Income Tax Acetaminophen

How Recent IRS Guidance Can Alleviate the Pain Caused by Madoff and Other Ponzi Schemes

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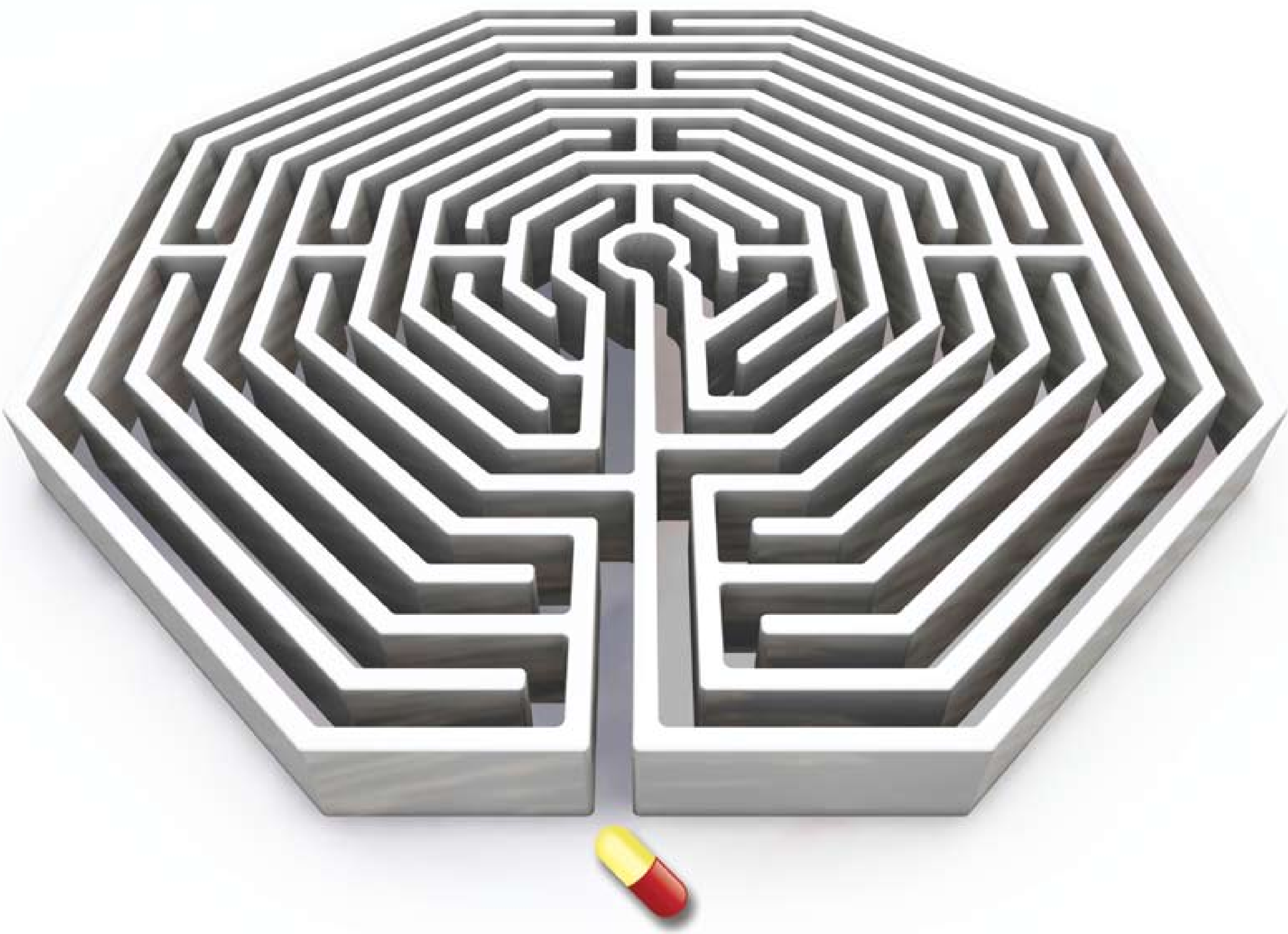

The recent economic downturn and credit crunch have shed light on several fraudulent investment schemes perpetrated on investors. Bernard Madoff is at the forefront. Madoff went to prison on July 15, 2009 to begin his 150-year prison term for his operation of a Ponzi scheme that reportedly resulted in investor losses of around $50 billion.[1] But Madoff is not alone. Several others have been accused over the past six months of conducting Ponzi arrangements resulting in reported combined losses of more than $12 billion.

