



*Many Investment Theft Loss Deductions  
Appear to Be Erroneous*

**September 27, 2011**

**Reference Number: 2011-40-124**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

1 = Tax Return/Return Information

2(f) = Risk Circumvention of Agency Regulations or Statutes

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 27, 2011

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION  
COMMISSIONER, WAGE AND INVESTMENT DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Many Investment Theft Loss Deductions  
Appear to Be Erroneous (Audit # 201040042)

This report presents the results of our review to assess the Internal Revenue Service's efforts to ensure validity of investment theft loss deductions. This audit is included in our Fiscal Year 2011 Annual Audit Plan coverage and addresses the major management challenges of Implementing Health Care and Other Tax Law Changes and Erroneous and Improper Payments and Credits.

Management's complete response to the draft report is included in Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.



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*Abbreviations*

<i>e-file(d)</i>	Electronically File(d)
IRC	Internal Revenue Code
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed



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## *Many Investment Theft Loss Deductions Appear to Be Erroneous*

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### *Background*

Internal Revenue Code (I.R.C.) Section (§) 165, along with associated regulations, procedures, and rulings, provides taxpayers with tax relief for investment theft losses. An investment theft loss occurs when someone steals a taxpayer's property held in connection with a transaction entered into for profit. The taking of property must be illegal under State law and committed with criminal intent. A theft includes the taking of money or property by blackmail, burglary, robbery, embezzlement, etc. Theft losses can also include losses resulting from Ponzi schemes. A Ponzi scheme is an investment fraud that involves the payment of fictitious investment returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high rates of return with little or no risk.

With little or no legitimate earnings, the schemes require a consistent flow of money from new investors to continue. Ponzi schemes tend to collapse when it becomes difficult to recruit new investors or when a large number of investors ask to cash out. In some instances, these schemes last for long periods of time and do not collapse until substantial sums of money have been contributed by investors. For example, in March 2009, Bernard Madoff pleaded guilty to 11 Federal felonies and admitted to turning his wealth management business into a massive Ponzi scheme that defrauded thousands of investors of billions of dollars. The amount missing from client accounts, including fabricated gains, was almost \$65 billion. The court-appointed trustee estimated actual losses to investors of \$18 billion.

***The IRS issued guidance to help  
provide taxpayers with some  
clarity on the tax implications  
resulting from Ponzi scheme  
investment theft losses.***

#### ***The Internal Revenue Service (IRS) recognized and addressed the tax implications of Ponzi scheme losses***

The number of investment theft loss victims as a result of a Ponzi scheme increased significantly in Tax Years 2008 and 2009. With the potentially large number of victims filing tax returns claiming these losses, IRS officials wanted to minimize both the IRS's administrative burden and the burden on the victims of Ponzi scheme losses. As such, the IRS issued a revenue procedure which provides victims with a uniform method for computing the theft losses from Ponzi-type investment schemes and helps to simplify related tax reporting for these taxpayers.

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<sup>1</sup> Investment property is any property held for investment, such as stocks, notes, bonds, gold, silver, vacant lots, and works of art.



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The IRS also issued a revenue ruling describing the proper income tax treatment under I.R.C. § 165 for losses resulting from Ponzi-type investment schemes.

- **Revenue Ruling 2009-9:** Provides taxpayers with guidance on determining the amount and timing of losses under I.R.C. § 165 resulting from Ponzi schemes. The ruling holds that a loss from a Ponzi scheme is a theft loss in a transaction entered into for profit; therefore, the theft loss rules under I.R.C. § 165 apply. Under the I.R.C. § 165 rules, a taxpayer must prove that the loss was from theft and the amount of the loss. The loss is deductible in the year the theft was discovered. However, a taxpayer is not allowed a deduction if there is a claim for reimbursement of any portion of the loss for which there is a reasonable prospect of recovery. Investment theft losses are not subject to either personal loss limitations, namely the \$100 and 10 percent of Adjusted Gross Income or the 2 percent of Adjusted Gross Income limitation.<sup>2</sup>
- **Revenue Procedure 2009-20:** Simplifies compliance for taxpayers by providing an optional safe harbor<sup>3</sup> means of determining the year in which the loss from a specified fraudulent arrangement<sup>4</sup> is deemed to occur and a simplified means of computing the amount of the loss. The safe harbor option allows qualified investors<sup>5</sup> to deduct either 75 or 95 percent of their qualified investment,<sup>6</sup> less the amount of any potential or actual recovery from insurance or similar contractual arrangements, in the year the lead figure is criminally charged. The remaining 5 or 25 percent of the loss may be deducted in the tax year in which there are no longer any reimbursement claims for which there is a reasonable prospect of recovery under the normal I.R.C. § 165 rules discussed above.

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<sup>2</sup> Adjusted Gross Income (U.S. Individual Income Tax Return (Form 1040), line 37) is the taxpayer's total income (line 22) minus the allowable adjustments (lines 23-35).

<sup>3</sup> Rev. Proc. 2009-20 provides an optional procedure, i.e., "safe harbor," under which qualified investors may treat a Ponzi loss as a theft loss deduction. The safe harbor also provides investors with a uniform manner for determining their theft losses. In addition, the safe harbor avoids potentially difficult problems of proof in determining how much income reported in prior years was fictitious or a return of capital and alleviates compliance and administrative burdens on both taxpayers and the IRS.

