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Ponzi Scheme Tax Losses

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Introduction

The theft loss tax deduction is an extremely valuable tax deduction, and for many victims of a Ponzi scheme fraud, the tax deduction will have a cash value equal to 35% or more, [1] depending upon state and city income taxes. Investors who are subject to federal, state, and city income tax may find that their recovery from the tax loss is equal to almost 50% of their theft loss. [2]

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

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

Losses from Ponzi schemes are acknowledged by the IRS to be "theft losses." [3] Theft losses are deductible from a taxpayer's ordinary income. [4] Unlike capital losses, which are limited for both corporations and individuals, [5] theft losses are granted ordinary loss treatment [6] and are not subject to the 2% floor or the 80% limitation on itemized deductions. [7] Theft loss attributed to investing in a Ponzi scheme also is not subject to the 10% adjusted gross income limitations. [8]

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

[4] §165(a), (c)(3).

[5] *See* §§1211 and 1212.

[6] §165(h)(2).

[7] §§67(b)(3) and 68(c)(3).

[8] *See* §165(h)(1) and (2).

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

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

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

[10] Section 6511(a) requires the taxpayer to initiate a claim for a refund within three years from

the date the tax return was filed, or two years from the date the tax was paid, whichever period expires later.

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

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

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

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

Definition of Theft Loss for Tax Purposes

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

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[12] CCA 200811016.

[13] *See* Rev. Rul. 2009-9, 2009-14 I.R.B. 735, at 4 (citing Rev. Rul. 72-112, 1972-1 C.B. 60).

[14] Rev. Rul. 2009-9.

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

[15] *See Jensen v. Comr.*, T.C. Memo 1993-393 and *Berardo v. Comr.*, T.C. Memo 1987-433.

[16] *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956).

[17] *See Vietzle v. Comr.*, 37 T.C. 504, 510 (1961), *acq.*, 1962-2 C.B. 6.

[18] *See Jensen v. Comr.*, T.C. Memo 1993-393.

Amount of Theft Loss Deduction

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

[19] For an excellent description of the calculation of tax basis, see Rev. Proc. 2009-20, 2009-14 I.R.B. 749, §4.06.

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

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

[20] *Stahl Specialty Co. v. U.S.*, 551 F. Supp. 1237 (W.D. Mo. 1982). *See also* Rev. Rul. 81-207, 1981-2 C.B. 57; *Clifton v. Comr.*, 50 T.C.M. 647 (1985); *Gras v. Comr.*, 33 T.C.M. 1018, 1022 (1974); *Chiles v. Comr.*, 51 T.C.M. 772 (1986).

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

[21] CCA 200451030; *Jensen v. Comr.*, T.C. Memo 1993-393. *See also* Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

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

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

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

X cannot deduct a tax loss based on the IRA's losses; the loss of those funds is not deductible because those funds were never taxed. Even if X received a $100,000 distribution from the IRA account, there still would be no deductible loss. If a taxpayer has no basis in the IRA (for example, because the taxpayer claimed a deduction for IRA contributions or because the IRS has not taxed the growth in value in the IRA), the taxpayer cannot take a deduction for the economic loss in the IRA. [23] Generally, a taxpayer may take a miscellaneous itemized deduction for an IRA loss only after all amounts in all IRA accounts have been distributed and the total distributions are less than the taxpayer's unrecovered basis, if any. [24] The loss rule applies separately to each type of IRA. Thus, for a taxpayer to report a loss in a traditional IRA, all traditional IRAs owned by the taxpayer have to be liquidated. Similarly, for a taxpayer to report a loss in a Roth IRA, all Roth IRAs owned by the taxpayer have to be liquidated.

