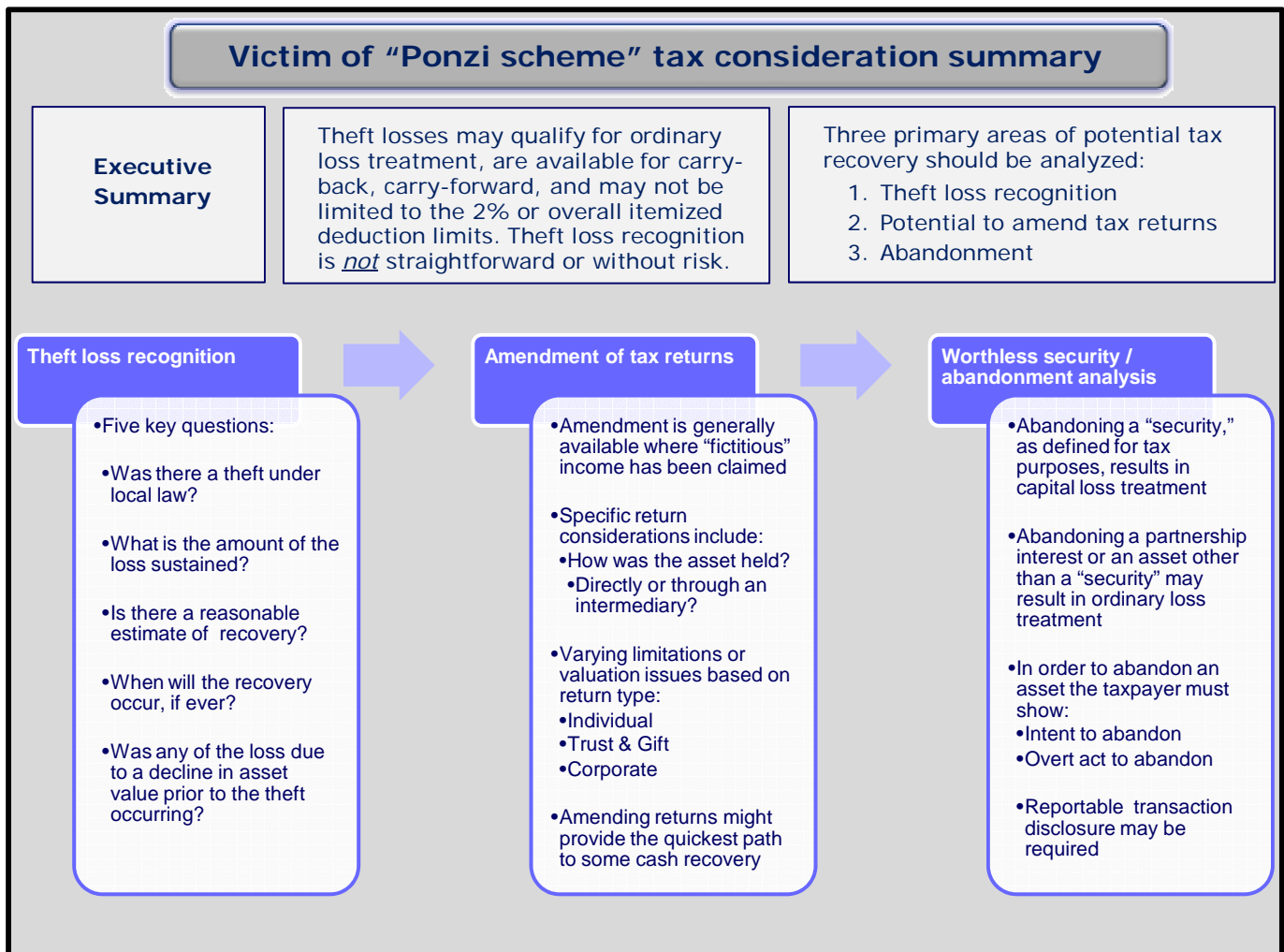


## Federal tax treatment of “Ponzi Scheme” theft losses

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The 2008 investing year is finally over, but it will not soon be forgotten. The S&P 500 Index opened on January 2, 2008, at 1,467.97 and closed on December 31, 2008, at 903.25, posting over a 38% loss in value. The year 2008 also may have handed investors one of the largest frauds committed in the history of the financial markets. These are certainly not small challenges for investors to overcome; however, one unlikely source of reprieve for U.S. taxable investors may lie in the Internal Revenue Code. Investors that suspect they have been involved in a fraudulent investment should be aware of how specific details can impact their personal tax situation. In many fraud cases, complete facts can be elusive; this stands to frustrate the tax process, as appropriate action is fact and circumstance specific. Many investors will face loose ends and uncertainty in the face of imperfect information; this does not make the tax reporting process easy. The goal of this summary paper is to provide a framework of options for investors embroiled in fraudulent investment schemes, many of whom will struggle with potential decisions based on circumstances yet to be determined.

