also involved elements of emotional manipulation, abuse of trust, or a personal or familial relationship. In other words, the "primary profit motive" test currently applied by courts should be eliminated,<sup>27</sup> recognizing that fraudulent schemes often exploit both financial expectations and emotional vulnerabilities without negating the taxpayer's underlying profit intent.

## **IV. The Second Issue - Changing the Partial Theft Losses Rule to Alleviate the Burden of Needing to Establish the Lack of Recovery Prospect**

### **A. Current Law**

Section 165(e) provides that, for purposes of determining a taxpayer's entitlement to a loss under section 165(a), a theft loss is sustained in the year that a taxpayer "discovers" the loss. The regulation also states that a theft loss is not deductible for the year "in which the theft occurs unless that is also the year in which the taxpayer discovers the loss."<sup>28</sup> A loss is discovered when a reasonable person in similar circumstances would have realized that he had suffered a theft loss.<sup>29</sup>

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<sup>27</sup> See *Helvering v. National Grocery Co.*, 304 U.S. 282, 289 & n. 5 (1938); *Wright v. Commissioner*, T.C. Memo. 2024-100, at \*6 (the Tax Court applying a five-factor test to determine the taxpayer's primary motive).

<sup>28</sup> Treas. Reg. section 1.165-8(a)(2).

<sup>29</sup> See *Cramer v. Commissioner*, 55 T.C. 1125, 1134 (1971).

Treas. Reg. section 1.165-1(d)(2) further requires taxpayers to demonstrate that there is no reasonable prospect of recovery to claim a theft loss deduction.<sup>30</sup>

Accordingly, to claim a theft loss deduction, a taxpayer must prove all three of the following elements:

1. A theft occurred under the law of the jurisdiction where the alleged loss occurred;
2. The amount of the theft loss; and
3. In the taxable year the deduction is claimed, the taxpayer can establish with reasonable certainty that there is no reasonable prospect of recovery.

However, Treas. Reg. 1.165-1(d)(2)(ii) provides the following example of when a deduction can be taken despite there being an outstanding claim for reimbursement:

If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then such portion of the loss is sustained during the taxable year in which the casualty or other event occurs. For example, if property having an adjusted basis of \$10,000 is completely destroyed by fire in 1961, and if the taxpayer's only claim for reimbursement consists of an insurance claim for \$8,000 which is settled in 1962, the taxpayer sustains a loss of \$2,000 in 1961. However, if the taxpayer's automobile is completely destroyed in 1961 as a result of the negligence of another person and there exists a reasonable prospect of recovery on a claim for the full value of the automobile against such person, the taxpayer does not sustain any loss until the taxable year in which the claim is adjudicated or otherwise settled. If the automobile had an adjusted basis of \$5,000 and the taxpayer secures a judgment of \$4,000 in 1962, \$1,000 is deductible for the taxable year 1962. If in 1963 it becomes reasonably certain that only \$3,500 can ever be collected on such judgment, \$500 is deductible for the taxable year 1963.<sup>31</sup>

The difference between the two scenarios in the regulation above is that in the former fact-pattern, the \$2,000 is the "unrecoverable amount" because the maximum the taxpayer can recover from insurance is only \$8,000, which ultimately settles in the future year. Whereas in the latter fact-pattern, the "unrecoverable amount" is not

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<sup>30</sup> Treas. Reg. section 1.165-1(d)(2).

<sup>31</sup> Treas. Reg. section 1.165-1(d)(2)(ii).

determinable as there is potential for full value recovery. Treas. Reg. section 1.165-1(d)(2)(i) further provides:

Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is ***a question of fact to be determined upon an examination of all facts and circumstances***. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, ***he must be able to produce objective evidence*** of his having abandoned the claim, such as the execution of a release.<sup>32</sup>

Accordingly, there is no objective standard to the “reasonable” test as provided by the Treasury Regulations, but the taxpayer must be able to produce objective evidence to claim a loss. Similarly, there is no separate test for partial theft loss. A taxpayer can claim partial theft losses as long as the above three requirements are met and the “partial loss” is ascertained reasonably. This means that when there is ongoing litigation or effort to recover, the taxpayer has to establish with reasonable certainty that no reimbursement will be received for a portion of the loss, *i.e.*, the “unrecoverable amount.”