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

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

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

Character of Loss

The investor is entitled to an ordinary loss rather than just a capital loss. The IRS considers a Ponzi scheme theft loss to be a loss that is incurred in a transaction entered into for profit. [25]

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

Privity Requirement

There are significant limitations on a taxpayer's ability to deduct a theft loss. An essential element of theft under the law of most states is specific intent to obtain the victim's property. Implicit in this requirement is *a relationship of privity between the perpetrator and the victim*. [26]

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

Where a debtor-creditor relationship has been established, the loss suffered is a bad debt rather than a theft loss, even though the debtor's inability to pay is due to a theft. [27] A taxpayer is not entitled to a theft deduction where his investment in corporate stock or corporate debt is diminished in value (or becomes worthless) because of theft or embezzlement from the corporation; if such stock is sold or exchanged or becomes wholly worthless, any resulting loss is capital. [28]

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

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

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

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[29] *Compare Vietzke v. Comr.*, 37 T.C. 504 (1961) (theft loss allowed; taxpayer fraudulently induced to advance funds to corporations for stock subscriptions that were subsequently stolen; corporate entity merely a device to swindle investors) *and Bellis v. Comr.*, 61 T.C. 354 (1973), *aff'd*, 540 F.2d 448 (9th Cir. 1976) (securities sold directly by corporation to taxpayer; loss would have been allowed if fraudulent intent had been shown) *with Barry v. Comr.*, T.C. Memo 1979-215 (no theft loss deduction when securities purchased on open market) *and De Fusco v. Comr.*, T.C. Memo 1979-230 (no direct sale; lack of privity "fatal flaw" in taxpayer's case). *See* FAA 20073801F (Chief Counsel's Office advises taxpayer is not entitled to theft loss deduction for losses related to exercise of stock option; detailed discussion of case law).

Limitations on Deductions

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

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[30] Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

Theft Loss Carrybacks and Carryforwards

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

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[31] §172(b)(1)(A)(i) and (F)(ii)(I).

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

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

Timing of Theft Loss Tax Deduction

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

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

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[33] §165(e).

[34] Regs. §1.165-8(a)(2).

[35] *Id.*

[36] Regs. §1.165-1(d)(3).

[37] Regs. §1.165-1(d)(2)(iii).

There are two key phrases to keep in mind when reading these general rules about timing of the deduction. The first is "*reasonable prospect of recovery*." The second phrase is "*ascertain with a reasonable certainty*." The effect of these rules on the appropriate timing of a theft loss deduction is as follows:

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

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

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

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

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

The new law in 1954, that still applies today, adopted the principle that generally a theft was "sustained" in the year of discovery. However, this definition was tempered as it applies only to that portion or all of the theft loss that the taxpayer could identify as *not having any reasonable prospect of recovery*. [38] Until it was clear that a loss was assured and "closed and completed," no deduction was allowed. The law attempts to ensure that no deduction is allowed in the year of discovery or any other year unless the loss is assured.

[38] Whether a reasonable prospect of recovery exists is determined by reviewing all facts and circumstances. Regs. §1.165-1(d)(2)(i).

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

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

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

This court must determine what was a "reasonable expectation" as of the close of the taxable year for which the deduction is claimed. The situation is not to be viewed through the eyes of the "incorrigible optimist" [39] and hence, claims for recovery whose potential for success are remote or nebulous will not demand a postponement of the deduction. [40] The standard is to be applied by foresight, and hence, we do not look at facts whose existence or production for use in later proceedings was not reasonably foreseeable as of the close of the particular year. Nor does the fact of a future settlement or favorable judicial action on the claim control our determination if we find that as of the close of the particular year, no reasonable prospect of recovery existed.

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

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39 *Ramsay Scarlett & Co. Inc. v. Comr.*, 61 TC 795, 811 (1974), *aff'd*, 521 F.2d 786 (4th Cir. 1975).

40 *U.S. v. S.S. White Dental Mfg. Co.*, 274 U.S. 398, 402-03 (1927).

Another court has stated it as:

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

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

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

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

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

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

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

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

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

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

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42 Typically, a court will find that a taxpayer has a reasonable prospect of recovery if the taxpayer is engaged in good faith in efforts to recoup a loss, and the chance of recovery is "sufficiently

probable to warrant bringing a suit." *Scofield Est. v. Comr.*, 266 F.2d 154, 159 (6th Cir. 1959).

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

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

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

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

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

[43] *Parmelee Transp. Co. v. U.S.*, 351 F.2d 619 (Ct. Cl. 1965).

