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Estate allowed deduction for theft loss suffered by an LLC in which it held an interest

The Tax Court finds a sufficient nexus between the Ponzi scheme theft loss suffered by an LLC and the value of the estate's interest in the LLC.

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The Tax Court, in a case of first impression, held that an estate was entitled to a theft loss deduction arising from the worthlessness of an investment account held by a limited liability company (LLC) in which the estate owned a 99% interest. The estate suffered a loss in value when its interest in the LLC was reduced to zero as a result of a multibillion-dollar Ponzi scheme. Thus, the theft loss sustained by the LLC directly reduced the value of the estate as well as the value of property available to the decedent's heirs.

Facts: At the time of his death in January 2008, James Heller, a resident of New York, owned a 99% interest in James Heller Family LLC (JHF). His daughter and son held equal shares of the remaining interest. JHF's only asset was an account with Bernard L. Madoff Investment Securities, valued on the date of Heller's death at approximately $16.6 million. Between March and November 2008, a co-executor of the estate withdrew $11.5 million from the JHF Madoff account and distributed it according to JHF's ownership interests. The estate's share, approximately $11.4 million, was used to pay taxes and administrative expenses.

In December 2008, Bernard Madoff was arrested and charged with securities fraud. In March 2009, Madoff admitted that he had perpetrated a Ponzi scheme through Madoff Securities and pleaded guilty to various federal crimes, including securities fraud, investment adviser fraud, money laundering, and perjury. As a result of the Ponzi scheme, the JHF Madoff account and the estate's interest in JHF became worthless.

In April 2009, a timely filed estate tax return reported $26.3 million as the value of Heller's gross estate. Included in this amount was Heller's 99% interest in JHF, valued at approximately $16.6 million at the time of his death. The estate tax return also claimed a nearly $5.2 million theft loss deduction relating to the Ponzi scheme, calculated as the difference between the value of the estate's interest in JHF on the date of Heller's death and the estate's share of the amount withdrawn from the Madoff account before it became worthless ($16.6 million — $11.4 million).

In February 2012, the IRS issued a notice of deficiency in which it disallowed the theft loss deduction because the estate did not incur the loss during its settlement. The IRS contended that under New York state law, JHF, not the estate, was the theft victim. The estate challenged the IRS's determination in Tax Court.

Issues: The estate tax is imposed on the value of property transferred to beneficiaries. The tax is imposed on the taxable estate, which is the value of the gross estate under Sec. 2031 reduced by allowable deductions. Under Sec. 2054, a deduction is allowed for losses incurred during the settlement of an estate arising from casualties or theft.

The issue before the court was whether an estate may take a theft loss deduction for losses relating to property it does not hold directly. The IRS argued that the losses arising from the JHF Madoff account were those of JHF and that a theft loss deduction therefore was not allowable to the estate. The estate argued that while JHF lost its sole asset as a result of the Ponzi scheme, the estate, during its settlement, also suffered a loss because the value of its interest in JHF declined from nearly $5.2 million to zero.

Holding: The court rejected the IRS's argument, finding that such a narrow interpretation was contrary to the broader nexus allowed by Sec. 2054 between the theft and the incurred loss. Looking both to the plain language of the statute and relevant case law, the court found that there was sufficient nexus between the theft and the estate's loss to allow the deduction. The loss the estate suffered related directly to its interest in JHF, and the worthlessness of JHF indisputably arose from the Ponzi scheme theft.

The court also found that allowing a theft loss deduction in this context was consistent with the purpose of the estate tax. Estate tax deductions are intended to ensure that the tax is imposed on the net estate, or the value of property that "passes from the dead to the living" (quoting *Jacobs*, 34 B.T.A. 594, 597 (1936)). The Ponzi scheme theft extinguished the value of the estate's JHF interest and, as a direct consequence, diminished the value of property available to the decedent's heirs.

- *Estate of Heller*, 147 T.C. No. 11 (2016)

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