Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: "Phantom Income" from Fraudulent Investment Schemes and Related Issues

This document should not be used or cited as precedent. This is in response to your request for advice on how to treat “phantom income" (that is, purported income reported to a taxpayer from a fraudulent investment scheme), from both open and closed years, for taxpayers who do not or cannot use the safe harbor provided in Rev. Proc. 2009-20. The memorandum also addresses several related issues affecting these taxpayers. All section references are to the Internal Revenue Code of 1986 or the Income Tax Regulations.

ISSUES AND CONCLUSIONS

This memorandum addresses situations where a taxpayer who invested in a fraudulent scheme does not or cannot use the safe harbor procedure provided in Rev. Proc. 2009-20. The following issues and conclusions are in Question and Answer format for clarity.

Q. 1: May a taxpayer amend returns for years in which the period of limitations for filing a claim for refund has not expired ("open years") to eliminate from income amounts that were falsely reported to the taxpayer as income (“phantom income”)?

A. 1: Yes. A taxpayer who does not or cannot use the safe harbor procedure provided in Rev. Proc. 2009-20 has two options:

a. The taxpayer may deduct the investment in the scheme, including amounts previously included in income, less cash withdrawals from the investment, as a theft loss under I.R.C. § 165(c)(2), in the year the theft is discovered (or later, if there is a reasonable prospect of recovery). For this purpose, it is irrelevant whether the prior income was fictitious or genuine. [1]

b. Alternatively, the taxpayer may amend returns for open years to recalculate income for those years by removing phantom income. If the taxpayer withdrew in cash amounts that were previously reported as income in an open year, the taxpayer would treat the withdrawal as a nontaxable return of capital. See Answer 2 below. If the taxpayer did not withdraw those amounts and reported the income as being constructively received, then the taxpayer would treat the phantom income as never having been received. The taxpayer must establish the amount of income that was fictitious in the open years.

Q. 2: When amending prior tax returns to eliminate phantom income, how does a taxpayer treat cash withdrawals from the investment scheme in open years? How does a taxpayer treat amounts that were included in income in years in which the period of limitations for filing a claim for refund has expired ("closed years")?

A. 2: If the taxpayer chooses to amend prior returns to eliminate phantom income and establishes the amount of income that was fictitious, then withdrawals of the taxpayer's investment, or "basis", in the scheme in an open year may be treated as a nontaxable return of capital. For this purpose, the "basis" in the scheme is the sum of the following: prior cash investments, plus amounts previously reported as income, less prior cash withdrawals.[2] The basis consists of all amounts included in income in closed years, without regard to whether that income was fictitious or genuine.

Q. 3: What is the treatment of withdrawals in excess of the taxpayer's investment in the scheme?

A. 3: If and to the extent that a taxpayer withdrew amounts in excess of the basis in the scheme, the taxpayer must include those amounts in income in the taxable year in which they are received. The calculation of basis is discussed in Answer 2 above.

Q. 4: Does a reasonable prospect of recovering the taxpayer's investment in a bankruptcy or similar proceeding prevent the taxpayer from amending prior returns to eliminate phantom income?

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[1] As used in this memorandum, an amount of purported income is "fictitious" (or "phantom") whether it was only constructively received, or, if paid, because the payment was actually not earned as the scheme's promoter falsely represented, but rather was a payment, from other investors' funds or the investor's own funds, to preserve and cover up the scheme.

[2] In this memorandum, we will use the terms "basis" or "unrecovered investment" to denote the investment in a scheme that has not yet been recovered for tax purposes.

A. 4: No. A reasonable prospect of recovering a taxpayer's investment postpones a theft loss deduction under section 165, but does not postpone or prevent amending prior returns to eliminate phantom income under section 61.

Q. 5: May a taxpayer who files amended returns to eliminate phantom income in open years still have a theft loss deduction? If so, how is it calculated?

