

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 22423
	)	
[Redacted]	)	DECISION
	)	
	)	
Petitioners.	)	
_____	)	

On July 30, 2009, the Idaho State Tax Commission’s (Commission) Income Tax Bureau (Bureau) issued a Notice of Deficiency Determination (NODD) to [Redacted] (petitioners) disallowing the petitioners’ refund claim for taxable years 2004 and 2005 and allowing the petitioners’ refund claim for taxable year 2007. The petitioners filed a timely petition for redetermination with respect to the denial of their refund claims for 2004 and 2005. The petitioners were informed of their appeal rights. The Idaho Code section 63-3045(2) hearing was held on February 11, 2010. The Tax Commission, having reviewed the file, hereby issues its decision.

**ISSUE**

Is the petitioners’ theft loss includible in the petitioners’ calculation of their Idaho Code section 63-3021 net operating loss for taxable year 2007? In order for the loss to be included in the calculation of the Idaho net operating loss, the loss must be an Internal Revenue Code (IRC) section 163(c)(3) casualty loss, and the loss must be on property physically located in Idaho at the time of the loss.

**FINDING**

1. The Commission finds that the petitioners’ theft loss is governed by IRC section 162(c)(2) not IRC section 162(c)(3); therefore, the theft loss is excluded from the calculation of the Idaho Code section 63-3021 net operating loss. Since it is excluded from the

calculation of the Idaho net operating loss, the Bureau correctly denied the petitioners' refund claim for taxable years 2004 and 2005.

2. Even if it were found that the petitioners' theft loss is governed by IRC section 162(c)(3), the petitioners have not met their burden of proof that the theft was a theft of property physically located within Idaho at the time of the theft. Accordingly, the Bureau correctly denied the petitioners' refund claim for taxable years 2004 and 2005.

3. Even if it is found that the petitioners' theft loss is includible in the calculation of the Idaho Code section 63-3021 net operating loss:

a. Idaho Code section 63-3022(c)(1) only provides for a carryback of an Idaho net operating loss to the "two (2) immediately preceding taxable years." Therefore, the petitioners' refund claim for a carryback of an Idaho net operating loss from taxable year 2007 to taxable year 2004 must be denied.

b. Idaho Code section 63-3022(c)(1) limits the amount of a carryback of an Idaho net operating loss to a "total of one hundred thousand dollars (\$100,000)" to the two (2) immediately preceding taxable years. Therefore, the petitioners' claim for refund of tax for taxable year 2005 relating to that portion of the Idaho net operating loss carryback from taxable year 2007 in excess of \$100,000 must be denied.

## **HISTORY**

### **1. Petitioners' Amended Idaho Income Tax Return for Taxable Year 2007**

In March 2009, the petitioners amended their Idaho resident individual income tax return for taxable year 2007 claiming a refund of overpaid tax in the amount of \$8,253. The amended return was filed in order to claim an additional federal Schedule A miscellaneous itemized deduction in the amount of \$558,500. The petitioners' requested a refund of \$8,193 relating to

their estimated payment remitted to the Commission in April 2008 on Idaho Form 51 plus a refund of their Idaho Code section 63-3024A grocery credit (in the amount of \$70) less the \$10 Idaho Code section 63-3082 permanent building fund tax. The Bureau approved the petitioners' refund claim of tax for taxable year 2007 plus added \$218 of interest calculated from March 23, 2009, (the date the amended return was filed) through October 1, 2009. The Bureau cited Idaho Code section 63-3073 as authority for limiting the calculation of interest on the amended return refund claim to the date in 2009 when the amended return was filed rather than the April 15, 2008, due date of the 2007 return. The Bureau states in its NODD:

Idaho Code Section 63-3073 provides that interest shall be allowed on a credit or refund of tax erroneously or illegally assessed or collected, but no interest shall be allowed on refunds resulting from voluntary or unrequested payments in excess of tax due.

Idaho Code Section 63-3072(b) requires that a taxpayer make a claim for credit or refund of overpaid tax. Such claim for credit or refund must be made on an amended return (Idaho Income Tax Administrative Rule 880.04).

We have allowed interest from the date you filed an amended return claiming the refund.

