OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
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Dear :

I apologize for the delay in responding to your inquiry dated March 1, 2004, on behalf of your constituents who want guidance on the proper tax treatment of losses incurred by investors in You asked whether the “frozen deposit rule” applies to interest income reported on Form 1099-INT, and whether taxpayers can deduct the investment losses as capital or casualty losses.

Unfortunately, the materials you enclosed did not provide us with a full understanding of the facts surrounding your inquiry. Therefore, the discussion below is based exclusively on information we received from your office.

sold notes and subordinated debentures to the public, and provided the sale proceeds to its parent, . Over 8,000 individual investors sustained combined losses of on notes and subordinated debentures they purchased from closed its offices, and the investors did not have any access to their accounts.

filed a bankruptcy petition. The Attorney General of , as well as federal law enforcement agencies, are investigating many of corporate officers.

Below is a description and analysis of the types of deductible losses under section 165 of the Internal Revenue Code (the Code) that investors may possibly have incurred on their purchase of notes and debentures from , and a brief discussion of the interest income issue.

The law allows a deduction for any loss not compensated by insurance or otherwise. To be allowed as a deduction under section 165(a) of the Code, a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year, except for a special rule relating to disaster losses that is not relevant here (section 1.165-1(b) of the Income Tax Regulations). For individuals, a deduction under section 165(a) of the Code 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)
- Losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft

**Investors' Ability to Deduct their Losses as Theft Losses**

Whether a loss constitutes a theft loss under section 165 of the Code is determined by examining the law of the state where the alleged theft occurred. *Edwards v. Bromberg*, 232 F.2d 107, 111 (5th Cir. 1956); *Viehweg v. Commissioner*, 90 T.C. 1248, 1253 (1988); Rev. Rul. 77-17, 1977-1 C.B. 44. To qualify as a theft loss under section 165(c) of the Code, the taxpayer must prove that the "loss resulted from a taking of property that is illegal under the law of the state where it occurred and that the taking was done with criminal intent." Rev. Rul. 72-112, 1972-1 C.B. 60. An actual conviction for theft under state law is not required to obtain a theft loss deduction under section 165(e) of the Code. *Paine v. Commissioner*, 63 T.C. 736, 740 (1975), *aff'd without published opinion*, 523 F.2d 1053 (5th Cir. 1975).

The law treats a loss arising from a theft as sustained during the taxable year in which the taxpayer discovers the loss. If, in the year the taxpayer discovers the theft loss, he or she makes a claim for reimbursement for which a reasonable prospect of recovery exists, the portion of the loss for which reimbursement may be received is not treated as sustained until the tax year in which it can be ascertained with reasonable certainty whether the taxpayer will receive such reimbursement (*See* sections 1.165-1(d)(3), 1.165-8(a)(2) of the Treasury Regulations). Whether a reasonable prospect of recovery for a reimbursement claim exists is determined by examining all the facts and circumstances. *See* section 1.165-1(d)(2)(i) of the Regulations.

For taxpayers who invested in to deduct their alleged losses as theft losses, they must demonstrate that a theft has occurred under law, and ascertain with reasonable certainty that they will not receive reimbursement of their losses from the bankruptcy proceedings, or any lawsuits that may be pending against the officers, directors, accountants, and lawyers of or , or some other source.

**Investors' Ability to Deduct their Losses as Worthless Securities Losses**

If any security which is a capital asset becomes worthless during the taxable year, the taxpayer can deduct the loss as a capital loss from the sale or exchange, on the last day of the taxable year, of a capital asset. A security can include a bond, debenture, note, or certificate or other evidence of indebtedness, issued by a corporation, with interest coupons or in registered form [sections 165(g)(1) and (2) of the Code].
A taxpayer cannot take a worthless securities deduction unless he or she can show that the security is completely worthless in the year claimed. A taxpayer cannot claim a deduction for partial worthlessness [Treasury Regulation section 1.165-5(d)]. The mere shrinkage in value of a security does not entitle a taxpayer to a worthless securities deduction if, on the date of the claimed loss, the security has any recognizable value. *See Favia v. Commissioner*, T.C. Memo. 2002-154, *citing* Treas. Reg. section 1.165-4(a).