The number of victims, magnitude of losses and low likelihood that such losses will be recovered has led to increased interest in the mechanisms available under the federal income tax laws for reducing the severity of victims' economic losses. The Internal Revenue Code (the Code) contains multiple provisions that, depending on the victim's particular facts and circumstances, may provide tax relief to a victim of a fraudulent investment scheme.[2]

The Code provision that has been most often applied in the Ponzi scheme context is Code Section 165(c)(3), which allows for the deduction of a loss of property arising from a theft.[3] Although existing authority establishes that victims of Ponzi schemes may qualify for the theft loss, certain ambiguities regarding the effect of the theft loss remain.

The Internal Revenue Service (IRS) recently addressed these remaining ambiguities by issuing two items of guidance: Revenue Ruling 2009-9 and Revenue Procedure 2009-20. Revenue Ruling 2009-9 clarifies several issues regarding the treatment and effect of theft losses resulting from fraudulent investment schemes. Revenue Procedure 2009-20 contains a safe harbor through which electing taxpayers can claim their theft loss resulting from the Madoff scheme in 2008.

Revenue Ruling 2009-9 – Untying Several Knots Under Existing Theft Loss Authority

Amount of Allowable Deduction

The most significant clarification made by Revenue Ruling 2009-9 relates to the amount of the deductible theft loss. In the Ponzi scheme situation where the promoter of the scheme is claiming that the value of investments is appreciating over time, the amount of the theft loss is limited to the amount of the taxpayer's cost basis.[4] Under prior authority, it was unclear how the cost basis would be measured in the Ponzi scheme context. Cost basis clearly includes the net amount of cash transferred from the investor to the Ponzi scheme promoter. But what about the fictitious earnings on the investments reported from the promoter to the investor over the years? Revenue Ruling 2009-9 resolves this issue. It clarifies that the amount of the deductible theft loss includes amounts reported to the investor as income in years prior to the year of discovery of the theft, provided that the investor includes those amounts in the investor's gross income for federal income tax purposes and reinvests those amounts in the arrangement.[5]

Revenue Ruling 2009-9 illustrates this result with an example in which the investor in Year 1 opened an investment account with the promoter and contributed $100 into the account. The investor instructed the promoter to use the $100 to purchase and sell securities on the investor's behalf and to reinvest any income and gains earned on the investment account. The investor contributed an additional $20 into the account in Year 3 and withdrew $30 from the account in Year 7. Thus, the net amount of cash contributed by the investor to the promoter equaled $90.

For each year from Year 2 to Year 7, the promoter reported that the investor's account generated $10 of income per year consisting of interest, dividends and/or capital gains. Thus, the total investment income generated by the investor's account over this time equaled $60. In Year 8, it was discovered that the promoter's investment and brokerage activity was a fraudulent Ponzi scheme, and that the reported investment activity and earnings were partially or wholly fictitious.

If the amount of the investor's theft loss deduction would be limited to the net amount of cash invested, the investor's deduction would equal $90. If, however, the investor could also take into account the amount of income reported to the investor from the promoter, the investor's theft loss deduction would equal $150. Revenue Ruling 2009-9 makes clear that the amount of the theft loss includes the amount of reported income on which the investor has paid tax.

Deductibility Limitations

Theft losses deductible under Code Section 165(c)(3) are deductible only to the extent that the amount of the loss from each theft exceeds $100 ($500 for 2009) and the amount of theft losses for the taxable year exceed 10 percent of the taxpayer's adjusted gross income.[6] Under existing authority, it was unclear whether the theft loss deduction would be subject to the aforementioned deductibility limitations in Code Section 165(h).

