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Vital Briefing

Relief for taxpayers with personal casualty and fraud-related theft losses on horizon

By Karen Servidea, J.D.

Key Takeaways:

- In September, the House of Representative passed The Tax Relief for Fraud Victims Act that would:
  - Remove current provision limiting allowance of personal casualty losses not attributable to federally or state declared disasters to amount of personal casualty gains.
  - Allow deduction for theft losses arising from fraud, deceit, or misrepresentation in year of loss (rather than year of discovery).
  - Exempt certain early withdrawals from qualified retirement plans related to theft losses involving fraud, deceit, or misrepresentation from the additional tax, and allow the distribution to be repaid within one year after the loss is discovered.
  - Hold open the statute of limitations for filing certain types of refund claims until one year after the discovery of a theft loss involving fraud, deceit, or misrepresentation.
- The bill now awaits action in the Senate.

Cyber-enabled crimes have defrauded Americans of almost $21 billion in a single year according to statistics cited by supporters of "The Tax Relief for Fraud Victims Act" (H.R. 9500). They note that generative artificial intelligence (AI) enables criminals to launch highly personalized attacks at scale by cloning the voices of loved ones. Meanwhile, say supporters, the tax code has not kept pace with today's digital threats.

The Tax Relief for Fraud Victims Act would amend several Internal Revenue Code provisions to protect victims of theft involving fraud, deceit, or misrepresentation. Among other things, the law would exempt distributions from retirement accounts relating to fraud-related theft losses from the penalty on early distributions. Taxpayers also would benefit from the elimination of a provision that, since 2018, has limited deductions for personal casualty losses to those attributable to certain officially declared disasters.

The House of Representatives passed the legislation, which was co-sponsored by Max L. Miller (R-OH), Thomas R. Suozzi (D-NY), and Vern Buchanan (R-FL), by a vote of 408 to 17 in September. The bill now awaits action in the Senate, where it was referred to the Finance Committee.

Personal Casualty Losses

In general, taxpayers are allowed to deduct losses for which they are not compensated or reimbursed by insurance or otherwise. Internal Revenue Code (IRC) § 165(a). In the case of an individual, the deduction is limited to: (1) losses incurred in a trade or business; (2) losses incurred in a transaction entered into for profit; and (3) except as otherwise provided, losses of property not connected with a trade or business or a transaction entered into for profit if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. IRC § 165(c).

As noted, exceptions apply to losses that are otherwise described in the third category, which are referred to as "personal casualty losses." IRC § 165(h)(3)(B) and (c)(3). In general, such a loss is allowed only to the extent that the amount arising from each casualty or theft exceeds $100. IRC § 165(h)(1). In addition, if personal casualty losses exceed personal casualty gains, the losses generally are allowed only to the extent of the sum of (1) the taxpayer's personal casualty gains and (2) so much of such excess as exceeds 10 percent of the taxpayer's adjusted gross income. IRC § 165(h)(2)(A). (For tax years beginning after 2024, the $100 per casualty/theft floor is increased to $500 for "qualified disaster-related personal casualty losses" and the 10 percent adjusted gross income rule is waived in certain cases involving such losses. See IRC § 165(h)(1) and (h)(6), as amended and added by Pub. L. 119-108.)

Since 2018, deductions for personal casualty losses have been even further limited. For tax years beginning after 2017 and before 2026, a personal casualty loss that

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otherwise would be deductible generally was allowable as a deduction only to the extent that it was attributable to a "Federally declared disaster." IRC § 165(h)(5), before amendment by the One Big Beautiful Bill Act (Pub. L. 119-21). For tax years beginning after 2025, the loss is allowable as a deduction only if it is attributable to a "Federally declared disaster" or a "State declared disaster." IRC § 165(h)(5). (A taxpayer may still claim personal casualty losses not attributable to federally or state declared disasters to the extent of any personal casualty gains, however.)

