DEPARTMENT OF THE TREASURY
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OFFICE OF THE CHIEF COUNSEL

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The Honorable Tom McClintock
Member, U.S. House of Representatives
4230 Douglas Boulevard, Suite 200
Granite Bay, CA 95746

Attention:

Dear Congressman McClintock:

This letter responds to your inquiry dated June 14, 2010, on behalf of your constituent, , and his wife, . asked whether relief is available for his wife and for other taxpayers who were victims of a perpetrator of fraudulent activities.

explained that his wife and other taxpayers paid money to the perpetrator. Many of the taxpayers, including , believed the perpetrator used their money to pay their federal and state tax liabilities. Instead, the perpetrator diverted the money for personal purposes. In addition, the perpetrator convinced some taxpayers to invest in what described as a Ponzi scheme. I hope the following general information on the relief that is available for taxpayers in these types of situations is helpful.

If the perpetrator stole money from taxpayers, they may be able to deduct the loss under section 165 of the Internal Revenue Code (the Code). A theft loss generally is deductible in the year the taxpayer discovers it or, if later, in the year in which a reasonable prospect of recovering the lost amount no longer exists (section 1.165-1(d)(3) of the Income Tax Regulations).

A taxpayer who loses money in a criminally fraudulent investment arrangement such as a Ponzi scheme may be entitled to an investment theft loss deduction (section 165(c)(2) of the Code). This type of loss is an itemized deduction that in some cases may result in a net operating loss that offsets gross income in prior or future taxable years. For further information on this type of loss, see Revenue Ruling 2009-9, which explains the income tax law that applies to investors who lose money in a criminally fraudulent investment arrangement, and Revenue Procedure 2009-20, which provides optional safe harbor treatment for qualified investors who lost money in this type of arrangement. I am enclosing a copy of both documents.

An individual taxpayer who is a victim of a theft of money by someone who falsely claims to be using the money to pay the taxpayer's tax liabilities may be entitled to a non-investment theft loss deduction under section 165(c)(3) of the Code. For this type of loss, the amount that the taxpayer can deduct as an itemized deduction is the amount of the loss, minus $100, that exceeds 10 percent of the taxpayer's adjusted gross income (section 165(h)(1) and (2) of the Code).

While deducting a loss may lower a taxpayer's gross income in the year of the loss, the underlying federal tax liabilities that the perpetrator falsely claimed to have paid are not affected, and if the liabilities remain outstanding the taxpayer must still pay them. However, avenues are available that taxpayers may wish to pursue with the IRS to mitigate hardships that outstanding federal tax liabilities can cause.

First, taxpayers may be able to pay the full amount of their tax liabilities in installments over a period of time under an installment agreement. Second, the IRS has an "Offer in Compromise" (OIC) program. An OIC is an agreement between the taxpayer and the government that settles a tax liability for less than the full amount owed. The IRS will generally accept an OIC when the full collection of the tax liability is unlikely and the amount offered reflects the reasonable collection potential from the taxpayer. An OIC also may be an option when a legitimate doubt exists that the assessed tax liability is correct, the collection of the tax liability in full would create an economic hardship on the taxpayer, or the collection of the tax liability would be unfair or inequitable. Information on these alternatives that may be helpful is available at www.irs.gov, including how to file an OIC, to set up installment payment agreements, and to seek help from a taxpayer advocate. I have also enclosed a copy of Publication 594, The IRS Collection Process.

As to penalties the IRS may impose, the process for relief varies depending on the type of penalty and the taxpayer's circumstances as to the liability for the penalty. Information on relief from penalties is available in Publication 594; IRS Notice 746, Information About Your Notice, Penalty and Interest; and IRS Notice 1215, What to do if You Disagree with the Penalty. I have enclosed a copy of these notices. A taxpayer may also include penalty liabilities in an installment agreement or OIC. Further information on relief from penalties is available at www.irs.gov.

I hope this information is helpful. If you have any questions, please call me o r at .

Sincerely,

Thomas D. Moffitt
Chief, Branch 2
(Income Tax & Accounting)

Enclosures (5)