

Deducting Losses for Defrauded Investors

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The financial collapse of high-profile investment institutions has generated billions of dollars of losses. A recent report notes that federal and state prosecutors “are preparing for a surge of prosecutions of financial fraud.”¹ A question may arise as to whether these losses for tax purposes are to be treated as investment losses, giving rise to capital loss limitations, or theft losses, which can be deducted without any limitations under the casualty loss rules.

Sec. 1211 limits an individual to a maximum of \$3,000 per year of net capital losses, while a corporation can deduct capital losses only to the extent of capital gains. Sec. 1212 allows corporations to carry back unused capital losses three years and to carry forward the losses for five years. Corporate capital losses that are unused are permanently lost. Individuals cannot carry unused capital losses back but are allowed an unlimited carryforward period. Therefore, it will usually be more beneficial to have an investment loss classified as a theft loss than a capital loss. Individuals calculate casualty losses on Form 4684, *Casualties and Thefts*.

Sec. 165(c) recognizes three types of casualty or theft losses:

1. Losses incurred in a trade or business;
2. Losses incurred in an activity engaged in for profit; and

3. Losses of personal use property not connected with a trade or business or an activity engaged in for profit.

Trade or business casualty or theft losses for self-employed individuals can be deducted in computing adjusted gross income (AGI). For employees, these losses are treated as itemized deductions subject to the 2% of AGI floor imposed by Sec. 67. Losses for personal use property of individuals are itemized deductions that are reduced by 10% of the individual's AGI plus \$100 (\$500 beginning in 2009) for each casualty occurrence.

The types of losses considered in this article are theft losses “incurred in an activity engaged in for profit.” These investment theft losses are not subject to the 10% of AGI reduction for losses of personal use property, the 2% of AGI floor for miscellaneous itemized deductions, or the itemized deduction phaseout rules of

¹ Segal, “Financial Fraud Rises as Target for Prosecutors,” *New York Times* A1, A19 (March 12, 2009).

Sec. 68. They are reported on Form 4684, Section B, and carried to line 28 of Form 1040, Schedule A, Itemized Deductions.

Sec. 172(d)(4)(C) provides that these losses (along with losses from casualties or thefts of personal use property) can be used in the calculation of a net operating loss (NOL), which can be carried back 3 years and forward 20 years.² Recently enacted Sec. 172(b)(1)(H) allows an eligible small business for a tax year ending in 2008 or, if the taxpayer elects, for any tax year beginning in 2008 to elect to carry back an NOL either three, four, or five years. An eligible small business is one whose average annual gross receipts do not exceed \$15 million over a three-year period.

Rev. Rul. 2009-9³ allows an individual who has been the victim of a theft loss to elect to have the provisions of Sec. 172(b)(1)(H) apply, providing the gross receipts test is met. Since the mandatory carryback for a theft loss is three years, essentially this means that a taxpayer who has an NOL as the result of theft could elect to carry back the loss either four or five years. The ruling also notes that because Sec. 172(d)(4)(C) treats a casualty or theft loss as a business deduction, an individual who sustains a casualty or theft after 2007 will be treated as an eligible small business.⁴ This means that the individual does not actually have to be in a trade or business to have the section apply as long as the gross receipts test is satisfied. Rev. Proc. 2009-19 explains the procedures necessary for making the election.⁵

Sec. 165(e) provides that theft losses are deductible in the year of discovery, not in the year the theft occurs. However, as discussed below, the loss is not deductible if there is a reasonable prospect for recovery. This is an especially important provision for defrauded investors because many times the theft is not discovered until years after it has occurred. Absent this provision, many taxpayers would lose the benefit of the theft loss deduc-

tion because of the three-year statute of limitation for claiming a deduction. In the recent case of defrauded investors in Bernard Madoff's Ponzi scheme (discussed in more detail below), many of the losses discovered in 2008 could be traced back to fraud committed in the 1990s or earlier.

This article will examine:

- The criteria for establishing when an investment loss has resulted from fraud;
- When the fraud loss can actually be deducted on the tax return; and
- Special tax issues that can arise as a result of Ponzi schemes, with special attention focused on the Madoff fraud, Rev. Rul. 2009-9, and Rev. Proc. 2009-20.

Capital Loss vs. Theft Loss

The principal issue that arises in investor cases involving theft is whether the loss occurred as the result of theft or was due simply to a bad investment. Invariably, the Service will argue that the taxpayer made a bad investment and is therefore subject to the capital loss limitations or that the fraud committed against the taxpayer does not constitute theft under the applicable state law. A decrease in the stock's value as a result of the theft is sufficient to deduct a loss. However, the amount of the loss cannot exceed the taxpayer's adjusted basis in the investment.⁶

Regs. Sec. 1.165-8(d) states that "the term 'theft' shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery." In Rev. Rul. 72-112, the IRS stated that "to qualify as a 'theft' loss . . . the taxpayer needs only to prove that his loss resulted from a taking of property that is illegal under the law of the state where it occurred and that the taking was done with criminal intent."⁷ However, it is not necessary that an actual conviction for theft be obtained against the perpetrator for the victim to take the deduction if the facts and circumstances indicate that theft occurred under state law.⁸

EXECUTIVE SUMMARY

- A theft loss incurred in an activity engaged in for profit is deductible as a miscellaneous itemized deduction not subject to the 2% of adjusted gross income floor. Whether or not a theft loss has occurred is determined under the law of the state where the loss occurred.
- Generally, for an investment loss to be a theft loss, the party perpetrating the fraud must have had a specific intent to defraud the victim and the victim must have purchased the investment directly from the perpetrator.
- A theft loss for which there is no prospect of recovery is deductible in the year the theft is discovered; however, if there is a reasonable prospect of recovery, the loss is not deductible until it is determined with reasonable certainty whether a reimbursement will be received.
- Losses from Ponzi schemes will generally be treated as theft losses; under Rev. Proc. 2009-20, if specific safe-harbor requirements are met, an investor with a loss from a Ponzi scheme may deduct a specified percentage of the loss as a theft loss in the year the theft is discovered.

