Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB/SE:AREA 8
SMRoth

date: February 24, 2003

to: Susan Kurtz
Revenue Agent
Santa Barbara POD

from: Associate Area Counsel
Thousand Oaks, CA

subject: [redacted] **PONZI SCHEME**

Your office has requested our advice on various legal issues raised in connection with claims filed by taxpayers in who made investments with [redacted]. We understand that you, in turn, will prepare a memorandum to PSP. Your memorandum will incorporate the conclusions in this memorandum, which will permit uniform treatment of various claims made by taxpayers who made investments with [redacted]. In short, the goal is to ensure the Service adopt uniform and defensible positions.[1]

The use of some definitions are helpful. Amended returns seeking to reverse interest, dividends, and net gains from the sale of capital assets reported with respect to [redacted] are referred herein as "claims." Where the word "loss" is used herein, it involves the loss, if any to which investors are entitled in connection with the loss of their portfolio value.

There are two distinct "worlds" the Service needs to address. The "real world" represents the cash or cash equivalent that was transferred between, or for the benefit of investors and [redacted] and vice versa. The other "world" is the so called "[redacted]" world, defined and created bookkeeping and accounting entries kept by [redacted] and his associates.

There are over [redacted] investors nationwide. Not all have filed claims. It is contemplated the Service Centers campuses will handle most of the claims, so a technically correct result is needed, but not one which would require audits of each individual claim. [redacted] was an unregistered investment manager during the years addressed in the investor's returns. [redacted] has

[1]Our national office concurs with our legal conclusions.

reportedly defrauded clients of approximately $[redacted] in a Ponzi-type investment scheme. The investors are filing claims/returns with the Service which raise the questions which appear below.

I. Questions

A. Whether investors are entitled to amend their return for an open year to reverse interest, dividends, and net gains from the sale of capital assets reported by them based on information provided by [redacted]? ("[redacted] world")

B. Whether the investors have incurred a deductible tax loss, and pursuant to I.R.C. § 165, and if so, in what year, in so far as:

1. income reported, but not physically received by the investors based upon portfolio information supplied by [redacted].

2. cash or cash equivalent that was transferred between, or for the benefit of investors and [redacted] and vice versa, in connection with the Ponzi scheme.

II. Factual background

In connection with this scheme, [redacted] pleaded guilty on [redacted] to [redacted] charges, ranging from mail fraud and money laundering to conspiracy to obstruct justice. [redacted] committed fraud on such a large scale that a website was created, [redacted], which provides extensive coverage of his fraudulent activities and related events.

On [redacted] [redacted] filed a Chapter 11 bankruptcy petition in the [redacted] The SEC started an informal investigation in [redacted] and was formally investigating [redacted] in late [redacted] as a possible unregistered paid investment advisor. The agency had commenced litigation against [redacted] by [redacted], and took formal action on [redacted].

According to the Bankruptcy Trustee's First Interim Report, dated [redacted], [redacted] "perpetrated a massive multi-year fraud on his investors, using funds from new investors to

pay inflated and false returns to other and older investors, while wasting tens of millions of dollars on ill-conceived and disastrous investments and paying staggering sums to certain associates and consultants." The report continues: "[F]rom [redacted] to [redacted], [redacted] received approximately $[redacted] from investors. He distributed approximately $[redacted] to investors. Of this $[redacted] [redacted] investors received approximately $[redacted], even though they had invested only $[redacted], thereby realizing an excess return of approximately $[redacted]." Our office has no further information concerning payments made by [redacted] or cash he had available at years end.

The "[redacted]" are retirement accounts with approximately [redacted] "investors" as partners.

There are two categories of investors:

1. Net debtors - investors who in the "real world" received money back from [redacted] in excess if what they put in.

2. Cash losers - those whose cash or cash equivalent investment exceeds any money received back.

Within these two categories are investors who reported dividends, interest and capital gains, and those who did not report dividends, interest and capital gains.

Investors have filed:

- 1040X claims for [redacted] through [redacted] to remove the reported interest, dividend, and net capital gains reported on their returns.

1040X claims to deduct theft loss in [redacted] creating NOL carryback to [redacted], [redacted] and [redacted].

- Original [redacted] returns to deduct theft loss

Many investors contend that [redacted] reported to them returns on their investment, but they allowed him to reinvest their returns rather than receive payment of them. Some investors contend they were never paid any return on their investment nor any return of the principal they

invested with [redacted].[2]

A forensic accounting report commissioned by the Bankruptcy Trustee reflects, to the extent that records are available, the amounts each investor invested, and the amount of money received from [redacted]. We understand the trustee is taking action to recover the excess return from these "net debtors."

It has also been reported that a $[redacted] class action lawsuit was filed on [redacted], against four California banks used by [redacted] in his fraudulent dealings with investors. We understand the bankruptcy trustee is a plaintiff in this action.

