

Personal Financial Planning

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PONZI SCHEMES: THE IMPLICATIONS FOR DEFRAUDED INVESTORS

DO YOU HAVE A CLIENT THAT LOST MONEY in the Bernard Madoff Ponzi scheme? A Ponzi scheme is defined as “an investment swindle in which some early investors are paid off with money put up by later ones to encourage more and bigger risks” (*Merriam-Webster’s Collegiate Dictionary* 964 (Merriam-Webster 2003)). Madoff is alleged to have done just that until, in 2008, an increase in requests for redemptions from his investors caused his \$50 billion pyramid to collapse.

If a client has lost money in the Madoff Ponzi scheme or another pyramid scheme, what are the client’s options? The Securities and Exchange Commission (SEC) has frozen all the assets of Madoff’s company as well as his personal assets. Although the Securities Investor Protection Corporation (SIPC) is handling investor claims and the investments of Bernard L. Madoff Investment Securities LLC in a liquidation of the company, usually a judge assigns a receivership to handle all the company’s affairs.

The receiver is an officer of the court, not an SEC employee, and ultimately has to answer to the judge that appoints him or her. The receiver is compensated from the assets collected. Along with aggregating the assets for liquidation, the receiver is also in charge of determining who is entitled to the money collected.

Typically investors are required to submit claim forms that the receiver (or in this case the SIPC) reviews for

accuracy. Investors will have to document the amount they are claiming as owed to them. That amount will be the initial amount invested plus additional investments, less any interest, dividends, or proceeds from the sale of any of the securities (redemptions).

For example, if an investor placed \$10,000 with Madoff and received 8% a year from 1999 until December 2008, the investor will have a claim of \$2,000 [$\$10,000 \text{ investment} - (8\% \text{ interest} \times 10 \text{ years})$]. If the same investor invested the \$10,000 but did not actually receive any return, the claim would be the original \$10,000 investment.

Caution: One issue in this situation will be whether the taxpayer actually reported the 8% annual earnings on his or her tax returns.

On the SIPC website (www.sipc.org), item number three under the seven most frequently asked questions is, “How long before I get my investment back?” The answer:

Most customers can expect to receive their property in one to three months. When the records of the brokerage firm are accurate, deliveries of some securities and cash to customers may begin shortly after the trustee receives the completed claim forms from customers, or even earlier if the trustee can transfer customer accounts to another broker-dealer. Delays of several months



usually arise when the failed brokerage firm's records are not accurate. It also is not uncommon for delays to take place when the troubled brokerage firm or its principals were involved in fraud.

In actuality, the liquidation of assets and the disbursement of the money can take a long time to resolve. It could take the SIPC or a receiver years to track down all the money and assets purchased with that money. For example, a Ponzi scheme shut down by the SEC on October 15, 1999, is still in receivership today. (See *SEC v. Homa*, No. 99-CV-06895, pending in the United States District Court for the Northern District of Illinois, Eastern Division.)

We Have a Loss; Now What?

As this article is being written, there is a great deal of speculation as to how and when to handle these losses. Because of the amount of money and the number of investors involved, the IRS is expected to release more details on how to properly report them. There is concern that as investors take these tax losses, the cost to the government will be enormous. (Estimates of the amount of money that Madoff cost investors range from \$17 billion to \$50 billion. See, e.g., Chung and Sender, "Investors Fear \$50bn Loss in Madoff's 'Big Lie,'" *Financial Times* 1 (December 13–14, 2008); Appelbaum and Hilzenrath, "SEC Didn't Act on Madoff Tips," *Washington Post* D1 (December 16, 2008).)

Amended Tax Returns

The most obvious and easiest first action item would be for a taxpayer to file amended tax returns to reclassify any income that the taxpayer previously reported as dividend, interest, or capital gains as return of principal, if actually received. If income was not actually received, it would not affect principal and would be, in effect, erroneously reported income. The IRS will allow amended tax returns for up to three years (Sec. 6511(a)). For any income claimed prior to three years, a taxpayer could argue that the taxes paid could be added to the investment principal.

Theft Loss

The IRS considers theft to be "the taking and removing of money or property with the intent to deprive the owner of it" (IRS Publication 547, *Casualties, Disasters, and Thefts* 3 (2008)). Do losses from a Ponzi scheme qualify as theft loss? Embezzlement, larceny, and robbery are all included in the definition of theft, so losses from Ponzi schemes are generally considered to be deductible as theft losses.

Corporate investors are in general allowed a deduction for any loss not compensated by insurance. However, for individuals, deductions for losses are limited to losses incurred in a trade or business, losses incurred in a transaction engaged in for profit, and casualty and theft losses (Sec. 165(c)). Theft losses are generally deductible in the year discovered by a taxpayer; however, a taxpayer who has made a claim for reimbursement is not entitled to a loss deduction until the tax year in which it can be determined with reasonable certainty whether the reimbursement will be received (Regs. Sec. 1.165-1(d)(3)).