<sup>4</sup> A specified fraudulent arrangement is an arrangement by which a party receives cash or other property from investors, alleges to earn income for the investors, reports income to the investors that is partially or wholly fictitious, makes payments of purported income or principal to some investors from amounts that other investors invested in the arrangement, and appropriates some of the investors' cash or property.

<sup>5</sup> Qualified investors who invested directly with the specified fraudulent arrangement qualify to deduct theft losses if they did not invest in a tax shelter and had no actual knowledge of the fraudulent nature of the arrangement before it became publicly known. Indirect investors who invested in the specified fraudulent arrangement through a pass-through entity are not qualified investors under the revenue procedure but may deduct their proportionate share of the loss passed through to them as reported on a Schedule K-1.

<sup>6</sup> Taxpayers deduct 75 percent if they intend to pursue any potential for third-party recovery and 95 percent if they do not intend to pursue any potential third-party recovery.



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The safe harbor requires taxpayers to waive their rights to file amended tax returns for prior years to eliminate the income that the scheme falsely reported to the taxpayer in each of those years. Instead, the taxpayer must claim the investment theft loss (which may include amounts reported in prior years) as a deduction only in the year the criminal charges are filed against the lead figure.

In comparison, if these victims choose not to apply the safe harbor treatment, their investment theft loss would be subject to the I.R.C. § 165 provisions described above. Figure 1 provides a comparison of key elements relating to the safe harbor provision and I.R.C. § 165 provisions.

**Figure 1: Comparison/Contrast Key Requirements Safe Harbor Method to Non-Safe Harbor Method for I.R.C. § 165 Investment Theft Loss Deductions**

Requirements	Safe Harbor Method	Non-Safe Harbor Method
Eligibility	“Qualified investor” is the person or entity that invested directly in the specified fraudulent arrangement.	Must be able to provide evidence that a theft of investment property occurred under Federal or State law.
Criminal Act	Lead figure is criminally charged.	Taxpayer must prove illegal taking of property with criminal intent. Lead figure does not have to be criminally charged.
Tax Year to Claim the Loss	Deduct a percent of the investment theft loss in the tax year the lead figure perpetrating the Ponzi scheme is criminally charged.	Deduct amount of the investment theft loss in the calendar year all recovery claims are finalized.
Amount of Loss Deducted	Deduct 75 or 95 percent of the investment loss with no loss dollar limit.	Deduct 100 percent of the investment loss less any recovery received or expected to be received.
Loss Reported on Tax Form	Casualties and Thefts (Form 4684), Section B (Business and Income-Producing Property).	Form 4684, Section B.
Documentation Supporting Loss to Be Included With Tax Return	Appendix A (Statement by Taxpayer Using Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement). <sup>7</sup>	None.

*Source: IRS guidelines and procedures.*

<sup>7</sup> Appendix A can be found in Internal Revenue Bulletin No. 2009-14 (April 6, 2009). See Appendix V of this report for an example. Appendix A must be filed by the “qualified investor,” which could be a partnership filing on behalf of partners.



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This review was performed at the Small Business/Self-Employed (SB/SE) Division Headquarters and the Large Business and International Division Headquarters in Washington, D.C.; the Submission Processing Site in Fresno, California; and the SB/SE Division Examination Policy Office in San Diego, California, during the period of October 2010 through June 2011. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

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\*\*\*\*\*2(f)\*\*\*\*\*. As a result, the IRS is unable to quantify the number of taxpayers claiming these losses.

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IRS procedures require taxpayers to report investment theft losses on Form 4684, Section B, and to include the investment theft loss amount on Itemized Deductions (Schedule A), line 28 (Other Miscellaneous Deductions). However,

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Schedule A, line 28, is used to report multiple losses and other tax items, including investment theft and casualty losses. Therefore, even though the IRS does transcribe this line, it cannot determine whether taxpayers are carrying an investment theft loss to this line for paper-filed tax returns. Schedule A, line 28, is used to report the following eight miscellaneous deductions:

- Gambling losses.
• Casualty and theft losses of income-producing properties.
• Federal estate taxes on income in respect of decedents.
• Amortizable bond premiums on bonds acquired before October 23, 1986.
• Deductions for repayment of amounts under claims of right if over \$3,000.
• Certain unrecovered investments in annuities.
• Impairment-related work expenses of disabled persons.
• Losses on other activities from large partnerships.

Our review of Tax Year 2008 electronically filed (e-filed) tax returns identified 1,967 taxpayers claiming investment theft losses of nearly \$781 million.8 The information from Form 4684, Section B, is captured for e-filed tax returns. \*\*\*\*\*2(f)\*\*\*\*\*

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8 This number does not agree with the total number of e-filed investment theft losses in our case review because 210 of the 2,177 individuals in our total used "casualty" in reporting partnership losses.



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estimates that more than 19,200 taxpayers have filed Tax Year 2008 tax returns claiming a combined total of more than \$8 billion in property income casualty and theft deductions.

The figure below provides the available statistics for the volume of tax returns and dollars of investment theft losses reported during Tax Year 2008 for paper and *e-file* returns.

