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## GREENTRADERTAX BLOG

### GREENTRADERTAX

**PFG investors can deduct theft losses on 2012 tax returns with Rev. Proc. 2009-20 safe harbor relief. That's great news!**

March 31, 2013

By Robert A. Green, CPA @GreenTraderTax with Darren L. Neuschwander, CPA @neuschwandercpa

*April 1, 2013 postscript: In our [2013 GTT Guide: 2012 Tax Return Examples for Section 1256 Contracts, Futures & Forex Traders](#), we added an example 2012 tax return example showing a PFG theft loss deduction in accordance with IRS Rev. Ruling 2009-09 and Rev. Proc. 2009-20. Notice the Schedule A (line 28) deduction without any limitation, coming from Form 4684 with worksheet, the footnotes and signature block. This example tax return reflects a \$100,000 deposit loss, 95% loss calculation (\$95,000), and after adding back the 30% recovery in 2012 (\$30,000), the Form 4684 and Schedule A line 28 theft loss deduction is \$65,000.*

Good news: The CCC was successful in winning IRS Rev. Proc. 2009-20 tax relief for PFGBest customers. Read the important update on the [CCC site](#). The [IRS letter](#) to the CCC states "...the PFGBest scheme qualifies as a 'specified fraudulent arrangement' within the meaning of Revenue Procedure 2009-20. Thus, investors who otherwise meet the requirements of Revenue Procedure 2009-20 may use the safe harbor, following the procedures as set forth in that revenue procedure."

As the CCC points out, "It is not required that PFGBest victims use this procedure. It may not provide the best solution for your particular tax situation. Claimants in the PFGBest case are urged to consult their tax professionals as soon as practicable to determine if it is appropriate and wise to seek relief under the safe harbor deduction for theft losses."

In this blog, I refer to IRS Rev. Ruling 2009-09 and Rev. Proc. 2009-20, and they are related to each other. Generally, a revenue ruling states the IRS position, whereas a revenue procedure provides return filing or other instructions concerning the IRS position.

#### PFG investors should use Rev. Proc. 2009-20 relief in 2012

In most cases, taxpayers are better off using this IRS Rev. Proc. 2009-20 "safe harbor" relief to deduct 95% of their *net* PFG theft losses in 2012 — the year of loss — with what effectively is like business ordinary loss treatment. Technically, it's an unrestricted itemized deduction reducing taxable income dollar-for-dollar and that's what counts most. Normally theft or casualty itemized deductions face lots of restrictions and limitations, including AMT, and state income tax limitations, too.

Many states limit itemized deductions and some (New Jersey) don't allow them at all. Check to see if your state honors Rev. Proc. 2009-20 theft loss relief. But, that may not be enough. For example, New York State confirmed it accepts Rev. Ruling 2000-20 losses, but there are many state limitations that may apply (see below).

When it comes to deducting tax losses, consider the following. Limitations, AMT preferences, unutilized loss amounts, capital loss carryovers, wasted negative taxable income, and using the loss mostly at the lowest marginal tax brackets are inefficient ways of dealing with the loss. To get the most bang for your buck, you want to use the tax loss in full against income of any kind, as soon as possible, at the higher tax brackets on both federal and state tax returns.

Ideally, PFG futures traders — and some electing forex traders — can report their 2012 Form 1099 trading gains with lower Section 1256 60/40 tax rates or offsetting capital gains with capital loss carryovers. They can deduct their theft loss with business ordinary loss treatment.

Unless you are a business trader qualifying for trader tax status, Rev. Ruling 2009-09 and Rev. Proc. 2009-20 relief is probably the best tax treatment you can have since there are no capital loss limitations or Schedule A limitations (10% or 2% of AGI). Plus for investors, Rev. Ruling 2009-09 includes theft losses in net operating loss (NOL) treatment and even adds one year to the normal two-year carryback (and/or 20-year carry forward). Normally, you only get NOL treatment with trader tax status (business treatment). NOL treatment helps ensure you don't have wasted losses with negative taxable income.

If you already sold your PFG bankruptcy claim, you can't use Rev. Ruling 2009-09 relief, and you have a realized capital loss. (We covered this in our March 7 [blog](#).)

#### Some traders may want to skip Rev. Ruling 2009-09 relief in 2012

Some business traders may be better off skipping Rev. Ruling 2009-09 "safe harbor" relief and using the default Section 165 business ordinary loss treatment. One problem is the loss may not be sustained until 2013 or 2014, as the trustee expects another 20% plus recovery of funds after 2012. But a Section 165(c)(1) business theft loss can be deducted from gross income (above the line) and that may help ensure better tax treatment on all fronts like AGI limitations, credits, state taxes and

more. Also, consider that your Obama-era tax rates may be much higher in 2013 and 2014 vs. lower Bush-era tax rates in 2012. States are also raising taxes this year and next. The ObamaCare 3.8% Medicare surtax on unearned income started in 2013 and a Section 165 theft loss on an investment is a deduction against unearned income for this Medicare tax calculation. The difference in tax rates may be well over 10% on a combined basis and that's meaningful. Saving state taxes is important if your state doesn't allow Rev. Ruling 2009-09 losses.

