Excerpt from eBook

The IRS and Defrauded Investors - Theft Tax Loss

Statement of Loss (IRC Sec 165)

Prepared by:

Gary S. Wolfe

THE WOLFE LAW GROUP

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Gary S. Wolfe has over 34 years of experience, specializing in IRS Tax Audits and International Tax Matters including: International Tax Planning/Tax Compliance, and International Asset Protection.

As of July 2016, Gary Wolfe has internationally published 15 books and 28 articles. Gary has received 14 international tax awards from five different Global expert societies in LONDON/UK including being voted one of the 100 leading world's law firms with votes from over 150,000 voters in over 160 countries with the following award: Global 100 (2016) (KMH Media Group) - CA/US International Tax Planning Law Firm of the Year.

For more information please visit our website: gswlaw.com

Gary S. Wolfe, A Professional Law Corporation
6303 Wilshire Blvd., Suite 201
Los Angeles, CA, 90048
Tel: 323-782-9139
Email: gsw@gswlaw.com

Chapter 5 – Statement of Law (IRC Sec 165)

IRC § 165(a) provides as a general rule that "any loss sustained during the taxable year" may be deducted if it is not compensated for by insurance or otherwise. Section 165(a), however, limits this broad rule by restricting an individual's deductions to:

1. Losses incurred in a trade or business or a transaction entered into for profit; and
2. Losses "from fire, storm, shipwreck, or other casualty, or from theft."

The "theft loss," which only includes losses to property not connected with the taxpayer's trade or business or for-profit transactions, and is further restricted by rules denying the deduction for the first $500 (2009)of loss from each casualty and allowing losses above this floor only to the extent they exceed 10 percent (10%) of adjusted gross income (IRC §165(h)). The courts have found a further limitation implicit in Section 165(a) – that a casualty loss is not allowable in any part if the deduction would frustrate well-defined public policy.

(See, Blackman v. CIR, 88 TC 677, 682 (1987) – taxpayer intentionally set fire to wife's clothes and negligently allowed fire to spread to entire house; held no casualty loss deduction because deduction "would severely and immediately frustrate the articulated public policy … against arson and burning," even though taxpayer never charged with crime; Mazzei v. CIR, 61 TC 497 (1974) – taxpayer defrauded by co-conspirators in scheme to counterfeit U.S. currency; held, theft loss of participant in criminal activity not deductible; Rev. Rul. 82-74, 1982-1 CB 110 (where taxpayer, in order to collect insurance, paid another to burn down taxpayer's building, public policy, precludes amount paid from being taken into account in determining gain on building's conversion). However, see, Hossbach v. CIR, 42 TCM (CCH) 80 (1981) [public policy not offended by allowing deduction for destruction by explosion of building used by taxpayer to manufacture illegal drugs]. IRC § 641(b) rules make § 165(c) apply to trusts and estates.)

Since losses attributable to business and profit-oriented property are deductible regardless of cause, the principal significance of the deduction allowed by § 165(c)(3) for casualty losses is that it encompasses personal residences, private automobiles, jewelry, home furnishings, and other property owned and used for personal purposes. Property of this type does not qualify for depreciation deductions while the taxpayer owns it, and losses on sales of such property are also nondeductible. (Reg. § 1.165-9(a).) If the property is damaged or destroyed by casualty, however, the resulting loss may be deducted under § 165 (c)(3).)

(IRC §165(c)(2)(3))

Under IRC §165, an individual may deduct losses arising from "fire, storm, shipwreck, or other casualty or from theft."

Under IRC §165(c)(2), an individual may deduct theft losses involving a transaction entered into for profit.

Under IRC §165(c)(3), an individual may deduct losses due to theft (which is defined to include fraud under California's Penal Code Section 484(a)) (see Treas. Reg. Section 1.165-8(d)).

A loss arising from theft is treated as sustained during the taxable year in which the Taxpayer discovers the loss (IRC §165(e)(1)).

The deductible amount is the lesser of the fair market value or basis of the property stolen (Treas. Reg. §1.165-8(c)), IRC §165(b).

