**Tax Tips**

**Deduction for Losses from Ponzi Schemes (Part 1of 2)**

Did you know that the IRS has special relief for victims of Ponzi schemes (and for investors in other similar fraudulent schemes)? Because Ponzi schemes generally continue for years, many investors are faced not only with the loss of their original investments, but also with having paid taxes on “phantom income,” based on fraudulent statements sent by the fraudster to investors over a number of years.

The first question the IRS answers—generally positively for investors—is exactly how the loss from the investment will be treated for tax purposes. If the loss was considered a capital loss, which is often the case when a taxpayer loses money on an investment in stocks or securities, individual taxpayers would be limited to offsetting the loss against their capital gains, plus an additional $3,000 allowed as a deduction against ordinary income. Although the excess loss can be carried forward indefinitely, it would do little for losses of the magnitude incurred by the typical Madoff investor. So it was good news for investors when IRS announced that investors can take an ordinary loss deduction and the deduction isn't subject to the 2% of adjusted gross income (AGI) limit on miscellaneous itemized deductions, the income-based limitation on itemized deductions, or the 10% of AGI limitation on the deduction for casualty losses.

**When the deduction is taken.** Taxpayers can deduct the loss in the year the theft was discovered. This deduction can be taken if the loss isn't covered by a claim for reimbursement or other recovery that has a reasonable chance of occurring. If there is a reasonable chance of recovery, the taxpayer must either reduce the deduction by that amount or, alternatively, make a special election under a 2009 revenue procedure, which is discussed farther below. If, after reducing the deduction, the taxpayer actually recovers less than the reduction in a later year, he or she can take an additional deduction in the year the recovery amount is ascertained. And a taxpayer is required to include in income any amount recovered greater than the amount anticipated at the time of taking the deduction.

**The amount of the deduction.** According to IRS, the amount of the theft loss is determined by adding to the amount of the initial investment any additional investments and any amounts the taxpayer reported as income and reinvested, minus any amounts withdrawn over the years and any reimbursements or likely recovery.

Here's an example. Assume A invested $500,000 in a Ponzi scheme in 2009, reported $40,000 of income on the investment each year in 2010, 2011, 2012, 2013, and 2014, all of which ($200,000) he reinvested. A discovered the theft in 2015, made no withdrawals over the years, and has filed a claim for reimbursement with the Securities Investor Protection Corporation (SIPC). A is likely to recover $500,000, which is the most any investor can recover from SIPC (subject to a $100,000 cash maximum). His ordinary loss deduction for 2015 is $200,000.

There is an alternative way to calculate the loss under an elective provision, which we’ll discuss in next month’s Tax Tips article when we wrap up our discussion of the IRS rules concerning the deductibility of losses you may sustained from Ponzi and similar fraudulent schemes.

If you have any questions concerning deducting losses generated from Ponzi and similar fraudulent schemes, please do not hesitate to call me at (562) 698-9891.

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