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How Ponzi Scheme Victims Can Benefit from Tax Relief

Sunday, February 14, 2010 by Doron F. Eghbali

The prevalence of Ponzi schemes make us think of tax consequences of these mostly costly and painful losses. Fortunately, the IRS has provided some relief.

CAPITAL LOSSES *VS* ORDINARY LOSSES

1. CAPITAL Losses

The IRS is loath to treating investment securities losses as anything other than capital losses. Capital losses are:

- Deductible to the extent of capital gains in a given year; *AND*
- Deductible to the extent of $3,000 or $1,500 married but filing separately in a given year.

Any capital loss leftover will have to be carried forward to future years and the same limitations apply.

As such, capital losses are not favorable in our federal tax system.

2. ORDINARY LOSSES

On the contrary, ordinary losses are quite favorable. They can written off against any type of income including but not limited to:

- Interest
- Salary
- Dividends
- Capital Gains
- Self-Employment Income

ORDINARY LOSS FOR PONZI SCHEME VICTIMS

The IRS has announced it treats losses incurred by victims of Ponzi investment schemes as ordinary losses.

Definition of Ponzi Scheme

This is when your money is never used for acquisition of investment assets. In fact, a fraud perpetrator steals your money. In a Ponzi scheme, the perpetrator uses money from later investors to pay interests and withdrawals to earlier investors without making any investments whatsoever.

RELIEF FOR PONZI SCHEME VICTIMS

- The whole loss can be deducted.
- The whole loss can be deducted without regard to itemized deduction restrictions.
- The whole loss can be deducted in the year incurred. However, the loss MUST be reduced by the amount of reasonable prospect of recovery.

SAFE HARBOR RULES

This means Ponzi scheme victims can deduct a loss on their return for the year the loss is discovered. The IRS would not ask questions about the timing or amount of such loss. Nonetheless, the following needs to be complied with:

1. The amount of such loss deduction depends on either 75% or 95% your qualified investment. Qualified investment means *Initial Investment+Subsequent Investment+Related Income Reported on Your Tax Returns for Prior Years-Withdrawals.*
2. THEN, you MUST reduce the 95% or 75% amount by any actual recoveries you collect in the year you discover the loss and ESTIMATES of recoveries from various other sources.
3. The end result is your allowable safe harbor loss deduction.

However, there are STILL some other ***complex*** procedures that need to be complied with as specified in IRS-Revenue Procedure 2009-20. You are *highly* advised to seek competent legal tax counsel.