**Figure 2: Form 1040 – Schedule A, Other Miscellaneous Deductions**

Tax Returns Filed in Tax Year 2008	Volume of Tax Returns	Total Amount of Other Miscellaneous Deductions (Line 28)	Percent of Money Reported on Line 28
Total Tax Returns With an Amount Reported on Line 28.	1,596,676	\$30,770,375,303	100%
E-Filed Tax Returns With an Amount Reported on Line 28.	1,021,536	\$10,693,358,208	35%
E-Filed Tax Returns With an Investment Theft Loss Deduction.	1,967	\$780,726,834	
Paper-Filed Tax Returns With an Amount Reported on Line 28.	575,140	\$20,077,017,095	65%
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Source: Treasury Inspector General for Tax Administration analysis of IRS Individual Return Transaction File<sup>9</sup> data.

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<sup>9</sup> The IRS database that contains data transcribed from initial input of the original individual tax returns during return processing.



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\*\*\*\*\*2(f)\*\*\*\*\*. For capital losses, taxpayers are required to provide a property description (100 shares of XYZ Company), dates acquired and sold, sale prices as well as cost or other basis, and related gains or losses on Capital Gains and Losses (Schedule D). Figure 4 identifies the information needed on Schedule D to claim a capital loss.



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**Figure 4: Information Needed to Claim a Capital Loss**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
<b>1</b>					
<b>2</b> Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . .					
<b>3</b> <b>Total short-term sales price amounts.</b> Add lines 1 and 2 in column (d) . . . . .					
<b>4</b> Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824					<b>4</b>
<b>5</b> Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .					<b>5</b>
<b>6</b> Short-term capital loss carryover. Enter the amount, if any, from line 8 of your <b>Capital Loss Carryover Worksheet</b> on page D-7 of the instructions . . . . .					<b>6</b> (                    )
<b>7</b> <b>Net short-term capital gain or (loss).</b> Combine lines 1 through 6 in column (f) . . . . .					<b>7</b>

Source: Tax Year 2008 Form 1040, Schedule D.

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 \*\*\*\*\*2(f)\*\*\*\*\*. According to the Federal Bureau of Investigation, investment theft losses are a significant issue for investors and will continue to be for years to come. Crimes involving investments (securities and commodities) are on the rise.<sup>10</sup>

**Recommendations**

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**Recommendation 1:** \*\*\*\*\*2(f)\*\*\*\*\*  
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<sup>10</sup> The 2009 Financial Crimes Report states that investment fraud investigations have increased by 33 percent over the last 5 years. For Fiscal Year 2009, the Federal Bureau of Investigation was investigating 1,510 cases of investment fraud and had 177 Special Agents assigned to address this problem.



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**Management's Response:** \*\*\*\*\*2(f)\*\*\*\*\*  
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\*\*\*\*\*2(f)\*\*\*\*\*. The IRS will assess the costs and availability of resources for additional transcription if the results of the recommended Compliance Initiative Project (see Recommendation 3) confirm a high risk of noncompliance.

**Recommendation 2:** \*\*\*\*\*2(f)\*\*\*\*\*  
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**Management's Response:** \*\*\*\*\*2(f)\*\*\*\*\*.  
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***Taxpayers Are Making Questionable or Erroneous Claims for Investment Theft Loss Deductions***

Based on our review of a statistically valid sample of 140 *e-filed* Tax Year 2008 tax returns on which taxpayers reported an investment theft deduction, we estimate that 1,788 (82.14 percent) of 2,177 tax returns may have erroneously claimed deductions totaling more than \$697 million, resulting in revenue losses totaling approximately \$41 million. Our sample was from Tax Year 2008 tax returns, and the audit statute of limitations may not allow the IRS sufficient time to complete the audits of these tax returns to recover the tax. However, these same issues will continue to exist in subsequent years.

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The IRS is not meeting its strategic goal of enforcing the law to ensure everyone meets their obligation to pay taxes. To achieve this goal, the IRS states that it will use the information it already receives and support proposals to increase information reporting while mitigating burden to the public. \*\*\*\*\*2(f)\*\*\*\*\*  
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Our review of the 140 *e-filed* tax returns identified 81 (58 percent) taxpayers who claimed investment theft losses totaling more than \$7.2 million that did not appear to meet the qualifications for this type of deduction. These claims were personal or capital losses and, as such, did not qualify as an investment theft loss. These potentially nonqualifying claims could result in a revenue loss totaling more than \$1.2 million.

- 62 (44 percent) tax returns – the taxpayers claimed investment theft losses totaling more than \$6.6 million. Our review of information retained by the IRS both from the taxpayer and third parties could not substantiate that these taxpayers had such investments or related thefts. These potentially nonqualifying deductions result in a potential revenue loss of more than \$1 million. For example:<sup>11</sup>

*Taxpayer A claims an investment theft loss of \$100,000 from the XYZ Company. Although the taxpayer does not have to provide support showing an investment in XYZ Company, IRS third-party records such as a Schedule K-1 or Proceeds From Broker and Barter Exchange Transactions (Form 1099-B) did not identify any documents issued by the XYZ Company to this taxpayer. Moreover, the taxpayers' prior year tax returns did not show income or loss associated with the investment. Given the lack of evidence of the investment, more information is needed by the IRS to substantiate whether the taxpayer was ever a victim of an investment theft.*

- 15 (11 percent) tax returns – the taxpayers claimed over \$396,000 in investment theft losses without establishing that they were a victim of a theft. These potentially nonqualifying deductions should have been taken as personal or capital losses (a maximum yearly deduction of \$3,000). These nonqualifying deductions result in a potential tax revenue loss of \$120,000. For example:

