Ponzi Schemes: Claiming Tax Deductions for Theft Loss

Presented by:

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Tax Refunds from Ponzi Scheme Losses Are Extremely Valuable

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By the end of this presentation you will better understand how these items relate to ponzi scheme tax loss:

THE SAFE HARBOR &
The Internal Revenue Procedure

THE LAW &
The Internal Revenue Ruling

TAX PLANNING
How the taxpayer will plan and implement his or her Ponzi scheme tax loss for maximum benefits now and in the future.
Richard S. Lehman, P.A.

- Masters in Tax Law from New York University Law School
- U.S. Tax Court and Internal Revenue Service experience in Washington D.C.
  » Served as a law clerk to the Honorable William M. Fay, U.S. Tax Court
  » Senior Attorney, Interpretative Division, Chief Counsel’s Office, Internal Revenue Service, Washington D.C.
- The firm regularly works with law firms, accountants, businesses and individuals struggling to find their way through the complexities of the tax law.
- With over 35 years as a tax lawyer in Florida, Lehman has built a boutique tax law firm with a national reputation for being able to handle the toughest tax cases, structure the most sophisticated income tax and estate tax plans, and defend clients before the IRS.

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Tax Refunds from Ponzi Scheme Losses Are Extremely Valuable

- Ordinary Income Loss can be used against all types of income.
- 3 - 5 Year Carry Back
- Fast Process to Receive Cash – Tax Refund and Amended Returns – No Litigation Costs or Delays
- Most Secure Payer – United States Government
- Can be as High as 35% Return for each Dollar Loss and more for state income tax refunds and due to the absence of deduction limitations
- Can be a higher value in future with higher taxes
- 20 Year Carry Forward
- Possibility of Receiving Interest on Tax Refunds from Prior Years

Value Can Be Lost Without Good Professional Advice
Ponzi Schemes & Theft Loss

- The Theft Loss
- Privity of Investor
- Character of Loss
- 5 Year Statute of Limitations/New Legislation
- Limitations on Deductions
II. Ponzi Schemes & Theft Loss

- Amount of the Theft Loss
- Year of Theft Loss Deduction
- Amount of Theft Loss Deduction in Year of Discovery
- Amount of Theft Loss Deduction in Later Years and Recoveries in Excess of Theft Loss Deductions
- The Johnson Cases — A Case Study
III. Theft Loss vs Amended Returns

- Circumstances for Amended Returns – Statute of Limitations
- Tax Planning for Amended Returns – 5 Year Statute and Future Income
- I.R.S. Position
- Interest Income
IV. Claw Backs

- Explanation of a Claw Back
- Internal Revenue Code §1341
Ponzi Schemes & Theft Loss
The Theft Loss allows a deduction for loss sustained during the taxable year and not compensated by insurance or otherwise.

For federal income tax purposes, “theft” is a word of general and broad connotation, covering any criminal appropriation of another’s property to the use of the taker, including theft by swindling, false pretenses and any other form of guile.

A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. However, a taxpayer need not show a conviction for theft.
The Amount & Timing Of The Theft Loss
# Comparison of Revenue Procedure vs. Revenue Ruling

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Tax Refunds from Ponzi Scheme Losses Are Extremely Valuable
Ponzi Schemes & Theft Loss

Definition of Theft:

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A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. However, a taxpayer need not show a conviction for theft.
The year of discovery is very important and evidence is critical here to show exactly when and how a taxpayer can pin down this time.

We look to several examples of CASE LAW to help us to define the “year of discovery” of a theft loss.
Year of Discovery

**Definition of Taxable Year of Discovery**

“...any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.” A loss is considered to be discovered when a reasonable person in similar circumstances would have realized that he or she had suffered an unrecoverable loss. Although a theft loss must be considered as sustained in the year of its discovery, [The code section] does not indicate that discovery of some false representation (even amounting to theft under applicable law) creates a theft loss as of the date of the discovery of the falsity of the representation. The statute “refers to the year of discovery of the loss, not of the theft.”
The Timing of the Deduction

Under the law a taxpayer who has suffered a theft loss shall take a theft loss deduction in the year the loss is sustained, which is the taxable year in which the taxpayer discovers the loss.
The Timing of the Deduction

However, if in the year the taxpayer discovers the loss, there exists a reasonable prospect of recovering some portion of the loss or all of the loss; the taxpayer must postpone the theft loss deduction for that portion of the loss or all of the loss that may reasonably be recovered.

If a taxpayer does not take a theft loss deduction for the entire loss in the year of discovery because the taxpayer has a reasonable prospect of recovering all or a portion of the loss, the theft loss deduction will be postponed until there is a recovery or there is a certainty that the postponed recovery will not happen. **The theft loss deduction will not be lost by virtue of it being postponed.**
Definition of “Reasonable Prospect of Recovery”

A reasonable prospect of recovery exists when the taxpayer has a bona fide claim for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in the taxpayer’s favor. The taxpayer is not, however, required to be an “incorrigible optimist” and claims with only remote or nebulous potential for success will not postpone the deduction.
Definition of “Reasonable Prospect of Recovery”

Courts have found that the deduction does need to be postponed where the financial condition of the party against whom the claim is filed is such that no recovery could be expected. The standard to be applied is primarily objective, but the taxpayer’s subjective attitude and beliefs are not to be ignored. One of the relevant factors is whether the taxpayer has filed a lawsuit to recoup the loss.
Definition of “Reasonable Prospect of Recovery”

Filing the lawsuit soon after the end of the tax year in which the loss was claimed suggests that the taxpayer did not consider the loss a closed and completed transaction. Unless litigation is speculative or without merit, where the taxpayer deems the chance of recovery sufficiently probably to warrant bringing a lawsuit and pursuing it with reasonable diligence to a conclusion, the taxpayer should postpone the loss deduction until the litigation is terminated. Another fact which can be considered is whether the taxpayer ultimately recovered as a result of a lawsuit.
Once the taxpayer has deducted all that could be deducted in the year of discovery by reducing the loss for all reasonable prospects of recovery the tax in year two, after the discovery year, from this point on will be able to claim continuing theft loss deductions until the loss is recovered in full.

However, at this point the taxpayer cannot deduct any more of his or her un-deducted theft loss unless the deduction can be “ascertained with a reasonable certainty”. This is a higher standard of proof.
**Definition of Ascertain with Reasonable Certainty:**

The requirement that a taxpayer “ascertain with reasonable certainty” means that a taxpayer must obtain a verifiable determination of the amount she will receive based on a resolution of the reimbursement claim before taking a theft loss deduction. Finally, requiring resolution of the claim with an objectively verifiable amount of loss is, as the government correctly notes, consistent with the plain meaning of “ascertain”… [as defined in a Dictionary of the English Language.]”
Theft Loss vs Amended Returns
Amended Returns

A deduction obtained from amending tax returns to eliminate only the Ponzi scheme income may be more valuable than a theft loss deduction.

Furthermore, refunds from amended returns may carry interest from the year of overpayment.
Claw Backs
Claw Backs and the Right to Use Code Section 1341

Generally in a Ponzi scheme there is a Trustee, usually in bankruptcy. The Trustee has what is called a “claw back” right to recoup funds from Ponzi scheme from investors who have received distributions from Ponzi scheme of funds that belonged to others who had invested in the scheme.
Claw Backs

**Example:** A claw back of $500,000 that provides a tax refund of only 15% in a year when income is low, ($75,000); might provide a cash return at the 35% high tax bracket from a prior high tax bracket year of ($175,000). The difference of 20% in the brackets is $100,000 of real money.

Furthermore, the interest paid on a refund going back in years could be significant. By waiving the benefits of Code Section 1341 the taxpayer eliminates the potential for these increased earnings from tax refunds.

**NOTE:** The Safe Harbor insists that the taxpayer waive their right to Internal Revenue Code Section 1341
## Comparison of Revenue Procedure vs Revenue Ruling

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Estate, Gift & Trust – Theft Deduction Rules
The income or estate tax deductions available depend on when the loss was incurred and when it was discovered.

There are three common situations:

1. the theft occurs before the decedent dies and is discovered during estate administration;
2. the theft occurs and is discovered during estate administration; and
3. the theft occurs after the accounts have been distributed.
Situation 1:

The theft occurs before the decedent dies and is discovered during estate administration.

Under these facts, the estate can claim an income tax deduction even though the loss occurred during a tax year of the decedent. An estate tax deduction is allowable only for losses that occurred during estate administration.
Situation 2:

The theft occurs and is discovered during estate administration

Such a loss is deductible as an estate tax deduction or an income tax deduction.
**Situation 3:**

The theft occurs after the accounts have been distributed

In this situation, the losses cannot be deducted by the estate as income or estate tax deduction. The losses would be deductible by the beneficiary, but only for income tax purposes. If estate administration is unduly prolonged, the estate may not be able to deduct the loss even if it still holds the asset. An argument could be made that the estate would no longer be holding the asset for the estate but as an agent for the beneficiary.
The tax lawyers helps analyze avenues of recovery:

For example, there may be a fairly recent estate involved in which an estate tax has been paid on the Ponzi scheme funds that were inherited. If this is the case, this must be considered in the calculations as the estate tax deduction, if available, may have a value of 45% to the taxpayer versus the 35% benefit of the income tax deduction.
Tax Planning

Value can be lost without good professional advice.
Tax Planning

The major principle seen in each of the court’s decisions is that victims of the fraud who want to take the theft loss deduction in the year of discovery, must be well advised to separately consider each of their potential sources of recovery.

Value can be lost without good professional advice.
The final professional product should provide the taxpayer with appropriate projections of the use of the tax losses under differing circumstances that are legally feasible to obtain. The client will be able to understand the financial effect of various options that the tax loss and litigation recoveries may provide for.

Since the theft loss may be carried back three years and carried forward 20 years, it is extremely valuable.
Tax planning should result in a professional work product that will most likely accompany an amended return or similar type of I.R.S. filing.

The document will most likely be the work product of at least three of the client’s advisors:

1. THEIR ACCOUNTANT
2. A TAX ATTORNEY
3. LITIGATION COUNSEL
A *litigation counsel* as part of the team is critical to a successful professional product for several reasons:

1. Each Ponzi scheme victim should understand every possible means of recovery that might be applied to the individual.

2. Recoveries from SIPC and the IRS are not the only avenues of recovery that will be considered.

3. As the facts unfold there may be more culprits of economic substance that can be a target of recovery.
The **tax lawyer** is an essential expert who will need to coordinate all of the matters in light of the taxpayer’s objectives and various legal standards that will need to be met to achieve those objectives.

The theft loss tax benefits that one does not claim immediately will not necessarily be lost but may be realized at a later point in time when there is finality to each respective area of recovery that a victim has chosen to pursue.
PROFESSIONAL
Tax Planning

With the professional team in place, the steps generally will be as follows:

1. Records
2. Basis Calculations
3. Sources of Recovery
4. Loss in Year of Discovery
5. Accounting Schedules and Forecasts

These projections will be critical.
1. In determining the reasonableness of a taxpayer’s belief of loss the courts had to be practical and aware of the individual facts of a case.

2. Circumstances are those that are known or reasonably could be known as of the end of the tax year for which the loss deduction is claimed. The only test is foresight, not hindsight.

3. Both objective and subjective factors must be examined.
1. The taxpayer’s legal rights as of the end of the year of discovery are all important and need to be studied to make a proper decision.

2. One of the facts and circumstances deserving of consideration is the probability of success on the merits of any claim brought by the taxpayer.

3. The filing of a lawsuit may give rise to an inference of a reasonable prospect of recovery. However, the inference is not conclusive nor mandatory. The inquiry should be directed to the probability of recovery as opposed to the mere possibility. A “remote possibility” of recovery is not enough; there must be “a reasonable prospect of recovery at the time the deduction was claimed, not later”.

Reasonable Prospect of Recovery
The Safe Harbor

The IRS Revenue Procedure
The Safe Harbor requires that the Ponzi scheme victims forego the opportunity to file amended returns for those years that are still open by the statute of limitations.

However, by amending a prior return instead of taking a theft loss deduction, a taxpayer can eliminate only the taxpayer’s Ponzi scheme “phantom income” from the taxable income in the prior years. This will typically be the high bracket income.
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Quantifying the Amount of Theft Loss Deduction in Year of Discovery

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<td>95% Loss Allowed (Loss Reduced by 5%)</td>
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<td>75% Loss Allowed (Loss Reduced by 25%)</td>
<td>Third Party Recovery Sought</td>
<td>Loss Reduced by any Potential Third Party Recovery</td>
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Tax Planning For Maximum Use Of Loss
Other Reductions to Qualified Investment Loss

1. Loss Reduced by Actual Recovery Received in the year of Discovery
2. Loss Reduced by Insurance policies In the name of the Qualified investor
3. Loss Reduced by Contractual arrangements that guarantees or otherwise protects against loss of the qualified investment
4. Loss Reduced by Certain Amounts Payable from the Securities Investor Protection Corporation (SPIC)

SAME FOR SAFE HARBOR OR THE LAW
The Amount of The Loss (Basis) & Phantom Income

• Definition of Phantom Income:

The Revenue Ruling and the Revenue Procedure both acknowledge that:

Theft loss resulting from a Ponzi scheme is generally...

1. The initial amount invested in the arrangement

   plus

2. Any additional investments upon which taxes have been paid, less amounts withdrawn

The I.R.S. agrees that if an amount is reported to the investor as income in years prior to the year of discovery of the theft and the investor includes the amount in gross income; then the amount of the theft loss is increased by the purportedly reinvested amount (the “Phantom Income”).
Value can be lost without good professional advice.
Rev. Proc. 2009-20

SECTION 1. PURPOSE

This revenue procedure provides an optional safe harbor treatment for taxpayers that experienced losses in certain investment arrangements discovered to be criminally fraudulent. This revenue procedure also describes how the Internal Revenue Service will treat a return that claims a deduction for such a loss and does not use the safe harbor treatment described in this revenue procedure.

SECTION 2. BACKGROUND

.01 The Service and Treasury Department are aware of investment arrangements that have been discovered to be fraudulent, resulting in significant losses to taxpayers. These arrangements often take the form of so-called “Ponzi” schemes, in which the party perpetrator the fraud receives cash or property from investors, purports to earn income for the investors, and reports to
the investors income amounts that are wholly or partially fictitious. Payments, if any, of purported income or principal to investors are made from cash or property that other investors invested in the fraudulent arrangement. The party perpetrating the fraud criminally appropriates some or all of the investors' cash or property.

.02 Rev. Rul. 2009-9, 2009 I.R.B (April 6, 2009), describes the proper income tax treatment for losses resulting from these Ponzi schemes.

.03 The Service and Treasury Department recognize that whether and when investors meet the requirements for claiming a theft loss for an investment in a Ponzi scheme are highly factual determinations that often cannot be made by taxpayers with certainty in the year the loss is discovered.

.04 In view of the number of investment arrangements recently discovered to be fraudulent and the extent of the potential losses, this revenue procedure provides an optional safe harbor under which qualified investors (as defined in § 4.03 of this revenue procedure) may treat a loss as a theft loss deduction when certain conditions are met. This treatment provides qualified investors with a uniform manner for determining their theft losses. In addition, this treatment avoids potentially difficult problems of proof in determining how much income reported in prior years was fictitious or a return of capital, and alleviates compliance and administrative burdens on both taxpayers and the Service.

SECTION 3. SCOPE
The safe harbor procedures of this revenue procedure apply to taxpayers that are qualified investors within the meaning of section 4.03 of this revenue procedure.

SECTION 4. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure.

.01 Specified fraudulent arrangement. A specified fraudulent arrangement is an arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors' cash or property. For example, the fraudulent investment arrangement described in Rev. Rul. 2009-9 is a specified fraudulent arrangement.

.02 Qualified loss. A qualified loss is a loss resulting from a specified fraudulent arrangement in which, as a result of the conduct that caused the loss—

(1) The lead figure (or one of the lead figures, if more than one) was charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement or a similar crime that, if proven, would meet the definition of theft for purposes of § 165 of
the Internal Revenue Code and § 1.165-8(d) of the Income Tax Regulations, under the law of the jurisdiction in which the theft occurred; or

(2) The lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in section 4.02(1) of this revenue procedure, and either –

(a) The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or

(b) A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

.03 Qualified investor. A qualified investor means a United States person, as defined in § 7701(a)(30) --

(1) That generally qualifies to deduct theft losses under § 165 and § 1.165-8;

(2) That did not have actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public;

(3) With respect to which the specified fraudulent arrangement is not a tax shelter, as defined in § 6662(d)(2)(C)(ii); and

(4) That transferred cash or property to a specified fraudulent arrangement. A qualified investor does not include a person that invested solely in a fund or other entity (separate from the investor for federal income tax purposes) that invested in the specified fraudulent arrangement. However, the fund or entity itself may be a qualified investor within the scope of this revenue procedure.
.04 Discovery year. A qualified investor’s discovery year is the taxable year of the investor in which the indictment, information, or complaint described in section 4.02 of this revenue procedure is filed.

.05 Responsible group. Responsible group means, for any specified fraudulent arrangement, one or more of the following:

(1) The individual or individuals (including the lead figure) who conducted the specified fraudulent arrangement;

(2) Any investment vehicle or other entity that conducted the specified fraudulent arrangement, and employees, officers, or directors of that entity or entities;

(3) A liquidation, receivership, bankruptcy or similar estate established with respect to individuals or entities who conducted the specified fraudulent arrangement, in order to recover assets for the benefit of investors and creditors; or

(4) Parties that are subject to claims brought by a trustee, receiver, or other fiduciary on behalf of the liquidation, receivership, bankruptcy or similar estate described in section 4.05(3) of this revenue procedure.

.06 Qualified investment.

(1) Qualified investment means the excess, if any, of --

(a) The sum of --

(i) The total amount of cash, or the basis of property, that the qualified investor invested in the arrangement in all years; plus
(ii) The total amount of net income with respect to the specified fraudulent arrangement that, consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for all taxable years prior to the discovery year, including taxable years for which a refund is barred by the statute of limitations; over

(b) The total amount of cash or property that the qualified investor withdrew in all years from the specified fraudulent arrangement (whether designated as income or principal).

(2) Qualified investment does not include any of the following—

(a) Amounts borrowed from the responsible group and invested in the specified fraudulent arrangement, to the extent the borrowed amounts were not repaid at the time the theft was discovered;

(b) Amounts such as fees that were paid to the responsible group and deducted for federal income tax purposes;

(c) Amounts reported to the qualified investor as taxable income that were not included in gross income on the investor's federal income tax returns; or

(d) Cash or property that the qualified investor invested in a fund or other entity (separate from the qualified investor for federal income tax purposes) that invested in a specified fraudulent arrangement.

.07 Actual recovery. Actual recovery means any amount a qualified investor actually receives in the discovery year from any source as reimbursement or recovery for the qualified loss.
Potential insurance/SIPC recovery. Potential insurance/SIPC recovery means the sum of the amounts of all actual or potential claims for reimbursement for a qualified loss that, as of the last day of the discovery year, are attributable to--

1. Insurance policies in the name of the qualified investor;
2. Contractual arrangements other than insurance that guaranteed or otherwise protected against loss of the qualified investment; or
3. Amounts payable from the Securities Investor Protection Corporation (SIPC), as advances for customer claims under 15 U.S.C. § 78fff-3(a) (the Securities Investor Protection Act of 1970), or by a similar entity under a similar provision.

Potential direct recovery. Potential direct recovery means the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year, against the responsible group.

Potential third-party recovery. Potential third-party recovery means the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year, that are not described in section 4.08 or 4.09 of this revenue procedure.

SECTION 5. APPLICATION

In general. If a qualified investor follows the procedures described in section 6 of this revenue procedure, the Service will not challenge the following treatment by the qualified investor of a qualified loss—

1. The loss is deducted as a theft loss;
(2) The taxable year in which the theft was discovered within the meaning of § 165(e) is the discovery year described in section 4.04 of this revenue procedure; and

(3) The amount of the deduction is the amount specified in section 5.02 of this revenue procedure.

.02 Amount to be deducted. The amount specified in this section 5.02 is calculated as follows—

(1) Multiply the amount of the qualified investment by—

(a) 95 percent, for a qualified investor that does not pursue any potential third-party recovery; or

(b) 75 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery; and

(2) Subtract from this product the sum of any actual recovery and any potential insurance/SIPC recovery.

The amount of the deduction calculated under this section 5.02 is not further reduced by potential direct recovery or potential third-party recovery.

.03 Future recoveries. The qualified investor may have income or an additional deduction in a year subsequent to the discovery year depending on the actual amount of the loss that is eventually recovered. See § 1.165-1(d); Rev. Rul. 2009-9.

SECTION 6. PROCEDURE

.01 A qualified investor that uses the safe harbor treatment described in section 5 of this revenue procedure must —
(1) Mark "Revenue Procedure 2009-20" at the top of the Form 4684, Casualties and Thefts, for the federal income tax return for the discovery year. The taxpayer must enter the "deductible theft loss" amount from line 10 in Part II of Appendix A of this revenue procedure on line 34, section B, Part I, of the Form 4684 and should not complete the remainder of section B, Part I, of the Form 4684;

(2) Complete and sign the statement provided in Appendix A of this revenue procedure; and

(3) Attach the executed statement provided in Appendix A of this revenue procedure to the qualified investor’s timely filed (including extensions) federal income tax return for the discovery year. Notwithstanding the preceding sentence, if, before April 17, 2009, the taxpayer has filed a return for the discovery year or an amended return for a prior year that is inconsistent with the safe harbor treatment provided by this revenue procedure, the taxpayer must indicate this fact on the executed statement and must attach the statement to the return (or amended return) for the discovery year that is consistent with the safe harbor treatment provided by this revenue procedure and that is filed on or before May 15, 2009.

