Business and Income-Producing Property Theft Losses

Cross References
- IRC §165
- Form 4684, *Casualties and Thefts*
- ILM 202511015, January 17, 2025

For tax years 2018 through 2025, personal casualty and theft loss of personal-use property for an individual is deductible only if attributable to a federally-declared disaster. An exception applies if the taxpayer has personal casualty gains for the tax year. Deductible personal casualty and theft losses are also subject to a $100 per event reduction, plus a 10% of adjusted gross income (AGI) reduction for combined casualty and theft losses for the year.

These limitations do not apply to business and income-producing property casualty and theft losses. Casualty and theft losses on business and income-producing property are reported in Part I, Section B of Form 4684, *Casualties and Thefts.* A business and income producing property casualty and theft loss is the lesser of:
- The taxpayer's adjusted basis in the property (cost or other basis minus depreciation allowed or allowable, including Section 179 and special depreciation), or
- The reduction in FMV due to the casualty or theft.
- Minus any insurance or reimbursement received or expected.

The loss is calculated separately for each item, including personal loss for mixed-use property. There is no $100 per event reduction and no 10% of AGI reduction.

If business or income-producing property is stolen or completely destroyed, the decrease in FMV is not considered, and the loss is calculated as follows.
- Adjusted basis of property
- Minus salvage value of the property
- Minus any insurance or reimbursement received or expected.

Form 4684, Section C provides a special safe harbor for reporting for criminal fraud victims of Ponzi-Type investment schemes.

The IRS recently released a legal memorandum concluding that some victims of scams may be allowed to deduct theft losses of income-producing property. The legal memorandum included 5 examples illustrating when a scam is considered a personal casualty and theft loss vs. an income-producing property casualty and theft loss.

Example #1

Example 1, compromised account scam. Taxpayer 1 was the victim of a compromised account scam involving an impersonator. Scammer A contacted Taxpayer 1 claiming to be a "fraud specialist" at Taxpayer 1's financial institution. Scammer A stated that Taxpayer 1's computer and bank accounts had been compromised and attempts were made to withdraw funds. Having gained Taxpayer 1's trust and created a sense of urgency, Scammer A fraudulently induced Taxpayer 1 to authorize distributions from IRA and non-IRA accounts and to transfer all the funds into new investment accounts created by Scammer A. Scammer A created and had access to the new investment accounts and immediately transferred the funds to an overseas account. At this point in 2024, Taxpayer 1 discovered that the accounts were empty, and Scammer A had stolen the funds. Taxpayer 1 contacted their financial institution and law enforcement and was informed that the distribution to an unknown person with an overseas account could not be undone and there was little to no prospect of recovery.

Taxpayer 1 authorized the distributions and transfers with the motive to safeguard and reinvest all of the funds in new accounts in the same manner as before the distributions. Therefore, the losses resulting from the scam were incurred in a transaction entered into for profit under IRC section 165(c)(2). Accordingly, Taxpayer 1 is entitled to deduct the loss in tax year 2024 because it qualifies as a theft loss and there is no reasonable prospect of recovery.

The amount of the loss allowable as a deduction is limited to the taxpayer's basis in the property. In this case, Taxpayer 1 is liable for federal income tax on the IRA account distribution and will recognize gain or loss from the disposition of assets in the non-IRA account, giving Taxpayer 1 basis in all of the stolen funds for purposes of calculating the amount of the deductible theft loss.

Example #2

Example 2, pig butchering investment scam. Taxpayer 2 is an individual who in 2024 was the victim of a pig butchering investment scam. Taxpayer 2 received an unsolicited email from Scammer A advertising an investment opportunity in cryptocurrency and promising large profits. The email directed Taxpayer 2 to the website of a new platform that would ostensibly invest in cryptocurrencies using proprietary methods to generate large profits.

Taxpayer 2 visited the advertised website, which appeared to be legitimate, and deposited a small amount of cash to invest. Within a few days, the account balance increased in value, and Taxpayer 2 decided to withdraw the money from the website. Taxpayer 2 received the payout, reinforcing the belief that the website was legitimate, and then deposited a larger amount of cash to invest. The investment increased in size and Taxpayer 2 once again successfully withdrew the funds.

