Deductibility of Losses in a Ponzi Scheme

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On December 11, 2008, Bernard Madoff, a decades-long veteran of Wall Street and pillar of the US financial community, was arrested for allegedly running a giant Ponzi scheme or pyramid fraud. Prosecutors have alleged that Mr. Madoff confessed to losing approximately 50 billion dollars in the scheme.[1] The Securities and Exchange Commission alleges that Mr. Madoff delivered consistently strong returns by secretly using the principal from new investors to make income and redemption payments to other investors. The scheme appears to have unraveled as more investors asked for redemptions in late 2008.

In the coming weeks and months, much will be written about the allegations against Mr. Madoff. This **Stroock Special Bulletin** has a narrower focus: it addresses, in general terms, whether and when taxpayers may deduct losses suffered in connection with a Ponzi scheme.[2]

Theft Losses

Under Section 165(a) of the Internal Revenue Code of 1986, as amended (the "Code"), taxpayers are allowed a deduction for "any loss sustained during the taxable year and not compensated for by insurance." A corporate investor generally may deduct any losses under this provision. In the case of individuals and other taxpayers treated as individuals, Code Section 165(c) limits the deduction to losses incurred in a trade or business ((c)(1)), losses incurred in a transaction engaged in for profit ((c)(2)), and, for transactions not engaged in for profit, casualty and theft losses ((c)(3)). Under Code Section 165(e), "any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss." However, a taxpayer is not entitled to deduct a loss if he has a claim for reimbursement until there is no reasonable prospect of recovery on the claim.[3]

Taxpayers are allowed to deduct their full basis in an investment that is the subject of a theft loss, even though the property was worth less at the time of the theft than their cost basis.[4] Whether "theft" occurs for purposes of the Tax Code depends on the law of the jurisdiction where the loss was sustained.[5] Theft includes, but is not limited to, embezzlement, larceny and robbery.[6] The courts and the IRS generally agree that losses sustained in a Ponzi scheme may be deducted as theft losses.[7] Theft losses generally are treated as ordinary losses, not capital losses.[8] Such losses are not restricted by the 2% or 80% itemized deduction limitations.[9]

One significant drawback of Code Section 165(c)(3) theft losses is that individuals are allowed to deduct such losses only to the extent that a loss from any one occurrence exceeds $100 and losses from all occurrences in the year the theft loss is allowed exceed 10% of the individual's adjusted gross income. For example, for an individual with adjusted gross income of $500,000, the first $50,100 of a theft loss would not be deductible. Where the investor in a Ponzi scheme is a partnership and the theft was of partnership assets, it appears that the partnership will report the theft loss. The law is unclear whether the 10% limitation applies at the partner or partnership level, or both. However, it is likely that the 10% limitation applies at the partner level.[10]

Whether a theft exists for tax purposes depends upon the intent of the promoter of the Ponzi scheme and the law of the state where the incident occurred. If it turns out that taxpayers invested in a true Ponzi scheme and investors' money was given to other investors, as opposed to invested in securities, it is likely the requisite intent to commit theft will exist. However, the possibility still exists that taxpayers' money was invested in the financial markets, at least initially. Therefore, some of the investors' losses may be attributed to an economic decline in value of the investments, which presumably generated actual losses upon a sale.

A taxpayer may take a theft loss only when there is no reasonable chance of recovery. Whether and when investors no longer have a reasonable chance of recovery is a question of fact.[11] In one case, the IRS concluded that investors who agreed to accept stock and participations in a litigation trust were not allowed a deduction until the litigation was resolved.[12] However, the IRS allowed a deduction to taxpayers who elected to receive one dollar in complete satisfaction of their claims in the year they received the money.[13] In another case, where a taxpayer was the victim of a Ponzi scheme, the IRS disallowed a theft loss claim while a reasonable likelihood existed the taxpayer would recover some portion of the losses sustained via the bankruptcy process.[14] The IRS held that the taxpayer could not deduct any portion of the loss subject to the taxpayer's claim for reimbursement.[15]

In many cases, the promoter of the Ponzi scheme may file for bankruptcy proceedings. A taxpayer that files a claim in the bankruptcy proceeding may not be able to claim a theft loss deduction until the litigation or bankruptcy proceedings are completed and the amount of recovery is certain. The amount actually recovered via the court proceedings by the taxpayer may be small in comparison to the loss, but until the exact amount is determined, the taxpayer may not be able to take a deduction.[16]

Thus, a taxpayer is faced with the difficult choice of whether to claim a theft loss deduction in the current year and forgo all possibility of recovery via litigation, or whether to make a claim for recovery and wait to take the deduction. Waiting to take the deduction could limit the value of the deduction because the NOL may be carried back only 3 years and the taxpayer's income and tax bracket may vary from year to year. If a taxpayer decides to take a loss in one year, and the IRS audits the taxpayer and denies the loss, it is important to consider amending the return in another year before the statute of limitations expires.

