J. H. McKinley and Edna McKinley v. Commissioner, 34 T.C. 59 (1960)

Under Section 165(e) of the Internal Revenue Code, a theft loss is deductible in the year the taxpayer discovers the loss, not necessarily the year the theft occurred.

Summary

The United States Tax Court addressed whether a taxpayer could deduct a theft loss in 1955 when the theft occurred in 1955 but the discovery of the theft was made in 1956. The taxpayer lent money to an individual who provided a forged stock certificate as collateral. The court held that because the taxpayer did not discover the theft until 1956, the deduction was not allowable in 1955, in accordance with Section 165(e) of the Internal Revenue Code. The ruling clarifies the timing of theft loss deductions, emphasizing the importance of the discovery date.

Facts

In 1955, J.H. McKinley (petitioner) lent $12,500 to W.D. Robbins, receiving a post-dated check and a stock certificate as collateral. The check was worthless, and the stock certificate was later discovered to be a forgery. Robbins was subsequently indicted and convicted of theft. The petitioners filed a joint federal income tax return for 1955, but did not claim a theft loss deduction related to the Robbins transaction. Upon audit, the Commissioner disallowed the theft loss and instead allowed a short-term capital loss. The petitioners contended that they were entitled to a theft loss deduction in 1955 because the theft occurred in 1955.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the petitioners' 1955 income tax return and disallowed the theft loss deduction. The petitioners challenged the Commissioner's decision in the U.S. Tax Court.

Issue(s)

1. Whether the petitioners are entitled to a theft loss deduction in 1955 under Section 165(a) and (e) of the Internal Revenue Code?

Holding

1. No, because under section 165(e) of the Internal Revenue Code, the loss is deductible in the year the taxpayer discovers the loss.

Court's Reasoning

The court referenced Internal Revenue Code Section 165(a), which allows deductions for losses sustained during the taxable year, and Section 165(e), which specifically states that theft losses are treated as sustained in the year the taxpayer discovers the loss. The court noted that while state law determines if a theft occurred, federal law determines when the loss can be deducted. The court found that the petitioners had established that a theft had occurred in 1955 under Texas law. However, the court emphasized that, based on the evidence, the petitioners did not discover the theft until 1956. The court found the petitioner's testimony uncertain regarding the date of discovery and noted that the absence of any claim for the loss on the 1955 tax return further supported the conclusion that the theft was discovered in 1956. The Court cited 26 C.F.R. 1.165-8, which supports the position that a theft loss is deductible in the year of discovery.

Practical Implications

This case highlights the importance of the timing of the discovery of a theft loss for tax purposes. Attorneys should advise clients to document the date of discovery of a theft loss to support a deduction in the appropriate tax year. The ruling clarifies that it is the year of discovery, not the year of the theft itself, that governs when a theft loss can be deducted for federal income tax purposes. This has implications for preparing tax returns, and for advising clients on when to claim theft loss deductions. It reinforces that, in tax law, substance often prevails over form, but procedural timing requirements are strictly enforced. Later cases regarding theft loss deductions continue to reference this case when the date of discovery is in dispute.