After the success of these investments, Taxpayer 2 invested significantly more money in the scheme with funds taken from IRA and non-IRA accounts that were transferred to the website. After the account balance increased significantly in value, Taxpayer 2 decided to liquidate the investment and withdraw cash from the website. Taxpayer 2 attempted to withdraw the funds but received an error message, and customer support did not respond. Taxpayer 2 began searching online to see whether other investors had similar problems and discovered claims from several people saying they had been defrauded by the website and Scammer A.

At this point in 2024, Taxpayer 2 contacted law enforcement and the financial institution from which the original funds were withdrawn and was informed that the transfer to the website's overseas account could not be undone and there was little to no prospect of recovery. Scammer A was never identified or charged with any state or federal crime.

Taxpayer 2 transferred the funds from the IRA and non-IRA accounts to the website for investment purposes. Therefore, the losses from the scam were incurred in a transaction entered into for profit under IRC section 165(c)(2). Accordingly, Taxpayer 2 is entitled to deduct the loss in tax year 2024 because it qualifies as a theft loss and there is no reasonable prospect of recovery.

As was the case with Taxpayer 1, Taxpayer 2 will be liable for federal income tax on the IRA account distribution and will recognize gain or loss from the disposition of assets in the non-IRA account, giving Taxpayer 2 basis in all of the stolen funds for purposes of calculating the amount of the deductible theft loss.

Example #3

Example 3, phishing scam. Taxpayer 3 is an individual who in 2024 was the victim of a phishing scam involving an impersonator. Taxpayer 3 received an unsolicited email from Scammer A claiming that Taxpayer 3's accounts had been compromised. The email contained official looking letterhead and was digitally signed by a "fraud protection analyst." The email contained a link, phone number, and directions to call the analyst to ensure Taxpayer 3's funds would be protected.

Taxpayer 3 immediately called the number in the email and communicated with Scammer A, who claimed to be the fraud analyst handling the case. Scammer A directed Taxpayer 3 to click on the link in the email, and then log into Taxpayer 3's tax-deferred retirement account so Scammer A could inspect the account for any issues. By clicking the link in the email, Taxpayer 3 gave Scammer A access to Taxpayer 3's computer. Scammer A was able to identify Taxpayer 3's account username and password as it was entered into the login screen. Scammer A also convinced Taxpayer 3 to do the same with Taxpayer 3's non-IRA account. The next day, Taxpayer 3 logged into the retirement account and the investment account to find that all funds had been distributed to an overseas account. Taxpayer 3 did not authorize the distributions of the funds from the accounts. Taxpayer 3 contacted law enforcement and the financial institutions and was informed that the distribution to the overseas account could not be undone and there was little to no prospect of recovery.

Unlike Taxpayers 1 and 2, Taxpayer 3 did not authorize the transactions in which funds from the IRA and non-IRA accounts were distributed or transferred to Scammer A. These transactions would generally be looked to for purposes of determining the character of the loss. However, in this case, because the transactions were not authorized by the taxpayer, we look to the stolen property, i.e., securities held in investment accounts, and determine whether they were connected to the taxpayer's trade or business, were invested in for profit, or held as general personal property.

Taxpayer 3 contributed to the IRA and to the non-IRA accounts for the purpose of investing and growing the funds to provide income to Taxpayer 3 in retirement, thereby establishing a profit motive. The theft of property while invested establishes that Taxpayer 3's loss was incurred in a transaction entered into for profit for purposes of IRC section 165(c)(2). Accordingly, Taxpayer 3 is entitled to deduct the loss in tax year 2024 because it qualifies as a theft loss and there is no reasonable prospect of recovery.

The amount of the loss allowable as a deduction is limited to Taxpayer 3's basis in the property. In this case, basis will be established to the extent Taxpayer 3 is liable for federal income tax on the IRA account distribution and recognizes gain or loss from the disposition of assets in the non-IRA account.