2 Casualty losses are subject to a three-year carryback (Sec. 172(b)(1)(F)(i)).

3 Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

4 The ruling does not explain how the gross receipts test would be applied in the case of an individual. Presumably, it would be based on either gross income on line 22 of Form 1040 or adjusted gross income on line 37.

5 Rev. Proc. 2009-19, 2009-14 I.R.B. 747.

6 Regs. Sec. 1.165-7(b)(1).

7 Rev. Rul. 72-112, 1972-1 C.B. 60.

8 *Vietzke*, 37 T.C. 504, 510 (1961), acq. 1962-2 C.B. 6.

State Law Controls

In Rev. Rul. 77-17,⁹ the Service denied a theft loss deduction to a taxpayer who purchased publicly traded corporate stock from a stockbroker. Trading of the stock was subsequently suspended due to irregular activities that constituted security fraud. The taxpayers were supposed to receive stock in a new corporation under a reorganization in bankruptcy. The ruling emphasized that the definition of fraud in the state where the fraud occurs is to be followed for tax purposes. In this jurisdiction, four elements were required to show fraud:

1. The perpetrator of the crime must have the specific intent to fraudulently deprive an owner of his or her property (in this case cash);
2. The perpetrator must obtain possession of and title to the victim's property;
3. The property must be obtained by means of false pretenses; and
4. The property owner must have relied upon the fraudulent representations in parting with his or her property.

In the taxpayer's case, the stock's loss in value did not come within the definition of theft for federal income tax purposes because the fraud's perpetrators did not (1) have the *specific* intent to defraud the taxpayer and (2) obtain possession and title to the taxpayer's property. The taxpayer had purchased his stock from a broker, not from the perpetrator of the fraud.

Intent to Defraud

In *Paine*,¹⁰ the Tax Court considered whether there was a specific intent to defraud the taxpayer of his property. The taxpayer purchased shares of stock in a corporation through a public stock exchange. *Paine* alleged that he was induced to do so by fraudulent financial statements issued by corporate officials. The officials issued those fraudulent statements to artificially inflate the stock's market price. The court denied a theft loss deduction because there was no evidence that the false

representations to *Paine* were made with the specific intent of criminally obtaining his property or destroying his right to enjoyment, as required under Texas law. Significantly, the court noted that *Paine* had not purchased the stock from the persons who made the misrepresentations, but on the open market. There was no evidence that the prior owners of the stock were involved in deceiving *Paine*. Instead they had engaged in a standard market transaction involving the sale and purchase of stock. *Paine* also failed to show that he relied on the misrepresentations to make the purchase.

The *Paine* court made the point that fraud could occur at the level of the corporate officers who were responsible for issuing false financial statements but that this would not necessarily constitute theft at the level of the investor who relied on the false financial statements to purchase the stock. For theft to occur at the investor level under the Texas law at issue there must be a direct purchase by the victim from the perpetrators. There will be no fraud if the stock's sellers are unaware of the wrongdoing, even if the information upon which the purchaser acts was knowingly fabricated with the specific purpose of inducing investors in general to pay inflated prices for the stock.

This means that it is possible for investors who rely on fraudulent financial statements to be treated differently for tax purposes, depending upon the circumstances of the representations. Investors who deal directly with the perpetrators of the false financial information and who pay those perpetrators directly will be considered to be legally defrauded under the facts of *Paine*. However, taxpayers who rely on the fraudulent financial statements but purchase the stock from a party who has no knowledge of the fraud will not be allowed a theft loss deduction. As the Tax Court has noted, "a taxpayer who purchases corporate stock on the open market cannot support a claim of theft under California law because there

is no privity between the alleged corporate defrauder and the taxpayer."¹¹

Conduit for Fraud

The Tax Court has held that a taxpayer who purchases stock from a broker must show that the broker was involved in the deception in order to deduct a theft loss.¹² However, in *Jensen*¹³ a theft occurred where the broker was not aware of the fraud but acted as a conduit for investor funds to the company running the illegal Ponzi scheme. The Tax Court noted: "There is no requirement that an investor have direct contact with the entity in which he is investing. It is not uncommon for investors to deal only with their brokers and never have direct contact with their investments. In such cases, the brokers act as conduits for the investors' funds." Essentially, the facts of *Jensen* suggest that the broker was acting as an intermediary for the promoter even though he was unaware of the fraud. The funds were going directly to the perpetrators of the fraud. This situation differs from one in which the purchaser of the investment uses a broker to purchase the investment, such as stock, from an innocent third party not involved in the theft.

The strict application of the state law requirement that the investor make the purchase of the fraudulent investment directly from the perpetrator of the fraud was illustrated in *De Fusco*.¹⁴ *De Fusco* was an employee of the Equity Funding Corporation of America (EFCA). The EFCA scandal is now largely forgotten, but it was the late 1960s and early 1970s equivalent of the Enron debacle of 2001. *De Fusco* purchased shares from a stockbroker. He based his purchase decisions on fraudulent representations made directly to him by his employer. The court noted:

Petitioner's purchases were stimulated in large part by the glowing prospects portrayed to the salesman at "brainwashing" meetings in the company offices. At some meetings EFCA officers,

⁹ Rev. Rul. 77-17, 1977-1 C.B. 44.

¹⁰ *Paine*, 63 T.C. 736 (1975), aff'd, 523 F.2d 1053 (5th Cir. 1975).

¹¹ *Singerman*, T.C. Summ. 2005-4.

¹² *Electronic Picture Solutions, Inc.*, T.C. Memo. 2008-212. The broker was

held not to be part of the deception, so a theft loss was denied.

¹³ *Jensen*, T.C. Memo. 1993-393, aff'd on another issue, 72 F.3d 135 (9th Cir. 1995).

¹⁴ *De Fusco*, T.C. Memo. 1979-230.

who were subsequently indicted and convicted, personally delivered the sales pitch. Some of the statements made by the officers at such meetings constituted gross misrepresentations.

