

1 Linda Frenklak
2 Tax Counsel III
3 Board of Equalization, Appeals Division
4 450 N Street, MIC: 85
5 PO Box 942879
6 Sacramento CA 95814
7 Tel: (916) 323-3087
8 Fax: (916) 324-2618

6 Attorney for the Appeals Division

7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of:) **HEARING SUMMARY²**
11) **PERSONAL INCOME TAX APPEAL**
12 **PAUL N. WINKLER¹**) Case No. 539074
13)

	<u>Year</u>	<u>Proposed Assessment</u>
	2006	\$52,446

17 Representing the Parties:

19 For Appellant: Paul N. Winkler
20 For Franchise Tax Board: Raul A. Escatel, Tax Counsel

22 QUESTION: Whether the Franchise Tax Board (FTB or respondent) properly disallowed an
23 income loss adjustment claimed for a theft loss on appellant's return for tax year
24 2006.

26 ¹ Appellant resides in Alameda County, California.

27 ² At the request of appellant, this appeal was postponed from the May 24, 2011 hearing calendar due to a scheduling conflict
28 and rescheduled to the July 26, 2011 hearing calendar. At the request of appellant, this appeal was postponed from the
July 26, 2011 hearing calendar due to a family matter and rescheduled to the November 15, 2011 hearing calendar.

1 HEARING SUMMARY

2 Factual Background

3 This appeal arises from appellant losing substantial amounts of money in PinnFund USA,
4 Inc. (PinnFund), a Carlsbad, California mortgage brokerage, which is considered one of the largest
5 Ponzi schemes³ in the history of San Diego, California (hereinafter referred to as the PinnFund
6 scheme).⁴ The sole issue in this appeal is whether appellant is entitled to claim an income loss
7 adjustment of \$1,413,140 on his 2006 California income tax return based on the money he lost in the
8 PinnFund scheme. James Hillman and Michael Fanghella established PinnFund in the late 1990s as a
9 subprime mortgage lending business. Fanghella acted as chief executive officer of PinnFund. Hillman
10 also created three funding entities, Allied Capital Partners, Grafton Partners, and Six Sigma, LLC
11 (collectively referred to as the funding entities), which were all managed by Peregrine Funding, Inc.
12 Hillman and his wife owned and controlled Peregrine Funding. The funding entities solicited investors
13 to invest funds in PinnFund mortgages. Pursuant to contracts between the funding entities and
14 PinnFund, the funding entities were required to deposit all investor funds into a trust account and the
15 funds were to be used exclusively for the purpose of funding loans. In 2000, appellant invested in
16 PinnFund by contributing \$500,000 to Six Sigma, LLC and \$1 million to Craving Investors, Inc.
17 (Craving); Craving transferred appellant's \$1 million of funds to Allied Capital Partners. (Resp.
18 Opening Br., pp. 1-2, fn. 4.)

19 On March 21, 2001, the Securities and Exchange Commission (SEC) filed an emergency
20 civil action in the United States District Court, Southern District of California, alleging that since 1993,
21 Hillman, Fanghella and the funding entities fraudulently raised \$330 million from at least 166 investors
22 for the purported purpose of funding residential home mortgages. (Resp. Opening Br., p. 2; SEC

23 ///

24 _____
25 ³ "A Ponzi scheme is a fraudulent investment scheme where '[m]oney from the new investors is used directly to repay or pay
26 interest to old investors, [usually] without any operation or revenue-producing activity other than the continual raising of new
27 funds. This scheme takes its name from Charles Ponzi, who in the late 1920s was convicted for fraudulent schemes he
conducted in Boston.' [Citation.]" (*People v. Williams* (2004) 118 Cal.App.4th 735, 739, fn. 2.)

28 ⁴ See San Diego Business Journal article dated February 10, 2003. (<http://www.allbusiness.com/legal/criminal-law-sentencing/10604614-1.html>.)

1 Litigation Release No. 16941, Mar. 22, 2001; SEC Litigation Release No. 17968, Feb. 4, 2003.)⁵
2 According to the SEC action, Hillman, Fanghella and the funding entities misappropriated the investors'
3 funds for their own gain to pay for operational losses of PinnFund, and to make repayments to investors
4 as part of a Ponzi-like scheme. (SEC Litigation Release No. 17968, Feb. 4, 2003.)⁶ The SEC action
5 also alleged that Hillman, Fanghella, PinnFund, and the funding entities circulated altered financial
6 statements of PinnFund and forged auditors' reports, which contain fraudulent omissions and
7 misrepresentations and conceal PinnFund losses in excess of \$95 million and the transfer to Fanghella of
8 more than \$107 million since 1997. (SEC Litigation Release No. 16941, Mar. 22, 2001.) On March 21,
9 2001, the court issued temporary restraining orders and orders freezing assets against Hillman,
10 Fanghella and the related entities, and it appointed a receiver over PinnFund. (Resp. Opening Br., p. 2,
11 SEC press release dated Nov. 7, 2006.)⁷ On April 2, 2001, the court appointed a permanent receiver,
12 Charles LaBella, over PinnFund. (SEC litigation release dated May 8, 2001; SEC press release dated
13 Nov. 7, 2006.) On April 2, 2001, April 25, 2001, and May 4, 2001, the court issued preliminary
14 injunctions and orders freezing assets as to Hillman, the funding entities, Fanghella, Pinnfund, and relief
15 defendants Kelly Cook and Reliance Holdings, LLC. (SEC litigation release dated May 8, 2001.)⁸ The
16 SEC named Kelly Cook and Reliance Holdings, LLC as relief defendants in its complaint in order to
17 obtain disgorgement of assets they allegedly received from the PinnFund scheme. (*Id.*)

