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What Every Victim of a Ponzi Scheme Must Know About Tax Deduction

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I. INTRODUCTION

A Ponzi scheme is investment fraud that receives funding from one group of investors and pays dividends to another group from the funds received. In fact, the scheme does not engage in any investment activities, and thus there is no investment income. However, the investors suffer a great deal of investment losses. By income tax law, only dividends are taxable, but not the return of investment capital. The operation is not only illegal and unethical, but also a violation of income tax law. This presents a daunting dilemma: How should the loss be treated?

The Ponzi scheme is not new. The scheme started as early as 1919 by Charles Ponzi who was involved in a $15 million fraud scheme (Ponzi, 1935). The scheme has been growing worldwide as late as March 7, 2012 by R. Allen Stanford who committed a $7 billion investment scam with 30,000 investors in 113 countries (Krauss, 2012(1)). He was sentenced to 110 years in prison (Krauss, 2012 (2)). During this period, there have been 114 major cases involving $114,922 billion in Ponzi scheme operations (Investment News, 2010). In recent years, this type of fraud has become more rampant. Between January 1, 2009 and July 1, 2010, there were 31 cases ranging from $800,000 to $8 billion with 12 to more than 800 investors in an average loss of $867,522 for each investor (Nicolas, et al 2011). Since then, between July 1, 2010 and June 30, 2013, there were nine more cases.

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The biggest Ponzi scheme in history occurred on December 11, 2008 by Bernard L. Madoff in a gigantic $65 billion scheme involving 13,000 investors (Efrati, et al 2008). On June 29, 2009, Madoff was sentenced to 150 years in prison (Frank and Efrati, 2009).

In the past, the Ponzi scheme never raised the eyebrows of the Internal Revenue Service (IRS). The Madoff debacle was so devastating that, on March 17, 2009, the fraud triggered the IRS to issue Rev. Rul. 2009-9 (Rev. Rul., 2009) and Rev. Proc. 2009-20 (Rev. Proc., 2009), which now govern the treatment of investment loss from this criminal fraud. Since then, the case went to court and no more IRS rulings were issued. The tax treatment involves the question as to whether the investment loss is a theft loss or a capital loss. If treated as a theft loss, should the deduction limitations apply? Since most fraudulent schemes have been going on for years, in what year should the loss be deductible and in what amount? If the loss is not fully deductible in the current year, in how many years can it be carried back and carried forward? During this multiple-year period the investors received income, but in substance it was fictitious. How should the dividends be handled now? Since the Madoff fraud was only discovered in 2008, are the taxpayers going to lose the statute of limitation? In order to mitigate the taxpayer's record-keeping chores and the IRS' administrative burden, the IRS now offers a safe harbor treatment by which the taxpayers are given an option. The answers to these questions sustain the substance of this article.

Since Ponzi schemes continue to occur regularly, every victim must know how the loss should be deducted. The following explains these tax rules and provides examples.

II. LITERATURE REVIEW

In reviewing the past literatures on Ponzi scheme, most described how the Ponzi scheme worked, but none dealt with the tax aspect. The most notable piece was Charles Ponzi's own autobiography in 1935 (Ponzi, 1935). He was an Italian immigrant living in the United States. In 1919, the Italian government issued postal stamps which were redeemable in Italian Liras. Since he lived in the United States he saw an investment opportunity in the trade between the U.S. dollars and the Italian Liras. He spent $30 USD to buy 100 Italian stamps. Later when the value of the Italian Liras went up relative to the U.S. dollars, he would redeem the Italian stamps for Italian Liras, and exchanged the Italian Liras for the U.S. dollars in the amount of $45 USD. The profit was $15 USD ($45 USD – $30 USD) and the rate of return on investment was 50 percent ($15 USD/$30 USD).

Ponzi convinced his relatives and friends to join his investment scheme and promised to pay return at 10 percent a month when the bank paid only five percent a year. Soon many investors were knocking down his door to invest millions of dollars. Later the Italian government stopped redeeming the postal stamps. Ponzi realized that his investment scheme had come to an end, but he still continued to pay the investors the promised return. In fact, he used the funds raised from the later investors to pay return to the earlier investors, but this did not last for long. When the rumors of his bankruptcy spread, many investors started withdrawing their money. By the time his scheme collapsed, he owed $150 million USD.

Another notable piece is the book "*The Ponzi Scheme Puzzle*" by Tamar Frankel (Frankel, 2012). This book is a comprehensive analysis of con artists and their victims. This book illustrates how Ponzi scheme artists design their attractive offers and hide their deceptions, and how they successfully advertise their schemes to make investors believe them. The book further

investigates the characters and behavior of con artists and their victims. The book also offers warning signs to investors so they do not become victims of these schemes.

There are many more pieces, but they do not deal with the tax aspect of Ponzi schemes. Not until the Madoff case in 2008 did the Ponzi scheme raise the question of tax loss deduction. Jeffers and Lauricella (2009) raise the question that: "Can the loss from the Madoff Ponzi scheme be treated as a theft loss?" or "It is possible that the IRS may argue strenuously that the Madoff Scheme does not involve a theft loss, and that the victims have a worthless security deduction … If that is the result, the losses will be considered as capital losses." The aspect concerns the tax question as to whether the loss from a Ponzi scheme should be treated as a "theft loss" or as a "capital loss." There is a difference between these two deductions.