The \$558,500 federal Schedule A deduction was a deduction from a theft loss. The petitioners described the loss as "lost money in scam known as [Redacted]."

Since the petitioners' federal itemized deductions for taxable year 2007, as amended, exceeded the petitioners' federal adjusted gross income for taxable year 2007, the petitioners did not receive a tax benefit for the full theft loss. Only \$35,001 of the \$585,500 theft loss was used to offset income in taxable year 2007. The remaining \$523,499 was treated by the petitioners as part of their federal and Idaho net operating loss carryback from taxable year 2007 to taxable years 2004 and 2005.

2. Petitioners' Amended Idaho Income Tax Returns For Taxable Years 2004 and 2005.

The petitioners filed an amended Idaho resident individual income tax return for taxable years 2004 and 2005 claiming an Idaho net operating loss carryback from taxable year 2007 of \$416,172 and \$107,327, respectively. The petitioners claimed an overpayment of taxes in the amount of \$19,483 and \$8,372 for taxable years 2004 and 2005, respectively.

The Bureau in the NODD denied the petitioners' refund claims. It is the Bureau's position that the petitioners:

“Ponzi-scheme” loss was properly claimed as an itemized deduction. Therefore, unless this deduction is allowable under section 165(c)(3) of the Internal Revenue Code, it is to be excluded from the computation of the Idaho net operating loss.

The Bureau determined in the NODD that under Idaho Code section 63-3021, the petitioners cannot include the loss in the calculation of an Idaho net operating loss.

3. [Redacted] Theft Loss

According to the complaint filed [Redacted] with a federal court, [Redacted] misappropriated and misused client assets. Among its improper activities, [Redacted] transferred at least \$460 million in securities from client investments accounts to [Redacted] proprietary “house” account. [Redacted] also used securities from client accounts as collateral to obtain a \$321 million line of credit as well as leverage financing. The bank that extended the \$321 million line of credit [Redacted] informed [Redacted] that it is in default under the credit agreement and, therefore, the bank intends to sell securities currently sitting in [Redacted] “house” account that were pledged as collateral for the loan beginning as soon as August 22, 2007. The securities to be sold may include securities that were fraudulently transferred to the “house” account from client accounts. [Redacted] has not kept accurate books and records, required to be kept under federal securities laws, necessary to verify the ownership of the

securities in its client and “house” accounts and to prevent the firm from selling assets that it is not entitled to sell and distributing the sales proceeds to persons not entitled to receive them.

According to the [Redacted] complaint, [Redacted] offered clients the opportunity to participate in a variety of investment programs each of which had its own investment policy designed to meet requirements and preferences of different types of clients. Regardless of which investment program a particular client chose, [Redacted] had the general practice of pooling the client’s assets with those of similar types of clients in one of three segregated client custodial accounts held [Redacted]. The accounts were referred to within [Redacted] as Seg 1, Seg 2, and Seg 3. Seg 1 contained assets of registered Futures Commission Merchants (FCM) with only domestic customer deposits. FCMs are futures brokers that are members of the National Futures Association (NFA) and investments are subject to the rules of the Commodity Futures Trading Commission (CFTC). Seg 2 contained assets of FCMs with foreign customer deposits. Seg 3 contained assets of all other types of clients, including hedge funds, trust accounts, endowments, and individuals. Under federal law, a registered investment adviser, [Redacted] is not allowed to have custody of any client funds or securities unless, among other requirements, the funds and securities are held in segregated accounts that hold only clients’ funds and securities. The [Redacted] asserts that [Redacted] routinely violated the requirement by commingling and transferring client funds and securities between the various client segregated accounts and between client accounts and a “house” account, which also contained securities which [Redacted] claimed it owned.

In the [Redacted] complaint, it is contended that on August 13, 2007, [Redacted] e-mailed customer account statements to its clients that were materially false and misleading. For example, the customer statements sent to clients whose assets were supposedly held in the Seg 3

account represented that the face value of the securities held in their accounts was, in the aggregate, more than \$670 million. The accounts reported no liabilities corresponding to these assets. Contrary to these representations, the [Redacted] custodial statement for the Seg 3 account on August 13, 2007, showed only approximately \$94 million of securities held on behalf of all Seg 3 clients. SEC examiners asked [Redacted] representatives about the discrepancy between the customer statements and the custodial statement and were informed that the customer accounts would not “tie out” because [Redacted] had moved securities among the Seg accounts and its own “house” account.