*Taxpayer A has an investment in ABC Corporation for \$35,000. At the time of sale, the taxpayer's investment has dropped in value to \$20,000, resulting in a \$15,000 loss on the sale of the investment. No one is pursuing civil or criminal actions against ABC Corporation for theft of investments. However, the taxpayer claims the \$15,000 as an investment theft loss deduction instead of a capital loss limited to \$3,000.*

- 4 (3 percent) tax returns – the taxpayers claimed more than \$215,000 in investment theft losses resulting from the Madoff Ponzi scheme. Madoff issued Forms 1099-B in an effort to maintain the perception of a valid investment. Our review of information retained by the IRS both from the taxpayer and third parties could not substantiate that these taxpayers had investments with Bernard Madoff. These nonqualifying deductions result in a potential revenue loss of more than \$26,000. For example:

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<sup>11</sup> All examples included in this report are hypothetical.



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*Taxpayer A takes a Ponzi theft loss deduction of \$300,000 and claims the loss is due to an investment in the Madoff Ponzi scheme. Independent research of third-party documentation could not find any Forms 1099-B for Tax Years 2007 and 2008 in the primary taxpayer's name or his or her spouse's name. Additionally, neither taxpayer was on the list of Madoff victims. Therefore, this deduction does not appear to be valid.*

In addition, neither the Treasury Inspector General for Tax Administration nor the IRS could make a determination on whether 34 (24 percent) of the 140 *e-filed* tax returns we reviewed met the qualifications to take investment theft loss deductions. These taxpayers claimed investment theft losses totaling more than \$20 million. These cases involved taxpayers for whom we were unable to substantiate either through information provided on the tax return or third-party documentation whether they were victims of investment theft, or taking investment theft loss deductions in an incorrect tax year, or electing the safe harbor provision without providing the required documentation. For example:

- 25 (18 percent) tax returns – the taxpayers claimed about \$7.7 million in investment theft losses and indicated on their Forms 4684 that the losses were associated with involvement in partnerships. However, our research of associated partnership tax returns showed that the partnerships did not include with their tax returns a Form 4684 reporting investment theft losses.<sup>12</sup> As such, it appears that these taxpayers did not incur an investment theft loss from those partnerships. For example:

*Taxpayer A claims an investment theft loss deduction in Tax Year 2008 of \$175,000. The taxpayer notes on their Form 4684 that the losses were reported on a Schedule K-1 from Partnership A, which had an investment theft loss due to the illegal scheme. However, the tax return filed by Partnership A has no Form 4684 reporting an investment theft loss. Therefore, the taxpayer's claim does not appear to be valid.*

- 7 (5 percent) tax returns – the taxpayers claimed more than \$10.6 million in investment theft losses that may have been deducted in the incorrect tax year. Only those taxpayers using the safe harbor option can claim their investment theft loss in the tax year the individual perpetrating the Ponzi scheme is criminally charged. However, to use the safe harbor, IRS guidelines require taxpayers to mark the top of their Form 4684 with "Revenue Procedure 2009-20" and to provide an Appendix A. These taxpayers took investment theft losses but did not notate selection of the safe harbor. If the taxpayer is

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<sup>12</sup> Partnerships are required to complete and attach Forms 4684 to their tax returns if they are claiming investment theft losses. The investment theft losses are then passed on to each partner on Schedule K-1 from a partnership. Partnerships can be multitiered, which means the loss can be passed through several partnerships. In these instances, the IRS often cannot determine whether the claim is valid and where the loss originated without performing an examination.



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not using safe harbor, these losses are treated as an I.R.C. § 165 investment theft loss with recoverable losses not allowed until there is no further possibility of recovery of such loss. For example:

Taxpayer A claims an investment theft loss deduction in Tax Year 2008 in the amount of \$250,000 for losses resulting from a Ponzi scheme. The court case (criminal and civil) relating to this Ponzi scheme is still ongoing at the time the tax return is filed. There is no indication on the tax return and/or Form 4684 that the taxpayer is electing the safe harbor provision. Without this election, the investment theft loss is treated as an I.R.C. § 165 and, as such, the taxpayer cannot claim any recoverable theft loss until all court cases (criminal and civil) are finalized.

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Safe harbor treatment on these claims should not have been allowed until the taxpayers provided the required information. For example:

Taxpayer A claims a \$750,000 loss on his e-filed tax return due to an investment in a Ponzi scheme and indicates on the Form 4684 the election of the safe harbor procedures in Revenue Procedure 2009-20 but does not provide the IRS with the required Appendix A. The taxpayer has not complied with the reporting instructions outlined in the Revenue Procedure.

It should be noted that IRS audit results from Tax Preparer Projects also showed that taxpayers are erroneously claiming investment theft loss deductions. As of December 24, 2010, the IRS determined that 96 percent of the 1,761 investment theft loss claims associated with tax returns under examination were erroneous, resulting in additional tax assessments totaling \$19.5 million. The IRS indicated that most of the erroneous investment theft losses include:

- Taxpayers converting capital losses to theft losses. Investment losses caused by stock market performance rather than outright theft are not deductible except as a capital loss (which is limited to a \$3,000 maximum per year).
- Taxpayers choosing to use the safe harbor option when they were not the victim of a Ponzi scheme or any other investment theft loss.