FOOTNOTES

1. A Ponzi scheme is an arrangement through which a promoter induces investors to pay money to the promoter through the prospect of large investment returns. The promoter often doesn't make any investments at all with the investors' funds and instead uses funds from later investors to pay off earlier investors. The promoter typically appropriates some of the investor funds for the promoter's personal use. *See* U.S. Securities and Exchange Commission website at: http://www.sec.gov/answers/ponzi.htm; Rev. Proc. 2009-20, 2009-14 I.R.B., Section 2.01 (April 6, 2009); Merriam-Webster's Online Dictionary, available at: http://www.merriam-webster.com/dictionary/ponzi%20scheme.
2. *See, e.g.*, I.R.C. § 165(a) ("Losses"); I.R.C. § 166 ("Bad Debts").
3. *See, e.g.*, *Jensen v. Commissioner*, T.C. Memo 1993-393; I.R.S. Chief Counsel Advice 200305028 (December 27, 2002).
4. *See* Treas. Reg. § 1.165-8(c), which provides that the amount deductible as a theft loss is determined under Treas. Reg. § 1.165-7(b), which provides that the amount deductible is the lesser of: (i) the fair market value of the property immediately before the casualty/theft; or (ii) the amount of the taxpayer's adjusted basis prescribed under Treas. Reg. § 1.1011-1 for determining the amount of loss from the sale or other disposition of the property. Treas. Reg. § 1.1011-1 provides that the basis for determining the amount of gain or loss from the sale or other disposition of the property is its cost as prescribed in Code Section 1012.
5. *See* Rev. Rul. 2009-9, Issue 4.
6. *See* I.R.C. § 165(h).
7. *See* I.R.C. § 165(f), I.R.C. § 1211(b) and I.R.C. § 1221(b).
8. *See* Rev. Rul. 2009-9, Issue 1.
9. *See id.*

The deductibility limitations in Code Section 165(h), however, apply only to theft losses of personal property under Code Section 165(c)(3), as opposed to theft losses incurred in connection with a transaction entered into for profit under Code Section 165(c)(2). Since an investor transferred money to the Ponzi scheme promoter presumably with the intention of making profit on the promoter's investments, the investor's theft loss was likely incurred under Code Section 165(c)(2). Claiming the deduction under Code Section 165(c)(2), however, could result in the loss being treated as incurred in connection with a capital asset and being subject to the limitations on deductibility of a capital loss.[7]

Revenue Ruling 2009-9 provides taxpayers with the best of both worlds. On the one hand, the loss incurred in connection with the fraudulent investment scheme qualifies as a theft loss, rather than an investment loss.[8] Accordingly, the loss is deductible against ordinary income and is not subject to the capital loss limitations.[9]

On the other hand, the loss is considered deductible under Code Section 165(c)(2) as a loss incurred in connection with a transaction entered into for profit, rather than a personal loss.[10] As a result, the theft loss is not subject to the deductibility limitations in Code Section 165(h).[11] Furthermore, Revenue Ruling 2009-9 points out that theft loss deductions are exempted from the limitations on deductibility of itemized deductions under Code Sections 67 and 68.[12]

The recent legislation provides that an eligible business taxpayer can elect to carryback an applicable 2008 net operating loss over a three-, four- or five-year carryback period.

Carryback Period for Theft Losses

Revenue Ruling 2009-9 clarifies that most individual taxpayers with a 2008 net operating loss arising from a theft loss can elect to carry back that loss over a period of up to five years.[13] A net operating loss can generally be carried back two years and carried forward 20 years.[14] Theft losses, however, are subject to a more favorable three-year carryback period.[15]

Recent legislation further extended the carryback period for applicable 2008 net operating losses incurred by an eligible small business taxpayer.[16] An "eligible small business" means a corporation, partnership or sole proprietorship that has average annual gross receipts of $15 million or less during the three taxable year periods ending with the taxable year in which the loss arose.[17] Theft losses allowable under Code Section 165(c)(2) or (3) are treated as attributable to a trade or business for purposes of the net operating loss deduction.[18] As a result, Revenue Ruling 2009-9 concludes that a theft loss sustained by an individual after Dec. 31, 2007, is treated for net operating loss deduction purposes as though it was incurred by a sole proprietorship.[19] Accordingly, Revenue Ruling 2009-9 concludes that a theft loss incurred by an individual with average annual gross receipts not exceeding $15 million can qualify for the extended net operating loss carryback applying to applicable 2008 net operating losses.[20]

An applicable 2008 net operating loss means the taxpayer's net operating loss for any taxable year ending in 2008 or, at the taxpayer's election, any taxable year beginning in 2008.[21] As discussed below, Revenue Procedure 2009-20 provides a safe harbor through which theft losses resulting from the Bernard Madoff scheme and potentially other fraudulent investment schemes may be deducted in 2008. Thus, the IRS is apparently contemplating that a substantial portion of theft losses claimed as a result of the Madoff scheme, and perhaps other recently alleged Ponzi schemes, will qualify as applicable 2008 net operating losses.