According to the petitioners’ representative, the petitioners, on August 23, 2005, had [Redacted] wire \$1,000,000 [Redacted] Custodian Seg 3 Fund account. From 2005 and prior to the discovery of the theft loss, [Redacted] provided the petitioners with account statements reflecting the value of their investment account. In 2007, the petitioners became aware of the theft. It is unclear if [Redacted] simply took the petitioners’ wire transfer from the beginning and invested in securities in [Redacted] name or if Sentinel actually invested in securities in the petitioners’ name and later transferred those securities to [Redacted] “house” account to be used as collateral for a loan.

On August 17, 2007, [Redacted] filed a voluntary petition for relief under Chapter 11 of the federal Bankruptcy Code.

## LAW AND ANALYSIS

Idaho Code section 63-3021 states in pertinent part:

**63-3021. Net operating loss.** (a) The term “net operating loss” means the amount by which Idaho taxable income, after making the modifications specified in subsection (b) of this section, is less than zero.

(b) Add the following amounts:

(1) The amount of any net operating loss deduction included in Idaho taxable income.

- (2) In the case of a taxpayer other than a corporation:
- (i) Any amount deducted due to losses in excess of gains from sales or exchanges of capital assets; and
  - (ii) Any deduction for long-term capital gains provided by this chapter.
- (3) Any deduction allowed under section 151 of the Internal Revenue Code (relating to personal exemption) or any deduction in lieu of any such deduction.
- (4) Any deduction for the standard or itemized deductions provided for in section 63 of the Internal Revenue Code, or section 63-3022(j), Idaho Code, except for any deduction allowable under section 165(c)(3) of the Internal Revenue Code (relating to casualty losses) pertaining to property physically located inside Idaho at the time of the casualty. (Emphasis added.)

Unless the theft loss qualifies as a casualty loss under IRC section 165(c)(3) on property physically located inside Idaho at the time of the casualty, the theft loss, just like the other federal IRC section 63 “itemized deductions” **is excluded** from the calculation of an Idaho net operating loss.

In their letter dated November 30, 2009, the petitioners’ representative argues that the petitioners’ theft loss qualifies as a deduction under IRC section 165(c)(3) and that it is irrelevant that the petitioners took the deduction under IRC section 165(c)(2) on their federal income tax return. As support for their position, the petitioners’ representative provided the following analysis:

I.R.C § 165(a) allows taxpayers a deduction for unrecovered losses. Section 165(c)(3) provides that such deduction will be limited to losses arising from theft. Investment losses are deductible under § 165(c)(3). See, e.g., *Jeppsen v. Comm’r.*, 128 F.3d 1410 (10<sup>th</sup> Cir. 1997). In *Jeppsen*, neither the IRS nor the court challenged the appropriateness of taking an investment loss deduction under § 165(c)(3) versus § 165(c)(2). A quick review of the case law—coupled with prior experience dealing with the IRS—reveals investment losses are routinely taken and allowed under § 165(c)(3).

Idaho law merely requires a taxpayer be eligible to take a federal tax deduction. Idaho law does not require a taxpayer to have actually taken the federal tax deduction. *Bogner v. State Dept. of Rev. & Tax.*, 693 P.2d 1056 (Idaho 1984). In *Bogner*, the Idaho Supreme Court held that “an Idaho resident on his or her state income tax form can deduct from taxable income itemized deduction as defined by various sections of the Internal Revenue Code . . . regardless of whether they choose to do so on their federal returns.” *Id.* At 856

In Bogner, the Court ruled that an individual taxpayer could claim a deduction on her state income tax return that she did not claim on her federal return because she took a tax credit instead. To support its conclusion, the Court relied on the following subsection of Idaho Code section 63-3022 which provided for an adjustment in arriving at Idaho taxable income:

In the case of natural persons, there shall be allowed as deductions from gross income either of the following at the option of the taxpayer: (1) the standard deduction as defined by section 63 Internal Revenue Code, or (2) itemized deductions as *defined* in sections 163, 164 ... Internal Revenue Code.