Nevertheless, De Fusco's loss did not constitute a theft for tax purposes because he made his purchases of EFCA stock from a stockbroker who had no part in the fraud. The court noted, "EFCA's officers were not prosecuted under the California theft statute, and as unforgivable as were their sins in other respects, we cannot determine that they committed a theft of petitioner's property in respect of petitioner's open market purchases of EFCA stock."

Foreign Law

The Tax Court has also used the local law to determine if there was a theft loss with respect to an acquisition in a foreign country. In *First Chicago Corp.*,¹⁵ a bank purchased more than \$14 million of stock in an investment bank in Brazil. The purchaser was aware of the overall political and economic volatility in Brazil and knew that there were certain weaknesses in the bank whose stock it was purchasing. However, First Chicago relied on false financial statements provided to it by the Brazilian bank in making the purchase. This constituted fraud under Brazilian law, so the court allowed First Chicago a theft loss deduction.

Fraud Is Not Always Theft

In Rev. Rul. 71-381,¹⁶ the IRS allowed a taxpayer a fraud loss where the taxpayer made a loan directly to the corporation based on fraudulent financial statements that were issued with the purpose of intentionally deceiving lenders. However, in *Stoltz*, where a taxpayer acted as a guarantor on a loan for a friend who lied about his financial ability to repay the loan, a district court disallowed a theft loss.¹⁷ Instead the taxpayer was limited to a short-term capital loss under the nonbusiness bad debt provisions of Sec. 166. The court noted that the legal definition for theft under Indiana law did not encompass payment to

a third party. According to the court, there was no fraud committed by the party to whom the taxpayer made payment.

The *Stoltz* case is particularly interesting because the court noted that the taxpayer was a victim of common law fraud under the five-part test of the applicable Indiana statute. The case illustrates that fraud will not always constitute theft for tax purposes. Similarly, the Tax Court disallowed a theft loss where a taxpayer loaned money to three corporations that invested the money in fraudulent trust funds. The theft was committed against the corporations that invested the funds directly, not the lender.¹⁸

Bifurcated Intent

A recently issued Chief Counsel Advice (CCA) addresses the consequences to investors of a company that engaged in subprime lending.¹⁹ The company had deliberately misrepresented its true financial condition in order to obtain funds. The investors provided the funds directly to the lending institution. Hence, a theft was held to have occurred for tax purposes. However, the facts in the case were complicated because the lending institution had also run a legitimate business at one time.

The CCA suggests, though it does not say so directly, that taxpayers who invested before the company began to engage in fraud would be subject to capital loss treatment. Hence, investors who sought theft loss treatment would have to show that they made their investments in reliance on the false representations of the company. Under such circumstances it is possible that some investors would have to bifurcate their losses between when their investments were made in a legitimate business and when the investments were made as a result of fraudulent misrepresentation.

Fraud in Reorganizations

In Rev. Rul. 77-18,²⁰ a theft loss was found when a taxpayer surrendered stock in an A reorganization (where a target corporation's assets are exchanged for stock in an acquiring corporation that is

received by target shareholders, and the target corporation ceases to exist). The target corporation entered into the reorganization as a result of its reliance on false financial statements issued by the acquiring corporation. Interestingly, the taxpayer's loss was not contingent on his individual approval of the merger. In addition, the target corporation's assets were surrendered to the acquiring corporation by the target, not by the taxpayer. Though not mentioned, it appears that the crucial fact in the ruling is that the target's assets were transferred directly to the acquirer. In the above-discussed cases where theft was found lacking, taxpayers purchased their stock from brokers who had no knowledge of the false financial statements that were relied on by the victims. However, even though the taxpayer had been the victim of theft, the court disallowed an immediate loss because the amount of the theft had not yet been determined. (See the following discussion.)

When to Deduct a Theft Loss

Even when it has been determined that there has been a theft loss, a deduction cannot be taken if a reasonable prospect for recovery exists. Reg. 1.165-1(d)(2)(i) states that if in the year a casualty occurs

there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of Sec. 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. . . . Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the tax year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

¹⁵ *First Chicago Corp.*, T.C. Memo. 1995-109.

¹⁶ Rev. Rul. 71-381, 1971-2 C.B. 126.

¹⁷ *Stoltz*, 410 F. Supp. 2d 734 (S.D. Ind. 2006).

¹⁸ *Willey*, T.C. Memo. 1998-58.

¹⁹ CCA 200811016 (3/14/08).

²⁰ Rev. Rul. 77-18, 1977-1 C.B. 46.

As long as there is a reasonable prospect for recovery of the stolen proceeds, the transaction will not be closed for tax purposes and a deduction will not be allowed.²¹ The burden of proof is on the taxpayer to show that there is no reasonable prospect for recovery.²² If such a reasonable prospect exists, the taxpayer can obtain the deduction by taking steps formally to abandon any claim for recovery. However, few taxpayers are willing to take such a step when there is a chance to regain any part of the stolen proceeds.

Reasonable Prospect of Recovery

In *Ramsay Scarlet*,²³ the Tax Court stated that a “reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor.” The court stated that it is the court that “must determine what was a ‘reasonable expectation’ as of the close of the taxable year for which the deduction is claimed.” Being told by one’s attorney that recovery attempts will probably be unsuccessful is not sufficient to establish that there is no reasonable expectation of recovery. The court also stated that “[t]he standard is to be applied by foresight, and hence, we do not look at facts whose existence and production for use in later proceedings was not reasonably foreseeable as of the close of the particular year.” This means that even if it turns out that there was no reasonable prospect for recovery in the year the theft was discovered, the deduction will not be allowed for that year if at the time it seemed reasonable that there was such a possibility.

Filing a lawsuit is a strong indication that the taxpayer believes there is a reasonable prospect for recovery. In *Huey*,²⁴ the Tax Court stated that “[t]he fact that petitioner filed a lawsuit to recover the deducted amount . . . ‘gives rise to an inference’ that

he had a reasonable claim.” Also, the continuing investigation into the possibility for recovery was evidence that a reasonable prospect existed.²⁵

A taxpayer can show the lack of a reasonable expectation of recovery where the person who committed the fraud had no assets from which any recovery could be expected. This means that the plaintiff’s prevailing in a civil suit would be meaningless. The Tax Court stated in *Schneider*²⁶ that the perpetrator of the fraud’s “practice of transacting business through nominees and holding no assets in his own name made him in effect judgment proof.”