## **B. Problem of the Current Law**

Given the complexity of modern scams, particularly those that develop over long periods spanning multiple tax years, such as the “pig-butcher” scheme, the current legal framework can be difficult to apply, especially when the theft is discovered well after the initial transactions and the likelihood of recovery remains uncertain.

For example, in a typical pig-butcher scheme, the victim is promised financial returns on an investment and initially receives what appear to be real gains, a tactic commonly referred to as “fattening the pig.” Encouraged by these early results, the victim invests a much larger sum, only to later discover that the entire operation was a fraud. This realization, however, is often delayed. Scammers frequently prolong the deception by inventing obstacles, such as fabricated tax or regulatory fees, or by simply

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<sup>32</sup> Treas. Reg. 1.165-1(d)(2)(i)(**emphasis added**).

withholding responses, keeping the victim hopeful and emotionally invested in the belief that recovery is still possible.

A notable pigbutchering case was in 2023, when a CEO of a bank in Kansas embezzled \$47 million from the bank to fund his investment in a pig-butchering scheme and was discovered when he requested a loan of \$12 million to help take his money out of the investment, which had run into supposed wire transfer issue.<sup>33</sup>

Case law in this area has dealt with theft loss in three scenarios. First, whether a taxpayer who claimed a theft loss deduction in the year of discovery, and whose deduction in that year was challenged by the taxing agency, had a reasonable prospect of recovering all or a portion of the loss in the year of discovery.<sup>34</sup> Second, whether a taxpayer whose decision to wait to claim a theft loss deduction until recovery efforts were complete was challenged by the taxing agency was appropriate in postponing the theft loss deduction when the taxpayer did not have any real prospect of recovering the loss.<sup>35</sup> Lastly, whether the taxpayer was appropriate in postponing the claiming of a theft loss deduction until after the year of discovery (in which the taxpayer had a reasonable prospect of recovery), but when recovery efforts were not yet completed or abandoned.<sup>36</sup>

Taxpayers claiming theft loss deductions often face challenges from the IRS regarding the “reasonable prospect of recovery,” arguing that a prospect of recovery is unknowable or that the taxpayer has not exhausted all avenues of recovery, regardless of the likelihood of success or cost associated with such pursuit. The following discussion in *Adkins v. United States* demonstrates the difficulty that taxpayers can face.<sup>37</sup>

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<sup>33</sup> Gabrielle Saulsbery, “Ex-Heartland Tri-State CEO charged with embezzling \$47M in crypto,” BankingDive, Feb. 8, 2024, <https://www.bankingdive.com/news/ex-heartland-tri-state-ceo-shan-hanes-charged-embezzling-47m-crypto-kansas-bank-failure/706992/> (last visited Mar. 24, 2025); “Material Loss Review of heartland Tri-State Bank,” Office of Inspector General Evaluation Report, Feb. 7, 2024, <https://oig.federalreserve.gov/reports/board-material-loss-review-heartland-tri-state-bank-feb2024.pdf> (last visited Mar. 24, 2025).

<sup>34</sup> See e.g., *Ramsay Scarlett & Co. v. Commissioner*, 61 T.C. 795 (1974)

<sup>35</sup> See e.g., *Estate of Scofield v. Commissioner*, 266 F.2d 154 (6th Cir. 1959)

<sup>36</sup> See e.g., *Johnson v. United States*, 74 Fed. Cl. 360, 365 (2006).

