



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Dear _____ :

I am responding to the letter dated April 2, 2009, received by the Commissioner of the Internal Revenue on October 27, 2009, from your group, _____, signed by you. You wrote to President Obama and Secretary Geithner about _____. Referencing the Internal Revenue Service (IRS), the letter specifically requested "consideration and tax relief from the IRS for _____, as was granted by the IRS to ... Ponzi scheme investors on March 17, 2009."

Section 165(a) of the Internal Revenue Code allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise, and is the provision applicable to victims of Ponzi schemes. For individuals, § 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit, and § 165(c)(3) allows a deduction for certain losses not connected to a transaction entered into for profit, including theft losses. Under § 165(e), a theft loss is sustained in the taxable year the taxpayer discovers the loss.

For federal income tax purposes, "theft" is a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and any other form of guile. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); § 1.165-8(d) of the Income Tax Regulations, cited in Rev. Rul. 2009-9, 2009-14 I.R.B. 735 (Apr. 6, 2009).

Revenue Procedure 2009-20, 2009-14 I.R.B. 749 (Apr. 6, 2009) (release date March 17, 2009), the relief provided to Ponzi scheme investors, provides an optional safe harbor treatment for taxpayers that experienced losses in certain investment arrangements discovered to be criminally fraudulent. The character of an investor's loss (ordinary or capital) related to fraudulent activity depends, in part, on the nature of the investment. For example, a loss that is sustained on the worthlessness or disposition of stock acquired on the open market for investment is a capital loss, even if

the decline in value of the stock is attributable to fraudulent activities of the corporation's officers or directors, because the officers or directors did not have the specific intent to deprive the shareholder of money or property. Rev. Rul. 77-17, 1977-1 C.B. 44, cited in Rev. Rul. 2009-9.

A loss from an investment in a so-called "Ponzi" scheme, on the other hand, in which the party perpetrating the fraud receives cash or property from investors, purports to earn income for the investors, and reports to the investors income amounts that are wholly or partially fictitious, is treated as an ordinary loss because the perpetrator of the Ponzi scheme did have the specific intent to deprive the investor of money or property. Rev. Rul. 2009-9. The safe harbor provided in Rev. Proc. 2009-20 describes how a taxpayer can qualify for a theft loss from investment arrangements discovered to be criminally fraudulent.

Generally, a depositor in a financial institution would not qualify for a theft loss under § 165. Rev. Rul. 77-383, 1977-2 C.B. 66. The relationship between the financial institution and the depositor is that of a debtor and a creditor, and thus the loss usually is a nonbusiness bad debt loss under § 166, deductible as a short-term capital loss. Rev. Rul. 77-383. See also Perrotto v. Commissioner, T.C. Memo. 1977-99 (relationship between a bank and its typical depositor of funds is that of a debtor and a creditor; economic loss therefore comes within the bad debt provisions of § 166); Sandquist v. Commissioner, T.C. Memo. 1978-281 (financial difficulties of bank may have arisen by reason of an embezzlement or theft, but depositor's relationship with bank was that of a creditor; any loss sustained comes within § 166); Smith v. Commissioner, T.C. Memo. 1979-76 (no evidence presented showing credit union bankruptcy caused by a casualty or theft, but even if so the relationship between a credit union and its typical depositor of funds is that of a debtor and a creditor). Therefore, the theft loss safe harbor relief provided to Ponzi scheme victims, in Rev. Proc. 2009-20, would be inapplicable.

There may be, however, other relief available which could permit a loss to be treated as an ordinary loss under § 165(c)(3). Section 165(l) provides for treatment of certain losses in insolvent financial institutions, if the provisions of the subsection are met. In adding § 165(l) to the Code in 1986, Congress noted that under then-current law, a loss experienced with respect to a deposit is treated as any other bad debt loss, and is therefore a capital loss under § 166. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. 337 (1986), reprinted in 1986-3 C.B. (Vol. 4) 337. Congress added § 165(l), which permits qualified individuals to elect to deduct the losses on deposits in qualified financial institutions as casualty losses in the year in which the amount of such loss can be reasonable estimated, subject to the generally applicable limitations on the deductibility of casualty losses.

I hope this information is helpful. Please contact _____ at _____ if we can be of further assistance.

Sincerely,

By: _____
Thomas D. Moffitt
Chief, Branch 2
(Income Tax and Accounting)