.02 By executing the statement provided in Appendix A of this revenue procedure, the taxpayer agrees—

(1) Not to deduct in the discovery year any amount of the theft loss in excess of the deduction permitted by section 5 of this revenue procedure;
(2) Not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year;

(3) Not to apply the alternative computation in § 1341 with respect to the theft loss deduction allowed by this revenue procedure; and

(4) Not to apply the doctrine of equitable recoupment or the mitigation provisions in §§ 1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511.

SECTION 7. EFFECTIVE DATE

This revenue procedure applies to losses for which the discovery year is a taxable year beginning after December 31, 2007.

SECTION 8. TAXPAYERS THAT DO NOT USE THE SAFE HARBOR TREATMENT PROVIDED BY THIS REVENUE PROCEDURE

.01 A taxpayer that chooses not to apply the safe harbor treatment provided by this revenue procedure to a claimed theft loss is subject to all of the generally applicable provisions governing the deductibility of losses under § 165. For example, a taxpayer seeking a theft loss deduction must establish that the loss was from theft and that the theft was discovered in the year the taxpayer claims the deduction. The taxpayer must also establish, through sufficient documentation, the amount of the claimed loss and must establish that no claim for reimbursement of any portion of the loss exists with respect to which there is
a reasonable prospect of recovery in the taxable year in which the taxpayer claims the loss.

.02 A taxpayer that chooses not to apply the safe harbor treatment of this revenue procedure to a claimed theft loss and that files or amends federal income tax returns for years prior to the discovery year to exclude amounts reported as income to the taxpayer from the investment arrangement must establish that the amounts sought to be excluded in fact were not income that was actually or constructively received by the taxpayer (or accrued by the taxpayer, in the case of a taxpayer using an accrual method of accounting). However, provided a taxpayer can establish the amount of net income from the investment arrangement that was reported and included in the taxpayer's gross income consistent with information received from the specified fraudulent arrangement in taxable years for which the period of limitation on filing a claim for refund under § 6511 has expired, the Service will not challenge the taxpayer's inclusion of that amount in basis for determining the amount of any allowable theft loss, whether or not the income was genuine.

.03 Returns claiming theft loss deductions from fraudulent investment arrangements are subject to examination by the Service.

SECTION 9. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-0074. Please refer to the Paperwork Reduction Act statement
accompanying Form 1040, U.S. Individual Income Tax Return, for further information.

DRAFTING INFORMATION

The principal author of this revenue procedure is Norma Rotunno of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Rotunno at (202) 622-7900.
Statement by Taxpayer Using the Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement

Part 1. Identification
1. Name of Taxpayer _____________________________________________
2. Taxpayer Identification Number _________________________________

Part II. Computation of deduction
(See Rev. Proc. 2009-20 for the definitions of the terms used in this worksheet.)

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Initial investment</td>
</tr>
<tr>
<td>2</td>
<td>Plus: Subsequent investments</td>
</tr>
<tr>
<td>3</td>
<td>Plus: Income reported in prior years</td>
</tr>
<tr>
<td>4</td>
<td>Less: Withdrawals (       )</td>
</tr>
<tr>
<td>5</td>
<td>Total qualified investment (combine lines 1 through 4)</td>
</tr>
<tr>
<td>6</td>
<td>Percentage of qualified investment</td>
</tr>
<tr>
<td></td>
<td>(95% of line 5 for investors with no potential third-party recovery; 75% of line 5 for investors with potential third-party recovery)</td>
</tr>
<tr>
<td>7</td>
<td>Actual recovery</td>
</tr>
<tr>
<td>8</td>
<td>Potential insurance/SIPC recovery</td>
</tr>
<tr>
<td>9</td>
<td>Total recoveries (add lines 7 and 8)</td>
</tr>
<tr>
<td>10</td>
<td>Deductible theft loss (line 6 minus line 9)</td>
</tr>
</tbody>
</table>

Part III. Required statements and declarations
1. I am claiming a theft loss deduction pursuant to Rev. Proc. 2009-20 from a specified fraudulent arrangement conducted by the following individual or entity (provide the name, address, and taxpayer identification number (if known)).

2. I have written documentation to support the amounts reported in Part II of this document.


4. If I have determined the amount of my theft loss deduction under § 5.02(1)(a) of Rev. Proc. 2009-20, I declare that I have not pursued and do not intend to
pursue any potential third-party recovery, as that term is defined in § 4.10 of Rev. Proc. 2009-20.

5. If I have already filed a return or amended return that does not satisfy the conditions in § 6.02 of Rev. Proc 2009-20, I agree to all adjustments or actions that are necessary to comply with those conditions. The tax year or years for which I filed the return(s) or amended return(s) and the date(s) on which they were filed are as follows:

________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________

Part IV. Signature

I make the following agreements and declarations:

1. I agree to comply with the conditions and agreements set forth in Rev. Proc. 2009-20 and this document.

2. Under penalties of perjury, I declare that the information provided in Parts I-III of this document is, to the best of my knowledge and belief, true, correct and complete.

Your signature here __________________________ Date signed: ______
Your spouse’s signature here ______________________ Date signed: ______

Corporate Name ________________________________
Corporate Officer’s signature ______________________
Title _____________________________
Date signed ______

Entity Name _____________________________________________________
S-corporation, Partnership, Limited Liability Company, Trust
Entity Officer’s signature ______________________________
Date signed ___________

Signature of executor __________________________________________
Date signed __________________________________________________
Part I

Section 165.—Losses.

26 CFR: § 1.165-8: Theft losses.
(Also: §§ 63, 67, 68, 172, 1311, 1312, 1313, 1314, 1341)

Rev. Rul. 2009-9

ISSUES

1. Is a loss from criminal fraud or embezzlement in a transaction entered into for profit a theft loss or a capital loss under § 165 of the Internal Revenue Code?

2. Is such a loss subject to either the personal loss limits in § 165(h) or the limits on itemized deductions in §§ 67 and 68?

3. In what year is such a loss deductible?

4. How is the amount of such a loss determined?

5. Can such a loss create or increase a net operating loss under § 172?

6. Does such a loss qualify for the computation of tax provided by § 1341 for the restoration of an amount held under a claim of right?

7. Does such a loss qualify for the application of §§ 1311-1314 to adjust tax liability in years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511?
FACTS

A is an individual who uses the cash receipts and disbursements method of accounting and files federal income tax returns on a calendar year basis. B holds himself out to the public as an investment advisor and securities broker.

In Year 1, A, in a transaction entered into for profit, opened an investment account with B, contributed $100x to the account, and provided B with power of attorney to use the $100x to purchase and sell securities on A’s behalf. A instructed B to reinvest any income and gains earned on the investments. In Year 3, A contributed an additional $20x to the account.

B periodically issued account statements to A that reported the securities purchases and sales that B purportedly made in A’s investment account and the balance of the account. B also issued tax reporting statements to A and to the Internal Revenue Service that reflected purported gains and losses on A’s investment account. B also reported to A that no income was earned in Year 1 and that for each of the Years 2 through 7 the investments earned $10x of income (interest, dividends, and capital gains), which A included in gross income on A’s federal income tax returns.

At all times prior to Year 8 and part way through Year 8, B was able to make distributions to investors who requested them. A took a single distribution of $30x from the account in Year 7.

In Year 8, it was discovered that B’s purported investment advisory and brokerage activity was in fact a fraudulent investment arrangement known as a “Ponzi”
scheme. Under this scheme, B purported to invest cash or property on behalf of each investor, including A, in an account in the investor’s name. For each investor’s account, B reported investment activities and resulting income amounts that were partially or wholly fictitious. In some cases, in response to requests for withdrawal, B made payments of purported income or principal to investors. These payments were made, at least in part, from amounts that other investors had invested in the fraudulent arrangement.

When B’s fraud was discovered in Year 8, B had only a small fraction of the funds that B reported on the account statements that B issued to A and other investors. A did not receive any reimbursement or other recovery for the loss in Year 8. The period of limitation on filing a claim for refund under § 6511 has not yet expired for Years 5 through 7, but has expired for Years 1 through 4.

B’s actions constituted criminal fraud or embezzlement under the law of the jurisdiction in which the transactions occurred. At no time prior to the discovery did A know that B’s activities were a fraudulent scheme. The fraudulent investment arrangement was not a tax shelter as defined in § 6662(d)(2)(C)(ii) with respect to A.

LAW AND ANALYSIS

Issue 1. Theft loss.

Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise. For individuals, § 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit, and § 165(c)(3) allows a deduction for certain losses not connected to a transaction entered into for
profit, including theft losses. Under § 165(e), a theft loss is sustained in the taxable year the taxpayer discovers the loss. Section 165(f) permits a deduction for capital losses only to the extent allowed in §§ 1211 and 1212. In certain circumstances, a theft loss may be taken into account in determining gains or losses for a taxable year under § 1231.

For federal income tax purposes, "theft" is a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and any other form of guile. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); see also § 1.165-8(d) of the Income Tax Regulations ("theft" includes larceny and embezzlement). A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. Rev. Rul. 72-112, 1972-1 C.B. 60. However, a taxpayer need not show a conviction for theft. Vietzke v. Commissioner, 37 T.C. 504, 510 (1961), acq., 1962-2 C.B. 6.

The character of an investor's loss related to fraudulent activity depends, in part, on the nature of the investment. For example, a loss that is sustained on the worthlessness or disposition of stock acquired on the open market for investment is a capital loss, even if the decline in the value of the stock is attributable to fraudulent activities of the corporation's officers or directors, because the officers or directors did not have the specific intent to deprive the shareholder of money or property. See Rev. Rul. 77-17, 1977-1 C.B. 44.
In the present situation, unlike the situation in Rev. Rul. 77-17, B specifically intended to, and did, deprive A of money by criminal acts. B’s actions constituted a theft from A, as theft is defined for § 165 purposes. Accordingly, A’s loss is a theft loss, not a capital loss.

Issue 2. Deduction limitations.

Section 165(h) imposes two limitations on casualty loss deductions, including theft loss deductions, for property not connected either with a trade or business or with a transaction entered into for profit.

Section 165(h)(1) provides that a deduction for a loss described in § 165(c)(3) (including a theft) is allowable only to the extent that the amount exceeds $100 ($500 for taxable years beginning in 2009 only).

Section 165(h)(2) provides that if personal casualty losses for any taxable year (including theft losses) exceed personal casualty gains for the taxable year, the losses are allowed only to the extent of the sum of the gains, plus so much of the excess as exceeds ten percent of the individual's adjusted gross income.

Rev. Rul. 71-381, 1971-2 C.B. 126, concludes that a taxpayer who loans money to a corporation in exchange for a note, relying on financial reports that are later discovered to be fraudulent, is entitled to a theft loss deduction under § 165(c)(3). However, § 165(c)(3) subsequently was amended to clarify that the limitations applicable to personal casualty and theft losses under § 165(c)(3) apply only to those losses that are not connected with a trade or business or a transaction entered into for profit. Tax Reform Act of 1984, Pub. L. No. 98-369, § 711 (1984). As a result, Rev.
Rul. 71-381 is obsolete to the extent that it holds that theft losses incurred in a transaction entered into for profit are deductible under § 165(c)(3), rather than under § 165(c)(2).

In opening an investment account with B, A entered into a transaction for profit. A's theft loss therefore is deductible under § 165(c)(2) and is not subject to the § 165(h) limitations.

Section 63(d) provides that itemized deductions for an individual are the allowable deductions other than those allowed in arriving at adjusted gross income (under § 62) and the deduction for personal exemptions. A theft loss is not allowable under § 62 and is therefore an itemized deduction.

Section 67(a) provides that miscellaneous itemized deductions may be deducted only to the extent the aggregate amount exceeds two percent of adjusted gross income. Under § 67(b)(3), losses deductible under § 165(c)(2) or (3) are excepted from the definition of miscellaneous itemized deductions.

Section 68 provides an overall limit on itemized deductions based on a percentage of adjusted gross income or total itemized deductions. Under § 68(c)(3), losses deductible under § 165(c)(2) or (3) are excepted from this limit.

Accordingly, A's theft loss is an itemized deduction that is not subject to the limits on itemized deductions in §§ 67 and 68.

**Issue 3. Year of deduction.**

Section 165(e) provides that any loss arising from theft is treated as sustained during the taxable year in which the taxpayer discovers the loss. Under §§ 1.165-
8(a)(2) and 1.165-1(d), however, if, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is sustained until the taxable year in which it can be ascertained with reasonable certainty whether or not the reimbursement will be received, for example, by a settlement, adjudication, or abandonment of the claim. Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances.

A may deduct the theft loss in Year 8, the year the theft loss is discovered, provided that the loss is not covered by a claim for reimbursement or other recovery as to which A has a reasonable prospect of recovery. To the extent that A’s deduction is reduced by such a claim, recoveries on the claim in a later taxable year are not includible in A’s gross income. If A recovers a greater amount in a later year, or an amount that initially was not covered by a claim as to which there was a reasonable prospect of recovery, the recovery is includible in A’s gross income in the later year under the tax benefit rule, to the extent the earlier deduction reduced A’s income tax. See § 111; § 1.165-1(d)(2)(iii). Finally, if A recovers less than the amount that was covered by a claim as to which there was a reasonable prospect of recovery that reduced the deduction for theft in Year 8, an additional deduction is allowed in the year the amount of recovery is ascertained with reasonable certainty.


Section 1.165-8(c) provides that the amount deductible in the case of a theft loss is determined consistently with the manner described in § 1.165-7 for determining the
amount of a casualty loss, considering the fair market value of the property immediately after the theft to be zero. Under these provisions, the amount of an investment theft loss is the basis of the property (or the amount of money) that was lost, less any reimbursement or other compensation.

The amount of a theft loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery. If an amount is reported to the investor as income in years prior to the year of discovery of the theft, the investor includes the amount in gross income, and the investor reinvests the amount in the arrangement, this amount increases the deductible theft loss.

Accordingly, the amount of A’s theft loss for purposes of § 165 includes A’s original Year 1 investment ($100x) and additional Year 3 investment ($20x). A’s loss also includes the amounts that A reported as gross income on A’s federal income tax returns for Years 2 through 7 ($60x). A’s loss is reduced by the amount of money distributed to A in Year 7 ($30x). If A has a claim for reimbursement with respect to which there is a reasonable prospect of recovery, A may not deduct in Year 8 the portion of the loss that is covered by the claim.


Section 172(a) allows as a deduction for the taxable year the aggregate of the net operating loss carryovers and carrybacks to that year. In computing a net operating
loss under § 172(c) and (d)(4), nonbusiness deductions of noncorporate taxpayers are generally allowed only to the extent of nonbusiness income. For this purpose, however, any deduction for casualty or theft losses allowable under § 165(c)(2) or (3) is treated as a business deduction. Section 172(d)(4)(C).

Under § 172(b)(1)(A), a net operating loss generally may be carried back 2 years and forward 20 years. However, under § 172(b)(1)(F), the portion of an individual’s net operating loss arising from casualty or theft may be carried back 3 years and forward 20 years.

Section 1211 of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (February 17, 2009), amends § 172(b)(1)(H) of the Internal Revenue Code to allow any taxpayer that is an eligible small business to elect either a 3, 4, or 5-year net operating loss carryback for an “applicable 2008 net operating loss.”

Section 172(b)(1)(H)(iv) provides that the term “eligible small business” has the same meaning given that term by § 172(b)(1)(F)(iii), except that § 448(c) is applied by substituting “$15 million” for “$5 million” in each place it appears. Section 172(b)(1)(F)(iii) provides that a small business is a corporation or partnership that meets the gross receipts test of § 448(c) for the taxable year in which the loss arose (or in the case of a sole proprietorship, that would meet such test if the proprietorship were a corporation).

Because § 172(d)(4)(C) treats any deduction for casualty or theft losses allowable under § 165(c)(2) or (3) as a business deduction, a casualty or theft loss an individual sustains after December 31, 2007, is considered a loss from a “sole
proprietyship” within the meaning of § 172(b)(1)(F)(iii). Accordingly, an individual may elect either a 3, 4, or 5-year net operating loss carryback for an applicable 2008 net operating loss, provided the gross receipts test provided in § 172(b)(1)(H)(iv) is satisfied. See Rev. Proc. 2009-19, 2009-14 I.R.B. (April 6, 2009).

To the extent A’s theft loss deduction creates or increases a net operating loss in the year the loss is deducted, A may carry back up to 3 years and forward up to 20 years the portion of the net operating loss attributable to the theft loss. If A’s loss is an applicable 2008 net operating loss and the gross receipts test in § 172(b)(1)(H)(iv) is met, A may elect either a 3, 4, or 5-year net operating loss carryback for the applicable 2008 net operating loss.

Issue 6. Restoration of amount held under claim of right.

Section 1341 provides an alternative tax computation formula intended to mitigate against unfavorable tax consequences that may arise as a result of including an item in gross income in a taxable year and taking a deduction for the item in a subsequent year when it is established that the taxpayer did not have a right to the item. Section 1341 requires that: (1) an item was included in gross income for a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to the item, (2) a deduction is allowable for the taxable year because it was established after the close of the prior taxable year or years that the taxpayer did not have a right to the item or to a portion of the item, and (3) the amount of the deduction exceeds $3,000. Section 1341(a)(1) and (3).
If § 1341 applies, the tax for the taxable year is the lesser of: (1) the tax for the taxable year computed with the current deduction, or (2) the tax for the taxable year computed without the deduction, less the decrease in tax for the prior taxable year or years that would have occurred if the item or portion of the item had been excluded from gross income in the prior taxable year or years. Section 1341(a)(4) and (5).

To satisfy the requirements of § 1341(a)(2), a deduction must arise because the taxpayer is under an obligation to restore the income. Section 1.1341-1(a)(1)-(2); Alcoa, Inc. v. United States, 509 F.3d 173, 179 (3d Cir. 2007); Kappel v. United States, 437 F.2d 1222, 1226 (3d Cir.), cert. denied, 404 U.S. 830 (1971).

When A incurs a loss from criminal fraud or embezzlement by B in a transaction entered into for profit, any theft loss deduction to which A may be entitled does not arise from an obligation on A’s part to restore income. Therefore, A is not entitled to the tax benefits of § 1341 with regard to A’s theft loss deduction.

Issue 7. Mitigation provisions.

The mitigation provisions of §§ 1311-1314 permit the Service or a taxpayer in certain circumstances to correct an error made in a closed year by adjusting the tax liability in years that are otherwise barred by the statute of limitations. O’Brien v. United States, 766 F.2d 1038, 1041 (7th Cir. 1995). The party invoking these mitigation provisions has the burden of proof to show that the specific requirements are satisfied. Id. at 1042.

Section 1311(a) provides that if a determination (as defined in § 1313) is described in one or more of the paragraphs of § 1312 and, on the date of the
determination, correction of the effect of the error referred to in § 1312 is prevented by the operation of any law or rule of law (other than §§ 1311-1314 or § 7122), then the effect of the error is corrected by an adjustment made in the amount and in the manner specified in § 1314.

Section 1311(b)(1) provides in relevant part that an adjustment may be made under §§ 1311-1314 only if, in cases when the amount of the adjustment would be credited or refunded under § 1314, the determination adopts a position maintained by the Secretary that is inconsistent with the erroneous prior tax treatment referred to in § 1312.

A cannot use the mitigation provisions of §§ 1311-1314 to adjust tax liability in Years 2 through 4 because there is no inconsistency in the Service’s position with respect to A’s prior inclusion of income in Years 2 through 4. See § 1311(b)(1). The Service’s position that A is entitled to an investment theft loss under § 165 in Year 8 (as computed in Issue 4, above), when the fraud loss is discovered, is consistent with the Service’s position that A properly included in income the amounts credited to A’s account in Years 2 through 4. See § 1311(b)(1)(A).

HOLDINGS

(1) A loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss, not a capital loss, under § 165.
(2) A theft loss in a transaction entered into for profit is deductible under § 165(c)(2), not § 165(c)(3), as an itemized deduction that is not subject to the personal loss limits in § 165(h), or the limits on itemized deductions in §§ 67 and 68.

(3) A theft loss in a transaction entered into for profit is deductible in the year the loss is discovered, provided that the loss is not covered by a claim for reimbursement or recovery with respect to which there is a reasonable prospect of recovery.

(4) The amount of a theft loss in a transaction entered into for profit is generally the amount invested in the arrangement, less amounts withdrawn, if any, reduced by reimbursements or recoveries, and reduced by claims as to which there is a reasonable prospect of recovery. Where an amount is reported to the investor as income prior to discovery of the arrangement and the investor includes that amount in gross income and reinvests this amount in the arrangement, the amount of the theft loss is increased by the purportedly reinvested amount.

(5) A theft loss in a transaction entered into for profit may create or increase a net operating loss under § 172 that can be carried back up to 3 years and forward up to 20 years. An eligible small business may elect either a 3, 4, or 5-year net operating loss carryback for an applicable 2008 net operating loss.

(6) A theft loss in a transaction entered into for profit does not qualify for the computation of tax provided by § 1341.

(7) A theft loss in a transaction entered into for profit does not qualify for the application of §§ 1311-1314 to adjust tax liability in years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511.
DISCLOSURE OBLIGATION UNDER § 1.6011-4

A theft loss in a transaction entered into for profit that is deductible under § 165(c)(2) is not taken into account in determining whether a transaction is a loss transaction under § 1.6011-4(b)(5). See § 4.03(1) of Rev. Proc. 2004-66, 2004-2 C.B. 966.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 71-381 is obsoleted to the extent that it holds that a theft loss incurred in a transaction entered into for profit is deductible under § 165(c)(3) rather than § 165(c)(2).

