Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Mary P. Hamilton
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(Small Business/Self-Employed)

from: R. Matthew Kelley
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(Income Tax & Accounting)

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subject:

This Chief Counsel Advice responds to your request for assistance dated September 8, 2011. This advice may not be used or cited as precedent.

LEGEND

Taxpayers =
Taxpayer-Husband =
Taxpayer-Wife =
Perpetrator =
Associate 1 =
Associate 2 =
Fund Manager 1 =
Fund Manager 2 =
Management Fund 1 =
Management Fund 2 =
Management Fund 3 =
Investment Fund 1 =
Investment Fund 2 =
Investment Fund 3 =
Investment Fund 4 =
Investment Fund 5 =
Investment Newsletter =

Year 1 =
Year 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
$aa = $
$bb = $
$cc = $
$dd = $
$ee = $

ISSUE

Whether Taxpayers' are theft losses for purposes of § 165 of the Internal Revenue Code under the facts described below, even though Taxpayers invested through individuals other than the primary perpetrator of the scheme, Perpetrator.

CONCLUSION

Taxpayers' are theft losses for purposes of § 165 of the Internal Revenue Code under the facts described below, even though Taxpayers invested through individuals other than Perpetrator, because Perpetrator intended to steal from Taxpayers.[1]

FACTS

Taxpayers' Investments in the Scheme

Taxpayers each invested in Investment Fund 1, an investment fund managed indirectly by Fund Manager 1 and Fund Manager 2 (collectively the fund managers). On Date 1, Taxpayer-Husband made a wire transfer of $aa to an account for Investment Fund 1. The wire transfer information was provided to Taxpayer-Husband by Associate 1. For all years prior to the year Perpetrator's scheme was uncovered, Taxpayer-Husband reported income totaling $bb, and withdrew approximately $cc. Taxpayer-Wife received an Investment Fund 1 account worth $dd from her father in Year 1, and reported income from the Investment Fund 1 account totaling $ee.

Taxpayer-Husband states that he learned about the investment funds in which he invested from Investment Newsletter, published by Associate 2, and invested in the

[1] In this memorandum, we address only whether the losses are deductible by Taxpayers as theft losses in the context of Taxpayers' relationship to Perpetrator. We do not address the amounts of the deductions, the year of the deductions, or whether Taxpayers are entitled to use the safe harbor treatment provided in Rev. Proc. 2009-20, 2009-1 C.B. 749.

funds based on the claims in Investment Newsletter as to Perpetrator's qualities as a money manager. Taxpayer-Wife states that Taxpayer-Husband had learned of the investment funds through Investment Newsletter and suggested the investment to her father.[2]

Structure of the Scheme

The fund managers were the managing members of Management Fund 1, which they created to manage Investment Fund 1, and Management Fund 2, which they created to manage both Investment Fund 3 and Investment Fund 4. Perpetrator separately formed Management Firm 3, which he created to manage both Investment Fund 2 and Investment Fund 5. The fund managers hired Perpetrator to serve as investment advisor to Management Fund 1 and Management Fund 2.

The fund managers and Perpetrator sold interests in Investment Fund 1, Investment Fund 3, and Investment Fund 4 through multiple private placement offerings. According to the private placement memoranda, the success of the funds was dependent on the fund managers' expertise, and the memoranda touted Fund Manager 1's experience in the securities industry. The memoranda stated that while Management Fund 1 and Management Fund 2 would rely on Perpetrator's investment advice, Management Fund 1 and Management Fund 2 would make all decisions concerning investment and trading activities in the funds, and that Management Fund 1 and Management Fund 2 had the sole responsibility for managing their respective investment funds.

Investors for the various funds were also solicited by Associate 2 through his Investment Newsletter, in which he extolled the skills of Perpetrator as a manager and recommended the various funds controlled by the fund managers and Perpetrator.

Perpetrator's scheme continued through the end of Year 2. On Date 2, Perpetrator was indicted on charges of securities fraud, mail fraud, and wire fraud. On Date 3, Perpetrator pled guilty to all counts of the indictment. On Date 4, the Securities and Exchange Commission filed a complaint for injunctive relief against Fund Manager 1 and Fund Manager 2, alleging reckless violations of the anti-fraud provisions of the federal securities laws. On Date 5, a court entered judgments of permanent injunction against Fund Manager 1 and Fund Manager 2.

LAW AND 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.

[2] The facts surrounding Taxpayer-Wife's investment in relationship to her father's investment remain unclear and are being developed by Exam.

For individuals, § 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit, and § 165(c)(3) allows a deduction for certain losses not connected to a transaction entered into for profit, including theft losses.

Section 1.165-1(b) of the Income Tax Regulations provides that to be allowable under § 165(a), a loss must be evidenced by a closed and completed transaction, fixed by identifiable events, and actually sustained during the taxable year. Only a bona fide loss is allowable, and substance and not mere form governs.

Section 165(e) provides that, for purposes of § 165(a), any loss arising from theft will be treated as sustained during the taxable year in which the taxpayer discovers the loss.

Sections 1.165-8(a)(2) and 1.165-1(d) provide that 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.

