Home Improvement or Home Disaster? Can The Tax Law Help When You Get Taken?

by Robert W. Wood *

At some point in our lives, most of us will hire contractors to perform work on our homes. There are many considerations in these relationships. Tax considerations rarely come to mind here. Still tax considerations can occasionally arise even in this context, and even where the horror story is much worse than most remodeling stories.

We'll focus on residential here, since surely these are the most painful situations. Hopefully, once a contractor is hired to perform construction work on your premises he will follow through with it to your satisfaction. At some point (usually even before work has begun) the contractor is likely to request advances for the purchase of materials from suppliers and to pay subcontractors.

If you've had prior dealings with this individual, or if you are a trusting soul, you might advance him the funds without requiring that the check be made jointly payable to him and the supplier and/or subcontractor. From a consumer protection standpoint (and in an ideal world) it's always best to make checks (at least significant ones) jointly payable to the contractor and his subcontractors and/or suppliers. In reality, things often don't always work out that way. (Reasons for the joint checks are set out below.)

Sometimes people just don't feel right (perhaps because they've known the contractor for years or because he comes highly recommended) asking a contractor to accept joint checks for supplies and subcontractor payments. Yet, given unfettered access (as the sole payee) to the funds, contractors sometimes fail (for one reason or another) to use the money to pay for either materials or subcontractors. Instead, sometimes contractors abscond with the money, or at least fail to pay their payroll taxes (more about that below).

Will Uncle Sam Partially Underwrite Your Losses?

Of course, this kind of thing does not happen every day, but it does happen. There may be no reasonable prospect of recovery from the contractor who has skipped town. You may or may not have a decent civil case, but even if you do, pursing it may be tough. The police probably will not be very helpful. The same is often true with contractors' state licensing boards.

From a tax perspective, a prime question is whether the taxpayer is entitled to a theft loss deduction under Section 165(c)(3) for the funds advanced to the contractor. The answer may depend if the contractor's actions rise to the level of a crime under applicable law. Section 165 generally allows for the deduction of theft losses "sustained during the taxable year and not compensated for by insurance or otherwise."

As it is used in Section 165(c)(3), the term "theft" is "a word of general and broad connotation, intended to cover and covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile".[1] For purposes of Section 165(c)(3), whether a deductible theft loss has occurred is determined under the laws of the state where the alleged loss took place (or under applicable federal law).[2]

For example, in California:

> Every person who shall feloniously steal, take, carry, lead, or drive away the personal property of another, or who shall fraudulently appropriate property which has been entrusted to him or her, or who shall knowingly and designedly, by any false or fraudulent representation or pretense, defraud any other person of money, labor or real or personal property, or who causes or procures others to report falsely of his or her wealth or mercantile character and by thus imposing upon any person, obtains credit and thereby fraudulently gets or obtains possession of money, or property or obtains the labor or service of another is guilty of theft.[3]

"Theft" for purposes of Section 165(c)(3) is not limited to the statutory crime of theft under applicable law; however, the act that results in the taxpayer's loss must be a crime in order for the loss to be deductible under Section 165(c)(3).[4] Even so, it is not necessary that the individual responsible for the theft actually be convicted of a crime for the taxpayer to have a deductible theft loss under Section 165(c)(3).[5]\

False Pretenses

In fact, the Ninth Circuit has gone so far as to hold that for purposes of Section 165(c)(3) a theft occurs where: (i) a taxpayer advances funds to a contractor to pay materials suppliers and subcontractors, (ii) the contractor fraudulently assures the taxpayer he has compensated these individuals with the advanced funds, and (iii) the contractor feloniously absconds with the taxpayer's money, subjecting the taxpayer's home to numerous mechanics' liens from the unpaid materials suppliers and subcontractors.[6] Thus, for purposes of Section 165(c)(3), a theft is deemed to occur where a contractor accepts payment from a taxpayer under false pretenses.[7]

There have been a few tax cases fleshing out these rules. For example, in *Miller v. Commissioner*,[8] a contractor was hired by the taxpayers to perform work on their home and was paid a large sum of money in advance. After performing only a small portion of the agreed-upon work, the contractor feloniously absconded with the money. The Tax Court ruled that the taxpayers were entitled to deduct as a theft loss the amount paid to the contractor for the work which was never performed.

In *Hartley v. Commissioner*,[9] the taxpayers entered into a construction contract with a contractor and gave him a substantial cash advance to allow him to purchase materials. Even so, the contractor purchased the materials on credit, thereby creating a mechanic's lien on the taxpayers' property, which they later paid to discharge. After performing a small portion of work, the contractor defaulted on the construction contract and feloniously absconded with the remaining money. Shortly thereafter the contractor filed for bankruptcy. The Tax Court held that the taxpayers were entitled to a theft loss deduction under Section 165(c)(3).

Tax Benefit Rule

Generally, theft losses are deducted in the year they are discovered.[10] A theft loss is generally not deductible where there is a reasonable prospect of recovery or reimbursement (through insurance or otherwise).[11] Even so, under the tax benefit rule of Section 111, if a taxpayer properly claims a theft loss under Section 165(c)(3) and thereafter is somehow reimbursed for the theft loss, the taxpayer must recognize gross income to the extent any previous theft loss deduction provided a tax benefit.

The basic idea is that the taxpayer should not have to include in income a recovered amount unless he previously received a "tax benefit" on account of that particular tax item. This exclusion applies to all losses, expenditures, and accruals made on the basis of deductions from gross income for prior taxable years.[12]

Arrivederci

If possible, it is a good idea to issue joint checks to your contractor and his materials suppliers and subcontractors. Admittedly, this is not always feasible. But, even when it is not, you might consider contracting directly with the material suppliers and subcontractors. True, that sounds like a hassle. However, this might save you a plethora of headaches down the road. Hopefully you will never be defrauded by a contractor, but if you are, at least you might be able to have Uncle Sam underwrite a portion of your misfortune (and recover a portion of your losses) by taking a theft loss deduction under Section 163(c)(3).

ENDNOTES

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1. *Nichols v. Commissioner*, 43 T.C. 842, 884 (1965) *quoting, Edwards v. Bromberg*, 232 F.2d107, 110 (5th Cir. 1956); See also, Treas. Reg. §1.165-8(d) (stating for purposes of I.R.C. §165 the term "theft" shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery).

2. *Bellis v. Commissioner*, 540 F.2d 448, 449 (9th Cir. 1976) *aff'g,* 61 T.C. 354 (1973).

3. Cal. Penal Code §484 (Deering 2004).

4. See *Bodine v. Commissioner*, T.C. Memo. 1984-143; *Luman v. Commissioner*, 79 T.C. 846 (1982).

5. *Monteleone v. Commissioner*, 34 T.C. 688 (1960).

6. *Norton v. Commissioner*, 333 F.2d 1005 (9th Cir. 1964) *aff'g*, 40 T.C. 500 (1963).

7. *Id.*

8. 19 T.C. 1046 (1953).

9. T.C. Memo. 1977-317

10. Treas. Reg. §1.165-8(a)(2).

11. Treas. Reg. §1.165-1(d)(3).

12. See Treas. Reg. 1.111-1(a).