The recent legislation provides that an eligible business taxpayer can elect to carryback an applicable 2008 net operating loss over a three-, four- or five-year carryback period.[22] Thus, Revenue Ruling 2009-9 indicates that taxpayers, including individuals, with average gross receipts of $15 million or less, who claim a theft loss in 2008, may elect to carryback a net operating loss resulting from that theft loss over an extended period of up to five years.

Other Issues

Revenue Ruling 2009-9 indicates the IRS position on two other issues relating to theft losses incurred in connection with a fraudulent investment scheme. First, the IRS takes the position that investors are not entitled to calculate under the alternative method in Code Section 1341 their tax liability for the tax year in which the loss is deducted.[23]

Second, the IRS takes the position that taxpayers cannot invoke the mitigation provisions of the Code to adjust their tax liability for years for which the statute of limitations for filing a claim for credit or refund has expired.[24] Thus, the IRS position is that taxpayers cannot use the mitigation provisions to adjust for the taxation of fictitious income

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10. *See* Rev. Rul. 2009-9, Issue 2.
11. *See id.*
12. *See id.* Code Section 67 provides that miscellaneous itemized deductions are deductible only to the extent the aggregate amount of the deduction exceeds two percent of the taxpayer's adjusted gross income. See I.R.C. § 67(a). Losses deductible under Code Section 165(c)(2) or (3) are explicitly excepted from the aforementioned two percent limitation. *See* I.R.C. § 67(b)(3). Code Section 68 provides an overall limit on itemized deductions based on a percentage of the taxpayer's adjusted gross income or total itemized deductions. *See* I.R.C. § 68(a). Again, losses deductible under Code Sections 165(c)(2) or (3) are explicitly excepted from the aforementioned overall limit. *See* I.R.C. § 68(c)(3).
13. *See* Rev. Rul. 2009-9, Issue 5.
14. *See* I.R.C. § 172(b)(1)(A).
15. *See* I.R.C. § 172(b)(1)(F).
16. *See* American Recovery and Reinvestment Act of 2009, Section 1211, Pub. L. No. 111-5, 123 Stat. 115 (February 17, 2009).
17. *See* I.R.C. § 172(b)(1)(H)(iv).
18. *See* I.R.C. § 172(d)(4).
19. *See* Rev. Rul. 2009-9, Issue 5. A theft loss is generally "sustained" in the taxable year in which the taxpayer discovers the loss. *See* I.R.C. § 165(e).
20. *See id.*
21. *See* I.R.C. § 172(b)(1)(H)(ii).
22. *See* I.R.C. § 172(b)(1)(H)(i)(I).
23. *See* Rev. Rul. 2009-9, Issue 6, Code Section 1341 and I.R.C. § 1341(a)(4) and (5).
24. *See* Rev. Rul. 2009-9, Issue 7.
25. The statute of limitations for filing a claim for credit or refund expires upon the later of: (i) three years from the time the return was filed; or (ii) two years from the time the tax was paid. *See* I.R.C. § 6511(a). Assuming filing of income tax returns and payment of tax on the extended due date of October 15 of each year, the statute of limitations is currently open for 2005 (filing and payment on October 15, 2006) and subsequent years.
26. *See* Rev. Rul. 2009-9, Issues 4 and 7.
27. *See* Rev. Proc. 2009-20, Section 5.01.

reported by the promoter during all years prior to 2005.[25] The IRS takes the view that the income reported to the investor from the promoter during each year was properly included in the investor's gross income for federal income tax purposes and can be recovered through a theft loss deduction.[26]

Revenue Procedure 2009-20 – A Safe Harbor for Taxpayers Claiming a Theft Loss Deduction

Revenue Procedure 2009-20 provides an optional safe harbor through which taxpayers can claim their theft losses from fraudulent investment arrangements, such as the scheme confessed by Madoff, without risk of IRS challenge.[27]

Timing of Deduction

The IRS has provided the safe harbor to address the primary difficulty in establishing entitlement to a theft loss deduction – timing – i.e., proving the tax year in which all or some part of the theft loss is deductible.[28] The problematic timing issue is discussed in Revenue Ruling 2009-9. A loss is generally deductible in the year in which it is sustained.[29] A theft loss is treated as sustained in the year in which the taxpayer discovers the loss.[30] The deductibility of the theft loss, however, is further deferred to the extent there exists in the year of discovery a claim for reimbursement with respect to which there is a reasonable prospect of recovery.[31] Any portion of the theft loss for which there is a reasonable prospect of recovery cannot be deducted until the tax year in which it can be ascertained with reasonable certainty whether the recovery will be made, for example, through a settlement, adjudication or abandonment of the claim.[32] Whether a reasonable prospect of recovery exists is a question of fact to be determined based on all the facts and circumstances.[33]

Proving that all or any portion of a theft loss is not subject to a reasonable prospect of recovery can be difficult and may defer the deduction of the theft loss for multiple years. In the Madoff situation for example, the court-appointed trustee is still investigating the value of assets owned by Madoff and his investment advisory company, Bernard L. Madoff Investment Securities LLC. In fact, as recently as July 2, 2009, federal marshals took possession of Madoff's $7 million Manhattan penthouse purportedly to enable the penthouse to be sold with the proceeds benefitting investors.[34]

In addition, there may be potential claims for recovery against other parties who may be determined to have participated in Madoff's fraud, such as other employees of Madoff's firm. Furthermore, the court-appointed trustee may be able to "claw back" assets that were fraudulently transferred by Madoff to others in prior years.[35] Some investors may have third party claims. In sum, the process of sorting through the wreckage of a fraudulent scheme to determine what value may be left for the survivors is a difficult and time consuming process that may not be completed for quite some time.

As a recognition of the difficulty faced by a taxpayer in proving deductibility of a theft loss by showing a lack of reasonable prospect of recovery, the IRS has provided the optional safe harbor in Revenue Procedure 2009-20 through which taxpayers can deduct a set percentage of their theft loss resulting from the Madoff scheme, and possibly other recently alleged fraudulent investment schemes, in their 2008 tax year.

Eligibility for the Safe Harbor

The safe harbor applies to taxpayers who are "qualified investors," which basically means any U.S. citizen, resident or domestically organized entity that transferred cash or other property directly to a "specified fraudulent arrangement" without actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public.[36] A "specified fraudulent arrangement" is essentially a Ponzi scheme. It is defined as an arrangement in which the promoter (referred to in the Revenue Procedure as the "lead figure") receives cash or other property from investors, purports to earn income for the investors, reports income amounts to the investors that are partially or wholly fictitious,

28. For some theft losses, taxpayers have difficulty establishing that the loss resulted from a theft. A "theft" for federal income tax purposes includes any criminal appropriation of another's property for the use of the taker, including theft by swindling, false pretenses and any other form of guile. *See Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956). *See* Rev. Rul. 72-112, 1972-1 C.B. 60. *See, Jensen v. Comm'r*, T.C. Memo 1993-393.
29. *See* I.R.C. § 165(a).
30. *See* I.R.C. § 165(e).
31. *See* Treas. Reg. § 1.165-8(a)(2); Treas. Reg. § 1.165-1(d)(2).
32. *See* Treas. Reg. § 1.165-1(d)(2)(i), (3).
33. *See* Treas. Reg. § 1.165-1(d)(2)(i).
34. *See* Associated Press, *Marshals Seize Madoff Penthouse*, The Wall Street Journal, *July 2, 2009* at: http://online.wsj.com/article/SB124655537756287145.html.

makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement, and appropriates all or some of the investors' cash or property.[37]

Thus, the safe harbor applies only to taxpayers who transferred funds directly to the Ponzi scheme promoter and does not apply to taxpayers who invested in the Ponzi scheme indirectly through a "feeder fund" – i.e., a separate fund or entity that received funds from investors and invested such funds in the Ponzi scheme.[38] In this situation, however, the feeder fund may itself be a "qualified investor" eligible for the safe harbor.[39]

Deductibility of the Theft Loss Under the Safe Harbor

The IRS will not challenge theft loss deductions claimed in the tax year and in the amount prescribed by Revenue Procedure 2009-20, provided that the taxpayer complies with certain procedural requirements discussed below.[40]

1. Timing of the Safe Harbor Theft Loss Deduction. The theft loss must be deducted in the "discovery year;" i.e., the taxable year of the investor in which the indictment, information or complaint is filed charging the promoter under state or federal law with the commission of fraud, embezzlement or a similar crime constituting a theft for federal income tax purposes.[41] Thus, calendar-year taxpayers who sustained losses as a result of the Madoff scheme would deduct their theft losses under the safe harbor in 2008 because the United States government filed its complaint against Madoff on Dec. 11, 2008, alleging federal securities fraud violations.[42]

> The specified percentage of the qualified investment that can be deducted differs depending on whether the taxpayer is seeking a potential third party recovery.

2. Amount of the Safe Harbor Theft Loss Deduction. The taxpayer can deduct a specified percentage of the excess of the taxpayer's "qualified investment" over the amount of the taxpayer's actual and potential insurance/SIPC recovery.[43] The "qualified investment" is essentially the net assets contributed to the fraudulent investment arrangement plus the reported income from the arrangement included in the taxpayer's gross income for federal income tax purposes. More specifically, the "qualified investment" is defined as the excess of: (i) the sum of: (a) the total amount of cash and basis of property that the taxpayer invested in the arrangement in all years; plus (b) the total amount of net income with respect to the arrangement that, consistent with the information received from the arrangement, the taxpayer included in income for federal income tax purposes for all taxable years prior to the discovery year, including taxable years for which a refund is barred by the statute of limitations; over (ii) the total amount of cash or property that the taxpayer withdrew in all years from the arrangement.[44]

Certain items are explicitly excluded from the definition of a "qualified investment," such as: (i) fees paid to the promoter and deducted for federal income tax purposes and (ii) income reported from the promoter to the taxpayer and not included in the taxpayer's gross income for federal income tax purposes.[45]

The specified percentage of the qualified investment that can be deducted differs depending on whether the taxpayer is seeking a potential third party recovery. A "potential third party recovery" is basically a claim for recovery against anyone other than:

- SIPC;
- insurers;
- contractually obligated guarantors;
- the promoter and his/her co-conspirators;
- the investment vehicle used to conduct the fraudulent investment arrangement and its employees, officers or directors;
- the liquidation, receivership, bankruptcy or similar estate established in order to recover assets for the benefit of investors or creditors; and
- parties that are subject to claims brought by a trustee, receiver or other fiduciary on behalf of the aforementioned liquidation, receivership, bankruptcy or similar estate.[46]

If a potential third party recovery is being pursued, the theft loss deduction will be calculated by multiplying the taxpayer's qualified investment by 75 percent.[47] If a potential third party recovery is not being pursued, the taxpayer will multiply the qualified investment by 95 percent.[48] Thus, the IRS safe harbor essentially assumes that a taxpayer seeking recovery from third parties has a reasonable prospect of recovering one-quarter of the loss and that a taxpayer not seeking third party recoveries has a reasonable prospect of recovering five percent of the loss.

35. It should be noted that the SEC filed a motion on July 20, 2009 in its case against R. Allen Stanford in which the SEC sought to preclude the receiver from pursuing "clawbacks" of funds paid to investors as return of principal and restrict the receiver to only pursuing "clawbacks" of funds paid out as profits. This SEC motion may signal an important shift in SEC policy and may be followed by similar SEC actions in other Ponzi scheme cases, such as *Madoff*.
36. *See* Rev. Proc. 2009-20, Section 4.03.
37. *See* Rev. Proc. 2009-20, Section 4.01.
38. *See* Rev. Proc. 2009-20, Section 4.03(4).
39. *See id.*
40. *See* Rev. Proc. 2009-20, Section 5.01.
41. *See* Rev. Proc. 2009-20, Sections 5.01(2), 4.04.
42. *See* Complaint, U.S. v. Madoff, 08 MAG 2735 (S.D.N.Y. Dec. 11, 2008).
43. The Securities Investor Protection Corporation (SIPC) is a governmentally created organization that restores missing funds to investors who have transferred amounts to brokerage firms that have since filed for bankruptcy or encountered financial difficulties. *See* www.sipc.org.
44. *See* Rev. Proc. 2009-20, Section 4.06(1).
45. *See* Rev. Proc. 2009-20, Section 4.06(2).
46. *See* Rev. Proc. 2009-20, Section 4.10.
47. *See* Rev. Proc. 2009-20, Section 5.02(1)(b).
48. *See* Rev. Proc. 2009-20, Section 5.02(1)(a).
49. *See* Rev. Proc. 2009-20, Section 5.02(2).
50. *See* Rev. Proc. 2009-20, Section 4.07.
51. *See* Rev. Proc. 2009-20, Section 4.08.
52. I.e., [75% multiplied by $1 million] minus $500,000.
53. I.e., the $1 million qualified investment minus the sum of: (i) the $250,000 previously deducted as a theft loss; and (ii) the $500,000 SIPC recovery.
54. *See* Treas. Reg. § 1.165-1(d)(3).
55. *See* Rev. Rul. 2009-9, Issue 3.
56. *See* Treas. Reg. § 1.165-1(d)(2)(iii); I.R.C. § 111.