Similarly, Zimmerman (2009) echoes the same question that: "The principal issue that arises in investor cases involving theft is whether the loss occurred as the result of theft or as due simply to a bad investment. Invariably, the Service will argue that the taxpayer made a bad investment and is therefore subject to the capital loss limitations or that the fraud committed against the taxpayer does not constitute theft under the applicable state law. A decrease in the stock's value as a result of the theft is sufficient to deduct a loss. However, the amount of the loss cannot exceed the taxpayer's adjusted basis in the investment." Again, this involves the argument between "theft loss" and "capital loss."

Further, Nicolas et al (2011) also raise the issue concerning the state income tax that: "Eight states have adopted specific guidance regarding the tax treatment of Ponzi losses. Some states base taxable income on federal AGI with no allowance for itemized deductions. In these states, taxpayers may be unable to deduct a Ponzi-scheme loss. Two states (New Hampshire and Tennessee) have only an interest and dividends tax. In these two states, taxpayers should

consider filing amended return for the last three years, taking the position that the amounts reported as dividends and interest were either phantom income or a return of capital and therefore not taxable." This points out that, if a state does not allow itemized deductions, loss from Ponzi scheme may not be deductible.

There are many other tax issues, such as net operating loss carry-forward, treatment of phantom income, period of deduction, limitation of deduction and more, which will be discussed further in this article.

III. RESEARCH QUESTIONS

A Ponzi scheme involves three parties: the investee, the investor and the tax authority. By its very nature the Ponzi scheme creates a great deal of confusion for all three parties. From the investee's point of view, should the fund received be treated as equity or as a liability? If the purpose is the former, the payout to the investor constitutes dividends. If the intention is the latter, the payout is a return of capital. From the investor's standpoint, is the fund contributed intended to be an investment or a business asset? If the contribution is the former, the loss should be treated as a capital loss. If the contribution is the latter, the loss constitutes a theft loss. These two treatments are quite different in income tax. From the tax authority's viewpoint, should the loss be deducted as a capital loss or as a theft loss, and how much? In fact, these questions are related to each other.

Further, since the IRS offers three options for tax deduction, from a taxpayer's point of view, what should be the best strategy to maximize the tax benefits? Should a taxpayer seek the third-party recovery or file an amended tax return? This depends on the tax savings for each option.

In addition, if an investor advertently falls into the trap of a Ponzi scheme, what should be the best strategy to minimize the loss? The structure of a Ponzi scheme consists of three variables: investment growth rate, dividend payout rate and the surviving period. When should an investor withdraw from a Ponzi scheme? What dividends can an investor expect? What growth of investment should an investor commit? The best strategy depends on the levels of these three variables. These questions will also be addressed.

IV. RESEARCH METHODOLOGY

This article is an in-depth legal study on a specific tax issue concerning losses from a Ponzi scheme. The problem involves the nature and amount of tax deduction. The basis comes from the Internal Revenue codes and special IRS rulings. The conclusion will be made on the basis of legal principles. Nevertheless, this article will be extended to offer some tax planning and investment strategies for those investors who may be victims of the Ponzi scheme.

V. HOW A PONZI SCHEME OPERATES

Every Ponzi scheme has one feature in common. The perpetrator sets up an investment firm to attract capital and promises to pay very high dividends, but they never engage in any investment activities. Take Madoff for example; under the firm of Bernard L. Madoff Investment Securities, LLC, Madoff received funds from investors and promised a return at a rate of as high as 12 percent a year. However, in fact, he did not buy or sell stocks or bonds (Dugan, 2009). Instead, he appropriated the earlier investors' fund to pay dividends to the later investors. Worse yet, he issued Form 1099 to the investors and the IRS showing these fictitious dividend payouts. The investors duly reported the dividends as taxable income on their tax

returns and paid income tax to the IRS. Moreover, Madoff falsified the fraudulent financial statements and had his CPA certify them. This scheme is known as a "Ponzi scheme," but the fraud was not discovered until two decades later. Besides the aspects of the devastating consequences on so many investors and the supervisory failure on the part of the Securities and Exchange Commission, what are the problems from an income tax point of view? First, the dividends never constitute the meaning of taxable income. Actually, the dividends are, in substance, return of capital. Secondly, should the taxpayers treat the losses as "capital losses" or "theft losses?" There is a big difference between these two treatments. This question is very controversial, as explained in the next section.

VI. CAPITAL LOSS VERSUS THEFT LOSS

Sales or exchanges of capital assets result in capital losses, which can be offset against capital gains, such as investment in stocks or bonds. Damages or theft of property give rise to casualty and theft losses, which cannot be offset against capital gains. What is the nature of losses from a Ponzi scheme? IRC §165 provides guidance for three different kinds of losses "(1) losses incurred in trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) losses of properties 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" (IRC §165). This means a taxpayer can deduct losses from ordinary business operations, such as purchase and sales of inventory. A taxpayer can also deduct losses from investment in stocks or bonds (*i.e.*, capital assets), which is known as "capital losses." A taxpayer can further deduct losses from casualty or theft losses from a

personal-use property, such as storm damage or burglary of home, which is termed "casualty and theft losses."

