Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Associate Area Counsel
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from: Paul M. Ritenour
Branch Chief

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subject: Offshore Compliance Project

This responds to your memorandum and request for advice sent to the national office on September 24, 2002. The requested advice concerns the treatment of investors who lost money in a Ponzi scheme. More specific advice would require the facts and circumstances of a particular taxpayer defrauded by the scheme.

ISSUES:

1. Whether taxpayers who invested in the scheme may treat payments designated as interest they received on promissory notes as a return of capital under the open transaction doctrine or similar principles.

2. Whether the investors are entitled to a theft loss.

3. If the investors are entitled to a theft loss, whether that loss may be claimed when there is a prospect of recovery in a future year.

CONCLUSIONS:

1. The interest payments received on the promissory notes are includible in income when received, as interest, except in rare and extraordinary circumstances in which an innocent investor could establish that it was uncertain whether the investor would ever recover the investment.

2. Investors would generally be entitled to a theft loss, providing that a theft occurred under local law. The loss may be disallowed if the taxpayer participated in a sham transaction intended to avoid federal income taxes, or if the allowance of the loss would be against public policy based on the taxpayer's own conduct.

3. A theft loss is generally deductible in the year the theft is discovered. However, if there is a reasonable prospect of recovery, only the portion as to which there is no prospect of recovery, if any, is deductible.

FACTS:

The promoters of the scheme operated a title loan company, which loaned money to customers at high interest and obtained an assignment of the title to the customer's car. Investors were induced to lend money to entities, which would in turn loan money to the title loan company. In exchange for their investment investors received short term promissory notes bearing interest rates ranging from 12 to 36 percent. Investors had the option of having their payments on the promissory notes deposited into an offshore credit card account, deposited in a domestic bank, or mailed directly to the investor. The funds obtained from investors were generally not lent to the title loan company, but instead were used to pay the promoter's commissions and fund interest payments to prior investors. This is the defining characteristic of a pyramid, or "Ponzi" scheme. In some instances investors received interest payments on their notes, but did not report these amounts as income.

A restraining order has been obtained against the promoters, and assets have been frozen. A receiver has been appointed, and is currently in the process of recovering assets for the benefit of investors.

LAW & ANALYSIS:

Issue 1:

Amounts received as interest, according to the terms of the promissory notes, would generally be includible, as such, in gross income. Deputy v. DuPont, 308 U.S. 488, 498 (1940). However, some investors contend that the unreported interest payments were a return of principal pursuant to the open transaction doctrine.

The open transaction doctrine, or "cost recovery method," applies in rare and extraordinary circumstances, see McShain v. Commissioner, 71 T.C. 998, 1004 (1979), to permit an investor to recover capital prior to recognizing gain where the receipt of deferred payments is speculative or contingent. The Supreme Court established the open transaction doctrine in Burnet v. Logan, 283 U.S. 404 (1931). In Logan, the taxpayer owned stock in a corporation which, along with several other corporations, held a leasehold interest in a mine. The taxpayer sold the stock for cash plus a royalty of 60 cents per ton on all ore apportioned to the corporation. There was no provision for a maximum or minimum tonnage. The contractual promise to pay the royalty was held to be too contingent and speculative to have any ascertainable value, and as a result, the transaction could not be regarded as closed.

Some authorities question whether the open transaction doctrine, which has generally been applied to deferred payment sales under § 1001, applies to payments of interest on a loan. See Parrish v. Commissioner, 168 F.3d 1098 (10th Cir. 1999).

However, the open transaction doctrine or similar principles have occasionally been applied to recoveries on a loan. For example, the doctrine has been applied to the purchase of notes at a discount where, at the time of acquisition, the investor was not reasonably certain that he would recover his cost. Underhill v. Commissioner, 45 T.C. 489, 495 (1966). In Underhill, a taxpayer acquired interest-bearing promissory notes at sizable discounts. The obligations were usually secured by second deeds of trust on residential property. The taxpayer reported the stated interest payments as income. However, the taxpayer did not report the discount income until he had recovered his entire investment. The Tax Court concluded that the obligations purchased by taxpayer were speculative and that taxpayer was not required to report any discount income until he had recovered his investment. The court noted that there was no issue as to the taxability of the stated interest payments to the taxpayer.[1] See also Phillips V. Frank, 295 F2d 629, 633-34 (9th Cir. 1961) (payments constituted a return of capital until they exceeded cost in circumstances where the borrower was in default).

With respect to notes issued in a fraudulent scheme, Greenberg v. Commissioner, T.C. Memo. 1996-281, permitted interest payments received by a passive investor in a Ponzi scheme to be treated as a recovery of principal in the year the scheme defaulted. There was sufficient evidence to determine the amount of funds paid and received by the taxpayers, and the case holds that the payments the taxpayers received were not interest because they were not compensation for the use or forbearance of money. Instead, the payments were made to conceal the fraudulent misappropriation of the taxpayers' investment.

However, while courts may occasionally apply a return-of-capital or open-transaction concept to interest payments, they have done so sparingly, consistent with the principle that the open transaction doctrine is only applied in "rare and extraordinary" circumstances. In the context of Ponzi and similar schemes, Greenberg has been applied narrowly. In Parrish, for example, which involved a principal in the scheme, the courts questioned whether the open transaction doctrine was applicable, and held that in any case the taxpayer had not met his burden of proof.

Similarly, in Premji v. Commissioner, T.C. Memo 1996-304, aff'd without published opinion, 139 F.3d 912 (10th Cir. 1998), the taxpayer received interest payments from an investment in a Ponzi scheme. Checks for the loan amount were also made available but the taxpayer chose to re-invest these amounts. The taxpayer argued that

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[1] In Underhill and certain other earlier cases, courts applied the open transaction doctrine to original issue or market discount, but not to stated interest payments. It is now more clearly settled than it was then that discount represents interest. In any case, the payments in the current case were apparently payments of stated interest.

the interest payments were not required to be included in income under the open transaction doctrine. The Tax Court concluded that the payments were income in the year received, and not a recovery of principal, since the taxpayer could not establish that the recovery of the principal amount was sufficiently uncertain when the amount had been made available to him. See also Wright v. Commissioner, T.C. Memo. 1989-557, aff'd, 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); and authorities discussed in Estate of Campana v. Commissioner, T.C. Summary Opinion 2001-159 (Sept. 26, 2001).

Thus, the weight of authority supports the conclusion that interest payments received on the promissory notes in the present case would generally not be considered a return of principal, except perhaps in rare and extraordinary circumstances in which an innocent investor could meet his or her burden of proof to establish that it was uncertain whether the investor would ever recover the investment. However, we note that the existence of the offshore accounts in this case could be considered an indication of fraud, and we do not believe that the holding of Greenberg would extend to a taxpayer who failed to report interest income and failed to disclose the existence of an offshore account.

Issue 2:

Section 165(a) of the Internal Revenue Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(c) provides that in the case of an individual, the deduction under subsection (a) is limited to losses incurred in a trade or business; losses incurred in any transaction entered into for profit, though not connected with a trade or business; and losses of property not connected with a trade or business if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

Section 1.165-8(d) of the regulations provides that the term "theft" shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery.

In Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1956), the court defined theft as "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." The court also stated that whether a theft loss occurs depends upon the law of the jurisdiction where it was sustained and that the exact nature of the crime, whether larceny or embezzlement, obtaining money under false pretenses, swindling or other wrongful deprivations of the property of another, is of little importance so long as it amounts to theft.

Therefore, investors in Ponzi schemes may be entitled to a theft loss under § 165(c)(3). Losses suffered by bona fide victims of a fraudulent scheme are generally not disallowed. See Berardo v. Commissioner, T.C. Memo. 1987-433.

However, in this instance the offshore accounts are troubling. If a taxpayer's activities in connection with a theft loss are contrary to public policy, that may be grounds for denying a theft loss deduction. See Richey v. Commissioner, 33 T.C. 272 (1959); Mazzei v. Commissioner, 61 T.C. 497 (1974). In Lincoln v. Commissioner, T.C. Memo. 1985-300, the taxpayer was swindled in connection with his participation in a scheme to buy stolen money at a discount. The Tax Court did not allow a theft loss deduction, stating that it is "as important to the policy of the state and nation to prevent attempts to buy stolen goods as it is to prevent an actual purchase [of stolen goods]." Similar policy concerns have been raised with respect to losses generated from investments in tax avoidance transactions. In such instances courts have concluded that either no theft occurred, or that the taxpayer received what was bargained for. Marine v. Commissioner, 92 T.C. 958 (1989), aff'd, 921 F.2d 280 (9th Cir. 1991); but see Nichols v. Commissioner, 43 T.C. 842 (1965), nonacq., Rev. Rul. 70-333, 1970-1 C.B. 38.

In the present case, investors would generally be entitled to a theft loss, providing that a theft occurred under local law. The loss may be disallowed, however, if the taxpayer participated in a sham transaction intended to avoid federal income taxes, or if the allowance of the loss would be against public policy based on the taxpayer's own conduct.

Issue 3:

Section 1.165-1(d) provides that a loss shall be allowed as a deduction under § 165(a) only in the year the loss is sustained. Generally, a loss is sustained in the taxable year in which the loss occurs as evidenced by a closed and completed transaction and as fixed by identifiable events. See § 1.165-1(d)(1).

Section 165(e) and § 1.165-8 of the Income Tax Regulations provide that a loss arising from a theft shall be treated under section 165(a) as sustained during the taxable year in which the taxpayer discovers the loss.

Section 1.165-8(a)(2) provides that if in the year the taxpayer discovers the loss arising from a theft there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is sustained, for purposes of section 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received. See also § 1.165-1(d)(3). Section 1.165-1(d)(2)(i) states, in part, that whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon examination of all facts and circumstances.

If in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of § 165, until the taxable year in which in can be ascertained with reasonable certainty whether or not such reimbursement will be received. See § 1.165-1(d)(3). Therefore, a theft loss deduction will be barred to the extent that a reasonable prospect of reimbursement exists. If the theft loss exceeds the claim for recovery, the excess would be deductible in the year the theft is discovered. Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975).

If you have questions with respect to this memorandum, please contact of this office, at .

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