There exists some authority that a taxpayer may take a portion of the total loss under Code Section 165 to the extent a bankruptcy or other court limits the amount of a taxpayer's recovery.[17] An IRS Chief Counsel Advice held that a taxpayer, with no other avenues of recovery aside from the relevant court proceedings, could deduct the amount that is excluded from the claim by the court because that amount was taxed in a prior year and was properly characterized as income for tax purposes. So, for example, if the court reduces a taxpayer's claim by his or her previous recoveries of cash, that reduction may be a currently deductible theft loss.

As previously mentioned, the amount of a theft loss is determined by the taxpayer's basis in the assets stolen. If a taxpayer claims a theft loss that includes in basis income reported in earlier years, and a court ultimately concludes that the income reported in earlier years was fictitious, the taxpayer may, under a special mitigation statute, be able to reopen the earlier years even if they are closed under the usual statute of limitations.[18]

The Securities Investor Protection Corporation (SIPC) may in some cases provide insurance coverage for up to $500,000 of losses. It should be noted that a taxpayer must file a claim to receive SIPC insurance proceeds if the taxpayer is eligible in order to be permitted to take a theft loss for the amount of loss covered by insurance.[19] The taxpayer cannot decide to waive the claim for the insurance and still claim a loss deduction for it.

If theft losses exceed an individual taxpayer's income in the year the taxpayer discovers the losses, a net operating loss is created and the taxpayer is entitled to a three-year carryback of the loss (and a 20-year carryforward) under Code Section 172.[20] Normally, Code Section 172 losses are primarily business operating losses and are subject to a two-year carryback rule.[21] However, a special three-year carryback and carryforward rule is applicable to theft and casualty losses.[22] Note, that the 10% adjusted gross income and $100 per casualty loss reductions are taken only once (*i.e.*, they are not taken again when computing the carryback or carryforward.)

As discussed above, Code Section 165(c)(2) allows deductions for losses incurred in a transaction entered into for profit. Arguably, where investors entered into transactions with an expectation of profit and the transactions generated losses, even theft losses, such losses should be deductible under Code Section 165(c)(2), not Code Section 165(c)(3), which imposes the "$100/10% AGI" limitation.[23] However, the IRS has taken the position that such a loss is deductible only under Code Section 165(c)(3).[24] When deciding whether a loss was incurred in a transaction that was entered into for profit or, rather, in a theft, the IRS has stated that the specific provisions related to theft losses override the "more general provisions" of the transaction entered into for profit section.[25] However, the better argument is that a taxpayer can take a theft loss in a Ponzi scheme as a transaction entered into for profit, and thus not be subject to the 10% limitation. Theft losses are defined to include both 165(c)(2) and 165(c)(3) in several places in the Code. Also, in several instances where the taxpayer took this position, the IRS failed to challenge it.[26]

Refund Claims for Prior Years

Taxpayers may file refund claims for income reported in prior years if, in subsequent years, it is determined that the income was not actually earned.[27] A taxpayer may consider filing an amended return for any open tax years, typically the last three years, and then, when calculating basis for the theft loss deduction he will take in 2008 or 2009, take into account any prior gains actually recognized in the years prior to the last open tax year. An individual taxpayer will have time to take a theft loss in 2008 or 2009 but should act quickly to amend prior returns. As noted above, it is possible the IRS may challenge the refund claim with respect to prior years. A recent Chief Counsel Advice memorandum 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.[28]

Claim of Right

Under the common law doctrine of "claim of right," a taxpayer as a general rule must report a receipt that purports to be an income item for the period in which he or she has control over the item. If such an item must later be returned, the taxpayer generally will be entitled to take a deduction for the returned amount in the tax year of the return.[29]