Partial Deduction

A taxpayer who can show that only a portion of the theft has a reasonable chance of recovery can deduct the portion for which no recovery is possible. In *Bubb*,²⁷ the taxpayer sought a deduction for the full amount of the theft loss for the year of discovery. The IRS argued against allowing the loss by alleging that there was a reasonable prospect for recovery. However, the court noted that there was a reasonable prospect for recovering only 5% of the loss. Therefore, it allowed 95% of the loss as a deduction for the year of discovery. In this case, the taxpayer could deduct the remainder once it could be ascertained that there was no reasonable prospect for its recovery. However, no deduction was allowed where the taxpayer received an initial estimate of a 21% recovery that was not yet finalized.²⁸

Subsequent Recovery

A subsequent recovery will not necessarily bar a deduction for the complete amount of the loss in the year of discovery. In *Jensen*,²⁹ the taxpayer deducted the full amount of the theft in 1984. In 1992 the taxpayer recovered over \$13,000 from a third party that was not responsible for the theft in a bankruptcy proceeding. The Tax Court held that, under facts in exist-

tence in 1984, there did not appear to be a reasonable prospect of recovery, so the full amount of the loss was allowed for that year. (Presumably, in accordance with the tax benefit rule, the taxpayer included the recovery on his 1992 tax return.)

The court also dismissed the Service’s argument that the taxpayer’s filing of a proof of claim in the bankruptcy meant that there was a reasonable prospect of recovery. The court distinguished a proof of claim in bankruptcy from the case in which a lawsuit for recovery was filed. The proof of claim did “not lead to the same inference” on the possibility of recovery as a lawsuit. “Filing the proof of claim in the bankruptcy case was merely a ministerial act that did not require the same degree of effort as pursuing a lawsuit.”

Timing

The usual course of action is for the taxpayer to claim a loss as early as possible while the IRS attempts to delay a deduction under the reasonable prospect of recovery rule. However, a taxpayer who unreasonably delays filing a claim for a theft loss can be denied a deduction once the three-year statute of limitation has lapsed. In *Woltman*,³⁰ the Service was able to show that the taxpayer had no reasonable prospect for recovery in the year he discovered the theft. The taxpayer believed that the perpetrator of the fraud was “judgment proof” and that the cost of litigation would exceed any potential recovery. When the taxpayer finally did attempt to deduct the loss, the statute of limitation had already passed.

Woltman could have avoided this problem by filing a formal disclaimer for the year the theft was discovered to any right to recovery. As noted above, Regs. Sec. 1.165-1(d)(2)(i) allows the taxpayer to forgo the reasonable prospect of recovery requirement if such a disclaimer is filed. The facts of *Woltman* suggest that there are instances in which it will be to

21 *Geisler*, T.C. Memo. 1988-404.

22 *Gale*, 41 T.C. 269, 276 (1963).

23 *Ramsay Scarlet & Co.*, 61 T.C. 795 (1974).

24 *Huey*, T.C. Memo. 1985-348.

25 *National Home Products, Inc.*, 71 T.C. 501 (1979).

26 *Schneider*, T.C. Memo. 1979-335. In addition, the perpetrator had given the

IRS a check that bounced.

27 *Bubb*, No. 91-0581 (W.D. Penna. 1993).

28 *Kaplan*, No. 8:05-cv-1236-T-24 EAJ (M.D. Fla. 2007).

29 *Jensen*, T.C. Memo. 1993-393.

30 *Woltman*, No. 83-0351-E (S.D. Cal. 1985).

a taxpayer's advantage to take the deduction once there is doubt about the prospect for recovery. If the taxpayer fears that the IRS may assess a penalty for taking too aggressive a position, a special disclosure can be filed with the return explaining the taxpayer's course of action.

The Madoff Scandal and Ponzi Schemes

The massive thefts masterminded by Bernard Madoff, a Wall Street insider, may be the largest investment fraud in history. Initial press reports placed the thefts at \$50 billion. A more recent report places the amount at \$65 billion.³¹ However, at present, it is not known whether this amount reflects the fraudulent inflated values of the investments that were being reported to investors or the actual amounts invested. Even if the actual investments that Madoff stole in his scheme turn out to be considerably less than \$65 billion, the sheer size of the fraud is likely to result in litigation that will drag on for many years.

Madoff carried out his fraud through what is known as a Ponzi scheme, named after Charles Ponzi, who operated a fraudulent scheme of this type in the 1920s.³² In a Ponzi scheme, the promoter of the scheme does not invest the funds solicited from investors. Instead the promoter pays early investors "income" with the proceeds solicited from later investors. The payments give the illusion that the scheme promoter is a successful investor. This illusion has the effect of drawing in more investors. However, Ponzi schemes collapse once the promoter cannot entice new investors. This happened to Madoff in 2008 when existing investors wanted to redeem their funds and there were not sufficient new investors to pay them off.

A microcosm of the problems faced by the victims of Madoff's fraud can be seen in the case of Aben Johnson,³³ the victim of another scheme, who was defrauded out of \$78 million. The theft was discovered in 1997. Johnson's attorneys pursued assets against 31 sources, including assets held in France, which resulted in potential recoveries of \$700 to \$20 mil-

lion. By 2001, approximately \$1.3 million had been recovered, and there was a possibility of recovering a maximum amount of an additional \$39.5 million. By 2005, Johnson was still collecting amounts from his lawsuit. A \$37 million deduction was allowed in 2001 because it was determined that the total maximum possible recovery by that time was about \$41 million.