A Ponzi scheme was structured as an investment vehicle, and the investors indeed intended to make such an investment for profit. Unfortunately, the investment was not sold or disposed of; as such, it is not qualified to be treated as "capital losses." Instead, the investment was stolen. The Ponzi scheme perpetrator knowingly and intentionally embezzled the investors' funds. Therefore, it constitutes "theft losses" rather than capital losses (Reg. §1.165-8(d)). This aspect is reaffirmed by Rev. Rul. 2009-9. As a consequence, losses from the Ponzi scheme have lost the benefits of reducing tax on capital gains.

Alternatively, can the Ponzi scheme losses be treated as "worthless securities?" IRC §165(g) provides that: "If any security which is a capital asset become worthless … shall be treated as a loss from the sale or exchange … of a capital asset" (IRC §165(g)). Since the investment in a Ponzi scheme is not sold or exchanged, it is not qualified as a capital asset; the losses are not treated as "worthless securities."

VII. LIMITS OF THE THEFT-LOSS DEDUCTION

The deduction of a theft loss is subject to the limitations of two floors: $100 for each event of loss and 10 percent of the taxpayer's adjusted gross income in the taxable year (IRC §165(h)(1) and (2)). If the loss from the Ponzi scheme is to be treated as a theft loss, should the loss deduction be subject to limitations? The loss deduction depends on the nature of the property. If the asset is a personal-use property or a transaction entered into not for profit, then the theft loss is subject to the deduction limit. This is termed a §165(c)(3) deduction. An example would be the theft of a personal-use car. On the other hand, in the case of a business-use property or a

transaction entered into for profit, the theft loss is not subject to the deduction limit. This is referred to as §165(c)(2) deduction. An example is a business-use truck that is destroyed in a highway accident. In either case, the tax deduction cannot exceed the adjusted basis of the property (IRC §165(b)).

What are the characteristics of a Ponzi scheme? In Madoff's case, he held himself out as "Bernard L. Madoff Investment Securities, LLC"—an investment firm. The investors made the investment for the purposes of making a profit. The investment was indeed a "transaction entered into for profit" (IRC §165(c)(2)) and Madoff clearly had criminal intent. Therefore, the loss from the Ponzi scheme is qualified to be a theft loss without any deduction limits. Rev. Rul. 2009-9 provides that "… the theft loss therefore is deductible under §165(c)(2) and is not subject to §165(h) limitations." In other words, the loss deduction needs not be reduced by $100 for each case of loss and 10 percent of the taxpayer's adjusted gross income in the taxable year. In fact, this procedure is outlined in Rev. Proc. 2009-20, Section 6.01(1) and Appendix A. The taxpayer is required to figure out the amount of "deductible theft loss" and enter it into Form 4684 without going through the limitations of the two floors.

Further, the "miscellaneous itemized deductions" are subject to the floor of two percent of the taxpayer's adjusted gross income (IRC §67(a)). However, the theft loss is not classified as a miscellaneous itemized deduction. Therefore, the loss needs not be further reduced.

VIII. YEAR OF DEDUCTION

In what year can the taxpayer deduct the loss? The theft loss is deductible only in the year the taxpayer discovers the loss (Reg. §§1.165-8(a)(2) and 1.165-1(d)). For example, the Madoff Ponzi scheme has been going on for the last 20 years, but the scheme was not discovered until

December 11, 2008. Thus, the year of deduction is 2008. This determination has an impact on the statute of limitations, which will be discussed later. At that time the taxpayer must also estimate the possible recovery in future years and subtract it from the deductible loss. If the actual recovery in the future year is less than what was estimated before, the additional loss is deductible in that future year. Conversely, if the actual recovery in the future year is more than what was estimated before, the additional recovery is included in the taxpayer's gross income in that future year.

IX. AMOUNT OF DEDUCTION

In the case of casualty loss, a taxpayer can deduct the lesser of the loss in the adjusted basis of the property or the decline in the market value of that property (Reg. §1.165-7). However, in the event of the loss from the Ponzi scheme, the deductible amount becomes more complicated because deduction involves fictitious income that was in substance never realized, and yet, the income was wrongfully reported to the IRS as income by Madoff's criminal act and was also reported as taxable income on the taxpayer's tax return. This is termed "phantom income," which will be discussed below. Under these circumstances, a taxpayer can deduct the sum of the initial investment and additional investment in later years, plus fictitious income reported as taxable income in prior years, but reduced by any withdrawals and actual recovery, such as Securities Investor Protection Corporation (SIPC), and potential third-party recovery (Rev. Rul. 2009-9). In fact, Rev. Proc. 2009-20 offers taxpayers a safe-harbor treatment, which will also be discussed later. Therefore, the taxpayer has an option in determining the deductible amount.

X. NET OPERATING LOSS CARRYBACK AND CARRY FORWARD

The Ponzi scheme has resulted in millions of dollars of losses on the part of many investors. The theft loss is one of the components of the "net operating loss." Many taxpayers may potentially end up with a huge amount of net operating loss. What is the timeframe for carrybacks and carry forwards? Usually, net operating losses can be carried back for only two years and carried forward for 20 years (IRC §172(b)(1)(A)). However, in the case of a casualty and theft loss, it can be carried back for three years (IRC §172(b)(1)(F)). Further, if the taxpayer is an "eligible small business" (*i.e.*, a gross receipt of $15 million or less), the casualty and theft loss can be carried back for either three, four or five years (IRC §172(b)(1)(H)(4)). The loss from the Ponzi scheme certainly qualifies for this favorable treatment.

