Insight Paper # 06:

Losses on Ponzi-type Investment Schemes

The IRS recently released guidance addressing the tax treatment of losses for individuals affected by Ponzi investment schemes. The IRS clarified that the guidance is not specifically for Madoff victims but for all individuals who have experienced losses from Ponzi-type investment schemes. Because of the economic downturn, the IRS reports that dozens of schemes have surfaced and that thousands of investors have been burned.

A Ponzi scheme for IRS purposes is considered a "specified fraudulent arrangement" that makes payments to investors from their own funds or funds paid by subsequent investors. Fictitious income is reported, as there is no actual profit earned. Such schemes pay and offer high returns to keep money flowing in from investors. This does not include situations in which brokers made bad investments by picking the wrong stocks. If you were actually invested in securities, your losses are governed by separate tax rules.

Ordinary theft loss. The guidance provides that investors in fraudulent investment arrangements are entitled to an ordinary theft loss under Internal Revenue Code Sec. 165, rather than just a capital loss. As a result, not only is the loss not restricted to a maximum $3,000 offset against ordinary income, but it can offset any ordinary income, including wages, with no limit. The loss is not subject to the personal loss limitations; however, only those who itemize deductions may claim it. If an investment advisor made poor investment decisions (as opposed to never making any investments), the investor would only be entitled to a capital loss rather than a theft loss.

The amount of the theft loss deduction includes the amount invested in the scheme, less any amounts withdrawn, any reimbursements, and any claims as to which there is a reasonable prospect of recovery. The deductible amount also includes any fictitious income reported to the investor in any year prior to the discovery of the theft that the investor included in gross income and paid tax on for that year.

To the extent an investor's theft loss deduction creates or increases a net operating loss in the year the loss is deducted, the investor normally may carry back up to three years and forward up to 20 years the portion of the net operating loss (NOL) attributable to the theft loss. If the loss is discovered in 2008, however, a special, more generous rule applies: the individual investor or proprietorship is treated as a small business that is eligible for the extended five-year NOL carryback period under the *American Recovery and Reinvestment Tax Act* .

CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS ADVISORS
6055 PRIMACY PARKWAY, SUITE 450 • MEMPHIS, TENNESSEE 38119
TEL: 901.761.3003 • FAX: 901.683.7901 • WWW.THEMARSTONGROUP.COM

Safe harbor treatment . Bilked investors of Ponzi schemes also have been given a streamlined, safe harbor route to take theft loss deductions. This safe harbor route simplifies the investor’s burden in proving when the loss took place, and it also expedites the process for the IRS's handling of these thousands of cases. The safe harbor, which the vast majority of investors are expected to use, provides a uniform approach for determining the year in which the loss occurred and a simplified method for calculating the loss amount.

The safe harbor allows the loss to be taken when a criminal complaint is issued against a promoter, rather than waiting until a conviction is handed down. Under the safe harbor, as much as 95 percent of the loss may be deducted, however, the loss amount cannot take into account the investor's net investment plus any actual recovery in the year of discovery and the amount of any recovery expected from private or other insurance (including insurance under the Securities Investor Protection Corporation (SIPC). The 95 percent applies to investors suing the promoter of the scheme. For investors suing third parties (persons other than the promoter), the percentage is reduced to 75 percent.

To take advantage of the safe harbor, an investor must complete the safe harbor statement, for which guidance is provided in IRS-published procedures. An investor claiming the safe harbor recovery amount must claim the entire loss for the year of discovery. An investor who previously filed original or amended prior year returns to claim the investment losses may claim the safe harbor amount but must identify the inconsistent prior year returns.

If you would like additional information about how to deduct investment fraud losses as theft losses, please give us a call. We would be happy to schedule an appointment to discuss the issue further with you.

The Marston Group, PLC

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