

IRS: Theft Losses: Net Income from Ponzi Schemes

The **California Tax Lawyer (Summer 2009 Edition)** published my article, **IRS Issues Guidance on Ponzi Schemes**, copy below.

Regarding theft losses (from Ponzi scheme “net income”), the IRS advised they will not challenge inclusion of income (from the Ponzi scheme investment) in Taxpayer’s basis if the Taxpayer can establish the amount of net income from the “investment”.

Specifically: “the IRS will not challenge the Taxpayer’s inclusion of that amount (i.e., net income) in basis for determining the amount of any allocable theft loss (i.e., from the Ponzi scheme), whether or not the income was genuine.”

Taxpayer’s tax deduction for a “Ponzi scheme” theft loss includes their qualified investment (i.e., investment plus phantom “net income” less reimbursement).

Please see enclosed:

IRS Issues Guidance on Ponzi Schemes

In Rev. Rul. 2009-9 and Rev. Proc. 2009-20, the IRS issued, in the words of Commissioner Doug Shulman, "guidance articulating the tax rules that apply and providing "safe harbor" procedures for Taxpayers who sustained losses in certain investment arrangements discovered to be criminally fraudulent."

Under Rev. Rul. 2009-9:

- An Investor's theft loss from a Ponzi scheme is a theft loss, which is not a capital loss.
- "Investment" theft losses are not subject to limitations that apply to "personal" casualty and theft losses.
- The theft loss is deductible in the year the fraud is discovered (except to the extent there is a claim with a reasonable prospect of recovery). The tax year in which the Investor discovers the theft (IRC §164(e)) must be the same tax year in which an indictment or similar allegation is made at the State or Federal level against the promoter of the scheme.

Under Rev. Rul. 2009-9, the amount of the theft loss is the "qualified

investment" (i.e., amount of money invested that was lost), plus post-2004 "phantom net income" from the "investment" less reimbursement, or other compensation.

Rev. Proc. 2009-20 provides Investors with a uniform manner for determining their theft losses,

Safe Harbor: Under the Rev. Proc. 2009-20 "safe harbor", Investors may claim tax deductions in the year that the theft was discovered (in the Madoff case, Tax Year 2008). Under the "safe harbor," the tax deductions may be claimed in an amount equal to 95% of their net loss (for Investors who do not pursue 3rd third party claims) or 75% of their net loss (for Investors who intend to pursue 3rd party claims against advisors who referred the Madoff investment).

No Safe Harbor: Taxpayers who do not apply the "safe harbor" treatment may deduct pre-2005 "phantom income" and amend prior years' tax returns. Rev. Proc. 2009-20 provides that "If the Taxpayer can establish the amount of net income from the investment arrangement, reported on tax returns, 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 IRC §6511 has expired, the IRS 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."

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