XI. TREATMENT OF PHANTOM INCOME

In the Ponzi scheme, the investors received fictitious dividend income and paid income tax on it. But in truth the taxpayer had no right to the item. This is termed "phantom income." How should this situation be treated? Can the taxpayer file an amended tax return for prior years? Can the taxpayer claim a theft-loss deduction in the year of discovery for the phantom income? If the taxpayer elects to file an amended tax return and claim a tax refund for prior years (IRC §1341), he or she is prohibited from claiming the theft-loss deduction for this amount of income in the year of discovery. Alternatively, the taxpayer, who elects to claim the theft-loss deduction in the year of discovery, is not allowed to file an amended tax return and claim a tax refund for prior years (Rev. Rul. 2009-9). Therefore, the taxpayer actually has an option for the treatment of the phantom income.

XII. PERIODS OF LIMITATION

A Ponzi schemes usually has been going on for many years. If the taxpayer elects to file amended tax returns and claim a tax refund for prior years, how many years can the taxpayer go back? Generally, the statute of limitation is only three years (IRC §6501(a)). In the case of the Madoff Ponzi scheme, since the year of discovery was 2008, the taxpayer can only go back three years (*i.e.*, 2007, 2006 and 2005). There are exceptions, but since the taxpayer has correctly reported the income in the past years, the exceptions do not apply.

XIII. SAFE HARBOR TREATMENT

Among all Ponzi schemes in history, Madoff's case stands out as the most notorious one. The fraud is truly astronomical in scale and in scope. The scheme involved $65 billion with 13,000 investors in seven binders spanning across a period of two decades. The scheme is indeed unprecedented. If all investors are going to go back to dig out all records and file amended tax returns, the IRS will face an avalanche of paper work. In order to alleviate this potential burden, the IRS offers taxpayers a safe-harbor option to simplify the tax treatment and cut all future workload. In determining the deductible amount of theft loss, Rev. Proc. 2009-20, §5.02 provides that (Rev. Proc. 2009-20):

"The amount specified in this section 5.02 is calculated as follows –

(1) Multiply the amount of the qualified investment by –

(a) 95 percent for a qualified investor that does not pursue any potential third-party recovery, or

(b) 75% for a qualified investor that is pursuing or intends to pursue any potential third-party recovery, and

(2) Subtract from this product the sum of any actual recovery and any potential insurance/SIPC recovery."

If the taxpayer agrees to take advantage of this safe-harbor treatment, the IRS further imposes restrictions on the part of the taxpayer. Rev. Proc. 2009-20, Section 6.02 provides that: "By executing the statement provided in Appendix A of this revenue procedure, the taxpayer agrees –

(1) Not to deduct in the discovery year any amount of the theft loss in excess of the deduction permitted by section 5 of this revenue procedure;

(2) Not to file return or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in the taxable year preceding the discovery year;

(3) Not to apply the alternative computation in §1341 with respect to the theft-loss deduction allowed by the revenue procedure; and

(4) Not to apply the doctrine of equitable recoupment or the mitigation provisions in §§1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations on filing a claim for return under §6511."

In simple terms, this means that the taxpayer will be given a maximum theft-loss deduction of 95 percent of the qualified investment. The qualified investment includes the initial and additional investments, plus fictitious income, but reduced by any withdrawals if the taxpayer agrees not to pursue any third-party recovery. The above deductible amount must be further reduced by any actual recovery and potential third-party recovery, if any. The above 95 percent deduction rate is reduced to 75 percent if the taxpayer intends to pursue any third-party recovery

in future years. However, the taxpayer must in turn agree not to deduct any additional theft loss in future years or file amended tax returns to claim tax refunds for prior years.

The above 95 percent/75 percent deduction rate applies before deducting any actual recovery and potential third-party recovery. In other words, the amount of actual recovery and potential third-party recovery are not subject to the 95 percent/75 percent limitation. Instead, it is deductible from the theft loss in its full amount and not just 95 percent/75 percent of it. The following is an example using Madoff's case to demonstrate how to apply the safe-harbor treatment.

XIV. EXAMPLE

An individual taxpayer invested $500,000 to Madoff's investment firm in 2002. He further invested an additional $120,000 in 2003. He received $10,000 cash dividends each year in 2003, 2004, 2005, 2006 and 2007, totaling $50,000 ($10,000 x 5 years). He filed Form 1040 every year and reported these cash dividends as gross income to the IRS and paid income taxes. He withdrew $70,000 in 2007. In 2008, it was discovered that the investment was actually a Ponzi scheme, and he thus had received $40,000 actual recovery from the investment firm. If he pursues potential third-party recovery from SIPC, he is expected to receive an additional $60,000 recovery in 2009. What is the deductible theft loss in each of the following three cases?

CASE A: The taxpayer agrees to apply the safe-harbor treatment and does not intend to pursue potential third-party recovery. The taxpayer further agrees not to file amended tax returns for prior years to claim tax refunds.