18 On April 2, 2001, the funding entities, as creditors of PinnFund, initiated an involuntary
19 Chapter 7 bankruptcy proceeding for Pinnfund, and the funding entities filed a voluntary Chapter 7
20 bankruptcy petition. (Resp. Opening Br., p. 2; SEC Litigation Release No. 16992, May 8, 2001; SEC
21 press release dated Nov. 7, 2006.) A bankruptcy trustee, Richard Kipperman, was subsequently
22 appointed for the funding entities. (SEC press release dated Nov. 7, 2006, Resp. Opening Br., p. 2.)

23 ///

24 _____
25 ⁵ <http://www.sec.gov/litigation/litreleases/lr16941.htm>; <http://www.sec.gov/litigation/litreleases/lr17968.htm>.

26 ⁶ <http://www.sec.gov/litigation/litreleases/lr17968.htm>.

27 ⁷ <http://www.sec.gov/divisions/enforce/claims/pinnfund.htm>.

28 ⁸ <http://www.sec.gov/litigation/litreleases/lr16992.htm>.

1 On November 29, 2001, a class action lawsuit was filed on behalf of the PinnFund
2 investors against Hillman, which was settled on December 19, 2001. (Resp. Opening Br., pp. 2-3.) The
3 settlement agreement provided that Hillman was “to transfer as much as \$57 million and assist the
4 Receiver and Trustee in pursuing claims against third parties.” (*Id.*, p. 3.)

5 On December 19, 2001, the SEC action ended with a final judgment being filed against
6 Hillman, which permanently enjoined Hillman from committing any future violations of the registration
7 and antifraud provisions of the federal securities laws, and required Hillman to pay disgorgement of
8 \$67,749,192.39 and \$110,000.00 in civil penalties. (SEC Litigation Release No. 17968, Feb. 4, 2003;
9 Resp. Opening Br., p. 3.) On December 31, 2001, pursuant to the terms of the settlement agreement,
10 Hillman and his wife disgorged to the SEC disgorgement account the following: \$17 million in cash,
11 investment assets worth up to \$10 million, and certain tax credits of unknown value. (Resp. Opening
12 Br., p. 3.)

13 With respect to the various actions investors filed against PinnFund and the funding
14 entities in their respective bankruptcy cases, a Global Settlement Agreement dated May 10, 2002, was
15 executed, which established a fund to be used to satisfy, settle and discharge claims from individuals and
16 entities that purchased shares in the funding entities. (Resp. Opening Br., p. 3.) The Global Settlement
17 Agreement provided that “\$23 million was to be deposited into the Fund, \$1.5 million to be transferred
18 to PinnFund, a reserve of \$6.5 million to be established, and the remaining, at least \$15 million, to be
19 distributed to the holders of investor claims.” (*Ibid.*) The Global Settlement Agreement also established
20 a litigation committee, which was comprised of the receiver, the trustee, and a representative of the
21 investor class, to coordinate and prosecute claims against third parties, including accounting firms, by
22 the investor class. (*Ibid.*)

23 On June 27, 2002, lawsuits were filed by the trustee for the funding entities and the class
24 representative against PricewaterhouseCoopers, RINA Accountancy Corporation (RINA), and Levitz,
25 Zacks & Ciceric alleging professional negligence, breach of contract, active concealment,
26 misrepresentation, and conspiracy to breach fiduciary duty. (Resp. Opening Br., p. 3.) As part of a
27 settlement agreement with RINA, its professional liability insurance company agreed to pay the trustee
28 on behalf of the litigation committee \$4,946,000. (*Ibid.*) The lawsuit against PricewaterhouseCoopers

1 was settled in 2004 for \$39.5 million. (*Id.*, p. 4; App. Reply Br., p. 1.)

2 In March 2003, the PinnFund investors filed a lawsuit against Sheppard, Mullin, Richter
3 & Hampton, LLC (the Sheppard lawsuit), a law firm, alleging professional malpractice, and aiding and
4 abetting breach of fiduciary duty for which the plaintiffs sought an amount to be proven at trial, but no
5 less than \$200 million. (Resp. Opening Br., p. 4.) The California Court of Appeal, in a published
6 opinion, *Peregrine Funding, Inc. v. Sheppard Mullin Richter and Hampton LLP* (2005) 133 Cal.App.4th
7 658, held that the plaintiffs' claims could proceed forward. (*Ibid.*) On March 13, 2007, the parties
8 reached a settlement of the Sheppard lawsuit for \$12.5 million, which the California superior court
9 approved on May 10, 2007. (*Ibid.*; App. Reply Br., p. 2.)