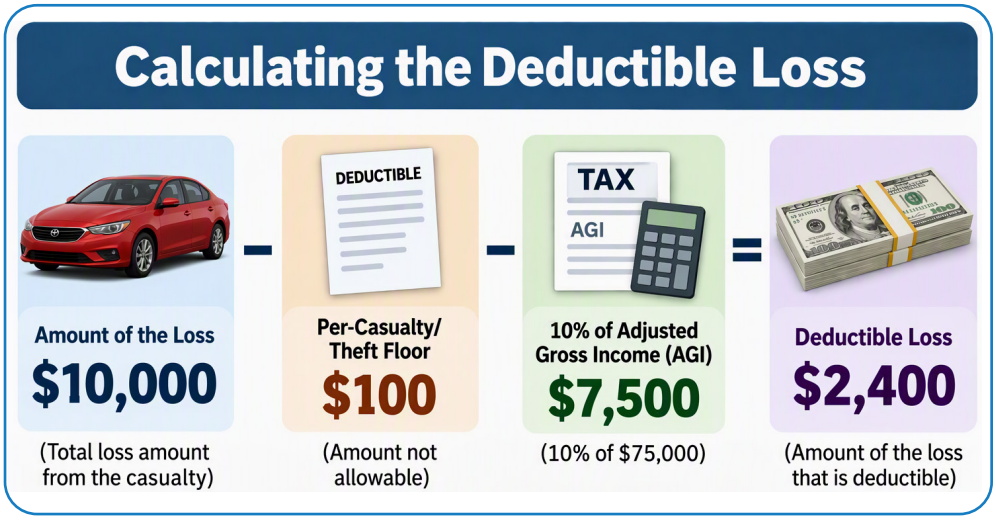
The Tax Relief for Victims of Fraud Act would eliminate the latter set of limitations. As a result, individuals generally would be allowed to deduct personal casualty losses that are not attributable to a federally or state declared disaster, subject to the $100 per-casualty/theft floor, to the extent that aggregate personal casualty losses exceed 10 percent of adjusted gross income.

For example, suppose an individual's car is destroyed in a fire that is not related to a federally or state declared disaster. The car was worth $10,000 immediately before the fire, and the individual's adjusted basis in the car is greater than $10,000. The individual receives no compensation for the loss by insurance or otherwise. Assume further that the individual does not have any personal casualty gains for the year and has adjusted gross income of $75,000.

Under current law, the individual would not be entitled to deduct any part of the loss. Under the proposed legislation, the individual would receive a deduction of $2,400, calculated as shown in the graphic below.

Fraud-related theft losses as personal casualty losses. As noted above, the term "personal casualty loss" includes losses from theft. Thus, under current law, an individual who sustains a loss not connected with a trade or business or a transaction entered into for profit arising from theft is not permitted to deduct the loss (unless the loss is attributable to a federally or state declared disaster).

In a 2025 Chief Counsel Memorandum, the IRS determined that losses sustained by five individuals in hypothetical scenarios involving the transfer of funds pursuant to scams constituted theft losses under IRC § 165. Whether the losses were deductible turned on whether they were incurred in transactions entered into for profit and thus not subject to the limitation on personal casualty loss deductions. In each scenario, the taxpayer invested funds in brokerage type accounts that invested in securities and other financial products and then, falling victim to a scam, either authorized the distribution of funds from the accounts and fund transfers to new accounts or a scammer or had a scammer make unauthorized distributions and transfers of funds from the accounts. It was determined that the taxpayers' original investments, before the scams, were transactions entered into for profit.



In the scenarios in which the taxpayers authorized the distributions and transfers, the IRS looked to the taxpayer's motive for doing so to determine whether the theft loss was incurred in a transaction entered into for profit. Taxpayers whose motive was to transfer funds from existing investment accounts to new investment accounts were determined to have a profit motive when authorizing the distributions and transfers. In one such scenario, for example, a scammer purporting to be a "fraud specialist" contacted the taxpayer and induced the taxpayer to authorize distributions from the accounts and to transfer the funds into new investment accounts created by the scammer. The scammer then transferred the funds out of the new investment accounts to an overseas account. Because the taxpayer authorized the distributions and transfers to safeguard and reinvest the funds in the same manner as before the distributions, the loss was determined to have been incurred in a transaction entered into for profit and to be deductible. *See* Chief Counsel Memorandum 202511015 (Taxpayer 1).

