IRS PUBLISHES PONZI SCHEME GUIDANCE TO ASSIST TAXPAYERS AFFECTED BY SUCH SCHEMES

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IRS Publishes Guidance

On March 17, 2009, the Internal Revenue Service issued two items to assist taxpayers who are victims of losses from Ponzi-type fraudulent investment schemes. The first item is a revenue ruling that clarifies the income tax law governing the treatment of losses in fraudulent schemes. The second is a revenue procedure that provides a safe-harbor method of computing and reporting the losses.

The revenue ruling is important because determining the amount and timing of losses from these schemes is difficult and dependent on the prospect of recovering the lost money. The revenue procedure simplifies compliance for taxpayers by providing a safe-harbor means of determining the year in which the loss is deemed to have occurred and a simplified means of computing the amount of the loss.

Rev. Rul. 2009-09

Rev. Rul. 2009-09 sets forth the following formal legal positions of the IRS and Treasury Department with respect to the deduction of theft losses from criminally fraudulent investments in the form of Ponzi schemes:

- **The investor is entitled to a theft loss, which is not a capital loss.** A theft loss from a Ponzi-type fraudulent investment scheme is an ordinary loss, so it is not subject to the normal limits on losses from investments, which typically limit the loss deduction to $3,000 per year when it exceeds capital gains.
- **The revenue ruling clarifies that "investment" theft losses are not subject to limitations that are applicable to "personal" casualty and theft losses.** The loss is deductible as an itemized deduction but is not subject to the 10

percent of adjusted gross income (AGI) reduction or the $100 reduction that applies to many casualty and theft loss deductions. In addition, the loss is not subject to the limits on itemized deductions in Sections 67 and 68 of the Internal Revenue Code of 1986, as amended (the "Code").

- **The theft loss is deductible in the year the fraud is discovered, except to the extent there is a claim with a reasonable prospect of recovery.** Determining the year of discovery and applying the "reasonable prospect of recovery" test to any particular theft is highly fact-intensive and can be the source of controversy. The revenue procedure accompanying this revenue ruling provides a safe-harbor approach that the IRS will accept for reporting these theft losses.
- **The amount of the theft loss includes the investor's unrecovered investment, including income reported in past years.** The ruling concludes that the investor generally can claim a theft loss deduction not only for the net amount invested, but also for the so-called "fictitious income" that the promoter of the scheme credited to the investor's account and that the investor reported as income on his or her tax returns for years prior to discovery of the theft, reduced by any cash withdrawals prior to the scheme's collapse. Cash withdrawals could eventually be subject to recovery from investors who lost their principal. The IRS's guidance does not address the tax implications from any clawbacks from other victims.
- **A theft loss in a transaction entered into for profit may create or increase a net operating loss under Section 172 of the Code that can be carried back up to 3 years and forward up to 20 years.** If the loss occurred in 2008, an individual taxpayer that had income of less than an average of $15 million per year over the prior three years (or, for a small business, less than $15 million in gross receipts) may carry the net operating loss back up to five years.

Rev. Proc. 2009-20

Rev. Proc. 2009-20 is intended to: (1) provide a uniform approach for determining the proper time and amount of the theft loss; (2) avoid difficult problems of proof in determining how much income reported from the scheme was fictitious, and how much was real; and (3) alleviate compliance burdens on taxpayers and administrative burdens on the IRS that would otherwise result. The revenue procedure provides two simplifying assumptions that taxpayers may use to report their losses:

- **Deemed theft loss.** The revenue procedure provides that the Service will deem the loss to be the result of theft if: (1) the promoter was charged under state or federal law with the commission of fraud, embezzlement or a similar crime that would meet the definition of theft; or (2) the promoter was the subject of a state or federal criminal complaint alleging the commission of such a crime, and either

(i) there was some evidence of an admission of guilt by the promoter or (ii) a trustee was appointed to freeze the assets of the scheme.

- **Safe harbor prospect of recovery.** Once theft is discovered, it often is difficult to establish the investor's prospect of recovery. Prospect of recovery is important because it limits the amount of the investor's theft loss deduction. The revenue procedure generally permits investors to deduct in the year of discovery 95 percent of their net investment less the amount of any actual recovery in the year of discovery and the amount of any recovery expected from private or other insurance, such as that provided by the Securities Investor Protection Corporation (SIPC). In the case of investors who are suing third-party financial advisers or other investment firms that directed their money into fraudulent schemes, the safe harbor deduction would be capped at 75 percent of the net investment.

In order to be eligible for the safe harbor, the investor must be a "qualified investor," in that he or she must (i) be a United States taxpayer under the Code, (ii) not have had actual knowledge that the arrangement was fraudulent before it was publicly disclosed, and (iii) have invested cash or other assets in the arrangement. A taxpayer is not considered to be a qualified investor if he or she did not invest directly in the specified fraudulent arrangement but, instead, invested through an intermediary investment fund or advisor. Thus, investors who unknowingly invest in a Ponzi scheme, such as the Madoff investment fund, through an intermediary fund or investment advisor are not covered by the safe harbor. However, the intermediary investment fund may itself qualify to claim the loss deduction under the safe harbor.

As noted above, the revenue procedure is a safe harbor, and it must be affirmatively elected. Taxpayers may opt out and pursue different amounts if they choose. To take advantage of the safe harbor, the taxpayer must complete the statement provided as "Appendix A" to Rev. Proc. 2009-20 and file it with the tax return, amended return or claim for refund. The statement requires the taxpayer to provide specified information

and computations. The taxpayer must also comply with all conditions set forth in the statement and in Rev. Proc. 2009-20, including that:

1. The taxpayer will not deduct any amount of the theft loss in excess of the amount permitted by Rev. Proc. 2009-20.
2. The taxpayer will not file returns or amended returns to exclude or recharacterize income from the fraudulent arrangement for previous tax years.
3. The taxpayer will not later apply the "claim of right" alternative computation under Section 1341 of the Code regarding the theft loss deduction.
4. The taxpayer will not apply the doctrine of equitable recoupment or the mitigation provisions to income from the fraudulent arrangement reported in prior tax years, which would otherwise be subject to the time limits for filing refund claims under Section 6511 of the Code.

Taxpayers electing not to use the safe harbor must demonstrate to the IRS that there is no "reasonable prospect of recovery" of their investment in the year the fraud is discovered, in order to deduct their investment fraud losses as theft losses during that year. If the taxpayer can establish the amount of income reported and included in gross income for tax years for which the statute of limitations on refunds has expired, the IRS will not challenge the inclusion of that amount in the basis of the investment for purposes of calculating the theft loss.