10 On November 7, 2006, the SEC announced that the defrauded investors of the PinnFund
11 scheme had received nearly \$70 million or approximately 31 percent of their allowed claim amounts and
12 the bankruptcy trustee "is continuing to recover assets and expects to make at least one more distribution
13 to eligible investors." (SEC press release dated Nov. 7, 2006.) According to respondent, "In total, the
14 various lawsuits filed against Hillman, Fanghella, PinnFund, the Funding Entities, and the banking,
15 accountancy, and law firms that aided and abetted in the fraud have resulted in judgments and
16 settlements totaling more than \$131 million, of which almost \$73 million has been paid to investors."
17 (Resp. Opening Br., p. 4.)

18 In March 2002, Fanghella pled guilty to six felonies, including money laundering, wire
19 fraud and tax evasion, and in February 2003, the federal court sentenced Fanghella to 10 years in prison.
20 (San Diego Business Journal article dated Feb. 10, 2003.)⁹ Hillman and an associate, Piotr Kodzis, were
21 indicted on charges of conspiracy, mail fraud, and wire fraud, and other individuals associated with the
22 conspiracy were indicted for a variety of criminal charges. (*Id.*) In August 2005, Hillman pled guilty to
23 one count of wire fraud, and on March 10, 2006, the federal court sentenced Hillman to three years and
24 10 months in federal prison. (San Diego Union Tribune article dated Mar. 11, 2006.)¹⁰

25 ///

26 _____
27 ⁹ (<http://www.allbusiness.com/legal/criminal-law-sentencing/10604614-1.html>.)

28 ¹⁰ (http://www.signonsandiego.com/uniontrib/20060311/news_1b11sentence.html.)

1 Procedural Background

2 On his 2001 California resident income tax return, appellant claimed a theft loss due to
3 his lost investments in the PinnFund scheme. Respondent audited appellant's 2001 return and
4 disallowed the claimed theft loss for the following reasons: 1) litigation related to the PinnFund scheme
5 was pending; 2) it appeared there would be recoveries for the defrauded investors; and 3) appellant was
6 not entitled to claim the theft loss until all pending litigation related to the PinnFund scheme was
7 concluded. (Resp. Opening Br., p. 4.) Respondent issued a Notice of Proposed Adjusted Carryover
8 Amount (NPACA) for tax year 2001, which reflected the adjustment of the claimed theft loss. (*Ibid.*)
9 Appellant protested the NPACA and respondent subsequently affirmed the NPACA, which went final.
10 (*Id.*, fn. 7.)

11 On his 2006 California resident income tax return, appellant claimed an income loss
12 adjustment of \$1,413,140 on line 14 of his 2006 Schedule CA. (Resp. Opening Br., p. 5, exhibit A-B.)¹¹
13 Respondent audited appellant's 2006 return and determined that as of December 31, 2006, the Sheppard
14 lawsuit, the last of the PinnFund litigation, was still pending and on May 10, 2007, the Superior Court
15 for Alameda County approved the settlement of that lawsuit. (Resp. Opening Br., p. 5.) Respondent
16 disallowed the income loss adjustment claimed on appellant's 2006 return and issued a Notice of
17 Proposed Assessment (NPA) dated December 26, 2008. (*Id.*, p. 5, exhibit C.) The NPA increased
18 appellant's taxable income by \$1,575,963¹² from \$-973,539 to \$602,424 and proposed additional tax of
19 \$53,806 plus interest. (*Id.*) Appellant protested the NPA in a letter dated February 12, 2009. (*Id.*,
20 exhibit D.) In the protest letter, appellant proposed that he "be allowed to take one-half of the original
21 investment as a theft loss (\$787,982) in 2006" and, because the total recovery from all litigation is not
22 expected to exceed 10 percent of the original investment, appellant "will deduct the remaining theft loss
23 representing about forty percent of [his] original investment in 2008, after all recoveries have been
24 received and all legal actions have been resolved." (*Id.*, p. 2.) As reflected in the final revised Notice of
25

26 _____
27 ¹¹ For purposes of this appeal, the claimed income loss adjustment of \$1,413,140 on appellant's 2006 California return will
be considered equivalent to a claimed theft loss deduction pursuant to Internal Revenue Code (IRC) section 165.

28 ¹² Respondent does not explain and it is unclear to staff how respondent calculated the "Pinnfund Loss/NOL Adjustment"
amount of 1,575,963, which is reflected on the NPA. Staff notes that appellant does not contend that respondent incorrectly
calculated this amount.

