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IS IT DEDUCTIBLE WHEN YOUR SPOUSE STEALS FROM YOU?

FACTS: A client's ex-wife, under her "emergency only" bank account access to his separate property bank account, withdrew – without his permission – a total of nearly $600,000. These withdrawals, multiple and continuing in ever larger amounts, were made without his knowledge or approval. The withdrawals, taken shortly before, and mostly after, the party's final Decree of Divorce was granted by the court, reduced his bank account to zero. The client "discovered" these multiple acts of theft, when he could not use his ATM card for groceries one day.

The client's money was the proceeds of sales of stock from an earlier start-up company sale, and was clearly earned prior to marriage. None of it had been comingled. All earnings while married, or community property under California law, had been spent during the marriage. On a fair reading of the facts, it was clear the property taken was the client's separate property.

We maintained the money taken was not property settlement, was not alimony, and was not an agreed, intended loan by our client to his ex-wife. We argued with IRS that it had to be something, and challenged the Service to define what it was, if not a series of thefts.

LAW: under the Code, a theft is an ordinary loss, deductible in the year of discovery [IRC Sec. 165(a) and (e)]. It will also qualify for treatment as a net operating loss and be carried back two years, or forward twenty years.

A theft is considered discovered in the year a "reasonable man" would have discovered it [Virginia M. Cramer, 55 TC 1125], and not in the year a taxpayer "remembers" it.

A deductible "theft" is any taking of property by one from another considered to be a crime in the state where the crime was committed [IRS Rev.Rul. 72-112; & numerous case cites].

There are many examples in tax case law of where one spouse has stolen from the other – while they are married. I will not cite them here as they are too numerous, and also comedic at times.

Whether such thefts are deductible by the victim first depends if the victim is / was deemed to be the sole owner of the stolen property at the time of theft. This will depend if the property taken was separate or community property. If separate property, this seems prima facie allowable as a theft. If community property, some states consider the victim spouse's one-half share to have been taken, and a deduction is allowed.

The most memorable case from this particular IRS Appeals case we settled favorably for our client is that of *Bagur v. Comm. 44 AFTR 2d 79-5713,* which relies on the "head and master provision" of Louisiana, Mississippi, and Texas property law. This provision holds that a man has a presumptive right to the property of his wife; to spend or do with it what he pleases – without her permission, regardless of the fact that her one-half is actually, _. The head and master provision in these states will apply even to the wife's earnings from her job. It is hard to imagine this law is still in force.

IRS PROCEEDINGS FOR OUR CLIENT: our client was in an ongoing state of medically certified clinical depression when the thefts occurred for a period of more than four years. He did not notice his money was being taken until his ATM card no longer worked. His ex-wife had moved to the East Coast. He did not proceed to sue her or have her indicted for theft because she was then (two years later) a single parent and poor. This failure to take action caused difficulty with IRS. However, the case law will support a late deduction filing, even if action in the year of discovery was not taken, if the taxpayer was "financially" (medically) disabled when he should have acted. The case law also did not deny a deduction simply because the taxpayer did not pursue a legal remedy. This is because the thefts… did occur.

There was also, in this case, an IRS bias that our client must somehow have known what was going on, and that he permitted or allowed the thefts to happen. IRS had a theory of the money taken as being alimony – when the divorce decree specifically stated no alimony was required. The funds taken were not property settlement; the divorce decree made it clear that there was zero community property to divide, or settle.

This case (for the 2005 and 2006 tax years), ended up in IRS Appeals for a second time, after four years of working with IRS on the amended returns audits and an initial earlier IRS Appeals Conference that had to be abandoned, due to an IRS error.

In the end, IRS Appeals in Denver, CO, agreed the takings were indeed "thefts" and allowed their deduction at 90% of the amounts taken. The IRS bias of supposed taxpayer knowledge pervaded even this far, to the ending "win". IRS also abated all penalties for the client, on the basis of his financial disability, and, paid the client interest on his refunds due him for the time from the filing of his original tax return up to the date of IRS refund.

IMPORTANT POINTS:

1). A theft is always deductible, even between spouses most of the time, whether still married or not.

2). The year of discovery is the legal year of a theft loss deduction. If this year is missed – due to the client did not earlier claim it, and the client is not financially disabled, the statute will run.

3). A theft is "discovered" in the year a "reasonable man" would discover it.

4). The meaning of “financial disability” is when for “any period of time a taxpayer is medically unable to handle their financial affairs, and there is no one else to act on their behalf”, [IRC Sec. 6511(h)].

5). Even though spousal thefts may seem “fishy” or, unusual, they should always be claimed as a deduction in the year of discovery. As should any theft. This is because when someone later reviews the matter or, has assistance with it, it may be too late. There are not many taxpayers who are able to use the financial disability exception, and will later find their time to file and claim a deduction for any theft has expired.