An individual is permitted to deduct losses to her property arising from "fire, storm, shipwreck, or other casualty, or from theft." The term "other casualty" defined as a sudden, unexpected event that is unusual in nature and beyond the control of the taxpayer.

A theft loss technically is not a casualty loss, but theft losses are aggregated with casualty losses for most purposes. The first $500 (2009) of each personal casualty or theft loss is not deductible, and personal casualty and theft losses are generally deductible only to the extent they exceed 10 percent of the taxpayer's AGI.

Casualty and theft losses that arise in a trade or business or activity engaged in for profit are deductible (as are other losses arising in these activities) and may qualify for beneficial treatment under Code Section 1231.

The portion of a loss that is reimbursed by insurance is not deductible (Code Section 165(a)). A personal casualty or theft loss is deductible only if the taxpayer files a timely claim for any insurance covering the loss. Code Section 165 (h) (5) (E).

Taxpayers claiming casualty and theft losses must file Form 4684, Casualties and Thefts, with their tax returns to claim the deduction. The IRS has also made available two workbooks, IRS Publication 584, Casualty, Disaster, and Theft Workbook, and IRS Publication 584B, Business Casualty, Disaster, and Theft Workbook, which contain schedules used to compute personal and business casualty and theft losses, respectively.

Treas. Reg. § 1.165-1(b) ["Substance and not mere form shall govern in determining a deductible loss"].

Rev. Rul. 2009-9, I.R.B. 2009-9 ["... Rev. Rul. 71-381 is obsolete to the extent that it holds that theft losses incurred in a transaction entered into for profit are deductible under §165(c)(3), rather than under §165(c)(2)."].

See generally Kaplan v. United States, 2008-1 U.S.T.C. ¶ 50,117 (M.D. Fla. 2007), in which the court, while acknowledging that there were different standards for determining whether a taxpayer is entitled to a theft loss deduction depending on the taxable year at issue, as well as that before a taxpayer may claim a deduction due to theft loss "the facts must show that as of the end of the tax year at issue, it was reasonably certain that the taxpayer had no reasonable prospect of recovering the amount of the loss that the taxpayer attempted to deduct," nonetheless seems to have disallowed a theft loss deduction because, as of the end of the year theft loss was discovered, the taxpayer could not reasonably ascertain the amount that they would ultimately recover.

See also Bubb, Jr. v. United States, 93-2 U.S.T.C. ¶ 50,572 (W.D. Pa. 1993), involving a taxpayer who attempted to claim a deduction for a portion of the theft loss in the year of discovery. The court concluded that "[b]ased upon an objective review of the totality of the facts and circumstances surrounding the losses as of the close of 1986, the taxable year for which the plaintiffs have claimed deductions [and the year in which the theft was discovered], the existence of a reasonable prospect of recovery beyond 5% of their investments did not exist"' and therefore the taxpayers were entitled to a deduction for 95 percent of their respective losses.

Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975) ["The standard is to be applied by foresight, and hence, we do not look at facts whose existence and production for use in later proceedings was not reasonably foreseeable as of the close of the particular year."]

Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811 (1971), aff'd, 521 F.2d 786 (4th Cir. 1975). See also Parmelee Transp. Co a United States, 351 F.2d 619, 628 (Fed. Cl. 1965) ["we stress that the mere existence of a "possible" claim or pending litigation will not alone warrant postponing loss recognition. There are many reasons for initiating lawsuits. In this case, taxpayer's antitrust claim for treble damages exceeded 19 million dollars. Where the stakes are so high, a suit may be "100% justified" even though the probability of recovery is minuscule. In short, although we offer no litmus paper test of "reasonable prospect of recovery," we note that the inquiry should be directed to the probability of recovery as opposed to the mere possibility. Analyzing the rule in percentage terms, we would consider a 40 to 50 percent or better chance of recovery as being "reasonable". A lawsuit might well be justified by a 10 percent chance."]; Premji v. Commissioner, 72 T.C.M. 16 (1996), aff'd, 139 F.3d 912 (10th Cir.