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**Recommendations**

The Commissioner, Small Business/Self-Employed Division, should:

**Recommendation 3:** Establish a Compliance Initiative Project to measure noncompliance with the claims of investment theft losses and, \*\*\*\*\*2(f)\*\*\*\*\*  
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**Management's Response:** IRS management will consult with the SB/SE Division Research function to analyze their processes and review historical data to determine whether the IRS needs to make changes to its processes and forms. As part of this analysis, the IRS will look at the feasibility of establishing a Compliance Initiative Project. The IRS will recommend applicable process improvements and compliance strategies based on the assessment of the level of noncompliance.

**Recommendation 4:** \*\*\*\*\*2(f)\*\*\*\*\*  
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**Management's Response:** \*\*\*\*\*2(f)\*\*\*\*\*  
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**Appendix I**

*Detailed Objective, Scope, and Methodology*

Our overall objective was to assess the IRS's efforts to ensure the validity of investment theft loss deductions. Data validation showed that source data for evaluation were reliable. To accomplish our objective, we:

- I. Identified processes established by the IRS to identify taxpayers claiming a Ponzi scheme loss deduction.
  - A. Participated in a walkthrough at a Submission Processing site and determined efforts taken by IRS tax examiners to identify tax returns that claimed Ponzi scheme loss deductions.
  - B. Discussed with the Code and Edit, Error Resolution, and Examination functions the steps taken to verify the accuracy of tax returns claiming Ponzi scheme loss deductions.
  - C. \*\*\*\*\*2(f)\*\*\*\*\*  
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- II. Assessed the effectiveness of IRS processes to ensure taxpayers who claimed Ponzi scheme loss deductions met documentation requirements and to identify questionable claims to be referred for additional action.
  - A. Participated in a walkthrough at a Submission Processing site and determined efforts taken to verify the completeness of Ponzi scheme loss deductions on tax returns at the time returns are processed.
  - B. Interviewed IRS personnel and reviewed procedures to identify the process used by the IRS to ensure taxpayers who claimed a Ponzi scheme loss deduction using safe harbor and non-safe harbor options met documentation requirements (required forms and information attached to returns).
  - C. Interviewed IRS personnel and reviewed available documentation to determine actions taken to validate specific items pertaining to Ponzi scheme loss deductions and identify questionable tax returns prior to referring the returns to other functions for additional actions (including referrals to examination). As part of this effort, we:
    1. Discussed with the special project coordinator the results of initiatives to stop fraudulent claims promoted by tax preparers.



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2. Discussed with SB/SE Division managers the monitoring of Ponzi scheme losses for fraudulent activity or noncompliance with requirements.
  - D. Reviewed available management information reports outlining post-processing efforts and results.
- III. Determined whether 908 taxpayers claiming approximately \$516 million on *e-filed* tax returns complied with filing and documentation requirements.
- A. Identified 793 tax returns with a possible Ponzi scheme loss deduction that did not submit U.S. Individual Income Tax Transmittal for an IRS *e-file* Return (Form 8453); however, since Appendix A documentation is only required for safe harbor claims, the test was inconclusive as tax returns using safe harbor provisions are not captured.
  - B. Identified the 115 tax returns with Forms 8453 where the taxpayers self-identified themselves as claiming a Ponzi scheme loss deduction.
    1. Selected a judgmental sample of 50 *e-filed* tax returns and found 2 taxpayers submitted Appendix A when taking the safe harbor option.
    2. Matched our sampled tax returns claiming a Madoff connection to a list of Madoff victims to identify individuals not listed on the Madoff file for evaluating their claims for Ponzi theft loss deductions to ascertain whether the claims were eligible for the deduction.
- IV. Determined whether individuals erroneously claimed a Ponzi scheme loss deduction.
- A. Selected a statistically valid, random sample of 140 *e-filed* Tax Year 2008 tax returns from an Individual Returns Transaction File<sup>1</sup> extract of 2,177 tax returns (\$803 million) claiming “Other Miscellaneous” deductions. We used attribute sampling to calculate the minimum sample size (134),<sup>2</sup> which we rounded to 140:  
$$n = (Z^2 p(1-p)) / (A^2 + (Z^2 p(1-p)/N))$$

Z = Confidence Level:	90 percent (expressed as 1.645 standard deviation)
p = Expected Rate of Occurrence:	5 percent
A = Precision Rate:	±3 percent
N = Population:	2,177

<sup>1</sup> The IRS database that contains data transcribed from initial input of the original individual tax returns during return processing.

<sup>2</sup> The formula  $n = (Z^2 p(1-p)) / (A^2 + (Z^2 p(1-p)/N))$  is from *Sawyer's Internal Auditing – The Practice of Modern Internal Auditing*, 4th Edition, pp. 462-464.



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*Many Investment Theft Loss Deductions  
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1. Reviewed the prints of *e-filed* tax returns and determined if the claimed deduction is a Ponzi scheme loss deduction electing the safe harbor option.
  2. Determined if taxpayers complied with filing and documentation requirements.
  3. Matched our sampled tax returns claiming a Madoff connection to a list of Madoff victims and identified taxpayers not listed on the Madoff file to ascertain whether the claims appear eligible for the deduction.
  4. For claims we determined to be potentially ineligible that were not selected for examination, we calculated the lost revenue to project the total potential revenue loss for our population (2,177 tax returns).
- B. Determined whether the tax returns were selected for examination.
1. Matched accounts to the Audit Inventory Management System<sup>3</sup> open and closed files to determine the status of cases and issues under examination consideration.
  2. Interviewed IRS managers and determined how cases with Ponzi scheme loss deductions are selected for examination.
  3. Reviewed management information reports and determined whether Ponzi scheme loss deductions are being tracked.

**Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the Internal Revenue Manual; *Standards for Internal Control in the Federal Government*; and the IRS's policies, procedures, and practices for processing investment theft losses. We evaluated these controls by interviewing management, examining applicable information, and reviewing samples of tax returns with investment theft losses.

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<sup>3</sup> The Audit Inventory Management System is a computer system used by the IRS functions to control tax returns, trace examination results, and provide management reports.





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*Many Investment Theft Loss Deductions  
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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner (Operations), Large Business and International Division SE:LB  
Deputy Commissioner of Operations, Wage and Investment Division SE:W  
Deputy Commissioner, Small Business/Self-Employed Division SE:S  
Director, Compliance, Wage and Investment Division SE:W:CP  
Director, Customer Account Service, Wage and Investment Division SE:W:CAS  
Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division  
SE:W:ETARC  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Director, Strategy and Finance, Wage and Investment Division SE:W:S  
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP  
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaison: Chief, Program Evaluation and Improvement, Wage and Investment Division  
SE:W:S:PEI



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Appendix IV

Example of Casualties and Thefts (Form 4684)

Form **4684** **Casualties and Thefts** OMB No. 1545-0177  
 Department of the Treasury Internal Revenue Service **2008** Attachment Sequence No. 26  
 Name(s) shown on tax return Identifying number

**SECTION A—Personal Use Property** (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.  
 Property A \_\_\_\_\_  
 Property B \_\_\_\_\_  
 Property C \_\_\_\_\_  
 Property D \_\_\_\_\_

	Properties			
	A	B	C	D
2 Cost or other basis of each property . . . . .	2			
3 Insurance or other reimbursement (whether or not you filed a claim) (see instructions) . . . . .	3			
4 Gain from casualty or theft. If line 3 is more than line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year . . . . .	4			
5 Fair market value before casualty or theft . . . . .	5			
6 Fair market value after casualty or theft . . . . .	6			
7 Subtract line 6 from line 5 . . . . .	7			
8 Enter the smaller of line 2 or line 7 . . . . .	8			
9 Subtract line 3 from line 8. If zero or less, enter -0- . . . . .	9			
10 Casualty or theft loss. Add the amounts on line 9 in columns A through D . . . . .				10
11 Enter the smaller of line 10 or \$100. But if the loss arose in a Midwestern disaster area because of a specified major disaster, enter -0-. See the instructions for a list of specified major disasters . . . . .				11
12 Subtract line 11 from line 10 . . . . .				12
13 Add the amounts on line 12 of all Forms 4684 . . . . .				13
14 Add the amounts on line 4 of all Forms 4684 . . . . .				14
15 • If line 14 is more than line 13, enter the difference here and on Schedule D. Do not complete the rest of this section (see instructions). • If line 14 is less than line 13, enter -0- here and go to line 16. • If line 14 is equal to line 13, enter -0- here. Do not complete the rest of this section. . . . .				15
16 If line 14 is less than line 13, enter the difference . . . . .				16
17 Add the amounts on line 12 of all Forms 4684 on which you entered a loss attributable to a federally declared disaster . . . . .				17
18a Is line 17 more than line 14? <input type="checkbox"/> Yes. Enter the difference. If you are filing Schedule A (Form 1040), go to line 19. Otherwise, enter this amount on line 5c of the Standard Deduction Worksheet—Line 40 in the Form 1040 instructions. Also, check the box on line 39c of Form 1040. If your standard deduction also includes the deduction for state or local real estate taxes, go to line 18b. Otherwise, do not complete the rest of Section A. Form 1040NR filers, see instructions. <input type="checkbox"/> No. Enter -0-. If you claim the standard deduction, do not complete the rest of Section A. . . . .				18a
b If your standard deduction includes the deduction for state or local real estate taxes, check this box and do not complete the rest of Section A. . . . . <input type="checkbox"/>				
19 Subtract line 18a from line 16 . . . . .				19
20 Add the amounts on line 12 of all Forms 4684 on which you entered -0- on line 11 . . . . .				20
21 Is line 20 less than line 19? <input type="checkbox"/> No. Enter the amount from line 16 on Schedule A (Form 1040), line 20, or Form 1040NR, Schedule A, line 8. Estates and trusts enter the amount from line 16 on the "Other deductions" line of your tax return. Do not complete the rest of Section A. <input type="checkbox"/> Yes. Subtract line 20 from line 19 . . . . .				21
22 Enter 10% of your adjusted gross income from Form 1040, line 38, or Form 1040NR, line 36. Estates and trusts, see instructions . . . . .				22
23 Subtract line 22 from line 21. If zero or less, enter -0- . . . . .				23
24 Add lines 18a, 20, and 23. Also enter the result on Schedule A (Form 1040), line 20, or Form 1040NR, Schedule A, line 8. Estates and trusts, enter the result on the "Other deductions" line of your tax return . . . . .				24

For Paperwork Reduction Act Notice, see page 5 of the instructions. Cat. No. 129970 Form 4684 (2008)



## Many Investment Theft Loss Deductions Appear to Be Erroneous

Form 4684 (2008) Attachment Sequence No. 26 Page 2

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side. Identifying number

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**SECTION B—Business and Income-Producing Property**

