Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200811016**
Release Date: 3/14/2008

CC:ITA:B01
POSTS-109638-07

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 165.00-00

date: June 22, 2007

to: Associate Area Counsel ( )
(Small Business/Self-Employed)

from: Thomas A. Luxner, Chief Branch 1
(Income Tax & Accounting)

---

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

X =

Y =

State A =

Year 1 =

Year 8 =

Year 9 =

Year 10 =

$*a* =

b =

c =

FACTS

The taxpayers (or investors) invested in notes issued by X. X has been in business as a lender for many years in State A. Some time before Year 1, X's business expanded to writing sub-prime mortgage loans in State A. X sold unsecured and uninsured notes exclusively to State A residents because the company wished to avoid being subject to federal securities regulations. The notes provided for stated interest at floating rates, which was payable monthly or at maturity. The notes are numbered, listed by series, and issued to named holders. The notes typically matured in one to five years. The investors could either receive interest payments directly or reinvest the interest in new notes. X maintained locations that resembled banks; tellers took "deposits" and promised to return money to investors in minutes if needed, though X was not a bank or savings and loan association or credit union, and was not supervised by state or federal banking authorities. X offered returns greater than those typically offered to bank depositors; but commensurate with returns available from corporate bonds. X was a legitimate business and was not formed as a fraud upon the investors, nor was it part of a tax avoidance scheme.

In Year 1, X was acquired by Y, which was primarily engaged in the business of mortgage lending. X continued in existence, however, its direct lending activities were curtailed. Most of the proceeds of X's borrowings were loaned to Y. The market for high-risk mortgages crashed in Year 4, and Y suffered significant losses. Y's business deteriorated as the losses mounted for the next several years. Y was only able to stay in business by using the cash X generated from the sale of its notes to the public for operating capital.

As required by local securities law, X distributed annual prospectuses to the investors. These prospectuses represented that X continued to conduct substantial business of its own and showed X to be solvent by virtue of its loans to Y. Y's financial condition was not disclosed. Officers and directors of X and Y made public statements misrepresenting the financial condition of X.

By Year 8, Y owed more to X's investors than the company was worth. In Year 9 the losses forced Y and its subsidiaries to cease operations and file for bankruptcy. Thousands of investors are affected by the bankruptcy with estimated losses of $*a.*

The liquidation plan for the company has been approved by the Bankruptcy Court. Investors received a payout of *b* cents on the dollar in late Year 10. We understand that another payout for *c* cents on the dollar is expected to be paid. Also, there are other assets to be sold, such as X's building. A letter explaining this to creditors was sent by the trustee.

In addition to the bankruptcy proceeding, several people associated with X have been indicted for securities violations under local law. Several have been imprisoned for

these violations. The president of X pled guilty to 22 counts of securities fraud in Year 10. Another insider was tried and found guilty on 22 counts of securities fraud in connection with X. At least one officer was indicted on criminal charges including obtaining signature or property by false pretenses and breach of trust with fraudulent intent under .

DISCUSSION

The memorandum that you have asked us to comment on concluded that theft losses would generally not be allowed; rather the losses resulted from the worthlessness of debt securities treated as capital losses under § 165(g) of the Internal Revenue Code. The memorandum based its assessment on a finding that X and Y were engaged in legitimate business and suffered losses in the ordinary course of that business. The memorandum states that no evidence was presented indicating that money was obtained from the investors by false pretenses or stolen after possession was lawfully obtained. The possibility that such evidence might be presented was mentioned in a footnote citing Rev. Rul. 71-381, 1971-2 C.B. 126. Subsequently, additional facts relating to the nature of the insiders fraudulent statements and resolution of their securities violations cases have been developed, and an insider has been indicted on criminal charges requiring a misappropriation of property as an element of the crime.

In addition to various statements by insiders downplaying the financial difficulties at X, financial statements presenting X as a solvent enterprise were issued to the investors. These statements did not contain Y's balance sheet, which would have shown Y's deep insolvency. X's financial statements treated the loans to Y as assets at face value. The financial statements also indicate that X was engaged in the mortgage business on its own behalf, which was no longer true after X was acquired by Y. Thereafter, X existed only to raise capital for Y.

However, X was in business for many years before these events occurred. Although these facts establish that a theft occurred, it remains a question of fact whether and when a theft occurred with regard to any particular investor, and what losses resulted from theft. We will briefly summarize the applicable lines of authority.

Theft

Section 165(a) provides that there will be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c) provides that in the case of an individual, the deduction under subsection (a) is limited to losses incurred in a trade or business; losses incurred in any transaction entered into for profit, though not connected with a trade or business; and losses of property not connected with a trade or business if such losses arise from fire, storm, shipwreck, or other casualty or from theft. Section 1.165-8(d) of the Income Tax Regulations provides that the term "theft" shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery.