<sup>37</sup> *Adkins v. United States*, 960 F.3d 1352 (Fed. Cir. 2020)

The Adkinses were victims of a pump-and-dump scheme that began in 1997.<sup>38</sup> Before the Appeals Officer could settle the case with the Adkinses in 2011 to allow the loss deduction of about \$2.5 million in 2004, the Adkinses had to file suit because the refund statute of limitations was about to expire.<sup>39</sup> In 2016, the Court of Federal Claims disallowed the loss, reasoning that the Adkinses could not have ascertained with reasonable certainty whether they would receive reimbursement for the loss.<sup>40</sup> On appeal, the Federal Circuit Court of Appeals reversed the decision of the Claims Court, finding that it had misinterpreted the regulations by imposing too high a standard on the Adkinses.<sup>41</sup> The Appeals Court clarified that the proper test is whether the Adkinses established that they did not have a reasonable prospect of recovery through the examination of the totality-of-the-circumstances.<sup>42</sup> On remand, the Claims Court again denied the theft loss deduction, reasoning that the Adkinses could not deduct a theft loss when the reasonable prospect of recovery was “unknowable” and that the Adkinses did not establish that there was no reasonable prospect of recovery in that year.<sup>43</sup> The Claims Court also explained that there were three possible venues that the Adkinses could have pursued to recover the theft loss.<sup>44</sup> On appeals, the Federal Circuit Court of Appeals overturned the Claims Court again, explaining that the regulations do not disallow a theft loss simply because a prospect of recovery is unknowable but only require a demonstration that the taxpayer did not have a reasonable prospect of recovery at the time.<sup>45</sup> In theft loss cases, a taxpayer is not required to pursue every possible avenue of recovery to establish that there is no reasonable prospect of recovery.<sup>46</sup> The taxpayer, with the advice of counsel, is generally best positioned to assess the facts of the case and determine which claims are worth pursuing.<sup>47</sup>

Despite the Adkinses' loss and the fact that the IRS Appeals Officer was about to settle, the law's lack of clarity regarding the standard for establishing whether they had a

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<sup>38</sup> *Id.* at 1355.

<sup>39</sup> *Id.* at 1359.

<sup>40</sup> *Adkins v. United States*, 125 Fed. Cl. 304, 319 (2016).

<sup>41</sup> *Adkins v. United States*, 856 F.3d 914, 920 (Fed. Cir. 2017).

<sup>42</sup> *Id.* at 919.

<sup>43</sup> *Adkins v. United States*, 140 Fed. Cl. 297, 321 (2018).

<sup>44</sup> *Id.*

<sup>45</sup> *Adkins v. United States*, 960 F.3d 1352, 1363 (Fed. Cir. 2020).

<sup>46</sup> *Id.* at 1365.

<sup>47</sup> *Id.*



reasonable prospect of recovery meant that the Adkinses had to spend almost a decade in litigation to get relief for over \$2.5 million of loss.

What if the victims of a complex fraud scheme had a prospect of recovery, except that the recovery would take years of litigation and accounting due to the complexities and amount involved? The Bernie Madoff Ponzi scheme started in the 1970s, and he later confessed to the scheme in 2008.<sup>48</sup> A trustee was appointed to account for the loss and claw back any ill-gotten gain. The first distribution to the victims did not occur until 2017, and the final distribution occurred in 2024.<sup>49</sup> In such cases, victims suffer real and immediate economic harm, yet they are denied meaningful tax relief while waiting for a recovery process that could span more than a decade. The IRS took action and issued Revenue Procedure 2009-20, providing an optional safe harbor that allows taxpayers to claim a section 165 theft loss in limited circumstances resulting from a Ponzi scheme, even if the loss would otherwise not be allowed due to the taxpayer having a reasonable prospect of recovery.

Many newer types of fraud schemes do not meet the safe harbor requirements, such as the condition that a lead figure must be criminally charged. As a result, taxpayers who suffer theft losses are still forced to engage in prolonged disputes with the IRS in order to have their losses recognized. But what happens when taxpayers have a prospect of recovery, yet only for a portion of their loss? For example, after uncovering an investment fraud and losing over \$10 million, the taxpayer filed a lawsuit against the scammer and learned that only \$5 million in assets were potentially recoverable. The taxpayer must continue pursuing the litigation to recover that amount and possibly secure a criminal indictment for theft, a process that could take years to resolve. In this example, the taxpayer is not allowed a full theft loss as a recovery prospect still exists beyond the discovery year. Similar situations may arise where a taxpayer invests in a real estate scheme and later learns the property is worth far less than represented or where the available assets within U.S. jurisdiction fall short of the total amount lost.

