Internal Revenue Service

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B02
PLR-128134-10
Date:
December 28, 2010

In re:

EIN:

TY:

Legend:

Taxpayer	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
E	=
F	=

State =
Company =
Account X =
Individual A =
Individual B =
Individual C =
Individual D =
x percent =
Amount 1 =
Amount 2 =
Amount 3 =
Loan X =
Entity R =
Entity U =
Entity V =
Entity Z =
S =
T =
Firm =
W =

Dear :

This is in response to your letter dated Date 1, and amended letters dated Date 2, Date 3, Date 4, and Date 5, filed on behalf of the above-named taxpayer in which you request the following rulings:

(1) Taxpayer is the qualified investor for purposes of claiming a theft loss deduction under § 4.03 of Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

(2) The discovery year, as defined in § 4.04 of Rev. Proc. 2009-20, is Year 8.

FACTS

Taxpayer was formed as a limited liability company in Year 3 in the state of State and has filed as a partnership for federal tax purposes since its formation. It is represented that Taxpayer was formed to conduct legitimate business activities involving E. Taxpayer sold its membership interests to investors and used the funds generated through the sale of membership interests to invest in loans originated by Company. Taxpayer offered its investors a flow-through of profits generated through the investments in the Company loans. Company maintained a bank account known as the Account X to collect loan payments from borrowers that Company would eventually pay to direct investors, including Taxpayer. During Taxpayer's entire existence, it participated in legitimate business activities, such as F.

In Year 4, some of Company's loans began to default. Individual A, President of Company from Year 2 until Date 6, and Individual B, chairman and CEO of Company from Year 1 until Date 6, the lead figures, concealed from investors that loans were not performing and caused Company to continue to pay interest to investors regardless of whether the underlying borrowers had made loan payments to the Account X. As a result, the Account X had insufficient funds to make payments to all of its investors, and Individuals A and B began to look for sources of money to cover the shortage in the Account X. One of the ways Individuals A and B covered the shortage was by not remitting principal payments to investors when borrowers paid off the loans. Individuals A and B made it appear as if the loans were still performing by paying the investors an amount calculated as if the borrowers had made only interest payments on the loans. Individuals A and B also funded the shortage in the Account X with money collected from new investors and by withholding payments from the Account X owed to Taxpayer. By the end of Year 5, Individuals A and B had used more than Amount 1 of Taxpayer's funds to make payments to other Company investors on non-performing loans.

In Year 5, Individuals A and B, who controlled Taxpayer through several tiered entities from its formation until Date 6, caused Taxpayer to create a fraudulent loan known as the Loan X. Individual A directed a broker, Individual C, to form two entities, Entity R and Entity U, for the sole purpose of extracting money from Taxpayer to fund the private developments and other investment projects of Individuals A and B. Entity R was the purported borrower in the Loan X transaction, and it funneled most of the loan proceeds to Entity U, which then transferred the proceeds to Entity V, an entity in which Individuals A and B held x percent of the ownership interests. Both Entity R and Entity U served as conduits with no legitimate business purpose through which Individuals A and B shifted Taxpayer's money to Entity V. Individuals A and B concealed the Loan X from Taxpayer's investors until Year 6. By Date 6, Individuals A and B had caused Taxpayer to transfer approximately Amount 2 in principal to the Loan X. Through these actions, Individuals A and B defrauded Taxpayer of its property and caused Taxpayer's funds to be misappropriated.

Taxpayer continued to sell membership interests until Date 7 and allowed investors to reinvest their distributions until around Date 8. As of Date 6, Taxpayer had about S investors and had raised approximately Amount 3 from investors. There is no indication that any of Taxpayer's partners, other than Entity Z and Entity V, partners managed by Individuals A and B, had any knowledge of fraudulent conduct by Individuals A and B prior to it becoming known to the general public.[1]

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[1] Individuals A and B were the managers of two entities, Entity Z and Entity V, that invested in Taxpayer. Entity Z was the manager of Taxpayer, and Entity V was the manager of Entity Z. Taxpayer's Operating Agreement required its manager to contribute to the capital of Taxpayer as the initial member. Besides

On Date 6, Company and Taxpayer filed for bankruptcy. As of the bankruptcy filing date, Taxpayer had various legitimate note receivables from unrelated third parties. Taxpayer emerged from bankruptcy according to a confirmed plan of reorganization in Year 7, and pursuant to Taxpayer's amended operating agreement approved as part of the plan confirmation, Individual D of Firm became Taxpayer's new manager. Since the plan confirmation, Taxpayer has been liquidating the estate, pursuing causes of action, and distributing proceeds to Taxpayer's investors. In Year 8, the United States Attorney for W filed a criminal information against Individual A charging him with one count of T, and he pled guilty to the charge.

REPRESENTATIONS

Taxpayer represented the following: (1) Taxpayer satisfies the requirements for a specified fraudulent arrangement and a qualified loss under §§ 4.01 and 4.02 of Rev. Proc. 2009-20; and (2) the fraudulent arrangement did not have a purpose of avoiding or evading taxes.

