New Jersey Law Journal

VOL. 208 - NO 10 JUNE 11, 2012 ESTABLISHED 1878

IN PRACTICE

TAX LAW

Defining Ponzi-Scheme Losses

Victims of this type of fraud suffer theft losses, not capital losses, which can result in a personal net-operating loss

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A Ponzi scheme can be described as a fraudulent investment operation that pays returns to its investors from their own money or the money paid by subsequent investors, rather than from profit earned by the individual or organization running the operation. The Ponzi scheme usually entices new investors by offering higher returns than other investments, in the form of short-term returns that are either abnormally high or unusually consistent. Perpetuation of the high returns requires an ever-increasing flow of money from new investors to keep the scheme going.

This type of scheme is named for Charles Ponzi, who became notorious for using the technique in 1920.

The system is destined to collapse because the earnings, if any, are less than the payments to investors. Usually, the scheme is interrupted by legal authorities before it collapses, either because a Ponzi scheme is suspected, or because the promoter is selling unregistered securities. As more investors become involved, the likelihood of the scheme coming to the attention of authorities increases.

Since the guilty plea of Bernard Madoff in 2009, there have been other Ponzi schemes uncovered. In 2010, Antoinette Hodgson pleaded guilty to conspiracy to commit wire fraud in connection with her operation of a Ponzi scheme that fraudulently solicited $45 million for investments in real estate from over 20 New York and New Jersey investors.

Because of the many Ponzi schemes perpetrated, the Internal Revenue Service has issued a number of rulings which provide tax relief to such investors who have lost money in these schemes.

In Chief Council Advice (CCA) No. 201213022, the IRS determined that losses resulting from investments in funds that were used to operate a Ponzi scheme were theft losses, even though the victims invested through individuals other than the perpetrator of the Ponzi scheme, because the perpetrator intended to steal from the victims.

In CCA No. 201213022, the investments were placed indirectly as investors made investments in funds managed by fund managers. The investors based their decision to invest on information provided in an investment newsletter in which the perpetrator's skills as a manager were extolled and where the investment newsletter recommended investment in various funds controlled by fund managers and the perpetrator.

It was determined by the IRS that the taxpayers were victims of a Ponzi scheme and that the perpetrator was guilty of theft under state law. The critical question, however, was the issue of privity between the investors and the perpetrator. The doctrine of privity in the common law of contract provides that a contract cannot confer rights or impose obligations arising under it on any person or agent except the parties to such contract. The premise is that only parties to contracts should be able to sue to enforce their rights or claim damages as such.

Applying this doctrine to the Ponzi investment scheme, the question the IRS had to determine was whether the taxpayers (investors) lacked the required privity with the perpetrator because the taxpayers invested through the fund managers rather than directly with the perpetrator.

The Chief Council Memorandum examined a number of court decisions that addressed lack of privity between victims and perpetrators, typically in-

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volving taxpayers who purchased shares of stock on the open market and who later lost their investment because the officers or directors stole money from their corporation. In those cases, the court held that there was no criminal intent on the part of the perpetrators to deprive the taxpayers of their property, and therefore the losses were capital losses, not theft losses. Moreover, the courts in these cases held that theft losses were not available because of lack of privity. In the open market cases, the taxpayers' property ended up in the hands of the parties on the other side of the market transaction and not within the theft scheme itself.

In CCA No. 201213022, the IRS rejected the application of the open market cases and instead determined that the Ponzi scheme in question was more similar to that examined by the Tax Court in *Jensen v. Commissioner*, T.C. Memo. 1993-393, where the Tax Court found that the taxpayers were in privity with the perpetrators of a Ponzi scheme, because the individual through whom they invested was merely a broker or conduit to the scheme. In *Jensen*, the perpetrators of the scheme referred potential investors to business associates so that they could invest in the scheme. The Tax Court in *Jensen* held that there was no requirement that the investor have direct contact with the entity in which he invested and that the business associate acted as a conduit for the taxpayer's funds because the taxpayer gave the business associate those funds for the sole purpose of investing in the scheme.

The Chief Council Memorandum concluded that the facts were analogous to *Jensen* and, unlike the frauds alleged in the open market cases, the funds ended up in the scheme at the disposal of the perpetrator. The fund managers' role in soliciting funds that were paid into the scheme did not deprive the taxpayers of privity with the perpetrator. Thus, the IRS ruled that the taxpayers' losses were theft losses for purposes of Section 165, even though the taxpayers invested through individuals other than the primary perpetrator of the scheme.

Investors who are victimized by Ponzi schemes have to hurdle many obstacles in order to obtain a theft loss.

The principal basis for taking the loss is set forth in Revenue Ruling 2009-9. The Ruling provides that a cash method taxpayer who invested sums of money with another individual who held himself out as an investment advisor but was later shown to have used funds in a Ponzi-type scheme was entitled to a theft loss. A theft loss is not capital loss because it arises from a transaction entered into for profit and is an ordinary loss deductible against ordinary income. The Ponzi victim can use the loss against ordinary income, or carry the loss back or forward under the net operating loss (NOL) rules.

A theft loss in a transaction entered into for profit is deductible under Section 165(c)(2), not Section 165(c)(3), as an itemized deduction that is not subject to the personal loss limits in Section 165(h), or the limits on itemized deductions in Sections 67 and 68.

A theft loss in a transaction entered into for profit is deductible in the year the loss is discovered, provided that the loss is not covered by a claim for reimbursement or recovery with respect to which there is a reasonable prospect of recovery.

The amount of a theft loss in a transaction entered into for profit is generally the amount invested in the arrangement, less amounts withdrawn, if any, reduced by reimbursements or recoveries, and reduced by claims as to which there is a reasonable prospect of recovery. Where an amount is reported to the investor as income prior to discovery of the arrangement, and the investor includes that amount in gross income and reinvests this amount in the arrangement, the amount of the theft loss is increased by the purportedly reinvested amount.

A theft loss in a transaction entered into for profit may create or increase a net operating loss under Section 172, which can be carried back up to three years and forward up to 20 years. An eligible small business may elect either a three-, four- or five-year net operating loss carry-back for an applicable 2008 net operating loss.

A theft loss in a transaction entered into for profit, however, does not qualify for the special computation of tax provided by Section 1341, nor does it qualify for the application of Sections 1311-1314 to adjust tax liability in years that are otherwise barred by the period of limitations on filing a claim for refund under Section 6511.

Following the guilty plea of Bernard Madoff in his notorious Ponzi-style investment fraud case, the IRS has issues several pronouncements providing taxpayer relief. In 2009, the IRS also issued Rev. Proc. 2009-20. This Revenue Procedure provides an optional safe harbor under which qualified investors (as defined in the procedure) may treat a loss from a criminal fraudulent investment arrangement as a theft loss deduction when certain conditions are met. ■