Idaho Code § 63-3022(1) (1980) (emphasis added).

In Bogner, the Court pointed out that “Section 164 of the Internal Revenue Code specifically *defines* foreign income taxes as an allowable deduction.” 107 Idaho at 856, 693 P.2d at 1058 (footnote omitted) (emphasis added). The Court then concluded:

Thus, it is clear that an Idaho resident on his or her state income tax form can deduct from taxable income itemized deductions as *defined* by various sections of the Internal Revenue Code, including § 164, regardless of whether they choose to do so on their federal returns. *Id.* (emphasis added).

In Bogner, the Court found Idaho Code section 63-3022(1) to be dispositive because it referred to “itemized deductions as defined” in various sections of the IRC, without requiring that the deductions be “allowed” as provided in IRC section 63. Although a theft loss governed by IRC section 165(c)(2) or IRC section 165(c)(3) would be an IRC section 63 itemized deduction, the present case is distinguishable from Bogner as the present case does not involve a choice of taking a federal credit in lieu of an otherwise allowable itemized deduction and instead involves a determination of which of the two IRC code sections govern the theft loss.

In Rev. Rul. 2009-09, the Internal Revenue Service provides the following clarification of theft loss treatment under the IRC, in pertinent part:

Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise. For individuals, § 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit, and § 165(c)(3) allows a deduction for certain losses not connected to a transaction entered into for profit, including theft losses. Under § 165(e), a theft loss is sustained in the taxable year the taxpayer discovers the loss. Section 165(f) permits a deduction for capital losses only to the extent allowed in §§ 1211 and 1212. In certain circumstances, a theft loss may be taken into account in determining gains or losses for a taxable year under § 1231.

For federal income tax purposes, “theft” is a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and any other form of guile. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); see also § 1.165-8(d) of the Income Tax Regulations (“theft” includes larceny and embezzlement). A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. Rev. Rul. 72-112, 1972-1 C.B. 60. However, a taxpayer need not show a conviction for theft. Vietzke v. Commissioner, 37 T.C. 504, 510 (1961), acq., 1962-2 C.B. 6.

The character of an investor's loss related to fraudulent activity depends, in part, on the nature of the investment. For example, a loss that is sustained on the worthlessness or disposition of stock acquired on the open market for investment is a capital loss, even if the decline in the value of the stock is attributable to fraudulent activities of the corporation's officers or directors, because the officers or directors did not have the specific intent to deprive the shareholder of money or property. See Rev. Rul. 77-17, 1977-1 C.B. 44.

In the present situation, unlike the situation in Rev. Rul. 77-17, B specifically intended to, and did, deprive A of money by criminal acts. B's actions constituted a theft from A, as theft is defined for § 165 purposes. Accordingly, A's loss is a theft loss, not a capital loss.

...

Rev. Rul. 71-381, 1971-2 C.B. 126, concludes that a taxpayer who loans money to a corporation in exchange for a note, relying on financial reports that are later discovered to be fraudulent, is entitled to a theft loss deduction under § 165(c)(3). **However, § 165(c)(3) subsequently was amended to clarify that the limitations applicable to personal casualty and theft losses under § 165(c)(3) apply only to those losses that are not connected with a trade or business or a transaction entered into for profit. Tax Reform Act of 1984, Pub. L. No. 98-**

**369, § 711 (1984).** As a result, Rev. Rul. 71-381 is obsolete to the extent that it holds that theft losses incurred in a transaction entered into for profit are deductible under § 165(c)(3), rather than under § 165(c)(2).

**In opening an investment account with B, A entered into a transaction for profit. A's theft loss therefore is deductible under § 165(c)(2) and is not subject to the § 165(h) limitations.**

(Emphasis added.) The Internal Revenue Service concluded that following the 1984 law change, a theft loss involving a transaction entered into for profit is a loss under IRC section 165(c)(2) not IRC section 165(c)(3). At least one court has agreed that IRC section 165(c)(2) controls the reporting of theft losses relating to transactions entered into for profit. Premji v. Commissioner, T.C. Memo. 1996-304, affd. without published opinion 139 F.3d 912 (10th Cir.1998). The Commission has previously found that a theft loss relating to investment transactions entered into for profit are governed by IRC section 165(c)(2). See Commission's 2007 published decision in Docket No. 19797 at <http://tax.idaho.gov/decisions/0719797.pdf>.