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

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

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

[44] *Rainbow Inn, Inc. v. Comr.*, 433 F.2d 640 (3d Cir. 1970) (citing *Comr. v. Duberstein*, 363 U.S. 278 (U.S. 1960)).

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

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

[45] *See Continental Illinois Corp. v. Comr.*, 94 T.C. 165 (1190). *See also Halliburton Co. v. Comr.*, 93 T.C. 758 (1989).

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

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

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

[46] *See Rainbow Inn, Inc. v. Comr.*, 433 F.2d 1640 (3d Cir. 1970).

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

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

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

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

[47] *Johnson v. U.S.*, 2008-1 USTC ¶50,142 (Fed. Cl. 2008); 2007-2 USTC ¶50,749 (Fed. Cl. 2007); and 2007-1 USTC ¶50,136 (Fed. Cl. 2006).

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

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

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

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

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

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

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

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

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

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

In denying the 1998 deduction, the court stated:

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

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

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

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[49] *Johnson v. U.S.*, 2007-1 USTC ¶50,136 (Fed. Cl. 2006).

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

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

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

The requirement that a taxpayer "ascertain with reasonable certainty" means that a taxpayer must *obtain a verifiable determination of the amount* the taxpayer will receive based on a resolution of the reimbursement claim before taking a theft loss deduction. Finally, requiring resolution of the claim with an objectively verifiable amount of loss is, as the government correctly notes, consistent with the plain meaning of "ascertain"... [as defined in a Dictionary of the English Language.]" [50]

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[50] *Id.* (emphasis added).

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

Other Sources of Tax Recovery

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

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

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

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

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

Rev. Rul. 2009-9 and IRS Safe Harbor (Rev. Proc. 2009-20)

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

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[51] 2009-14 I.R.B. 735.

[52] 2009-14 I.R.B. 749.

These two IRS documents form a good package and were drafted in record time for any government agency.

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

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

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

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

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

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

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

Determination	**Rev. Proc. 2009-20 Safe Harbor**	**The Law and Rev. Rul. 2009-9**
Ponzi Scheme Loss Is a Theft Loss Deductible as an Ordinary Loss	Agreed — result similar to Rev. Rul. 2009-9	Agreed — result similar to safe harbor
Amount of the Loss (Basis) Includes Phantom Income	Agreed — result similar to Rev. Rul. 2009-9	Agreed — result similar to safe harbor
Five-Year Carryback of Net Operating Losses Applies	Agreed — result similar to Rev. Rul. 2009-9	Agreed — result similar to safe harbor
Deduction Is Not Reduced by Application of a Certain Percentage or Dollar Limitation	Agreed — result similar to Rev. Rul. 2009-9	Agreed — result similar to safe harbor
Respect for Pass-Through Entities	Agreed — result similar to Rev. Rul. 2009-9	Agreed — result similar to safe harbor
Year of Discovery Deductibility	Agreement by IRS to a defined set of events	Taxpayer must rely on case law for similar results

Amount of Loss Recognized in Year of Discovery	Agreement by IRS to specific percentage amounts	Taxpayer must rely on case law for similar results
Waiver of Right to File Amended Returns	Potential tax benefit waived	Potential tax benefit available
Clawbacks and Right to Use Code §1341	Potential tax benefit waived	Potential tax benefit available
Interest Paid on Refunds	Potential economic benefit waived	Potential economic benefit available
IRS Administrative Issues	Administrative ease	Increased proof requirement, increased audit potential

Following a summary of general principles to be gleaned from the chart above, this article will then discuss the comparison of each of the determinations in the left column in greater depth.

