The Honorable Mitch McConnell  
United States Senate  
Washington, D.C. 20510  

Attention:  ---------------------

Dear Senator McConnell:

This letter responds to your inquiry dated July 16, 2010, on behalf of several of your constituents. You asked that we respond to several concerns that ------------------------- wrote specifically about investors who lost money in what they described as Ponzi schemes.

Taxpayers who lose money in criminally fraudulent investment arrangements such as Ponzi schemes may be entitled to investment theft loss deductions (section 165(c)(2) of the Internal Revenue Code (the Code)). For additional information on this type of loss, see Revenue Ruling 2009-9, which explains the income tax law that applies to investors who lose money in criminally fraudulent investment arrangements, and Revenue Procedure 2009-20, which provides optional safe harbor treatment for qualified investors who lost money in this type of arrangement. I have enclosed copies of both documents. The following general information addresses the three specific concerns that ------------------------- raised.

**Losses of assets held in individual retirement accounts (IRAs) or similar tax-deferred investment vehicles.** The Code limits a loss or other deduction to a taxpayer’s cost or other “basis” to prevent multiple deductions or exclusions for the same amount. If taxpayers have basis in a tax-favored retirement plan or IRA (for example, because they made after-tax contributions to an IRA), they can take a miscellaneous itemized deduction to the extent they have unrecovered basis after the distribution of their entire interest in the plan or IRA. For an IRA, the total amount in all
of the taxpayer’s IRAs must have been distributed. This rule applies separately to a taxpayer’s traditional and Roth IRAs. If taxpayers have no basis in the retirement plan or IRA (for example, because they claimed a deduction for IRA contributions), the law prohibits them from claiming a deduction for the economic loss in the plan or IRA.

Allowing taxpayers with no basis in a retirement plan or IRA to take a loss deduction for amounts that they deducted or excluded from gross income would provide those taxpayers two deductions, or both a deduction and an exclusion, for the same dollars. Two deductions also would put those taxpayers in a more favorable tax position than other taxpayers who sustained a Ponzi scheme economic loss of the same amount outside of a retirement plan or IRA (and thus received only one tax deduction).

**Losses of assets held by charitable trusts.** Federal tax law generally recognizes charitable trusts as entities separate from individual taxpayers. This recognition enables taxpayers to make charitable contributions to the trusts that are deductible to the extent allowed under section 170 of the Code. Because trusts are separate entities, only the trusts, rather than the beneficiaries, may deduct theft losses if perpetrators stole money from the trusts. The losses claimed by a charitable trust would affect the amount and character of the distributions made to the trust’s beneficiaries.

**Timing of loss deduction.** In general, a taxpayer may deduct a theft loss in the year the taxpayer discovers the loss or, if later, in the year in which a reasonable prospect of recovering the lost amount no longer exists (section 1.165-1(d)(3) of the Income Tax Regulations). Whether a reasonable prospect of recovery exists depends on all the facts known at the end of the tax year in which the taxpayer discovers the loss. Until taxpayers can determine their expected recovery with reasonable certainty, they cannot establish the year of their loss deduction. Under current law, taxpayers generally may not deduct theft losses in the taxable year in which state or federal authorities freeze a perpetrator’s assets because at that time the taxpayers typically still have reasonable prospects of recovering their losses.

However, if a taxpayer is eligible to use the safe harbor treatment in Revenue Procedure 2009-20, the taxpayer may choose to deduct a portion of the loss, computed using the revenue procedure, in the year in which authorities charge the perpetrator under state or federal law with a crime that would meet the definition of theft for purposes of section 165 of the Code.

Additional information on the rules for reporting theft losses is in the enclosed Publication 547, *Casualties, Disasters, and Thefts.*
I hope this information is helpful. If you have any questions, please call me at [phone number], or [another phone number] at [another phone number].

Sincerely,

Andrew James Keyso
Deputy Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (3)