DRAFTING INFORMATION

The principal author of this revenue ruling is Andrew M. Irving of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Irving at (202) 622-5020 (not a toll-free call.)
Introduction

THE FOLLOWING IS REPORT NO. 1 IN WHAT IS INTENDED TO BE A SERIES of reports focusing on the tax benefits available as a result of the Bernard Madoff fraud. These Reports are not intended to be and can not serve as legal advice to any reader. Each taxpayer has their own unique factual situation which is going to need to be reviewed by tax advisors and litigation counsel before any legal conclusions can be reached. The Reports are being made in a series form since there is still a great deal of facts to be uncovered in the Bernard Madoff fraud. These facts are going to be extremely important in coming to conclusions about tax positions.

Furthermore, there could be guidance from the I.R.S. in this particular situation or any number of other factors that require the subject matter to be updated on a continual basis. The Bernard Madoff fraud has resulted in much pain throughout the world. Hopefully some of this can be eased in the form of tax relief from either the U.S. or other countries whose citizens are entitled to permit their financial losses to be deducted from their taxes.

THE BERNARD MADOFF TAX LOSSES

The Basics

The theft loss tax deduction is an extremely valuable tax deduction and for most victims of the Madoff fraud the deduction will have a cash value equal to 35% or more depending upon state and city income taxes. Investors who are subject to federal, state, and city income tax may find that their recovery from the tax loss is equal to almost 50% of their theft loss.

As an alternative to claiming a deduction for a theft loss, in certain limited circumstances funds that have been paid to an investor from a Ponzi scheme, that were reported by that investor as “income” in a previous year, may instead be considered a return of the defrauded investor’s capital and not taxable income. If this is the case an investor might not claim a theft loss but might still file an amended tax return for some of the previous years and claim a tax refund of the tax paid on the improperly reported “income” in those year(s).

Furthermore, under limited circumstances, so long as the statute of limitations has not run out; income taxes that have been paid by Ponzi investors on “phantom income” that represented fake profits that never existed may be recovered by filing amended returns and eliminating the phantom income as a taxable income item in open years.

There are several methods of tax recovery that are available to Ponzi scheme victims. However, each of these potential options of recovery have their limitations, restrictions, and strict requirements that must be met if one is to take advantage of the maximum tax benefits from the Madoff theft.
The two most critical mistakes that result in the loss of the maximum advantage of these tax deductions seem to be:

1. the failure to deduct the tax losses in the proper year, and
2. to enter into settlements that may turn the ordinary theft loss into a capital loss that will be of much less value. The latter can occur for example, if an investor were to accept shares of stock as part of a settlement and then those shares of stock (a capital asset) lost all of their value.

The benefits and the traps make it important to tax plan properly to maximize the tax losses. It is critical that tax advisors and litigation counsel work closely together in order to not foreclose any of the available options for Madoff victims to make use of tax losses. Hopefully, professionals working together will avoid costly mistakes.

In considering the various options of recovery available for tax losses some fundamental knowledge of the law is important. We are going to cover those fundamentals into the following order.

- The Amount of the Theft Loss Deduction
- The Timing of the Theft Loss Deduction
- Tax Loss Carry Backs and Tax Loss Carry Forwards
- Deduction in the Year of Loss
- Deduction in Years Other Than the Year of Loss
- Other Sources of Tax Recovery
- Payments Received as a Return of Capital - Not Income
- “Phantom Income” Tax Treatment
- Tax Planning and the Practical Effects of the Tax Rules - Mistakes to Avoid.

The Amount of the Theft Loss

The amount of the theft loss that is deductible is calculated as

*the tax basis of the lost assets reduced by insurance proceeds recoverable and other claims for which there is a reasonable prospect of recovery.*

**To result in a tax loss the lost asset must have a tax basis.**

If the theft is accomplished in a manner that results in the taxpayer’s failure to include the lost asset in income or if a taxpayer has claimed the amount of the loss as a different type of deduction no theft loss will be allowed. In such a case, there should be no deduction because the lost property would have a zero tax basis.

**Example:**

A court denied any theft deduction loss for embezzled property where a taxpayer (“Employer”) had already received a tax benefit from the loss through the embezzler’s inflating the tax payer’s cost of goods sold in order to accommodate the embezzlement. The taxpayer’s former comptroller, (“Employee”) had embezzled more than $700,000 over the preceding seven years. All the embezzlements were accomplished through fictitious charges by the Employee that increased the Employer’s cost of goods sold and reduced the Employer’s taxable income by the embezzled amount each year. There was an economic loss but not a tax loss since the tax loss had already been deducted.

Note 1: This subject and a more thorough exploration of some of the critical issues raised in this Report No. 1 are discussed in Report No. 2 that will be published prior to February 1st, 2009.
Another example would be losses suffered by an I.R.A. or other deferred compensation plans where the amounts deposited into the plan for the beneficiary have never been included in the beneficiary’s income. There is no tax basis by the beneficiary in any of these funds.

However, in the Madoff situation, a taxpayer should receive a basis for theft tax loss purposes for taxes paid on “phantom income” that was credited to the investor’s account, whether or not it was paid to that account by Madoff.

Furthermore, it is recognized that costs such as legal fees incurred in collecting on Ponzi schemes were deductible as a theft loss. Courts have found that these costs and others such as the costs of recovery or salvage are so closely identified with the theft loss itself as to add further theft losses.

**Basis for Theft Loss Tax Deduction**

Assume over the years that the taxpayer X invests $1.0 million with Bernard Madoff personally and $1.0 million is invested by taxpayer’s I.R.A. with Bernard Madoff. Assume that by 2008 that each account statement reflected an investment account equal to $2.0 million in taxpayer’s personal account and $2.0 million in taxpayer’s I.R.A. The taxpayer paid a federal income tax on all of the funds shown as income in the personal account. Assume both accounts totaling $4.0 Million are completely lost. The taxpayer’s **TAX LOSS** (not economic loss) for recovery purposes is $2,000,000. Taxpayer invested $1.0 million and “earned” $1.0 million upon which taxes were paid. Had the taxpayer received a $100,000 distribution from the personal account in a prior year the basis for the loss purposes in the personal account would be $1.9 Million.

The taxpayer has **NO** basis for a tax loss by the I.R.A. Those funds were never taxed, so their loss cannot result in deductible tax loss. In the event the taxpayer received a $100,000 distribution from the I.R.A. account there still would be no effect on tax basis. In this situation the I.R.A. distribution would have been received and a tax paid upon receipt. Clearly, the I.R.A. loss is an economic loss, but it is not translated into a deductible tax loss.

**The Timing of the Theft Loss Tax Deduction**

This issue, the timing of the theft loss deduction, is the critical issue in the Madoff theft. Most likely, the vast majority of the victims of the fraud will want to claim a theft deduction for the year 2008. Such a claim, if submitted properly may result in the swiftest and largest cash recovery from the Bernard Madoff theft of all of the sources of recovery. This will be in the form of tax refunds. Furthermore, to the extent the theft losses are not all used as a claim for a refund of prior taxes paid, they will be available to offset future income starting as early as 2009.

There may be valid reasons for investors to claim the theft loss deduction in a year other than 2008. Therefore, the general rule described above will not fit every taxpayer. Furthermore, it may be more difficult to claim a deduction in 2008 if the investor, in the year 2008, took such steps as to file a claim in the bankruptcy courts and formally filed litigation claims against Madoff and any number of others, or took any other actions in 2008 that reflected high expectations of recovery of the Madoff theft.

However, as mentioned above and discussed further below, the Madoff loss, if not taken in 2008 as a “theft loss deduction” may be deductible in 2008 in a form of a deduction other than a theft loss.
The basic rules governing the theft tax loss deduction are straightforward:

- The theft loss deduction is a deduction of ordinary income
- The theft loss deduction may be carried back three (3) years and carried forward twenty (20) years.

When it comes to the proper timing of the theft loss deduction it gets more complicated. The basic rules that govern the proper year that the theft loss deduction should be claimed as a deduction are as follows:

- A tax deduction is allowed for any theft loss sustained during the taxable year and not compensated for by insurance or otherwise.

A theft loss is treated as sustained during the taxable year in which the taxpayer discovers the loss.

However, a theft loss is not deductible in the taxable year in which the theft was discovered to the extent that a claim for reimbursement exists and there is a reasonable prospect of recovery of the loss.

- If a theft loss cannot be deducted in all or any portion of the year of discovery because a reasonable prospect of recovery of the loss exists, then the theft loss deduction must be taken in the year (s) that it can be ascertained with a reasonable certainty that no further recovery will be received.

- If the taxpayer deducts a theft loss in the year of discovery because no reasonable prospect of recovery exists at that time and the taxpayer later receives compensation or reimbursement, the compensation or reimbursement does not cause a re-computation of the deduction; instead it is included in gross income for the year received.

There are two key phrases to keep in mind when reading these general rules about the timing of the deduction.

The first is “reasonable prospect of recovery”. The second phase is “ascertain with a reasonable certainty”.

The effect of these phrases on the appropriate timing of a theft loss deduction is as follows:

- A taxpayer who suffers a theft loss should take that theft loss deduction in the year the loss is sustained, which is in the taxable year in which the taxpayer discovers the loss. However, if in the year the taxpayer discovers the loss there is a reasonable prospect of recovering all or some portion of the loss, the taxpayer must postpone taking the theft loss deduction to later years; unless the taxpayer can show that as to all or some portion of the loss there is no reasonable prospect of recovery.

- If the taxpayer does not take a theft loss deduction in the year of discovery, in the following years the taxpayer may not take a theft loss deduction until the year in which the taxpayer can ascertain with reasonable certainty whether the expected reimbursement will in fact be received or not.

- The bottom line is that taxpayers who claim a deduction in the year 2008 for a theft tax loss will require a simpler legal standard of proof to an entitlement to the deduction in that year; than those taxpayers who will be required to prove their entitlement to the theft loss deduction in any other year than the year of discovery.
What does this mean in practical terms? We will look at two examples to answer this.

- Assume Taxpayer X invests $1.0 million with Bernie Madoff in January 1, 2004. Taxpayer’s account is credited every year with the Madoff Income and no distributions are made. Total Madoff Income is $500,000 by 2008.

Furthermore assume, the taxpayer had income from other sources for all the years in question equal to $300,000 per year. Assume taxpayer’s tax bracket on all of taxpayers’ income is 35%. The taxpayer treated the loss of his Madoff money in the year 2008 as a total loss and the taxpayer never believed any amount would be recovered.

### Theft Tax Loss

The Loss Carry Back and Carry Forward Rules - Year of Deduction 2008

<table>
<thead>
<tr>
<th>YEAR</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from Madoff</td>
<td>$110,000</td>
<td>$120,000</td>
<td>$130,000</td>
<td>$140,000</td>
<td>($1,500,000)</td>
</tr>
<tr>
<td>Income from Other Sources</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Total Taxable Income</td>
<td>$410,000</td>
<td>$420,000</td>
<td>$430,000</td>
<td>$440,000</td>
<td>$0</td>
</tr>
<tr>
<td>Tax Losses Applied</td>
<td>-0-</td>
<td>($420,000)</td>
<td>($430,000)</td>
<td>($350,000)</td>
<td>($300,000)</td>
</tr>
<tr>
<td>Taxable Income After Madoff Losses</td>
<td>$410,000</td>
<td>-0-</td>
<td>-0-</td>
<td>$90,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Tax Benefit @ 35%</td>
<td>-0-</td>
<td>$147,000</td>
<td>$150,500</td>
<td>$122,500</td>
<td>$105,000 (tax not paid on $300,000)</td>
</tr>
</tbody>
</table>

Discussion:

1. **Income from Madoff.** During the four years of the taxpayer’s $1 Million investment the Madoff returns total $500,000. The taxpayer did not receive any distributions of any funds and paid his or her Federal income tax on the Madoff income from separate sources.

2. **Income from other Sources.** Income from sources separate from the Madoff income is $300,000 per year.

3. **Total taxable Income.** Taxable income for the years 2004 through 2007 include the Madoff taxable income and other income.

4. **Tax Losses Applied.** The Madoff theft was discovered in 2008 and a deduction is claimed for $1,500,000. The $1,500,000 tax loss is deducted first in the year 2008 and carried back for three years to 2005 where it is used to its fullest extent available. The same applies to 2006.

5. **Taxable Income After Madoff Losses.** By 2007 the loss is fully exhausted.

6. **Tax Benefit.** The total tax recovery is $525,000. (35% x $1,500,000).

Assume instead, that the taxpayer filed numerous lawsuits and believed in 2008 that from all of the lawsuits filed that there would be an unknown recovery amount. The taxpayer did not claim a loss deduction in that year. Assume that the taxpayer diligently pursued those lawsuits and abandoned them in 2012 with no recovery. Assume also from the years 2009 – 2028, that due to a change of circumstances the taxpayer’s income from other sources was reduced to $200,000 annually instead of $300,000 annually as shown in the first chart.

**Note 2:** The distinctions between and the effects of the two key standards “reasonable prospect of recovery” and “to ascertain a recovery with a reasonable certainty”; are discussed in further depth in Report No. 2.
It is clear that the delay in claiming the deduction until 2012 has been costly even though the same amount of tax of $525,000, was recovered. The last recovery in this example is in the year 2016 when the last $100,000 of tax loss is deducted, an 8 year delay of a cash tax benefit.

The Johnson Case
A Real Life Example of What Not to Do

There is one very recent case that involved a “Ponzi like” scheme perpetrated on a Palm Beach couple. This case has added a good deal of clarity to the law on the timing of the theft loss deduction and other related deductions.

In 1997 Palm Beach County residents Aben Johnson and Joan Johnson discovered they were the victims of a fraud scheme involving the purchase of gems and jewelry in which they had lost approximately $78 million. The scheme had lasted from 1988—1997. During almost the entire time of the fraud the Johnsons “income” from their investments in gems was the repayment of their own funds that were paid previously to the perpetrator. Though the Johnsons discovered the fraud in 1997 they did not take any formal actions against the perpetrators of the fraud in 1997. The Johnsons however, did undertake an investigation in 1997.

Clearly, the value of the theft loss deduction was of such a size, that the issue of the timing of the deductions warranted every argument in a tax lawyer’s arsenal. In the course of trying to convince the court of the proper year of the theft loss deduction, the court was asked to choose between the years 1997, 1998, 2001, and 2005.

The court, that decided the last of the three Johnson cases in January of 2008, provided a great deal of guidance for the intelligent treatment of the Madoff theft losses.

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**THEFT TAX LOSS**

The Loss Carry Back and Carry Forward Rules - Year of Deduction 2012

<table>
<thead>
<tr>
<th>YEAR</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013-2028</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from Madoff</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>(1,500,000)</td>
<td>-0-</td>
</tr>
<tr>
<td>Income from Other Sources</td>
<td>$300,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total Taxable Income</td>
<td>$300,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Tax Losses Applied</td>
<td>-0-</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Taxable Income After Madoff Losses</td>
<td>$300,000</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0- until year 2016</td>
</tr>
<tr>
<td>Tax Benefit @ 35%</td>
<td>-0-</td>
<td>$70,000</td>
<td>$70,000</td>
<td>$70,000</td>
<td>$70,000</td>
<td>$245,000 Total Year 2013-2016</td>
</tr>
</tbody>
</table>
The court in the Johnson case confirmed that in the year of the discovery of the theft, the taxpayer could claim a deduction for that portion of a theft loss that the taxpayer could identify as not having a reasonable prospect for a recovery.

However, the Johnson’s tried to claim all of their theft losses in 1997, not just a designated provable portion that could not be recovered. Since in 1997 there appeared to be many avenues of recovery, this meant there was a “reasonable prospect of recovery” with an unknown amount. Therefore, the court denied the year deduction for the 1997, the year the loss was discovered.

The court found that the year of the discovery of a loss ordinarily should be the proper year of taking the loss. However, if there may be some reimbursement of the loss, and if the extent of the reimbursement is unknown or cannot be quantified in the year of discovery then the loss should not be taken in the year of discovery.

The taxpayers then claimed a major loss in 1998 and in 1998 the taxpayer made a better attempt to quantify the portion of the loss that would not be recovered. However, in 1998 the taxpayer admitted to the fact that they were using “estimates”. Consequently, the court denied any theft loss deduction in 1998.

Since 1998 was not the year of the discovery of the theft by the taxpayers the burden of proving the right to a deduction had changed. In 1998 the taxpayer had to prove not just that there was not a reasonable prospect of a recovery of any portion of the theft loss. The theft loss deduction was denied in 1998 because in that year, in order to receive a theft loss deduction, the taxpayer had to “ascertain with a reasonable certainty” that no further recovery of the loss was possible.

In denying the theft loss deduction for 1998 the court pointed out that there are two different legal standards and even indicated that evidence that was insufficient to meet the standards of 1998, the year after the date of discovery; may have been sufficient to meet the standards of the year of discovery, 1997.

THE MAJOR PRINCIPLE
SEEN IN EACH OF THE COURT’S DECISIONS IS THAT VICTIMS OF THE FRAUD WHO WANT TO TAKE THE THEFT LOSS DEDUCTION IN 2008, THE YEAR OF DISCOVERY, ARE WELL ADVISED TO SEPARATELY CONSIDER EACH OF THEIR POTENTIAL SOURCES OF RECOVERY, NOT ONLY MUST THEY DOCUMENT AND QUANTIFY EACH SEPARATE SOURCE OF RECOVERY. THEY ALSO MUST SEPARATELY PROVE THE LIMITATIONS TO EACH SOURCE OF RECOVERY. THEY MIGHT EVEN CONSIDER ABANDONING RIGHTS OF RECOVERY OF LITTLE OR NO VALUE IF A CONTINUING CLAIM MAY BE HARMFUL TO CLAIMING THE TAX DEDUCTION IN THE YEAR(S) OF MOST BENEFIT.
In denying the 1998 deduction the court stated:

- Several court decisions have tended to combine the “reasonable prospect of recovery” inquiry and the “ascertain with reasonable certainty” inquiry. However, these two inquiries are distinct and the standards to be applied are different...

- The taxpayers’ contention that the analysis of their lawyers and accountants is sufficient to “ascertain with reasonable certainty” standard is not supported. By their own admission, plaintiffs state that they made an “estimate” of the amount of recovery...

- The analysis performed by the lawyers and accountants may have been sufficient to determine whether there was a “reasonable prospect for recovery” in the year of discovery but it was not sufficient to “ascertain with reasonable certainty” the amount of reimbursement the plaintiffs would receive after a resolution of their reimbursement claims. Thus, the plaintiffs’ theft loss deduction in 1998 based on an “estimate” that was made well before the recovery process was resolved was premature and cannot be sustained.

Since the year 1998 was not the year the theft loss was discovered and since the Johnsons had decided to enter into extensive litigation by 1998, a theft loss deduction could not be taken until the Johnsons could ascertain with a reasonable certainty that the reimbursement will not be received for any portion of the loss.

Again the court’s words defined the higher standard for 1998.

- After having elected to pursue a claim for reimbursement for which there was a reasonable prospect of recovery, the plaintiffs did not “ascertain with reasonable certainty” in 1998 whether or not reimbursement would be received. To ascertain “reasonable with a certainty” whether or not such reimbursement will be received may be, for example, by a settlement of the claim, or by an adjudication of the claim, or by an abandonment of the claim.

- The requirement that a taxpayer “ascertain with reasonable certainty” means that a taxpayer must obtain a verifiable determination of the amount that she will receive, based on a resolution of the reimbursement claim before taking a theft loss deduction. Finally, requiring resolution of the claim with an objectively verifiable amount of loss is, as the government correctly notes, consistent with the plain meaning of “ascertain”… [as defined in a Dictionary of the English Language.]

It was not before 2001 that the Johnson’s eventually clearly defined with certainty the amount of recovery they would receive and were entitled to a theft loss deduction for the unrecoverable amount.

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**IT IS OBVIOUS THAT OBTAINING THE THEFT LOSS DEDUCTION FOR THE YEAR 2008 WILL INVOLVE AS CLEAR AN UNDERSTANDING AS POSSIBLE OF THE CHARACTERISTICS OF THE TWO KEY LEGAL PHRASES:**

“REASONABLE PROSPECT OF A RECOVERY”

AND “ASCERTAIN WITH A REASONABLE CERTAINTY”.
Other Sources of Tax Recovery

Investors may not need too be concerned about their ability to recover taxes paid on the phony “profits” that were being credited to investors’ accounts as taxable income. This is often referred to as “Phantom Income.”

Phantom Income in the Madoff accounts was typically reported over the years as taxable income on which taxes were paid. These amounts upon which taxes have been paid will be considered part of the investor’s basis and will be part of the loss amount for theft loss deduction whether the funds were actually paid in the account or not.

Furthermore, the tax benefits of the loss of Phantom Income can be accomplished in another way than the theft tax loss deduction.

In the same Johnson case previously discussed, the taxpayer proved to the court that in the last few years of the Johnson Ponzi scheme there never was any significant amount of capital. Therefore since new capital was simply passing through to pay off the investors with their own money, the court permitted the taxpayer to file amended returns that eliminated the Ponzi scheme “false income” or “phantom income” as taxable income.

There is one other theory of recovery. Again it may be only available in the situation where “Madoff Income” did not exist at all and that new money did little more than pass through the scheme to pay distributions to old money. Under limited circumstances, taxpayers who have received actual cash payments from the Ponzi scheme have been permitted to amend previous returns reflecting those actual payments as a non-taxable return of capital.
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Introduction

REPORT NO. 1 INTRODUCED THE READER TO A KEY PHRASE. The phrase is a reasonable prospect of recovery. This phrase determines whether a deduction for the theft loss in a Ponzi scheme, such as Madoff’s, should be taken in the year it is discovered or some other future year. The law does not permit the deduction to be claimed in a year prior to the year of discovery.

Since the timing of the theft loss deduction is critical to the real economics of the recovery, this phrase is all important. Therefore, before considering tax planning opportunities, this Report will study the phrase a reasonable prospect of recovery in more depth.

The phrase finds its origin in the early internal revenue codes that permitted a theft loss deduction for losses sustained in a taxable year but did not define the word sustained. Therefore, prior to 1954 the law was unsettled as to when a loss was sustained. This caused taxpayers to often lose their tax deduction for a theft loss when the statute of limitations had run on prior years; and it was later found that a loss had been sustained in one of those prior years that was no longer open for change.