When it comes to choosing between Rev. Ruling 2009-09 and other Section 165 loss alternatives, it's important to understand exactly what you qualify for, how it relates to your status, and your income and loss otherwise in the related tax years. Crunch the numbers with an accountant in the know and make the right decision for you. Every taxpayer is different. File a 2012 extension to give yourself more time to see as well. You'll know how 2013 is shaping up before the extension deadline.

#### **How to deduct PFG theft losses in accordance with Rev. Proc. 2009-20**

In accordance with Rev. Proc. 2009-20, plan on using the 95% theft loss deduction option, as few traders are part of a third-party lawsuit which would require the 75% loss option.

The PFG trustee recovered 30% of funds for futures traders in 2012. PFG futures traders may deduct 95% of their theft loss amount, and then must add back the 30% recovery. For example, if you lost \$100,000, first take 95% of the loss amount (\$95,000) and then add back the 30% recovery (\$30,000), for a net theft loss deduction of \$65,000. Report that theft loss on a 2012 Form 4684 as an itemized deduction without limitation (see further details below).

Unfortunately, forex traders had no money protection like segregation of funds for futures traders, and the trustee did not recover any funds for them in 2012. Forex traders may deduct 95% of their entire deposit lost. For example, if you lost \$100,000, you can deduct \$95,000 on Form 4684 without limitation.

We understand that some PFG retail forex and spot metals traders hired their own attorneys to represent their interests in the bankruptcy proceedings, versus the interests of futures account holders. They seek "customer account" status for retail forex and spot metals accounts in the bankruptcy proceedings, rather than potential unsecured creditor status. In our view, this is not a "third-party lawsuit", so these PFG forex and metals traders can still deduct 95% of their theft losses under Rev. Proc. 2009-20.

Reports from the CCC indicate the trustee may recover an additional 20% to 30% of funds for futures traders and forex traders in 2013 or 2014, perhaps different amounts for different types of traders. If there is recovery of funds over the 5% amount not deducted in 2012, then you have gross income to report in the year of collection as a cash method taxpayer. If there is recovery of funds under the 5% amount reserved above, then you can have an additional Form 4684 deduction without limitation for that final loss amount.

Even if you have gross income in 2013 or 2014 subject to higher tax rates and perhaps Medicare tax on unearned income, it's still a good deal for investors without trader tax status, as other Section 165 options are generally worse.

#### **Rev. Ruling 2009-09 under the microscope**

Here is a redacted and shortened version of Rev. Ruling 2009-09 with my comments as they apply to PFG losses.

#### **Rev. Rul. 2009-9, IRC Sec(s). 165 Loss — theft loss; fraudulent investment scheme.**

Cash-method taxpayer ... in Ponzi-type scheme, IRS ruled that loss incurred was theft loss, not capital loss, and as it arose from transaction entered into for profit, it isn't subject to limitations under Code Sec. 165(h). Guidance was also provided on timing and amount of deduction, possible application of extended NOL carrybacks for eligible small business investors ...

*My comment: A Madoff Ponzi scheme was broadened under the title "Ponzi-type scheme" to include a PFG-style theft or embezzlement loss. PFG CEO Russell Wasendorf was indicted for embezzlement in 2012 and that satisfies the criminal standard which is at the heart of Rev. Ruling 2009-09. In 2011, the IRS further modified this ruling to include a crook who commits suicide before his indictment for a crime. This ruling is all about accelerating the loss for a cash method taxpayer into the year it was discovered and the crime was decreed by a court. An accrual method taxpayer could accrue losses.*

#### **Issues**

- (1) Is a loss from criminal fraud or embezzlement in a transaction entered into for profit a theft loss or a capital loss under 165 of the Internal Revenue Code? – *Answer, theft loss with full ordinary loss-type treatment.*
- (2) Is such a loss subject to either the personal loss limits in 165(h) or the limits on itemized deductions in 67 and 68? – *Answer, no limits on Schedule A which would otherwise be the norm.*
- (3) In what year is such a loss deductible? – *Answer, the year theft loss is discovered and crime decreed, and both happened for PFG in 2012.*
- (4) How is the amount of such a loss determined? – *Answer, it's laid out in Rev. Proc. 2009-20; 95% of net loss after recovery if no third-party lawsuit, 75% with third-party lawsuit.*
- (5) Can such a loss create or increase a net operating loss under 172? [/i] *Answer, yes and the two-year carryback is expanded to three years. The 20-year NOL carry forward remains the same.*

