Ponzi Scheme Tax Treatments

Unfortunately, some taxpayers in our region have been adversely impacted by, and financially suffered as a result of, investment in fraudulent investment arrangements known as "Ponzi" schemes. In a Ponzi scheme, taxpayers make a financial investment and are reported income that is wholly or partially fictitious. Payments of the fictitious income to investors are made from cash or property that other investors in the fraudulent arrangement paid.

In 2009, the IRS issued guidance addressing the tax treatment of losses incurred by taxpayers from Ponzi schemes[1]. Based on this guidance, investors in such schemes are entitled to claim a theft loss deduction under IRC Section 165 which entitles to them to an ordinary deduction (rather than a capital loss). These losses are reported as itemized deductions and are not subject to the 2% floor limitations of other miscellaneous itemized deductions.

The Ponzi scheme loss is treated as sustained during the taxable year in which the taxpayer discovers the loss. In some circumstances, there is a reasonable prospect for recovery of lost investment funds. If a reasonable prospect for recovery exists, no deduction is allowable for that portion of the loss that is reasonably expected to be recovered. The deduction for that portion of the loss may only be deducted if/when it can be ascertained with reasonable certainty that a reimbursement will not be received. Whether a reasonable prospect of recovery exists is a question of fact that must be evaluated in light of all facts and circumstances surrounding each case.

The IRS recognized that whether and when an investor meets the requirements for claiming a loss for an investment in a Ponzi scheme are highly factual determinations that often cannot be made with certainty in the year the loss is discovered. As a result, Rev. Rul. 2009-20 was issued to provide an optional safe harbor formula to enable investors to deduct losses from Ponzi schemes when certain conditions are met which result in a qualified loss. The safe harbor method provides for a deduction calculated by multiplying the qualified investment by a specified percentage (95% or 75% depending on the investor's recovery pursuit intentions) and then subtracting any actual recoveries of the qualified investment. This optional safe harbor was designed to alleviate some of the compliance and administrative burdens of satisfying the standard theft loss deduction requirements.

To contrast the original theft loss related to a Ponzi scheme investment as described above, some taxpayers may be obligated to return income earned from Ponzi scheme investments to the Ponzi scheme bankruptcy administrator. These payments, known as clawback repayments, would have been previously reported as income by the investor. IRS guidance provides that

[1] Rev. Rul. 2009-9 and Rev. Rul. 2009-20

these clawback repayments are not theft losses and the amount of the ordinary deduction calculated by the investor upon repayment is calculated using one of two prescribed methods.

Because of the complexities of the analysis and the facts and circumstances determinations involved with accounting for losses related to Ponzi scheme investment, taxpayers are urged to seek counsel to ensure their compliance with the prescribed rules and to ensure they receive the greatest tax benefit for losses incurred.

Got a question? Ask us… we would be happy to assist you.