Once the appropriate percentage has been applied to the qualified investment, the amounts of the actual and potential SIPC/insurance recovery must be subtracted in order to determine the amount of the theft loss deductible under the safe harbor.[49] The actual recovery refers to amounts actually received in the discovery year from any source.[50] The potential SIPC/insurance recovery basically refers to the sum of the amounts of all actual or potential claims for reimbursement for the taxpayer's loss made to SIPC, insurers and contractual guarantors.[51]

There may be an additional theft loss deduction in a subsequent year. For example, assume that a taxpayer has a qualified investment of $1 million and a potential SIPC recovery in the amount of $500,000. If pursuing third party recoveries, $250,000 could be deducted as a theft loss under the safe harbor in 2008.[52] If the taxpayer does not recover any amounts in years subsequent to 2008 other than its $500,000 SIPC recovery, the remaining $250,000 of qualified investment[53] could be deducted in a subsequent year in which it is determined with reasonable certainty that no further recovery will be made.[54]

To the extent that the taxpayer reduced the amount of the deducted theft loss to take into account potential recoveries that were actually received in a subsequent year, such recovery is not included in income in such later year.[55] Thus, in the prior example, if the $500,000 SIPC recovery was actually received in 2009, that $500,000 would not be included in 2009 income for federal income tax purposes.

If a taxpayer deducts an amount that is not subject to a reasonable prospect of recovery, but it turns out that the deducted amount is actually recovered in a subsequent tax year, that recovered amount is included in income for federal income tax purposes in the year of recovery. In the prior example, assume that the taxpayer deducted the final $250,000 of the theft loss in 2010 under a claim that it was reasonably certain that there was no longer any reasonable prospect of recovering that amount because all remaining third party claims had been abondoned. In 2011, however, the taxpayer unexpectedly receives a recovery of $50,000 because additional promoter assets are located and paid to investors. The $50,000 would be included in income in 2011 because that amount reflects the recovery of an amount for which the taxpayer received a tax benefit in an earlier year.[56]

Procedure for Claiming the Safe Harbor Theft Loss Deduction

In order to claim the theft loss deduction under the safe harbor, certain procedural requirements must be satisfied. First, the taxpayer must mark "Revenue Procedure 2009-20" at the top of the Form 4684, Casualties and Thefts, included in the federal income tax return for the discovery year.

Second, the taxpayer must complete and sign a statement titled: "Statement by Taxpayer Using the Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement" (Statement)." The form of the Statement is attached as Appendix A to Revenue Procedure 2009-20. The Statement must be attached to the federal income tax return for the discovery year.

In executing the Statement, the taxpayer represents under penalties of perjury that the taxpayer is eligible for the safe harbor relief and has written documentation to support the amounts used in calculating the theft loss deduction under the safe harbor. The taxpayer also agrees to comply with the conditions and agreements set forth in the Statement and Revenue Procedure 2009-20. In particular, if the taxpayer has filed any original or amended returns to exclude or recharacterize income reported by the promoter with respect to the fraudulent investment arrangement, the taxpayer must list the tax year(s) for which such returns were filed and the date(s) of filing and agree to all adjustments or actions necessary to comply with the conditions of the safe harbor.

Should Taxpayers Participate in the Safe Harbor?

The safe harbor for deducting theft losses provides significant advantages. If the taxpayer satisfies the timing and procedural requirements and calculates the amount of the theft loss deduction in accordance with the Revenue Procedure, the theft loss can be claimed in the relevant discovery year without risk of IRS challenge.

The security offered by the safe harbor, however, comes with a cost. Taxpayers claiming a theft loss deduction pursuant to the safe harbor must take a "haircut" on the amount of the theft loss claimed in the discovery year – either 5 percent for those who are not pursuing potential third party recovery or 25 percent for those who are.

Whether it is advisable to accept this "haircut" as a price of admission in the safe harbor will depend on the quality of the evidence supporting a claim that the taxpayer's loss is not subject to a reasonable prospect of recovery as of the end of the discovery year. Where there is scarce publicly available information regarding the value of assets that are available for recovery by investors, the uncertainty in establishing the amount subject to a reasonable prospect of recovery as of the end of the discovery year may support the conclusion that it makes sense to participate in the Revenue Procedure 2009-20 safe harbor.

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