The “Ponzi Scheme” is one classic type of pyramid sham, and some unfortunate investors in 2008 may be faced with the reality that they funded one of the world’s largest. In a classic Ponzi scheme, investors are supplied with higher than normal, yet fictional, rates of return on their investment. These high returns entice additional investment dollars into the scheme. In the early stages of the scheme, if an investor chooses to withdraw some or all of an investment, the redemption request is honored. The scheme “Managers” may even go so far as to pay a small profits dividend; the net result of this redemption activity is to further legitimize the investment in the eyes of the investor and other potential targets. Invariably, the published rates of return are falsehoods, redemption activity is funded by subsequent contributions, investment dollars are absconded with, and ultimately the structure collapses inward when redemption requests exceed new investment proceeds. Unfortunately, in most cases, by the time the impropriety is discovered, it is too late to recover anything more than a fractional share of the total invested assets.

From a tax perspective, an investor suffering a loss as a result of theft will generally have options to recognize a tax benefit that are not available under a non-fraudulent loss. Although a theft loss claimant may have more options for recognition of the loss, one key control element that may be lost relates to the timing of the loss. Under non-fraudulent circumstances, when an investor loses money in a financial instrument, the investor is generally able to determine the timing of recognition of the loss. Subject to anti-abuse rules such as §1091<sup>1</sup> losses from wash sales, §1092 straddles, and subject to method of accounting requirements such as §475 mark-to-market accounting methods, if an investor decides to liquidate a loss position they will realize a loss for tax purposes in the tax year of liquidation. Where a loss from theft is determined, the taxpayer will recognize the loss, to the extent ascertainable, in the taxable year in which such loss is discovered.<sup>2</sup> Nonetheless, timing differences aside, recognition of loss involving theft may grant a taxpayer additional options not available in typical capital loss transactions.

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<sup>1</sup> References to section, at times designated by the “§” symbol, refer to 26 U.S.C. – Internal Revenue Code  
<sup>2</sup> §165(e)



A typical loss, which is non-§1256 or another marked-to-market variant, related to an investment in a security will result in capital loss treatment. However, a loss involving a theft related to an investment transaction could give the taxpayer several different loss recognition options. Three potential options, which are the primary subject of this paper, include:

- I. Theft loss recognition
- II. Amendment of prior year open returns
- III. Worthless security recognition / abandonment of partnership interest

## **I. Theft loss recognition**

Code §165(a) allows deductions for any losses sustained that are not compensated for by insurance or otherwise. Code §165(c) limits the losses of individuals to losses incurred in either a trade or business, losses incurred in any transaction entered into for profit, or losses of certain personal property if from casualty or theft. Code §165(e) allows for the deduction of losses related to theft and provides that such losses shall be treated as being sustained during the taxable year in which the loss is discovered. Unlike capital losses, which come with limitations for both corporations and individuals,<sup>3</sup> theft losses are granted ordinary loss treatment<sup>4</sup> and are not subject to the 2% or 80% itemized deduction limitations.<sup>5</sup> In addition, while not free from doubt, a theft loss attributed to investing in a Ponzi scheme may not be subject to the 10% adjusted gross income limitations of §165(c)(3). If there is a silver lining for a taxable investor with substantial losses from a Ponzi scheme investment, it might just be treatment as a loss from theft.

An investor who loses money in a fraudulent scheme should qualify as having incurred losses in a transaction entered into for profit;<sup>6</sup> however, in order to qualify for theft loss treatment, the investor must also answer the following questions:

- A) Did a “theft” occur under local law?
- B) What was the total amount of the loss sustained?
- C) How much, if any, might reasonably be recovered through SIPC insurance, through related lawsuits and other proceedings, or from the fund directly?
- D) When might recoverable amounts actually be recovered?
- E) Was part of the loss due to a bona fide decline in the value of investments?

Courts have repeatedly accepted Ponzi schemes as theft losses within the meaning of §165(e).<sup>7</sup> Victims of frauds discovered in 2008 may need to wait for more facts to become available to make a determination of theft, but there does not need to be a prosecution prior to an investor claiming the deduction.<sup>8</sup> The Regulations under §165 provide for a definition of “theft”;<sup>9</sup>

<sup>3</sup> §§1211 & 1212

<sup>4</sup> §165(h)(2)

<sup>5</sup> §§67(b)(3) & 68(c)(3)

<sup>6</sup> §165(c)(3) provides additional limitations for individuals in certain cases

<sup>7</sup> Jensen v. Commissioner, T.C. Memo. 1993-393 and Berardo v. Commissioner, T.C. Memo. 1987-433

<sup>8</sup> Monteleone v. Commissioner, 34 T.C. 688 (1960)

<sup>9</sup> 26 CFR §1.165-8(d)

however, the courts have stated that whether a theft loss occurs depends upon the law of the jurisdiction where it was sustained.<sup>10</sup>

Often times a fund investment is multi-tiered, with fund operators accepting investments directly from individuals and corporations, as well as through “feeder” hedge funds and fund of funds operating in partnership form. For direct investors in a fraud, the determination of theft could be straightforward, that is, these persons invested directly in a fund based on false or misleading financial information provided to them directly by the fund manager. In cases where investors funded intermediaries that in turn provided investment funds to the fraudulent fund, the determination of who incurred a theft could be more difficult. In cases involving intermediaries, there are two possible scenarios: 1) the intermediary partnerships were fraudulently induced into investment, or 2) the individual investors of the intermediaries were fraudulently induced into investment by complicit general partners of the intermediaries.