[/i]

*Sections 6 and 7 deal with complex mitigation beyond the scope of this article.*

#### **Facts...**

*My comment: Redacted all as they relate to the Bernie Madoff investment management Ponzi scheme and PFG was very different for many traders. But the PFG CEO stole their money and he was indicted for embezzlement, a theft loss. The IRS letter to CCC acknowledged that most PFG traders did self-directed trading rather than engage PFG for investment management. The IRS appreciated the CCC's point that Wasendorf lied about and stole the underlying account collateral, using some*

*investors' collateral to cover other investors' collateral, and that is a Ponzi-type scheme.*

## Law And Analysis

### Issue 1. Theft loss.

Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise. For individuals, 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit...

For federal income tax purposes, "theft" is a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and any other form of guile ... The character of an investor's loss related to fraudulent activity depends, in part, on the nature of the investment. For example, a loss that is sustained on the worthlessness or disposition of stock acquired on the open market for investment is a capital loss, even if the decline in the value of the stock is attributable to fraudulent activities of the corporation's officers or directors, because the officers or directors did not have the specific intent to deprive the shareholder of money or property ... In the present situation, B specifically intended to, and did, deprive A of money by criminal acts. B's actions constituted a theft from A, as theft is defined for 165 purposes. Accordingly, A's loss is a theft loss, not a capital loss.

### Issue 2. Deduction limitations.

... A's theft loss is an itemized deduction that is not subject to the limits on itemized deductions.

*My comment: I deleted the content showing how Section 165 works to significantly reduce loss deductions due to limitations on Schedule A and go right to the punch line above. You still need to use Form 4684 which feeds into Schedule A, but without limitations, it's treated like an ordinary loss. That means you don't reduce AGI, which otherwise would have been a good thing to do to reduce taxes in other areas of your tax return. For further guidance on how to deduct the loss on your tax return, follow Rev. Proc. 2009-20 to the letter of the law (see below).*

### Issue 3. Year of deduction.

Section 165(e) provides that any loss arising from theft is treated as sustained during the taxable year in which the taxpayer discovers the loss. Under 1.165-8(a)(2) and 1.165-1(d), however, if, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is sustained until the taxable year in which it can be ascertained with reasonable certainty whether or not the reimbursement will be received, for example, by a settlement, adjudication, or abandonment of the claim.

*My comment: MF Global was not declared a theft loss and it doesn't qualify for Rev. Ruling 2009-09 "safe harbor" relief. The key is criminality. Some CCC members have wondered if MFG CEO and ex-Senator John Corzine has a get-out-of-jail card and Teflon-political status from criminal prosecution. MFG traders had to wait for the loss to be sustained by a court in January 2013 (see our March 7, 2013 [blog](#)).*

A may deduct the theft loss in Year 8 the year the theft loss is discovered, provided that the loss is not covered by a claim for reimbursement or other recovery as to which A has a reasonable prospect of recovery. To the extent that A's deduction is reduced by such a claim, recoveries on the claim in a later taxable year are not includible in A's gross income. If A recovers a greater amount in a later year, or an amount that initially was not covered by a claim as to which there was a reasonable prospect of recovery, the recovery is includible in A's gross income in the later year under the tax benefit rule, to the extent the earlier deduction reduced A's income tax... Finally, if A recovers less than the amount that was covered by a claim as to which there was a reasonable prospect of recovery that reduced the deduction for theft in Year 8, an additional deduction is allowed in the year the amount of recovery is ascertained with reasonable certainty.

*My comment: This shows how the gross income in a later year works. This shows the problem with Section 165 losses that don't qualify for Rev. Ruling 2009-09 relief. Section 165 theft losses may be significantly limited on Schedule A, and then the recovery income is gross income without limitation in a subsequent year. That's tax inefficient.*

### Issue 4. Amount of deduction.

*My comment: I deleted this section because it applies to the Madoff Ponzi-scheme. Madoff investors had to keep track on their investments over the years, their reported income and distributions. It all was part of the final accounting in Rev. Ruling 2009-09, as it was fraudulent over the years.*

*Most PFG self-directed traders have it easier because they did not engage PFG for investment management services. Look at your last monthly statement or better yet, the amount submitted to and confirmed by the bankruptcy trustee as your original theft loss amount. Reduce that amount by any amount later recovered by the trustee and paid to you. If you started 2012 with \$75,000 in your PFG account and had a trading gain of \$25,000 before the bankruptcy, and no additions or withdrawals during the year, your trading account balance at the bankruptcy date should be \$100,000. If it was a different amount, then account for the difference in your trading gain to be reported.*