Whether a loss from theft has occurred depends upon the law of the jurisdiction where it was sustained. The exact nature of the crime, whether larceny or embezzlement, or obtaining money under false pretenses, swindling or other wrongful deprivations of the property of another, is of little importance so long as it amounts to theft. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); Monteleone v. Commissioner, 34 T.C. 688, 692 (1960), acq. 1960-2 C.B.6.

The Service has adopted this broad definition of the term "theft" for purposes of § 165(c)(3). Rev. Rul. 72-112, 1972-1 C.B. 60, held that extortion of a ransom payment from a parent constitutes theft for the purposes of § 165. Rev. Rul. 72-112 stated:

... [T]o qualify as a "theft" loss within the meaning of section 165(c)(3) of the Code, the taxpayer needs only to prove that his loss resulted from a taking of property that is illegal under the law of the state where it occurred and that the taking was done with criminal intent.

In Rev. Rul. 71-381, the taxpayer was induced to lend money to a corporation by fraudulent financial statements provided by the corporation's president that did not reflect large liabilities that made the corporation insolvent. As a result, the president of the corporation was convicted by a court for violating the state securities law by issuing false and misleading financial documents. The ruling held that since the money was obtained by false representations constituting a misdemeanor under state law, the taxpayer was entitled to a theft loss deduction. Reliance by the taxpayer on the misrepresentations and the specific intent to separate the taxpayer from his money through fraud are critical to the ruling's reasoning.

Thus, a loss that is the direct result of fraud or theft is deductible under § 165, even though the theft is accomplished through a purported borrowing or offer to sell a security. Commissioner v. Vietzke, 37 T.C. 504 (1961) acq., 1962-1 C.B. 4 (fraudulent stock subscription is theft); Rev. Rul. 77-215, 1977-1 C.B. 51 (kiting checks is theft from the bank); Rev. Rul. 71-381.

However, the worthlessness of valid debt is not a theft loss, see Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1933), even if the debt is worthless because the debtor was the victim of theft. Rev. Rul 77-383, 1977-2 C.B. 66 (depositors allowed bad debt deductions when a bank suffered embezzlement).

The facts of the reviewed memorandum state that several X and Y insiders have been convicted of or plead guilty to securities violations under local law.

> It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly, to: (1) employ any device, scheme, or artifice to defraud; (2) make any untrue statement of a material fact or to omit to state a

> material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
>
> (3) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

A theft is a loss of property. As recognized in the reviewed memorandum, not every securities violation is a theft of property since, as in the case of the State A statute, a loss or taking of property is generally not a required element of securities fraud. See Paine v. Commissioner, 63 T.C. 736 (1975), aff'd without published opinion, 523 F.2d 1053 (5th Cir. 1975); Bellis v. Commissioner, 61 T.C. 354 (1973), aff'd, 540 F.2d 448 (9th Cir. 1974). Thus, losses on open market transactions are not theft losses even if the market values of the securities were inflated by insiders' fraud. Rev. Rul. 77-17, 1977-1 C.B. 44.

In this case, criminal charges have also been brought against at least one officer of Y. The law in State A provides that obtaining a signature or property by false pretenses with intent to cheat and defraud a person of that property is a crime. State A law also defines as a crime breach of trust with fraudulent intent. . The elements of the latter crime are not delineated in the statute, but it has been described as an extension of common law larceny to situations where possession of the property was obtained lawfully. . In , the State A Supreme Court stated:

A loss that results from a change in business conditions is not a loss from theft. In Paine, 63 T.C. 736, the taxpayer claimed losses with respect to publicly traded stock, bought and sold on the open market, as ordinary theft losses due to securities violations by the corporation's officers. The court held that although the officers' unlawful conduct diminished the value of the taxpayer's stock, there was no specific intent to defraud the taxpayer or acquire his property. The court also found that the taxpayer had not demonstrated what portion of the loss suffered on the sale of the stock resulted from the officer's fraud, and what portion was attributable to poor results from the business.

A determination must be made whether, or at what point, loans to X no longer represented bona fide debt. A distinguishing characteristic of bona fide debt is the intention of each party that the money advanced be repaid. Commissioner v. Makransky, 321 F.2d 598, 600 (3d Cir. 1963), aff'g 36 T.C. 446 (1961); Moore v. United States, 412 F.2d 974, 978 (5th Cir. 1969); Litton Business Systems, Inc. v.

Commissioner, 61 T.C. 367, 377 (1973), acq., 1974-2 C.B. 3. The borrower's intent must be more than a "vague hope" of repaying the loan. Cf. McSpadden v. Commissioner, 50 T.C. 478 (1968).

X conducted substantial business for many years, issuing notes and repaying debts as they came due. It is a question of fact when a loan to X was no longer bona fide debt, but a theft, or when the officers' conduct with regard to the money entrusted to X by the investors amounted to an arrogation of those funds with the intent to deprive the investors of their enjoyment.