Section 1.165-8(d) provides that the term "theft" includes, but is not limited to, larceny, embezzlement, and robbery. "[T]he word 'theft' is not like 'larceny,' a technical word of art with a narrowly defined meaning but is, on the contrary, a word of general and broad connotation, intended to cover and covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile." Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1956); see also Rev. Rul. 2009-9, 2009-1 C.B. 735.

To deduct a theft loss under § 165(a), a taxpayer must show that "the 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." Rev. Rul. 72-112, 1972-1 C.B. 60; see also Edwards, 232 F.2d at 111. In many cases, a specific intent to deprive the victim of his or her property is an essential element of the crime, and specific intent requires a degree of privity between the perpetrator and the victim of the crime. See, e.g., Marr v. Commissioner, T.C. Memo 1995-250.

In this case, Exam agrees that Taxpayers, indirectly or directly, are victims of a Ponzi scheme. Exam also agrees that Perpetrator is guilty of a crime under a state law that defines the crime as requiring, in part, that the perpetrator have "intent to deprive another of property or to appropriate the same to himself or to a third person." However, Exam has requested assistance on the issue of whether Taxpayers lacked privity with Perpetrator because Taxpayers invested through the fund managers, rather than directly with Perpetrator.

The cases in which the Tax Court has addressed the lack of privity between victims and perpetrators typically involve taxpayers who purchased shares of stock on the open market. In Marr, the taxpayer purchased several blocks of stock on the open market on

the advice of his broker. As the market price of the shares declined, the taxpayer was forced to sell shares to meet margin calls. The court found that the taxpayer was not entitled to a theft loss for the value of his shares because there was no appropriation of the taxpayer's property by the alleged defrauders: the taxpayer's property was acquired by the parties who sold the taxpayer the stock.

Similarly, in Crowell v. Commissioner, T.C. Memo. 1986-314, the taxpayer claimed a theft loss arising from shares purchased on the open market. The court found that there was no theft loss because there was no specific intent by the corporate officers and directors to deprive the taxpayer of his property. In other cases arising from the same fraud, the Tax Court held that taxpayers were not entitled to theft loss deductions because of the lack of privity between the perpetrators of the fraud and the taxpayers. The taxpayers had no direct dealing with the corporate officers, and it was not the officers and directors who took, obtained, or withheld the taxpayers' property. See DeFusco v. Commissioner, T.C. Memo. 1979-230; Barry v. Commissioner, T.C. Memo. 1978-215.

Finally, in Electric Picture Solutions v. Commissioner, T.C. Memo. 2008-212, the taxpayer purchased blocks of shares on the open market through a broker. Rather than allege or attempt to establish a purchaser-seller relationship between itself and the company, the taxpayer argued that it was defrauded by its broker. However, the court found that the taxpayer did not establish that the broker or his agents had "guilty knowledge or intent" or that the broker made any false representations with intent to deceive the taxpayer. The taxpayer also failed to establish that the broker appropriated the taxpayer's property in connection with the purchase of shares.

In each of these cases, the taxpayers purchased their interests in the entities on the open market, and the court found that there was no criminal intent on the part of the perpetrators to deprive the taxpayers of their property. Instead, the taxpayers' property ended up in the hands of the parties on the other side of the market transaction, not within the scheme itself.

In contrast, in Jensen v. Commissioner, T.C. Memo. 1993-393, aff'd on other issues 72 F.3d 135 (9th Cir. 1995), the Tax Court found that the taxpayers were in privity with the perpetrators of the scheme because the figure through whom they invested was merely a broker or a conduit to the scheme. The taxpayers invested in a Ponzi scheme through a business associate. The perpetrators of the scheme referred potential investors to the associate so that they could invest in the scheme. The Tax Court held that there is no requirement that the investor have direct contact with the entity in which he is investing, and that the associate acted as a conduit for the taxpayers' funds because the taxpayers' gave the associate their funds for the sole purpose of investing in the scheme through him.

The facts in Jensen are more analogous to Taxpayers' situation than are the facts in the open market cases. Taxpayers' property, like the taxpayers' property in Jensen—and

unlike in the frauds alleged in the open market cases—ended up in the scheme and at the disposal of Perpetrator. Taxpayers did not purchase their interests in Investment Fund 1 from third parties on the open market; they obtained their interests in Investment Fund 1 after reading about the fund in Investment Newsletter published by Associate 2 and paying money into the fund itself. Taxpayers state that they invested in Investment Fund 1 based on the reputation of Perpetrator as an investment manager.

Perpetrator effectively controlled the investing activity of each of the funds, and used each of the funds as a vehicle for his scheme, regardless whether his official role was owner of or investment advisor to the fund. Distinctions made between individual investment funds and between different investor's accounts had little meaning: Perpetrator treated the funds as a single source of money regardless of the fund in which the investor purportedly invested. There was no intermediate step where the fund managers invested in Perpetrator's scheme.

Under these facts, it is clear that Taxpayers directly invested in the vehicles that Perpetrator used to operate the Ponzi scheme, and that Perpetrator intended to appropriate Taxpayers' property from Taxpayers. The fund managers' role in soliciting funds that were paid into the scheme does not deprive Taxpayers of privity with Perpetrator. Therefore, Taxpayers' losses are theft losses for purposes of § 165, even though Taxpayers invested through individuals other than the primary perpetrator of the scheme.

Please call William W. Burhop at (202) 622-7900 if you have any further questions.

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