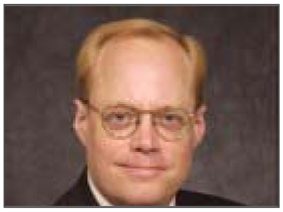

Robert W. Wood

THE TAX LAWYER

Aug. 1 2011 — 8:37 am

How Bad Is Your Tax Shelter?

Image by JD Hancock via Flickr

No one wants to lose money, and losing money while trying to save it is especially frustrating. What if you buy something you ***think*** will save you taxes only to find you were defrauded? You may be tempted to sue. But at the very least, you might assume you can deduct the cash you lost in the shelter! See Seeking Shelter In Tax Shelters?

Not always. That's the lesson of *Vincentini v. Commissioner*. There, the court ruled an investor who thought he was buying tax benefits couldn't even claim a theft loss when the investment imploded and the promoters went to jail. What's more, although he relied on a CPA, his reliance was "unreasonable" so penalties applied.

Sound harsh? The tax deductibility of theft losses isn't always controversial, but is touchy with tax shelters. There's a long tradition of tax shelter investors trying to deduct all that's promised to them, but when the deal goes south and their tax deductions fail, claiming a theft loss deduction.

Perhaps it's a Hail Mary pass, but it has a certain appeal. "Dear IRS," the investor might say, "if this shelter is as bad as you say it is, I was defrauded out of my money."

Tax shelters are defined by the tax code to include any plan or arrangement having a significant purpose of avoiding or evading federal income tax. That sounds incredibly broad—a huge number of transactions have tax ramifications as a significant purpose! The key is whether the tax ramifications are the ***reason*** for entering into the transaction. See When Too Good Tax Deals Become Fraud.

You can deduct theft losses not compensated for by insurance. For an individual, the deduction is limited to losses in a trade or business, a transaction for profit, or losses from fire, storm, shipwreck, casualty or theft. See IRC Code Section 165(c). You count a loss from theft during the year you discover it. See IRC Section 165(e). But if you have a claim for reimbursement with a reasonable prospect of recovery, you can't claim any loss until it's clear it won't be reimbursed.

Dominick Vincentini invested in shelters with Anderson Ark & Associates (AAA). On his 1999 return, he claimed a partnership loss of $907,470, offsetting $796,629 in early distributions from his IRA. His return was prepared by Gary Kuzel, a CPA recommended by AAA. Kuzel also helped document the shelter. See CPA Sentenced in $120 Million Tax Shelter Case.

In early 2001, AAA principals were arrested and indicted for various crimes. Many were convicted by 2002 and ordered to pay restitution in 2004. See Four Defendants Sentenced in $120 Million International Tax Shelter Case. In 2003, the IRS disallowed all Vincentini's shelter losses so he amended his 1999 return and claimed a theft loss deduction.

The IRS denied that too, saying he still might recover. The Tax Court agreed, noting Vincentini had not shown there was no reasonable prospect of recovery in 2001. See Memorandum Findings of Fact and Opinion and Supplemental Memorandum Opinion. The Tax Court also upheld penalties. Since Vincentini knew Kuzel was affiliated with AAA, he shouldn't have relied on him.

On appeal to the Sixth Circuit, Vincentini argued that the convictions and presence of court-appointed lawyers in the criminal trials made it clear Vincentini was never going to see a dime. There still might be a recovery through a civil suit, said the court. The Sixth Circuit also upheld the penalties. Vincentini conducted no research on Kuzel's professional background or his ties with AAA.

Bottom line? Theft loss nuances are one more reason to stay away from tax shelters.

For more, see:

Two Out of Three Not Good Enough

Man Invests $1.7M with Author of Financial Success Audiotapes and Shockingly, Things End Badly

Couple acquitted of tax fraud

Seeking Shelter In Tax Shelters?

Tax Shelters Not Über Alles

Know Tax Shelters When You See Them?

To Avoid Fate Of Wesley Snipes, Skip Tax Protester Arguments

Ten Tax Protestor Claims To Avoid

IRS: Topic 515 – Casualty, Disaster, and Theft Losses

IRS: Abusive Tax Shelters and Transactions

IRS: Abusive Tax Schemes – Criminal Investigation

Robert W. Wood practices law with Wood LLP, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009, Tax Institute), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.