



Theft Losses from Investments in "Ponzi" Schemes: Tax Treatment of Distributions Received From a Trustee/Receiver

Q1: In many criminally fraudulent investment schemes, a court-appointed trustee or receiver is assigned to recover and sell assets derived from the scheme and distribute the proceeds to victims as a full or partial recovery of their theft losses. Is a taxpayer who receives such a recovery required to include the amount in income for federal income tax purposes?

A1: Whether a taxpayer who recovers amounts lost in a fraudulent investment scheme is required to include the recovery in income depends on whether the taxpayer claimed a tax deduction for the theft loss in any prior year. A taxpayer who has not yet claimed a tax deduction for the theft loss is not required to include in income a recovery from the trustee or receiver. Instead, the recovery will reduce the amount a taxpayer may eventually claim as a loss. A taxpayer who claimed a tax deduction for the theft loss, however, may be required to include the recovery in income, depending on the extent to which the theft loss deduction created a "tax benefit" for the taxpayer.

Q2: How does a taxpayer who claimed a tax deduction for a theft loss determine the amount of a subsequent recovery that he or she must include in income?

A2: Under a provision of law known as the tax benefit rule, a taxpayer must include in income the recovery of any amount deducted in a prior taxable year to the extent the prior year's deduction reduced the taxpayer's tax liability for that year (or created a net operating loss carryback or carryover). For example, if a taxpayer properly deducts a \$100 theft loss in 2009, and the deduction reduces the taxpayer's 2009 income tax liability, a recovery of \$100 received in 2011 is includible in full in the taxpayer's income in 2011 under the tax benefit rule. Similarly, if the 2009 theft loss exceeds the taxpayer's 2009 taxable income and creates a net operating loss carryback or carryover, a recovery of \$100 received in 2011 is includible in full in the taxpayer's income in 2011. The recovery is ordinary income and not capital gain.

Q3: May a taxpayer amend a prior year's income tax return to reduce a properly claimed theft loss by the amount of a recovery received in a subsequent year?

A3: No. If a taxpayer properly claimed a theft loss deduction and in a later year recovers a portion of the amounts lost, the taxpayer may not amend the prior year's income tax return to reduce the theft loss deduction by the amount of the recovery. Instead, the recovery is includible as tax benefit income in the year received.

Q4: Using the optional safe harbor provided in Rev. Proc. 2009-20, a taxpayer claimed a deductible theft loss in 2009 equal to 95% of the total qualified investment, reduced by amounts the taxpayer reasonably expects to recover from insurance or from the Securities Investor Protection Corporation (potential insurance/SIPC recovery). In 2011, the taxpayer receives the expected insurance/SIPC recovery. Does the taxpayer have income under the tax benefit rule in 2011?

A4: No, the taxpayer does not have income in 2011 under the tax benefit rule. As the taxpayer properly reduced the deductible theft loss by the potential insurance/SIPC recovery in 2009, when those amounts are recovered in 2011 the taxpayer does not have to report the recovery as income under the tax benefit rule.

Q5: If, under the optional safe harbor provided in Rev. Proc. 2009-20, a taxpayer claimed a deductible theft loss in 2009 equal to 95% of the total qualified investment (assume the taxpayer had no potential insurance/SIPC recovery), and in 2012 the taxpayer recovers 4% of the taxpayer's total qualified investment, does the taxpayer have income under the tax benefit rule in 2012?

A5: No, the taxpayer does not have income in 2012 under the tax benefit rule. The 4% recovery is treated as first reimbursing the portion of the theft loss for which the taxpayer did not claim a deduction in 2009 (i.e., the 5% portion of total qualified investment that was not deductible under the safe harbor). Because the 4% recovery is a recovery of an amount that was not previously deducted, it is not income under the tax benefit rule. The taxpayer may have an additional theft loss deduction for the remaining 1% loss that has not been recognized or recovered. This loss is properly deductible in the year it is determined that there is no reasonable prospect of recovering this remaining 1%.

Q6: If, under the optional safe harbor provided in Rev. Proc. 2009-20, a taxpayer claimed a deductible theft loss in 2009 equal to 95% of the total qualified investment (assume the taxpayer had no potential insurance/SIPC recovery), and if the taxpayer recovers 4% of the taxpayer's total qualified investment in 2012 and 3% of total qualified investment in 2013, does the taxpayer have income under the tax benefit rule in 2013?

A6: Yes, the taxpayer will have income under the tax benefit rule in 2013. As discussed in Q&A 5, the taxpayer would not have income under the tax benefit rule in 2012 upon receipt of the 4% recovery because the 4% recovery does not exceed the unrecovered portion of the theft loss for which the taxpayer did not claim a deduction. As of the end of 2012, the taxpayer has deducted 95% of the total qualified investment, and recovered 4%. Accordingly, only 1% of the unrecovered total qualified investment remains for which the taxpayer has not claimed a deduction. In 2013, the 3% recovery is treated as first reimbursing the remaining unrecovered portion of the theft loss for which the taxpayer has not claimed a deduction (1%). The remaining 2% is income in 2013 under the tax benefit rule.

For example, assume the taxpayer's total qualified investment is \$200X, and the taxpayer, consistent with Rev. Proc. 2009-20, claimed a deductible theft loss of \$190X (95% of the total qualified investment) in 2009 (assume the taxpayer had no potential insurance/SIPC recovery). In 2012, the taxpayer recovers \$8X. In 2013, the taxpayer recovers \$6X. The amount includible in income in 2013 under the tax benefit rule is computed as follows:

2009

Total qualified investment	\$200X
Deductible theft loss (95%)	<u>\$190X</u>
Remaining unrecovered total qualified investment (5%)	\$ 10X

2012

Recovery of 4% of total qualified investment \$ 8X
Remaining unrecovered total qualified investment (1%) \$ 2X

None of the \$8X recovery is includible in income in 2012 under tax benefit rule because the \$8X recovery does not exceed the unrecovered portion of the theft loss for which the taxpayer did not claim a deduction (\$10X).

2013

Recovery of 3% of total qualified investment \$ 6X

Because the \$6X recovery exceeds the remaining unrecovered portion of the theft loss for which the taxpayer did not claim a deduction (\$2X), the excess (\$4X) is includible in income in 2013 under the tax benefit rule.

For further information see the section entitled "Insurance and Other Reimbursements" in [Publication 547](#) and the section entitled "Recoveries" in [Publication 525](#).

A trustee or receiver may use this information to respond to questions from investors and may include a copy of these questions and answers with any distributions sent to investors.

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