Although the two scenarios may have different legal implications, there will, in all likelihood, be little difference from a tax perspective. In the early 1990s, a large Ponzi scheme was uncovered in Florida that involved thousands of investors spread across multiple jurisdictions. The IRS faced inconsistent taxpayer treatment of these losses, and during the course of auditing the investments, issued two field service advice memoranda (FSAs).<sup>11</sup> At issue was whether the loss should be accounted for at the partner or the partnership level, given that it was currently unknown whether the general partner of the partnership had participated in the fraud.<sup>12</sup> If the loss were to be accounted for at the partnership level, the so-called TEFRA partnership audit provisions would apply and the IRS could focus resources at the intermediary level.<sup>13</sup> If, however, the losses were to be accounted for at the individual level, the IRS was concerned that the statute of limitations would expire and thus the opportunity to contest deductions would be lost.

The IRS was considering issuing protective statutory notices of deficiency to each investor in order to preserve the ability to contest the timing and character of deductions. Ultimately, the IRS was comfortable having the partnerships issue valid statute of limitation extensions, as it was determined that a loss would be determined at the partnership level whether the general partner was the victim of fraud or complicit in the scheme. The IRS reasoned that if the alleged theft victimized the partnership, and the general partner acted in his capacity as partner, then clearly this was a partnership-level loss. Furthermore, under the Revised Uniform Limited Partnership Act, a general partner that commits fraud is deemed as not acting in its capacity as a partner, and the partnership is entitled to deduct the loss as if a non-partner had committed the embezzlement.<sup>14</sup> As such, under either of the two scenarios, the treatment of the loss as a theft loss should be accounted for at the partnership level. In any event, taxable investors in feeder funds that in turn invest in a fraudulent fund have a significant vested interest in how the feeder

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<sup>10</sup> Edwards v. Bromberg, 232 F. 2d 107 (5<sup>th</sup> Circuit 1956)

<sup>11</sup> FSAs are issued by the IRS National Office to respond to requests for guidance from IRS field personnel. FSAs provide non-binding advice to IRS staff and do not set precedent or establish uniform IRS treatment of positions.

<sup>12</sup> See 1994 FSA Lexis 555, June 3, 1994 and 1997 FSA Lexis 319, June 3, 1997

<sup>13</sup> Tax Equity and Fiscal Responsibility Act of 1982, see §§6221-6234

<sup>14</sup> See 1997 FSA Lexis 319, June 3, 1997



fund manager reports the loss. The proper treatment of losses at the feeder fund level (i.e., capital vs. ordinary) could result in a tax benefit differential of as much as 20%.

The amount of the loss sustained might seem simple at first blush; however, in the flow-through context, this determination becomes less clear. For investors to calculate the amount of their loss in dollar terms (as a percentage it very well might be 100%), they will first need to determine their adjusted cost basis. Within a partnership structure, partners receive increases in basis for their contributions<sup>15</sup> as well as for their distributive share of taxable income.<sup>16</sup> Investors pay tax currently on distributive share income even if no cash is received from the investment. In many cases a Ponzi scheme presents a double whammy: the principal investment amount is lost, and, where taxable distributive share allocations are made, cash tax payments have been remitted based on fraudulent performance gains. The longer a Ponzi operation runs without detection, the greater the potential tax cost outlay will be.

Dramatically disparate tax treatment could occur depending on how fund performance is reported to investors, and ultimately on how feeder funds report losses to investors. In a case where an operation has been running for decades with new investors accepted on a continuous basis, there could be a significant disparity in the treatment of taxable U.S. investors. Given the differential in capital gain and ordinary tax rates, and given that theft losses receive ordinary treatment, although not free from doubt, it is conceivable that a taxable investor that lost everything could come out ahead after tax on a nominal basis.

Consider a scenario where an investor contributed fifteen years ago to a feeder hedge fund invested exclusively in what turns out to be a fraudulent fund, identified as such during 2008 and recognized as a theft in the relevant jurisdiction. Assume additionally that the investor has never redeemed any funds and has been reported long-term capital gains each year on their Schedule K-1.