III. Legal Analysis

A. Whether investors are entitled to amend their returns for an open year to reverse interest, dividends, and net gains from the sale of capital assets reported based on information provided by [redacted]? ("[redacted] world")

Gross income includes all income from whatever source derived. I.R.C. § 61; Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). This includes compensation for services such as fees, commissions, and other similar items. The first principle of our income tax system is that income must be taxed to the one who earns it. Commissioner v. Culbertson, 337 U.S. 733 (1949).

Capital gains, interest, and dividends are all included in gross income. I.R.C. § 61(a)(3),(4),(7). An item of income is includable in the gross income of a cash basis taxpayer in the tax year when it is actually or constructively received. Treas. Reg. § 1.451-1(a). Income is constructively received in the tax year in which it is credited to the taxpayer's account, set apart for him, or otherwise made available so that he may draw upon it at any time. Treas. Reg. § 1.451-2(a). When the payor lacks funds to make the payment, there can be no constructive receipt. Noel v. Commissioner, 50 T.C. 702, 706-07 (1968).

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[2]Our office asked the Trustee for records which reflect how much [redacted] reported to the investors at years end. The Trustee could not provide such an accounting to us. Our best evidence of the amounts of returns on investments the investors were told are the amounts shown on the tax returns of the investors.

Our office believes there is insufficient evidence that investors could have been paid the gains, interest, and dividends that [redacted] reported to them in [redacted].[3]

Furthermore, lending credence to this position is the [redacted] ruling of [redacted] of the [redacted] that [redacted]s written agreement last year to plead guilty to fraud, conspiracy and money laundering establishes clearly that his investment empire was a scam from its beginning in [redacted].

However, the investors may not be entitled to a refund of the full amount of income tax they paid associated with the inclusion of the "phantom income." Many investors received cash from [redacted] during the year in which the claim and prior years. Some adjustment to amount of claim may be needed.

The weight of authority holds that certain distributions to taxpayers in "Ponzi" or pyramid schemes, where proceeds of later investors are used to pay distributions to early investors, lending an appearance of legitimacy to a fraudulent investment, are current income. Parrish v. Commissioner, T.C. Memo. 1997-474, affd. 168 F.3d 1098 (8th Cir. 1999); Premji v. Commissioner, T.C. Memo. 1996-304, affd. without published opinion, 139 F.3d 912 (10th Cir. 1998); Wright v. Commissioner, T.C. Memo. 1989-557, affd. without published opinion, 931 F.2d 61 (9th Cir. 1991); Murphy v. Commissioner, T.C. Memo. 1980-218, affd. per curiam, 661 F.2d 299 (4th Cir. 1981); Harris v. United States, 431 F. Supp. 1173 (E.D. Va. 1977).

In all but one of the above cases, however, the taxpayer had recovered and was in either actual or constructive receipt of his initial "investment" during the same taxable year as the Ponzi distributions. In the exceptional case, Parrish, the taxpayer was not a passive investor but was an officer and director of the scheme's corporate vehicle and did not introduce evidence to show either the amounts he invested or received.

In two other cases, the taxpayer had not recovered the initial investment during the same tax year as the Ponzi distributions, courts have held that the distributions were

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[3]Some investors were aware of the Ponzi scheme before they filed their [redacted] return, therefore their failure to report the income is not due to a decision to reinvest. Some others did report the income on the [redacted] returns, and are now seeking to reverse that income.

not income but return of investment funds. Taylor v. United States, 98-1 USTC ¶ 50,354 (E.D. Tenn. 1998); Greenberg v. Commissioner, T.C. Memo. 1996-281.

Therefore, before the full amount of the claim can be allowed, a determination must be made on whether the taxpayer has recouped his/her initial investment with [redacted].[4] We understand that you in possession of the Trustee's forensic accounting of cash transactions between [redacted] and the investors.

B. Whether the investors have incurred a deductible tax loss, pursuant to I.R.C. § 165, and if so, in what year, in so far as:

1. income reported, but not physically received by the investors based upon portfolio information supplied by [redacted].

2. cash or cash equivalent that was transferred between, or for the benefit of investors and [redacted] and vice versa, in connection with the Ponzi scheme.

A theft loss is deductible in the year in which the loss is sustained. I.R.C. § 165(a); Treas. Reg. § 1.165-1(d)(1). A theft loss is sustained in the tax year in which the investor discovers the loss. I.R.C. § 165(e); Treas. Reg. § 1.165-1(d)(3),-8(a)(2). The loss is not deductible for the year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss. Treas. Reg. § 1.165-8(a)(2); Alison v. United States, 344 U.S. 167, 170 (1952); Marine v. Commissioner, 92 T.C. 958, 976 (1989), aff'd without pub. op., 921 F.2d 280 (9th Cir. 1991).