As in the example in Rev. Rul. 2009-09, in opening up an investment account with Sentinel Management Group, Inc., the petitioners entered into a transaction for profit. The petitioners' representative stated in a letter dated November 30, 2009, that the petitioners "began **investing** their money with Sentinel Management Group around 2005" and that the petitioners "lost their \$558,500 **investment** due to Sentinel's theft." Therefore, the petitioners' theft loss is related to a "transaction for profit" and is deductible under IRC section 165(c)(2) not IRC section 165(c)(3). As a deduction under IRC section 165(c)(2), the theft loss is excluded from the calculation of the Idaho Code section 63-3021 net operating loss for taxable year 2007.

Even if it were to have been found that the theft loss was governed by IRC section 165(c)(3), the petitioners have not provided documentation showing that the loss was a loss on property physically located within Idaho at the time of the loss. The petitioners'

representative stated in a letter dated November 30, 2009, that the petitioners “could have demanded immediate payment of their investment. Any payment made by Sentinel would have been drawn on an Idaho bank. Therefore, the loss pertains to property physically located inside Idaho at the time of the casualty and should be included in the computation of [the petitioners’] Idaho net operating loss.” Additionally, in a letter dated September 30, 2009, the petitioners’ representative argued that “Sentinel’s scheme was out right theft which is no different than someone breaking into another’s garage and stealing tools and other personal items. This type of illegal activity is out right theft and qualifies under 165(c)(3) of the IRS Code.” The Commission respectively disagrees with the representative’s analysis. There is no evidence supporting a position that an employee of Sentinel was physically in Idaho in 2007 and absconded with the petitioners’ money or securities similar to a situation where a burglar enters someone’s home and steals tools. As for the representative’s argument that the petitioners would have drawn upon an Idaho bank is speculation and has no merit with respect to whether or not property was physically located inside Idaho at the time of the theft.

In the Commission’s published decision in Docket No. 19727, the Commission, when confronted with a similar situation involving the theft loss of a taxpayer’s investment account, held that:

The property must have been “physically located inside Idaho at the time of the casualty.” The investment is an intangible. The U. S. Supreme Court has held that “intangible property is not physical matter which can be located on a map.” Delaware v. New York, 507 U.S. 490, 498(1993); Texas v. New Jersey, 379 U.S. 674, 677 (1965). If it cannot be located on a map, it follows that it cannot be “physically located inside Idaho at the time of the casualty.”

The same rational holds true for the instant case. It is the petitioners’ burden of proving error on the part of the deficiency determination for taxable year 2005. Albertson’s, Inc. v. State Dept. of Revenue, 106 Idaho 810, 814, (1984); Parsons v. Idaho State Tax Comm'n, 110 Idaho

572, 574 (Ct. App. 1986). Since the petitioners have not met this burden of proof of showing that theft loss was on property physically located within Idaho at the time of the theft, the loss cannot be included in the calculation of the Idaho Code section 63-3021 net operating loss for taxable year 2007.

Even if the petitioners' theft loss was included in the calculation of their Idaho net operating loss for taxable year 2007, the petitioners made two fatal errors when filing their refund claims. First, Idaho Code section 63-3022(c)(1), which governs the carryback of an Idaho net operating loss for taxable years after 2001, only allows taxpayers to carry the loss back to the two preceding taxable years. The petitioners are not entitled to carry any portion of an Idaho net operating loss from taxable year 2007 back to taxable year 2004. The petitioners' refund claim for taxable year 2004 must be denied.

Secondly, Idaho Code section 63-3022(c)(1) limits the carryback of an Idaho net operating loss to \$100,000. The petitioners' attempt to claim a refund of tax on that portion of an Idaho net operating loss in excess of the \$100,000 limitation must be denied.

WHEREFORE, the Notice of Deficiency Determination dated July 30, 2009, including the denying of the petitioners' refund claim for taxable years 2004 and 2005, is hereby AFFIRMED, and MADE FINAL.

An explanation of the petitioners' right to appeal this decision is enclosed.

DATED this \_\_\_\_ day of \_\_\_\_\_ 2010.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2010, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

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