1 Action (NOA) dated July 2, 2010, respondent modified the NPA by allowing a net operating loss (NOL)
2 of \$14,620 from tax year 2004, which reduced the proposed additional tax from \$53,806 to \$52,446.
3 (*Id.*, exhibit E.)¹³ This timely appeal followed.

4 Appellant's Contentions

5 In the appeal letter, appellant argues that he properly claimed his entire loss of
6 \$1,413,140 from the PinnFund scheme as an income loss adjustment on his 2006 return. Appellant
7 asserts that respondent improperly relies on the settlement of the Sheppard lawsuit in 2007 as grounds
8 for disallowing the claimed theft loss as he only received a relatively nominal recovery from this
9 settlement and would only receive future nominal recoveries. (Appeal Letter, p. 1.) Appellant also
10 asserts that he is entitled to claim the theft loss in tax year 2006 under Treasury Regulation section
11 1.165-1(d)(3) because there was clearly no prospect of significant recovery as of the end of 2006.
12 Appellant takes issue with respondent's position that this regulation requires "deferring the entire theft
13 loss until such time as all potential recoveries can be exactly quantified." (*Id.*, pp. 1-2.) Citing the
14 decision of the United States Court of Federal Claims ("Federal Court of Claims") in *Johnson v. United*
15 *States* (2008) 80 Fed. Cl. 96, app. dism. (Fed. Cir. 2010) 2010 U.S. App. LEXIS 12030, appellant
16 contends that he was not required to wait to claim the theft loss deduction for a portion of his loss until
17 the total amount of recovery from every source was established, and once a portion of the recovery was
18 established, he was entitled to claim a theft loss deduction for the portion he was reasonably certain not
19 to recover. (*Id.*, p. 2.)

20 Appellant also contends that the Internal Revenue Service (IRS) conducted a complete
21 audit of his 2006 federal return, including the PinnFund theft losses, and the IRS and respondent
22 reviewed the same documentation and circumstances. (Appeal Letter, p. 2.) Citing an IRS no-change
23 notice dated April 20, 2010, a copy of which is attached to the appeal letter, appellant asserts the IRS
24 took the position that in tax year 2006, appellant could claim the entire PinnFund loss amount as a theft
25

26
27 ¹³ The NOA provides, "This revision is our response to your protest of our [NPA] referred to above." (Resp. Opening Br.,
28 exhibit E.) It also provides, "This notice is revised in accordance with the recommendation of the hearing officer." (*Ibid.*)
Staff notes that other than the NOA's reference to the hearing officer, there is no indication in the file that a protest hearing
was held, nor is there any reference to an original NOA. Staff further notes that respondent asserts that appellant argued
during protest that from 2002 to 2004 he received from PinnFund income distributions, which respondent ignored in
computing the proposed assessment, and it addressed this issue in its final revised NOA. (Resp. Opening Br., p. 6, fn. 13.)

1 loss and he could report any subsequent recoveries as income in the year(s) received. (*Ibid.*) The
2 attached IRS letter indicates that the IRS completed its review of the examination of appellant's 2006
3 tax return and made no changes to his reported tax. (*Id.*, Attachment.)

4 Appellant further contends that during the end of 2006, he had conversations with
5 Mr. Kipperman that gave him cause to believe he would receive no more than a nominal recovery from
6 the pending litigation. (Appeal Letter, p. 2.) According to appellant, he received \$58,483 from the
7 \$12.5 million settlement, the recoveries have been nominal, as Mr. Kipperman correctly indicated, and
8 the maximum potential post-2006 recovery is 13 percent or less of appellant's original investment.
9 (*Ibid.*) Appellant asserts that on his 2006 return, he took the position that, because any future recovery
10 would only be nominal, the entire loss was deductible in that tax year, and he would report any future
11 recoveries as income in the tax years in which they would be received. (*Ibid.*) Appellant argues that it is
12 reasonable for respondent to allow him the entire loss in tax year 2006 because he "stands to recover a
13 maximum of 13 percent of the original investment," and "the Pinn Funds filed bankruptcy over 7 years
14 ago." (*Ibid.*) Appellant claims that delaying any theft loss deduction based on a potential nominal
15 recovery not yet realized is not in the spirit of the relevant code sections, supported by the holding in
16 *Johnson v. United States, supra*, or in accordance with the IRS's findings with regard to appellant's
17 federal 2006 return. (*Ibid.*)

18 Alternatively, appellant argues that, based on information from Mr. Kipperman,
19 respondent could establish the amount of potential recovery at a maximum of \$175,000, which is 13.1
20 percent of appellant's original investment, and appellant's claimed theft loss on his 2006 return could be
21 adjusted by this amount to \$1,243,140.¹⁴ (Appeal Letter, p. 2.)