Assuming a \$1 million dollar initial capital contribution and a 12% annual compounded growth rate, and factoring in historic long-term capital gain rates for a taxpayer in the top marginal tax bracket, an investor of 15 years would chart the growth and tax basis of the investment as follows (ignoring time value considerations):

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<sup>15</sup> See §722, or in the case of a transfer of interest §742

<sup>16</sup> See §705, also see §703

Year	BOY Capital Account	% Return	EOY Capital Account	LTOG	LTOG tax rate	LTOG taxes paid
1993	1,000,000	12%	1,120,000	120,000	28%	33,600
1994	1,120,000	12%	1,254,400	134,400	28%	37,632
1995	1,254,400	12%	1,404,928	150,528	28%	42,148
1996	1,404,928	12%	1,573,519	168,591	28%	47,206
1997	1,573,519	12%	1,762,342	188,822	28%	52,870
1998	1,762,342	12%	1,973,823	211,481	28%	59,215
1999	1,973,823	12%	2,210,681	236,859	20%	47,372
2000	2,210,681	12%	2,475,963	265,282	20%	53,056
2001	2,475,963	12%	2,773,079	297,116	20%	59,423
2002	2,773,079	12%	3,105,848	332,769	20%	66,554
2003	3,105,848	12%	3,478,550	372,702	20%	74,540
2004	3,478,550	12%	3,895,976	417,426	15%	62,614
2005	3,895,976	12%	4,363,493	467,517	15%	70,128
2006	4,363,493	12%	4,887,112	523,619	15%	78,543
2007	4,887,112	12%	5,473,566	586,453	15%	87,968
2008	5,473,566	-100%	-0-			<b>872,868</b>

Going into 2008, the investor would show a beginning capital account balance of \$5,473,566 and would have paid cumulative long-term capital gain taxes of \$872,868. If in 2008 the investor qualifies for a 100% theft loss deduction, and is currently in the highest marginal tax bracket of 35%, the investor would receive a total tax benefit of \$1,915,748 (\$5,473,566 x 35%). Under this extreme example, the investor has written checks for \$1,872,868 (\$1 million to the fraud and \$872,868 to the IRS) and has received a total tax benefit of \$1,915,748.

It is not clear how the IRS, or Congress for that matter, would view such an accounting; but as details of 2008 frauds continue to emerge, there will undoubtedly be a few surprises. Although Ponzi schemes are probably not known for their reporting accuracy, and are actually incentivized to report not only attractive rates of return but also favorable tax treatment of those returns, the above example may remain hypothetical only. If the fact pattern regarding investment return were the same, but the investor had been receiving allocations of short-term capital gain and other ordinary tax rate items, there would be no rate arbitrage to benefit the investor<sup>17</sup>. Congress is aware that varying tax rates based on asset classification can result in net rate benefit to taxpayers; and in some instances, such as depreciation recapture under §1245 and §1250, have enacted legislation to equalize the impact on tax revenue. Feeder fund managers, as well as feeder fund investors, should also be aware that certain loss transactions may be required to be disclosed as a “reportable transaction” (see section III below for additional information).

Theft loss deductions under §165(e) have provided for a number of court opinions that can be looked to for guidance when determining appropriate tax treatment. One case potentially providing support for an ordinary deduction of adjusted partnership basis is *Pinson v.*

<sup>17</sup> This does not consider potential state tax rate arbitrage. For instance, an arbitrage would exist if a significant percentage of gain comes from treasury bill interest, which is taxed federally, but not at the state level, and there is no offsetting adjusted basis reduction at the state level.

*Commissioner* (T.C. Memo 1990-234). In this case, the taxpayer tried to deduct as a theft loss payments from a partnership that should have been paid but were not due to theft. In the *Pinson* opinion the tax court states “...we must decide whether a cash basis taxpayer is entitled to a theft loss deduction for allegedly embezzled income, the answer depends upon whether the taxpayer reported the allegedly embezzled funds and paid tax on them. If the taxpayer has not, no sophisticated analysis is necessary to reach the conclusion that no deduction is allowed.” Based on this finding, it would seem reasonable that if a taxpayer has reported income from a partnership then the taxpayer’s basis should be increased and accounted for as part of the loss.

As is often the case in analyzing a tax position, however, other available information may cast a potentially opposing and negative light on the prospective deduction. In *Kaplan v. United States*, 2007 U.S. Dist. LEXIS 59684 (M.D. Fla.2007), a taxpayer invested almost \$6 million into what turned out to be a Ponzi scheme involving over 800 investors and almost \$600 million of “investments.” Between 1992 and 1999, the investor reported having received \$4,136,433 in income and having paid \$1,125,967 in federal taxes. From 1992 to 1998, the tax rate on long-term capital gains was 28%; and in 1999, the tax rate on long-term capital gains was 20%<sup>18</sup>. During this period the taxpayer paid an average tax rate of 27.22% on the income, which would indicate that the majority of income received was in the form of long-term capital gains. The taxpayer first became aware of the potential fraud in late 2000 and on their 2001 income tax return claimed a theft loss deduction for the combined amount of their initial investment, their investment earnings, and, interestingly, the taxes paid on their investment earnings. The IRS asked the court to summarily dismiss the case, arguing: (1) the taxpayer did not prove they would not recover the funds, (2) a theft loss cannot be claimed for income allegedly earned, and (3) a theft loss cannot be claimed for taxes paid because the tax payments did not constitute a theft. The court ruled in favor of the IRS on all three points.

