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The Honorable Johnny Isakson
United States Senator
One Overton Park, Suite 970
3625 Cumberland Boulevard
Atlanta, Georgia 30339

Attention:

Dear Senator Isakson:

I am responding to your letter of September 20, 2010, on behalf of your constituents, _____ and _____. They wrote about the deductibility of fraudulent investment scheme losses. The _____ suggested a change in the law to allow victims of fraudulent investment schemes to deduct theft losses for assets held in retirement accounts and charitable remainder trusts.

Revenue Ruling 2009-9 explains the income tax law that applies to investors who lost money in a fraudulent investment arrangement and are entitled to a theft loss deduction. Revenue Procedure 2009-20 provides an optional safe harbor treatment for qualified investors who lost money in certain fraudulent investment arrangements.

Qualified investors under the revenue procedure include only investors that transferred cash or property to the perpetrators of the fraudulent scheme. These direct investors include individuals, partnerships, limited liability corporations, and other "persons" as defined in section 7701(a)(3) of the Internal Revenue Code (the Code). The primary reason for the restriction to direct investors under Revenue Procedure 2009-20 is because they are the party from which the perpetrator of the fraudulent arrangement stole money or property, and thus the proper party to compute and claim a theft-loss deduction under section 165 of the Code.

However, the restriction does not prevent indirect investors from indirectly benefitting from the safe harbor treatment, for example, by deducting their share of a theft loss sustained by a passthrough entity that uses the safe harbor. A charitable remainder

trust (CRT) is exempt from federal income tax (although it may be subject to excise taxes). A CRT differs from an IRA and a section 401(k) retirement plan in that a CRT is an entity separate from its grantor for income tax purposes, with its own separate return filing requirements. Because under current law only a direct investor can claim theft losses arising from a Ponzi scheme, only a trustee, on behalf of a CRT, can claim losses arising from the Ponzi scheme. However, the CRT must be a qualified investor under Revenue Procedure 2009-20, which would affect the amount and character of the distributions made to its beneficiaries.

For investments held in tax-deferred vehicles such as IRAs, the Code limits a loss or other deduction to the taxpayer's cost of 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.

If taxpayers have no basis in the retirement plan or IRA (for example, because they claimed a deduction for IRA contributions or because we have not taxed the growth in value in the IRA), they cannot take a deduction for the economic loss in the plan or IRA. In this situation, we will not tax now or in the future economic income that we never taxed, or that we taxed but an IRA deduction offset. 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 contributed to a retirement plan or IRA on an after-tax basis and sustained a Ponzi scheme economic loss of the same or a similar amount (and thus received only one tax deduction).

To change the law to allow the deduction of theft losses for assets held in retirement accounts and charitable remainder trusts would require legislative action by the Congress. We do not comment on the federal tax consequences of any proposed legislation.

I hope this information is helpful. If you have any questions, please contact me or
at .

Sincerely,

Christopher F. Kane
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Office of Associate Chief Counsel
Income Tax & Accounting