22 In his reply brief, appellant argues that it is not reasonable to postpone the theft loss
23 deduction beyond tax year 2006. He contends that the total proceeds from settlements amounted to
24 \$131 million gross and the investors only received \$73 million or 55.8 percent of the gross proceeds
25 amount. (App. Reply Br., p. 2.) He argues that the \$12.5 million settlement of the Sheppard lawsuit, the
26

27 ¹⁴ Staff notes that appellant claimed an income loss adjustment of \$1,413,140 on his 2006 return and subtracting \$175,000
28 from this figure results in an adjusted theft loss amount of \$1,238,140, rather than 1,243.140. It is unclear whether this
\$5,000 discrepancy was an inadvertent error on the part of appellant.

1 final case to be settled, only translated into a return to investors of less than six percent and appellant
2 only received \$60,000 of \$1,413,140 of invested capital. (*Ibid.*) Appellant asserts that, by agreement
3 with the bankruptcy trustee, the settlement of that lawsuit resulted in the “Bartco law firm” receiving 25
4 percent of all settlement proceeds plus costs, and the bankruptcy trustee also received fees for his
5 services. (*Ibid.*) According to appellant, he informed respondent that he was willing to amend his 2006
6 return and withhold \$200,000 or approximately 15 percent of his total theft loss claim for the 2007
7 settlement of the Sheppard lawsuit, which would have been more than sufficient as he ultimately only
8 received less than \$60,000 of \$1,413,140 of invested capital. (*Ibid.*)

9 Appellant asserts that *Johnson v. United States, supra*, supports his position because “all
10 other cases had been decided, giving a firm measure of expectation, in the final case, [the Sheppard
11 lawsuit.]” (App. Reply Br., p. 2.) Appellant further asserts that under IRC section 165, a taxpayer is not
12 required to be an “incorrigible optimist” in order to claim a theft loss, and all facts and circumstances
13 should be considered in determining the prospect of a recovery. (*Ibid.*) Appellant states, “The facts in
14 this case give a clear expectation of recovery and [in no] event is it possible for [appellant] to make [a]
15 total recovery.” (*Ibid.*) In addition, appellant argues that respondent is incorrectly interpreting Treasury
16 Regulation section 1.165-1(d)(2), because “[a] theft loss is not to be delayed in its entirety if there is still
17 a claim pending.” (*Ibid.*) According to appellant, Treasury Regulation section 1.165-1(d)(2)
18 “specifically addresses the portion of the claim that has not been concluded and provides that to the
19 extent that claim remains open it [cannot] be deducted.”

20 Appellant contends in his reply brief that in 2009, the IRS audited his 2006 federal return
21 and upheld the original theft loss of \$1,413,140. (App. Reply Br., p. 2.) He further contends that
22 “[s]pecifically audited was the theft loss relating to all the Hillman funding entities,” and the IRS
23 directed him to claim on future returns any recovery as ordinary income. (*Ibid.*)

24 Lastly, appellant argues the following:

25 Given the extensive litigation in obtaining recovery for the Hillman funding entities, to
26 post pone [sic] the deduction beyond 2006 is not reasonable. The final legal settlement,
27 even in a best case scenario, would have netted the taxpayer some 11 percent of his
28 original investment. The taxpayer had already waited 6 years and for the conclusion of
all other settlements. Those settlements provided a clear measure of what is a reasonable
expectation for recovery. In the case of the final settlement, [the Sheppard lawsuit,],
history shows that ultimately Winkler received some 6 percent of his total invested

1 capital and therefore, as a settlement, was willing to postpone the deduction of some
2 \$200,000 of his invested capital, from 2006 to 2007.

3 (App. Reply Br., pp. 2-3.)

4 Respondent's Contentions

5 Respondent concedes that appellant suffered a theft loss from his investment in the
6 PinnFund scheme and that he discovered the loss in 2001 when the SEC filed an action against
7 PinnFund, Fanghella, Hillman, and the funding entities. (Resp. Opening Br., pp. 7-8.) Respondent
8 contends, however, that appellant is not entitled to claim any portion of his claimed theft loss on his
9 2006 return because in 2007, there was a reasonable expectation of reimbursement for appellant's loss.
10 (*Id.*, p. 6.) According to respondent, it was not until May 10, 2007, when the Sheppard lawsuit was
11 settled, that appellant could determine exactly how much of the settlement proceeds from the Sheppard
12 lawsuit he would receive and thus how much of his original investment he would be entitled to claim as
13 a theft loss. (*Id.*, p. 8.) Respondent contends there is no merit in appellant's argument that, because he
14 only recovered 0.58 percent of the \$12.5 million settlement in 2007, he should be allowed to claim a
15 theft loss in 2006 for the portion of his loss that he recovered prior to 2007. (*Ibid.*) Respondent asserts
16 that under Treasury Regulation section 1.165-1(d)(3), appellant must refrain from claiming a deduction
17 for any portion of his theft loss until May 10, 2007, the date when the Sheppard lawsuit settled. (*Ibid.*)
18 Respondent also asserts that appellant did not know how much he would recover from the Sheppard
19 lawsuit until the court approved the settlement on May 10, 2007. (*Ibid.*) Respondent points out that the
20 investors in the Sheppard lawsuit requested at least \$200 million at trial and appellant's portion of the
21 settlement proceeds could not be ascertained with reasonable certainty until May 10, 2007. (*Ibid.*)