Taxpayers who were motivated to transfer funds to a scammer as part of a non-investment scam, such as a romance or kidnapping scam, however, were determined not to have a profit motive. In the romance scam scenario, for example, the taxpayer received an unsolicited text message from a scammer and developed a virtual

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romantic relationship with the scammer. The scammer told the taxpayer that a relative needed medical assistance that the scammer could not afford. The taxpayer authorized distributions from his or her investment accounts to a personal bank account and then transferred the money to the scammer's overseas account to cover the purported medical expenses. After the transfer of money, the scammer stopped responding to the taxpayer's messages, and the taxpayer realized that the scammer had stolen the money. The loss was determined not to have been incurred in a transaction entered into for profit, and, as a personal casualty loss, it was not deductible. *See* Chief Counsel Memorandum 202511015 (Taxpayer 4).

As with the example involving the car destroyed in a fire, The Tax Relief for Fraud Victims Act would change the result in the above romance scam scenario and other scenarios where a taxpayer incurs a theft loss in a transaction that is not entered into for profit. Such losses would be deductible, subject to the $100 per-casualty/theft floor, to the extent that aggregate personal casualty losses exceed 10 percent of adjusted gross income.

Timing of Fraud-Related Theft Losses

Under current law, a loss arising from theft is treated as sustained during (and thus is deductible in) the tax year in which the taxpayer discovers the loss, unless in that year a claim for reimbursement with respect to which there is a reasonable prospect of recovery exists. IRC § 165(e); Treas. Reg. §§ 1.165-8(a)(2), 1.165-1(d). The pending legislation would allow a taxpayer to elect to treat a loss arising from theft involving fraud, deceit, or misrepresentation as sustained during the tax year in which the loss occurs. The draft law leaves it to the Department of the Treasury to define the phrase "loss arising from theft involving fraud, deceit, or misrepresentation."

Summary of Changes Proposed in The Tax Relief for Fraud Victims Act

Issue	Current Law	Tax Relief for Fraud Victims Act
Personal casualty losses not attributable to federally or state declared disasters	Not deductible (but may be used to offset personal casualty gains)	Deductible, subject to $100 per-casualty/theft floor, to the extent that aggregate personal casualty losses exceed 10 percent of adjusted gross income
Deduction for fraud-related theft loss	Claimed in year loss is discovered (unless in that year there is a claim for reimbursement with a reasonable prospect of recovery)	Taxpayer may elect year of discovery or year loss occurred
Early retirement withdrawals tied to fraud-related theft losses	Generally subject to 10% penalty	Penalty waived and repayment allowed
Refund claim deadline for claims tied to fraud-related theft losses	Standard 2- or 3-year period	Extended to 1 year after discovering loss

Suppose, for example, that in the above-referenced scam involving the "fraud specialist," the authorization by the taxpayer, the distribution and transfer of funds, and the taking of the funds by the scammer occurred in year 1, but the taxpayer did not discover the theft until year 2. Assume that there is no prospect of recovery as of the end of year 2. Under current law, the taxpayer would have to claim the loss deduction in year 2. Assuming that such a loss would be considered to arise from theft involving fraud, deceit, or misrepresentation, the pending legislation would give the taxpayer the option of claiming the deduction in the year in which the loss occurs – year 1, in this example – instead.

Early Distributions from Retirement Plans Relating to Fraud-Related Theft Losses

The bill also includes amendments relating to early distributions from qualified retirement accounts, such as 401(k)s, that are related to losses arising from theft involving fraud, deceit, or misrepresentation. In general, distributions received by a taxpayer from such an account before the taxpayer attains the age of 59 ½ are subject to an additional tax of 10 percent. IRC § 72(t). Current law provides several exceptions, including, for example, certain distributions made in connection with the birth or adoption of a child and certain distributions for first-time homebuyers.