As with any technical argument, the specific facts of the case are crucial to understanding the final opinion. Not explained in the case background is the structure of the investment; for instance, did the taxpayer receive a partnership interest, did they fund some type of brokerage account, or was there some other more exotic type of arrangement? In this instance, although we are left with imperfect information, we may be able to glean some key points from the decision. Prior to the final decision in *Kaplan*, the IRS allowed the taxpayer to amend open year returns, thereby removing the previously claimed “phantom” capital gain income and receiving a refund of capital gain taxes paid. Arguing point one above, the IRS challenged the deduction of the theft loss by claiming that the taxpayer did not “show that it was reasonably certain as of December 31, 2001 [sic] that there was no reasonable prospect of recovering...funds.” On this point, the court reiterates the compelling case set forth by the IRS. The fact that the taxpayer decided to deduct the entire amount lost as a theft with no regard for ongoing litigation or reports of asset listings from the bankruptcy trustee probably did not help their cause. The key lesson on timing of a theft deduction, which in many cases might provide the most compelling evidence against taking the deduction, is for the taxpayer to make sure that they either have a solid basis

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<sup>18</sup> These rates assume the taxpayer was in the top marginal tax bracket for each year. From July 29, 1997, through July 21, 1998, the 28% rate applied to investments held for 12-18 months. For this hypothetical scenario, the 28% rate is assumed for 1998.

for taking a portion of the loss as a theft, or they can prove that fixed and determinable events have transpired that show with reasonable certainty that no recovery will occur.

On the issue of phantom income, or rather, income reported that increased the basis of the taxpayer's investment in the fraud, the court's findings were in lockstep with the IRS. In this case the taxpayer had reported and paid tax on income in years where the statute of limitations had expired. The IRS argued, and the court agreed, that the taxpayers did not provide sufficient proof that the income ever existed; therefore, they were incapable of proving there was a theft. Code §1311, which is discussed in more detail below, might have been available to provide relief in this situation, but the decision does not mention this. On this point in particular, it would be beneficial to have a complete set of facts as on its face this decision seems inequitable and possibly inconsistent with both §165 as well as other highlighted court decisions. Speculating on the causation of court decisions can be dangerous, but taxpayers arguing overly aggressive tax positions are probably not looked upon favorably. In this case, there is indication that the taxpayer's initial claim of invested amount and reported investment return is higher than the ultimate facts proved – both of these items would grant a more favorable tax deduction to the taxpayer, to the detriment of the IRS. The taxpayer also claimed actual taxes paid as a theft loss, which is inconsistent with the taxpayer's claim of theft loss on their increased adjusted basis. To this point, the court reasoned: "...the payment of income taxes on the income, while unnecessary, did not constitute an unlawful taking by the IRS. Without an unlawful taking, there can be no theft loss deduction for the taxes paid on the phantom income."

As highlighted in the *Kaplan* case, theft deductions that straddle the statute of limitations can produce some eyebrow-raising results. In another case, a theft loss discovered in 1965, yet spanning multiple earlier years, presented additional complexities. The final result in this case, however, was decided favorably for the taxpayer. In *B.C. Cook & Sons, Inc. v. Commissioner*, 59 T.C. 516 (T.C. 1972),<sup>19</sup> the taxpayer suffered a theft loss when an employee embezzled from the company and concealed the missing funds by inflating cost of goods sold. The employee accomplished this by creating sham companies, and then fraudulently issued payments to the companies for raw materials. As the inventory turned, the taxpayer claimed deductions for the as-yet-unknown embezzled amounts. After the statute of limitations had closed on the tax years to which the embezzled amounts were deducted, the taxpayer discovered the theft. Under Code §165(e), theft losses are sustained when discovered – the taxpayer claimed a theft loss and was allowed this loss by the tax court, giving the taxpayer a double deduction for the same loss. The IRS, citing the consistency doctrine, announced it would not follow the decisions of the tax court or the U.S. court of appeals in relation to this series of cases.<sup>20</sup> As with the *Kaplan* case, the *B.C. Cook* case provides an inequitable result, which has been highlighted in other decisions.<sup>21</sup> Given the events of the 2008 calendar year, it would not be surprising if these inconsistencies are litigated to final resolution over the upcoming years.

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<sup>19</sup> See also *B.C. Cook & Sons, Inc. v. Commissioner*, 65 T.C. 422 (T.C. 1975), aff'd. 584 F. 2d 53 (5<sup>th</sup> Cir. 1978)

<sup>20</sup> See Rev. Rul. 81-207 (I.R.S. 1981)

<sup>21</sup> See *Stahl Specialty Co. v. United States*, 551 F. Supp. 1237 (W.D. Mo. 1982)



Under §165, any amounts recoverable are not deductible as theft losses. The taxpayer will not be allowed a deduction for amounts covered by insurance, whether or not the taxpayer pursues the insurance claim, and amounts for which there is a “reasonable” chance of recovery. High-profile frauds are likely to be expedited from a liquidation standpoint; however, if pending litigation lingers, this may call into question the amount that ultimately could be recoverable. The determination of what constitutes a reasonable chance of recovery is based on the specific facts and circumstances of each situation that are known at the end of the tax year for which the deduction is claimed; additionally, the burden of proof is on the taxpayer to substantiate these amounts.