22 Respondent contends that the decision of the Federal Court of Claims in *Johnson v.*
23 *United States*, *supra*, 80 Fed. Cl. 96, does not support appellant's position. Respondent asserts that, in
24 that case, the taxpayer first secured a judgment against the individual who defrauded him, and then after
25 ascertaining the amount recoverable from the judgment did the taxpayer claim a theft loss deduction for
26 the amount he would not recover. (Resp. Opening Br., p. 10.) According to respondent, the court in that
27 case held that the taxpayer may take a theft loss deduction for the portion of the loss he would not
28 recover of the amount secured by the judgment. (*Ibid.*) Respondent contends that appellant also ignores

1 the examples provided in Treasury Regulation section 1.165-1(d)(2) for ascertaining with reasonable
2 certainty, such as by a settlement of a claim, whether reimbursement will occur. (*Ibid.*) In appellant's
3 case, respondent asserts that it was only when the final litigation ended with an approved settlement on
4 May 10, 2007,¹⁵ that appellant ascertained with reasonable certainty the full extent of his theft loss.
5 (*Ibid.*)

6 Respondent argues that, although appellant seems to suggest the holding in *Johnson v*
7 *United States, supra*, and Treasury Regulation section 1.165-1(d)(3) permit him a partial theft loss
8 deduction in 2006 on the ground that his recovery in 2007 was nominal compared to the overall \$12.5
9 million settlement, he fails to cite any authority under IRC section 165 for such an exception to the
10 timing of a theft loss deduction. (Resp. Opening Br., p. 10.) Respondent also contends that appellant
11 would not be entitled to claim a theft loss deduction in 2006 because in his appeal letter he stated that
12 1) he expected in 2007 to receive an additional \$88,000 based on assets held in the liquidating trust from
13 the bankruptcy proceedings; and 2) he expected as of December 31, 2006, to receive future cash receipts
14 of \$200,000. (*Id.*, p. 11.)

15 Applicable Law

16 Income tax deductions are a matter of legislative grace, and the burden is on the taxpayer
17 to show by competent evidence that he is entitled to any deductions claimed. (*New Colonial Ice Co. v.*
18 *Helvering* (1934) 292 U.S. 435; *Appeal of James C. and Monablance A. Walshe*, 75-SBE-073, Oct. 20,
19 1975.) In order to carry that burden, a taxpayer must point to an applicable statute and show by credible
20 evidence that he comes within its terms. (*Appeal of Robert R. Telles*, 86-SBE-061, Mar. 4. 1986.)
21 Unsubstantiated assertions are insufficient to satisfy the burden of proof. (*Id.*) The fact that it may be
22 difficult, if not impossible, for the taxpayer to substantiate any claimed deduction does not relieve him
23 of this burden. (*Burnet v. Houston* (1931) 283 U.S. 223; *Appeal of Wing Edwin and Faye Lew*,
24 73-SBE-053, Sept. 17, 1973.) Further, there is a presumption of correctness as to respondent's denial of
25 deductions. (*Appeal of Gilbert W. Janke*, 80-SBE-059, May 21, 1980; *Todd v. McColgan* (1949) 89
26 Cal.App.2d 509.)

27
28 ¹⁵ Respondent inadvertently referred to March 10, 2007, rather than May 10, 2007. (Resp. Opening Br., p. 10.)

1 R&TC section 17201 incorporates by reference the provisions of IRC section 165 as
2 relevant to this appeal. IRC section 165(a) allows individuals to claim as a deduction “any loss
3 sustained during the taxable year and not compensated for by insurance or otherwise.” Under IRC
4 section 165(c), such a loss includes “losses of property not connected with a trade or business or a
5 transaction entered into for profit, if such losses arise from . . . theft.”¹⁶ (Int.Rev. Code, § 165(c)(3).)
6 Theft losses are “treated as sustained during the taxable year in which the taxpayer discovers such loss.”
7 (Int.Rev. Code, § 165(e).) However, in order for a theft loss deduction to be allowed, the loss must be
8 evidenced by a closed and completed transaction. (Treas. Reg. § 1.165-1(b).) Under the “closed
9 transaction” doctrine, an essential inquiry is whether the taxpayer had a claim for reimbursement with
10 respect to which there was a reasonable prospect of recovery. (*Dawn v. Commissioner* (9th Cir. 1982)
11 675 F.2d 1077, 1078 (citing *Ramsay Scarlett & Co. v. Commissioner*, (1974) 61 T.C. 795, 807, aff’d (4th
12 Cir. 1975) 521 F.2d 786.) “When such a claim exists, no portion of the loss with respect to which
13 reimbursement might be received is sustained until it becomes reasonably certain that reimbursement
14 will not be received.” (*Ibid.* citing Treas. Reg. § 1.165-1(d)(2)(i).) The treasury regulations explain:

15 Any loss arising from theft shall be treated as sustained during the taxable year in which
16 the taxpayer discovers the loss . . . However, if in the year of discovery there exists a
17 claim for reimbursement with respect to which there is a reasonable prospect of recovery,
18 no portion of the loss with respect to which reimbursement may be received is sustained,
for purposes of [the theft loss deduction] . . . , until the taxable year in which it can be
ascertained with reasonable certainty whether or not such reimbursement will be
received.

