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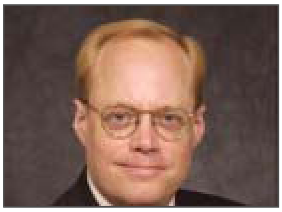

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THE TAX LAWYER

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Ponzi Scheme Tax Advice

Image via mehtafiscal.com

If you pay high taxes you might think the federal government is a kind of Ponzi scheme: tax money in and federal gravy out. A bit of redistribution of wealth, just not quite what the Occupy Movement wants. Some elements may seem especially Ponzi-like: Social Security Is Much Worse Than A Ponzi Scheme.

But you'll feel ***even more*** stung if you lost money to Bernard Madoff or another ***real*** Ponzi scheme operator. Fortunately, when you are defrauded you can usually claim a tax loss. Of course, a loss on your taxes hardly makes you whole. If you're in a 35% tax bracket, a deductible loss costs you 65%. Uncle Sam picks up the rest.

IRS theft loss deductions come in many guises and the IRS has specifically addressed Ponzi schemes. If you're the victim of a Ponzi scheme there's some retroactive good news applying to any year after Dec. 31, 2007. Shortly after Madoff's guilty plea the IRS provided safe harbors for victims of "specified fraudulent arrangements"—IRS speak for Ponzi scheme. These rules were designed to eliminate uncertainty about when you could claim losses and in what amount.

With a Ponzi scheme, records won't be clear about what is real and what is fake. See Revenue Procedure 2009-20. The filing of criminal charges was a key threshold to this 2009 relief, but the IRS recognized there wouldn't be criminal charges if the perpetrator was deceased. Thus, Revenue Procedure 2009-20 listed safe harbors for Ponzi scheme victims, to address situations where a lead figure died and foreclosed criminal charges.

Now, in Revenue Procedure 2011-58, the IRS has modified the definition of a "qualified loss" retroactive to 2007. This IRS Revenue Ruling allows investors a theft loss, not a capital loss. A theft loss from a Ponzi scheme is not subject to the normal limits on losses from investments. Those rules normally allow only $3,000 a year beyond capital gains from investments.

You deduct it in the year you discover the fraud unless you have a claim with a reasonable prospect of recovery. Determining the year of discovery and applying the "reasonable prospect of recovery" rule depends on your facts. This IRS Revenue Procedure provides two assumptions taxpayers can use to report losses.

Your theft loss can include your unrecovered investment, including income you reported in past years. Investors generally can claim a theft loss deduction for the net amount invested and even for the "fictitious income" the promoter of the scheme credited to you account—on which you paid tax!—before you discovered the fraud.

Some taxpayers argue they should be allowed to amend prior tax returns since the income most Ponzi scheme victims were reporting in the past was fictitious. But the IRS generally disagrees with this approach and doesn't address it in its Ponzi guidance.

For more, see:

Commissioner Shulman's Senate Finance Testimony on Ponzi Schemes and Offshore Tax Evasion Legislation

Victims' revenge: Ponzi targets cheat the taxman

Post-Madoff, a Greater Awareness of Ponzi Schemes

IRS Internal Revenue Bulletin 2009-14

IRS Revenue Procedure 2009-20

IRS Publication 2194

IRS 2010 Milestones

Robert W. Wood practices law with Wood LLP, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009, Tax Institute), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.