Theft losses are recorded on Form 4684, *Casualties and Thefts*, as an ordinary loss not subject to the 2% limitation on miscellaneous itemized deductions or the 80% itemized deduction limit. The Sec. 165(c)(3) limitation allows individuals to deduct the losses only to the extent that a loss from one occurrence exceeds \$100 and losses from all occurrences exceed 10% of the individual's adjusted gross income. For example, an individual with \$350,000 adjusted gross income would not be able to deduct the first \$35,100 of a theft loss. If the investor is a partnership, the partnership would report the losses and the 10% limitation would likely come into play at the partner level; however, it is not clear whether there would also be a limitation at the partnership level.

When to Deduct the Loss

One reason the IRS needs to issue more guidance on the treatment of Ponzi scheme losses is to clarify when to take the theft losses. In past situations, the IRS has not applied the rules consistently.

According to the Form 4684 instructions, taxpayers should

[d]educt the part of your casualty or theft loss that is not reimbursable in the tax year the casualty occurred or the theft was discovered. . . . If you are not sure whether part of your casualty or theft loss will be reimbursed, do not deduct that part until the tax year when you become reasonably certain that it will not be reimbursed. [2008 Instructions for Form 4684, p. 2]

In the Madoff scheme, it became clear in 2008 that it was a Ponzi scheme. However, the SIPC has claimed that some of the money invested will be recovered. The amount is unclear; certainly not all \$50 billion currently claimed as lost will be recovered. The actual amount may not be determined for some time, maybe even years; meanwhile, investors have been devastated by their losses. It would seem from the above form instructions and some court cases that the IRS has allowed for theft losses to be reported to the extent a bankruptcy or other court limits the amount of the recovery in the year of the loss. (See, e.g., *Ramsay Scarlett & Co.*, 61 T.C. 795 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975).)

For example, if a taxpayer had an initial investment of \$50,000 in 1999 and reported income of 8% a year through the end of 2008 (without compounding), the investor would have reported income on tax returns of \$4,000 a year since 1999. If the taxpayer issues a claim of \$90,000 to the SIPC and the SIPC reduces the claim to the original \$50,000 basis, the taxpayer has a theft loss in 2008 of \$40,000, provided the taxpayer did not amend the prior three years' tax returns to reduce income by \$4,000 for each of those years. In that case, the taxpayer will have a theft loss of \$28,000 in 2008 and will have another theft loss to report in the year that the actual final proceeds from the SIPC and any other receivership are received to the extent that the \$50,000 basis was not recovered.

A bankruptcy filing by the Ponzi scheme promoter can further complicate matters. A taxpayer generally cannot claim a theft loss deduction for the

amount of a claim in bankruptcy proceedings until the end of the proceedings, when the amount of recovery is certain. However, to the extent that a bankruptcy court limits the amount it will attempt to recover, a deduction for losses not included in a bankruptcy claim will not be postponed until the end of the bankruptcy proceedings (CCA 200451030).

Theft Losses in Excess of Income

In some cases, a taxpayer's theft losses in a tax year will be great enough to cause a net operating loss. For net operating losses due to casualty and theft losses, a taxpayer is allowed a three-year carryback period and a 20-year carryforward period under Sec. 172. The 10% adjusted gross income and \$100 per loss limits are taken into account only once, in the year of the claim. They are not calculated for each carryback or carryforward year.

SIPC Insurance

Once a taxpayer files a claim with the SIPC, the SIPC may provide insurance

coverage for up to \$500,000 of losses. If the taxpayer is eligible for the insurance, the taxpayer is required to file a claim in order to take a theft loss for the amount not reimbursed by the insurance. The taxpayer cannot decide to waive the claim for the insurance and still claim a theft loss deduction for it (Sec. 165(h)(5)(E)).

Tax-Exempt Organizations

The above discussion does not apply to defrauded tax-exempt organizations. They have no recourse for tax losses because they pay no taxes. Their only option for recovering part of their lost investments is through the process currently being administered by the SIPC.

Summary

The losses incurred in a Ponzi scheme may be deductible as theft loss under Sec. 165(a) as an ordinary deduction in the year the loss was discovered, with certain limitations. A taxpayer cannot deduct losses as long as there is a possibility of recovery and litigation is ongoing. However, the IRS has allowed for theft losses in the

year of the loss if the amounts were previously reported as income and are determined to be uncollectible. The rules and regulations regarding Ponzi scheme losses are complicated. It is in the best interests of taxpayers, tax preparers, and the IRS for the Service to issue clear guidance on how to properly report these losses.

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EditorNotes

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