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

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

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

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

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

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

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

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

Both Rev. Rul. 2009-9 and Rev. Proc. 2009-20 also make it clear that a theft loss from a Ponzi scheme is an ordinary loss and not a capital loss. Note that (as discussed above under the heading "Privity Requirement") in the case of a scheme involving securities fraud, a taxpayer will prevail only if there is a direct buyer-seller relationship linking the taxpayers and the defrauders. Mere reliance on the fraudulent representations of a corporate officer to make or maintain an investment may be insufficient. [54]

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[54] *Compare Vietzke v. Comr.*, 37 T.C. 504 (1961) (theft loss allowed; taxpayer fraudulently induced to advance funds to corporations for stock subscriptions that were subsequently stolen; corporate entity merely a device to swindle investors) *and Bellis v. Comr.*, 61 T.C. 354 (1973), *aff'd*, 540 F.2d 448 (9th Cir. 1976) (securities sold directly by corporation to taxpayer; loss would have been allowed if fraudulent intent had been shown) *with Barry v. Comr.*, T.C. Memo 1979-215 (no theft loss deduction when securities purchased on open market) *and De Fusco v. Comr.*, T.C. Memo 1979-230 (no direct sale; lack of privity "fatal flaw" in taxpayer's case). *See* FAA 20073801F (Chief Counsel's Office advises taxpayer is not entitled to theft loss deduction for losses related to exercise of stock option; detailed discussion of case law).

The Amount of the Loss (Basis) and Phantom Income

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

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

Rev. Rul. 2009-9 says it best:

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

[56] Rev. Rul. 2009-9 at 8.

Five-Year Carryback of Net Operating Losses

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

Deduction Not Reduced by Application of Percentage or Dollar Limitations

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

[57] §67(b)(3).

[58] §68(c)(3).

[59] *See* §165(h)(1).

Respect for Pass-Through Entities

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

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

Year of Discovery and Deductibility

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

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

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

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

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

(2) the lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in section 4.02(1) of Rev. Proc. 2009-20, and either —

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

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

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

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

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

[60] *Cramer v. Comr.*, 55 T.C. 1125, 1134 (1971); *Farber v. Comr.*, 53 T.C.M. 932 (1987); *McComb v. Comr.*, 36 T.C.M. 725 (1977).

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

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

[61] *See Russell v. U.S.*, 592 F.2d 1069 (9th Cir. 1979), *cert. denied*, 444 U.S. 946 (1979); *Kautzmann v. U.S.*, 86-2 USTC ¶9582 (1986); *Lary v. U.S.*, 608 F. Supp. 258 (D.C. Ala. 1985); *Juback v. U.S.*, 526 F. Supp. 78 (D.C.N.Y. 1981); *Botwinik Bros. of Mass., Inc. v. Comr.*, 39 T.C. 988 (1963).

Amount of Loss in the Year of Discovery

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

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

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

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

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

In addition, under the safe harbor, *after* calculating either one of these percentage amounts, *the Ponzi scheme investor must subtract any actual recoveries or potential insurance recoveries or guarantee type* to determine the final allowable theft loss in the discovery year. This includes recoveries from SIPC. [62]

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

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

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

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

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

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

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

Safe Harbor	Comparison	The Law
100%	Amount of quantified investment loss	100%
95% loss allowed (loss reduced by 5%)	Amount of quantified investment loss; no recovery sought	Loss reduced by any potential recovery from Ponzi scheme "Responsible Group"
75% loss allowed (loss reduced by 25%)	Amount of quantified loss permitted; third-party recovery sought	Loss reduced by any potential third-party recovery
Loss reduced by actual recovery received in 2008	Other reductions to quantified investment loss	Loss reduced by actual recovery received in 2008
Loss reduced by insurance policies in the name of the qualified investor		Loss reduced by insurance policies in the name of the qualified investor
Loss reduced by contractual arrangement that guarantees or otherwise protects against loss of the qualified investment		Loss reduced by contractual arrangement that guarantees or otherwise protects against loss of the qualified investment
Loss reduced by certain amounts payable from the Securities Investor Protection Corporation (SIPC)		Loss reduced by certain amounts payable from the Securities Investor Protection Corporation (SIPC)

Doctrine of Equality of Treatment and Nature of a Safe Harbor

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

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

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

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

Waiver of Tax Rights

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

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

Waiver of the Right to File Amended Returns Eliminating Income

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

Clawbacks and the Right to Use Code §1341

The Trustee in many Ponzi schemes has the right to recover funds paid to Ponzi scheme victims. Payments of Ponzi scheme profits may have to be repaid by the recipient. This is known as a clawback.