Example #4

Example 4, romance scam. Taxpayer 4 is an individual who in 2024 was the victim of a romance scam involving an impersonator. Taxpayer 4 received an unsolicited text message from Scammer A and proceeded to develop a virtual romantic relationship. Scammer A convinced Taxpayer 4 that a close relative was in dire need of medical assistance, but Scammer A could not afford the expensive medical bills. Taxpayer 4 authorized distributions from an IRA account and a non-IRA account to a personal bank account, and then transferred the money to Scammer A's overseas account to cover the purported medical expenses. After Taxpayer 4 transferred the money, Scammer A stopped responding to messages. At this time, in late 2024, Taxpayer 4 realized that the romantic relationship with Scammer A was not real, and that Scammer A had stolen Taxpayer 4's funds. Taxpayer 4 contacted their financial institution and law enforcement and was informed that the distribution to the overseas account could not be undone and there was little to no prospect of recovery.

Taxpayer 4's motive was not to invest or reinvest any of the distributed funds from the IRA and non-IRA accounts but, rather, to voluntarily transfer the funds to Scammer A, albeit under false pretenses. Notwithstanding the fraudulent inducement, Taxpayer 4 did not have a profit motive when authorizing the distributions and transfers. Therefore, the losses were not incurred in a transaction entered into for profit and were instead personal casualty losses under IRC section 165(c)(3). Personal casualty losses sustained in 2018 through 2025 are disallowed under IRC section 165(h)(5), except to the extent of personal casualty gains or unless attributable to a federally declared disaster. Because Taxpayer 4 had no personal casualty gains and the loss was not attributable to a federally declared disaster, Taxpayer 4's theft loss is not deductible in 2024. Furthermore, the distribution from the IRA account is subject to federal income tax and Taxpayer 4 is required to recognize gain or loss from the disposition of assets in the non-IRA account.

Example #5

Example 5, kidnapping scam. Taxpayer 5 is an individual who in 2024 was the victim of a kidnapping scam involving an impersonator. Scammer A contacted Taxpayer 5 by text and phone and claimed to have kidnapped Taxpayer 5's grandson for ransom. Taxpayer 5 demanded to speak to Taxpayer 5's grandson and heard his voice over the phone begging for help. Scammer A directed Taxpayer 5 to transfer money to an overseas account and not to contact law enforcement. Taxpayer 5 did not know that Scammer A had used artificial intelligence to clone the grandson's voice and that no kidnapping had taken place.

Under immense duress, Taxpayer 5 authorized distributions from an IRA account and a non-IRA account, then directed those funds to be deposited in the overseas account Scammer A provided, hoping to ensure the safety of Taxpayer 5's grandson. Later the next day, Taxpayer 5 was able to contact other family members and Taxpayer 5's grandson and learned that no kidnapping had taken place. Taxpayer 5 immediately contacted law enforcement and their financial institution but was informed that the distribution to the overseas account could not be undone and there was little to no prospect of recovery.

Taxpayer 5's motive was not to invest any of the funds distributed from the IRA and non-IRA accounts but, rather, to voluntarily transfer the funds to Scammer A, albeit under false pretenses and duress. Notwithstanding the fraudulent inducement and duress, Taxpayer 5 did not have a profit motive; therefore, the losses were not incurred in a transaction entered into for profit and were instead personal casualty losses under IRC section 165(c)(3). Personal casualty losses sustained in 2018 through 2025 are disallowed under IRC section 165(h)(5), except to the extent of personal casualty gains or unless attributable to a federally declared disaster. Because Taxpayer 5 had no personal casualty gains and the loss was not attributable to a federally declared disaster, Taxpayer 5's theft loss is not deductible in 2024. Furthermore, the distribution from the IRA account is subject to federal income tax and Taxpayer 5 is required to recognize gain or loss from the disposition of assets in the non-IRA account.

Author's Comment

AI (artificial intelligence) scams have been making the news and some of the advice to combat these type of scams is to talk with family members and create a secret code word, such as the name of grandpa's boat, the name of a family pet, or some other word that everyone in the family knows to verify whether the person on the phone is real or fake.

The IRS legal memorandum also concluded that none of the taxpayers in the examples above qualify for the Ponzi Safe Harbor in Rev. Proc. 2009-20 for various reasons.