Whether a security is worthless depends on whether the corporation's stock has either liquidating or potential value. *Morton v. Commissioner,* 38 B.T.A. 1270, 1278, 1279 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940). Liquidating value of a stock may be determined by examining the company's asset value and comparing total assets and total liabilities. *Id.* at 1278. Potential value is determined by examining whether the facts and circumstances indicate reasonable hope and expectation that the company's foreseeable future operations will create liquidating value. *Id.* at 1278- 1279; *The Austin Company, Inc. v. Commissioner*, 71 T.C. 955, 970 (1979), *acq.*, 1979-2 C.B. 1.

A loss is evidenced by closed and completed transactions and fixed by identifiable events [Treas. Reg. section 1.165-1(b)]. Identifiable events that negate or severely limit the existence of potential value include: liquidation of the corporation, cessation of business, bankruptcy, or the appointment of a receiver to take over the company's assets and business. *Steadman v. Commissioner*, 50 T.C. 369, 377 (1968), *aff'd*, 424 F.2d 1 (6th Cir.), *cert. denied*, 400 U.S. 869 (1970). However, none of these events, alone, is determinative. We must examine all of the facts and circumstances of each taxpayer's case before deciding whether the security is completely worthless at the end of the taxable year. *Boehm v. Commissioner*, 326 U.S. 287, 293 (1945), *reh'g. den.*, 326 U.S. 811 (1946). As noted above, we do not allow a loss if a taxpayer makes a claim for reimbursement at the time of the loss for which a reasonable prospect of recovery exists [Treas. Reg. section 1.165-1(d)(2)(i)].

Based on the facts provided, the notes and subordinated debentures that sold may fall within the definition of security; however, it is not clear whether issued the notes and debentures with interest coupons or in registered form (section 165(g)(2)(C) of the Code).

Whether a loss due to worthlessness is actually sustained during the taxable year is a highly factual determination. closing of its offices and the beginning of bankruptcy proceedings are factors we would consider in determining whether the notes and debentures became completely worthless in tax year . However, the following factors may prevent such a determination: any ongoing bankruptcy proceedings and/or any pending lawsuits against the officers, directors, accountants, and attorneys of or , both of which could result in distributions to the investors for all or part of their investments.

**<u>Investors' Ability to Deduct Losses in Insolvent Financial Institutions</u>**

Certain taxpayers, who experience a loss on their deposits in a qualified financial institution due to its bankruptcy or insolvency, can elect to treat the loss as a loss described in section 165(c)(3) of the Code incurred during the taxable year. Or, subject to certain limitations, they can treat them as an ordinary loss incurred in a transaction entered into for profit [sections 165(c)(2) and (3) and 165(l) of the Code]. A qualified financial institution includes any:

- Bank, as defined in section 581 of the Code,
- Institution described in section 591 of the Code,
- Credit union where deposits or accounts are insured under federal or state law or are protected or guaranteed under state law, or
- Similar institution chartered and supervised under federal or state law

as described in section 165(l)(3) of the Code.

We cannot determine whether the investors may use this provision, as we do not have sufficient information to ascertain whether is a qualified financial institution within the meaning of section 165(l)(3) of the Code.

**<u>Investors' Interest Income May be Taxable</u>**

Interest income is included within the meaning of gross income. Generally, income is taxable to a cash method taxpayer in the year in which he or she actually or constructively receives it [Treas. Reg. section 1.451-1(a)]. Income is constructively received in the taxable year in which it is credited to the taxpayer's account, set apart for the taxpayer, or made available so that the taxpayer may draw upon it at any time or could have drawn upon it during the taxable year if notice of intention to withdraw had been given [Treas. Reg. section 1.451-2(a)].

However, interest credited on a frozen deposit in a qualified financial institution during the calendar year is included in gross income only to the extent of the net amount the taxpayer withdraws during the calendar year and the amount of the deposit which is available for withdrawal as of the close of the taxable year (section 451(g)(1) of the Code). A frozen deposit is defined as a deposit that cannot be withdrawn due to the bankruptcy or insolvency of a qualified financial institution (section 451(g)(4) of the Code).

If credited the interest to its investors' accounts, the investors would appear to be in constructive receipt of the income and would thus be taxed on the interest. We do not have sufficient facts to determine whether the taxpayers' deposits qualify as frozen deposits within section 451(g) of the Code.

I hope this information is helpful. If you have further questions, please call me or at .

Sincerely,

ROBERT M. BROWN
Associate Chief Counsel
(Income Tax and Accounting)