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<sup>48</sup> “Bernie Madoff Case,” FBI, <https://www.fbi.gov/history/famous-cases/bernie-madoff> (last visited Mar. 24, 2025).

<sup>49</sup> <https://madoffvictimfund.com/> (last visited Mar. 24, 2025).

Treasury Regulations section 1.165-1(d)(2)(ii) provides that in this situation, the taxpayer may deduct a partial theft loss up to the unreimbursable amount from insurance, or in these examples, the unrecoverable amount. The standard for claiming a partial theft loss is similar to that of a full theft loss and requires the taxpayer to show that there is no reasonable prospect of recovery for the unrecoverable portion. However, a significant challenge arises when the taxpayer continues to pursue litigation to recover the remaining “recoverable” amount. Some common issues that may arise involve proving that the fraudster would not have future income, or that funds that were transferred to other third parties would not be recoverable. These good-faith recovery efforts can complicate or weaken the taxpayer’s position by showing that there exists a prospect of recovery.

### **C. Proposed Change**

Given the practical difficulties taxpayers face in claiming a theft loss deduction — particularly when a potential claim exists or when litigation or recovery efforts are ongoing—a safe harbor is needed to reduce prolonged uncertainty and tax burdens. The first proposed change is establishing a safe harbor that permits a full or partial theft loss deduction based on available, objective evidence. Such evidence could include asset disclosures, bankruptcy filings, court-supervised estimates, expert reports, or forensic accounting analyses. This approach would be analogous to claiming charitable contribution deductions, where (assuming a deduction of more than \$5,000) deductions are allowed based on qualified appraisals (and/or other reliable records).<sup>50</sup> If the taxpayer ultimately recovers any portion of the loss previously deducted, the recovered amount would be included in income in the year of recovery.<sup>51</sup>

The second proposed change is to establish a de minimis procedural simplification exception, under which a taxpayer would not be required to demonstrate a lack of reasonable prospect of recovery if certain conditions are met. Specifically, if the taxpayer’s income falls below a defined amount (adjusted for inflation), or if the theft loss does not exceed a set percentage of the taxpayer’s gross income, such as 10 percent, the loss would be deductible. This exception would still require the loss to

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<sup>50</sup> See e.g., Treas. Reg. section 1.170A-13(c)(3), 1.170A-16, 1.170A-17.

<sup>51</sup> Treas. Reg. section 1.165-1(d)(2)(iii) and the tax benefit rule IRC section 111.

arise from a profit-seeking activity, and any future recovery would be included in gross income under existing tax rules. However, the exception would offer timely relief and spare taxpayers from engaging in costly or futile efforts to prove the lack of reasonable recovery solely to satisfy the deductibility standard.

**V. The Third Issue – Adding a Safe Harbor Provision Relating in Economic Benefit Received from Distribution**

Another issue that compounds the financial loss to the scam victims is the taxable consequences of retirement plan withdrawals. Generally, under IRC 72 and IRC 408(d)(1), amounts distributed out of an individual retirement account are generally included in gross income by the payee or distributee, who is generally the individual or beneficiary who is eligible to receive funds from the retirement account. The victims are required to recognize this income even if the funds were then transferred and stolen.

Case law has exempted a taxpayer from being liable for a distribution from the retirement accounts under certain circumstances. Such as when the taxpayer did not authorize the withdrawal request nor received an economic benefit from the distribution,<sup>52</sup> or when the taxpayer merely acted as an agent or conduit of the retirement accounts in making the investment.<sup>53</sup>

One crucial inquiry to determine whether there is gross income is whether there is an economic benefit accruing to the taxpayer.<sup>54</sup> Even when an economic benefit may not be received, the taxpayer's control over the funds could be a deemed benefit.<sup>55</sup>

Taxpayers who fall victim to scams are often not financially sophisticated, and the withdrawal of funds from a retirement account is frequently the result of

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<sup>52</sup> See e.g., *Roberts v. Commissioner*, 141 T.C. 569 (2013); *Balint v. Commissioner*, T.C. Memo. 2023-118.