1998) [a theft loss deduction "need not be postponed where the financial condition of the party against whom the claim is filed is such that no recovery could be expected."].

Theft Defined

Theft is the illegal taking of money or property with the intent to deprive the owner of it. (W. Lafave, Criminal Law section 8.5, at 721 (2d Ed. 1986)). Theft includes, but is not limited to, larceny, embezzlement, and robbery. (Reg. Section 1.165-8(d). See also Rev. Rul. 72-112, 1972-1 C.B. 60 (theft is any felonious taking of money or property by which a taxpayer sustains a loss, whether defined or punishable under the penal codes of the state as larceny, robbery, burglary, embezzlement, extortion, kidnapping for ransom, threats, or blackmail)).

A theft loss deduction does not depend on the existence of a crime of theft in the state in which the loss occurs. The leading case in this area stated that for tax purposes, theft is "a word of general and broad connotation, intended to cover and covering, any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile." Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956). The court added that the exact nature of the crime is not important, as long as it amounts to theft.

Although "theft" for tax purposes is not limited to the statutory crime of theft, the act resulting in the loss must be a crime under state law. (See MTS International, Inc. v. Commissioner, 169 F.3d 1018 (6th Cir. 1999); Luman v. Commissioner, 79 T.C. 846 (1982); Bodine v. Commissioner, T.C. Memo. 1984-143).

A taxpayer whose property was taken by another under a legal procedure, such as foreclosure, cannot claim a theft loss because no theft has occurred, even if the procedure was improperly used. (See, e.g., Johnson v. United States, 291 F.2d 908 (8th Cir. 1961); Vance v. Commissioner, 36 T.C. 547 (1961); Marlowe v. Commissioner, T.C. Memo. 1967-12; Zaccaria v. Commissioner, T.C. Memo. 1961-102; Johnson v. Commissioner, T.C. Memo. 2001-97).

In the case of misrepresentation, there must be an intent to defraud. A loss sustained when a taxpayer is the victim of a misunderstanding, or is simply outsmarted due to a misrepresentation that is not fraudulent, is not a theft loss. (See, e.g., Skoznik v. Commissioner, 55 T.C. 1055 (1971); Schacht v. Commissioner, 47 T.C. 552 (1967), acq. 1968-2 C.B. 2; Gibson v. Commisioner, T.C. Memo. 1982-374; Schonhoff v. Commissioner, T.C. Memo. 1963-213; Fuhrmann v. Commissioner, T.C. Memo. 1959-81).

A theft loss deduction will be allowed if obtaining money from another under false misrepresentations or false pretenses constitutes fraud under state law. Rev. Rul. 71-381, 1971-2 C.B. 126, modified by Rev. Rul. 2009-9, 2009-14 I.R.B. 735. For example, where the officers of a legitimate mortgage lending business engaged in securities fraud that, in part, led to the bankruptcy of the company, the IRS held that it is a question of fact whether, and at what point, the investors' loans to the company were no longer bona fide debts and instead thefts of the investors. CCA 200811016.

In cases involving stock purchased on the open market, however, the courts have consistently disallowed theft loss deductions relating to a decline in the value of the stock that was attributable to corporate officers misrepresenting the financial condition of the corporation, even when the officers were indicted for securities fraud or other criminal violations. Paine v. Commissioner, 63 T.C. 736, aff'd without published opinion, 523 F.2d 1053 (5th Cir. 1975).
The IRS will disallow theft loss deductions with respect to a decline in the market value of stock caused by the disclosure of accounting fraud or other illegal misconduct of the officers or directors of the corporation that issued the stock. Notice 2004-27, 2004-1 C.B. 782.

When a theft is related to a transaction entered into by the taxpayer for profit, such as when the taxpayer invests in a pyramid, or Ponzi, scheme, the taxpayer may be entitled to a deduction. Victims of Ponzi schemes may elect special rules to calculate their theft deduction.