As highlighted in the *Kaplan* case above, the IRS has effectively argued against the taxpayer’s ability to claim theft losses on the basis that the taxpayer is unable to prove that the deduction does not have a reasonable chance of recovery. For an investor involved in a fraud to claim a valid theft loss, they will need to prove that no reasonable chance of recovery exists for the amount claimed as a deduction. The taxpayer’s desire to claim a loss as a theft is diametrically opposed to the taxpayer’s attempt to do everything in their power to try to recover their loss from the fraudsters. In fact, the harder and longer the taxpayer works at recovering their loss, the more they potentially make the case for not taking a theft deduction. Taxpayers potentially build a case against themselves as their lawsuits wind through the courts, the trustees list and schedule assets for sale, and additional asset searches are conducted.

In the case of lower-tier feeder funds, where an investor has received a partnership interest in exchange for their investment, the reasonable determination of recovery could be even more difficult. Ponzi schemes involving partnerships may involve legal pursuit of not only the general partner or managing member, but also the limited partners based on the timing of payments from the fund.<sup>22</sup> Under U.S. bankruptcy laws, successful fraudulent conveyance claims may allow a bankruptcy trustee to void certain transfers made or incurred before the date of the bankruptcy filing. Pursuit of these claims could involve multiple financial institutions in various jurisdictions, leading to protracted time frames and uncertain outcomes. While the courts have stated taxpayers need not be “incorrigible optimists” when considering recoverable amounts, they have also stated that “if a taxpayer’s prospect of recovery was simply unknowable at the end of the year at issue, then the taxpayer will not be entitled to take the theft loss deduction that year.”<sup>23</sup>

Investors may need to wait for additional facts to emerge to determine whether their investment holdings decreased as a result of deteriorating business conditions, theft, or both. If the answer is both, it will be necessary to determine at exactly what point the change occurred, as that demarcation will establish capital loss treatment versus ordinary theft loss treatment.<sup>24</sup> Based on the scale of the losses involved in any given situation, it would be welcomed for the IRS to issue specific advice, similar to the advice related to casualty losses issued after Hurricane Katrina, in order to guide taxpayers with their reporting requirements.

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<sup>22</sup> See 362 B.R. 624 (2007), *Bayou Group, LLC & Bayou Superfund, LLC v WAM Long/Short II, LP*

<sup>23</sup> See *Ramsay Scarlett & Co. v. Commissioner*, 61 T.C. 795 (T.C. 1974), and *Wagner v. US*, 2003 U.S. Dist. LEXIS 2122 (M.D. Fla. 2003)

<sup>24</sup> See IRS CCA 200811016 (I.R.S.2007)

## II. Amendment of prior year open returns

For individual and corporate taxpayers, the ability to amend prior year open returns, usually for the prior three years, might be an option if it is determined that taxable income amounts claimed were fictitious.<sup>25</sup> One note of caution here, based on existing IRS guidance, to the extent that distributions have been received in cash, they cannot be considered fictitious, or “phantom,” for this purpose.<sup>26</sup> For partnership filers the ability exists to amend prior year returns, but the process is more cumbersome.

For amended partnership procedures, Form 8082 is used. Form 8082 is also used in the case of individual partners who report inconsistent treatment between items from their Schedule K-1 and amounts entered on their individual returns. As discussed above, in tiered partnership structures involving lower-tier feeder entities, the determination of the types of losses will need to be made at the lower-tier partnership level. Thus, an individual partner in a feeder partnership that in turn is invested in a fraud will have a strong preference in how the intermediary partnership reports the loss. Although it is possible for an individual taxpayer to report inconsistent treatment on their individual tax return from the amounts received on their Schedule K-1, tax professionals may view this position as aggressive. Additionally, in situations where certain investors do not dispose of their entire partnership interest, the amount of the loss may be limited to the extent the activity is passive under section 469.