<sup>53</sup> See e.g., *McGaugh v. Commissioner*, T.C. Memo. 2016-28, at \*9.

<sup>54</sup> See *Roberts v. Commissioner*, 141 T.C. 569, 582 & n.19 (2013).

<sup>55</sup> See *Gomas v. United States*, No. 8:22-cv-1271-TPB-TGW, 2023 U.S. Dist. LEXIS 122729, at \*11 (M.D. Fla. July 17, 2023)(the taxpayers' status as distributees were unaffected by their daughter's subsequent fraud after the retirement accounts distribution reached their bank accounts because they maintained control over those accounts); see also *Nice v. United States*, No. 18-7362, 2019 U.S. Dist. LEXIS 179302, at \*13, 124 A.F.T.R.2d (RIA) 2019-6403 (E.D. La. Oct. 16, 2019)(despite the taxpayer's son restricting and misappropriating the taxpayer's access to the retirement accounts withdrawal due to the progression of the taxpayer's dementia, the taxpayer still retained access to a checkbook, enabling the use of the funds); but see *Ancira v. Commissioner*, 119 T.C. 135, 138 (2002)(taxpayer did not realize income because he was deemed to act as a conduit to the transaction when he received the check from the retirement accounts and promptly forward it to purchase the investment)

manipulation by the scammer. While the taxpayer may have had legal control over the funds for a brief period, they did not receive any true economic benefit. A safe harbor should be established to provide relief in such cases where the taxpayer acted in good faith and promptly transferred the funds under deceptive circumstances.

Under the proposed safe harbor, a taxpayer who transfers substantially all (at least 95 percent) of an retirement accounts or similar retirement account distribution to a third party within 30 days would be treated as having acted merely as a conduit, not as a distributee. This would prevent the taxpayer from being taxed on a distribution from which they received no personal benefit. In such cases, the theft loss would be attributed to the retirement accounts itself and not be deductible by the taxpayer. To prevent abuse, the safe harbor could require documentation showing that the transfer occurred under circumstances involving fraud or deception, and that the taxpayer acted in good faith and took reasonable steps to recover the funds upon discovering the theft.

## **VI. Conclusion**

The federal tax treatment of theft losses has not kept pace with the evolving landscape of fraud. Victims of scams are often left without meaningful tax relief due to rigid legal standards that fail to account for emotional manipulation, partial recoveries, and unintended tax consequences from retirement account withdrawals. Although the IRS has offered limited guidance and relief, such as in the CCM and in Revenue Procedure 2009-20, these efforts do not sufficiently address the complexity or variety of modern scam scenarios.

This paper identifies three broad problems and proposes four practical and targeted reforms to improve the fairness and administrability of theft loss deductions. First, the law should recognize that transfers made under fraudulent inducement or for the protection of one's financial interests may satisfy the profit-motive requirement under IRC section 165(c)(2). Second, a safe harbor should be adopted to allow taxpayers to claim partial theft losses based on objective evidence of unrecoverable amounts, without having to exhaust every theoretical avenue of recovery. Third, and alternatively, de minimis procedural simplification exception should be added to allow the taxpayer to claim a theft loss without needing to prove the lack of prospect of recovery if the loss amount is within a certain range. Lastly, when retirement account

distributions occur under fraudulent circumstances, a conduit safe harbor should be established to shield taxpayers from the unfair tax burden of recognizing income on funds that were immediately stolen and provided no economic benefit.

These changes would help align the Code with economic reality and provide timely relief to taxpayers who are already victims of financial harm. As fraud schemes grow more sophisticated, so too must the legal standards that govern how we treat losses caused by them.