If a taxpayer's activities in connection with a theft loss are contrary to public policy, a deduction for a theft loss may be denied. A theft loss could be denied if a taxpayer participated in a sham transaction intended to avoid federal income taxes. FSA 200305028. A theft loss deduction was also denied to investors who loaned money to a corporation in a Chapter 11 reorganization in exchange for a security interest in telephone equipment because the investors were not the victims of theft. There was no indication that the corporation was not a viable business, that the equipment sold did not exist, or that the corporation intentionally made false representations to the investors to induce them into making the investment. CCM 200406046.

A theft loss deduction may be prohibited by another Code provision. For example, in Rust Communications Group, Inc. v. United States, 90-1 U.S.T.C. 50,263 (Cl. Ct. 1990), a corporation tried to deduct a $60,000 penalty imposed for its failure to pay its 1980 corporate income tax on time, which was caused by an employee's embezzlement. A theft loss deduction was allowed for the money that was embezzled, but the deduction for the penalty was denied because of Code Section 162(f), which bars the deduction of fines and penalties even though the failure to pay was directly attributable to the embezzlement.

Proof of Theft

A taxpayer must establish that his property was stolen in order to claim a theft loss. Allen v. Commissioner, 16 T.C. 163 (1951). It is not sufficient for a taxpayer to show only that the property is missing, but it is sufficient to show that theft is the most plausible explanation for the disappearance of the property. (Jory v. Commissioner, 52 T.C. 288 (1969); Meyers v. Commissioner, T.C. Memo. 1959-39). It is not necessary to identify or convict the alleged thief. (Jones v. Commissioner, 24 T.C. 525 (1955), acq., 1955-2 C.B. 7; Wilson v. Commissioner, T.C. Memo. 1982-107).

The most common alternate explanation that a taxpayer must address is that the missing property was lost or misplaced. For example, when a taxpayer discovers a wallet [See, e.g., Bakewell v. Commissioner, 23 T.C. 803 (1955); Smith v. Commissioner, 10 T.C. 701 (1948); Gray v. Commissioner, T.C. Memo. 1954-225.] or jewelry [See, e.g., Allen v. Commissioner, 16 T.C. 163 (1951); Manahan v. Commisioner, 9 T.C.M. 1095 (1950).] missing after a brief trip, the possibility that it was lost is as plausible as theft, and a theft loss has been denied. On the other hand, theft was found to be the most plausible explanation for the disappearance of cash or jewelry from a hiding place or safe box when others had access to it. (See, e.g., Kennedy v. United States, 109 F. Supp. 509 (D.R.I. 1952); Jones v. Commissioner, 24 T.C. 525 (1955), acq., 1955-2 C.B. 7; Jungert v. Commissioner, T.C. Memo. 1968-116; Meyers v. Commissioner, T.C. Memo. 1959-39; Turner v. Commissioner, 9 T.C.M. 883 (1950).

While filing a police report will not, by itself, establish the occurrence of a theft [See, e.g., Lee v. Commissioner, T.C. Memo. 1982-35.], case law indicates that the failure to file a report is a negative factor. (See James v. Commissioner, 10 T.C.M. 440 (1951) (casualty loss deduction disallowed because the taxpayer did not report the theft).

Year and Amount of Theft Loss Deduction

Theft losses must be deducted in the year the theft is discovered. Reg. Section 1.165-8 (a)(2). The loss is not deductible in the year the theft occurred (unless it is the same as the year of discovery). Reg. Section 1.165-8(a)(2). The year of discovery is deemed to be the year a "reasonable person" would have discovered the loss. (Cramer v. Commissioner, 55 T.C. 1125 (1971), acq., 1971-2 C.B. 2; Elliott v.Commissioner, 40 T.C. 304 (1963), acq., 1964-1 C.B. 4; Puscas v. Commissioner, T.C. Memo. 1978-73).

Code Section 165(e) provides that the loss is deductible in the year that the taxpayer discovers it. This rule is especially helpful to a taxpayer after the statute of limitations has run for the year in which the theft occurred.

For theft losses, the amount of the loss is always the fair market value or the basis of the property stolen, because its value is zero after the theft. Reg. Section 1.165-8(c). The amount a theft loss deduction is determined in a manner consistent with the rules that are applied to casualty loss deductions. (Reg. Section 1.165-8(c).