Since the taxpayer agrees to apply the safe-harbor treatment, he is not allowed to file amended tax returns to claim a tax refund, and hence the entire $50,000 dividends income is

deductible. Therefore, the taxpayer's qualified investment is $600,000 ($500,000 + 120,000 + 50,000 – 70,000). The taxpayer can deduct 95 percent of the $600,000 qualified investment (*i.e.*, $570,000). Since the taxpayer has received $40,000 in actual recovery from the investment firm, it should reduce the deductible loss. Further, since the taxpayer does not intend to pursue potential third-party recovery, he does not have to estimate the recovery. Thus, no estimated recovery reduces the deductible loss. As a result, the taxpayer's deductible theft loss is $530,000 ($570,000 – 40,000). The 95 percent reduction applies before deducting the $40,000 actuary recovery. The entire amount of $40,000 recovery is fully subtracted from the deductible loss. The actuary recovery is not subject to the 95 percent limitation.

CASE B: The taxpayer agrees to apply the safe-harbor treatment, but intends to pursue potential third-party recovery. The taxpayer further agrees not to file amended tax returns for prior years to claim tax refunds.

In this situation, the qualified investment is the same as CASE A, which is $600,000 ($500,000 + 120,000 + 50,000 – 70,000). However, since the taxpayer intends to pursue potential third-party recovery, the deductible loss is reduced from 95 percent to only 75 percent of the $600,000 qualified investment, which is $450,000 ($600,000 x 75%). The taxpayer must also estimate the potential third-party recovery, which is $60,000, and deduct the estimated recovery from the deductible loss, together with the $40,000 actual recovery from the investment firm. Therefore, the taxpayer's deductible theft loss is $350,000 ($450,000 – 40,000 – 60,000). The 75 percent reduction applies before deducting both the $40,000 actual recovery and the $60,000 potential third-party recovery. Further, since the taxpayer has reduced the deductible theft loss by the amount of $60,000 potential third-party recovery, if the actual recovery is more than that amount in the future, the difference should be added to gross income. Conversely, if

the actual recovery is less that amount in the future, the difference is further deductible at that time.

CASE C: The taxpayer does not agree to apply the safe-harbor treatment and intends to file amended tax returns and intends to purse potential third-party recovery.

Since the statute of limitation is only three years, the taxpayer can file amended tax returns for only 2007, 2006 and 2005, but not 2004 and 2003. Thus, the $30,000 ($10,000 x 3 years) dividends income from 2007, 2006 and 2005 cannot be claimed as loss deduction. Only the $20,000 ($10,000 x 2 years) dividends income from 2004 and 2003 can be claimed. The taxpayer's qualified investment is now $570,000 ($500,000 + 120,000 + 20,000 – 70,000) and it is 100 percent deductible without the 95 percent/75 percent reduction. Further, since the taxpayer intends to pursue potential third-party recovery, he must estimate the amount of recovery ($60,000), which reduces the deductible loss, along with the $40,000 actual recovery from the investment firm. As a result, his deductible theft loss is $470,000 ($570,000 – 40,000 – 60,000).

The results are summarized in Table 1:

Table 1. Safe Harbor Treatments

YEAR	TRANSACTION	CASE A	CASE B	CASE C
2002	Initial investment	$500,000	500,000	500,000
2003	+ Subsequent investment	+120,000	+120,000	+120,000
2003-2007	+ Dividend income	+50,000	+50,000	+20,000
2007	- Withdrawal	(70,000)	(70,000)	(70,000)
	TOTAL	600,000	600,000	570,000
	x Percentage .	x95%	x75%	x100%
		570,000	450,000	570,000
2008	- Actual recovery	(40,000)	(40,000)	(40,000)
2009	- Potential third-party recovery	(0)	(60,000)	(60,000)
	DEDUCTIBLE THEFT LOSS	530,000	350,000	470,000

This example illustrates that the taxpayer is given an option. The taxpayer may or may not choose to file amended tax returns or pursue potential third-party recovery. The choice has an impact on the amount of theft-loss deduction. The choice also has consequences on the tax refunds and potential third-party recovery in the future. The following section delineates possible strategies in relation to a Ponzi scheme.

XV. TAX PLANNING STRATEGIES FOR PONZI SCHEME

The safe-harbor treatment may give rise to opportunities for tax-planning strategies. Now, a taxpayer is given a great variety of options. If a taxpayer chooses not to file amended tax returns or pursue potential third-party recovery, the deductible theft loss would be higher, but the benefits of tax refund and the potential third-party recovery are lost. The decision lies on whether the tax savings of higher-loss deduction are higher or lower than the benefits of tax refund and the third-party recovery. If the former is greater than the latter, the decision would be more beneficial to give up the third-party recovery and to not file amended tax returns, and vice versa.

If a taxpayer chooses not to file amended tax returns, but intends to pursue the third-party recovery, the deductible theft loss is lower, but there is a benefit of receiving the potential third-party recovery. This decision depends on whether the benefit of potential third-party recovery is more than or less than the losses of tax refund and theft-loss deduction. If the former is more than the latter, the decision would be better off to pursue the third-party recovery, but not to file amended tax returns, and vice versa.

If a taxpayer chooses to file amended tax returns, he is not allowed to apply the safe-harbor treatment. He cannot deduct the phantom income for the period of three years prior to the

discovery of the Ponzi scheme, but he is free to pursue the third-party recovery. The deductible loss may be less, but there are benefits of a tax refund and the potential third-party recovery. The decision depends on whether the benefits of tax refund and the potential third-party recovery are greater than or less than the sacrifice of the theft-loss deduction. If the former is more than the latter, the decision would be more desirable to give up the theft-loss deduction and file amended tax returns, and vice versa.