Determining the maximum recoverable amount for Madoff's investors will probably take many years. Since Madoff defrauded thousands of investors, there is an additional problem of determining how much each investor is entitled to receive from recovered assets. There is also the issue of legal fees and forensic accounting fees, which are likely to run into the tens of millions, or even hundreds of millions, of dollars. Such fees will probably be withheld from the amounts recovered by the investors. These fees will also need to be allocated among investors because for individuals and certain trusts they constitute miscellaneous itemized deductions under Sec. 212's allowance of a deduction for expenditures made to ascertain a tax liability. These deductions are subject to the 2% of AGI floor per the Sec. 67 limitation.

Safe Harbor

Until recently, it appeared that defrauded investors in Ponzi schemes would probably have to wait many years before getting any tax benefit for their losses, due to the requirement that investors cannot take the losses until they can be ascertained with reasonable certainty. However, Rev. Proc. 2009-20,³⁴ applicable for years after 2007, establishes a safe harbor for qualified investors who suffer a qualified loss as the result of a fraudulent Ponzi scheme. A qualified investor is a person who transferred funds to the "lead figure" promoting a "specified fraudulent arrangement" that caused the investor to lose the investment.

The qualified investor must not have had actual knowledge of the fraud, and the specified fraudulent arrangement

must not have been a tax shelter as defined in Sec. 6662(d)(2)(C)(ii) with respect to the investor. The qualified investor must also be someone allowed to deduct the theft loss under Sec. 165 or Regs. Secs. 1.165-168. However, it should be kept in mind that a qualified investor does not have to use the safe-harbor provisions. In that case, the normal rules discussed earlier will apply (i.e., the reasonable certainty standard for a theft loss deduction).

A qualified investor who meets the safe-harbor criteria may either:

- Deduct 95% of the investment loss if he or she is not pursuing recovery from a third party; or
- Deduct 75% of the loss if he or she is pursuing or intends to pursue recovery from a third party.

A third party is any party other than the responsible group for the fraud. The responsible group for the fraud consists of:

1. Individuals, including the lead figure, who conducted the specified fraudulent arrangement;
2. An investment vehicle or other entity that conducted the specified fraudulent arrangement and employees, officers, or directors of that entity;
3. A liquidation, receivership, bankruptcy, or similar estate established with respect to individuals who conducted the fraud; or
4. Parties subject to claims brought by a trustee, receivership, bankruptcy, or similar estate described in no. 3.

The deduction is reduced by any (1) actual recovery from any party and (2) potential recoveries from either an insurance company or the Securities Investor Protection Corporation. This means that if the investors are pursuing only members of the responsible group for the fraud, they can deduct 95% of the loss in the year of discovery. Any future recoveries in excess of 5% would have to be included in income under the tax benefit rule. In the event that there are no future recoveries, the investors can deduct the amounts not deducted for the year of discovery once they establish that there is no reasonable prospect for recovery.

31 Enriques, "Madoff Will Plead Guilty; Faces Life for Vast Swindle," *New York Times* A1 (March 11, 2009).

32 On Ponzi schemes, see Greenspan, *Annals of Gullibility: Why We Get Duped*

and *How to Avoid It* 133-35 (Praeger 2009).

33 Johnson, 80 Fed. Cl. 96 (2008).

34 Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

Rev. Proc. 2009-20 provides a form and instructions on the procedures that qualified investors must follow to take advantage of the safe harbor. The form also includes stipulations to which the qualified investor must agree in order to deduct the loss. The qualified investor must also write "Revenue Procedure 2009-20" on the top of the Form 4684 for the year of the theft's discovery.

It should be emphasized that the safe harbor allowing an immediate deduction even when third parties (75% deduction) or the responsible group (95% deduction) are being pursued will be limited to those investors defrauded in Ponzi schemes that meet the specified fraudulent arrangement requirements, and not investors who are defrauded in other types of arrangements. Rev. Proc. 2009-20 defines a specified fraudulent arrangement as one in which the lead figure responsible for the fraud:

- Receives cash or other property from investors;
- Purports to earn income for the investors;
- Reports income amounts to the investors that are wholly or partially fictitious; and
- Appropriates some or all of the investors' cash or property.

In addition, a qualified investment will not include:

- Amounts borrowed by an investor from those responsible for the fraud if they have not been repaid at the time the loss is claimed;
- Fees paid to those responsible for the fraud if they have previously been deducted;
- Amounts reported to the qualified investor as income not included on the tax return; and
- Cash or property invested in a fund or entity (separate from the qualified investor) that invested in the specified fraudulent arrangement (see the discussion below on feeder organizations).

Rev. Proc. 2009-20 also restates the general proposition, discussed earlier, that it is not necessary to obtain an actual conviction to show fraud in order to take

advantage of the safe harbor. It is only necessary to show that:

- The figure promoting the fraud (the lead figure) is "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 section 165"; or
- The lead figure was the subject of a state or federal criminal complaint, not withdrawn or dismissed, and (1) the complaint alleged an admission by the lead figure to the crime or (2) a receiver or trustee was appointed with respect to the fraudulent arrangement or assets of the fraudulent arrangement were frozen.³⁵

The discovery year of the theft loss for purposes of this procedure is the year that either of these criteria is satisfied.

Feeder Organizations

Another issue that may arise with Madoff is that in some cases he used "feeder" organizations to funnel investments into his organization. A feeder organization obtains funds from investors and then passes those funds to another organization. Hence, the feeder acts as an intermediary. The investors may not even be aware of what the feeder organization is doing, and the feeder may not be aware of the fraudulent nature of the ultimate destination of the funds. As noted earlier, even though the deduction of a theft loss often requires that the investors make the payments directly to the perpetrators, a court may allow the loss if the investor pays the funds to an intermediary that subsequently funnels the funds to the perpetrator. The Tax Court in *Jensen*, discussed above, held that it is not necessary for the intermediary to be a party to the theft for the investor to deduct the loss.³⁶

However, in *Jensen* the taxpayer knew that his broker was acting as an intermediary for the investment that turned out to be fraudulent. Madoff's victims who were not aware that the feeder organizations were funneling their money to Madoff

may be found to lack the necessary "privity" because there was no specific intent by Madoff to defraud them. In this case, the investors might have to show that the feeder organizations were also knowing parties to the fraud to obtain the loss, or their situation may not meet the definition of theft under local law.