LAW & ANALYSIS

Section 165(a) of the Internal Revenue Code allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise. A loss arising from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss, not a capital loss, under § 165. Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

For federal income tax purposes, "theft" is a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses, and any other form of guile. *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956); *see also* § 1.165-8(d) of the Income Tax Regulations. A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. Rev. Rul. 72-112, 1972-1 C.B. 60.

Section 165(e) states that any loss arising from theft shall be treated as sustained in the taxable year the taxpayer discovers the loss. Under §§ 1.165-8(a)(2) and 1.165-1(d), however, if, in the year of discovery, 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 until the taxable year in which it can be ascertained with reasonable certainty whether or not the reimbursement will be received. Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances.

Individuals A and B, Taxpayer is not aware of any employees or directors of Company, Entity Z, or Entity V that had knowledge prior to the bankruptcy petition date of fraudulent activities by Individuals A and B.

Rev. Proc. 2009-20 provides an optional safe harbor treatment for qualified investors that experience losses in certain investment arrangements discovered to be criminally fraudulent. Rev. Proc. 2009-20 applies to losses for which the discovery year, as defined in § 4.04 of Rev. Proc. 2009-20, is a taxable year beginning after December 31, 2007.

Section 5.01 of Rev. Proc. 2009-20 provides that if a qualified investor follows the procedures described in Rev. Proc. 2009-20, the 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 the revenue procedure; and (3) the amount of the deduction is the amount specified in the revenue procedure.

Section 4.03 of Rev. Proc. 2009-20 defines a qualified investor as a United States person, as defined in § 7701(a)(30) –

> (1) That generally qualifies to deduct theft losses under § 165 and § 1.165-8;
>
> (2) That did not have actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public;
>
> (3) With respect to which the specified fraudulent arrangement is not a tax shelter, as defined in § 6662(d)(2)(C)(ii); and
>
> (4) That transferred cash or property to a specified fraudulent arrangement. A qualified investor does not include a person that invested solely in a fund or other entity (separate from the investor for federal income tax purposes) that invested in the specified fraudulent arrangement. However, the fund or entity itself may be a qualified investor within the scope of the revenue procedure.

Section 7701(a)(30) provides that the term “United States person” includes a domestic partnership.

Section 4.01 of Rev. Proc. 2009-20 defines a specified fraudulent arrangement as an arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income from investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors’ cash or property.

Section 4.02 of Rev. Proc. 2009-20 defines a qualified loss as a loss resulting from a specified fraudulent arrangement in which, as a result of the conduct that caused the loss –

(1) The lead figure (or one of the lead figures, if more than one) was charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement or a similar crime that, if proven, would meet the definition of theft for purposes of § 165 and § 1.165-8(d), under the law of the jurisdiction in which the theft occurred; or

(2) The lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in section 4.02(1) of this revenue procedure, and either –

(a) The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or

(b) A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

Section 4.04 of Rev. Proc. 2009-20 states that a qualified investor's discovery year is the taxable year of the investor in which the indictment, information, or complaint described in the definition of qualified loss under § 4.02 is filed.

Issue 1: Is Taxpayer the qualified investor for purposes of claiming a theft loss deduction under Rev. Proc. 2009-20?

Taxpayer satisfies the requirements for a qualified investor under § 4.03 of Rev. Proc. 2009-20: (1) Taxpayer is a United States person, as defined in § 7701(a)(30), that generally qualifies to deduct theft losses under § 165 and § 1.165-8; (2) there is no indication that the partners, other than two partners managed by Individuals A and B, had any knowledge of fraudulent conduct by Individuals A and B prior to it becoming known to the general public; (3) Taxpayer represented that the specified fraudulent arrangement was not a tax shelter, as defined in § 6662(d)(2)(C)(ii); and (4) Individuals A and B, through the Loan X and by withholding payments owed to Taxpayer, caused Taxpayer to transfer money to a specified fraudulent arrangement.

Issue 2: Is Year 8 the discovery year as defined in § 4.04 of Rev. Proc. 2009-20?

Taxpayer's discovery year for purposes of Rev. Proc. 2009-20 is the taxable year in which the information described in the qualified loss requirements under § 4.02 is filed. Based on the criminal information filed by the United States Attorney for W against Individual A, one of the lead figures, in Year 8 and Taxpayer's representation that it satisfies the requirements of a qualified loss under § 4.02, Taxpayer's discovery year for purposes of Rev. Proc. 2009-20 is Year 8.

CONCLUSION

Based on the information submitted and representations made, we conclude that:

(1) Taxpayer is the qualified investor for purposes of claiming a theft loss deduction under Rev. Proc. 2009-20.

(2) The discovery year for purposes of claiming a theft loss deduction under Rev. Proc. 2009-20 is Year 8.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative. Please attach a copy of this letter ruling to the federal income tax return for the taxable year in which the taxpayer claims the theft loss deduction.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a statement executed under penalties of perjury by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. This letter ruling is limited to the matters specifically addressed. No opinion is expressed as to whether Taxpayer has satisfied the other requirements for claiming a theft loss under Rev. Proc. 2009-20.

Sincerely,

Norma C. Rotunno
Senior Technician Reviewer, Branch 2
(Income Tax & Accounting)

cc: