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TIR 09-15: Massachusetts Personal Income Tax Treatment of Certain Criminally Fraudulent Investment Arrangements

Background: [Federal Income Tax Treatment](#)

On March 17, 2009, the IRS issued Rev. Rul. 2009-9 and Rev. Proc. 2009-20 in response to taxpayers who are victims of losses from certain criminally fraudulent investment arrangements. These arrangements often take the form of so-called "Ponzi" schemes, in which the party perpetrating the fraud receives cash or property from investors, purports to earn income for the investors, and reports to the investors income amounts that are wholly or partially fictitious. Rev. Rul. 2009-9 clarifies the federal income tax law governing losses from such schemes, including the nature of such losses (theft losses under Internal Revenue Code ("IRC") § 165(c)(2)), the amount of such losses to be allowed, and the year of deductibility.

Rev. Proc. 2009-20 provides an optional safe harbor method for computing a deemed theft loss in the case of a "qualified investor" with a "qualified loss" from a "specified fraudulent arrangement." A taxpayer using the safe harbor must agree not to file amended federal income tax returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year. Rev. Proc. 2009-20 applies to losses for which the discovery year is a taxable year beginning after December 31, 2007.

The federal safe harbor allows those qualified investors that are not pursuing certain "third-party recoveries" to deduct as a deemed theft loss in the "discovery year" an amount equal to (a) 95% of the "qualified investment" (generally, the investor's initial and subsequent investments plus income previously reported, less withdrawals of cash or property), minus (b) the sum of (i) any actual recovery and (ii) any potential recovery from the Securities Investor Protection Corporation (SIPC), from private insurance, or from other sources. Those investors that are pursuing recoveries from third parties are allowed to deduct an amount equal to (a) 75% of the qualified investment, minus (b) the sum of any actual recovery and any potential SIPC/insurance/other recovery. If the theft loss deduction allowed by the safe harbor creates a net operating loss (NOL), then the rules of Rev. Rul. 2009-9 allow for federal carryback of the NOL for 3 – 5 years and federal carryforward of the NOL for 20 years.[\[1\]](#)

Section 8.01 of Rev. Proc. 2009-20 explains how a taxpayer not using the safe harbor would claim a theft loss for federal income tax purposes under the generally applicable provisions governing the deductibility of losses under IRC § 165. Section 8.02 of Rev. Proc. 2009-20 explains how a taxpayer not using the safe harbor would file or amend prior-year federal returns to exclude amounts that had been reported to the taxpayer as income from the investment arrangement, to the extent the taxpayer can establish that such amounts did not truly constitute income that had been actually or constructively received (or accrued). Section 8.02 states:

A taxpayer that chooses not to apply the safe harbor treatment of revenue procedure 2009-20 to

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a claimed theft loss and that files or amends federal income tax returns for years prior to the discovery year to exclude amounts reported as income to the taxpayer from the investment arrangement must establish that the amounts sought to be excluded in fact were not income that was actually or constructively received by the taxpayer (or accrued by the taxpayer, in the case of a taxpayer using an accrual method of accounting). . . .

Massachusetts Personal Income Tax

The Massachusetts personal income tax statute does not adopt the federal deduction for theft loss under IRC § 165 for individual investors. Thus, the federal rules described in Rev. Rul. 2009-9 and the optional federal safe harbor method for a qualified investor to claim a theft loss deduction under Rev. Proc. 2009-20 are not applicable for Massachusetts personal income tax purposes. In a further departure from federal law, an NOL deduction is not allowable under the Massachusetts personal income tax statute. As a result, Massachusetts does not allow the federal NOL carryback or carryforward.

The purpose of this TIR is to explain the Massachusetts income tax abatements and deductions potentially available to qualifying individual taxpayers who invested in a criminally fraudulent investment arrangement, but only if the taxpayer was not complicit in the fraud:

- Potential abatements for prior years. A taxpayer, whether or not he or she elects the federal safe harbor under Rev. Proc. 2009-20, may be eligible to file an application for abatement for open tax years to exclude from Massachusetts income “fictitious” income that had been reported by the taxpayer in those open tax years.
- Potential deduction for capital loss in subsequent year when actual loss finally determined and sustained. A taxpayer with a “qualified loss” from a “specified fraudulent arrangement”, as these terms are defined under Rev. Proc. 2009-20, may be eligible for a capital loss deduction for Massachusetts personal income tax purposes when such loss is ultimately sustained. Massachusetts capital loss treatment may apply whether or not a taxpayer elects the federal safe harbor.
- Double abatements and double deductions not allowed. Where more than one taxpayer was involved in one or more direct or indirect investments in a criminally fraudulent investment arrangement, whether through or in the form of a partnership, joint investment arrangement, or otherwise, each affected taxpayer is allowed to file an application for abatement to exclude only his or her proportionate share of any fictitious income reported in an open tax year. Likewise, each participant in such an investment with a “qualified loss” from a “specified fraudulent arrangement” is allowed to claim a capital loss deduction for only his or her proportionate share of the capital loss when ultimately sustained.

This TIR also explains that taxpayers must include in gross income any recoveries of cash or property in excess of their basis in their investment. Their basis will generally reflect the amounts contributed by the taxpayers plus any income reported for years that are not open for abatement, less any withdrawals.

I. Abatements for Wholly or Partly Fictitious Income Previously Reported in Open Tax Periods

An individual who filed a Massachusetts personal income tax return declaring income that is later determined to be fictitious due to a criminally fraudulent investment arrangement is generally eligible to file an application for abatement of tax associated with this fictitious income for tax years in which such fictitious income was reported that are open under the statute of limitations for abatement. In such cases, fictitious income will generally be amounts reported to the taxpayer as part of the fraud, on Forms 1099 or otherwise, and previously included in the taxpayer’s income reported for Massachusetts tax purposes, where the taxpayer establishes that such amounts did not in fact constitute actual income that had been actually or constructively received (or accrued).^[2]

A taxpayer who uses the federal safe harbor and who is foreclosed from filing federal amended

returns for prior years may, nevertheless, submit an application for abatement of Massachusetts personal income tax to establish in fact that certain items of gross income were wholly or partly fictitious for years that remain open under G.L. c. 62C, §§ 30, 37. See Section III below with regard to substantiation of abatement claims.

II. Capital Loss in Subsequent Tax Year in which Loss is Finally Determined and Sustained

A. General

For Massachusetts personal income tax purposes, a loss resulting from a criminally fraudulent investment scheme as described in Rev. Rul. 2009-9 and Rev. Proc. 2009-20 will be treated as a capital loss from the disposition of an investment that is a capital asset.^[3] This treatment is available only to taxpayers who were not complicit in the fraud. Massachusetts capital loss treatment is available whether or not an affected taxpayer elected the federal safe harbor under Rev. Proc. 2009-20.

In general, a taxpayer may claim a capital loss only in that taxable year in which a capital asset is sold or exchanged. If a security which is a capital asset becomes worthless during a taxable year, the loss resulting therefrom is generally treated as a loss from a sale or exchange, on the last day of that taxable year. Similarly, for purposes of this TIR, if an investment in a criminally fraudulent investment scheme as described herein becomes worthless during a taxable year, a resulting capital loss may be treated as being realized on the last day of such taxable year. Such investment will be considered to become worthless only when there is no reasonable prospect of any recovery (or further recovery) and when the investment has no current liquidating value and no potential value. This determination of worthlessness is a question of fact, with the taxpayer bearing the burden to prove worthlessness.

B. Calculation of Capital Loss Amount

A taxpayer who invested in a criminally fraudulent investment scheme will be treated as having basis in a capital asset for Massachusetts tax purposes. In determining gain or loss from the sale or other disposition of a capital asset, the taxpayer's "adjusted basis" must be calculated. The adjusted basis is the amount of the original investment and all subsequent investments^[4] minus any cash or other actual withdrawals or other recoveries^[5], however derived.^[6] Fictitious income amounts reported for Massachusetts tax purposes on account of the criminally fraudulent arrangement, to the extent substantiated by the taxpayer and not abated in open taxable years, will be treated as reinvested amounts and added to basis accordingly.

III. Substantiation Issues

A taxpayer seeking Massachusetts tax relief due to a criminally fraudulent investment arrangement must maintain all records substantiating the associated fictitious income or loss. Substantiation must be provided in association with any application for abatement and must be maintained to document any capital losses claimed. In general, substantiation should include, without limitation, the following:

1. Proof that the investment income reported on the Massachusetts personal income tax returns in open years is from a criminally fraudulent investment arrangement and the extent to which it is fictitious and does not represent income actually or constructively received (or accrued).
2. In the case of a taxpayer who elected the federal safe harbor, a copy of fully executed federal 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*. Also, copies of all written documentation to support the amounts reported in Appendix A.
3. A copy of any claim submitted to the SIPC trustee and documentation of the amount of SIPC proceeds received.
4. Substantiation of the criminally fraudulent investment arrangement and the reporting thereof, such as investment statements, Forms 1099, and other tax documents relating to the open years and closed years relevant to the abatement application.
5. Proof of all contributions or other investments, distributions or other withdrawals, income reported, recoveries from SIPC, insurance, or otherwise.

6. Copies of Massachusetts personal income tax returns for both open and closed years for which the taxpayer included in gross income items of fictitious income that were fabricated by the operator of the criminally fraudulent investment arrangement.
7. A chart or spreadsheet summarizing the investment each year since inception as follows:

Year	Cash in [7]	Cash out [8]	Cumulative net cash invested (reflecting cash in and cash out over time) [9]	Reported fictitious earnings from Forms 1099 or otherwise MA Gross Income = (Capital gains, Dividends, Other) [10]	Cumulative earnings over time	Account balance = net cash invested + cumulative earnings (year end)
Each year since inception. ...						
2004						
2005						
2006						
2007						
Subsequent years, as applicable. . . .						

IV. Examples

Example 1:

Criminally fraudulent investment arrangement. Abatement application for open years 2005, 2006, 2007. The taxpayer, who was not complicit in the fraud, invested \$2,000,000 and never took any cash out of the account. A 15% annual “earnings” ratio is assumed for purposes of the example.

Year	Cash in (assume January 1 contribution)	Cash out	Net cash Invested (If investor received more than put in, this figure would be negative)	Reported earnings Form 1099 15% x (prior year Acc. Bal. + contr. - distr.) MA Gross Income	Cumulative earnings over time	Account balance = net cash invested + cumulative earnings (year end)
2003	1,000,000	0	+1,000,000	150,000	150,000	1,150,000

2004	1,000,000	0	+2,000,000	322,500	472,500	2,472,500
2005	0	0	+2,000,000	370,875	843,375	2,843,375
2006	0	0	+2,000,000	426,506	1,269,881	3,269,881
2007	0	0	+2,000,000	490,482	1,760,363	3,760,363

2005 \$0 withdrawn, \$370,875 included in MA gross income

2006 \$0 withdrawn, \$426,506 included in MA gross income

2007 \$0 withdrawn, \$490,482 included in MA gross income

Abatement results for open years for Example 1: Assuming adequate proof of the above amounts, this taxpayer is entitled to a recalculation of tax for the following open years:

2005 - exclude \$370,875 fictitious income from gross income

2006 - exclude \$426,506 fictitious income from gross income

2007 - exclude \$490,482 fictitious income from gross income

The taxpayer's basis in the investment is equal to the cash contributed plus the amounts demonstrated to be fictional that were included in Massachusetts gross income during closed tax years, less any withdrawals or recoveries (in this example, zero). Thus, the taxpayer's adjusted basis after removing gross income in 2005, 2006, and 2007 is \$2,472,500. The taxpayer received \$500,000 in SIPC proceeds in 2009; thus, the taxpayer's adjusted basis is \$2,472,500 - \$500,000, or \$1,972,500.