The new law in 1954, that still applies today, adopted the principle that generally a theft was sustained in the year of discovery. However, this definition was tempered since it only applies to that portion or all of the theft loss that the taxpayer could identify as not having any reasonable prospect of recovery. Until it was clear that a loss was assured and closed and completed, there would be no deduction. The law attempts to make sure there is no deduction in the year of discovery or any other year unless the loss is assured.

The law tries to draw a fine line here. On one hand whether there is a reasonable prospect is a subjective matter in the eyes of the taxpayer. For example, at the year’s end 2008, many Madoff victims having heard about total losses and claw backs and questions of SIPC coverage may have believed there was no reasonable prospect of recovery at all.

However, on the other hand, the courts tell us that this subjective reasonable belief must be measured against objective facts.

There is no set of fixed rules that clearly define the taxpayer’s reasonable prospect of a recovery, that will result in a limitation of a taxpayer’s theft loss deduction in the year of discovery. However, it is possible to have a grasp of the concept by reviewing court statements defining the concept. We will also look at general principles that have emerged from the court cases and review two cases that could be said to represent the extreme ends of the spectrum of just what is a reasonable prospect of recovery.

Note 1: As explained in Report No. 1, most taxpayers will want to claim their theft loss deduction(s) starting in 2008 for maximum tax benefits and to take advantage of the legal standard that governs the allowance of the theft loss deduction in the year of its discovery.
One court has defined the *reasonable prospect of recovery* as follows:

This court must determine what was a *reasonable expectation* as of the close of the taxable year for which the deduction is claimed. The situation is not to be viewed through the eyes of the *incorrigible optimist* and hence, claims for recovery whose potential for success are remote or nebulous will not demand a postponement of the deduction. The standard is to be applied by foresight, and hence, we do not look at facts whose existence or production for use in later proceedings was not reasonably foreseeable as of the close of the particular year. Nor does the fact of a future settlement or favorable judicial action on the claim control our determination if we find that as of the close of the particular year, no reasonable prospect of recovery existed.

...a determination of whether a loss was in fact sustained in a particular year cannot fairly be made by confining the tier of facts to an examination of the taxpayer’s beliefs and actions. Such an issue of necessity requires a practical approach, all pertinent facts and circumstances being open to inspection and consideration regardless of their objective or subjective nature.

In determining whether a reasonable prospect of recovery existed as of the year of discovery, we start from the premise that petitioner is not required to avoid both *the scullion role of the incorrigible optimist* and *the charbadian character of the stygian pessimist*. The standard to be applied is the EXERCISE OF SOUND BUSINESS JUDGMENT BASED UPON AS COMPLETE INFORMATION AS IS REASONABLY OBTAINABLE.

Another court has stated it as:

The *reasonableness* of a taxpayer’s prospect of recovery is primarily tested objectively, although a court may consider to a limited extent evidence of the taxpayer’s objective contemporaneous assessment of his own prospect of recovery. “[t]he taxpayer’s attitude and conduct are not to be ignored, but to codify them as the decisive factor in every case is to surround the clear language of ... [the statute] with an atmosphere of unreality and to impose grave obstacles to efficient tax administration.”

In addition to these general statements, the courts in deciding whether there is a prospect for a reasonable recovery have also agreed on several principles that provide further guidance:

(i) In determining the reasonableness of a taxpayer’s belief of loss the courts had to be practical and aware of the individual facts of a case.

(ii) The relevant facts and circumstances are those that are known or reasonably could be known as of the end of the tax year for which the loss deduction is claimed. The only test is foresight, not hindsight.

(iii) Both objective and subjective factors must be examined.

(iv) The taxpayer’s legal rights as of the end of the year of discovery are all important and need to be studied to make a proper decision.

(v) One of the facts and circumstances deserving of consideration is the probability of success on the merits of any claim brought by the taxpayer.

(vi) The filing of a lawsuit may give rise to an inference of a reasonable prospect of recovery. However, the inference is not conclusive nor mandatory. The inquiry should be directed to the probability of recovery as opposed to the mere possibility. A *remote possibility* of recovery is not enough; there must be a *reasonable prospect of recovery at the time the deduction was claimed, not later.*
The bottom line of the timing of the theft loss deduction is this.

Under the law a taxpayer who has suffered a theft loss shall take a theft loss deduction in the year the loss is sustained, which is the taxable year in which the taxpayer discovers the loss. However, if in the year the taxpayer discovers the loss, there exists a reasonable prospect of recovering some portion of the loss or all of the loss; the taxpayer must postpone the theft loss deduction for that portion or all of the loss that may reasonably be recovered.

If a taxpayer does not take a theft loss deduction for the entire loss in the year of discovery because the taxpayer has a reasonable prospect of recovering all or a portion of the loss, the theft loss deduction will be postponed until there is a recovery or there is a certainty that the postponed recovery will not happen. The theft loss deduction will not be lost by virtue of it being postponed.

During taxable years after the year of discovery, the taxpayer may take a theft loss deduction for that portion of any postponed losses when the taxpayer can ascertain with reasonable certainty that the reimbursement will in fact no longer be received. A taxpayer may ascertain with reasonable certainty whether he or she will be reimbursed by a settlement of the claim, by an adjudication of the claim or by an abandonment of the claim.

Lawsuits

Another way to try to appreciate the concept of a reasonable prospect of recovery is to review a few of the cases that were hotly contested and could be said to be on the extreme ends of the view of whether or not a taxpayer had a reasonable prospect of recovery. In reviewing these cases it is important to keep in mind that the presence or absence of a lawsuit seeking recovery is often a big factor in determining whether the taxpayer believed they would receive a recovery or not.

One court in weighing whether the presence of a lawsuit seeking recovery should determine whether the taxpayer had a reasonable prospect for recovery put it this way.

While we offer no detailed opinion as to the merits of the taxpayer’s legal position . . . we find that the taxpayer did have a reasonable prospect of recovering something. In arriving at this conclusion, we stress that the mere existence of a POSSIBLE claim or pending litigation will not alone warrant postponing loss recognition. There are many reasons for initiating lawsuits. In this case, taxpayer’s antitrust claim for treble damages exceeded 19 million dollars. Where the stakes are so high, a suit may be 100% JUSTIFIED even though the probability of recovery is miniscule. In short, although we offer no litmus paper test of reasonable prospect of recovery, we note that the inquiry should be directed to the probability of recovery as opposed to the mere possibility. Analyzing the rule in percentage terms, we would consider a 40 to 50 percent or better chance of recovery as being REASONABLE. A lawsuit might well be justified by a 10 percent chance.
Normally where a taxpayer is in good faith willing to go to the trouble and expense of instituting suit to recoup a theft type loss, the courts seem to find that as a matter of fact there was a sufficient chance of at least part recovery to justify that the taxpayer should defer the claim of a theft loss deduction until the litigation in question is concluded. This is not to suggest that in some cases the facts and circumstances will not show such litigation to be specious, speculative, or wholly without merit and that the taxpayer hence was not reasonable in waiting to claim the loss as a deduction.

Another court stated the importance of a lawsuit in determining a *reasonable prospect of recovery* as follows

> . . . the mere existence of pending litigation won’t alone warrant postponing loss recognition. In determining whether there’s a reasonable prospect of recovery, the inquiry should be directed to the probability of recovery as opposed to the mere possibility. And where the taxpayer’s chances of recovery in a lawsuit were in the realm of remote possibility rather than reasonable prospect, the court held that postponement of the loss deduction wasn’t required.

**Case Law**

Looking at the two cases that also will help define the *reasonable prospect of recovery* standard, we see two situations in which great efforts were made to seek a recovery of a loss, including extensive litigation. In both cases the courts did a complete analysis of the legal rights of the taxpayers and determined in one line of cases the taxpayer did not have a reasonable prospect of recovery even though the taxpayers never wrote the theft loss off of their corporate financial statements in the year of discovery; had tremendous lobbying efforts on their behalf both individually and through trade groups to recoup their losses from multiple sources; and in the case of one taxpayer (a bank) even had the perpetrators’ money deposited in their bank while the actions seeking recovery were ongoing. Since the victim, a bank had no legal rights to hold the deposited money; the funds were released from the victim bank to the perpetrator of the theft.

This was the situation when the Iranian government expropriated assets of U.S. companies in Iran with the fall of the Shah of Iran and the Iranian Hostage taking. In this case, the I.R.S. argued against permitting a theft loss in the year of discovery.

In spite of several potential areas of recovery, which did in fact later lead to recovery and consideration that was paid for confiscated assets; the court was convinced that no legal rights existed for recovery in the year of discovery. Without legal rights, efforts that may present only a possibility of recovery are not enough to stop the taxpayer from taking the theft loss deduction in the year of discovery.

On the other hand, while in the Iranian expropriation cases the existence of only possible legal rights did not foreclose the deduction, another court took a different view of the presence or absence of legal rights in the year of discovery. In this other court the I.R.S. insisted that a taxpayer must take his theft loss in the year of discovery because of the status of that taxpayer’s legal rights.
There, even though a taxpayer won litigation in the lower court awarding him a recovery, the Court found the lower court’s ruling was illogical and that in spite of the ruling allowing a recovery, the taxpayer had no real possibility of a recovery. The Court ruled that this taxpayer had no legal rights to recovery and was therefore forced to take the deduction in the year of discovery. The Court’s independent review of the litigation awarding the recovery was that the lower court’s opinion (which was in fact overruled) was wrong. Therefore, the taxpayer could not even rely on a successful lower court opinion to support his belief in the year of discovery that there would be a recovery.

Now you see why we have tax lawyers.

**Tax Planning**

The term *tax planning* usually envisions taking steps in advance of an economic transaction in order to maximize tax benefits from the profits that may occur from the transaction. There is also the concept of the *post mortem tax planning* which is found in the estate tax area and provides some flexibility for transactions and the setting of tax values after death.

Tax planning for the maximum tax benefits from the Madoff loss will have a little bit of both. The loss has already occurred, however, what remains is how the taxpayer will plan and implement his or her Madoff tax loss for maximum benefits now and in the future.

The tax planning for the most part will be to provide the taxpayer with appropriate projections of the use of the tax losses under differing circumstances so that the client will be able to understand the financial effect of various options that the tax loss and litigation recoveries may provide for. Since the theft loss may be carried back three years and carried forward 20 years, it is extremely valuable.

**A litigation counsel** as part of the team is critical to a successful professional product for several reasons. Each Madoff victim should understand every possible means of recovery that might be applied to the individual. Recoveries from SIPC and the IRS are not the only avenues of recovery that will be considered. As the facts unfold there may be more culprits of economic substance that can be a target of recovery.

Certain accountants, financial advisors, principals of feeder funds, boards of directors and the various Madoff bankrupt estates may be just a few of the potential sources of recovery. If these sources of recovery are viable, the Madoff victim will need to carefully weigh the pluses and minuses of the postponed tax benefits that may result from a victim choosing to actively pursue certain areas of recovery. As in all economic matters, the emphasis should always be on the maximum recovery of money from third parties before relying on the recovery from tax benefits.
The theft loss tax benefits that one does not claim immediately will not necessarily be lost but may be realized at a later point in time when there is finality to each respective area of recovery that a victim has chosen to pursue.

For example, a taxpayer who files a SIPC claim expecting to recover $500,000 from SIPC may not claim a theft loss on that $500,000 in the year of discovery. The taxpayer should not however be prohibited from claiming a theft loss on Madoff losses in excess of $500,000.

Assume SIPC ultimately pays the $500,000 claim for only $300,000 in the year 2010. At that point, in 2010, the taxpayer would claim a further theft loss of $200,000.

The litigation lawyer will not only be necessary to analyze avenues of recovery and litigation claims, the litigator will also be important as an expert who is well versed regarding the viability or non viability of any claims for recovery. Therefore he or she will be very helpful in the taxpayer determining those avenues to pursue and those avenues that should be discontinued if their continuation would provide the I.R.S. with a strong argument to not permit the theft loss in the year of discovery, 2008.

The third essential expert is the tax lawyer who will need to coordinate all of the matters in light of the taxpayer’s objectives and various legal standards that will need to be met to achieve those objectives.

With the professional team in place, the steps generally will be as follows:

1. RECORDS.
The taxpayer must gather as complete a collection as possible of all financial records for as far back as one can find that involved the Madoff investment. This should include statements, tax returns and in some cases even estate tax returns.

2. BASIS CALCULATIONS.
A determination of the taxpayer’s tax basis in the Madoff loss must be undertaken. This basis needs to be calculated for each separate account as there may be different tax treatments and basis for estates, trusts, individuals, both American and non residents, corporations both domestic and foreign and charities.

3. SOURCES OF RECOVERY.
A detailed description should be made of the various sources of recovery that have been explored. In those areas where no recovery is possible or none sought, a taxpayer may want to formally renounce rights to certain forms of recovery to ensure that there is no question that the taxpayer had no reasonable belief of a prospect of recovery as to those rights.

4. LOSS IN YEAR OF DISCOVERY.
Once the sources of recovery have been inventoried a determination should be made regarding the maximum potential loss that can be deducted for the year 2008. It will be critical to prove that if a taxpayer is seeking a source of recovery that the recovery is not reflected as the possibility to recover an unlimited or maximum amount of recovery if that is not truly the case. Recoveries that are open ended in nature will harm the chances to claim the theft loss deduction in 2008.
5. Accounting Schedules and Forecasts.

Upon determining the amount of theft loss for which there is no potential for recovery in 2008, it is then important to prepare the appropriate accounting schedules. These should reflect the effect of the tax losses and the cash that may be recovered from amended returns and the tax free income that may be earned because theft losses may be carried forward for 20 years.

These projections will be critical. For example, there may be a fairly recent estate involved in which an estate tax has been paid on the Madoff funds that were inherited. If this is the case, this must be considered in the calculations as the estate tax deduction, if available, may have a value of 45% to the taxpayer versus the 35% benefit of the income tax deduction.

Furthermore, these projections should be useful for planning purposes. Calculations will be needed to keep track of the theft tax losses that will be deferred in those cases where the taxpayer believed there was a reasonable prospect of recovery. In those cases, in the event eventually there is a recovery, the recovery will not be subject to tax but will reduce any original unused theft tax losses. To the extent a recovery exceeds any theft tax loss, it will be subject to taxation.

Once these basic steps have been taken, so that the taxpayer is aware of all of the options, there will be a number of considerations; some of them that may need to be acted on quickly.

In the event an estate tax deduction may be more valuable than the income tax deduction, it will be very important to pay attention to the statute of limitations on the filing of the form 706 estate tax return.

There are many real life examples that will start the reader thinking about the maximum tax planning for the Madoff losses.

Assume an elderly victim of the Madoff theft may have significant unused theft tax losses that can only be used as a carry forward over the next 20 years. This income tax benefit might be cut short with the death of the Madoff victim. Is it possible to plan the family situation to preserve these losses or use them up on other income during the Madoff victim’s life?

One might ask in a town like Palm Beach, how many tax marriages or tax mergers might result. For example, unmarried Mr. X may be broke with a $20 Million theft tax loss that he cannot use going forward since he has little or no income. On the other hand, the widowed Mrs. Y may have an income stream of $4 Million a year and really hates to pay taxes. Does a joint income tax return that permits X’s net operating losses to be used by a future Mrs. X make this a wedding made in heaven?

In determining the value of tax losses, one will also have to consider whether the tax losses being carried forward during the 20 year period will actually be much more valuable than the tax loss that will be carried back. Will a multi trillion deficit result in taxes in the 40% and 50% tax range instead of the 35% tax range in the future?
THE NEXT REPORT NO. 3
WILL CONTINUE TO FOCUS ON TAX PLANNING.

Comments and questions have been coming in steadily and these will serve as a source for this continuing discussion since many readers have common issues.

*During the entire course of this analysis it is extremely important to stress that the taxpayer should be careful not to take steps that will harm their position regarding the tax deductions.* Though this may not be the best practice on all occasions, this author is generally advising clients to not file their year 2008 tax returns at the earliest possible date. Extension requests accompanied by the appropriate tax payments should provide taxpayers with more time to review unfolding events and take studied tax positions. The filing of the year 2008 income tax return early may commit the taxpayer to a position that is not in the taxpayer’s best interest. Since that position has been taken (without the benefit of many material facts) it could foreclose future tax options.

It is also to note that since April 15th, is fast approaching that relief procedures may be available for taxpayers who are concerned that their year 2005 tax returns (filed on April 15th, 2006) will be closed from a statute of limitations standpoint.
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The Madoff Tax Losses
Is the Safe Harbor Worth it?

Much has been written about the two documents released by the I.R.S. regarding the taxation of Ponzi schemes. There is Revenue Ruling 2009-9 (the “Rev. Rul.”) in which the I.R.S. has clarified much of the unsettled law in this area. Likewise there is Revenue Procedure 2009-20 (the “Rev. Proc.”) which provides an uncomplicated path through the law and will be helpful to thousands of Madoff victims who will have a short route to cash refunds from tax losses. This will be sorely needed by many. This is provided in what the I.R.S. calls a “safe harbor” procedure.

The two documents by IRS are a good package and drafted in record time for any government agency. The I.R.S. worked well.

However, it is important to remember IRS is not in business to give back money. The “safe harbor” needs to be carefully studied because it is a safe harbor that could be extremely expensive from a tax standpoint. It might be a safe harbor but the tax cost to dock your boat in this harbor could be very high.

One very simplistic example. Assume that there is $30 Billion of Madoff losses that would be able to receive theft loss tax benefits. Assume this Madoff income or amounts of principal, when taxed were in the highest tax brackets. This is because most earners of Madoff phantom income had other sources of taxable income.

Therefore, again to keep it simple, assume the average tax bracket is 35% for the Madoff income included in prior years. Taxes collected (10.5 Billion) (35% x $30 Billion).

Assume these Madoff losses are deducted in 2008 and used against income for the years 2003 through 2007 as loss carry backs from the theft loss deduction.

This will mean that Madoff income and Madoff investments of principal that have been taxed at the highest brackets will be carried back and applied against all of the income in a particular year. To a large extent these losses will offset income in each prior year that was earned at lower rates. Income and principal taxed at 35% might be offsetting income in a carry back year taxed at only 15%.

The amount of any refund from the loss carry back will suffer accordingly. If it is assumed that the refund paid on the $30 Billion in tax was a refund based at an average 25% tax rate, (25% x $30 Billion) the refunds paid to the taxpayer would total ($7.5 Billion). In this case the I.R.S. has made $3.0 Billion ($10.5 Billion in tax – 7.5 Billion in refunds)

Furthermore, the I.R.S. will have kept the $10.5 Billion in tax revenue for years without paying interest.
For reasons like this and for many other situations many Madoff victims may choose not to avail themselves of the safe harbor of Rev. Proc. 2009-20. This is especially so since the legal guidance offered by Rev. Ruling 2009-9 is so helpful.

I have chosen to use the Chart on the following page to explain and compare the effects of the Revenue Ruling and the Safe Harbor. I have also attached both the Ruling and the Procedure as an Appendix. I believe the Chart shows that for many taxpayers the “tax rights” that must be waived to take advantage of the “tax benefits” of the safe harbor could be very expensive and unnecessary. Many taxpayers will find that the tax benefits available by relying on the Revenue Ruling and the state of the law are preferable alternatives to the benefits of the safe harbor.

The Chart refers to a series of footnotes that are discussed as a narrative in this Report No. 3. As the Chart is being described and in closing we will look at some of the tax planning concepts that must be considered before choosing between the safe harbor and the law.

Introduction to the Chart

Prior to the issuance of Revenue Ruling 2009-9 there was a good deal of case law interpreting various aspects of the theft loss deduction. The cases relied on, were at times 40 to 50 years old and many reflect the absence of the type of forensic accounting that can be accomplished today. For this reason and others, though there was a great deal of case law interpreting the statutes and regulations, there remained a great deal of confusion on where certain lines were drawn. The Internal Revenue Service has done an extremely good job of clarifying that confusion by way of the Revenue Ruling. These clarifications are very helpful whether one chooses to be covered by the safe harbor or not.

The Chart shows that there are certain benefits to using the safe harbor, but it also shows that most of the tax benefits granted by the safe harbor are no different from the tax benefits that the taxpayer would receive under the law as interpreted by the Revenue Ruling. However to achieve these benefits, the safe harbor requires that the taxpayer must waive potential valuable tax rights.

Finally, the Chart shows the I.R.S. is using a not so subtle form of administrative coercion to force the use of the safe harbor by announcing that those who do not choose the safe harbor may be subject to stricter standards of proof and an increased audit potential.

Therefore, it is imperative that Madoff victims meet with their accountants and financial advisors that have the knowledge and facilities to provide proper spread sheets that will compare the economic effect of the use of the safe harbor versus that of the reliance on the law in each individual situation.

The chart shows another extremely important economic factor. Under the alternatives to the safe harbor, Madoff victims could be entitled to significant interest payments on the I.R.S. refunds from amended returns and claw backs that are calculated on prior years, some of which may have occurred long ago.

The theft loss refunds under the safe harbor will not carry interest if they are timely paid once a claim is filed.
## Madoff Ponzi Scheme

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The Footnotes

1. A Ponzi Scheme Loss is a Theft Loss Deductible as an Ordinary Loss.
   Both the Revenue Ruling and the Revenue Procedure agree that a loss from a Ponzi scheme is a theft loss for tax purposes. The Revenue Ruling is a good guide to the standard that must be met for a loss to be considered a theft.

   Both the Revenue Ruling and the Revenue Procedure also make it clear that a theft loss from a Ponzi scheme is an ordinary loss and not a capital loss.