Under the safe harbor, the taxpayer must waive his/her right to make use of §1341 in the event the taxpayer must repay money in a clawback situation. Section 1341 in essence provides that if a taxpayer paid tax on income to which the taxpayer claimed a right in a prior year, and the taxpayer later was required to repay that income in a different year, the taxpayer may take the deduction for the repayment in the year in which the deduction is most tax-beneficial. That could be either the year in which the repayment was made or the year in which the later — repaid income was taxed. *This is the case even if the statute of limitations is closed with respect to the year in which the original tax was paid.*

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

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

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

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

Interest on Refunds

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

[65] Rev. Rul. 2009-9.

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

IRS Administrative Issues

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

[66] *Id.*

Ponzi Scheme Effect on Estates and Trusts

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

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

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

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

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

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

Clawback of Estate Funds

As discussed, a Ponzi scheme trustee may assert the "clawback" laws that will permit the trustee to recover Ponzi scheme distributions from an investor's estate. This situation could be very important to people who are using the safe harbor, as one of the requirements of the safe harbor is to waive the right to use §1341. [67]

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[67] Rev. Rul. 2009-9 at 9.

Clawbacks would seem to be deductible by the estate without §1341 for the year of payment as an estate expense or loss.

Carrybacks and Carryforwards

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

Deduction for IRA Losses

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

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[68] See "Madoff and Other Fraudulent Schemes: Tax and Planning Implications," available at http://business.cch.com/securitieslaw/news/03-20-09a.pdf (citing §408(d)(2)(A)).

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

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

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

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[71] *Id.*

IRAs may also be subject to clawbacks. If the funds being repaid were previously reported as income on the taxpayer's prior income tax returns, as would have been the case for required minimum distributions from IRAs, the taxpayer must be able to take a deduction for the repaid funds on his or her income tax return under the claim of right doctrine.

Tax Planning

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

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

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

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

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

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

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

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

Certain accountants, financial advisors, principals of feeder funds, boards of directors, and the various Ponzi scheme bankrupt estates may be just a few of the potential sources of recovery. If these sources of recovery are viable, the Ponzi scheme victim will need to carefully weigh the advantages and disadvantages of the postponed tax benefits that may result from a choice to actively pursue certain sources of recovery. However, it is important to note again that while the fact of litigation pursued by the taxpayer against these sources may indicate the existence of a prospect of recovery, it will not bar the deduction in the year of discovery if the likelihood of recovery can be shown to be remote. [73] Thus, a theft loss deduction would be allowable where a source of recovery against whom a claim is made is shown not to have sufficient assets to satisfy the judgment or liquidate the claim. [74] This also applies where a source of recovery is solvent but judgment-proof (e.g., where he has hidden the stolen property and his other assets are insignificant in value). As in all economic matters, the emphasis should always be on the maximum recovery of money from third parties before relying on the recovery from tax benefits.

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

74 *See Hendrick Ranch Royalties v. Comr.*, 1 T.C.M. 794 (1943); *Gottlieb Realty Co. v. Comr.*, 28 B.T.A. 418 (1933), *acq.*, XII-2 C.B. 6 (1933). *See also Mann v. Comr.*, 42 T.C.M. 1766 (1981) (suit by taxpayer against embezzler did not preclude deduction for loss in year of discovery because taxpayer knew he had no hope of recovery and filed the action purely out of anger).

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

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

The litigation lawyer will be needed not only to analyze avenues of recovery and litigation claims, but also as an expert who is well-versed regarding the viability or non-viability of any claims for recovery. [75] Therefore, he or she will be very helpful to the taxpayer in determining which avenues to pursue and which should be discontinued if their continuation would provide the IRS with a strong argument to disallow the theft loss in the year of discovery.

