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## SAFE HARBOR FOR DEDUCTING PONZI SCHEME LOSSES

By Victor Sy, CPA, MBA

IRS has issued comprehensive guidance for the investors caught in Bernard Madoff's notorious Ponzi-style fraud. Overall, the guidance takes an **extremely generous, pro-taxpayer position**, allowing the losses to be claimed as **ordinary losses and even allowing NOLs** generated by Ponzi schemes to be treated as sole proprietorship losses potentially eligible to be **carried back** 3, 4, or 5 years. The guidance specified two Revenue rulings: 2009-9 and 2009-20 to aid victims of fraudulent schemes.

Revenue Ruling 2009-9 prescribes generous tax treatment while Revenue Ruling 2009-10 provides a safe harbor for determining the loss year and the amount of the loss.

IRS Revenue Procedure 2009-20 provides an optional **safe harbor** treatment for taxpayers that experience losses in certain investment arrangements discovered to be **criminally fraudulent**. The revenue procedure also describes how the IRS will treat a return that claims a deduction for such a loss and does **not** use the safe harbor treatment described in the revenue **procedure**:

1. These returns are **subject to examination** by the service.
2. A taxpayer who claims a theft loss deduction without following the safe harbor treatment must
  - Establish that the loss was from **theft** which was **discovered in the year the deduction is claimed**,
  - Have sufficient **documentation** to establish the amount of the claimed loss, and
  - Be able to prove that **no** claim for reimbursement for any part of the loss exists for which there is a reasonable prospect of recovery in the tax year of the claimed loss.
3. Additional requirements apply if the taxpayer files or amends a return to exclude previously reported investment income that was not actually or constructively received.

**Safe Harbor:** Under the safe harbor provisions of Rev Proc 2009-20 if a qualified investor follows the procedures prescribed, the Revenue Service will **not challenge** the following treatment by the qualified investor of a **qualified loss** -

1. The loss is deducted as a **theft** loss;
2. The taxable year in which the theft was discovered within the meaning of § 165(e) is the **discovery year** described in section 4.04 of the revenue procedure; and
3. The **amount** of the deduction is the amount specified in section 5.02 (amount to be deducted below) of the revenue procedure.

**Safe Harbor Deduction – Where loss not readily determinable:**

1. 95% for a qualified investor that does **not** pursue any potential third-party recovery; or
2. 75% for a qualified investor **pursuing or intends to pursue** potential third party recovery; and
3. “Required” taxpayer **statement** attached to filed tax return;
4. Returns previously filed and in compliance;
5. Deductible amount = Amount invested Plus reinvested income (previously included in gross income) less recovered amounts.

**Future Recoveries:** The qualified investor may have income or an additional deduction in a year subsequent to the discovery year, depending on the actual amount of the loss that is eventually recovered.

**Procedure:** A **qualified** investor that uses the **safe harbor** treatment described **must**:

1. Mark "[Revenue Procedure 2009-20](#)" at the top of the Form 4684, Casualties and Thefts, for the federal income tax return for the discovery year.
2. Complete and sign the [statement](#) provided in the appendix of Rev Proc 2009-20 and
3. Attach the executed statement to the qualified investor's timely filed (including extensions) federal income tax return for the discovery year.

[Statement - by executing the statement, the taxpayer agrees:](#)

1. Not to deduct in the discovery year any amount of the theft loss in excess of the deduction permitted by section 5 of this revenue procedure;
2. Not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year;
3. Not to apply the alternative computation in § 1341 with respect to the theft loss deduction allowed by this revenue procedure; and
4. Not to apply the doctrine of equitable recoupment or the mitigation provisions in §§ 1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511.

[California](#) will follow Revenue Procedure 2009-20, and will accept the form provided in Appendix A of the Revenue Procedure which provides an optional "safe-harbor" allowing taxpayers to avoid later IRS challenges.