2. The Amount of the Loss (Basis) and Phantom Income.
   The Revenue Ruling and the Revenue Procedure both acknowledge that the amount of a theft loss resulting from a Ponzi scheme is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn. Furthermore, both agree that if an amount is reported to the investor as income in years prior to the year of discovery of the theft and the investor includes the amount in gross income; then the amount of the theft loss is increased by the purportedly reinvested amount (the “Phantom Income”).

   The Revenue Ruling says it best:
   The amount of a theft loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery. If an amount is reported to the investor as income in years prior to the year of discovery of the theft, the investor included the amount in gross income, and the investor reinvests the amount in the arrangement, this amount increases the deductible theft loss.

3. Five Year Loss Carry Back of Net Operating Losses.
   The safe harbor provides that the Section 1211 of the American Recovery and Reinvestment Act amends the IRS code to allow certain taxpayers, including individuals, to be eligible to elect a 3, 4 or 5 year net operating loss carry back that is applicable only to net operating losses in the year 2008. The Revenue Ruling also interpreted this change in the law to apply to individual investors. The Revenue Ruling that is attached is very instructive on the requirements that must be met to qualify for the five year carry back and the legal reasons why it does apply to individual Ponzi scheme victims.

4. The Deduction is not Reduced by the Application of Certain Percentage or Dollar Limitations.
   The Revenue Ruling makes it clear that the theft loss is an itemized deduction and that several Code Sections that typically apply limitations to deductions are not applicable to theft losses from a Ponzi scheme. The 2% limit on itemized deductions does not apply to the theft loss; nor does the overall limit of itemized deductions that is based on a percentage of adjusted gross income apply. Finally, the $100 exclusion that must be met before taking a deduction for personal theft losses does not apply to Ponzi Scheme theft losses.

   The safe harbor grants the same treatment.
5. Respect for Pass through Entities.

The safe harbor directly comments on the treatment of investors in Ponzi schemes through entities that are separate and apart from the Ponzi victims, such as partnerships. The safe harbor states that an investor that would otherwise be qualified for a theft loss will not be considered to be qualified to claim that deduction under the safe harbor. Instead, the safe harbor states that the actual fund or entity itself in which a Madoff investor has invested in will be considered the qualified investor for purposes of the safe harbor.

There have been comments by I.R.S. officials and commentators that pass through entities such as partnerships and Sub Chapter S companies will report Madoff losses to each investor on their Schedule K-1 so that investors who can not use the safe harbor may file for their losses under the standard rules applied to pass through entities.

These “indirect investors” who want to avail themselves of the safe harbor need to make sure that the pass through entity in which they have invested is a “qualified investor” and complies with the safe harbor procedures.

Furthermore, in determining whether the five year extended loss carry back period will apply, again the I.R.S. will look to the pass through entity and its gross receipts. The five year carry back is only available to qualified investors whose annual gross receipts for 2006, 2007 and 2008 do not exceed $15 Million.


The safe harbor, like the law both find that a Ponzi scheme will be treated as a theft loss and as a theft loss it is deductible in the year of discovery.

The safe harbor provides a specific definition of the discovery year by linking the year of discovery to a year in which certain actions may be taken against the perpetrators of a Ponzi scheme. The safe harbor provides that the taxpayers who do not follow the safe harbor must establish “that the theft loss was discovered in the year the taxpayer claims the deduction”.

The taxpayer who is not choosing the “safe harbor” may have the responsibility to prove under the existing law that the year 2008 was the year of discovery. In essence I.R.S. is saying to the taxpayer prove there was a theft loss and prove the taxpayer knew about it in 2008.

The facts here speak for themselves. Madoff was arrested in December 2008 for crimes that would qualify as the theft under the safe harbor and the general law. Furthermore, Madoff’s arrest and crimes were of broad public knowledge before the end of the year 2008. It would be rare to find even non Madoff related individuals who had not heard about the scheme by 12/31/08. In most cases, the taxpayer’s records are meticulous.

The law and the Revenue Ruling interpret “the year of discovery” for theft losses in a more liberal way than the requirements of the safe harbor. The safe harbor requires that certain specific actions be taken by authorities before a theft loss is discovered for tax purposes. The law does not require that the taxpayer go to that extent to have a theft loss.

The case law defines the proof needed to pinpoint the year of discovery as follows:

A loss is considered to be discovered when a reasonable man in similar circumstances would have realized the fact that he had suffered a theft loss.

The year of discovery has also been described as:

“The proper year in which to claim a theft loss . . . being the year when the taxpayer in fact discovers the loss”.

The safe harbor considers the discovery year to be the year in which an indictment, an information or a complaint is filed against the perpetrator(s) of the Ponzi scheme.
This author believes that the typical Madoff taxpayer will be in the position to prove, if necessary, that as far as they are concerned, the Madoff loss is in the year 2008. A review of the facts here finds that Madoff was indicted for his crimes in 2008. The safe harbor would find that this is sufficient enough. However, there is much more to the evidence that can prove that 2008 was the year of discovery.

Since the Madoff investment was so critical to many economic plans, every Madoff investor who had discovered the theft in 2008 will most likely have document upon document of proof. This will be in the form of communications between the taxpayers and their lawyers, accountants, family members and others. It will include documents received from the trustee in receivership and numerous professionals soliciting services and email communications. The list of evidence goes on.

As to the year of discovery, it would seem the I.R.S. will have very little direct evidence to overcome a well prepared tax return reflecting the strength of the taxpayer’s position and the strength and depth of the proof of that position.

Finally, for whatever it is worth, the Revenue Ruling uses a factual example with facts much like the Madoff case and acknowledges that the year 2008 would be the year of discovery at least for victims in the ruling.

On the whole, when it comes to the year of discovery, the actual factual situations for the typical Madoff victims that do not accept the safe harbor are very similar to those that accept the safe harbor. Certainly, there will be highly unusual situations that will not fit this mold.

While there are no guarantees it would seem that the case law; the particular facts regarding the Madoff theft; and the finding by I.R.S. in the Revenue Procedure that the year of discovery was 2008, are all powerful proof for equal treatment on the issue of the year of discovery for all Madoff victims that are similarly situated whether the safe harbor rules would apply or not.

7. Amount of Loss in the Year of Discovery.

In their statements, the Revenue Ruling and the safe harbor both acknowledge as a legal matter that the determination of the year of discovery which is the year for the deduction of the theft loss and the determination of the amount of the deduction in the year of discovery are two different exercises.

The safe harbor actually acknowledges this legal principle by establishing percentage amounts of deductibility for the loss in the year of discovery.

Both acknowledge that if, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is deductible in that year. However, the portion for which there is no prospect of recovery is deductible in the year of discovery.

In the safe harbor, the I.R.S. makes a factual determination for all Ponzi schemes and not just Madoff. This determination is that a certain percentage amount of a theft loss can be deducted in the year of discovery of a Ponzi scheme when calculating the ultimate amount of the deductible loss.

The safe harbor provides two specific amounts that may be claimed as the amount of loss in the year of discovery. Those amounts fall into two categories. The Madoff victim will be permitted to take the amount of the entire theft loss and deduct 95% of that amount so long as the taxpayer is not seeking any third party recovery for theft loss tax purposes.
In the event that the Madoff investor is pursuing or intends to pursue any recovery from third parties, then the amount deductible in the year of discovery will be limited to 75% of the deductible loss.

A Revenue Ruling only comments on the law. It gives legal guidelines as to the timing of deductibility of a loss but cannot comment on the specific amount of the loss in the year of discovery. The Revenue Procedure says that if a taxpayer does not use the safe harbor it will be up to the taxpayer to rely on the case law in this area to prove that the 95% and 75% figures used in the safe harbor are accurate or close enough to be relied on by ALL Madoff victims.

It is important here to keep in mind that whether a taxpayer uses the Rev. Rul. or the safe harbor, whether the amount of the theft loss that is being deducted in 2008 is 75%, 85% or 95% of the total theft loss; the balance of the theft loss that is not claimed in the year of discovery (2008) will be claimed in a later year when it is clear that no further recovery will be available. No theft loss deduction is “lost” just because it is not deducted in the year of discovery.

The taxpayer who does not use the Safe Harbor may still claim the 95% and 75% figures as correct. However, that taxpayer is going to be required to prove that the 95% and 75% figures used by the I.R.S. are accurate for the taxpayer’s situation using evidence that is separate and apart from the I.R.S. findings. The I.R.S. has definitely done many taxpayers a favor in the safe harbor by determining a fixed percentage for Ponzi scheme loss in the year of discovery. However, for Madoff victims, the law may provide a similar result if there is the right proof to back it up.

The law provides that the taxpayer would be permitted to take 100% of the loss in the year of discovery minus any amounts for which there is a reasonable prospect of recovery. To determine what the safe harbor provides to the taxpayer, another comparative chart is necessary.


If one does not use the safe harbor to pin down the amount of the loss in the year of discovery, success may depend upon the state of the taxpayer’s books and records and the expertise of the taxpayer’s tax lawyer and accountant.

**Certainly if there is no solid proof of the taxpayer’s potential recovery amount or lack thereof, the taxpayer may be well advised to take the safe harbor.**

**The Doctrine of Equality of Treatment and the Nature of a Safe Harbor**

While tax law as a general rule does not look at the equities of a taxpayer’s situation, Madoff and other Ponzi schemes might warrant that type of treatment.

To begin with, one needs to understand what generally is meant by a safe harbor and the “doctrine of equality of treatment”.

A safe harbor is typically an I.R.S. procedure that permits taxpayer’s certain tax treatment without administrative question because the permitted tax treatment is well within the outside boundaries of what I.R.S. believes is the law.
Furthermore, there is a Doctrine of Equality of Treatment that is applied sparingly but nevertheless requires the I.R.S. to exercise its discretion in a manner so that similarly situated taxpayers are treated equally.

It would seem difficult for the I.R.S. to make a factual finding that all of the taxpayers suffering Ponzi scheme theft losses, wherever and whenever they may be, will be permitted a deduction at certain fixed rates at 95% and 75%; while denying these same rates of deduction to a select group of similarly situated taxpayers who choose not to do it the I.R.S. way.

Quantifying the Amount of Theft Loss in Year of Discovery

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<td>Amount of Qualified Loss Permitted. Third Party Recovery Sought.</td>
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**Other Reductions to Qualified Investment Loss**

- Loss Reduced by Actual Recovery Received in 2008
- Loss Reduced by Insurance Policies in the Name of the Qualified Investor
- Loss Reduced by Contractual Arrangements that Guarantee or Protect against Loss of the Qualified Investor
- Loss Reduced by Certain Amounts Payable from the Securities Investor Protection Corporation (SIPC)
- Loss Reduced by Actual Recovery Received in 2008
- Loss Reduced by Insurance Policies in the Name of the Qualified Investor
- Loss Reduced by Contractual Arrangements that Guarantee or Protect against Loss of the Qualified Investor
- Loss Reduced by Certain Amounts Payable from the Securities Investor Protection Corporation (SIPC)
The Waiver of Tax Rights

Footnotes 1 through 7 compared the benefits of the safe harbor with the law as described by the Revenue Ruling.

Footnotes 8, 9 and 10 explore The Waiver of Potential Benefits in exchange for the benefits of the safe harbor and how costly that harbor may be from a tax standpoint.

8. Waiver of the Right to File Amended Returns.

The safe harbor requires that the Madoff victims forego the opportunity to file amended returns for those years that are still open by the statute of limitations. However, by amending a prior return instead of taking a theft loss deduction, a taxpayer can eliminate only the taxpayer’s Madoff “phantom income” from the taxable income in the prior years. This will typically be the high bracket income. This manner of recouping loss in a Ponzi scheme generally has been acceptable under the law in limited circumstances. The theory is that if there was no “real income” at the time it was reported, the phantom income can be eliminated as taxable income instead of being claimed as a theft loss. In the Madoff situation this theory would seem to have a lot of merit. It is bolstered by statements by authorities that there was a lack of any real trading by Madoff for years.

Amending a prior return permits the taxpayer to eliminate Madoff income for the years 2005 through 2007 and other open years (if the statute of limitations for 2005 has been preserved). Many taxpayers will receive a significant benefit by amending their returns instead of claiming the theft loss for prior years. By amending prior returns to eliminate Madoff income, the taxpayers will generally be receiving a refund only for their Madoff “phantom income” tax payments. This will typically be from the higher tax brackets thus, a deduction obtained from amending tax returns to eliminate only the Madoff income may be more valuable than a theft loss deduction. Furthermore, refunds from amended returns may carry interest from the year of overpayment. (see below)

A taxpayer’s waiver of this right to file amended returns could be very costly, depending upon the amount of the losses, the year of the losses and the taxpayers’ financial situation in both the past and in the future.

The ability to use Madoff tax losses at the highest brackets by amending prior tax returns will leave more of those losses available to be carried forward into future years as opposed to being used to offset income from prior years and lower tax brackets. To the extent that amended returns do not use up all of the tax losses, these excess losses can be claimed as theft losses in the year 2008 and can then be used as a 20 year carry forward against ordinary income. With the Federal income tax already destined to become higher and state and cities raising their income taxes, theft loss deductions that are carried forward may have significantly more value in the future. They may in the future provide deductions for income that could be subject to federal, city and state income taxes totaling in excess of 50%.

The safe harbor insists that the taxpayer waive their right to Internal Revenue Code Section 1341. Code Section 1341 in essence provides that if a taxpayer paid tax on income that the taxpayer claimed a right to a prior year and the taxpayer then was required to pay that income in a different year, the taxpayer would be able to take the deduction either in the year in which the payback or claw back was made or in the year that the income which was clawed back was taxed. This is the case even if the statute of limitations is closed in the year that the original tax was paid.

The Revenue Ruling did comment on the use of this Code Section 1341 and stated that it was not applicable under the circumstances of the Revenue Ruling. However, the Revenue Ruling did not go far enough since it did not describe or comment on whether Code Section 1341 applies to a claw back situation. A full discussion of a taxpayer’s possible rights under Code Section 1341 is beyond the scope of this Report. However, many taxpayers that are required to make claw backs might find that Code Section 1341 would apply to their claw backs and that waiving the rights to the use of this section could be extremely costly.

The tax bracket comparisons here could be significantly different for those taxpayers who may have to pay claw backs in future years. Taxpayers that pay claw backs and have very little taxable income in future years may take a deduction for the amount of the claw back payment. However, those taxpayers might make only minimal use of the claw back deduction. By using Code Section 1341 there is the potential for taxpayers to claim that claw back payments should be applied against taxable income in old years (otherwise closed by the statute of limitations) where they would be much more valuable as tax deductions if income was reported at high tax brackets in these years.

For example, a claw back of $500,000 that provides a tax refund of only 15% in a year when income is low, ($75,000); might provide a cash return at the 35% high tax bracket from a prior high tax bracket year of ($175,000). The difference of 20% in the brackets is $100,000 of real money. Furthermore, the interest paid on a refund going back in years could be significant. By waiving the benefits of Code Section 1341 the taxpayer eliminates the potential for these increased earnings from tax refunds.

10. Interest on Refunds.

An unstated benefit in the Ruling and the Revenue Procedure that is being waived when taxpayers choose the safe harbor is the possibility of receiving interest paid in those circumstances where either the use of Code Section 1341 or the use of amended returns will result in refunds.

Taxpayers that receive refunds as a result of the safe harbor will receive those refunds as a result of the loss carry back to prior years from the year 2008. Tax refunds from the carry back of net operating losses are calculated from the filing date in the year in which the net operating loss arose.

Furthermore, in the case of a refund from such a loss, the interest will start on the filing of the claim, plus a further interest free 45 day period within which I.R.S. may pay the claim after it is filed.

However, where the refund of an overpayment as a result of an amended tax return or because of Section 1341, the interest on that refund amount is calculated from the prior year when the overpayment was made.
Finally we reach Footnote No. 11. This deals with the Internal Revenue Service indications that there may be administrative difficulty for tax returns by Madoff victims that do not choose to use the safe harbor. The Service has clearly stated that those people who do not choose the safe harbor will need to be concerned with proving the year of the theft loss and proving the amount of the theft loss under the existing rules. However, this statement by I.R.S. is tempered since it also states that taxpayers that are not covered by the safe harbor will also not be challenged on the issue of whether “phantom income” is deductible when the phantom income amounts shown on the taxpayer’s return were based on information received from the Ponzi scheme, in the taxable years.

Finally, the Service added a caveat that tax returns claiming Ponzi scheme type deductions that do not use the safe harbor may be subject to increased audit exposure.

12. Tax Planning.
There are many that may significantly benefit by making use of the safe harbor. For many, the Revenue Ruling and the law will be helpful. This will depend upon each individual circumstance. Large Madoff tax losses and smaller ones all need to pay attention to the traps and opportunities.

Taxpayer’s that use the “safe harbor” are also going to need sound advice on the valuation of their SIPC claims. They must focus on how this might reduce the amount of the theft loss in the year 2008. For example, a taxpayer with a maximum $500,000 Madoff loss and a claim against SIPC for $500,000 that is not resolved by the time the tax return is filed, may be forced to delay claiming any theft loss deduction in 2008 since there is a “reasonable prospect of recovery” of the investor’s loss. The inability to use the theft loss in 2008 could significantly affect the amount of any tax refund.

AMENDED RETURNS MIGHT PERMIT THE MADOFF VICTIMS TO HAVE THEIR TAX BENEFITS AND A SIPC RECOVERY.

ESTATES AND TRUSTS
There will be a host of estate and income tax issues that will not be covered by the safe harbor and that have not been answered by the Revenue Ruling. Not to be overlooked is the effect on the deductibility of theft losses from a standpoint of an income tax versus an estate tax value.

IRAS AND PENSIONS
Losses in IRAs and Pension accounts will generally not be deductible for tax purposes since they represent the loss of funds with no tax basis. However, there may be recoveries of funds by these entities or claw backs that will be taken from them that will need to be addressed if millions are not to be lost in potential tax deductions.
LOSS CARRY FORWARDS

One also cannot overlook the general tax planning thinking that needs to occur in planning for loss carry forwards that may result from the Madoff tax theft. In the case amended returns have been filed, it is also important to file for the theft loss in year 2008 for the balance of losses. This will apply to those who take advantage of the safe harbor and those who do not. Going forward there will be many who will have Madoff tax losses to offset against future income. These losses may be permitted for a period of 20 years from the date of discovery of the theft. These future tax losses may go unused and be wasted for taxpayers who pass away. Those that have greatly reduced income against which tax deductions may be used will need special attention if those deductions are not to be wasted.

A GOOD DEAL OF THINKING IS IN ORDER

for family members and related parties to determine how to legally take the best advantage of the Madoff tax loss that are carried forward. They could be very valuable or wasted assets.

There will be many tax planning tools available to meet these needs.
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Ponzi Scheme Tax Losses
by Richard S. Lehman, Esq.

Introduction
The theft loss tax deduction is an extremely valuable tax deduction, and for many victims of a Ponzi scheme fraud, the tax deduction will have a cash value equal to 35% or more, depending upon state and city income taxes. Investors who are subject to federal, state, and city income tax may find that their recovery from the tax loss is equal to almost 50% of their theft loss. ¹

¹ This applies to taxpayers in the highest income bracket designated by the IRS, many of whom have already paid federal taxes on phantom income in prior years at the 35% rate. See §1(i)(2). Except as otherwise indicated, references to "§" or "Section" are to the Internal Revenue Code (Title 26 of the United States Code or USC) and the regulations thereunder (Title 26 of the Code of Federal Regulations or CFR).

² The overall tax burden (federal, state, and city income taxes) on taxpayers in the highest income bracket designated by the IRS who live in cities like New York can be as high as 50%.

Losses from Ponzi schemes are acknowledged by the IRS to be "theft losses." ² Theft losses are deductible from a taxpayer's ordinary income. ⁴ Unlike capital losses, which are limited for both corporations and individuals, ⁵ theft losses are granted ordinary loss treatment ⁶ and are not subject to the 2% floor or the 80% limitation on itemized deductions. ⁶ Theft loss attributed to investing in a Ponzi scheme also is not subject to the 10% adjusted gross income limitations. ⁸

⁴ §165(a), (c)(3).
⁵ See §§1211 and 1212.
⁶ §165(h)(2).
⁷ §§67(b)(3) and 68(c)(3).
⁸ See §165(h)(1) and (2).

As an alternative to claiming a deduction for a theft loss, in certain limited circumstances, funds that have been paid to an investor from a Ponzi scheme and that were reported by that investor as "income" in a previous year may instead be considered a return of the defrauded investor's investment and not taxable income. If this is the case, an investor might not claim a theft loss but could still file an amended tax return for some of the previous years and claim a tax refund by eliminating the improperly reported "income" in those years. ⁹

⁹ The IRS Office of Chief Counsel has stated that the ability to amend a return with respect to reported income is given to taxpayers in "rare and extraordinary circumstances" and that the treatment is properly applied only with respect to amounts actually or constructively received after the fraud was discovered. CCA 200811016. See also Greenberg v. Comr., T.C. Memo 1996-281; CCAs 200305028 and 200451030.

Various methods of tax recovery are available to Ponzi scheme victims. However, each of these potential recovery options has its limitations, restrictions, and strict requirements that must be met if one is to take advantage of the maximum tax benefits from the Ponzi scheme theft. ¹⁰

¹⁰ Section 6511(a) requires the taxpayer to initiate a claim for a refund within three years from...
the date the tax return was filed, or two years from the date the tax was paid, whichever period expires later.

The benefits and the traps that stand in the way of those tax refunds make it important to tax plan properly to maximize the tax losses. It is critical that tax advisors and litigation counsel work closely together in order not to foreclose any of the available options for Ponzi victims to make use of tax losses while they are available. 11

11 As the U.S. Supreme Court case of Brockamp v. U.S. makes clear, limitations on filing periods tend to be strictly enforced. 519 U.S. 347 (1997).