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

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

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

1. *Records.* The taxpayer must gather as complete a collection as possible of all financial records, going as far back in time as possible, involving the Ponzi scheme investment. These should include statements, income tax returns, and in some cases even estate tax returns. [76]

2. *Basis Calculations.* A calculation of the taxpayer's basis in the Ponzi scheme loss must be undertaken. The taxpayer's basis in each separate account must be calculated, as there may be different tax treatments and bases for estates, trusts, American resident individuals, nonresident American individuals, foreign individuals, domestic corporations, foreign corporations, and charities. [77]

3. *Sources of Recovery.* A detailed description should be made of the various sources of recovery that have been explored. [78] In areas where no recovery is possible or none is sought, a taxpayer may want to formally renounce rights to certain forms of recovery *to ensure that there is no question that the taxpayer had no reasonable belief of a prospect of recovery as to those rights.*

4. *Loss in Year of Discovery.* Once the sources of recovery have been inventoried, a determination should be made regarding the maximum potential loss that can be deducted for the discovery year. If a taxpayer is pursuing a source of recovery, it will be critical to ensure that the source is not viewed as offering a potential recovery of the maximum amount if that is not truly the case. Potential recoveries that are "open ended" in nature will harm the chances to claim the theft loss deduction in the discovery year. [79]

5. *Accounting Schedules and Forecasts.* Upon determining the amount of theft loss for which there is no potential for recovery in the discovery year, it is then important to prepare the appropriate accounting schedules. These should reflect the effect of the tax losses and the cash that may be recovered from amended returns and the tax-free income that may be earned because theft losses may be carried forward for 20 years. [80]

76 See Appendix X to Rev. Proc. 2009-20, requiring that the taxpayer has "written documentation to support the amounts reported."

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

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

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

80 *Id.*, stating that "the qualified investor may have income or an additional deduction in a year subsequent to the discovery year depending on the actual amount of the loss that is eventually recovered." (citing §1.165-1(d); Rev. Rul. 2009-9).

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

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

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

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

Tax Planning for Trusts

Trusts with assets invested in a Ponzi scheme generally will have much larger losses in the current year than they can use. Income tax planning for such trusts involves using the losses as soon as possible and making sure all of them can be used. To accomplish this, the trust must generate more taxable income. There are several ways this can be accomplished. First, additional gifts can be made to the trust. More trust assets generate more income, and the more income, the faster the losses can be used up. Second, leveraged sales can be made to the trust. Assuming that the assets sold to the trust produce a total return in excess of the interest rate on the note, the value of the trust will increase. Finally, wills can be amended to increase trust funding. [81]

81 See discussion in "Madoff and Other Fraudulent Schemes: Tax and Planning Implications." Available at < http://business.cch.com/securitieslaw/news/03-20-09a.pdf>.

Assume an elderly victim of the Ponzi scheme theft may have significant unused theft tax losses that can be used only as a carryforward to the next 20 years. This "income tax benefit" might be cut short with the death of the Ponzi scheme victim. Is it possible to plan the family situation to preserve these losses or use them to offset other income during the Ponzi scheme victim's life? One might ask, in a town such as Palm Beach, how many "tax marriages" or "tax mergers" might result. For example, unmarried Mr. X may be broke with a $20 million theft tax loss that he cannot use going forward because he has little or no income. On the other hand, the widowed Mrs. Y may have an income stream of $4 million a year and may really hate to pay taxes. Does a joint income tax return that permits Mr. X's net operating losses to be used by a future Mrs. X make this a wedding made in heaven? [82]

82 These questions, while not clearly answered by any known cases, Rev. Rul. 2009-9, or Rev. Proc. 2009-20, could be assumed answered in the negative under public policy argument. The Fifth Circuit in *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956), and the Tax Court in *Lincoln v. Comr.*, 50 T.C.M. 185, 189 (1985), both have stated clearly that if the taxpayer's activities in

connection with the theft loss are contrary to public policy, it would be valid grounds for denying a theft loss deduction. Given this assertion, it could easily be assumed that a marriage entered into solely for the purpose of receiving a theft loss deduction would be considered contrary to public policy. The burden of proving that the theft loss deduction was the sole purpose for entering into the marriage would, however, rest with the IRS, thus making this a viable option for couples willing to take the risk.

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

Conclusion

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

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