We understand the events of [redacted]'s misuse of the funds invested with him did not come to light until sometime in [redacted]. Indeed, investors continued to invest with him into early [redacted]. The year of discovery is [redacted] and thus, any investors' claim for a theft loss in the tax year [redacted] would be premature.

Furthermore, there are limitations of the amount of loss which may be claimed. If in the year in which the taxpayer

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[4]We recognize that the degree with which this determination can be made with certainly depends on the amount of resources the Service dedicates to the audit of the claims.

discovers the loss there is a claim for reimbursement for which there is a reasonable prospect for recovery, "no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received." Treas. Reg. § 1.165-1(d)(3). Whether a reasonable prospect of recovery exists is a question of fact, determined by examining all the facts and circumstances. Treas. Reg. § 1.165-1(d)(2)(i); Boehm v. Commissioner, 326 U.S. 287, 292-93 (1945); Dawn v. Commissioner, 645 F.2d 1077, 1078 (9th Cir. 1982).

In the pending bankruptcy case the Trustee is seeking the return of approximately $[redacted] from net debtors and $[redacted] from the banks that allegedly assisted [redacted] in his fraud. The Trustee recently forwarded a letter to indicating that, as of [redacted] [redacted]% was the estimated recovery percentage for any particular investor who has a claim pending in the bankruptcy court as of that date. The estimated recovery rate of [redacted]% does not include a consideration of the $[redacted] litigation referenced above.[5]

Have the investors incurred a deductible tax loss, pursuant to I.R.C. § 165, in so far as the income reported, but not physically received (phantom income) by the investors based upon portfolio information supplied by [redacted]? If yes, in what year?

The answer to this question is yes. We understand that investors reported phantom income and paid tax attributable to that phantom income. This creates a tax basis in the phantom income.

In calculating the adjusted basis in the theft, the taxpayers must demonstrate that the income was reported. The basis must be adjusted by reductions in reported phantom income through amended returns as addressed in Question I.A. and Legal Analysis III.A. above. Furthermore, if the

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[5]In his [redacted] Disclosure Statement, the Trustee estimated the **initial payments to** unsecured creditors to be [redacted]% **to** [redacted]%, subject to the uncertainties of litigation with respect to many claims and other factors that may or may not be resolved in the Trustee's favor.

investors are "net debtors," an allowable phantom income theft loss must be reduced by the cash received (to the extent the Service can confirm this amount) from [redacted] in excess of cash invested.

Concerning the year of the loss, Treasury Reg § 1.165-1(d)(3) states that "Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss. However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained."

If the investors reported phantom income in years now closed by the statute of limitations, they cannot file claims for refund to reverse the reported phantom income. Furthermore, the investors have no remedy as to these closed years in the pending bankruptcy proceedings as to. Our office believes that there is a closed and completed transaction in

so far as phantom income in closed years. There are no contingent events which might impact further recovery, in so far as the phantom income reported years closed by the statute of limitations. Therefore, this portion of the loss is fixed as being sustained in [redacted].

Have the investors incurred a deductible tax loss, pursuant to I.R.C. § 165, in so far as cash or cash equivalent that was transferred between, or for the benefit of investors and [redacted] and vice versa, in connection with the Ponzi scheme. If yes, in what year?

The answer to the second question is also yes, there is a loss, to the extent that the investor has tax basis. The investors sustained a real loss of cash entrusted with another for investment which was misused. The amount invested with [redacted] in the closed years must be included in the basis in computing the theft loss ultimately allowed. Jensen v. Commissioner, T.C. Memo. 1993-393, affd. without published opinion 72 F.3d 135 (9th Cir. 1995). The taxpayers must demonstrate this amount as part of their loss deduction.

A distinct category of investors, such as members of the "[redacted]" who transferred their retirement accounts to [redacted], require another level of

scrutiny to determine the amount of the allowable theft loss. Some of the amounts transferred to [redacted] may not have tax basis due to Code sections allowing income exclusion for contributions to retirement accounts. Only by tracing the history of the retirement contributions by the investors for the accounts transferred to [redacted] can the proper amount of tax basis be determined.

Concerning the appropriate year of the theft loss, there are two possible approaches. In one approach we allow the losses in [redacted] reduced by the Trustee's estimated recovery rate to ease tax administration. We recognize that policing the reporting of additional income received by the investors in later years might be difficult, but the Trustee has pledged to issue Forms 1099 to the debtors which would identify the amount above the expected recovery rate.

The alternative is to not allow the loss at all until all the dust settles in the Bankruptcy Court, and determine with some specificity the recovery of each individual. This is the approach our office is recommending, and our national office concurs.

IV. Conclusion

If you have any questions, call Steven M. Roth at (805) 371-6702, ext. [redacted].

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Date

Steven M. Roth
Senior Attorney