It is possible that some of the investors that received payments in a Ponzi scheme may be required to return those payments.[30] In such a case, the investors may claim a deduction in the current year for the money that they have to repay.[31]

Trust, Estate and Gift Tax Issues

Losses from a Ponzi scheme may have estate tax implications for a taxpayer who was the beneficiary or fiduciary of an estate that had an account with the sponsor at the time of the decedent's death. If the estate paid Federal estate tax, the taxpayer may be able to submit a claim for a refund. Generally, the Federal estate tax is calculated based on the fair market value of the estate's assets on the decedent's date of death or the alternate valuation date, which is six months after death. If the estate paid estate tax, then presumably the tax was based, in part, on the significant value of the Ponzi scheme account. If, in hindsight, it is believed that the value was illusory, it follows that in hindsight the estate should have paid less estate tax.

Code Section 6511(a) requires that the taxpayer 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. As the U.S. Supreme Court case of *Brockamp v. U.S.*[32] makes clear, this limitation period tends to be strictly enforced.

The date on which a promoter began a Ponzi scheme will be relevant for estate tax purposes. The estate will have to show that the value reported on the Federal estate tax return was not the actual fair market value of the account on the relevant valuation date. If the estate tax valuation date predated the commencement of the Ponzi scheme, a refund may be unavailable.

If the estate is still open, then it must be determined whether the loss occurred during the settlement of the estate or before the decedent died. If the loss occurred during the settlement of the estate, it can be used either to reduce the value of the estate for estate tax purposes or to claim a theft loss deduction on the income tax return, but not both.[33] If the theft occurred before the decedent died, then an income tax deduction would be available to the taxpayer on the taxpayer's IRS form 1040, and the estate would report the item on the estate tax return at little or no value.

Trusts and estates generally are treated as individuals for income tax purposes and thus generally would be subject to the 10% limitation on theft losses, if it is applicable. It may be advisable to terminate a trust or estate so that the loss can flow through to the beneficiaries.[34] However, it may be preferable not to terminate the trust before the loss can be taken, because there may be some uncertainty as to whether the theft loss may be taken by a beneficiary after the trust has terminated.

If the estate paid state estate tax, the taxpayer may also consider submitting a claim for a refund of that tax. In New York State, such a claim must be submitted 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 applicable statute of limitations will vary from state to state.

If the taxpayer made or received a gift of an interest in a Ponzi scheme account, the taxpayer may also consider filing a claim for a refund of any gift tax paid in connection with the gift. The Federal gift tax is based on the fair market value of the gifted property on the date of the gift. Presumably the gift would have been overvalued, based on information that became known to the taxpayer after the gift was completed. As with estate tax refunds, Code Section 6511(a) permits the taxpayer to file 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. If a gift was made but no gift tax was paid (because the gift was within the taxpayer's available exemption amount), so that no refund is being sought, then presumably the gift tax return could be amended to provide a more accurate value of the gifted interest. This would help preserve the taxpayer's available gift tax exemption.

Although most states do not have an independent gift tax, taxpayers should be mindful of submitting a claim for a refund of state gift tax if any such tax was imposed. The applicable statute of limitations will vary from state to state.

Foreign Investors

Code Section 873(b)(1) provides that theft losses generally are deductible to foreign taxpayers regardless of whether the losses are connected to a US trade or business, as long as the property lost is located within the US. Thus, the theft losses may be used to offset income effectively connected with a US trade or business. This would not be of any use to a foreign taxpayer that had no income effectively connected to a US business.

Conclusion

If a loss originates from a Ponzi scheme, investors may be able to take a Code Section 165(a) "theft loss" as an ordinary deduction in the year the loss was "discovered," possibly only to the extent the loss exceeds 10% of adjusted gross income. However, a taxpayer may not deduct such losses while there is a possibility of recovery and litigation is ongoing. Once the losses are fixed and determinable and recovery is denied or limited, the taxpayer may deduct the losses (subject to the limitations discussed above) and to the extent the losses exceed taxable income, the taxpayer may carry back the losses for three years and may be eligible to receive a refund.

It could prove strategic for a taxpayer to adopt a "wait and see" approach with respect to claiming theft losses in the current tax year. However, a taxpayer may have the ability to amend prior tax returns and seek a refund immediately. If a taxpayer decides to pursue this route, he or she should act quickly, because of statute of limitations issues. Some members of the tax community speculate that the IRS will likely issue guidance on this matter. Where ambiguity in the tax law creates uncertainty for a large group of taxpayers, it is in the best interest of the IRS to avoid conflict and provide clarity.