Timing of a loss:

To the extent that you determine that an investor's losses are the result of the worthlessness of a security under § 165(g) the loss occurs when the security is wholly worthless. Section 1.165-5(c). A security becomes worthless when it has no current liquidating value and no potential value. Morton v. Commissioner, 38 B.T.A. 1270, 1279 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940). The determination of worthlessness is a question of fact and the burden of proving worthlessness is on the taxpayers. Boehm v. Commissioner, 326 U.S. 287 (1945), reh'g denied, 326 U.S. 811 (1946). Identifiable events establishing worthlessness in this case might include the closing of the bankruptcy case or notice by the trustee that no further distributions would be made.

To the extent that you determine an investor's loss results from theft, §165(e) and § 1.165-8 provide that a loss arising from a theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss.

Section 1.165-8(a)(2) provides that if in the year the taxpayer discovers the loss arising from a theft there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is sustained, for purposes of § 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received. See also § 1.165-1(d)(3). Therefore, a theft loss deduction will be barred to the extent that a reasonable prospect of reimbursement exists. If the theft loss exceeds the claim for recovery, the excess would be deductible in the year the theft is discovered. Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975). If further distributions of uncertain amounts are forthcoming it cannot be ascertained with reasonable certainty whether or not such reimbursement will be received and the loss deduction must be postponed. See, Johnson v. United States, 74 Fed. Cl. 360 (2006).

Treatment of income:

Taxpayers using the cash receipts and disbursements method of accounting must include amounts in gross income when actually or constructively received. Section

1.451-1(a).[1] This includes amounts representing interest under § 1.446-2(e), as well as other returns on investment.[2] See Premji v. Commissioner, T.C. Memo. 1996-304, aff'd without published opinion, 139 F.3d 912 (10th Cir. 1998).

In certain cases involving fraudulent schemes courts have applied the open transaction doctrine treating payments to taxpayers as a return of capital and not ordinary income. These cases state that the payments were not for the use or forbearance of money, and thus were not interest, but were used to conceal fraud. Greenberg v. Commissioner, T.C. Memo. 1996-281; Kooyers v. Commissioner, T.C. Memo. 2004-281. You have stated that a number of investors have filed amended returns for open years, recharacterizing the taxable interest they reported in those years as, in hindsight, a nontaxable return of principal. This was not the case in either Greenberg or Kooyers, where the fraud was discovered before the taxpayer reported the amounts as income.

The open transaction doctrine is applied in rare and extraordinary circumstances when recovery is so uncertain so at to prevent treating the transaction as closed. Burnet v. Logan, 283 U.S. 404 (1931); McShain v. Commissioner, 71 T.C. 998 (1979). We believe this treatment is proper for amounts actually or constructively received after the fraud was discovered. Thus, payments made by X in the year the fraud was discovered—like the recoveries paid by the trustee—are not income unless the taxpayer's basis is exceeded. Returns may be amended if an amount was reported as income but was not in fact actually or constructively received. See, Taylor v. United States, 81 AFTR 2d 98-1683, 98-1 USTC ¶ 50,354 (E.D. Tenn. 1998) (involving "phantom income" that the taxpayer was falsely told had been earned).

However, the open transaction doctrine should not be applied retroactively, and must yield to the general rule that each tax year stands on its own. See, Burnet v. Sanford & Brooks, 282 U.S. 359 (1931); see also, Parrish v. Commissioner, T.C. Memo. 1997-474, aff'd 168 F.3d 1098 (8th Cir. 1999); Premji v. Commissioner, T.C. Memo. 1996-304 (which explains constructive receipt in the context of a fraudulent scheme); Wright v. Commissioner, T.C. Memo. 1989-557, aff'd without published opinion, 931 F.2d 61 (9th Cir. 1991). The proper remedy for taxpayers who have suffered a loss is a deduction. Cf. Spring City Foundry, 292 U.S. 182. The Code provides some relief by allowing theft losses to be carried back under § 172.

---

[1] For purposes of this memorandum, we have assumed that the interest in question is not original issue discount, subject to the income inclusion rules under § 1272 and § 1.1272-1. Based on the facts presented to us, however, it is unclear whether the interest in all cases is not original issue discount. For example, if the interest is payable at maturity on a particular note, the interest most likely is original issue discount and, if so, would be includible in the investor's income as it accrues, regardless of whether a payment was actually or constructively received during the tax year. In the case of a note that provides for monthly interest payments, the interest may be original issue discount because the interest is not qualified stated interest within the meaning of § 1.1273-1(c); however, the facts are insufficient to determine if the interest is qualified stated interest.

[2] See § 1.1275-2(a) in the case of a note that has original issue discount.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call if you have any further questions.

THOMAS A. LUXNER
Chief Branch 1
Associate Chief Counsel
(Income Tax & Accounting)