**Part I Casualty or Theft Gain or Loss** (Use a separate Part I for each casualty or theft.)

25 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property A \_\_\_\_\_  
 Property B \_\_\_\_\_  
 Property C \_\_\_\_\_  
 Property D \_\_\_\_\_

	Properties			
	A	B	C	D
26 Cost or adjusted basis of each property . . . . .	26			
27 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3 . . . . . <i>Note: If line 26 is more than line 27, skip line 28.</i>	27			
28 Gain from casualty or theft. If line 27 is more than line 26, enter the difference here and on line 35 or line 40, column (c), except as provided in the instructions for line 39. Also, skip lines 29 through 33 for that column. See the instructions for line 4 if line 27 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year. . . . .	28			
29 Fair market value before casualty or theft . . . . .	29			
30 Fair market value after casualty or theft. . . . .	30			
31 Subtract line 30 from line 29 . . . . .	31			
32 Enter the smaller of line 26 or line 31 . . . . . <i>Note: If the property was totally destroyed by casualty or lost from theft, enter on line 32 the amount from line 26.</i>	32			
33 Subtract line 27 from line 32. If zero or less, enter -0- . . . . .	33			
34 Casualty or theft loss. Add the amounts on line 33. Enter the total here and on line 35 or line 40 (see instructions) . . . . .	34			

**Part II Summary of Gains and Losses** (from separate Parts I)

(a) Identify casualty or theft	(b) Losses from casualties or thefts		(c) Gains from casualties or thefts includible in income
	(i) Trade, business, rental or royalty property	(ii) Income-producing and employee property	
<b>Casualty or Theft of Property Held One Year or Less</b>			
35 _____	( )	( )	( )
36 Totals. Add the amounts on line 35 . . . . .	36	( )	( )
37 Combine line 36, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions . . . . .			37
38 Enter the amount from line 36, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 28, or Form 1040NR, Schedule A, line 16, and enter the amount from property used as an employee on Schedule A (Form 1040), line 23, or Form 1040NR, Schedule A, line 11. Estates and trusts, partnerships, and S corporations, see instructions . . . . .			38
<b>Casualty or Theft of Property Held More Than One Year</b>			
39 Casualty or theft gains from Form 4797, line 32 . . . . .			39
40 _____	( )	( )	( )
41 Total losses. Add amounts on line 40, columns (b)(i) and (b)(ii) . . . . .	41	( )	( )
42 Total gains. Add lines 39 and 40, column (c) . . . . .			42
43 Add amounts on line 41, columns (b)(i) and (b)(ii) . . . . .			43
44 If the loss on line 43 is more than the gain on line 42: <b>a</b> Combine line 41, column (b)(i) and line 42, and enter the net gain or (loss) here. Partnerships (except electing large partnerships) and S corporations, see the note below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions. . . . .			44a
<b>b</b> Enter the amount from line 41, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 28, or Form 1040NR, Schedule A, line 16, and enter the amount from property used as an employee on Schedule A (Form 1040), line 23, or Form 1040NR, Schedule A, line 11. Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11 . . . . .			44b
45 If the loss on line 43 is less than or equal to the gain on line 42, combine lines 42 and 43 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3 . . . . . <i>Note: Partnerships, enter the amount from line 44a, 44b, or line 45 on Form 1065, Schedule K, line 11. S corporations, enter the amount from line 44a or 44b on Form 1120S, Schedule K, line 10.</i>			45

Form 4684 (2008)

Source: *Casualties and Thefts (Form 4684).*



*Many Investment Theft Loss Deductions  
Appear to Be Erroneous*

**Appendix V**

*Example of Appendix A*

APPENDIX A

**Statement by Taxpayer Using the Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement**

Part I. *Identification*

1. Name of Taxpayer \_\_\_\_\_
2. Taxpayer Identification Number \_\_\_\_\_

Part II. *Computation of deduction*

(See Rev. Proc. 2009-20 for the definitions of the terms used in this worksheet.)

Line	Computation of Deductible Theft Loss Pursuant to Rev. Proc. 2009-20		
1	Initial investment		
2	Plus: Subsequent investments		
3	Plus: Income reported in prior years		
4	Less: Withdrawals	(    )	
5	Total qualified investment (combine lines 1 through 4)		
6	Percentage of qualified investment (95% of line 5 for investors with no potential third-party recovery; 75% of line 5 for investors with potential third-party recovery)		
7	Actual recovery		
8	Potential insurance/SIPC recovery		
9	Total recoveries (add lines 7 and 8)	(    )	
10	Deductible theft loss (line 6 minus line 9)		

Part III. *Required statements and declarations*

1. I am claiming a theft loss deduction pursuant to Rev. Proc. 2009-20 from a specified fraudulent arrangement conducted by the following individual or entity (provide the name, address, and taxpayer identification number (if known)).  
\_\_\_\_\_
2. I have written documentation to support the amounts reported in Part II of this document.
3. I am a qualified investor as defined in § 4.03 of Rev. Proc. 2009-20.
4. If I have determined the amount of my theft loss deduction under § 5.02(1)(a) of Rev. Proc. 2009-20, I declare that I have not pursued and do not intend to pursue any potential third-party recovery, as that term is defined in § 4.10 of Rev. Proc. 2009-20.
5. If I have already filed a return or amended return that does not satisfy the conditions in § 6.02 of Rev. Proc 2009-20, I agree to all adjustments or actions that are necessary to comply with those conditions. The tax year or years for which I filed the return(s) or amended return(s) and the date(s) on which they were filed are as follows:  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_



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Part IV. *Signature*

I make the following agreements and declarations:

1. I agree to comply with the conditions and agreements set forth in Rev. Proc. 2009-20 and this document.
2. Under penalties of perjury, I declare that the information provided in Parts I-III of this document is, to the best of my knowledge and belief, true, correct and complete.

