Legislative Recommendation #54

Allow the Limitation on Theft Loss Deductions in the Tax Cuts and Jobs Act to Expire So Scam Victims Are Not Taxed on Amounts Stolen From Them

SUMMARY

- *Problem:* The tax code historically has allowed individual taxpayers to deduct theft losses, but for tax years 2018 through 2025 the code has sharply restricted the availability of this deduction. Together with timing constraints on deductions and refund claims, this restriction generally prevents scam victims from offsetting their losses.
- *Solution:* Allow the current theft loss restriction to expire, thereby restoring the pre-2018 rules, and allow taxpayers to claim a theft loss deduction in the year of the related income event by filing an amended return even if they discovered the theft after the refund limitations period.

PRESENT LAW

IRC § 165(a) generally authorizes taxpayers to deduct "any loss sustained during the taxable year and not compensated for by insurance or otherwise." For tax years 2018 through 2025, IRC § 165(h)(5) provides that an individual taxpayer may only claim a casualty and theft loss deduction to the extent the loss is attributable to a federally declared disaster.[1]

Under IRC § 165(c), the limitation of IRC § 165(h)(5) does not apply where an individual taxpayer incurs the loss in a trade or business or in any transaction entered into for profit.[2]

IRC § 165(e) provides that a taxpayer must deduct a theft loss in the year in which the taxpayer discovers the theft.

IRC § 72(t) imposes a ten percent additional tax on early distributions from qualified retirement accounts made before the taxpayer reaches age 59½, with enumerated exceptions.[3]

REASONS FOR CHANGE

Before the Tax Cuts and Jobs Act (TCJA),[4] IRC § 165 allowed individual taxpayers who are victims of theft to deduct their losses from taxable income. The TCJA significantly narrowed this deduction. As a result, many scam victims now face tax bills on money they lost to fraudsters.

While the theft loss deduction is still available for businesses and for individuals who incur losses in transactions entered into for profit under IRC § 165(c), most scam victims do not fall into these categories.

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1 IRC § 165 losses are colloquially referred to as "casualty and theft" losses. Casualty losses include losses attributable to federally declared disasters, which have generally remained deductible under the Tax Cuts and Jobs Act (TCJA). Theft losses incurred by individuals, however, generally may not be deducted under the TCJA. *See* Pub. L. No. 11597, § 11044, 131 Stat. 2054, 2087 (2017).

2 IRC § 165(c)(1) addresses losses incurred in a trade or business, while IRC § 165(c)(2) addresses losses incurred in any transaction entered into for profit (although not connected with a trade or business).

3 The ten percent amount is legally an additional tax, although it is often referred to as a ten percent "penalty." Exceptions are enumerated in IRC § 72(t)(2).

4 Pub. L. No. 115-97, § 11044, 131 Stat. 2054, 2087 (2017).

The IRS previously provided relief for Ponzi scheme victims, determining such false investments were entered into for profit,[5] but currently there is no similar protection for victims of other scams.

> *Example:* A taxpayer, scammed into withdrawing retirement funds, must pay taxes on the withdrawal, plus a ten percent additional tax if they are not yet 59½ years old.[6] This is the case even though the scammer absconded with the funds and the taxpayer never benefitted from the money withdrawn.

Whether a scam victim can deduct a loss like this often depends on proving a profit motive.[7] This may be plausible for investment scams, but it is nearly impossible for romance, technical support, or scare tactic scams.[8]

Even when a deduction is permitted, existing statute of limitation periods can prevent victims from claiming refunds if they discover the scam too late.[9] In addition, because current law requires the taxpayer to claim the deduction in the year the theft was discovered (not in the year the taxpayer lost the money), a taxpayer who is still within the statute of limitations period for a refund might not have enough income in the later year to deduct the loss fully.[10] This means victims might not be able to deduct all of their losses against the amount stolen from them.[11]

RECOMMENDATIONS

- Allow the current provisions of IRC § 165(h)(5) to expire, thereby reinstating the pre-TCJA language so its availability is not limited to losses incurred in federally declared disaster areas.[12]
- Amend the current IRC § 165(e) to enable scam victims to deduct a loss in the same year as any associated income inclusion event.[13]
- Amend IRC § 6511 to extend the limitations period for refund claims related to newly discovered theft losses due to scams.
- Amend IRC § 72(t) to create an exception to the ten percent additional tax on early distributions from qualified plans (*e.g.,* IRC § 401(k), IRA, or other tax-deferred accounts) that were withdrawn because of a scam.

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5 Rev. Rul. 2009-9, 2009-14 I.R.B 735; Rev. Proc. 2009-20, 2009-14 I.R.B. 749, *as modified by* Rev. Proc. 2011-58, 2011-50 I.R.B 849. These rulings were issued to provide clarity to victims of a scheme famously perpetrated by Bernard Madoff.

6 IRC § 72(t)(1).

7 For factors to consider in determining whether a taxpayer entered into a transaction for profit, see Treas. Reg. § 1.183-2.

8 For a discussion of tax-related scams, see National Taxpayer Advocate 2024 Annual Report to Congress, https://www.taxpayeradvocate.irs.gov/AnnualReport2024.

9 IRC § 6511.

10 IRC § 165(e).

11 Consider an example that illustrates how losses may be limited. Assume a taxpayer with a fixed annual income of $50,000 is scammed out of $100,000 from their IRC § 401(k) account in Year One, creating total income in that year of $150,000. In Year Three, the taxpayer discovers the scam. Under current law, the taxpayer cannot deduct the $100,000 loss against the Year One income of $150,000. Instead, the taxpayer must claim the deduction in Year Three against their fixed income of $50,000. This means there may not be enough income for the taxpayer to net out the $100,000 theft loss.

12 Congress could choose to make this change retroactive to provide relief to recent scam victims.

13 Congress could give taxpayers the option to claim the loss in the year a statutory change is enacted.