Example 2:

Criminally fraudulent investment arrangement. Abatement application for open years 2005, 2006, 2007. The taxpayer, who was not complicit in the fraud, invested \$5,000,000 and received regular cash distributions of \$250,000 on January 1 each year until 2008 when the fraud was made public. A 15% "earnings" ratio is assumed for purposes of the example.

Year	Cash in (assume January 1 contribution)	Cash out (assume taken out on January 1)	Net cash Invested (If investor received more than put in, this figure would be negative)	Reported earnings Form 1099 15% x (prior year Acc. Bal. + contr. - distr.) MA Gross Income	Cumulative earnings over time	Account balance = net cash invested + cumulative earnings (year end)
2000	5,000,000		+5,000,000	750,000	750,000	5,750,000
2001	0	250,000	+4,750,000	825,000	1,575,000	6,325,000
2002	0	250,000	+4,500,000	911,250	2,486,250	6,986,250
2003	0	250,000	+4,250,000	1,010,438	3,496,688	7,746,688
2004	0	250,000	+4,000,000	1,124,504	4,621,191	8,621,191
2005	0	250,000	+3,750,000	1,255,679	5,876,870	9,626,870
2006	0	250,000	+3,500,000	1,406,530	7,283,401	10,783,400
2007	0	250,000	+3,250,000	1,580,010	8,863,411	12,113,411

2005 \$250,000 withdrawn, \$1,255,679 included in MA gross income
 2006 \$250,000 withdrawn, \$1,406,530 included in MA gross income
 2007 \$250,000 withdrawn, \$1,580,010 included in MA gross income

Abatement results in open years for Example 2: A taxpayer is allowed to remove gross income in the open years that was reported and subject to Massachusetts tax, to the extent that taxpayer substantiates that it was fictitious income that was not actually or constructively received (or accrued).

No gross income is required to be recognized in these open years because in each year the aggregate basis (reflecting all contributions plus income reported in closed years, less all distributions and recoveries) exceeds the amount of cash received in those years.

Assuming adequate substantiation of the above amounts, this taxpayer is entitled to a recalculation of tax for the following open years:

2005 – exclude \$1,255,679 fictitious income from gross income
 2006 – exclude \$1,406,530 fictitious income from gross income
 2007 – exclude \$1,580,010 fictitious income from gross income

The taxpayer's basis in the investment is equal to the cash contributed plus the amounts demonstrated to be fictional that were included in Massachusetts gross income during closed tax years, less any withdrawals or recoveries. Thus, the taxpayer's adjusted basis after removing gross income in 2005, 2006, and 2007 is \$7,871,191, which reflects the total account balance above at the end of 2004 (\$8,621,191) less the distributions in 2005, 2006, and 2007 (totaling \$750,000). This basis would then be further reduced for any post-2007 withdrawals, SIPC proceeds, or any other recoveries.

Example 3:

Criminally fraudulent investment arrangement. Abatement application for open years 2005, 2006, 2007. The taxpayer, who was not complicit in the fraud, invested \$2,000,000 and received a single cash distribution of \$2,500,000 on January 1, 2006. A 15% "earnings" ratio is assumed for purposes of the example.

Year	Cash in (assume January 1 contribution)	Cash out (assume taken out on January 1)	Net cash Invested (If received more than put in, this figure is negative)	Reported earnings Form 1099 15% x (prior year Acc. Bal. + contr. - distr.) MA Gross Income	Cumulative earnings over time	Account balance = net cash invested + cumulative earnings (year end)
2003	1,000,000	0	+1,000,000	150,000	150,000	1,150,000
2004	1,000,000	0	+2,000,000	322,500	472,500	2,472,500
2005	0	0	+2,000,000	370,875	843,375	2,843,375
2006	0	2,500,000	-500,000	51,506	894,881	394,881
2007	0	0	-500,000	59,232	954,113	454,113

