TaxNewsFlash

United States

No. 2016-433
September 26, 2016

Tax Court: Estate entitled to theft loss incurred by family LLC

The U.S. Tax Court today—in a case of first impression—held that an estate is entitled to a theft loss deduction under section 2054 when the estate's interest in a family limited liability corporation (LLC) suffered a loss due to a Ponzi scheme. The court rejected the IRS's claim that no theft deduction could be allowed because the LLC, and not the estate, suffered the loss.

The case is: *Estate of Heller v. Commissioner,* 147 T.C. No. 11 (September 26, 2016). Read the Tax Court's **opinion** [PDF 48 KB]

Background

The decedent, at time of his death in January 2008, owned a 99% interest in a family LLC. The LLC's only asset was an account held by Madoff Investment Securities. Between March and November 2008, one of the co-executors withdrew amounts from the Madoff account, the estate's portion of which was used to pay the estate taxes and administrative expenses. In December 2008, Bernard Madoff, the chairman of Madoff Securities, was arrested, and charged him with securities fraud relating to a multibillion-dollar Ponzi scheme. Subsequently, he pleaded guilty to various federal crimes, including securities fraud, investment adviser fraud, money laundering, and perjury.

Because of the Ponzi scheme, the LLC's interest in the Madoff account and the estate's interest in the LLC became worthless. The estate on April 1, 2009, timely filed Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* on which a gross estate of approximately $26.3 million was reported, including the value in the LLC (approximately $16.5 million). The estate also claimed a theft loss deduction of approximately $5.2 million relating to the Ponzi scheme (that is, the difference between the value of the estate's interest in the LLC reported on the estate tax return and the estate's share of the amounts withdrawn from the Madoff account.)

The IRS issued to the estate a notice of deficiency, determining that the estate was not entitled to the theft loss deduction because the estate did not incur a theft loss during its settlement—but that the theft loss was that of the LLC. The estate filed a petition with the Tax Court, and then a motion for summary judgment.

Tax Court's opinion

The Tax Court today issued an opinion concluding that the estate was entitled to deductions relating to "losses incurred during the settlement of * * * [the estate] arising * * * from theft" pursuant to section 2054. As noted by the court, this issue—that is, whether an estate is entitled to a section 2054 theft loss deduction relating to property held by an LLC—was one of first impression. As the court noted, neither the regulations nor the legislative history relating to section 2054 (or its predecessors) addressed this issue.

While the IRS conceded that Madoff Securities defrauded the LLC, the IRS also contended that the estate was not entitled to a section 2054 deduction because the LLC incurred the loss, not the estate. However, the Tax Court explained that section 2054 allows for a broader nexus (i.e., between the theft and the incurred loss) than did the "narrow interpretation" by the IRS. The Tax Court concluded that the phrase "arising from" in section 2054 allows the estate a deduction "if there is a sufficient nexus between the theft and the estate's loss." Here, the loss suffered by the estate related directly to its interest in the LLC and the worthlessness of which arose from the theft.