To ensure compliance with requirements imposed by the United States Treasury Department in Circular 230, we inform you that any tax advice contained in this memorandum is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

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1. WSJ, December 13-14, 2008.
2. For a useful synopsis of the tax related issues, see *New York Times*, "Tax Deductions for Theft Losses Could Help Some Investors," December 19, 2008.
3. Treas. Reg. §§ 1.165-1(d)(2)(i) and (3).
4. The loss is, however, limited to the lesser of basis or fair market value if the property stolen was not used in a trade or business or held for the production of income. See Treas. Reg. §§ 1.165-8(c) and 1.165-7(b) (1). The remainder of this bulletin assumes that any Ponzi scheme theft losses relate to property held for the production of income for purposes of determining the amount of the theft loss deduction.
5. CCA 200811016.
6. Treas. Reg. §1.165-8(d).
7. CCA 200451030; *David Jensen, et ux. v. Commissioner*, T.C. Memo. 1993-393. It should be noted, however, that a deduction may be disallowed for participants who were aware of the fraudulent or illegal nature of the scheme, under a "frustration of public policy" doctrine.
8. *See* Code Section 165(h)(2) and the legislative history to the Tax Reform Act of 1984. If the taxpayer had income from casualties or condemnations that exceed the theft loss, the net amount may result in capital gain.
9. Code Sections 67(b)(3) and 68(c)(3). Code Section 67(b)(3) disallows such deductions to the extent itemized deductions do not exceed 2% of adjusted gross income. Code Section 68(c)(3) limits certain taxpayers' deductions to the lesser of 3% of gross adjusted gross income or 80% of the other allowable itemized deductions for the tax year.
10. McKee, Nelson & Whitmire: *Federal Taxation of Partnerships & Partners*. *See also* Code Section 62(a) (defining adjusted gross income to apply only to individuals).
11. CCA 200451030.
12. CCA 200406046.
13. *Id*.
14. CCA 200451030.
15. *Id*. *See also Kaplan v. US*, 100 AFTR 2d 2007-5674 (2007) and Johnson v. U.S., 80 Fed. Cl. 96 (2008), noting that if a portion of a loss cannot be taken in one year because there is a reasonable prospect of recovery, then that loss cannot be taken until it is reasonably certain that that portion will not be recovered, citing Treas. Reg. § 1.165-1(d) (if in the year of the loss 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 section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received.").
16. CCA 200451030.
17. *Id*.

18. *See* Code Section 1311.

19. Code Section 165(h)(5)(E).

20. CCA 200451030. It should be noted that corporate taxpayers are subject to a two-year carryback and 20-year carry forward rule.

21. Section 172(b)(1)(A)(i).

22. Sections 172(b)(1)(F)(i) and 172(b)(1)(F)(ii)(I). *See also* Code Section 172(d)(4)(C). It is unclear whether the 3 year carryback applies even to theft losses that may be considered to arise under Code Section 165(c)(2)(which may not be subject to the 10% adjusted gross income limitation).

23. CCA 200451030.

24. *Id.* If a taxpayer, who invested in the Ponzi scheme via a partnership, has a large amount of capital gain in the year the theft loss would be allowed, he may want to consider selling his partnership interest and taking what would generally be a long term capital loss.

25. GCM 34481. *See also* GCM 38161.

26. *See*, *e.g.*, *Premji v. Comm.* 139 F.3d 912 (1998).

27. CCA 200811016.

28. *Id.*

29. *See also* Code Section 111.

30. For example, the bankruptcy trustee may invalidate some of the payments or some of the later investors whose money went to the earlier investors may have a claim against the earlier investors.

31. *See* Code Section 1341. A deduction in the year of repayment, however, often will not reduce the taxpayer's tax liability by the same amount paid as a result of the initial receipt of income. Code Section 1341 aims to resolve this problem. When it applies, Code Section 1341 benefits the taxpayer by allowing a choice of either (1) deducting repayment of an amount previously included in income or (2) reducing tax liability for the year of repayment by the amount of the tax increase in the prior year attributable to receipt of the repaid income.

32. *Brockamp v. U.S.*, 519 U.S. 347 (1997).

33. *See* Code Section 2054.

34. *See* Code Section 642(h).

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