The IRS offers many options for taxpayers to deduct losses from Madoff's Ponzi scheme. In order to maximize the benefits, a taxpayer must be aware of what is deductible and to what extent the loss is deductible. These strategies apply to any kind of Ponzi scheme.

XVI. INVESTMENT PLANNING STRATEGIES FOR PONZI SCHEMES

A Ponzi scheme is such that the scheme receives funds from a group of investors and pays the funds to the other group. Evidently, for this scheme to survive, the incoming funds must be greater than the outgoing funds. How long the scheme can survive depends on the incoming investment growth rate and the outgoing dividends payout rate. The higher the incoming investment growth rate, the longer the scheme can survive. Likewise, the greater the dividends payout rate, the shorter Ponzi scheme can survive, and vice versa. Therefore, the equilibrium point of a Ponzi scheme involves three variables: investment growth rate, dividends payout rate and surviving period.

For example, a Ponzi scheme receives $100,000 investment at a growth rate of 15 percent a year at the beginning of each year. The scheme pays out dividends at a rate of 25 percent on the amount of accumulated investment at the end of each year. How many years can this Ponzi scheme survive? The answer is nine years. Table 2 below shows the details of computations.

Table 2. Equilibrium Point of a Ponzi Scheme

Year #	Incoming investment growth rate at 15% on 1-1 $a = a(1+0.15)^{n-1}$	Accumulated Investment b=b+a	Outgoing dividend payout rate at 25% on 12-31 c=bx25%	Balance of fund d=d+a-c
1	100,000	100,000	25,000	75,000
2	115,000	215,000	53,750	136,250
3	132,250	347,250	86,812	181,687
4	152,087	499,337	124,834	208,940
5	174,900	674,238	168,559	215,281
6	201,135	875,373	218,843	197,573
7	231,306	1,106,679	276,669	152,210
8	266,001	1,372,681	343,170	75,041
9	305,902	1,678,584	419,646	(38,702)
Total	1,678,584		1,717,286	(38,702)

What is the importance of knowing this equilibrium point of nine surviving years? In this particular example, if the investor knows that this Ponzi scheme can survive only nine years, he should withdraw the investment before that time. If this investor receives dividends at a rate of more than 25 percent a year, this is a red flag to withdraw. If his investment growth rate is less than 15 percent a year, this is another red flag to alert him to withdraw earlier. Information on these three variables is very important. The scheme is a game between the investor and the Ponzi-scheme perpetrator. Can the former really out-beat the latter? The answer is that the situation is extremely difficult. That is because the investor knows information of only one of the three variables (*i.e.*, the outgoing dividends payout rate). He does not know the information of the other two variables (*i.e.*, incoming investment growth rate and the surviving period). As a consequence, he cannot figure out the equilibrium point. On the other side of the game, the Ponzi-scheme perpetrator knows the information of all three variables. That is why Bernard Madoff kept sending out incorrect information so as to fool the investors. The misinformation serves as a smoke screen to prevent the investors from getting the true information. In fact,

Madoff's Ponzi scheme survived 20 years. This situation indicates that Madoff was a very sophisticated Ponzi-scheme operator.

Frank and Lauricella (2008) reveals that: "Mr. Madoff's social and business connections, and remarkably consistent return of 10% to 12%, brought in billions of dollars from hundreds of investors … Clients pointed to Mr. Madoff's stature with Nasdaq and his seat on a government advisory panel on stock market regulators as proof of his reputation. Mr. Madoff burnished his stature by serving on charitable boards and starting a family foundation … Adding to Mr. Madoff's allure was his exclusivity: Investors had to be invited to join, and could be thrown out at will … Madoff was one of the stars in Wall Street." This shows that Mr. Madoff knew how to create false information to mislead investors, and the investors were indeed misled. By doing so, the investors cast no doubt on Madoff's credibility and become ignorant on the equilibrium point of his Ponzi scheme.

This example is only one particular case. Table 3 lists six more cases.

Table 3. Various Equilibrium Points of a Ponzi Scheme

Case	Incoming investment growth rate	Outgoing dividend payout rate	Surviving period
1	10%	10%	39 years
2	10%	15%	17 years
3	10%	20%	11 years
4	15%	25%	9 years
5	20%	25%	10 years
6	25%	25%	12 years

These six cases determine six different equilibrium points. For example, in Case 1, if the incoming investment growth rate is 10 percent a year and outgoing dividends payout rate is also 10 percent a year, the Ponzi scheme can survive as long as 39 years. On the other hand, in Case 6, if the investment growth rate is 25 percent, while the dividends rate is also 25 percent, the Ponzi scheme can survive as short as 12 years. This table is so designed that the first three cases

keep investment growth rate constant at 10 percent; whereas, the dividends payout rate is increasing from 10 percent to 20 percent. As the dividends rate increases, the surviving period decreases from 39 years to 11 years. On the contrary, in the last three cases, the dividends rates are kept constant at 25 percent, while the investment growth rate increases from 15 percent to 25 percent. As a result, the surviving period increases from nine years to 12 years.