In considering the various recovery options available for tax losses, some fundamental knowledge of the law is important. Those fundamentals are covered in this article in the following order:

- Definition of Theft Loss for Tax Purposes
- Privity Requirement
- Amount of Theft Loss Deduction — Basis and Phantom Income
- Tax Loss Carrybacks and Tax Loss Carryforwards
- Timing of Theft Loss Deduction
- Other Sources of Tax Recovery
  - Payments Received as Return of Investment, Not Income
  - "Phantom Income" as Return of Investment
- IRS Ponzi Scheme Revenue Ruling
- IRS Safe Harbor
- Tax Effect of Clawback of Ponzi Scheme Profits
- Tax Effect of Losses on Estates and Trusts
- Tax Planning and Practical Effects of Tax Rules — Mistakes to Avoid

Definition of Theft Loss for Tax Purposes

Regs. §1.165-8(d) states that for purposes of the theft loss deduction, the term “theft” shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery. Whether “theft” occurs for federal tax purposes can also depend on the law of the jurisdiction where the loss was sustained. 12 A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred, and was done with a criminal intent. 13 The IRS ruled that, if the perpetrator of the Ponzi scheme violated a state criminal law, the Ponzi scheme losses are theft losses for federal tax purposes because the perpetrator intended to, and did, deprive the investor of money by criminal acts. 14

12 CCA 200811016.

Courts have repeatedly accepted Ponzi schemes as theft losses within the meaning of §165(e). 15 For federal income tax purposes, courts have generally construed “theft” as a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses, and any other form of guile. 16 A taxpayer need not show that the Ponzi scheme perpetrator was convicted for theft. 17 However, a deduction might be disallowed to participants who were aware of the fraudulent or illegal nature of the scheme, under a “frustration of public policy” doctrine. 18
Amount of Theft Loss Deduction

The amount of the theft loss that is deductible is calculated as the tax basis of the lost assets reduced by insurance proceeds recoverable and other claims for which there is a reasonable prospect of recovery. 19


To result in a tax loss, the stolen asset must have a tax basis. If the theft is accomplished in a manner that results in the taxpayer's failure to include the stolen asset in income, or if a taxpayer has claimed the amount of the loss as a different type of deduction (such as a business expense deduction), no theft loss deduction will be allowed because the stolen property has zero basis.

For example, a court denied a theft loss deduction for embezzled property where a taxpayer ("Employer") had already received a tax benefit from the loss through the embezzler's inflation of the taxpayer's cost of goods sold in order to accommodate the embezzlement. The taxpayer's former comptroller ("Employee") had embezzled more than $700,000 over the preceding seven years. All of the embezzlements were accomplished through fictitious charges by Employee that increased Employer's cost of goods sold and reduced Employer's taxable income by the embezzled amount each year. The court concluded that a "theft loss deduction should be disallowed where the proceeds embezzled were never reported as income and, accordingly, no tax was paid on them." 20


However, in the Ponzi scheme situation, a taxpayer will receive basis for taxes paid on "phantom income" that was credited to the investor's account, whether or not it was paid to that account by the Ponzi scheme. 21


Furthermore, costs such as legal fees incurred in collecting on Ponzi schemes are deductible as a theft loss. Courts have found that these costs and others, such as the costs of recovery, are so closely identified with the theft loss itself as to add further theft losses. 22

22 See, e.g., Vincent v. Comr., 219 F.2d 228 (9th Cir. 1955); Ander v. Comr., 47 T.C. 592 (1967).

Assume that, over the years, taxpayer X invests $1 million in a Ponzi scheme personally, and X's IRA invests $1 million in the same Ponzi scheme. Assume that, by 2008, each account statement reflected an investment account equal to $2 million in taxpayer's personal account and $2 million in X's IRA. At that time, the Ponzi scheme collapsed. X paid a federal income tax on all of the funds shown as income in the personal account. Assume both accounts, totaling $4 million, are completely lost. X's tax loss for recovery purposes is $2 million. X invested $1 million and "earned" $1 million upon which taxes were paid. Had X received a $100,000 distribution from the personal account in a prior year, X's basis the personal account for tax loss purposes in would be $1.9 million.

X cannot deduct a tax loss based on the IRA's losses; the loss of those funds is not deductible because those funds were never taxed. Even if X received a $100,000 distribution from the IRA account, there still would be no deductible loss. If a taxpayer has no basis in the IRA (for example, because the taxpayer claimed a deduction for IRA contributions or because the IRS has not taxed the growth in value in the IRA), the
taxpayer cannot take a deduction for the economic loss in the IRA. Generally, a taxpayer may take a miscellaneous itemized deduction for an IRA loss only after all amounts in all IRA accounts have been distributed and the total distributions are less than the taxpayer's unrecovered basis, if any. The loss rule applies separately to each type of IRA. Thus, for a taxpayer to report a loss in a traditional IRA, all traditional IRAs owned by the taxpayer have to be liquidated. Similarly, for a taxpayer to report a loss in a Roth IRA, all Roth IRAs owned by the taxpayer have to be liquidated.

IRS Info. Letter 2010-0234 (12/30/10).

See IRS Pub. 590. Investment losses in traditional IRAs and Roth IRAs are treated the same because only basis is taken into account in determining the amount of losses. IRS Info. Letter 2007-0034.

Editor's Note: A bill (S. 3166) that was introduced in the Senate on March 25, 2010, would allow investors who lost money in their IRAs as a result of fraud to recoup some of their losses through the use of a theft loss deduction. The bill would also permit small investors to withdraw money from retirement accounts without penalty to assist them with their daily cash flow needs and would raise the limit on tax-free contributions to retirement accounts to help those investors recoup their losses more quickly.

Character of Loss
The investor is entitled to an ordinary loss rather than just a capital loss. The IRS considers a Ponzi scheme theft loss to be a loss that is incurred in a transaction entered into for profit.

Rev. Rul. 2009-9, 2009-14 I.R.B. 735, in which the IRS ruled that a loss incurred by a taxpayer with respect to an investment in a Ponzi scheme is deductible under §165(c)(2) as a theft loss from a transaction entered into for profit.

Privy Requirement
There are significant limitations on a taxpayer's ability to deduct a theft loss. An essential element of theft under the law of most states is specific intent to obtain the victim's property. Implicit in this requirement is a relationship of privity between the perpetrator and the victim.

See, e.g., Stolz v. U.S., 410 F. Supp. 2d 734 (S.D. Ind. 2006) (while deductibility of loss due to personal guarantee is generally determined under §166 and Regs. §1.166-9, district court held that under Indiana law, any theft loss that may have occurred was between lender and debtor and not between debtor and guarantor and, therefore, guarantor was not entitled to take theft loss even where debtor fraudulently induced guarantor to guarantee loan).

Where a debtor-creditor relationship has been established, the loss suffered is a bad debt rather than a theft loss, even though the debtor's inability to pay is due to a theft. A taxpayer is not entitled to a theft deduction where his investment in corporate stock or corporate debt is diminished in value (or becomes worthless) because of theft or embezzlement from the corporation; if such stock is sold or exchanged or becomes wholly worthless, any resulting loss is capital.

Locke v. Comr., 8 B.T.A. 534 (1927), acq., VII-1 C.B. 19 (1928); see CCA 200451030 (investors in Ponzi scheme that held loan obligations respected as bona fide debt were entitled to §166 bad debt deduction; investors that held instruments that were not bona fide debt were entitled to §165 theft loss).

Jasinski v. Comr., 37 T.C.M. 1 (1978); Willey v. Comr., 75 T.C.M. 1757 (1998). See Notice 2004-27, 2004-16 I.R.B. 782 (IRS will disallow deduction for theft loss relating to decline in value of stock acquired on the open market for investment where such loss is attributable to corporate officers misrepresenting the financial condition of the corporation, even where the officers were indicted for securities fraud or other criminal violations; if such stock is sold or exchanged or becomes wholly worthless, any resulting loss is capital).

Accordingly, if a taxpayer cannot rely on a criminal violation of federal securities laws (some of which do not require privity), the ability of victims of securities fraud who purchase stock in the open market to deduct their loss as a theft loss will vary. In situations involving securities fraud, a taxpayer will generally prevail
only if there is a direct buyer-seller relationship linking the taxpayers and the defrauders. Mere reliance on the fraudulent representations of a corporate officer to make or maintain an investment may be insufficient. 29

29 Compare Vietzke v. Comr., 37 T.C. 504 (1961) (theft loss allowed; taxpayer fraudulently induced to advance funds to corporations for stock subscriptions that were subsequently stolen; corporate entity merely a device to swindle investors) and Bellis v. Comr., 61 T.C. 354 (1973), aff'd, 540 F.2d 448 (9th Cir. 1976) (securities sold directly by corporation to taxpayer; loss would have been allowed if fraudulent intent had been shown) with Barry v. Comr., T.C. Memo 1979-215 (no theft loss deduction when securities purchased on open market) and De Fusco v. Comr., T.C. Memo 1979-230 (no direct sale; lack of privity "fatal flaw" in taxpayer’s case). See FAA 2007-3801F (Chief Counsel’s Office advises taxpayer is not entitled to theft loss deduction for losses related to exercise of stock option; detailed discussion of case law).

Limitations on Deductions

An investment theft loss is not subject to the $100 per event or the 10% of adjusted gross income personal casualty loss floors because it is a loss from a transaction entered into for profit. 30 The theft loss is available only to those who itemize deductions.


Theft Loss Carrybacks and Carryforwards

The investment theft loss forms part of the taxpayer’s operating loss that may be carried back or forward under normal net operating loss rules. Generally these rules provide for a three-year loss carryback and 20-year loss carryforward (or “carryover”) limitation. 31

31 §172(b)(1)(A)(i) and (F)(ii)(I).

However, if the loss is discovered in 2008 or 2009, Rev. Rul. 2009-9 treats an individual investor or proprietorship as a small business that is eligible for the extended five-year NOL carryback period under the American Recovery and Reinvestment Act of 2009. 32 However, there is a limit on taxpayers that meet the “small business” test of eligibility. If a taxpayer has more than $15 million in maximum gross income, the taxpayer will not qualify for the five-year NOL carryback under the American Recovery and Reinvestment Act of 2009, but the regular three-year NOL carryback arising for casualty or theft losses may be utilized.

32 Pre-2009 WHBAA §172(b)(1)(H), as amended by the 2009 ARRA §1211(a).

Timing of Theft Loss Tax Deduction

The proper timing of the theft loss deduction is more complicated.

A tax deduction is allowed for any theft loss sustained during the taxable year and not compensated by insurance or otherwise. 33 A theft loss is treated as sustained during the taxable year in which the taxpayer discovers the loss. 34 However, a theft loss is not deductible in the taxable year in which the theft was discovered to the extent that a claim for reimbursement exists and there is a reasonable prospect of recovery of the loss. 35 If a theft loss cannot be deducted in the year of discovery because a reasonable prospect of recovery of the loss exists, then it cannot be deducted until the year in which it can be ascertained with reasonable certainty that no reasonable prospect of recovery exists. 36 If the taxpayer deducts a theft loss in the year of discovery because no reasonable prospect of recovery exists at that time, and the taxpayer later receives compensation or reimbursement, the compensation or reimbursement does not cause a recomputation of the deduction; instead, it is included in gross income for the year received. 37

33 §165(e).
34 Regs. §1.165-8(a)(2).
35 Id.
36 Id.
There are two key phrases to keep in mind when reading these general rules about timing of the deduction. The first is "reasonable prospect of recovery." The second phrase is "ascertain with a reasonable certainty." The effect of these rules on the appropriate timing of a theft loss deduction is as follows:

A taxpayer who suffers a theft loss should deduct that theft loss in the year the loss is sustained, which is the taxable year in which the taxpayer discovers the loss. However, if in the year the taxpayer discovers the loss there is a reasonable prospect of recovering all or some portion of the loss, the taxpayer must postpone taking the theft loss deduction unless the taxpayer can show that, as to all or some portion of the loss, there is no reasonable prospect of recovery.

If the taxpayer does not take a theft loss deduction in the year of discovery, then in the following years the taxpayer may not take a theft loss deduction until the taxpayer can ascertain with reasonable certainty whether or not the expected reimbursement will in fact be received.

The bottom line is that taxpayers who claim a deduction in the year of discovery for a theft loss will require a simpler legal standard of proof to an entitlement to the deduction in that year than taxpayers who will be required to prove their entitlement to the theft loss deduction in any year other than the year of discovery.

A closer study of the comments above is important to maximize theft loss tax benefits. The phrase "a reasonable prospect of recovery" determines whether a deduction for the theft loss in a Ponzi scheme should be taken in the year it is discovered or in some other future year. The law does not permit the deduction to be claimed in a year prior to the year of discovery. Because the timing of the theft loss deduction is critical to the real economics of the recovery, this phrase is all-important.

The phrase finds its origin in the early internal revenue codes that permitted a theft loss deduction for "losses sustained" in a taxable year but did not define the word "sustained." Therefore, prior to 1954, the law was unsettled as to whether a loss was "sustained." This often caused taxpayers to lose their tax deduction for a theft loss when the statute of limitations had run on prior years, and it was later found that a loss had been "sustained" in one of those prior years that was no longer open for change.

The new law in 1954, that still applies today, adopted the principle that generally a theft was "sustained" in the year of discovery. However, this definition was tempered as it applies only to that portion or all of the theft loss that the taxpayer could identify as not having any reasonable prospect of recovery. Until it was clear that a loss was assured and "closed and completed," no deduction was allowed. The law attempts to ensure that no deduction is allowed in the year of discovery or any other year unless the loss is assured.

The law tries to draw a fine line here. On one hand, whether there is a "reasonable prospect" is a subjective matter in the eyes of the taxpayer. On the other hand, the courts tell us that this subjective "reasonable belief" must be measured against objective facts.

There is no set of fixed rules that clearly define the taxpayer's "reasonable prospect of a recovery," that will result in a limitation of a taxpayer's theft loss deduction in the year of discovery. However, it is possible to gain a grasp of the concept by reviewing court statements and court cases defining the concept. This article examines general principles that have emerged from the court cases and reviews two cases that could be said to represent the opposite extreme views on what is a reasonable prospect of recovery.

Courts have defined the "reasonable prospect of recovery" as follows:

This court must determine what was a "reasonable expectation" as of the close of the taxable year for which the deduction is claimed. The situation is not to be viewed through the eyes of the "incorrigible optimist" and hence, claims for recovery whose potential for success are remote or nebulous will not demand a postponement of the deduction. The standard is to be applied by foresight, and hence, we do not look at facts whose existence or production for use in later proceedings was not reasonably foreseeable as of the close of the particular year. Nor does the fact of a future settlement or favorable judicial action on the claim
control our determination if we find that as of the close of the particular year, no reasonable prospect of recovery existed.

... a determination of whether a loss was in fact sustained in a particular year cannot fairly be made by confining the tier of facts to an examination of the taxpayer's beliefs and actions. Such an issue of necessity requires a practical approach, all pertinent facts and circumstances being open to inspection and consideration regardless of their objective or subjective nature.


Another court has stated it as:

The "reasonableness" of a taxpayer's prospect of recovery is primarily tested objectively, although a court may consider to a limited extent evidence of the taxpayer's objective contemporaneous assessment of his own prospect of recovery. "[t]he taxpayer's attitude and conduct are not to be ignored, but to codify them as the decisive factor in every case is to surround the clear language of ... [the statute] with an atmosphere of unreality and to impose grave obstacles to efficient tax administration." 41

41 Jeppsen v. Comr., 123 F.3d 1410 (10th Cir. 1997).

In addition to these general statements, the courts, in deciding whether there is a prospect for a reasonable recovery, have also agreed on the following principles, which provide further guidance:

(i) In determining the reasonableness of a taxpayer's belief of loss, courts must be practical and aware of the facts of the individual case.

(ii) The relevant facts and circumstances are those that are known or reasonably could be known as of the end of the tax year for which the loss deduction is claimed. The only test is foresight, not hindsight.

(iii) Both objective and subjective factors must be examined.

(iv) The taxpayer's legal rights as of the end of the year of discovery are all-important and need to be studied to make a proper decision.

(v) One of the facts and circumstances deserving of consideration is the probability of success on the merits of any claim brought by the taxpayer.

(vi) The filing of a lawsuit may give rise to an inference of a reasonable prospect of recovery. However, the inference is neither conclusive nor mandatory. The inquiry should be directed to the probability of recovery as opposed to the mere possibility. A "remote possibility" of recovery is not enough; there must be a reasonable prospect of recovery at the time the deduction was claimed, not later.

The bottom line of the timing of the theft loss deduction is that a taxpayer who has suffered a theft loss may take a deduction in the year the loss is sustained, which is generally the taxable year in which the taxpayer discovers the loss. However, if in the year the taxpayer discovers the loss, there is a reasonable prospect of recovering some portion or all of the loss, the taxpayer must postpone the theft loss deduction for the portion of the loss that may reasonably be recovered. 42

42 Typically, a court will find that a taxpayer has a reasonable prospect of recovery if the taxpayer is engaged in good faith in efforts to recoup a loss, and the chance of recovery is "sufficiently
probable to warrant bringing a suit." Scofield Est. v. Comr., 266 F.2d 154, 159 (6th Cir. 1959).

If a taxpayer does not take a theft loss deduction for the entire loss in the year of discovery because the taxpayer has a reasonable prospect of recovering all or a portion of the loss, the theft loss deduction will be postponed until there is either a recovery or a certainty that the postponed recovery will not happen. The theft loss deduction will not be lost by virtue of having been postponed.

During taxable years after the year of discovery, the taxpayer may take a theft loss deduction for that portion of any postponed losses when the taxpayer can ascertain with reasonable certainty that the reimbursement will in fact not be received. A taxpayer may ascertain with reasonable certainty whether he or she will be reimbursed by a settlement of the claim by an adjudication of the claim or by an abandonment of the claim.

Another way to try to appreciate the concept of a "reasonable prospect of recovery" is to review a few of the cases that were hotly contested and arguably are the opposite extreme points of view regarding whether or not a taxpayer had a reasonable prospect of recovery. In reviewing these cases, it is important to keep in mind that the presence or absence of a lawsuit seeking recovery is often a significant factor in determining whether or not the taxpayer believed he or she would receive a recovery.

As one court explained, in weighing whether the presence of a lawsuit seeking recovery should determine whether the taxpayer had a reasonable prospect for recovery:

While we offer no detailed opinion as to the merits of the taxpayer's legal position ... we find that the taxpayer did have a reasonable prospect of recovering something. In arriving at this conclusion, we stress that the mere existence of a "possible" claim or pending litigation will not alone warrant postponing loss recognition. There are many reasons for initiating lawsuits. In this case, taxpayer's antitrust claim for treble damages exceeded 19 million dollars. Where the stakes are so high, a suit may be "100% justified" even though the probability of recovery is miniscule. In short, although we offer no litmus paper test of "reasonable prospect of recovery," we note that the inquiry should be directed to the probability of recovery as opposed to the mere possibility. Analyzing the rule in percentage terms, we would consider a 40% to 50% or better chance of recovery as being "reasonable." A lawsuit might well be justified by a 10% chance. 43


Normally, where a taxpayer is in good faith willing to go to the trouble and expense of instituting suit to recoup a theft type loss, the courts seem to find that as a matter of fact there was a sufficient chance of at least partial recovery to justify the taxpayer's deferral of the claim of a theft loss deduction until the litigation is concluded. This should not be read to suggest that in some cases the facts and circumstances will not show such litigation to be specious, speculative, or wholly without merit and that the taxpayer was unreasonable in waiting to claim the loss as a deduction.

Another court explained the importance of a lawsuit in determining a "reasonable prospect of recovery" as follows:

... the mere existence of pending litigation won't alone warrant postponing loss recognition. In determining whether there's a reasonable prospect of recovery, the inquiry should be directed to the probability of recovery as opposed to the mere possibility. And where the taxpayer's chances of recovery in a lawsuit were in the realm of remote possibility rather than reasonable prospect, the court held that postponement of the loss deduction wasn't required. 44


Courts in two cases took in-depth looks at the effect of a taxpayer's legal rights in determining whether a reasonable prospect of recovery existed.

Examining the two cases that will help define the "reasonable prospect of recovery" standard; great efforts
were made to obtain a recovery of a loss, including extensive litigation. In both cases, the courts did a complete analysis of the legal rights of the taxpayers. In one line of cases the courts determined that the taxpayers did not have a reasonable prospect of recovery even though the taxpayers never wrote the theft loss off of their corporate financial statements in the year of recovery, had tremendous lobbying efforts on their behalf both individually and through trade groups to recoup their losses from multiple sources, and in the case of one taxpayer (a bank), even had the perpetrators' money deposited in their bank while the actions seeking recovery were ongoing. Because the victim, a bank, had no legal rights to hold the deposited money, the funds were released from the victim bank to the perpetrator of the theft. 45


This was also the situation when the Iranian government expropriated assets of U.S. companies in Iran with the fall of the Shah of Iran and the Iranian hostage-taking. In this case, the IRS argued against permitting a theft loss in the year of discovery.

In spite of several potential areas of recovery, which did in fact later lead to recovery and consideration that was paid for confiscated assets, the court was convinced that no legal rights existed for recovery in the year of discovery. Without legal rights, efforts that may present only a possibility of recovery are not enough to stop the taxpayer from deducting the theft loss in the year of discovery.

While the existence of "possible legal rights" did not foreclose the deduction in the Iranian expropriation cases, another court took a different view of the presence or absence of legal rights in the year of discovery. In this other court, the IRS insisted that a taxpayer must take his theft loss in the year of discovery because of the status of that taxpayer's legal rights. 46


There, even though a taxpayer won litigation in the lower court awarding him a recovery in a particular year, the court found the lower court's ruling was illogical and that in spite of the ruling allowing a recovery, the taxpayer had no real possibility of a recovery. The court ruled that this taxpayer had no legal rights to recovery and was therefore forced to take the deduction in the year of discovery. The court's independent review of the litigation awarding the recovery found that the lower court's opinion (which was in fact overruled) was wrong. Therefore, the taxpayer could not even rely on a successful lower court opinion to support his belief in the year of discovery that there would be a recovery.