Where the feeder organization lacked any knowledge of the crime and the investor lacked knowledge of the ultimate destination of the funds, the feeder organization might be held to be the victim of theft, not the taxpayer investor. On the other hand, in *Jensen* the feeder for the funds was acting in the nature of a conduit for the fraudulent promoter of the fund, even though the feeder had no knowledge of the fraud. Hence, if Madoff's feeders are found to have been acting as his conduits, it may not be necessary to establish that they had knowledge of the fraud for the investors to deduct theft losses.

Neither the recently issued Rev. Rul. 2009-9 nor Rev. Proc. 2009-20 gives any direct guidance on the issue of feeder organizations. Rev. Proc. 2009-20 states that a qualified investor eligible for either of the two immediate deductions (discussed above) "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." Similarly, a qualified investment does not include "[c]ash 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."³⁷

It does not appear that these categories would apply to taxpayers like those in *Jensen*'s situation who lacked knowledge of the actual fraud but were funneling money through a conduit to a specified fraudulent arrangement. The issue of whether a theft loss deduction is allowed for investors who used feeder organizations may depend upon how close the

35 Rev. Proc. 2009-20, §4.02.

a Ponzi scheme.

36 See the discussion of *Jensen* at notes 13 and 29 above; that case also involved

37 Rev. Proc. 2009-20, §§4.03 and 4.06.

feeder was to the fraud promoter. Feeders that are totally independent of the promoter may be found not to be conduits; hence, investor funds that went to the promoter via the feeder may be subject to capital loss limitations.

Net Winner Investors

Ponzi schemes may also present tax problems not found in most fraudulent investments. This is because some Ponzi investors do get paid, and some of these payees may even be classified as “net winner investors”—that is, they get more than they invested.³⁸ One issue that may arise is how payments that have been made to investors in the form of dividends or other income in prior years should be treated for tax purposes. Investors may believe that because the payments they received from the Ponzi scheme promoter were not real income, they can file amended returns for refunds for years still open under the statute of limitation on the theory that the payments declared as income were a return of capital.

Amended Returns

The IRS recently addressed the issue of filing amended returns for income reported from Ponzi schemes for years not closed by the statute of limitation (normally three years). Rev. Rul. 2009-9 discusses years still open under the statute of limitation for Ponzi scheme victims. However, it says nothing directly about amending returns for income reported in those years as a result of information received from the Ponzi scheme promoter.

In an illustration, the ruling discusses the case of an individual who has reported income from the Ponzi scheme over a period of years 2 through 7. In year 7, he receives \$30 of principal from the scheme. The fraud is discovered in year 8. The ruling states that the amount that would qualify for the theft loss is increased by amounts reported as income in prior years and decreased by amounts of money received. Essentially, the ruling is taking the

approach that the recovery for income reported in a prior year is to be taken in the form of the theft loss and not by amending the returns for open years. If the returns for open years could be amended, the amount of the theft loss for the discovery year would have to be reduced by the amounts of income reduction from the prior years.

Rev. Proc. 2009-20 states that if a taxpayer wants to take advantage of the safe-harbor provisions for immediate deduction in the year a Ponzi scheme is discovered, as discussed earlier, he or she must agree not to amend returns for tax years still open under the statute of limitation. However, if the taxpayer decides to forgo the safe harbor, the issue of amending returns for open years becomes more problematic.

Return of Capital

The issue of whether payments from Ponzi schemes that have been classified as income can be reclassified as return of capital has arisen in a number of cases. The Tax Court considered this issue in *Premji*,³⁹ which involved a taxpayer defrauded in a Ponzi scheme. Premji cashed four \$2,000 checks that he had received as interest on the investment. With each interest check he also received a \$20,000 principal payment that he chose to reinvest. The court held that each of the \$2,000 checks was taxable interest, not a return of principal as asserted by Premji, because there was no evidence that the \$20,000 checks that were a return of capital could not have been cashed at the time they were received.

The court's holding suggests that if Premji could not have cashed the \$20,000 principal investment checks due to lack of funds, then the so-called interest payments could have been treated as a return of capital. The logic of the *Premji* court strongly suggests that a taxpayer cannot treat reinvested income as a return of capital if the principal amount invested was actually available to the taxpayer. How-

ever, the *Premji* court did not require the taxpayer to include in income checks he could not cash due to insufficient funds.

In *Parrish*,⁴⁰ the Eighth Circuit upheld a Tax Court decision not allowing the taxpayer to reclassify interest income as a return of capital. However, as the court noted, Parrish failed to prove he was a victim of fraud or how much he had loaned or invested. Moreover, there was some indication that Parrish himself was engaged in fraudulent activities. Similarly, in *Marretta*,⁴¹ the Third Circuit did not allow a taxpayer to reclassify interest payments as a return of capital when he had received more interest payments than his original investment and failed to report any of these distributions on his tax return.

However, in other cases involving Ponzi schemes, courts have allowed taxpayers to reclassify investment income as a return of capital. In *Taylor*,⁴² a federal district court allowed taxpayers who had amended their returns to reclassify interest reported from a Ponzi scheme promoter as a return of capital because the perpetrator of the scheme did not make any investments on the investors' behalf. In *Greenberg*,⁴³ the Tax Court stated that interest payments are made for the forbearance of money but that the payments received by the taxpayers were made with the intent to conceal the fraudulent nature of the promoter's activities. Therefore, the payments were a return of capital.

In *Kooyers*,⁴⁴ the taxpayers loaned money to a Ponzi scheme promoter. Once again, the Tax Court stated that true loans are for the forbearance of money but that the payments made to the taxpayers were for the purpose of concealing the fraudulent nature of the promoter's activities. The *Kooyers* court made the important distinction between cases, such as those in *Kooyers*, *Taylor*, and *Greenberg*, in which the Ponzi scheme investors came in late and had no chance of recovering their investment and those cases in which the payments on the investment were not reclassified as return of capital (i.e.,

38 For an illustration of net winner investors in a Ponzi scheme, see *Kaplan*, No. 8:05-cv-1236-T-24 EAJ (M.D. Fla. 2007), where 75 of the 800 investors profited.

