Post 110663-05

REVISED AS OF 4/19/05

date: March 24, 2005

to: Group Manager, Compliance,

from: Associate Area Counsel

subject:

Request for Advice: Treatment of Losses

This memorandum responds to your request for assistance dated February 9, 2005. This memorandum should only be used in relation to the taxpayers that invested in . and should not be otherwise cited as precedent.

Issues

1. Whether investors in are entitled to claim a theft loss?

2. If investors are not entitled to claim a theft loss, what type of loss, if any, would they be entitled to claim?

3. If investors are entitled to claim a loss, when would they be entitled to claim that loss?

4. Whether interest income received from Inc. is ordinary income or return of capital?

Conclusions

1. No. The investors in cannot take the losses as a theft loss.

2. The investors are entitled to a capital loss for the amounts lost after taking into consideration gains received.
3. Because the capital asset has not become worthless, the taxpayer/investors cannot claim the loss at this time.

4. The interest income received from is ordinary income.

**Facts**

was established in

Beginning in the 1990s, the business was expanded

sold unsecured and uninsured notes to

The notes were promises to pay back the principal after a fixed amount of time, and the notes yielded variable amounts of interest scaled to the level of the fixed investment. The notes varied from $ to $ and typically matured in years. The investors could either receive interest payments directly or reinvest the interest in additional notes.

The company offered returns as high as 8.5 percent. was a legitimate business and was not formed as a tax avoidance scheme or sham.

In , was acquired by , which was later renamed . When the market for crashed in found itself going deep into debt. The assets of were used by for operating capital. By owed more to depositors than the company was worth. Eventually, the losses forced and its subsidiaries to cease operations and file for bankruptcy in . Approximately investors are affected by the bankruptcy with estimated losses of $ . This is in .

The liquidation plan for the company has been approved by the Bankruptcy Court. Out of about $ that the Bankruptcy Court has obtained thus far, $ went to expenses and $ went to attorneys fees. The remainder will be divided among investors. Investors already received a payout of on the dollar in late .

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The Internal Revenue Service is now beginning to receive numerous refund claims in connection with . Investors are filing amended returns for the years to eliminate interest income earned from and the payments are being reclassified as a return of capital. In addition, many investor/taxpayers are amending returns and filing returns claiming theft losses for the full amount of their investments. Some investors are filing income tax returns claiming a capital loss.

Discussion

General:

Section 165(a) provides that there will be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c) provides that in the case of an individual, the deduction under subsection (a) is limited to losses incurred in a trade or business; losses incurred in any transaction entered into for profit, though not connected with a trade or business; and losses of property not connected with a trade or business if such losses arise from fire, storm, shipwreck, or other casualty or from theft.

Only sustained losses are deductible. This means that they must be evidenced by closed and completed transactions, or otherwise fixed by identifiable events. Pending litigation can preclude a loss deduction because the underlying transaction would not be considered to be closed and completed. See Hill v. Commissioner, 75-2 USTC ¶ 9632 (10 Cir. 1975); Rev. Ruling 74-80, 1974-1 C.B. 117.²

Issue 1: Theft Loss:

Whether a loss from theft has occurred depends upon the law of the jurisdiction where it was sustained. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); Monteleone v. Commissioner, 34 T.C. 688, 692 (1960), acq. 1960-2 C.B.6. The law in provides that obtaining property and funds by false pretenses is a crime. S

² A partial exception exists to the completed transaction rule in the statutory exception for a deduction for a partially worthless bad debt or for an addition to a bad debt reserve. I.R.C. § 166.
The present case is different from the much publicized Ponzi schemes in which a determination was made to allow theft losses if the taxpayers could prove the amount of the investment and if there was no probability of recovery. In those cases, the entire investment was a sham and the promoters of the schemes were stealing investors’ money for their own personal gain. In this case, was a legitimate company and the investments were legitimate but mismanagement occurred at the expense of the investors. There is evidence that these officers knew that the company was not doing well financially and did not impart this information to investors. Nevertheless, there is no evidence that the funds were obtained by false pretenses or were stolen after being obtained. Moreover, so the investors had some knowledge that there may be a problem with their investments. Accordingly, while the situation is certainly sympathetic, no theft has occurred under local law that would give rise to a theft loss deduction under section 165.  

Issue 2: Allowable loss:

It is the position of some investors that they are entitled to claim a casualty loss. Generally, a casualty loss is a loss resulting from damage to, or destruction of, property. A casualty loss is a loss of property arising from fire, storm, shipwreck, or other casualty. I.R.C. § 165(c)(3). A casualty loss may arise from a disaster, auto accident, hurricane or flood. Treas. Reg. § 1.165-7(b)(3). It requires an event of a sudden, unexpected or unusual nature. Rev. Rul. 76-134, 1976-1 C.B. 54.

In the present case, the loss suffered by the investors in would not meet the definition of a casualty as set forth in the Code and regulations. Moreover, there was no sudden or unexpected event causing the loss. Rather, it was the decline of the company over many years that ultimately resulted in bankruptcy.

The taxpayer/investors may try to elect to claim the losses as casualty losses because the lost funds were deposits in an insolvent financial institution. I.R.C. § 165(l)(1). Nevertheless, this subsection only applies to deposits in commercial banks, thrift institutions, insured credit unions, and similar state or federally chartered institutions. was not a financial institution under this definition so this election would not be available to the investors in the present case.