These results show that the dividends rate and the surviving period bear a negative relationship. Conversely, the investment growth rate and the surviving period bear a positive relationship. This demonstrates that, if an investor demands a higher dividends rate, the scheme will result in a shorter surviving period. If an investor can increase the investment growth rate, the scheme can lengthen the surviving period, and vice versa. In other words, an increase in the dividends payout rate can be compensated by an increase in investment growth rate. This result clearly indicates that an investor must know how to calculate the equilibrium point so as to map out the best strategy. However, the equilibrium point depends on these three pieces of information. In reality, this information might prove to be very difficult to obtain.

XVII. CURRENT DEVELOPMENT OF MADOFF'S PONZI SCHEME

At the time of collapse on December 11, 2008, the size of Madoff's Ponzi scheme was estimated to be as much as $65 billion. Immediately thereafter Securities Investor Protection Corporation (SIPC) took over the fund and appointed a trustee to liquidate the assets. An investor can claim reimbursement from the SIPC up to a maximum of $500,000 per customer, of which $250,000 is in cash. According to the SIPC report on April 1, 2013 (SIPC, 2013), it has paid out $807 million. The loss in principle was about $17.5 billion. The trustee has recovered $9.32 billion, plus $2 billion by the U.S. Attorney in Manhattan, and distributed $5.44 billion to

the investors. The bankruptcy proceedings are stilling continuing. In that process the trustee encountered the following problems:

In How Many Years Can the Investors Be Clawed Back?

In Madoff's Ponzi scheme, he did not actually engage in any investments at all. Instead, he distributed the later investor's funds to the previous investors. Many investors received as high as 12 percent dividends rate. This Ponzi scheme can sustain only when the investment growth rate is higher than the dividends payout rate. In the past ten years, the entire economy suffers recession. As a consequence, Madoff's Ponzi scheme naturally came to an end. However, many investors received a great amount of dividends and withdrew funds prior to the collapse. In bankruptcy proceedings, the investors are required to repay the funds back to the bankruptcy estate. In Madoff's case, in how many years can the trustee ask the investors for reimbursement? This is known as a "clawback fund." The trustee claims six years according to the New York law; whereas, the investors argue for two years as per federal bankruptcy law (Rothfeld, 2011). The dispute went to the U.S. Court of Appeals for the Second Circuit in Southern New York. On August 16, 2011, the case was ruled in favor of the investors (U.S. Court of Appeals, 2011). In other words, the investors are required to return the fund to the bankruptcy estate for any money received only two years prior to the date of the collapse. For example, the estate of Jeffry M. Picower agreed to return $7.2 billion (Henriquest, 2010). The trustee has filed 1,000 lawsuits to recoup $100 billion of funds. This court decision to shorten the clawback period from six years to two years will cut the trustee's clawback funds from $11 billion to $6.2 billion (Henriquest, 2011).

Can the Feeder Fund be Held Responsible?

Madoff's Ponzi scheme has a special phenomenon. In addition to the regular investors who invest with Madoff directly, many investment companies also join in. The former is termed "direct investor," while the later "feeder fund." The feeder fund only serves as a broker to receive money from the investors and then transfer the funds to Madoff. Madoff would pay dividends or withdrawals to the feeder fund which, in turn, transfers money to the investors. These investors are called "indirect investors." As a result, Madoff actually did not deal with these indirect investors. Instead, the feeder fund serves as an intermediary. If the direct investors are required to return the funds back to the bankruptcy estate, can the trustee also ask the feeder fund to do the same?

The feeder funds are not small. The losses to Madoff's Ponzi scheme are quite large. Here are some examples: Fairfield Greenwich Advisors ($7.50 billion), Tremont Capital Management ($3.30 billion), Banco Santander SA ($2.87 billion), Ascot Partners, a hedge fund ($1.80 billion), Access International Advisors ($1.40 billion), Fortis Bank Nederland NV ($1.35 billion), Union Bancair Privee ($1.00 billion), etc. (Kim, 2009).

The trustee asked these feeder funds to reimburse the money that they received from Madoff to the bankruptcy estate on the grounds that they should know or should have known that Madoff was engaged in a Ponzi scheme. These feeder funds intentionally feed money to Madoff for the purpose of receiving higher than usual dividends. The trustee "accused the banks of ignoring warning signs about Mr. Madoff's Ponzi scheme and allowing the fraud to continue" (Albergotti, 2013). They should be held responsible in the same way as the direct investors. For example, just in the case of JPMorgan Chase & Co. alone, the trustee asked to return $6.4 billion (Henriques, 2010). The feeder funds refused to return the money on the grounds that they are

not the true investor; instead, they are only acting as brokers. The case also went to the U.S. Court of Appeals for the Second Circuit in Southern New York. On June 20, 2013, the case was ruled in favor of the feeder funds (U.S. Court of Appeals, 2013(2)). In other words, the feeder funds are not responsible for returning the money that they received from Madoff back to the bankruptcy estate.

Who Is Entitled to Distribution—Direct Investors vs. Indirect Investors

As mentioned previously, there are three kinds of investors in Madoff's Ponzi scheme: direct investors, feeder funds and indirect investors. Who is entitled to the distribution of Madoff's bankruptcy estate fund? There is no dispute that the direct investors take first priority. The distribution might be justifiable for the feeder fund to claim the right of distribution, though they are not the real investors. However, in the case of the indirect investors, the distribution is disputable. Are the indirect investors really entitled to the distribution? They are the real investors, but they did not give money to Madoff directly. The money went through the feeder funds. The trustee refused to distribute the bankruptcy estate fund to the indirect investors, but the indirect investors disagree. The case also went to the U.S. Court of Appeals for the Second Circuit in Southern New York. On February 22, 2013, the case was ruled in favor of the trustee (U.S. Court of Appeals, 2013(1)). As a result, the indirect investors cannot sue the bankruptcy estate for recovery. Instead, the feeder fund may distribute its recovery fund to the indirect investors.