2005 \$0 withdrawn, \$370,875 included in MA gross income
 2006 \$2,500,000 withdrawn, \$51,506 included in MA gross income

2007 \$0 withdrawn, \$59,232 included in MA gross income

Abatement results for open years for Example 3: Cash payments received by the taxpayer are treated first as a return of capital to the extent of the taxpayer's adjusted basis, and the balance of the amount received constitutes includible gross income. Assuming adequate substantiation of the above amounts, this taxpayer is entitled to a recalculation of tax for the following open years:

2005 - exclude \$370,875 of fictitious income from gross income

2006 – The taxpayer's adjusted basis before taking into account the cash withdrawal in 2006 is equal to the amount of cash contributed plus the amounts demonstrated to be fictional that were included in Massachusetts gross income during closed tax years, or \$2,472,500.

\$2,500,000 amount withdrawn - \$2,472,500 basis = \$27,500 excess that is includable in income, taken into account in determining partial abatement as follows:

Partial Abatement: exclude \$51,506 of fictitious income from gross income and add \$27,500 to Part C gross income (long term capital gain).

2007 - exclude \$59,232 of fictitious income from gross income

The taxpayer's adjusted basis, after excluding and including gross income as explained above, is \$0.

/s/Navjeet K.Bal

Navjeet K.Bal

Commissioner of Revenue

NKB:MTF:adh

November 30, 2009

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[1] Rev. Proc. 2009-20 provides that a qualified investor may have income or an additional deduction in a year subsequent to the discovery year depending on the actual amount of the investor's loss that is eventually recovered.

[2] As described in Section II, below, amounts contributed to a criminally fraudulent investment arrangement will generally be treated as a capital asset for Massachusetts purposes. Any recoveries of cash or property in excess of the investor's basis in the investment (generally the amounts contributed plus any income reported for years that are not open for abatement, less any withdrawals) must be included in gross income.

[3] In general, net capital losses (from Part A and Part C income) may be used only to offset net capital gains (Part A and Part C). There is a \$2,000 per year limit on the deduction of excess net capital losses (Part A and Part C) against Part A income consisting of interest and dividends. Net capital losses cannot be deducted from Part B income. To the extent not deductible in the current taxable year, a taxpayer may carry forward excess net capital loss to succeeding taxable years. See G.L. c. 62, §§ 1, 2, and 3.

[4] This TIR does not address questions relating to the calculation of gain or loss and of a taxpayer's basis in any case in which a taxpayer has made an investment in, or received a withdrawal or other recovery from, a criminally fraudulent investment arrangement *in kind rather than in cash*. In the event that a taxpayer has made such an in-kind investment or obtained an in-kind withdrawal or other recovery, such taxpayer is directed to apply to the Department of Revenue's Rulings and Regulations Bureau for a letter ruling, describing all pertinent facts, for the purpose of determining the impact on basis and the amount of any capital loss that may be claimed or gain to be reported. See 830 CMR 62C.3.2.

[5] See preceding footnote regarding any withdrawals or other recoveries that are not received in cash.

[6] Any clawback amounts required to be paid by an investor, and actually paid, to a bankruptcy trustee will be treated as reductions in distributions, thus increasing an investor's basis to the extent thereof. SIPC payments and any insurance or other recoveries by the investor will be treated as recoveries of amounts invested, thus reducing basis to the extent thereof.

[7] In the event that any investment or withdrawal (or other recovery) is in kind rather than in cash, see footnote 4, *supra*.

[8] See preceding footnote.

[9] This amount will be "positive" if more cash was invested than withdrawn; however, the amount will be "negative" if more cash was taken out than invested.

[10] Taxpayers who are substantiating claims must provide detail as to the particular categories of reported fictitious investment income to the extent that there are differences that would impact the calculation of any Massachusetts adjustment for a prior year (e.g., relative to an abatement claim seeking to exclude previously reported dividend income as opposed to short-term capital gains or *vice versa*). The examples in this TIR will not go into that level of detail.