39 *Premji*, T.C. Memo. 1996-304, aff'd, 139 F.3d 912 (10th Cir. 1998).

40 *Parrish*, 168 F.3d 1098 (8th Cir. 1998).

41 *Marretta*, No. 04-2679 (3d Cir. 2006).

42 *Taylor*, No. 3:96-cv-0920 (E.D. Tenn. 1998).

43 *Greenberg*, T.C. Memo. 1996-281.

44 *Kooyers*, T.C. Memo. 2004-281.

Premji) because those investors had come in early and hence had the opportunity for capital recovery.

The IRS has indicated that it will not accept the recovery of capital argument, though its reasoning for the position appears flawed. In CCA 200305028, it argued that the weight of authority, based on *Premji* and *Parrish*, argued against recovery of capital. The memo cites the *Greenberg* decision for the proposition that the taxpayer may prevail only in rare circumstances.⁴⁵ However, the memo ignored the factual distinctions, discussed above, between the cases, namely that *Premji* had the opportunity to recover his capital while *Parrish* had not proven he was the victim of fraud. These factors were not present in *Greenberg*. The Service made a similarly flawed argument in CCA 200451030, where it once again relied on *Premji* and *Parrish*.⁴⁶

In CCA 200811016,⁴⁷ the IRS disallowed the filing of amended returns to recover income reported from fraudulent transactions as a return of capital. The memo justified its position by arguing that the taxpayers who prevailed in *Greenberg* and *Kooyers* had discovered the fraud before filing their returns. Here the IRS advances the argument that a subsequent discovery of fraud would bar the reclassification of income to capital recovery for prior years.

The memo overlooked some key facts. First, the Tax Court itself never made such a distinction in those two cases. Second, in *Kooyers*, the Tax Court approvingly cited the district court's decision in *Taylor* (discussed above) in which the taxpayer was allowed to amend prior-year returns. Third, in *Kaplan* (discussed below), the Service agreed to allow a taxpayer who had been the victim of a Ponzi scheme to amend his returns for the three years still open under the statute of limitation.

Investors defrauded by Madoff who seek refunds of "income" reported on their tax returns for the three years (2005–2007) still open under the statute of limitation on the basis that these payments constitute a return of capital may have to

show that recovery of their original principal was not possible. It appears from the currently known facts that Madoff did have sufficient funds to redeem the portfolios of some of his investors. However, as noted earlier, Rev. Rul 2009-9 will allow these taxpayers to increase their theft loss by amounts reported as reinvested income on prior-year returns.

Distortions

The issue of having to recognize income for prior years may cause substantial distortions where there are dividends and capital gains taxed at 15%.

Example: Investor *D* invested \$100,000 in Madoff's Ponzi scheme. In 2005, 2006, and 2007, *D* received and cashed checks for \$10,000 each year that were classified as dividends eligible for the maximum 15% tax rate. Assume that when *D* is eligible to deduct the loss he is in the 28% tax bracket.

If the so-called dividends are a return of capital and *D* amends his returns for open years, he will receive a \$4,500 refund (\$10,000 for each of the three open years × 15%) and a tax benefit of \$19,600 from the theft loss of the remaining \$70,000 (\$100,000 original investment minus \$30,000 return of capital times the 28% tax rate equals \$19,600). Hence, the total tax benefit is \$24,100 (\$4,500 refund plus \$19,600 tax saved from the theft loss deduction).

Note that in the above example if the taxpayer does not claim a refund for the three open years, he has actually benefited by creating a "phantom basis" for non-existent income. Hence, he will be eligible for a refund of \$28,000 (\$100,000 basis × 28% tax rate) vs. the \$24,100. The \$30,000 of "dividends" taxed at 15% yields a 28% deduction when it is *not* classified as a return of capital. In essence, the taxpayer has paid \$4,500 to receive a tax refund of \$8,400 (\$30,000 × 28%). Under these circumstances, taxpayers might want to forgo claiming a refund for open years.

Moreover, as noted earlier, Rev. Proc. 2009-20 will allow an immediate deduction of either 95% or 75% of an investor's loss in the year of discovery if he or she agrees not to amend returns for open years, with the remainder deductible when there is no reasonable prospect of recovery. Hence, agreeing to the terms of the revenue procedure by not amending returns for open years can actually yield greater overall tax savings by deducting a theft loss at the taxpayer's current marginal tax rates as opposed to receiving a refund at the lower 15% rate from an amended return.

The distortion created in the above example also arises when a taxpayer in the Ponzi scheme chooses to have the 15% taxed "dividend" income reinvested, thereby causing a potential increase in basis that can yield a 28% deduction when the theft loss is deducted. It is very common for mutual fund investors to reinvest their dividends and capital gains.

Reinvested Income

The issue of taxpayer refunds from amounts declared as income from a Ponzi scheme arose in *Kaplan*,⁴⁸ a case decided by a federal district court in Florida. The IRS had agreed to allow *Kaplan* to claim refunds, plus interest, for years not closed by the statute of limitation for income reported on his tax returns as a result of the fraudulent statements the Ponzi scheme promoter provided him. Although not entirely clear from the court's recitation of the facts, it appears that *Kaplan* never actually received any funds from the promoter but opted to have them reinvested. The court never addressed the issue of whether these amounts were actually available to *Kaplan*. The refund of the taxes paid resulted in *Kaplan* reducing the amount of the theft loss claim by the amount of the nonexistent income reported on his returns.

A major problem in *Kaplan* was that the reinvested income on which he paid tax was from years closed by the statute of limitation. The *Kaplan* court referred to this income as "phantom income," never

45 CCA 200305028 (12/27/02).

46 CCA 200451030 (12/23/03).

47 CCA 200811016 (3/14/08).

48 *Kaplan*, No. 8:05-cv-1236-T-24 EAJ (M.D. Fla. 2007).

stating specifically that it was reinvested, though it is clear from the overall facts that this is what happened. The court did not allow Kaplan to add this income to his basis because it was nonexistent. This means that Kaplan got the worst of all possible situations: He paid tax—for which he could not get a refund—on nonexistent income that he never received but did not get the step-up in basis allowed to taxpayers who reinvest real income.