Your signature here \_\_\_\_\_ Date signed: \_\_\_\_\_

Your spouse's signature here \_\_\_\_\_ Date signed: \_\_\_\_\_

Corporate Name \_\_\_\_\_

Corporate Officer's signature \_\_\_\_\_

Title \_\_\_\_\_

Date signed \_\_\_\_\_

Entity Name \_\_\_\_\_  
S-corporation, Partnership, Limited Liability Company, Trust

Entity Officer's signature \_\_\_\_\_

Date signed \_\_\_\_\_

Signature of executor \_\_\_\_\_

Date signed \_\_\_\_\_

April 6, 2009

754

2009-14 I.R.B.

Source: Internal Revenue Bulletin No. 2009-14 (April 6, 2009).



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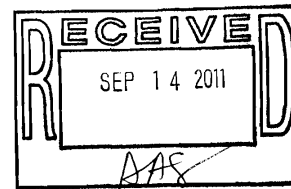
**Appendix VI**

*Management's Response to the Draft Report*



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

SEP 13 2011



MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Faris R. Fink *Faris R Fink*  
Commissioner, Small Business/Self-Employed Division

SUBJECT: Many Investment Theft Loss Deductions Appear to Be Erroneous  
(Audit # 201040042)

Thank you for the opportunity to review your draft report titled: "Many Investment Theft Loss Deductions Appear to Be Erroneous." We appreciate your recognition of our efforts to address the tax implications of the Ponzi scheme losses by: (1) issuing a Revenue Procedure to provide victims with a uniform method for computing the theft losses from these schemes and to simplify related tax reporting for these taxpayers; and (2) issuing a Revenue Ruling describing the proper income tax treatment under Internal Revenue Code Section 165.

We have investigated promoters of abusive investment theft loss schemes and the taxpayers who have participated in such schemes. To maximize these compliance efforts, we have worked collectively with other impacted IRS business units and our internal counsel. We have also developed internal websites to provide our examiners with additional technical information, conducted case reviews, and conducted training workshops. In addition, we have provided information on our public website, [www.irs.gov](http://www.irs.gov), including telephone and e-mail contacts for additional information for external stakeholders to assist with taxpayer compliance.

Your report observes that the Service initiated investigations to identify promoters of abusive theft loss claims and that examination of clients of these promoters determined that 96 percent of tax returns did not qualify for investment theft losses. It is important to note that we targeted those promoters because we had information indicating that they were promoting abusive schemes to attempt to avail their clients of improper investment theft loss deductions. For this reason, it is not surprising that the examinations of these clients resulted in a very high disallowance rate. However, it cannot be assumed that the noncompliance rate is the same for the entire population of taxpayers claiming investment theft loss deductions.



*Many Investment Theft Loss Deductions  
Appear to Be Erroneous*

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2

Attached is a detailed response outlining our corrective actions. If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, SB/SE Director, Examination at (859) 669-5526.

Attachment



*Many Investment Theft Loss Deductions  
Appear to Be Erroneous*

Attachment

**RECOMMENDATION 1:**

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*

**CORRECTIVE ACTION:**

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*. We will assess the costs and availability of resources for additional transcription if the results of the recommended Compliance Initiative Project (CIP) (see Recommendation 3) confirm a high risk of noncompliance.

**IMPLEMENTATION DATE:**

June 15, 2016

**RESPONSIBLE OFFICIAL(S):**

Director, Submission Processing (W&I)

**CORRECTIVE ACTION MONITORING PLAN:**

We will monitor this action as part of our internal management control process.

**RECOMMENDATION 2:**

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*.

**CORRECTIVE ACTION:**

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*

**IMPLEMENTATION DATE:**

December 15, 2013

**RESPONSIBLE OFFICIAL(S):**

Director, Media and Publications (W&I)

**CORRECTIVE ACTION MONITORING PLAN:**

We will monitor this action as part of our internal management control process.

**RECOMMENDATION 3:**

Establish a Compliance Initiative Project to measure noncompliance with the claims of investment theft losses and, \*\*\*\*\*2(f)\*\*\*\*\*

**CORRECTIVE ACTION:**

IRS will consult with SB/SE Research to analyze our processes and review our historical data to determine whether we need to make changes to our processes and forms. As part of this analysis, we will look at the feasibility of establishing a CIP. IRS will recommend applicable process improvements and compliance strategies based on SB/SE Research's assessment of the level of noncompliance.



*Many Investment Theft Loss Deductions  
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**IMPLEMENTATION DATE:**

December 15, 2015

**RESPONSIBLE OFFICIAL:**

Director, Examination Policy (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

We will monitor this action as part of our internal management control process.

**RECOMMENDATION 4:**

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*.

**CORRECTIVE ACTION:**

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*

**IMPLEMENTATION DATE:**

December 15, 2015

**RESPONSIBLE OFFICIAL:**

Director, Examination Policy (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

We will monitor this action as part of our internal management control process.