When Investments Go Wrong: IRS Safe Harbors for Ponzi Scheme Losses

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It's been several years since Bernie Madoff confessed to taking billions of dollars from investors in his fake asset management division. But, Ponzi schemes existed well before Madoff pulled off his extravagant plot, and you will always come across people who think they can skirt the law (and ethics in general). Sometimes, these "opportunities" seem like legitimate investments until you start looking at the statements. So, what do you do if you've been caught in a Ponzi scheme?

First, know that you do have some protection. You "invested" your money, so you can't just get it all back unfortunately. You live and you learn. However, you are eligible to claim tax-deductible losses on that money. The problem is that you'll have a heck of a time proving your Ponzi scheme losses in the year of the loss, which could really hurt your finances.[1] Luckily, the safe harbor laws grant additional protection. Legislation passed in 2009 allows losses from a Ponzi scheme to be carried back 5 years on your taxes, as long as you are eligible[2].

So, what do you do when you find yourself victim to investment fraud?

Using Tax Law Safe Harbors

First, you should know that you are not required to use the Ponzi scheme tax relief safe harbor. But, you'd be silly not to. If you don't invoke the safe harbor rules, your losses will be deducted using the general rules for theft loss, which means jumping through more hoops and possibly being audited. Yes, you read that correctly. Regarding taxpayers who choose not to use the safe harbor, the IRS has stated:

Returns claiming theft-loss deductions from fraudulent investment arrangements are subject to examination by the [IRS].[3]

That means being audited.

When the IRS actually *threatens* you with an audit, you should probably take it seriously. And, what about those general theft rules? If you forego the safe harbors, you'll be required to prove:[4]

- The loss actually was theft;
- You claimed this loss on your taxes the year you found out about it (which can be

difficult to prove);
- You have the exact dollar amounts lost, with documentation; and
- You cannot reasonably expect to recover the loss through reimbursements in the year you found out about the theft and claimed the deductions.

All in all, it’s just easier to follow the safe harbor rules. In fact, you’ll have a much nicer time of it with the IRS if you do.[5] Here’s how it will work when you use the Ponzi scheme tax relief safe harbor laws:

- You will be able to deduct the fraudulent scheme as a theft loss.
- You will be able to deduct the loss the year the scheme was found out (i.e. when the perpetrator was indicted, or when the perpetrator either admits guilt or has their assets frozen following a federal or state criminal complaint).
- Your losses will be calculated with the safe-harbor formula.

Using the safe harbor rules, you have less evidence to provide, and the deduction process is simpler for you to complete. You should know that the IRS **often** disagrees with deductions for theft loss. Safe harbor rules prevent that.

How Safe Harbor Amounts are Calculated

Before you can take advantage of the safe harbor, you’ll need to show that you are in compliance with its requirements by providing statements of the following (under penalty of perjury):[6]

- The name of the Ponzi scheme perpetrator;
- Confirmation that you have written documentation to back up your deduction amounts;
- Your declaration of status as a Ponzi scheme victim and qualified defrauded investor; and
- Confirmation that you will abide by all terms of declaration.

This information will need to be attached to your tax return.[7] Also, in this statement, you will show your loss deduction calculations for the discovery year, as follows:[8]

1. The starting number is your original investment.
2. Add all of your subsequent investment amounts.
3. Add any money that was supposedly reinvested on your behalf and that you claimed on your tax returns as income (but for which you received no cash payments from the perpetrator).
4. Subtract any withdrawals you made from the investment fund. The resultant number

is your **qualified investment**.
5. Next, determine whether you are a Ponzi victim with possible third-party recovery.
6. Determine your **net qualified investment**. If you do have possible third-party recovery, you will multiple the **qualified investment** amount from step 4 by 75 percent. If you do not have possible third-party recovery, multiply the **qualified investment** amount by 95 percent.
7. List any money you actually recovered from the Ponzi scheme (through any source) in the year you are making a deduction.
8. List the totals for any agreements that protect you from the loss, including insurance policies, contracts, and amounts you are entitled to by the Securities Investor Protection Corporation (SIPC).
9. Add together your total recoveries from step 7 and step 8.
10. Finally, you will subtract the answer in step 9 from the answer in step 6 in order to get your **gross theft-loss deduction**.

It’s all pretty straightforward. As long as you kept all of your statements, and financial and insurance documents, you’ll have everything you need. In subsequent years, you’ll make adjustments for an additional recovery income or for increased losses in the case that your reasonably estimated recovery claims were too low.[9]

Typically, personal theft is subject to certain reductions before it can be claimed as a tax deduction.[10] First, the amount is reduced by a flat $100. Then, you reduce the remaining amount by 10 percent of your AGI. Fortunately, Ponzi scheme victims are not subject to these reductions; individuals can claim the full deductible amount, and businesses can claim the full business casualty loss amount.

Why the IRS Wants You to Follow Safe Harbor Rules

Do you really benefit from using the safe harbor calculations for your deductions? Let’s look at what you agree to give the IRS:

- You will only deduct the amounts calculated in their formula (in the year the scheme was discovered);
- For taxable years that precede the year of discovery, you will not amend or file tax returns that re-characterize or exclude income;
- You will not claim Section 1341 benefits for your Ponzi scheme loss (restoration of an amount under the claim of right doctrine); and
- You will not use the mitigation provisions of Sections 1311–1314 or the doctrine of equitable recoupment.

The IRS has made a strong statement against claiming the rights and provisions in that last bullet point.[11] It's always a gamble going against the IRS in a situation that will likely end up in court. You *could* win the case, but will it be worth the time, money, and effort to challenge it?

Prevention

By being educated in financial matters and paying attention to your personal and business finances, you can avoid Ponzi schemes. For one thing, you should never, ever give someone else complete control of your money. The best advice is to always know exactly what you are investing in and not making financial decisions that you don't understand—even if everyone else is doing it. The government also has some guarantees set up to help people avoid losses: Federal Deposit Insurance Corporation (FDIC) and the Securities Investor Protection Corporation (SIPC).

Aside from avoiding fraudulent investments and being aware of government protections, you have a couple of other options for reducing your risk. One way is to have insurance on your investments. Making the investments yourself (rather than having someone else handle it) is the another way to avoid investment fraud losses. If you feel nervous about making these decisions on your own, know that you have resources from the Internet, news publications, financial magazines, and television, and just because someone says they are a financial expert doesn't necessarily mean they know more than you do.

Even if you do hire an investment advisor to help you make decisions, you should always maintain control of your funds yourself. Never let an advisor have direct access to your money. You can reduce your chances of needing these safe harbor rules in the future if you ask questions about your portfolio and always know what is happening with your money.

1. Rev. Proc. 2009-20, Section 2.03 ^
2. IRC Section 172(b)(1)(H) ^
3. Rev. Proc. 2009-20, Section 8.03 ^
4. Rev. Proc. 2009-20, Section 8.01 ^
5. Rev. Proc. 2009-20, Section 5.01 ^
6. Rev. Proc. 2009-20, Appendix A, Part III ^
7. Rev. Proc. 2009-20, Section 6.01 ^
8. Rev. Proc. 2009-20, Appendix A, Part II ^
9. Rev. Proc. 2009-20, Section 5.03; Rev. Rul. 2009-9, Law and Analysis, Issue 3, Year of Deduction ^
10. http://www.irs.gov/pub/irs-pdf/p547.pdf ^
11. Rev. Rul. 2009-9 ^