*PFG traders should report their 1099 income or loss during 2012 up until the bankruptcy. The trustee sent 1099-Bs for Section 1256 contracts. We understand from a PFG forex client that he also received a 1099-B, which normally is not sent for spot forex, only forex forwards. Perhaps the trustee wants to make sure that all PFG traders report their income during the year.*

### Issue 5. Net operating loss.

Section 172 allows as a deduction for the taxable year the aggregate of the net operating loss carryovers and carrybacks to that year. In computing a net operating loss, nonbusiness deductions of noncorporate taxpayers are generally allowed only to the extent of nonbusiness income. For this purpose, however, any deduction for casualty or theft losses allowable under 165(c)(2) or (3) is treated as a business deduction.

*My comment: This is great news and one of the best parts of this safe harbor relief. Many PFG traders did not qualify for trader tax status/business treatment, so in accordance with Section 165, they couldn't deduct their theft losses as a business loss in the year sustained. Normally, NOLs only are comprised of business losses, not capital losses and not itemized deductions.*

Under 172, a net operating loss generally may be carried back two years and forward 20 years. However, under 172(b)(1)(F), the portion of an individual's net operating loss arising from casualty or theft may be carried back three years and forward 20 years.

*My comment: For casualty or theft losses, the carryback is increased to three years. But, the third year back (2009) was not a good income year for most traders, and that could mean using the NOL carryback at lower tax rates. Remember with NOLs, you can elect to forgo the NOL carryback and carry it forward 20 years instead. It might be better to apply the NOL in 2013 and 2014 against Obama-era tax hikes. The IRS said that capital loss carryovers can't reduce unearned income, so we expect that NOL's won't either for purposes of the ObamaCare Medicare tax on unearned income.*

To the extent A's theft loss deduction creates or increases a net operating loss in the year the loss is deducted, A may carry back up to three years and forward up to 20 years the portion of the net operating loss attributable to the theft loss.

#### **Rev. Proc. 2009-20 guidance**

*Excerpt from RIA:* "A "qualified investor" using the Rev. Ruling 2009-09 safe harbor treatment must:

- (1) mark "Revenue Procedure 2009-20" at the top of the Form 4684, Casualties and Thefts, for the tax return for the discovery year. The taxpayer must enter the "deductible theft loss" amount from line 10 in Part II of Appendix A of [Rev Proc 2009 -20](#) on line 34, section B, Part I, of Form 4684 and shouldn't complete the remainder of section B, Part I, of Form 4684;
- (2) complete and sign the statement provided in Appendix A of Rev Proc 2009 -20 ; and
- (3) attach the executed statement provided in Appendix A to the qualified investor's timely filed (including extensions) federal income tax return for the discovery year.

*My comment: We confirmed with IRS chief counsel that taxpayers can file an extension with no mention of Rev. Proc. 2009-09 losses or Rev. Proc. 2009-20, and execute the strategies mentioned here with their 2012 tax return filed before the extended due date of Oct. 15, 2013. That's what is meant by "including extensions" above. Just make sure you file a "valid extension," otherwise your extension is null and void. Read more about extensions on our March 20, 2013 [blog](#).*

By executing the statement provided in Appendix A of Rev Proc 2009 -20 , the taxpayer agrees not to:

- (1) deduct in the discovery year any amount of the theft loss in excess of the deduction permitted under the rules;
- (2) file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in tax years preceding the discovery year."

#### **State tax treatment**

**(RIA excerpt)** - "Each state may treat these losses differently. New York, for example, has announced that it will recognize the safe harbor under Rev. Proc. 2009-20 for purposes of determining the amount of New York state itemized deductions for the theft loss. However, itemized deductions in New York are reduced for taxpayers with income in excess of certain thresholds (that is also the case for federal income tax purposes, but the IRS has explicitly excepted these losses from those reductions). And the NOL provisions permitted for federal purposes aren't permitted for New York because the state allows NOL deductions only for losses attributable to a business, trade, profession, or occupation carried on in New York. The losses from a Ponzi-like fraudulent investment arrangement generally won't qualify."

#### **Bottom line from Green**

Deducting PFG losses is nuanced and complex. It's important to understand Section 165 and Rev. Ruling 2009-09, read the CCC site PFG tax news, read our tax blogs, and then crunch the numbers with a good CPA who understands all these rules and different tax-filing scenarios and options. If used, apply Rev. Proc. 2009-20 to the letter of the law. What you should ultimately do is highly dependent on your overall income and loss and tax posture in perhaps a number of tax years. We are helping many new clients on PFG and MFG losses, so [contact us](#) for help soon.

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