T.C. Memo. 1988-508, 56 T.C.M. (CCH) 501

Taxpayers seeking a theft loss deduction bear the burden of proving a theft occurred under applicable state law, including demonstrating fraudulent intent by the perpetrator, reliance by the taxpayer on misrepresentations, and a lack of reasonable prospect of recovery.

Summary

Petitioners invested in limited partnerships purportedly engaged in commodities trading and carburetor development and sought theft loss deductions after the SEC initiated action against related entities. The Tax Court denied the deductions, holding that the petitioners failed to meet their burden of proving a theft under Texas law. The court found insufficient evidence of false representations made with the intent to steal from the petitioners, reliance on such representations, or that the losses stemmed from fraud rather than a poorly executed business venture. Furthermore, the court noted petitioners did not demonstrate a lack of reasonable prospect of recovering their investments.

Facts

Petitioners invested in limited partnership interests in PCarb, PScreen, and TRD, Ltd., based on offering memoranda and advice from their investment advisor. PCarb's offering memorandum detailed investments in commodities and the development of a new carburetor. In 1977, the Securities and Exchange Commission (SEC) brought an action against Inventive Industries, Inc., PCarb, and related individuals, alleging securities violations. A permanent injunction was entered against the defendants, and an independent director was appointed to oversee Inventive and related entities, including PCarb. The independent director's reports revealed chaotic financial records, commingled funds, and an unlikely prospect of continued operations, suggesting potential liquidation. Petitioners claimed theft loss deductions for their partnership investments.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax for various years. Petitioners contested these deficiencies in Tax Court, conceding the deductibility of losses as originally reported but arguing for theft loss deductions under Section 165 of the Internal Revenue Code. The Tax Court considered the case based on stipulated facts and exhibits.

Issue(s)

1. Whether the petitioners are entitled to theft loss deductions under Section 165 for their out-of-pocket payments to limited partnerships PCarb, PScreen, and TRD, Ltd.

Holding

1. No, because the petitioners failed to prove that a theft occurred under Texas law.

Court's Reasoning

The court applied Texas Penal Code Section 31.03, which defines theft as unlawful appropriation of property with intent to deprive the owner, without the owner's effective consent (including consent induced by deception). Relying on prior Tax Court precedent, particularly *Paine v. Commissioner*, the court emphasized that to prove theft through false representations, taxpayers must demonstrate:

1. False representations were made.
2. The representations were made with the specific intent to obtain property from the taxpayer.
3. The taxpayer relied on these misrepresentations.
4. The taxpayer's loss was causally related to the misrepresentations.

The court found that petitioners failed to provide evidence of any false statements, intent to criminally appropriate their money, or reliance on misrepresentations. While the independent director's reports indicated financial disarray and potential mismanagement, they did not conclusively establish fraudulent intent directed at the investors. The court stated, "*There is no evidence establishing that any statements or representations that Foreman may have relied on were false; there is no evidence establishing that any false statements were made with the intent of criminally appropriating Foreman's money; and there is no evidence establishing that Foreman's loss was related to any false representations.*" The court distinguished *Nichols v. Commissioner*, where a theft loss was allowed because the promised transaction was a complete sham. In *Foreman*, the partnerships engaged in actual, albeit troubled, business activities. Finally, the court noted petitioners did not demonstrate they had no reasonable prospect of recovering their investments from partnership assets or from individuals involved.

Practical Implications

Foreman v. Commissioner underscores the significant burden taxpayers face when claiming theft loss deductions, particularly in investment contexts. It clarifies that a mere business failure or investment gone sour does not automatically constitute a theft for tax purposes. Legal professionals should advise clients that to successfully claim a theft loss, they must present concrete evidence of fraudulent intent specifically directed at them, demonstrate reliance on fraudulent misrepresentations, and prove a lack of any reasonable prospect of recovering their investment. This case highlights the importance of thorough due diligence before investments and the need for robust evidence to support theft loss claims in tax disputes. It serves as a reminder that proving theft requires more than demonstrating an investment loss; it demands proof of criminal deception under applicable state law.