In the present case, the type of loss available to the investors would be a capital loss. Capital losses arise from the sale or exchange of capital assets, and for individuals, the definition of a capital asset includes most everything, including investments. I.R.C. § 1221. For a capital loss to be deductible, the asset must have been held for more than one year. The investments in this case were held for less than one year. Therefore, the losses must be claimed as capital losses.
been acquired for business or investment purposes and not for personal use. I.R.C. §§ 165(f) and 1211(b). Issued notes to the investors, the funds were deposited with the expectation that interest would be earned on the income. Investors did receive interest payments on their investments. Thus, the notes were capital assets held for investment purposes. Moreover, notes with come under the definition of securities as set forth in section 165(g)(2)(C). With regard to any security that is a capital asset, section 165(g)(1) provides if the security becomes worthless during the taxable year, the loss resulting therefrom will be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

In order to determine a capital loss, capital gains and losses are combined to determine whether there is a net gain or loss. For individual taxpayers, net capital losses are limited to $3,000.00 per year ($1,500 if married and filing separately), and unused losses may be carried over for an unlimited time period until the loss is exhausted. 4 I.R.C. § 1212. Based upon the facts of this case, the proper treatment is capital loss treatment.

Issue 3: Timing of Loss:

In order to claim a capital loss, the taxpayer must show that the asset became wholly worthless at any time during the taxable year. Treas. Reg. § 1.165-5(c). A security becomes totally worthless when it has no value or potential value. The determination of worthlessness is a question of fact and the burden of proving worthlessness is on the taxpayers. Generally, a taxpayer must prove that the securities had some value at the end of the preceding tax year, or at the beginning of the tax year in which the loss is claimed; the securities became completely worthless during the year in which the loss is claimed; and the worthlessness of the securities was established by an identifiable event. See e.g. Malmstedt v. Commissioner, T.C. Memo. 1976-46.

Pending litigation, including bankruptcy, precludes a determination that a security is completely worthless because there may be a prospect of some recovery and the transactions would not be closed until the proceedings are completed. See e.g., Schnurr v. Commissioner, T.C. Memo. 1989-275; In re Steffen, 2003-1 USTC ¶ 50,454 (Bankr. M.D. Fla. 2003); Wagner v. Commissioner, 2003-1 USTC ¶ 50,238 (M.D. Fla. 2003).

In this case, filed for bankruptcy in . Nevertheless, the investments were not completely worthless in that year because there was $ in the bankruptcy estate. The taxpayers received a payout in of on the dollar; thus, the asset was not worthless in or in any year prior to

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4 The losses cannot be classified as nonbusiness bad debts pursuant to section 166 of the Internal Revenue Code because section 166(e) provides that section 166 does not apply to a debt which is evidenced by a security as set forth in section 165(g)(2)(C).
that time. According to the Bankruptcy trustee, accordingly, the earliest year that the loss could be taken would be , if a determination is made that there are no funds remaining for further payouts to investors or if a final pay out is made and no further litigation is pending. The investors are not entitled to claim a loss for any year prior to and it remains to be seen whether the investors can claim a loss for . Once a determination is made that the investments are worthless, the taxpayers would have to prove the amount of their investment, their basis therein, and offset any gains to establish the loss amount. The loss deduction would then be limited to $3,000.00 per year ($1,500.00 per year for married filing separately) until the loss is exhausted.

Issue 4: Treatment of Income:

For years prior to the ultimate downfall of , investors received a good return on their investments and received interest payments. The investors whose returns have been reviewed in conjunction with their claims for refund initially reported the payments as interest income. Now many investors are filing amended returns for reclassifying these payments as a return of capital and treating them as tax free distributions.

In certain Ponzi schemes, Courts found payments to taxpayers to be a return of capital and not ordinary income because the payments were not for the use or forbearance of money but were used to conceal fraud. Greenberg v. Commissioner, T.C. Memo. 1996-281; Taylor v. United States, 81 AFTR 2d 98-1683, 98-1 USTC ¶ 50,354 (E.D. Tenn. 1998); Kooyers et ux., et al. v. Commissioner, T.C. Memo. 2004-281. On the contrary, the Service has taken the position that certain distributions in Ponzi or Pyramid schemes were ordinary income. Parrish v. Commissioner, T.C. Memo. 1997-474, aff’d. 168 F.3d 1098 (8th Cir. 1999); Premji v. Commissioner, T.C. Memo. 1996-304, aff’d without published opinion 139 F.3d 912 (10th Cir. 1998); Wright v. Commissioner, T.C. Memo. 1989-557, aff’d without published opinion, 931 F.2d 61 (9th Cir. 1991).

In the present case, the taxpayers’ investments were legitimate ones and the interest earned thereon was legitimate. There was no Ponzi scheme where payments were made to investors to conceal fraudulent misappropriations. The problem arose due to a decline in the market and mismanagement of funds. There are between investors affected by the failure of the company. Some of the investors invested with for years. Some rolled their interest payments into other notes, some received interest payments. In many cases, the investors made money in prior years in the form of a return on their investment. The investors received interest.

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6 For example, if an investor in a Ponzi scheme invested $20,000.00 and only received payments of $5,000.00, the $5,000.00 would be a return of capital and not ordinary income.
payments “for the use and forbearance of their money”; thus, the interest payments are ordinary income and not a return of capital. 7

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If you have any questions, please contact the undersigned at .

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Senior Attorney

Approved:

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Associate Area Counsel  Date

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7 The investors received a Form 1099-INT for the ; however, no payouts or rollovers were made to investors.