**The Johnson Case: A Real-Life Example of What Not to Do**

One very recent case involving a "Ponzi-like" scheme perpetrated on a Palm Beach couple has added a good deal of clarity to the law on the timing of the theft loss deduction and other related deductions.

In 1997, Palm Beach County residents Aben Johnson and Joan Johnson discovered that they were the victims of a fraud scheme involving the purchase of gems and jewelry in which they had lost approximately $78 million. 47 The scheme had lasted from 1988 to 1997. During almost the entire time of the fraud, the Johnsons' "income" from their investments in gems was the repayment of their own funds that were paid previously to the perpetrator. Although the Johnsons discovered the fraud in 1997, they did not take any formal actions against the perpetrators of the fraud in 1997. However, they did undertake an investigation in 1997.


The value of the theft loss deduction was so great that the issue of the timing of the deductions warranted every argument in a tax lawyer's arsenal. In the course of trying to convince the court of the proper year of the theft loss deduction, the court was asked to choose among the years 1997, 1998, 2001, and 2005.

The court, which decided the last of the three Johnson cases in January 2008, provided a great deal of guidance for the treatment of Ponzi scheme theft losses.

*The major principle seen in each of the court's decisions is that victims of fraud who want to deduct the theft*
loss in the year of discovery are well-advised to consider each of their potential sources of recovery separately. They must not only document and quantify each separate source of recovery, but they must prove the limitations on each source of recovery separately. They might even consider abandoning rights of recovery of little or no value if a continuing claim may be harmful to claiming the tax deduction in the year(s) of most benefit.

The court in Johnson confirmed that, in the year of the discovery of the theft, the taxpayer could claim a deduction for the portion of a theft loss that the taxpayer could identify as not having a reasonable prospect for a recovery.

However, the Johnsons tried to claim all of their theft losses in 1997, not just a designated provable portion that could not be recovered. Because there appeared to be many avenues of recovery in 1997, there was a "reasonable prospect of recovery" of an unknown amount. Therefore, the court denied the deduction for the year 1997, the year in which the loss was discovered.

The court acknowledged that the year of the discovery of a loss ordinarily is the proper year of deducting the loss. However, if there may be a partial or full reimbursement of the loss, and if the extent of the reimbursement is unknown or cannot be quantified in the year of discovery, then the loss should not be deducted in the year of discovery.

The taxpayers then claimed a major loss in 1998, and in 1998 made a better attempt to quantify the portion of the loss that would not be recovered. 48 However, in 1998 the taxpayers admitted that they were using "estimates." Consequently, the court denied any theft loss deduction in 1998.

48 The Johnsons relied on Corral Creek Cattle Co. v. Comr., T.C. Memo 1978-260, for their argument that a taxpayer is permitted to take a theft loss deduction for a portion of a loss, while pursuing reimbursement for that portion in the year following the year of discovery.

Because 1998 was not the year of the discovery of the theft by the taxpayers, the burden of proving the right to a deduction had changed. In 1998, the taxpayers had to prove more than just that there was not a reasonable prospect of recovery of any portion of the theft loss. The 1998 theft loss deduction was denied because, in order to receive a theft loss deduction for that year, the taxpayers had to "ascertain with a reasonable certainty" that no further recovery of the loss was possible.

In denying the theft loss deduction for 1998, the court pointed out that there are two different legal standards and even indicated that the evidence, which was insufficient to meet the standards of 1998, may have been sufficient to meet the standards of the year of discovery, 1997.

In denying the 1998 deduction, the court stated:

Several [court] decisions have tended to combine the "reasonable prospect of recovery" inquiry and the "ascertain with reasonable certainty" inquiry. However, these two inquiries are distinct and the standards to be applied are different ...

The plaintiffs' contention that the analysis of their lawyers and accountants is sufficient to meet the "ascertain with reasonable certainty" standard is not supported. By their own admission, plaintiffs state that they made an "estimate" of the amount of recovery ...

The analysis performed by the lawyers and accountants may have been sufficient to determine whether there was a "reasonable prospect for recovery" in the year of discovery but it was not sufficient to "ascertain with reasonable certainty" the amount of reimbursement the plaintiffs would receive after a resolution of their reimbursement claims. Thus, the plaintiffs' theft loss deduction in 1998 based on an "estimate" that was made well before the recovery process was resolved was premature and cannot be sustained. 49


Because 1998 was not the year in which the theft loss was discovered, and because the Johnsons had decided to enter into extensive litigation by 1998, a theft loss deduction could not be claimed until the Johnsons could ascertain with a reasonable certainty that reimbursement would not be received for any
portion of the loss.

Again, the court's words defined the higher standard for the year after the year of loss:

After having elected to pursue a claim for reimbursement for which there was a reasonable prospect of recovery, the plaintiffs did not "ascertain with reasonable certainty" in 1998 whether or not reimbursement would be received. To ascertain "with reasonable certainty" whether or not such reimbursement will be received may be, for example, by a settlement of the claim, or by an adjudication of the claim, or by an abandonment of the claim.

The requirement that a taxpayer "ascertain with reasonable certainty" means that a taxpayer must obtain a verifiable determination of the amount the taxpayer will receive based on a resolution of the reimbursement claim before taking a theft loss deduction. Finally, requiring resolution of the claim with an objectively verifiable amount of loss is, as the government correctly notes, consistent with the plain meaning of "ascertain"... [as defined in a Dictionary of the English Language.]”

50 Id. (emphasis added).

It was not until 2001 that the Johnsons eventually clearly defined with certainty the amount of recovery they would receive and were entitled to a theft loss deduction for the unrecoverable amount. It is obvious that obtaining the theft loss deduction for the proper year requires an as clear as possible understanding of the characteristics of the two key legal phrases "reasonable prospect of a recovery" and "ascertain with a reasonable certainty."

Other Sources of Tax Recovery

Under limited circumstances, instead of taking a theft loss deduction, a taxpayer may amend a prior year's tax return and omit only the taxpayer's Ponzi scheme "phantom income" from the taxable income in the prior years. This might also include actual cash payments, which also have been found under very limited circumstances to be considered to be "returns of capital." Typically, this will eliminate only the high-bracket income.

This manner of recouping loss in a Ponzi scheme generally has been acceptable under the law in limited circumstances. The theory that permits such amended returns is that if there was no "real income" at the time it was reported, the phantom income can be eliminated as taxable income instead of being claimed as a theft loss. Essentially, it requires a showing that when the taxpayer was receiving cash flow, there was no principal left in the Ponzi scheme and, therefore, the taxpayer's payment into the scheme was in effect the source of the cash paid out by the scheme.

Many taxpayers will receive a significant benefit by amending their returns instead of claiming the theft loss for prior years. By amending prior returns to eliminate Ponzi scheme income, the taxpayers will generally be receiving a refund only for their Ponzi scheme "phantom income" tax payments. This typically will be from the higher tax brackets; thus, a deduction obtained from amending tax returns to eliminate only the Ponzi scheme income may be more valuable than a theft loss deduction. Furthermore, refunds from amended returns may carry interest from the year of overpayment.

The ability to use Ponzi scheme tax losses at the highest brackets by amending prior tax returns will leave more of those losses available to be carried forward into future years as opposed to being used to offset income from prior years and lower tax brackets. To the extent that amended returns do not use up all of the tax losses, these excess losses can be claimed as theft losses in the year of discovery and can then be carried forward and used against ordinary income for 20 years.

With the federal income tax already destined to become higher and states and cities raising their income tax rates, theft loss deductions that are carried forward may have significantly more value in the future. They may in the future provide deductions for income that could be subject to federal, city, and state income taxes totaling more than 50%.


In 2009, two important documents were issued by the IRS regarding the taxation of Ponzi schemes. In Rev. Rul. 2009-9, 51 the IRS clarified much of the previously unsettled law in this area. The safe harbor provided
in Rev. Proc. 2009-20 \textsuperscript{52} applies to losses for which the discovery year is a taxable year beginning after December 31, 2007; it offers thousands of Ponzi scheme victims a badly needed uncomplicated shortcut to cash refunds from tax losses.

\textsuperscript{51} 2009-14 I.R.B. 735.  
\textsuperscript{52} 2009-14 I.R.B. 749.

These two IRS documents form a good package and were drafted in record time for any government agency. However, it is important to remember that the IRS is not in business to give back money. The “safe harbor” needs to be studied carefully, because it could be extremely expensive from a tax standpoint. It might be a safe harbor, but the tax cost to dock your boat in this harbor could be very high.

To provide a very simplistic example, assume that there are $30 billion of Ponzi scheme losses that would be able to receive theft loss tax benefits. Assume that this Ponzi scheme income or amounts of principal, when taxed, were in the highest tax brackets. Therefore, again to keep it simple, assume the average tax bracket is 35% for the Ponzi income included in income by taxpayers in prior years. Taxes collected $10.5 billion (35% \times $30 billion).

Assume these Ponzi scheme losses were deducted in 2009 and used against income for the years 2004 through 2009 as theft loss carrybacks.

This will mean that Ponzi scheme income and Ponzi scheme investments of principal that have been taxed at the highest brackets will be carried back and applied against all of the income in a particular prior year. To a large extent, these losses will be used to offset income in each prior year that was earned at lower rates. Income and principal taxed at 35% might be offsetting some income in a carryback year that was taxed at only 15%.

The amount of any refund from the loss carryback will suffer accordingly. If it is assumed that the refund paid on the $30 billion in tax was a refund based on an average 25% tax rate (25% \times $30 billion), the refunds paid to the taxpayer would total $7.5 billion. In this case, the IRS has made $3.0 billion ($10.5 billion in tax - $7.5 billion in refunds). Furthermore, the IRS will have kept the $10.5 billion in tax revenue for years without paying interest on it.

For reasons like this, many Ponzi scheme victims may choose not to avail themselves of the safe harbor of Rev. Proc. 2009-20. This is especially so because the legal guidance offered by Rev. Rul. 2009-9 is so helpful.

The chart below summarizes and compares the effects of Rev. Rul. 2009-9 and the Rev. Proc. 2009-20 safe harbor. The chart shows that, for many taxpayers, the “tax rights” that must be waived to take advantage of the “tax benefits” of the safe harbor could be very expensive and unnecessary. Many taxpayers will find that the tax benefits available by relying on the revenue ruling and other law are preferable alternatives to the benefits of the safe harbor.

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<tr>
<td>Ponzi Scheme Loss Is a Theft Loss Deductible as an Ordinary Loss</td>
<td>Agreed – result similar to Rev. Rul. 2009-9</td>
<td>Agreed – result similar to safe harbor</td>
</tr>
<tr>
<td>Amount of the Loss (Basis) Includes Phantom Income</td>
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<td>Agreed – result similar to safe harbor</td>
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<tr>
<td>Five-Year Carryback of Net Operating Losses Applies</td>
<td>Agreed – result similar to Rev. Rul. 2009-9</td>
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<td>Deduction Is Not Reduced by Application of a Certain Percentage or Dollar Limitation</td>
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<td>Waiver of Right to File Amended Returns</td>
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Following a summary of general principles to be gleaned from the chart above, this article will then discuss the comparison of each of the determinations in the left column in greater depth.

Before Rev. Rul. 2009-9 was issued, there was a good deal of case law interpreting various aspects of the theft loss deduction. The cases relied on were at times 40 to 50 years old, and many reflect the absence of the type of forensic accounting that can be accomplished today. For this reason and others, although there was a great deal of case law interpreting the statutes and regulations, there remained a great deal of confusion about where certain lines were drawn. 53 The IRS has done an extremely good job of clarifying that confusion by way of Rev. Rul. 2009-9. These clarifications are very helpful, whether or not one chooses to be covered by the “safe harbor.”

53 See, e.g., Rev. Rul. 72-112, 1972-1 C.B. 60 (holding that extortion constituted theft for purposes of §165(c)(3)). But see Towers v. Comm., 24 T.C. 199 (1955), aff’d sub nom. Bonney v. Comm., 247 F.2d 237 (2d Cir. 1957) (holding that extortion under a New York criminal statute did not constitute theft for purposes of the predecessor to §165(c)(3)). The Bonney case made no reference to Edwards v. Bromburg, which had been decided some months earlier. Furthermore, there is only one subsequent case that favorably cited Towers or Bonney for this position, i.e., Ing v. U.S., 94-1 USTC ¶§50,031 (D. Haw. 1993). In Ing, the taxpayer sued an ex-mistress and her husband in state court to recover funds they had allegedly extorted from the taxpayer. The defendants filed counterclaims in the state court case. The state court determined that none of the parties were credible and, thus, neither party was entitled to recover.

The chart demonstrates that there are certain benefits to using the safe harbor, but it also shows that most of the tax benefits granted by the safe harbor are no different from the tax benefits that the taxpayer would receive under the law as interpreted by Rev. Rul. 2009-9. However, to achieve these benefits, the safe harbor requires that the taxpayer must waive valuable potential tax rights.

Finally, the chart shows the IRS is using a not-so-subtle form of administrative coercion to force the use of the safe harbor by announcing that those who do not choose the safe harbor may be subject to stricter standards of proof and increased audit potential.

Therefore, it is imperative that Ponzi scheme victims meet with their accountants and financial advisors that have the knowledge and facilities to compare the economic effect of the use of the safe harbor to that of reliance on the law in each individual situation.

The chart shows another extremely important economic factor. Under the alternatives to the safe harbor, Ponzi scheme victims could be entitled to significant interest payments on the IRS refunds.

**A Ponzi Scheme Loss Is a Theft Loss Deductible as an Ordinary Loss**

Both Rev. Rul. 2009-9 and Rev. Proc. 2009-20 agree that a loss from a Ponzi scheme is a theft loss for tax purposes. Rev. Rul. 2009-9 is a good guide to the standard that must be met for a loss to be considered a theft.

Both Rev. Rul. 2009-9 and Rev. Proc. 2009-20 also make it clear that a theft loss from a Ponzi scheme is an ordinary loss and not a capital loss. Note that (as discussed above under the heading “Privity Requirement”) in the case of a scheme involving securities fraud, a taxpayer will prevail only if there is a direct buyer-seller relationship linking the taxpayers and the fraudurers. Mere reliance on the fraudulent representations of a corporate officer to make or maintain an investment may be insufficient. 54
54 Compare Vietzke v. Comr., 37 T.C. 504 (1961) (theft loss allowed; taxpayer fraudulently induced to advance funds to corporations for stock subscriptions that were subsequently stolen; corporate entity merely a device to swindle investors) and Bellis v. Comr., 61 T.C.2d 354 (1973), affd. 540 F.2d 448 (9th Cir. 1976) (securities sold directly by corporation to taxpayer; loss would have been allowed if fraudulent intent had been shown) with Barry v. Comr., T.C. Memo 1979-215 (no theft loss deduction when securities purchased on open market) and De Fusco v. Comr., T.C. Memo 1979-230 (no direct sale; lack of privity "fatal flaw" in taxpayer's case). See FAA 20073801F (Chief Counsel's Office advises taxpayer is not entitled to theft loss deduction for losses related to exercise of stock option; detailed discussion of case law).

**The Amount of the Loss (Basis) and Phantom Income**

Rev. Rul. 2009-9 and Rev. Proc. 2009-20 both acknowledge that the amount of a theft loss resulting from a Ponzi scheme is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn. 55 Furthermore, both agree that if an amount is reported to the investor as income in years preceding the year of discovery of the theft and the investor includes the amount in gross income, then the amount of the theft loss is increased by the purportedly reinvested amount (the "Phantom Income")

55 This manner of theft loss determination is consistent with the rules applied in casualty theft loss deductions. See Regs. §1.165-8(c). See also Gabsa v. Comr., 43 T.C.M. 447 (1982).

Rev. Rul. 2009-9 says it best:

The amount of a theft loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery. If an amount is reported to the investor as income in years prior to the year of discovery of the theft, the investor included the amount in gross income, and the investor reinvests the amount in the arrangement, this amount increases the deductible theft loss. 56


**Five-Year Carryback of Net Operating Losses**

Rev. Proc. 2009-20 notes that §1211 of the American Recovery and Reinvestment Act of 2009 amended the Internal Revenue Code to allow certain taxpayers to be eligible to elect a three-, four-, or five-year net operating loss carryback that applies only to net operating losses in the year 2008 and 2009. Rev. Rul. 2009-9 also allows individual investors to avail themselves of the extended NOL carryback period provided by §1211 of the American Recovery and Reinvestment Act of 2009.

**Deduction Not Reduced by Application of Percentage or Dollar Limitations**

Rev. Rul. 2009-9 makes it clear that the theft loss is an itemized deduction and that several Code provisions that typically impose limitations on deductions do not apply to theft losses from a Ponzi scheme because the IRS regards theft losses from a Ponzi scheme losses as losses from a transaction entered into for profit. The 2% limit on itemized deductions does not apply to the theft loss, 57 nor does the overall limit of itemized deductions that is based on a percentage of adjusted gross income apply. 58 Finally, the $100 exclusion that must be met before taking a deduction for personal theft losses does not apply to Ponzi scheme theft losses. 59 The Rev. Proc. 2009-20 safe harbor grants the same treatment.

57 §67(b)(3).
58 §68(c)(3).
59 See §165(h)(1).

**Respect for Pass-Through Entities**

The Rev. Proc. 2009-20 safe harbor expressly addresses the treatment of investors in Ponzi schemes through entities that are separate and apart from the Ponzi victims, such as partnerships. It states that an investor that otherwise would be qualified for a theft loss will not be considered to be qualified to claim that deduction.
under the safe harbor. Instead, the actual *fund or entity* itself in which a Ponzi scheme investor has invested *will be considered the qualified investor for purposes of the safe harbor.*

IRS officials and commentators have commented that pass-through entities such as partnerships and Subchapter S corporations will report Ponzi scheme losses to each investor on their Schedule K-1 so that investors who cannot use the safe harbor may file for their losses under the standard rules applicable to owners of interests in pass-through entities.

**Year of Discovery and Deductibility**

The safe harbor, like the revenue ruling, confirms that the Ponzi scheme will be treated as a theft loss, which means that the loss is deductible in the year of discovery.

The safe harbor provides a specific definition of the year of discovery by linking it to a year in which certain actions may be taken against the perpetrators of a Ponzi scheme.

The law and *Rev. Rul. 2009-9* interpret “the year of discovery” of theft loss more liberally than the safe harbor. *The safe harbor requires that certain specific actions be taken by authorities before a theft loss is discovered for tax purposes.* The law does not require the taxpayer to go to that extent to recognize a theft loss.

The *Rev. Proc. 2009-20* safe harbor defines the year of discovery as the year in which any of the following formalities were complied with:

1. the lead figure (or one of the lead figures, if more than one) was charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement, or a similar crime that, if proven, would meet the definition of “theft” for purposes of §165 of the Internal Revenue Code andRegs. §1.165-8(d), under the law of the jurisdiction of which the theft occurred; or

2. the lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in section 4.02(1) of *Rev. Proc. 2009-20,* and either —
   
   (a) the complaint alleged an admission by the lead figure or the execution of an affidavit by that person admitting the crime; or
   
   (b) a receiver or trustee was appointed with respect to the arrangements or the assets of the arrangement were frozen.

The taxpayer who does not choose to use the safe harbor may have the burden of proving under the existing law that a particular year was the year of discovery. In essence, the IRS is requiring a taxpayer who does not meet the safe harbor requirements to prove that there was a theft loss and to prove that he/she knew about it in a particular year.

The U.S. Tax Court defines the proof needed to pinpoint the year of discovery quite differently, as follows:

A loss is considered to be discovered when a reasonable man in similar circumstances would have realized the fact that he had suffered a theft loss. 60


The year of discovery has also been defined by courts as follows:

The proper year in which to claim a theft loss ... being the year when the taxpayer in fact discover the loss. 61

Amount of Loss in the Year of Discovery

In their statements, both Rev. Rul. 2009-9 and Rev. Proc. 2009-20 acknowledge as a legal matter that the determination of the year of discovery, which is the year for the deduction of the theft loss, and the determination of the amount of the deduction in the year of discovery, are two different exercises.

Rev. Proc. 2009-20 actually acknowledges this legal principle by establishing percentage amounts of deductibility for the loss in the year of discovery.

Both IRS documents acknowledge that if, in the year of discovery, there is a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then no portion of the loss for which reimbursement may be received is deductible in that year. However, the portion for which there is no prospect of recovery is deductible in the year of discovery.

In Rev. Proc. 2009-20, the IRS makes a determination for all Ponzi schemes that a certain percentage amount of a theft loss can be deducted in the year of discovery of a Ponzi scheme when calculating the ultimate amount of the deductible loss.

The safe harbor specifically sets forth what may be claimed as the amount of loss in the year of discovery. Those amounts fall into different categories. The Ponzi scheme investor will be permitted to deduct 95% of the amount of the entire theft loss in the year of discovery if the taxpayer is not seeking any third-party recovery for theft loss tax purposes. If the Ponzi scheme investor is pursuing or intends to pursue any recovery from third parties (i.e., parties other than the perpetrator(s)), then the amount deductible in the year of discovery will be limited to 75% of the deductible loss.

In addition, under the safe harbor, after calculating either one of these percentage amounts, the Ponzi scheme investor must subtract any actual recoveries or potential insurance recoveries or guarantee type to determine the final allowable theft loss in the discovery year. This includes recoveries from SIPC. §2

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62 These are amounts payable from the Securities Investor Protection Corporation (SIPC) as advances for customer claims under 15 USC §78fff-3(a) (the Securities Investor Protection Act of 1970), or by a similar entity under a similar provision.