A. 5: Yes. To the extent that a taxpayer who amends prior returns to eliminate phantom income in open years does not recover the entire basis in the scheme as a return of capital under section 61, the remaining basis is deductible as a theft loss under section 165, in the year the theft is discovered (or later, if there is a reasonable prospect of recovery).

Q. 6: Should the Service assert that the taxpayer cannot eliminate phantom income in open years because in each year the taxpayer constructively received not only an amount equal to the purported income but also the taxpayer's entire investment?

[redacted]

FACTS

The following examples are hypothetical situations similar to questions encountered previously and are intended to illustrate the conclusions above. However, these examples are not intended to be exhaustive of all possible circumstances. The principles described in this memorandum must be applied appropriately in each case.

Situation 1 describes a scenario where the taxpayer is an individual who included in income all amounts that were falsely reported to him as income from the fraudulent investment scheme on his income tax returns for years in which the period of limitations to file a claim for refund under section 6511 has expired (“closed years”) and years in which the period has not expired (“open years”). However, the taxpayer did not actually withdraw any cash from the scheme. The scheme entered into bankruptcy, and the taxpayer received 20% of his initial investment as a recovery through the bankruptcy proceedings.

Situation 2 describes a scenario where the taxpayer included all amounts that were falsely reported to her as income from the scheme on her income tax returns for closed and open tax years, but made cash withdrawals in both closed and open years totaling more than she initially invested with the scheme. The taxpayer in Situation 2 did not receive any recovery through the bankruptcy proceedings. However, the taxpayer in Situation 2 did recover 10% of her initial investment in Year 10 through a separate legal action against her broker, who was found to have been negligent in advising B to invest in the fraudulent investment scheme.

Situation 3 describes a scenario where the taxpayer included all amounts that were falsely reported to him as income from the scheme on his income tax returns for closed and open tax years, and made cash withdrawals in open years exceeding his total investment (initial investment plus income reported in closed years) in the scheme. The taxpayer in Situation 3 did not receive any recovery through the bankruptcy proceedings.

Further discussion of the facts and application of the law to each Situation is discussed in the “Application of Law to Situations” section below.

LAW AND ANALYSIS

Theft Losses

Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise. For individuals, section 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit. 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; *see also* section 1.165-8(d) (theft shall be deemed to include, but not necessarily be limited to, larceny, embezzlement, and robbery). However, a taxpayer need not show a conviction for a theft in order to be entitled to a theft loss deduction. *Vietzke v. Commissioner*, 37 T.C. 504, 510 (1961), *acq.*, 1962-2 C.B. 6.

Under section 165(e), a theft loss is sustained in the taxable year the taxpayer discovers the loss. The regulations explain that a theft loss is not sustained if, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery. *See* sections 1.165-1(d), 1.165-8(a)(2). No portion of the loss with respect to which reimbursement may be received is sustained until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Section 1.165-1(d)(3).

Revenue Ruling 2009-9

Rev. Rul. 2009-9, 2009-14 I.R.B. 735, describes the proper income tax treatment for losses resulting from fraudulent investment schemes. Rev. Rul. 2009-9 generally holds that a loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss and is deductible under section 165(c)(2) in the year the loss is discovered, provided that the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery.

Additionally, the ruling holds that the amount of a theft loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery. If an amount is reported to the investor as income in years prior to the year of discovery of the theft, the investor includes the amount in gross income, and the investor reinvests the amount in the arrangement, this amount increases the deductible theft loss.

Revenue Procedure 2009-20 Safe Harbor Procedure

Rev. Proc. 2009-20, 2009-14 I.R.B. 749, provides an optional safe harbor under which qualified investors that experienced losses from a specified fraudulent arrangement may treat a qualified loss as a theft loss deduction. The safe harbor provides qualified investors with a uniform manner for determining their theft losses, avoids potentially difficult problems of proof in determining how much income reported in prior years was fictitious, and alleviates compliance and administrative burdens on both taxpayers and the Service.

Section 8.01 of Rev. Proc. 2009-20 states that taxpayers who either choose not to or cannot use the safe harbor are subject to the generally applicable provisions governing theft losses under section 165. Thus, a taxpayer seeking a theft loss deduction has the burden to establish, for example, that the loss was from theft, the proper year of discovery, the amount of the claimed loss, and that no claim for reimbursement of the loss exists with respect to which there is a reasonable prospect of recovery in the year the taxpayer claims the loss.

A taxpayer who files or amends returns to exclude amounts reported as income from an investment arrangement is not eligible for the safe harbor. Rev. Proc. 2009-20, § 6.02(2). Section 8.02 provides that a taxpayer who chooses to exclude income in open years must establish that these amounts in fact were not income that the taxpayer actually or constructively received. However, with respect to income reported in closed years, the revenue procedure provides that as long as the taxpayer can prove the net amount of income that was reported on a prior return and included in gross income consistent with the information received from the arrangement, the Service will not challenge the taxpayer's inclusion of that amount in basis for determining the amount of any allowable theft loss, whether or not the income was genuine.

Recharacterization of Prior Withdrawals as a Return of Capital

As § 8.02 of Rev. Proc. 2009-20 recognizes, there is authority for recharacterizing withdrawals from a Ponzi scheme as a nontaxable return of capital (although a taxpayer that chooses to do so is not eligible for the safe harbor).

Ordinarily, all accessions to wealth, clearly realized, and over which the taxpayers have complete dominion, must be included in taxable income. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). This includes income realized from a fraudulent investment scheme.[3]

However, in certain circumstances involving fraudulent schemes, taxpayers may recharacterize withdrawals in open years as a nontaxable return of capital instead of as taxable income from the scheme. *Johnson v. United States*, 79 Fed. Cl. 266, 271 (2007) (held that money taxpayers received from fraudulent gem transactions and reported as capital gain income was really a return of capital designed to conceal the fraud). *See also Kooyers v. Commissioner*, T.C. Memo. 2004-281 (held that amounts reported by a fraudulent investment scheme on Form 1099-INT that the taxpayer did not include on a tax return were not taxable interest but were non-taxable return of investment funds); *Greenberg v. Commissioner,* T.C. Memo. 1996-281 (court recharacterized amounts received by petitioners in a Ponzi scheme as a return of investment made to conceal the fraud rather than as interest income).

Thus, taxpayers, to the extent of their investment, or "basis," in the scheme, may amend tax returns for open years to eliminate from income amounts that they can prove were fraudulently reported as income from the scheme.

If and to the extent that a taxpayer withdraws cash in excess of that investment, however, the excess is income under section 61, even if the taxpayer was not a participant in the scheme, and even though it was not the type of income (for example, interest, dividends, capital gains) the taxpayer originally thought it was.

Amounts Reported that Taxpayers May Exclude from Income

Based on the authorities and reasoning cited above, it is clear that taxpayers who choose to recharacterize withdrawals as a return of capital from a fraudulent scheme in open years under section 61 may exclude from income their *cash* investment or investments, less any previous withdrawals.

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[3] *See Harris v. United States*, 431 F. Supp. 1173 (E.D. Va. 1977); *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, *aff'd without published opinion*, 139 F.3d 912 (10th Cir. 1998); *Wright v. Commissioner*, T.C. Memo. 1989-557, *aff'd without published opinion*, 931 F.2d 61 (9th Cir. 1991); *Murphy v. Commissioner*, T.C. Memo. 1980-218, *aff'd per curiam*, 661 F.2d 299 (4th Cir. 1981).

A question has arisen, however, concerning how to treat amounts that were reported to the taxpayer as income in prior, closed (or "barred") years, and reported as income on the taxpayer's federal tax returns. This "barred-year basis" can be added to the amount of a taxpayer's theft loss *deduction*, whether the income was fictitious, genuine, or both. *See* Rev. Rul. 2009-9; Rev. Proc. 2009-20, § 8.02. The question is whether this amount of basis can be excluded from income under section 61 if a taxpayer chooses to eliminate phantom income from open years. Specifically, must a taxpayer prove amounts reported and taxed as income in closed years were fictitious or genuine for purposes of recharacterizing income as a return of capital in an open year?[4] How is the taxpayer's basis in the investment affected when the taxpayer either did or did not withdraw cash from the investment in barred years?

We interpret §§ 8.01 and 8.02 of Rev. Proc. 2009-20 together to mean that, while taxpayers generally bear the burden to prove the legitimacy of amounts included in income, amounts that a taxpayer included in income on a return filed in a closed year should be includible in the taxpayer's basis not only for purposes of computing the amount of a theft loss deduction under section 165, but also for purposes of recharacterizing income in open years under section 61, and that this treatment applies whether or not the closed-year income was genuine, fictitious, or a combination of both. We recognize that the first sentence of § 8.02 may be read to imply that a taxpayer must prove the legitimacy of amounts included in income in closed years, and that the second sentence of § 8.02 only states that basis attributable to closed-year income may be included in basis "for determining the amount of any allowable theft loss" under section 165. However, while adding "barred-year basis" to the amount of a theft loss is an option for taxpayers in this situation, we believe this amount should also be available to reduce income under section 61. With respect to closed years, this interpretation of § 8.02 is consistent with the overall spirit of reducing administrative burdens on both taxpayers and the Service by minimizing difficult problems of proof. Taxpayers still, however, bear the burden to prove that income purportedly earned in *open* years, and which they seek to exclude, was, in fact, fictitious.[5]

Accordingly, whether a taxpayer is determining the amount invested in a scheme for purposes of determining the amount of a theft loss deduction under section 165, or for purposes of recharacterizing open-year income under section 61, the basis is generally

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[4] Fraudulent schemes often begin as legitimate investments, and often earn actual income even after they turn fraudulent. For example, if a scheme was legitimate in closed years, and an investor with an initial investment of $100 actually earned $5 in cash in a closed year and chose to reinvest it, the $5 was arguably as much of a cash investment as the initial $100, and the investor should be able to recover the full $105 as a return of capital, if the scheme turned fraudulent in a later, open year.

[5] Note that this means that while a so-called "net winner" will have income from a fraudulent scheme under section 61, even after a redetermination of income, the concept of a "net winner" for federal income tax purposes differs from the definition of that term in other contexts, in that, for tax purposes, amounts reported as income in closed years are deemed to have been from accurately-reported transactions, consistent with how they were treated on the closed-year returns.

determined by the same formula. This formula is reflected in the definition of a "qualified investment" in § 4.06 of Rev. Proc. 2009-20: (1) cash invested, plus (2) amounts previously included in taxable income (in either open or closed years), less (3) cash withdrawn.[6]

Effect of a Prospect of Recovery on Elimination of Phantom Income

As discussed above, under the section 165 regulations and case law, a reasonable prospect of recovery with respect to a theft loss will postpone a theft loss deduction until the amount of the recovery is established with reasonable certainty. This rule does not apply to the computation of income under section 61, however. Accordingly, whether there is a reasonable prospect of recovery with respect to a taxpayer's investment in a fraudulent scheme does not postpone or otherwise affect eliminating phantom income by amending prior returns to recharacterize amounts reported as income from that scheme under section 61.[7]

A taxpayer cannot derive a double benefit from the same investment, however, and amounts that are treated as a nontaxable recovery of investment in an open year cannot be treated as part of a theft loss deduction in a later year.

Calculating the Remaining Theft Loss

After amending prior returns to remove amounts that were not in fact income, any remaining tax basis a taxpayer has in the investment scheme (including amounts reported as income in closed years) may be deducted as a theft loss under section 165 in the later of either the taxable year the theft is discovered or, if there is a claim for reimbursement, the taxable year in which the amount of the recovery can be established with reasonable certainty. Any amount that has been treated as a non-taxable return of capital under section 61, however, is no longer available as part of a taxpayer's basis in the investment to be deducted under section 165.

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[6] To the extent a taxpayer has recharacterized a withdrawal in a prior open year as an excludible return of capital, this amount is no longer counted as part of a taxpayer's basis in the investment for purposes of computing a remaining theft-loss deduction under section 165.

[7] Similarly, section 165(e), which provides that a theft loss is generally deductible under section 165 in the year the theft is discovered, has no effect on the determination of income under section 61.

Constructive Receipt

Questions have arisen as to whether the Service may assert the doctrine of constructive receipt to claim that a taxpayer has income from a fraudulent investment scheme—even if the taxpayer chooses to eliminate phantom income from open years—on the theory that the taxpayer could have withdrawn the taxpayer's entire investment in the scheme.

For example, assume a taxpayer invested $100 and the scheme reported $10 of income to the taxpayer, which the taxpayer chose to withdraw in cash. The taxpayer can show that the purported payment of income was not actually income, and seeks to recharacterize it as a nontaxable return of a portion of the $100 investment. The question arises whether the Service may assert that the taxpayer should be treated for tax purposes as having *constructively* withdrawn the full $110 in the account (and reinvested $100), with the result that the taxpayer would be viewed as having withdrawn more cash that the taxpayer invested. This treatment would result in $10 of income and the taxpayer would not be able to eliminate any phantom income on the amended return, even if the $10 that was reported as income was fraudulent.[8]

Income is constructively received if it is made available so that the taxpayer may draw upon it at any time, but not if control of its receipt is subject to substantial limitations or restrictions. *See* section 1.451-2(a) of the Income Tax Regulations. In specific circumstances, courts have applied the doctrine of constructive receipt to investors in Ponzi schemes. *See Premji v. Commissioner*, T.C. Memo. 1996-304, *aff'd without published opinion*, 139 F.3d 912 (10th Cir. 1998) (taxpayer failed to report certain interest income; court held that taxpayer must report the income earned on the principal amount that taxpayer chose to reinvest); *Marretta v. Commissioner*, T.C. Memo. 2004-128, *aff'd without published opinion*, 168 Fed. Appx. 528 (3d Cir. 2006) (unreported income from Ponzi scheme; taxpayer failed to prove that amounts were return of capital; taxpayer stipulated that principal was available to him on request). However, whether receipt is subject to substantial limitations or restrictions, including the payor's practical ability to pay, depends on the facts and circumstances. *See, e.g., Johnson v. Commissioner,* 25 T.C. 499, 503 (1955), *acq*., 1956-2 C.B. 6; *Rosenberg v. United States*, 295 F. Supp. 820, 822 (E.D. Mo. 1969), *aff'd*, 422 F.2d 341 (8th Cir. 1970).

Under this case law and given the factual nature of the issue, the Service has some discretion to determine when to assert the doctrine of constructive receipt in the recomputation of Ponzi income. [redacted]

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[8] A similar argument could be made if the taxpayer did not withdraw the $10, but originally reported the $10 as constructively received and reinvested. The Service could still assert that income cannot be reduced on an amended return, on the ground that the taxpayer constructively received (and reinvested) the *full* $110, which would exceed the taxpayer's $100 cash investment by $10.

[redacted]

APPLICATION OF LAW TO SITUATIONS

Situation 1 Facts

A is an individual who uses the cash receipts and disbursements method of accounting and files income tax returns on a calendar year basis. In Year 1, A entered into a transaction for profit and opened an investment account with X, who held himself out to the public as an investment advisor and securities broker. A contributed $100x to the account and provided X with power of attorney to use the money in the account to purchase and sell securities on A's behalf.

X periodically issued account statements to A that reported the securities purchases and sales that X purportedly made in A's investment account and the balance of the account. X also issued tax reporting statements to A and to the Service that reflected purported gains and losses on A's investment account. X reported to A that no income was earned in Year 1, and that for each of the Years 2 through 7 the investments earned $20x of income (interest, dividends, and capital gains), which A included in gross income on A's federal income tax returns for each year.

At all times prior to Year 8 and part way through Year 8, X was able to make distributions to investors who requested them. A took no distributions in any year and instructed X to reinvest all income and gains that were purportedly earned.

In Year 8, it was discovered that X's purported investment advisory and brokerage activity was in fact a Ponzi scheme. X purported to invest cash or property on behalf of investors (including A) and reported income amounts that were partially or wholly fictitious. In response to requests for withdrawal, X made payments of purported income or principal to investors from amounts that were, at least in part, amounts other investors had invested in the scheme.

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[9] There are circumstances in which it may be appropriate to assert the doctrine of constructive receipt, as reflected in cases like *Premji* and *Marretta*, *supra*, to prevent the taxpayer from recharacterizing income from the scheme. [redacted]

When X's fraud was discovered in Year 8, X had only a small fraction of the funds that X reported on the account statements that X issued to A and other investors. As of Year 8, A may file a claim for refund for the open years, Years 5 through 7, but not for the closed years, Years 2 through 4. A amended his income tax returns for the open years to eliminate from income amounts that A was able to prove X fraudulently reported as income to him.

X entered into bankruptcy in Year 8, and a receivership was established under federal bankruptcy laws. The receivership made final distributions and closed operations in Year 10. A received $20x as a recovery through the bankruptcy proceedings in Year 10. A had no other claims for reimbursement related to X's investment scheme for any portion of the loss.

X's actions constituted criminal fraud or embezzlement under the law of the jurisdiction in which the transactions occurred. At no time prior to the discovery of the fraudulent nature of the activity by the general public did A know that X's activities were fraudulent.[10]

Situation 1 Application

In Situation 1, A initially invested $100x in X's fraudulent investment scheme and reported income of $20x from the scheme each year from Years 2 through 7, inclusive.

After discovery of the fraud in Year 8, A filed amended returns for the open years, Years 5 through 7, to remove the $60x of phantom income falsely reported to A for those years.[11] For purposes of this situation, assume that A has established that the amounts reported as income in the open years were not in fact income to A.

A reported and included in income $60x purportedly earned from the scheme in closed years, Years 2 through 4. A has basis in the investment consistent with the position taken on his tax returns in the closed years, that A earned $60x of income and reinvested all of it. For this purpose, it is irrelevant whether the $60x of income from the closed years was in fact fictitious, genuine, or a combination of both. Thus, A has a basis of $160x in the investment scheme as of the beginning of Year 5.

For Year 5, A originally treated $20x of income as constructively received and reinvested. A amends the Year 5 return to eliminate the $20x from income. At the end

[10] In none of these situations was the fraudulent investment scheme a tax shelter as defined in § 6662(d)(2)(C)(ii).

[11] We note that the timing rules for claiming a theft loss under section 165 (specifically, claiming a theft loss in the year of discovery under section 165(e) and the prospect of recovery rules from the section 165 regulations) do not affect A's ability to file amended returns to eliminate phantom income from open years.

of Year 5, A's basis in the scheme remains $160x, since there was no actual income that was reinvested.[12]

A amends his returns for Year 6 and Year 7 with similar results.

Since A amended his tax returns to remove phantom income reported in the open years, A has a basis of $160x, not $220x as fraudulently reported on the scheme's internal books and records, as of the beginning of Year 8.

After the bankruptcy receivership closes in Year 10 and A recovers $20x, A no longer has a claim for reimbursement with respect to which there is a reasonable prospect of recovery. A may deduct $140x ($160x of basis in the investment minus the $20x recovery) in Year 10 as an investment theft loss under section 165(c)(2).

Situation 2 Facts

B is an individual who uses the cash receipts and disbursements method of accounting and files income tax returns on a calendar year basis. Prior to Year 1, broker Y advised B to invest in X's investment scheme. B invested $100x in X's fraudulent investment scheme in Year 1 based on Y's advice. X reported to B that no income was earned in Year 1, and that for each of the Years 2 through 7 the investments earned $20x of income (interest, dividends, and capital gains), which B included in gross income on her federal income tax returns for each year as either constructively or actually received.

B withdrew $50x in Year 4 and $65x in Year 7, prior to discovering the fraudulent nature of the scheme. On her income tax returns for those years, B originally reported as income the $20x she received in cash, and treated the remainder of the withdrawals as a nontaxable return of capital.

After X's fraud was discovered in Year 8, B amended her income tax returns for the open years, Years 5 through 7, to eliminate from income amounts that B was able to prove X had fraudulently reported to her as income. B had a reasonable prospect of recovery in the bankruptcy proceeding, but did not in fact receive any recovery.

B pursued legal action against Y and recovered $10x in Year 10, based on the finding that Y was negligent in advising B to invest in X's fraudulent investment scheme. The legal action against Y was separate from the bankruptcy proceeding with respect to X's scheme.

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[12] In terms of the basic formula for determining the basis for unrecovered investment in the scheme—cash invested, plus amounts included in income, less cash withdrawals—A's investment after Year 5 remains $160x, not $180x, because the basis is no longer increased by the $20x included in A's Year 5 original return since A amended his Year 5 tax return to remove the $20X.

B had no other claims for reimbursement for any portion of the loss. At no time prior to discovery by the general public did B know that X's activities were fraudulent.

Situation 2 Application

In Situation 2, the facts are similar to Situation 1, except that B withdrew $50x in Year 4 and $65x in Year 7, did not receive any recovery from the bankruptcy proceedings, and recovered $10x from a separate legal action against another party in Year 10.

After discovery of the fraud in Year 8, B filed amended returns for the open years, Years 5 through 7, to remove the $60x of income falsely reported to her in those years. For purposes of this situation, assume that B has established that the amounts reported as income in the open years were not in fact income to B.

B reported and included in income $60x purportedly earned from the scheme in closed years, Years 2 through 4. B has basis in the investment consistent with the position taken on her tax returns in closed years, that B earned $60x of income and reinvested all of it. As of the beginning of Year 5, B has basis of $110x, calculated as follows: $100x of initial investment, plus $60x of purported income reported to B and included on her tax returns for the closed years (Years 2 through 4), minus the $50x she withdrew in Year 4.

For Year 5, B originally reported $20x of income as constructively received and reinvested. B amends the Year 5 return to eliminate the $20x from income. As of the end of Year 5, B's basis in the scheme remains $110x.

For Year 6, B originally reported $20x of income as constructively received and reinvested. As she did for Year 5, B amends the Year 6 return to eliminate the $20x from income. As of the end of Year 6, B's basis in the scheme remains $110x.

For Year 7, B originally treated $20x of her $65x withdrawal as income, which she reported as such on her return, and $45 as a nontaxable return of her capital. On her amended return, the fact that B originally reported the $20 as actually received, not constructively received, does not prevent her from recharacterizing the $20 payment as a nontaxable return of capital, although the cash withdrawal will reduce her basis in the scheme. Since B has a basis in the scheme of $110x, for purposes of her amended return for Year 7 B can treat the entire $65x withdrawal as a nontaxable return of capital, resulting in a reduction of her reported income in that year from $20x to zero.

Since B withdrew $65x in Year 7, B has basis in the investment of $45x as of the beginning of Year 8 ($110x of basis minus $65x treated as a nontaxable return of capital in Year 7).[13]

After the bankruptcy receivership and the legal action against Y close in Year 10, B no longer has a claim for reimbursement with respect to which there is a reasonable prospect of recovery. B may deduct $35x ($45x of basis in the investment minus the $10x recovery from the action against Y) in Year 10 as an investment theft loss under section 165(c)(2).

Situation 3 Facts

C is an individual who uses the cash receipts and disbursements method of accounting and files income tax returns on a calendar year basis. C also invested $100x in X's fraudulent investment scheme in Year 1. X reported to C that no income was earned in Year 1, and that for each of the Years 2 through 7 the investments earned $20x of income (interest, dividends, and capital gains), which C included in gross income on his federal income tax returns for each year.

C withdrew $80x in Year 6 and $95x in Year 7, prior to discovering the fraudulent nature of the scheme.

After X's fraud was discovered in Year 8, C amended his income tax returns for the open years, Years 5 through 7, to eliminate amounts that C was able to prove X had fraudulently reported to him as income. C had a reasonable prospect of recovery in the bankruptcy proceeding, but did not in fact receive any recovery.

C had no other claims for reimbursement for any portion of the loss. At no time prior to discovery by the general public did C know that X's activities were fraudulent.

Situation 3 Application

In Situation 3, the facts are similar to Situation 1, except that C withdrew $80x in Year 6 and $95x in Year 7, and did not receive any recovery from the bankruptcy proceedings. C initially invested $100x and purportedly received a total of $120x of income from the scheme, which C initially reported on his tax returns as ordinary income for Years 2 through 7.

[13] In terms of the basic formula for determining the basis in the scheme—cash invested, plus amounts included in income, less cash withdrawals—B's unrecovered investment after Year 7 is B's $100x initial investment, plus $60x included in income (in the closed years), less $115x total cash withdrawn. Since B has amended the returns for open Years 5 through 7, the $60 originally included in B's income for those years is no longer taken into account in the basis computation.

After discovery of the fraud in Year 8, C filed amended returns for the open years, Years 5 through 7, to eliminate the $60x of phantom income falsely reported to C in those years. For purposes of this situation, assume that C has established that the amounts reported as income in the open years were not in fact income to C.

C reported and included in income $60x purportedly earned from the scheme in the closed years, Years 2 through 4. C has basis in the investment consistent with the position taken on his tax returns in the closed years. Thus, C has a basis of $160x in the investment scheme as of the beginning of Year 5.

For Year 5, C originally treated $20x of income as constructively received and reinvested. C amends the Year 5 return to eliminate the $20x from income. As of the end of Year 5, C's basis in the scheme remains $160x.

For Year 6, C originally reported $20x of income, and withdrew $80x in cash. Since C has basis in the scheme of $160x, C can treat the entire $80x withdrawal as a return of capital. Accordingly, C amends the Year 6 return to eliminate $20x from income. Since C withdrew $80x in Year 6, C has basis in the investment of $80x as of the end of Year 6 ($160x of basis minus $80x treated as a nontaxable return of capital in Year 6).

For Year 7, C originally reported $20x of income, and withdrew $95x in cash. C may treat $80x of the $95x C withdrew in Year 7 as a nontaxable return of capital as an offset to his basis of $80x as of the beginning of Year 7. The remaining $15x (the excess of the $95x withdrawal over the $80x basis) is ordinary income, because C received $15x more than the $160x that C invested in the scheme (consisting of C's initial $100x investment plus $60x of income C reported in closed years).[14] *See Harris*, 431 F. Supp. 1173. Accordingly, C amends his Year 7 return to reflect a net $5x reduction in C's income from the scheme (eliminating the $20x of phantom income but including $15x of ordinary income from the withdrawal).

Since C has recovered his entire investment for tax purposes, C has no remaining basis to deduct as a theft loss under section 165.[15]

[14] It is irrelevant for this purpose that X falsely reported to C that C had earned $20x of income in Year 7. C's liability for tax on $15x is based on his having withdrawn more than he invested (i.e., $175x withdrawals minus $160x investment), not on the Year 7 transactions falsely reported to him by X.

[15] If C had subsequently received a recovery in the bankruptcy proceeding, it would be includible in his income in full, since he had already recovered his investment for tax purposes. In reality, however, an investor like C may be required to repay a portion of the funds received from the scheme as a "clawback" in the bankruptcy proceeding. The possibility of such a clawback payment does not prevent C from realizing $15x of income in Year 7. The clawback payment is treated for tax purposes as a separate event in the year the clawback payment is made. The tax consequences of clawback payments are outside the scope of this memorandum.

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 contact me or Selvan Boominathan at (202) 622-7900 if you have any further questions.

Sincerely,

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