Office of Chief Counsel
Internal Revenue Service
memorandum

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date: June 06, 2014

to:
Attorney (, Group 1)
(Small Business/Self-Employed)

from: Norma Rotunno
Senior Technician Reviewer, Branch 2
(Income Tax & Accounting)

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subject: Tax Treatment of Investment Theft Losses

This Chief Counsel Advice responds to your request for assistance dated March 5, 2014. This advice may not be used or cited as precedent.

ISSUES

Whether an investor (Investor) who transferred money to the principals of to invest with , is entitled to the safe harbor treatment for theft losses under Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58.

CONCLUSIONS

Investor is eligible for the safe harbor treatment under Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, subject to subsequent recovery of amounts, if any, by Investor.

FACTS

Most of the following facts are in addition to those already provided in your request for advice.

In , Investor, an individual taxpayer, transferred money to as an investment, the proceeds of which were purportedly used to purchase

. Investor has asserted that she is entitled to claim a theft loss under Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, similar to investors that invested directly with .

In exchange for Investor's funds, Investor did not receive a

.

Persons who transferred money to to invest in had a with .

owned, operated, and managed until . Bankruptcy proceedings were commenced against . was created in the bankruptcy proceedings, and the plan of reorganization treated the investors as of . You have indicated that [redacted].

filed a civil complaint against , alleging the following violations

:

In , the ruled in favor of the on all counts and ordered against each of the found that the investments promoted by . This conclusion was based on the following findings: the investors invested money in

. This finding was based on evidence of

[1]

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LAW AND ANALYSIS

Section 165(a) of the Internal Revenue Code ("Code") allows a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise. A loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss under section 165(c)(2). *See* Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

Revenue Procedure 2009-20

The Service and the Treasury Department issued Revenue Procedure 2009-20, which provides an optional safe harbor for taxpayers who experience losses in certain criminally fraudulent investment arrangements, or so-called "Ponzi" schemes. The procedure provides investors with uniform and simplified methods for determining the timing and amount of a theft loss deduction.

Rev. Proc. 2009-20 allows a “qualified investor” to take a theft loss deduction for a "qualified loss" resulting from a specified fraudulent arrangement. See sections 4, 5 of Rev. Proc. 2009-20. A qualified investor is defined in the procedure as a U.S. person that generally qualifies to deduct theft losses under §§ 165 and 1.165-8 that did not have actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public, provided the U.S. person transferred cash or property to a specified fraudulent arrangement. Section 4.03 of Rev. Proc. 2009-20. In addition, section 4.03(4) provides that 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, and that the fund or entity itself may be a qualified investor within the scope of the revenue procedure. The procedure 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, the lead figure (or lead figures) of the scheme is criminally charged 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 section 165.[2] Section 4.02 of Rev. Proc. 2009-20. The procedure provides that a qualified investor may deduct the theft loss in the discovery year, generally defined as the year in which the criminal charge is filed. Sections 4.04 and 5.01(2) of Rev. Proc. 2009-20.

[2] Section 4 of the revenue procedure contains additional requirements with respect to the type of criminal charge, whether an admission by the lead figure is alleged, and the appointment of a receiver or trustee with respect to the fraudulent arrangement or assets of the arrangement being frozen.

Revenue Procedure 2011-58

The Service recognized that the deaths of lead figures in certain Ponzi schemes prevented government authorities from charging them with criminal theft. In these cases, qualified investors would have been unable to meet the definition of a qualified loss in Rev. Proc. 2009-20 solely due to the death of the lead figure. Therefore, the Service and Treasury issued Rev. Proc. 2011-58 to address those cases.

Rev. Proc. 2011-58 modified the definition of a qualified loss in Rev. Proc. 2009-20 to include the situation in which the lead figure or an associated entity involved in the specified fraudulent arrangement was the subject of one or more civil complaints or similar documents (such as a notice or order instituting administrative proceedings or other document the Internal Revenue Service designates) filed by a state or federal governmental entity with a court or in an administrative agency enforcement proceeding, and all of the following requirements are satisfied:

(a) The civil complaint or similar documents together allege facts that comprise substantially all of the elements of a specified fraudulent arrangement conducted by the lead figure;

(b) The death of the lead figure precludes a criminal charge by indictment, information or criminal complaint against that lead figure; and

(c) A receiver or trustee was appointed with respect to the arrangement or the assets of the arrangement were frozen. Section 4.01 of Rev. Proc. 2011-58.

In addition, the procedure modified the definition of discovery year in section 4.04 of Rev. Proc. 2009-20 to include the later of either the year in which the civil complaint or similar document which alleges facts that comprise substantially all the elements of a specified fraudulent arrangement is filed, or the year in which the lead figure dies. Section 4.02 of Rev. Proc. 2011-58.

[redacted]

[redacted]

The Restatement Third of Agency defines agency as: "the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.[3] In *Huff*, the Tax Court found that "An agency relationship is created when by mutual consent, either implied or expressed, one party (i.e., the agent) agrees to act on behalf of the other (i.e., the principal) and be subject to the principal's control."[4]

Accordingly, because were found to be

for federal tax purposes. Because
the losses realized with respect to investments are properly attributable to Investor and not
.
should properly be viewed as agents of Investor because
were acting on behalf of, and to, Investor. In addition,
, which sets forth that

Having chosen their form as agents of Investor and

may not participate in the realized losses, which are properly attributable to Investor. Investor should be viewed as transferring cash or property to the specified fraudulent arrangement and should be viewed as acting as agents of Investor,
, consistent with their chosen form as set forth in
and the conclusions of law reached and
.[5]

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[3] RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) (Restatement).

[4] *Huff v. Commissioner*, 138 T.C. 258, 266 (2012). *See Esmond Mills v. Commissioner*, 132 F.2d 753, 755 (1st Cir. 1943).

[5]

Rev. Proc. 2009-20 indicates, however, that 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. In such a case, the fund or entity itself may be a qualified investor within the scope of the revenue procedure. This provision would allow equity owners in pass-through entities to claim losses allocable to them as owners of the pass-through entity. This provision was not intended to preclude investors who would otherwise qualify for a theft loss under the revenue procedure from recognizing such loss. This provision should not apply here because attributing the loss to will not result in the loss being allocated to Investor

Thus, Investor is the qualified investor for purposes of Rev. Proc. 2009-20.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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 (202) 317-7011 if you have any further questions.

By contrast, and consistent with *Huff* and the Restatement, the analysis in this memorandum looks at the relationship between and Investor in analyzing whether Investor is entitled to a federal tax theft loss under Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58.