19 (Treas. Reg. § 1.165-1(d)(3); see also Treas. Reg., § 1.165-8.) Also, the treasury regulations provide:

20 Whether a reasonable prospect of recovery exists with respect to a claim for
21 reimbursement of a loss is a question of fact to be determined upon an examination of all
22 facts and circumstances. Whether or not such reimbursement will be received may be
23 ascertained with reasonable certainty, for example, by a settlement of the claim, by an
24 adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims
25 that the taxable year in which a loss is sustained is fixed by his abandonment of the claim
26 for reimbursement, he must be able to produce objective evidence of his having
27 abandoned the claim, such as the execution of a release.

26 ¹⁶ Whether acts constitute “theft” for purposes of the theft loss deduction must be determined under the law of the jurisdiction
27 where the loss was sustained. (*Edwards v. Bromberg* (5th Cir. 1956) 232 F.2d 107; *Riet v. Commissioner*, T.C. Memo. 1989-
28 494.) California Penal Code section 484, subdivision (a), defines theft to include obtaining money by false pretenses and
section 503 defines embezzlement as “the fraudulent appropriation of property by a person to whom it has been entrusted.”
(See also Treas. Reg. § 1.165-8(d) (defining theft broadly to include, but not necessarily be limited to, larceny,
embezzlement, and robbery).)

1 (Treas. Reg., § 1.165-1(d)(2)(i).)

2 “Determining whether taxpayers had a claim for reimbursement that provided a
3 reasonable prospect for recovery is an objective inquiry requiring an examination of the facts and
4 circumstances surrounding the deduction.” (*Dawn v. Commissioner, supra*, 675 F.2d at p. 1078 (citation
5 omitted).) Although a taxpayer’s subjective belief as to whether there was a reasonable prospect of
6 recovery is a factor to consider, the standard to be applied is an objective one. (*Jeppsen v.*
7 *Commissioner* (10th Cir. 1997) 128 F.3d 1410, 1418.) See also *Boehm v. Commissioner* (1945) 326
8 U.S. 287, 292-293 (the standard to be applied is primarily objective, but the taxpayer’s subjective
9 attitude and conduct are not to be ignored.) Where a taxpayer files a lawsuit to recover the deducted loss
10 there is an inference that the taxpayer had a claim for reimbursement that provided a reasonable prospect
11 of recovery. (*Dawn v. Commissioner, supra*, 675 F.2d at p. 1078.) The determination of whether a
12 reasonable prospect of recovery exists as of the end of the tax year is a question of foresight, not
13 hindsight. (*Jeppsen v. Commissioner, supra*, 128 F.3d at p. 1416.) Hence, “a taxpayer’s ultimate
14 recovery does not *control* whether, at the end of a taxable year, that taxpayer enjoyed a reasonable
15 prospect of recovering property stolen during that taxable year.” (*Id.* at p. 1415.) Lawsuits filed after
16 the close of a tax year for which the theft loss deduction was claimed may be considered in determining
17 whether the taxpayer had a reasonable prospect of recovery so long as the taxpayer contemplated filing
18 the lawsuit during the tax year. (*Id.* at p. 1418.) Furthermore, if a taxpayer’s prospect of recovery was
19 simply unknowable at the end of the tax year at issue, then the taxpayer will not be entitled to take the
20 theft loss deduction that year. (*Ibid.*)

21 Treasury Regulation section 1.165-1(d)(3) further explains that “if in the year of
22 discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of
23 recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for
24 purposes of section 165, until the taxable year in which it can be ascertained with reasonable certainty
25 whether or not such reimbursement will be received.” (See also Treas. Reg., § 1.165-8.)

26 In *Johnson v United States, supra*, 80 Fed. Cl. 96, the issue was whether the plaintiffs
27 were entitled to a theft loss deduction in either 1998 or 2001 for any portion of the losses they suffered
28 as the victims of fraud. In a prior proceeding (*Johnson I*), the court granted the government’s motion for

1 summary judgment, holding that the plaintiffs were not entitled to claim a theft loss deduction in 1997,
2 the year they discovered the theft loss, or in 1998 because they were actively pursuing recovery of their
3 losses in 1998 and had not ascertained with reasonable certainty the amount they would recover. In
4 *Johnson I*, the court held that, if in the year of discovery of the theft loss there is a reasonable prospect
5 of recovery, then the taxpayer “must wait to take the theft loss deduction until the recovery process is
6 finalized, either through an adjudication or a settlement, until the taxpayer abandons her collection
7 efforts, or until the claim for reimbursement is resolved in some other way.” (*Id.* at p. 116.) The court
8 held that under its interpretation of the IRC and Treasury Regulations section 1.165-1(d)(2), the
9 reasonable prospect of recovery standard only applies in the year the taxpayer discovers the theft loss
10 and the reasonable certainty standard applies for the subsequent years. (*Id.* at pp. 117-118.) In other
11 words, if in the year of the theft loss discovery there is a reasonable prospect of recovery, then the
12 taxpayer is not permitted to take a theft loss deduction for any portion of his loss until the year in which
13 he ascertains with reasonable certainty that he would not recover that portion of the loss.