Not unlike the complications that exist for partnerships contemplating the amendment of open year returns due to phantom income and overstated assets, similar issues will exist related to estate and gift tax filings. The key component of any gift transfer or estate tax calculation centers squarely on valuation. If a significant component of the value of the estate or gift turns out to be a fraudulent investment, a litany of issues will be sure to follow. In the tax context for instance, the estate, or donor in cases of gifts, might realize they overpaid taxes based on a fraudulently inflated value. Unfortunately, the regulations focus on facts available at the applicable valuation date (date of gift, date of death, or alternate valuation date).<sup>27</sup> “Available,” in this context, means “discoverable by reasonable inquiry.”<sup>28</sup> Given the difficulty of independently uncovering a Ponzi scheme, an executor or a donor may find it very difficult to convince a court that the subsequent discovery of the fraud should be taken into account in the valuation of an investment that later is determined to be a Ponzi scheme. Amended returns or claims for refund should be considered only if it is determined after a full review of case law, some of which has acknowledged the effect of subsequent events,<sup>29</sup> that a sufficiently reasonable basis exists. For gift tax filers using Form 709, the amendment process calls for using the same forms but indicating that the updated filing is amending a prior filing. If amending Form 706, the executor should follow the special procedures detailed in the Form instructions. The executor also might consider an estate tax deduction for “losses during administration”<sup>30</sup>

<sup>25</sup> See Taylor v. United States, 81 AFTR 2d 98-1683, 98-1 USTC par. 50,354 (E.D. Tenn. 1998)

<sup>26</sup> See IRS CCA 2008110016 (I.R.S.2007)

<sup>27</sup> See Regs. §§20.2031-1(b) and 25.2512-1

<sup>28</sup> Necastro Est. v. Comr., 68 T.C.M. 227 (1994) and US. v. Simmons, 346 F. 2d 213 (5<sup>th</sup> Cir. 1965)

<sup>29</sup> See Noble Est. v. Comr., T.C.M. 2005-2 and cases cited therein

<sup>30</sup> §2054



instead of a valuation adjustment. If applying for a refund Form 843 should be used, attaching an amended Form 706 or Form 709 to show the calculations.

The prospect of receiving ordinary theft loss treatment might compel many investors to forgo amending prior open year returns in order to reduce prior capital gains, and instead attempt to treat the full loss as a theft. Theft loss will afford a taxpayer ordinary loss treatment, which can be much more favorable than capital loss treatment (see the example above where a long-term investor actually received a positive gain on investment post tax). As mentioned previously, §165(a) allows for the deduction of any loss sustained during the taxable year and not compensated for by insurance or otherwise. Code §165(c) limits losses in the case of individuals to: (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) losses not connected with a trade or business or entered into for profit if the loss stems from certain casualties or from theft. Although it may seem straightforward that taxpayers would classify their investment activity as being entered into “for profit,” thereby falling under §165(c)(2), there does exist a view in the professional community that *all* theft losses for individuals fall within §165(c)(3). This is important because under §165(c)(3) losses are allowed only to the extent they exceed 10% of adjusted gross income. For higher income taxpayers this limitation may severely diminish, or even eliminate, the benefit of the theft loss under section 165.

Code §67 limits certain itemized deductions in the case of individuals. Code §67(a) provides that “...itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.” However, §67(b) provides a specific exclusion for theft losses. Under §67(b) all miscellaneous itemized deductions shall be limited other than, among others, “the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c)...” Since either direct investment or investment in an investment partnership should be deemed as entered into for profit, the losses associated with the investment should not be limited by §67. Additionally, the losses are provided a specific exclusion under §68, which imposes an overall limitation on itemized deductions.

In addition to not being limited based on type of deduction under §67, or limited by adjusted gross income under §68, theft losses are available to be carried back to prior years and carried forward to future years. Code §172 describes the treatment of net operating loss deductions for individuals and other types of taxpayers. Theft losses for individuals are eligible for carryback, generally three years, which can be accomplished by amending returns using Form 1040X . A refund of prior year tax payments can also be expedited by using Form 1045 where applicable. The IRS must process a filed Form 1045 by the later of: (1) 90 days from the date the completed application for refund is filed, or (2) the last day of the month that includes the due date (including extensions) for the current period return. Additional theft losses, not used as part of the carryback process, can then be carried forward for a period of 20 years.

A less likely, but not unrealistic, situation might arise if the IRS denies a current deduction of theft loss where the taxpayer has already paid tax on prior fictitious income. To mitigate the net

tax loss a taxpayer would suffer in this situation, there exists a mechanism under §1311 to potentially remediate this problem. Code §1311 mitigation is available in situations where items have been erroneously reported and inconsistently treated by either the taxpayer or the IRS; it applies to situations where adjustment is not possible, such as in cases where the statute of limitations has expired and return amendment is not available. Mitigation is a complex area and can be hard to achieve; however, prior year errors that affect partner basis calculations are one example of a specific item to which this code section applies.<sup>31</sup> Under the above scenario, an IRS determination of disallowance may qualify for Code §1311 mitigation, as the IRS would have allowed for increases in tax basis during years of reported gain but subsequently disallowed losses on increased adjusted basis amounts.

### **III. Worthless security recognition / abandonment of partnership interest**

When a partnership interest becomes worthless, how is this accounted for? What is actually happening when this occurs? Is there a tax loss, and if so what is the character?