The IRS has addressed this arbitrary result in Rev. Rul. 2009-9. Taxpayers who have reported income from Ponzi schemes for years that are closed by the statute of limitation, as well as years that are not closed, can add that reported income to their basis for purposes of declaring a theft loss. Similarly, Rev. Proc. 2009-20 provides that qualified investment amounts that a taxpayer can deduct as a fraud loss include amounts reported as income on returns for years prior to the discovery year, including tax years barred by the statute of limitation. The procedure states that these reinvested amounts are added to the theft loss even if the taxpayer decides not to use the safe harbor (i.e., by filing amended tax returns for open years) for obtaining an immediate 95% or 75% deduction. However, if a taxpayer actually received the income in those prior years, he or she would have to reduce his or her theft loss basis by the amount received after increasing the basis for the amount of income reported. Similarly, a taxpayer would have to decrease theft loss basis by any capital recoveries for prior years.

Clawback

Some of Madoff's investors may have a problem with what is called a "clawback." This means that investors who received payments from Madoff may be forced under New York state law to turn funds received over to a bankruptcy trustee, even if they had no knowledge of the fraud.⁴⁹ In the case of investors who are subject to clawbacks, a theft loss should be allowed under the origin of the claim doctrine. In *Gilmore*,⁵⁰ the

Supreme Court stated that to take a deduction, the origins of the circumstances allowing the deduction must arise in connection with a profit-seeking or business activity. Since the amounts turned over to the bankruptcy trustee have their origin in the fraudulent nature of the Ponzi scheme, taxpayers who must make these payments should be allowed to deduct them as a theft loss.

Taxpayers subject to clawback provisions may also have to take account of the requirements of Sec. 1341(a). This section applies when amounts that the taxpayer had an unrestricted right to when included in income on the tax return in a prior year or years are restored in a subsequent year. The section applies if the deduction for the amount restored exceeds \$3,000. It requires that the tax assessed against the taxpayer be the lesser of (1) the income tax in the year of restoration with the deduction or (2) the tax for the current year without the deduction less the decrease in tax from the prior year that would have occurred had the amount not been included on the tax return of that prior year. When Sec. 1341(a) is applicable, there will be no theft loss allowed for restored amounts because this would result in a double deduction—one for the theft loss and one for the application of the section.

Claim of Right

Rev. Rul. 2009-9 discusses the claim of right doctrine in Sec. 1341(a) within the context of theft losses. The ruling notes that such losses are not subject to the section's rules because they do not involve returning income. However, this part of the ruling should not be confused with clawbacks (not addressed in the ruling), where a taxpayer must return income included on a prior return. The ruling also states that defrauded taxpayers will not be eligible for the mitigation provisions in Secs. 1311–1314.

Conclusion

Defrauded individual investors can take an itemized deduction not subject to

reductions, limitations, or phaseouts. Theft losses can also generate an NOL. However, the deduction is available only when the taxpayer shows that the necessary elements for a legal definition of fraud exist under state law or the jurisdiction where the fraud occurs (i.e., a foreign country). If the taxpayer buys an investment that was induced by fraudulent representations, no theft loss will be allowed if the actual purchase was executed through a third party (i.e., a stockbroker) not connected with the organization promoting the fraud. However, this rule should not apply if the third party in effect was acting as a conduit for the promoter.

Theft losses are deductible in the year of discovery. However, the loss can be deducted only when the taxpayer can show there is no reasonable prospect for recovery. This prospect exists as long as the taxpayer is pursuing steps to ascertain whether the perpetrator has assets from which a recovery can be realized. Taxpayers who want to file for an immediate refund can waive their right to recovery. Otherwise, they may have to wait many years before they know whether recovery is possible. If it can be firmly established that only a partial recovery is possible, the taxpayer can take an immediate deduction for that part of the fraud for which there is no reasonable prospect of recovery.

Taxpayers defrauded in Ponzi schemes have separate issues. Rev. Proc. 2009-20 allows those taxpayers a safe harbor to deduct an immediate loss for the year of discovery. The deduction is either:

- 95% of the qualified loss if the qualified investors are pursuing only members of the group responsible for the fraud; or
- 75% if they are pursuing third parties not connected with the fraud.

However, the taxpayers must file a statement that is provided in the revenue procedure. Those taxpayers who file the statement must agree not to claim a refund for income reported on tax returns from Ponzi schemes for years still open under the statute of limitation.

49 Berensen, "Even Winners May Lose Out with Madoff," *New York Times* A1, B4 (December 19, 2008).
50 *Gilmore*, 372 U.S. 39 (1963).

There is still the issue as to whether taxpayers who decide not to take advantage of the revenue procedure's safe-harbor provisions can amend their returns for the years still open under the statute of limitation. In such a case, these taxpayers would file for a refund by claiming income recognized for those open years as a return of capital. Although the Service has indicated a reluctance to allow taxpayers to amend their returns in such a situation, the weight of case authority suggests that taxpayers can file for refunds if the taxpayers could not recover their principal investments during the periods they were receiving "income" from the Ponzi scheme promoter. However, as discussed earlier, it may be more advantageous from the tax perspective not to amend returns for open years.

For all years prior to the discovery year, including years closed by the statute of limitation, Rev. Rul. 2009-9 and Rev. Proc. 2009-20 allow victims of Ponzi schemes to add income reported but not received (reinvested income) on a tax return to the amount of the theft loss basis. Taxpayers who under claw-back rules must return to bankruptcy courts amounts that yield a deduction of more than \$3,000 in the year of the return will find some relief under Sec. 1341(a).

Because of the sheer size and scope of the Madoff scandal, defrauded investors may have to wait many years until they know how much they can recover. Fortunately for them, Rev. Proc 2009-20 allows immediate tax relief for qualified investors.

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EditorNotes

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