14 The court noted that “the IRC and Treasury Regulations do not preclude a taxpayer from
15 taking deductions for portions of a theft loss in different years.” (*Id.* at p. 118, fn. 9.) With respect to
16 1998, the court held that the plaintiffs were not entitled to a theft loss deduction because “the plaintiffs
17 were still clearly engaged in efforts to determine how best to pursue their legal claims, as demonstrated
18 by the fact that, in 1999, the plaintiffs added forty-one additional third- party defendants to their claim
19 against Mr. Hasson, and in 2000, the plaintiffs added fifteen additional third-party defendants.” (*Id.* at
20 p. 118.) As of the end of 2001, the court found that the plaintiffs established that the remaining claims
21 against Mr. Hasson and his associates were valued at and the plaintiffs could have potentially received,
22 at most, \$39,548,563.32 after December 31, 2001. (*Id.* at p. 120.)

23 The court found “particularly relevant” the following example set forth in Treasury
24 Regulations section 1.165-1(d)(2)(ii):

25 [I]f the taxpayer’s automobile is completely destroyed in 1961 as a result of the
26 negligence of another person and there exists a reasonable prospect of recovery on a
27 claim for the full value of the automobile against such person, the taxpayer does not
28 sustain any loss until the taxable year in which the claim is adjudicated or otherwise
settled. If the automobile had an adjusted basis of \$5,000 and the taxpayer secures a
judgment of \$4,000 in 1962, \$1,000 is deductible for the taxable year 1962. If in 1963 it
becomes reasonably certain that only \$3,500 can ever be collected on such judgment,
\$500 is deductible for the taxable year 1963.

1 (*Id.* at p. 120.)

2 The court held that “the plaintiffs were not required to wait until the total amount of
3 recovery from every source was established to take a theft loss deduction for a portion of their loss.”
4 (*Ibid.*) Thus, the court held that, “The regulation and the example therefore confirm the plaintiffs’
5 contention that once a ‘portion’ of the recovery was established, they were entitled to take a theft loss
6 deduction for the ‘portion’ that they were reasonably certain they would not recover.” (*Ibid.*) Given the
7 fact that the plaintiffs established the amount that they could potentially receive after December 31,
8 2001, the court found that the plaintiffs ascertained with reasonable certainty in 2001 that they had no
9 prospect of recovering a portion of their theft loss in the amount of \$37,216,383.04 and therefore they
10 were entitled to claim a theft loss deduction in that amount for tax year 2001. (*Id.* at p. 120.)

11 STAFF COMMENTS

12 Appellant bears the burden of proving he is entitled to claim an income loss adjustment
13 for a theft loss from the PinnFund scheme on his 2006 return. There is no dispute that appellant’s lost
14 investment in the PinnFund scheme constitutes a theft, which he discovered in 2001, and that appellant’s
15 loss therefore qualifies as a theft loss within the meaning of IRC section 165. (Resp. Opening Br., p. 7.)
16 The issue before the Board is whether, for purposes of claiming the deduction, appellant’s theft loss was
17 sustained during tax year 2006. In this regard, appellant has the burden of establishing that as of the end
18 of 2006, he was able to ascertain with reasonable certainty that he would not recover the amount for
19 which he claimed the loss deduction. (Treas. Reg., §§ 1.165-1(d)(2)(i), 1.165-1(d)(3); accord Treas. Reg.
20 § 1.165-8(a)(2).)

21 At the hearing, the parties should be prepared to discuss whether the holding of *Johnson*
22 *v. United States*, *supra*, 80 Fed. Cl. 96, is applicable to the facts in this appeal.

23 In addition, the parties should be prepared to discuss appellant’s contention that the IRS
24 conducted a complete audit of his 2006 federal return, including the PinnFund theft loss, and allowed
25 him to claim the entire theft loss amount on his 2006 federal return and to report any subsequent
26 recoveries as income in future years, as purportedly indicated by the IRS no change order dated
27 April 20, 2010. The parties should also be prepared to discuss the outcome of the lawsuit against Levitz,
28 Zacks & Ciceric.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

In the event that appellant has additional evidence supporting his position, he should submit it to the Board and respondent at least 14 days prior to the hearing date.¹⁷

///

///

///

Winkler_lf

¹⁷ Exhibits should be submitted to: Claudia Madrigal, Board Proceedings Division, Board of Equalization, P. O. Box 942879 MIC: 80, Sacramento, CA 94279-0080.