If a taxpayer loses several items from one theft or if a husband and wife filing jointly suffer separate losses as a result of the same theft, only one $500 reduction is required.

Thefts Involving Transactions Entered Into for Profit

A loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss, not a capital loss, even though losses from an investment are normally capital losses. While losses due to theft are generally deducted as a theft loss under Code Section 165(c)(3), losses due to theft involving a transaction entered into for profit are instead deducted under Code Section 165(c)(2), which contains fewer limitations on the amount that may be deducted. Rev. Rul. 2009-9, 2009-14 I.R.B. 735, modifying Rev. Rul. 71-381, 1971-2 C.B. 126.

Like all theft losses, a theft loss involving a transaction entered into for profit is deductible in the year the loss is discovered, provided that the loss is not covered by a claim for reimbursement or recovery with respect to which there is a reasonable prospect of recovery. The amount of the theft loss is generally the amount invested in the arrangement, reduced by amounts withdrawn, by reimbursements and recoveries, and by claims as to which there is a reasonable prospect of recovery. Where an amount is reported to the investor as income prior to discovery of the theft and the investor includes that amount in gross income and reinvests this amount in the arrangement, the amount of the theft loss is increased by the reinvested amount. Rev. Rul. 2009-9, 2009¬14 I.R.B. 735. However, investors in fraudulent arrangements such as Ponzi schemes may make an election that provides a uniform manner for determining the theft losses. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

In a Ponzi scheme, the party perpetrating the fraud receives cash or property from investors, purports to earn income for the investors, reports to the investors income amounts that are wholly or partially fictitious, and criminally appropriates some or all of the investors' cash or property, and any payments of purported income or principal made to the investors are made from cash or property that other investors invested in the fraudulent arrangement.

Generally

Unlike other theft losses, theft losses due to a transaction entered into for profit are not limited to losses that exceed $500 (2009) or to losses that exceed 10 percent of the taxpayer's adjusted gross income. Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

Unlike other theft losses, theft losses due to a transaction entered into for profit are not subject to the AGI limit for itemized deductions. Similarly, the losses are not subject to the 2-percent of adjusted gross income limit for miscellaneous itemized deductions. Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

Generally, a net operating loss (NOL) can be carried back up to two years and forward up to 20 years, but eligible small businesses can elect to carry back 2008 NOLs three, four, or five years. Code Section 172. A special rule applicable to theft losses allows individuals to carry back the theft loss for up to three years. Code Section 172(b)(1) (F). Further, theft losses are treated as a business deduction, and thus eligible individuals who sustain a 2008 theft loss may be able to elect the four or five year carryback period allowed to small businesses. Code Section 172(d)(4)(C).

Ponzi scheme (safe harbor rules)

Victims of fraudulent arrangements such as Ponzi schemes may elect to apply special rules to their theft losses. Rev. Proc. 2009-20, 2009-14 I.R.B. 749. This safe harbor allows investors to treat a loss as a theft loss deduction when certain conditions are met, and provides a uniform manner for determining the theft losses. The election is available for the tax year of the investor beginning after December 31, 2007, in which the indictment, information, or complaint is filed against the lead figure in the scheme.

This election avoids potentially difficult problems of proof in determining how much income reported in prior years is fictitious or a return of capital, and alleviates compliance and administrative burdens on both taxpayers and the IRS.

To make the election, the taxpayer must mark "Revenue Procedure 2009-20" at the top of Form 4684, Casualties and Thefts, for the tax year of the investor in which the indictment, information, or complaint is filed against the lead figure. The taxpayer must also complete and sign the statement provided in Appendix A of Rev. Proc. 2009-20, 2009-14 I.R.B. 749, and attach the statement to the taxpayer's return. If, before April 17, 2009, the taxpayer has filed a return (original or amended) that is inconsistent with the election, the taxpayer can file a corrected return on or before May 15, 2009, and indicate this fact on the statement attached to the corrected return.