If the goal of the taxpayer is to realize a tax loss for a worthless investment, a logical starting point might be to consider Code §165(g), which describes conditions necessary for realizing losses on worthless securities. Under §165(g), securities are defined as 1) a share of stock in a corporation; 2) a right to subscribe for, or to receive, a share of stock in a corporation; or 3) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation. Regulations under §1.165-5(c) go on to state that if any security, as defined above, that is a capital asset becomes wholly worthless during the taxable year, a capital loss will be allowed as if a sale or exchange occurred on the last day of the year. Unfortunately, to the holder of a partnership interest, the discussion of worthless securities under §165(g) will provide little guidance. Fortunately there exists a mechanism, not unlike theft losses, that could provide partnership interest holders ordinary loss treatment.

In the partnership context, taxpayers could potentially realize benefit if their interest becomes worthless or they “abandon” their interest. Although §165 does not use the term abandon, Regulation §1.165-2(a) refers to obsolescence of non-depreciable property, which has become known as abandonment in case law. The regulation allows as an ordinary loss “a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any non-depreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use....” Section (b) of Regulation §1.165-2 precludes section (a) from applying to losses sustained from the sale or exchange of property, i.e., capital transactions. As discussed below, a partner must determine that their relinquishing of partnership interest does not constitute a sale or exchange to qualify for ordinary loss treatment.

The concept of abandonment as it relates to partnership interest is fairly well litigated.<sup>32</sup> Prior to 1993 however there was inconsistency cross circuit which created confusion. Much of the

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<sup>31</sup> See §1312(7)

<sup>32</sup> See *Citron v. Commissioner*, 97 T.C. 200 (1991), *Echols v. Commissioner*, 950 F.2d 209 (5<sup>th</sup> Cir. 1991)

confusion resulted from the interpretation of what constituted a “sale or exchange,” which is a crucial ingredient needed in recognizing a capital gain or loss provided in definitions set forth under §1222. Ultimately, this caused the IRS in July of 1993 to issue Revenue Ruling 93-80,<sup>33</sup> which sought to clarify issues surrounding the abandonment or worthlessness of partnership interests.

Revenue Ruling 93-80 summarizes two distinct situations as follows. In situation one, a partner abandons their partnership interest and at the time the only liabilities of the partnership are nonrecourse and are shared equally among the partners. Situation two is the same as situation one except that the abandoning partner in this instance does not share in the liabilities.

In situation one, the abandoning partner realizes a capital loss because the partner is deemed to receive a distribution under §752(b). This deemed distribution triggers the application of §731. Under §731(a), “any gain or loss recognized...shall be considered as gain or loss from the sale or exchange of the partnership interest...” In situation two, the abandoning partner may treat the loss as ordinary under §165(a). In this case §731 was not triggered as there was no actual or deemed distribution, thus there is no “sale or exchange” of partnership interest.

What then are the conditions necessary to prove abandonment of one’s partnership interest? To establish the abandonment of an asset, the taxpayer must show an intention to abandon the asset and must overtly act to abandon the asset. Establishing the abandonment of an asset, much like establishing the worthlessness of an asset, is based on all the pertinent facts and circumstances involved. Much like the analysis involved in considering a theft loss, determining whether abandonment of a partnership interest makes sense is very fact specific. Also, depending on the size of the loss taken on an abandonment of partnership interest, a taxpayer might have to disclose a reportable transaction as described in Regulations under §1.6011-4. For individuals who incur a loss of \$2 million or greater in a single year, or \$4 million or greater over multiple years, as a result of abandoning a partnership interest, Form 8886 may be required to report the transaction.<sup>34</sup> Before taking any action, investors should make sure they have all the pertinent facts in place and retain professional tax counsel to help guide their tax decision-making process.

One last option available to a taxpayer is a straightforward sale of the investment which would result in capital loss treatment. This might be the best option if a determination is made that qualifying for a theft loss or qualifying for abandonment is not possible. Under this scenario, the taxpayer will gain back the benefit of determining the timing of the loss, i.e., they can decide when a closing transaction takes place. This process might prove more difficult where an investor owns an interest in an investment partnership, as many subscription documents contain standard language around non-transferability of interest. This language exists to protect the fund from being deemed “publicly traded,” which could result in an entity-level tax. In cases where an investor is willing to take a complete capital loss and forfeit any potential for recovery, however, there is always the possibility of lining up an arm’s-length bona fide sale transaction to

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<sup>33</sup> 1993-2 C.B. 239

<sup>34</sup> See Rev. Proc. 2004-66 (I.R.S. 2004)



achieve this. To ensure loss recognition it is important that the sale occur at arm's length and must not be to a related party under §267.

With the 2009 investing year already under way, it would be nice to simply forget about certain events occurring within 2008. Unfortunately, many of the events occurring during 2008 may have long-term implications that could prove irresolvable even over the next twelve months. For investors trying to make sense of the myriad potential options for maximizing future benefit, or minimizing future loss, the best strategy -- as is always the case in a tax context -- is to be well armed with information.

If you have any questions on the above referenced information please feel free to contact Dave Earley at Deloitte Tax LLP, [dearley@deloitte.com](mailto:dearley@deloitte.com), 617-437-2096.

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