How Should Madoff's Fund be Distributed—Net Winners vs. Net Losers

Even if all parties can agree that the remaining bankruptcy estate fund shall be distributed only to the direct investors and the feeder funds, but not to the indirect investors, there remains the dispute as to on what basis should the funds be distributed. In other words, how is the pro-rata ratio determined among all claimants? Different basis in determining the ratio will results in different amount of distribution. This question involves each investor's amount of investment. Madoff's Ponzi scheme has a weird feature. On the one hand, there are investors who withdrew more money than what they put in, which is known as "net winners." On the other hand, there are also investors who withdrew money less than what they put in, which is termed "net losers." In a competition for the payout of the funds, the former argued that the distribution "be based on all the money listed on the victims' account statements when the Ponzi scheme unraveled on December 11, 2008." Whereas, the latter advocated that the payout "be based on how much investors lost in principal deposits, not how much they lost in profit fabricated by Mr. Madoff." (Albergotti, 2012).

There is a big difference between these two bases. The net winners may have withdrawn so much money from the funds that they do not have much principal left over. That is why they prefer to use the amount of money involved in their accounts, which is certainly greater than the remaining principal. On the contrary, the net losers did not withdraw too much money from the funds. There is not much difference between the principal and the amount of money involved in their accounts. That is why they prefer to use the principal as the basis. In comparison with the net winners, the net losers would share a higher pro-rata ratio. This time the case went to the U.S. District Court for Southern New York and was then ruled in favor of the net losers. Therefore, the distribution ratio is the principal, not the amount of money in the account, to

determine the payout. Immediately thereafter, the trustee distributed $2 billion to the investors (Albergotti, 2012).

This is the current development of Madoff's Ponzi scheme. There are many more problems; for example, should the interest be counted as investment in determining the amount of payout to the victims of Madoff's Ponzi scheme? The answer is negative. These problems indicate that the decision is not easy in determining how the Madoff's bankruptcy estate should be distributed. The situation involves the direct investors, the feeder funds and the indirect investors. The decision also concerns how far the trustee can claw back the funds paid to the investors prior to the bankruptcy. The problem further deals with the basis in determining the payout ratio among the investors. Every Ponzi scheme victim must be aware of these problems.

XVIII. CONCLUSION

By the nature of a Ponzi scheme, the investment loss constitutes a theft loss rather than a capital loss. Further, the investment is a transaction entered into for profit. As a result, the theft loss is fully deductible without limitations. This article demonstrates that the amount of the theft-loss deduction consists of the initial investment and any additional investments, plus any phantom income included in taxable income in prior years, but reduced by withdrawals and any actual recovery and potential third-party recovery. The nondeductible theft loss qualifies as a net operating loss that can be carried back for five years and carried forward for 20 years. The phantom income is deductible as part of the theft loss, provided no amended tax return is filed to claim a tax refund. The statute of limitation is three years. Thus, the taxpayer cannot go back to the years where the periods of limitation have expired.

The IRS offers a safe harbor treatment for investors. Qualified investment includes the initial and additional investment, plus phantom income minus withdrawals. If the taxpayer agrees not to file an amended tax return and also not to pursue a potential third-party recovery, the deductible theft loss is 95 percent of the qualified investment, but reduced by the actual recovery and potential third-party recovery. If the taxpayer intends to pursue a potential third-party recovery, the maximum deduction rate is reduced to 75 percent, but reduced by the estimated potential third-party recovery. If the taxpayer intends to pursue the potential third-party recovery and also files amended tax returns, the qualified investment cannot include the phantom income for the three years prior to the discovery of the Ponzi scheme, but the theft-loss deduction is 100 percent and reduced by actual recovery and the estimated third-party recovery. An example was given for demonstrative purposes.

The IRS offers three options. The key is the prospect of potential third-party recovery in the future as compared to the tax savings on the loss deduction at the present time. If the former is not greater than the latter, the decision is really not beneficial to seek the third-party recovery and sacrifice the benefits of the tax deduction. Another concern is the comparison between the inclusion of phantom income deduction and filing of the amended tax return. If the benefit of the former is not more than the latter, the decision is really not advisable to claim the phantom income deduction and give up the rights to file an amended tax return, and vice versa.

In addition, this article also offers investment-planning strategies. The strategy involves the question as to when an investor should withdraw from a Ponzi scheme. The decision depends on how long a Ponzi scheme can survive, which in turn depends on the incoming investment growth rate and the outgoing dividends payout rate. This decision point is termed “equilibrium point.”

If an investor receives dividends more than or the investor contributes capital less than this equilibrium point, he or she should withdraw before the surviving period.

Despite Madoff's notorious case, the Ponzi scheme continues today. An investor must be aware of any red flags. If the scheme occurs, an investor must know the best strategy to minimize the investment loss. An investor must further know how to deduct the loss so as to maximize the benefit of tax deduction.

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