The pending legislation would add another exception for "[a]ny distribution to the

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extent it relates to any loss arising from theft involving fraud, deceit, or misrepresentation for which a deduction is allowed under [IRC § 165(a)]." Although the bill does not define what it means for a distribution to relate to a theft loss from fraud, in remarks at a hearing held by the House Ways and Means Committee, Miller described the bill as "ensur[ing] that retirement accounts are not treated as [a] taxable windfall when drained by scammers."

The proposal also would allow a taxpayer who receives an early distribution relating to a theft loss arising from fraud, deceit, or misrepresentation to repay the distribution to an eligible retirement plan within one year following the discovery of the loss.

Period of Limitations for Filing Refund Claims

The bill would extend the period of limitations for filing a refund claim (1) with respect to a deduction under IRC § 165(a) for a loss arising from theft involving fraud, deceit, or misrepresentation or (2) of the additional tax on early distributions from retirement accounts relating to such a loss.

Under the standard period of limitation IRC § 6511(a), a taxpayer must file a claim for refund with the IRS within three years of filing a return or two years of paying the tax, whichever period expires later. Suppose that, for some reason, the taxpayer in the "fraud specialist" example above does not discover the loss until five years after it occurs. By then, the limitations period for claiming a refund for the year in which the loss occurred is likely to have expired, which would effectively deprive the taxpayer of the ability to elect to deduct the loss in that year. Similarly, if a taxpayer who incurs a penalty for an early distribution from a qualified retirement account that is stolen in a fraud-related theft does not discover the loss until five years after the distribution, the limitations period for claiming a refund of the penalty normally will have expired by the time of the discovery.

The bill thus provides that the period of limitations for filing either of the types of refund claims described above shall not expire before the date that is one year after the taxpayer discovers the loss, thus providing relief to the taxpayers in the foregoing examples. The bill would also except both types of refund claims from the general rule (IRC § 6511(b)(2)) that limits the amount of a credit or refund to payments made by the taxpayer during a two- or three-year lookback period from the filing of the refund claim.

Effective Date, Retroactivity, and Claim Processing Deadline

In general, the amendments proposed in The Tax Relief for Fraud Victims Act would be effective for tax years beginning after 2025. In recognition of the significant theft losses from fraud that taxpayers have already sustained, however, retroactive relief would be available in certain circumstances:

- The amendments (including the extended period of limitations for filing a refund claim) relating to early distributions from retirement accounts would apply to distributions made after 2020.
- In the case of a personal casualty loss sustained after December 31, 2020, and before January 1, 2026, arising from theft involving fraud, deceit, or misrepresentation, the amendments would be effective for tax years beginning after 2020. In such a case, if the taxpayer discovers the loss before the law is enacted, the period of limitations for filing a claim for refund with respect to a deduction for the loss or of the penalty on early retirement account distributions related to the loss would be extended until one year after the date that the law is enacted.

Additionally, the law would require the IRS to process certain refund claims within two years after filing. The requirement would apply to claims with respect to: (1) a deduction under IRC § 165(a) for a personal casualty loss sustained after December 31, 2020, and before January 1, 2026, arising from fraud-related theft, or (2) an early distribution from a retirement account relating to a fraud-related theft loss.

Looking Ahead

Having passed the House of Representatives, The Tax Relief for Fraud Victims Act now awaits action in the Senate, where it was referred to the Finance Committee. Although it is impossible to know for certain whether the bill will become law, its bipartisan support in the House suggests that its prospects are good. If enacted, the legislation would provide meaningful tax relief for victims of fraud-related theft, as well as individuals who sustain any type of personal casualty loss that is not attributable to a federally or state declared disaster. Given the bill's proposed general effective date (tax years starting after 2025), taxpayers and practitioners should preserve documents relating to fraud-related theft losses and personal casualty losses sustained in the current year. They should also consider reviewing prior years for potential refund claims under the bill's retroactive provisions.

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