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Rev. Rul. 2009-9 only comments on the law. It gives legal guidelines as to the timing of deductibility of a loss but does not comment on the specific amount of the loss in the year of discovery. Rev. Proc. 2009-20 states that if a taxpayer does not use the safe harbor, the taxpayer will have to rely on the case law in this area to prove that the 95% and 75% figures used in the safe harbor are accurate or close enough to be relied on by all Ponzi victims.

Here it is important to keep in mind that whether a taxpayer uses Rev. Rul. 2009-9 or the Rev. Proc. 2009-20 safe harbor, whether the amount of the theft loss that is being deducted in the year of discovery is 75%, 85% or 95% of the total theft loss, the balance of the theft loss that is not claimed in the year of discovery will be claimed in a later year when it is clear that no further recovery will be available. No theft loss deduction is “lost” just because it is not deducted in the year of discovery.

A taxpayer who does not use the safe harbor may still claim the 95% and 75% figures. However, that taxpayer will be required to prove that the 95% and 75% figures are accurate for the taxpayer's situation using evidence that is separate and apart from the IRS's findings. The IRS definitely has done many taxpayers a favor in the safe harbor by determining a fixed percentage for Ponzi scheme loss in the year of discovery. However, for Ponzi scheme victims who do not use the safe harbor, the law may provide a similar result if the taxpayer has the proof to back it up.

Under the law, the taxpayer would be permitted to take 100% of the loss in the year of discovery minus any amounts for which there is a reasonable prospect of recovery. To determine what the safe harbor provides to the taxpayer, another comparative chart is necessary.

If one does not use the safe harbor to pin down the amount of the loss in the year of discovery, success may depend upon the state of the taxpayer's books and records and the expertise of the taxpayer's tax lawyer and accountant. If there is no solid proof of the taxpayer's potential recovery amount or lack thereof, the taxpayer may be well-advised to use the safe harbor if available.

Quantifying the Amount of Theft Loss Deduction in the Year of Discovery

http://taxandaccounting.bna.com/btac/T12104/spilt_display.adp?fe...=19008273&vname=rejml&fcn=1&wsn=499862500&fn=19008273&split=0
<table>
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<th>Safe Harbor</th>
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<tr>
<td>100%</td>
<td>Amount of quantified investment loss</td>
<td>100%</td>
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<tr>
<td>95% loss allowed (loss reduced by 5%)</td>
<td>Amount of quantified investment loss; no recovery sought</td>
<td>Loss reduced by any potential recovery from Ponzi scheme “Responsible Group”</td>
</tr>
<tr>
<td>75% loss allowed (loss reduced by 25%)</td>
<td>Amount of quantified loss permitted; third-party recovery sought</td>
<td>Loss reduced by any potential third-party recovery</td>
</tr>
<tr>
<td>Loss reduced by actual recovery received in 2008</td>
<td>Other reductions to quantified investment loss</td>
<td>Loss reduced by actual recovery received in 2008</td>
</tr>
<tr>
<td>Loss reduced by insurance policies in the name of the qualified investor</td>
<td></td>
<td>Loss reduced by insurance policies in the name of the qualified investor</td>
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<tr>
<td>Loss reduced by contractual arrangement that guarantees or otherwise protects against loss of the qualified investment</td>
<td>Loss reduced by contractual arrangement that guarantees or otherwise protects against loss of the qualified investment</td>
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</tr>
<tr>
<td>Loss reduced by certain amounts payable from the Securities Investor Protection Corporation (SIPC)</td>
<td>Loss reduced by certain amounts payable from the Securities Investor Protection Corporation (SIPC)</td>
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</tbody>
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**Doctrine of Equality of Treatment and Nature of a Safe Harbor**

While tax law as a general rule does not look at the equities of a taxpayer’s situation, Ponzi schemes might warrant that type of treatment. To begin with, one must understand what is meant generally by a “safe harbor” and the “doctrine of equality of treatment.”

A safe harbor typically is an IRS procedure that permits taxpayers to obtain certain tax treatment without administrative question because the permitted tax treatment is well within the outside boundaries of what IRS believes is the law. Furthermore, there is a Doctrine of Equality of Treatment that is applied sparingly but nevertheless requires the IRS to exercise its discretion in a manner so that similarly situated taxpayers are treated equally.

It would seem difficult for the IRS to make a determination that all the taxpayers suffering Ponzi scheme theft losses, wherever and whenever they may be, will be permitted a deduction at certain fixed rates at 95% and 75%, while denying these same rates of deduction to a select group of similarly situated taxpayers who choose not to do it the IRS way. 63

63 IBM Corp. v. U.S., 343 F.2d 914 (Ct. Cl. 1965).

**Waiver of Tax Rights**

All of the comparisons so far of Rev. Rul. 2009-9 and the Rev. Proc. 2009-20 have compared the similarities and benefits of the safe harbor with those provided under the law.

The following describes a *Waiver of Potential Benefits* that must be exchanged for the benefits of the safe harbor and illustrates how costly that safe harbor may be from a tax standpoint.

**Waiver of the Right to File Amended Returns Eliminating Income**

The safe harbor requires the Ponzi scheme victim to forego the opportunity to file amended returns for years that are still open by the statute of limitations. A taxpayer’s waiver of this right to file amended returns could be very costly, depending upon the amount of the losses, the year of the losses, and the taxpayer’s past, present, and future financial situation.

**Clawbacks and the Right to Use Code §1341**

The Trustee in many Ponzi schemes has the right to recover funds paid to Ponzi scheme victims. Payments of Ponzi scheme profits may have to be repaid by the recipient. This is known as a clawback.
Under the safe harbor, the taxpayer must waive his/her right to make use of §1341 in the event the taxpayer must repay money in a clawback situation. Section 1341 in essence provides that if a taxpayer paid tax on income to which the taxpayer claimed a right in a prior year, and the taxpayer later was required to repay that income in a different year, the taxpayer may take the deduction for the repayment in the year in which the deduction is most tax-beneficial. That could be either the year in which the repayment was made or the year in which the later — repaid income was taxed. This is the case even if the statute of limitations is closed with respect to the year in which the original tax was paid.

A full discussion of a taxpayer's possible rights under §1341 is beyond the scope of this article. However, many taxpayers that are required to make clawback repayments might find that §1341 would apply to their repayments and they should not waive the right to use §1341 if it applies because such a waiver could be very costly. 64

64 To satisfy the requirements of §1341(a)(2), a deduction must arise because the taxpayer is under an obligation to restore the income. Regs. §1.1341-1(a)(1)-(2); Alcoa, Inc. v. U.S., 509 F.3d 173, 179 (3d Cir. 2007); Kappel v. U.S., 437 F.2d 1222, 1226 (3d Cir.), cert. denied, 404 U.S. 830 (1971).

The tax bracket comparisons here could be significantly different for those taxpayers who may have to make clawback payments in future years. Taxpayers may make clawback payments in future years and have very little taxable income in future years against which to take a deduction for the amount of the clawback payment. Those taxpayers might make only minimal use of the clawback deduction. However, by using §1341, there is the potential for taxpayers to claim that clawback payments should be applied against taxable income in old years (otherwise closed by the statute of limitations) where they would be much more valuable as tax deductions if income was taxed at high rates in those years.

For example, the tax deduction of a clawback of $500,000 that provides a tax refund of only 15% in a year when income is $75,000 might provide a cash return at the 35% tax rate from a prior high tax bracket year when income was $175,000. The difference of 20% in the tax rates translates into $100,000 of real money. Furthermore, the interest paid on a refund relating to a distant past year could be significant. By waiving the benefits of §1341, the taxpayer eliminates the potential for these increased earnings from tax refunds.

**Interest on Refunds**

An unstated benefit in Rev. Rul. 2009-9 and Rev. Proc. 2009-20 that is waived when a taxpayer chooses the safe harbor is the possibility of receiving interest in circumstances where either the use of §1341 or the use of amended returns would result in refunds. 65


In the case of a refund from a loss carryback, there is an interest-free 45-day period within which the IRS may pay the claim after it is filed. However, where the refund of an overpayment is a result of an amended tax return or because of §1341, the interest on that refund amount is calculated from the prior year when the overpayment was made.

**IRS Administrative Issues**

The IRS indicates that there may be administrative difficulty with tax returns by Ponzi scheme victims who do not choose to use the safe harbor. The IRS has stated clearly that persons who do not choose the safe harbor will need to be concerned with proving the year of the theft loss and proving the amount of the theft loss under the existing rules. 66 However, this statement by IRS is tempered by its statement that taxpayers not covered by the safe harbor will not be challenged on the issue of whether "phantom income" is deductible when the phantom income amounts shown on the taxpayer's return were based on information received from the Ponzi scheme in the taxable years. Finally, the IRS added a caveat that tax returns claiming Ponzi scheme deductions that do not use the safe harbor may be subject to increased audit exposure.

66 Id.

**Ponzi Scheme Effect on Estates and Trusts**
A Ponzi scheme may result in an income tax deduction at the estate level, a valuation discount for estate purposes, or no deduction at all by the estate, depending upon, among other things, the timing of estate administration events, the date of death, and the date of discovery.

The income or estate tax deductions available depend on when the loss was incurred and when it was discovered. There are three common situations:

If the theft occurs before the decedent dies, but is discovered during estate administration, the estate may claim an income tax deduction.

If the theft occurs and is discovered during estate administration, the estate may claim an income tax deduction or an estate tax deduction.

If the theft occurs after the accounts have been distributed, the estate will have neither income nor estate tax deduction.

If the theft was discovered before death, the reduced value of brokerage accounts should be reflected in their estate tax value regardless of whether the date of death or alternate valuation date value was used. If the loss was discovered after the date of death but before the six-month alternate valuation period, the alternate valuation date could be used to reflect the lower value.

**Clawback of Estate Funds**

As discussed, a Ponzi scheme trustee may assert the “clawback” laws that will permit the trustee to recover Ponzi scheme distributions from an investor's estate. This situation could be very important to people who are using the safe harbor, as one of the requirements of the safe harbor is to waive the right to use 61341. 67

Clawbacks would seem to be deductible by the estate without 61341 for the year of payment as an estate expense or loss.

**Carrybacks and Carryforwards**

The carryback period for casualty and theft losses is three years. However, if a theft loss was discovered before a taxpayer's death, it would seem that carryforwards would probably be lost. The taxpayer has filed his or her last Form 1040 (U.S. Individual Income Tax Return) and there are no further tax years to which the loss could be carried forward. This would leave only the three-year carryback period.

**Deduction for IRA Losses**

For purposes of determining the taxation of IRA distributions, all traditional IRAs maintained for an individual must be aggregated and treated as one IRA. 68 An IRA loss may be recognized only if all of an individual's IRAs have been distributed and the amounts distributed are less than the individual's unrecovered basis. 69 The basis in a traditional IRA is equal to the nondeductible contributions in the IRAs. 70 If an IRA owner has a zero basis in the IRA because all of the contributions were deductible, then there will be no deductible loss.

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69 Id. citing Notice 89-25, 1989-1 CB 662.

70 Id. citing IRS Pub. 590, Individual Retirement Arrangements, at 41 (2008).

Roth IRAs have basis, and losses will be deductible to the extent of the basis. To recognize a loss on a Roth IRA, all of the individual's Roth IRA accounts must be distributed, and the amount of the loss is equal to the individual's unrecovered basis minus the amounts distributed. 71

71 Id.
under the claim of right doctrine.

**Tax Planning**

There are many taxpayers that may benefit significantly by making use of the safe harbor. For others, Rev. Rul. 2009-9 and the law will be helpful. This will depend upon the facts and circumstances of each individual case. Victims of large Ponzi scheme tax losses and smaller ones alike need to pay attention to the traps and opportunities.

Taxpayers that use the “safe harbor” are also going to need sound advice on the valuation of their SIPC claims. They must focus on how this might reduce the amount of the theft loss in the year of discovery. For example, a taxpayer with a maximum $500,000 Ponzi scheme loss and a claim against SIPC for $500,000 that is not resolved by the time the tax return is filed may be forced to delay claiming any theft loss deduction because there is a “reasonable prospect of recovery” of the investor’s loss. The inability to use the theft loss in the year of discovery could significantly affect the amount of any tax refund. Amended returns might permit Ponzi scheme victims to have their tax benefits and a SIPC recovery.

The term “tax planning” usually means taking steps in advance of an economic transaction in order to maximize the potential tax benefits of the transaction. Similar is the concept of “post mortem tax planning,” which is found in the estate tax area and provides some flexibility for transactions and the setting of tax values after death.

Tax planning for maximum tax benefits from a Ponzi scheme loss will have a little bit of both. The loss has already occurred; however, the taxpayer still may plan and implement his or her Ponzi scheme tax loss for maximum benefits now, in the past, and in the future. 72

> 72 This is why it is important to advise taxpayers who are victims of both a Ponzi scheme and a loss in the family that, while the emotionally driven reflexive tendency may be to take whatever loss deduction may be available immediately, this may preclude certain future deductions that may provide more economic benefits to the taxpayer. This would help justify the need for spending additional resources on a professional tax planner.

This author believes that the tax planning should result in a professional work product that will most likely accompany an amended return or similar type of IRS filing. The document will most likely be the work product of at least three of the taxpayer’s advisors. These should include the taxpayer’s accountant or an accountant specialized in this area, a tax attorney, and tax litigation counsel.

The tax planning for the most part will involve providing the client with appropriate projections of the use of the tax losses under differing circumstances so that the client will be able to understand the financial effect of various options that the tax loss and litigation recoveries may provide. Because the theft loss may be carried back three years and carried forward 20 years, it is extremely valuable.

Having litigation counsel as part of the team is critical to a successful professional product for several reasons. Each Ponzi scheme victim should understand every possible means of recovery that might be applied to the individual. Recoveries from SIPC and the IRS are not the only avenues of recovery that will be considered. As the facts unfold, they may reveal more potential recovery targets.

Certain accountants, financial advisors, principals of feeder funds, boards of directors, and the various Ponzi scheme bankrupt estates may be just a few of the potential sources of recovery. If these sources of recovery are viable, the Ponzi scheme victim will need to carefully weigh the advantages and disadvantages of the postponed tax benefits that may result from a choice to actively pursue certain sources of recovery. However, it is important to note again that while the fact of litigation pursued by the taxpayer against these sources may indicate the existence of a prospect of recovery, it will not bar the deduction in the year of discovery if the likelihood of recovery can be shown to be remote. 23 Thus, a theft loss deduction would be allowable where a source of recovery against whom a claim is made is shown not to have sufficient assets to satisfy the judgment or liquidate the claim. 24 This also applies where a source of recovery is solvent but judgment-proof (e.g., where he has hidden the stolen property and his other assets are insignificant in value). As in all economic matters, the emphasis should always be on the maximum recovery of money from third parties before relying on the recovery from tax benefits.

> 73 See Cahn v. Comr., 92 F.2d 674 (9th Cir. 1937), rev’g 33 B.T.A. 783 (1935).

The theft loss tax benefits that one does not claim immediately will not necessarily be lost, but may be realized at a later time, when there is finality to each respective area of recovery that a victim has chosen to pursue.

Example: Taxpayer T files an SIPC claim expecting to recover $500,000 from SIPC. T may not claim a theft loss on that $500,000 in the year of discovery, but T should be able to claim a theft loss for Ponzi scheme losses in excess of $500,000. Suppose SIPC ultimately pays $300,000 on the $500,000 claim in the year 2010. In 2010, T could claim a further theft loss of $200,000.

The litigation lawyer will be needed not only to analyze avenues of recovery and litigation claims, but also as an expert who is well-versed regarding the viability or non-viability of any claims for recovery. Therefore, he or she will be very helpful to the taxpayer in determining which avenues to pursue and which should be discontinued if their continuation would provide the IRS with a strong argument to disallow the theft loss in the year of discovery.

As discussed earlier, the viability or non-viability of any claims for recovery must be analyzed by an expert, with an eye toward preventing a situation in which the IRS denies the deduction until the prospect a recovery no longer exists. See Regs. §1.165-1(d)(3).

The third essential expert is the tax lawyer, who will need to coordinate all of the matters in light of the taxpayer's objectives and various legal standards that will need to be met to achieve those objectives.

With the professional team in place, the steps generally will be as follows:

1. Records. The taxpayer must gather as complete a collection as possible of all financial records, going as far back in time as possible, involving the Ponzi scheme investment. These should include statements, income tax returns, and in some cases even estate tax returns.

2. Basis Calculations. A calculation of the taxpayer's basis in the Ponzi scheme loss must be undertaken. The taxpayer's basis in each separate account must be calculated, as there may be different tax treatments and bases for estates, trusts, American resident individuals, nonresident American individuals, foreign individuals, domestic corporations, foreign corporations, and charities.

3. Sources of Recovery. A detailed description should be made of the various sources of recovery that have been explored. In areas where no recovery is possible or none is sought, a taxpayer may want to formally renounce rights to certain forms of recovery to ensure that there is no question that the taxpayer had no reasonable belief of a prospect of recovery as to those rights.

4. Loss in Year of Discovery. Once the sources of recovery have been inventoried, a determination should be made regarding the maximum potential loss that can be deducted for the discovery year. If a taxpayer is pursuing a source of recovery, it will be critical to ensure that the source is not viewed as offering a potential recovery of the maximum amount if that is not truly the case. Potential recoveries that are "open ended" in nature will harm the chances to claim the theft loss deduction in the discovery year.

5. Accounting Schedules and Forecasts. Upon determining the amount of theft loss for which there is no potential for recovery in the discovery year, it is then important to prepare the appropriate accounting schedules. These should reflect the effect of the tax losses and the cash that may be recovered from amended returns and the tax-free income that may be earned because theft losses may be carried forward for 20 years.
See Appendix X to Rev. Proc. 2009-20, requiring that the taxpayer has "written documentation to support the amounts reported."

If this calculation is properly undertaken and supporting documentation provided, the IRS has stated in Rev. Proc. 2009-20, that it will not challenge that the loss deducted is a theft loss.

See Rev. Proc. 2009-20 for detailed discussions of actual recovery, potential insurance/SIPC recovery, potential direct recovery, and potential third-party recovery, and a discussion of the limitations created by the various sources of recovery.

See Rev. Proc. 2009-20, discussing calculation of amount to be deducted based on investor's pursuit of any potential third-party recovery.

Id., stating that "the qualified investor may have income or an additional deduction in a year subsequent to the discovery year depending on the actual amount of the loss that is eventually recovered." (citing 81, 165-1(d); Rev. Rul. 2009-9).

These projections will be critical. For example, there may be a fairly recent estate involved in which an estate tax has been paid on the Ponzi scheme funds that were inherited. If this is the case, this must be considered in the calculations, because the estate tax deduction, if available, may have a value of 45% to the taxpayer versus the 35% benefit of the income tax deduction.

Furthermore, these projections should be useful for planning purposes. Calculations will be needed to keep track of the theft tax losses that will be deferred in cases where the taxpayer believed there was a reasonable prospect of recovery. In those cases, in the event that there eventually is a recovery, the recovery will not be subject to tax, but will reduce any original unused theft tax losses. To the extent a recovery exceeds any theft tax loss, it will be subject to taxation.

Once these basic steps have been taken, so that the taxpayer is aware of all of the options, there will be a number of considerations, some of which may need to be acted on quickly.

In the event an estate tax deduction may be more valuable than the income tax deduction, it will be very important to pay attention to the statute of limitations on the filing of the estate tax return.

**Tax Planning for Trusts**

Trusts with assets invested in a Ponzi scheme generally will have much larger losses in the current year than they can use. Income tax planning for such trusts involves using the losses as soon as possible and making sure all of them can be used. To accomplish this, the trust must generate more taxable income. There are several ways this can be accomplished. First, additional gifts can be made to the trust. More trust assets generate more income, and the more income, the faster the losses can be used up. Second, leveraged sales can be made to the trust. Assuming that the assets sold to the trust produce a total return in excess of the interest rate on the note, the value of the trust will increase. Finally, wills can be amended to increase trust funding.

Assume an elderly victim of the Ponzi scheme theft may have significant unused theft tax losses that can be used only as a carryforward to the next 20 years. This "income tax benefit" might be cut short with the death of the Ponzi scheme victim. Is it possible to plan the family situation to preserve these losses or use them to offset other income during the Ponzi scheme victim's life? One might ask, in a town such as Palm Beach, how many "tax marriages" or "tax mergers" might result. For example, unmarried Mr. X may be broke with a $20 million theft tax loss that he cannot use going forward because he has little or no income. On the other hand, the widowed Mrs. Y may have an income stream of $4 million a year and may really hate to pay taxes. Does a joint income tax return that permits Mr. X's net operating losses to be used by a future Mrs. X make this a wedding made in heaven?

These questions, while not clearly answered by any known cases, Rev. Rul. 2009-9, or Rev. Proc. 2009-20, could be assumed answered in the negative under public policy argument. The Fifth Circuit in Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956), and the Tax Court in Lincoln v. Comr., 50 T.C.M. 185, 189 (1995), both have stated clearly that if the taxpayer's activities in
connection with the theft loss are contrary to public policy, it would be valid grounds for denying a theft loss deduction. Given this assertion, it could easily be assumed that a marriage entered into solely for the purpose of receiving a theft loss deduction would be considered contrary to public policy. The burden of proving that the theft loss deduction was the sole purpose for entering into the marriage would, however, rest with the IRS, thus making this a viable option for couples willing to take the risk.

In determining the value of tax losses, one will also have to consider whether the tax losses being carried forward during the 20-year period will actually be much more valuable than the tax loss being carried back. Will a multitrillion-dollar deficit result in taxes in the 40% and 50% tax range instead of the 35% tax range in the future?

**Conclusion**

It is critical that tax advisors and litigation counsel plan properly and work closely together to avoid foreclosing any of the options available for a Ponzi scheme victim to make use of tax losses while they are available, and to determine which of the many potential avenue(s) of recovery would maximize that particular victim's economic benefit from the tax losses, considering that victim's particular situation.