If the taxpayer makes the election, the IRS will not challenge the taxpayer's treatment of the loss as theft loss; the taxpayer's treatment of the year in which the theft was discovered (and in which the taxpayer is therefore allowed to claim the deduction) as the tax year of the investor in which the indictment, information, or complaint is filed against the lead figure; or the taxpayer's treatment of the amount of the deduction. Rev 2009-14 I.R.B. 749.

By making the election the taxpayer can deduct as a theft loss 95 percent of the taxpayer's investment in the fraudulent arrangement, but only if the taxpayer does not pursue any potential third-party recovery. If the taxpayer does pursue such a recovery, the taxpayer can only deduct 75 percent of the taxpayer's investment. In either case, the deduction must be reduced by all actual or potential claims for reimbursement that, as of the last day of tax year of the investor in which the indictment, information, or complaint is filed against the lead figure, are attributable to insurance policies in the name of the investor, contractual arrangements other than insurance that guaranteed or otherwise protected against loss of the investment, or amounts payable from the Securities Investor Protection Corporation (SIPC) as advances for customer claims under 15 U.S.C. Section 78fff-3a (or by a similar entity under a similar provision). The deduction is not reduced by any other actual or potential claims for recovery, including claims against an individual or entity that conducted the fraudulent arrangement or claims against an entity established to recover assets for the benefit of investors or creditors. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

If the taxpayer receives an additional recovery in a later year, the taxpayer may have to include that amount in income in the year it is received. Similarly, if the recovery turns out to be less than expected, the additional loss is claimed in that later year. Req. Section 1.165-1(d)(2).

A taxpayer's investment in the fraudulent arrangement is the total amount of cash, or the basis of property, that the taxpayer invested in the arrangement in all years. The taxpayer's investment is increased by the total amount of net income with respect to the arrangement that, consistent with information received from the arrangement, the taxpayer included in income for federal tax purposes for all tax years (including years for which a refund is barred by the statute of limitations) prior to the tax year of the investor in which the indictment, information, or complaint is filed against the lead figure. The taxpayer's investment is decreased by the total amount of cash or property that the taxpayer withdrew in all years from the arrangement, wither designated as income or principal. The taxpayer's investment does not include: amounts borrowed from the arrangement and then reinvested in the arrangement, to the extent the amounts were not repaid at the time the theft was discovered; amounts such as fees that were paid to the arrangement and deducted for federal income tax purposes; amounts reported to the taxpayer as taxable income that were not included in gross income of the taxpayer's tax return; or cash or property that the taxpayer invested in a fund or other entity that invested in the fraudulent arrangement. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

Before an election can be made, the lead figure in the fraudulent arrangement (or one of the lead figures) must be charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement, or a similar crime that, if proven, would meet the definition of theft under Code Section 165 under the law of the jurisdiction in which the theft occurred. Alternatively, the election can be made if the lead figure was the subject of a state or federal complaint alleging the commission of a Ponzi scheme and either (1) the complaint alleged an admission by the lead figure or the execution of an affidavit by that person admitting the crime, or (2) a receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

To be eligible to make the election:

1. The taxpayer must be a U.S. taxpayer under Code Section 7701(a)(30), meaning that the taxpayer must be a U.S. citizen or resident, or a domestic partnership, corporation, estate, or trust;

2. The taxpayer must not have had actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public; and

3. The taxpayer must have directly transferred cash or property to the fraudulent arrangement; and

4. The investment arrangement must not have been a tax shelter. Rev. Proc. 2009¬20, 2009-14 I.R.B. 749.

Investors who invested solely in a fund or other entity (separate from the investor for federal tax purposes) that invested in the fraudulent arrangement are not eligible to make the election, but the fund or entity itself may make the election.

By making the election, the taxpayer agrees not to deduct more than allowed under the election; not file returns or amended returns to exclude or recharacterize income reported with respect to the fraudulent arrangement in years preceding the tax year of the investor in which the indictment, information, or complaint is filed against the lead figure; not to apply the alternative computation in Code Section 1341 for restorations of amounts held under a claim of right; and not to apply the doctrine of equitable recoupment or the mitigation provisions of Code Sections 1311, 1312, 1313, and 1314. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

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