The Nonprofit Advocate

Covering Legal Issues for Nonprofit Organizations

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In this issue

Recent Developments

IRS Issues Revenue Ruling and Procedure on Ponzi Theft Loss Recognition

On March 17, the IRS released Revenue Ruling 2009-09 and Revenue Procedure 2009-20 regarding the deduction of theft losses from criminally fraudulent investment arrangements that take the form of "Ponzi" schemes. Revenue Procedure 2009-20 provides an optional safe harbor method for eligible taxpayers to deduct such losses and a simplified method for eligible taxpayers to determine the amount and timing of their theft loss deductions. Revenue Ruling 2009-09 addresses the tax treatment of such types of losses. The ruling categorizes the losses as theft losses and provides guidance on the character, timing and amount of the deduction. The procedure and ruling will be published in Internal Revenue Bulletin 2009-14 on April 6, 2009.

Revenue Procedure 2009-20

Rev. Proc. 2009-20 provides both an optional safe harbor treatment for taxpayers that have experienced criminally fraudulent theft losses and guidance with respect to the deduction of such losses when the safe harbor treatment is not utilized. The Rev. Proc. shows that the IRS is aware of fraudulent "Ponzi" arrangements that have resulted in significant losses to taxpayers. In these arrangements, the party perpetrating the fraud receives cash or property from investors, appropriates it and reports fictitious income amounts to the investors. Any payments that are made to investors are made from cash or property that other investors invested in the fraudulent arrangement.

The requirements for claiming a theft loss for an investment in a Ponzi scheme involve a factual determination that often cannot be made by taxpayers with certainty in the year the loss is discovered. Rev. Proc. 2009-20 provides an optional safe harbor under which qualified investors may deduct a theft loss when certain conditions are met. If a qualified investor follows the proper procedures, the IRS will not challenge the treatment as a theft loss. The revenue procedure applies to losses for which the discovery year is a taxable year beginning after December 31, 2007. A taxpayer that chooses not to apply the safe harbor treatment provided by the procedure remains subject to all the generally applicable provisions governing the deductibility of losses under § 165.

A qualified loss is a loss resulting from a specified fraudulent arrangement in which, as a result of the conduct that caused the loss:

(1) the lead figure was charged by indictment or information under state or federal law with the commission of fraud, embezzlement or a similar crime that, if proven, would meet the definition of theft for purposes of §§ 165 and 1.165-8(d) under the law of the jurisdiction in which the theft occurred; and

(2) the lead figure was the subject of a state or federal criminal complaint alleging the commission of a crime, and either – (a) the complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or (b) a receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

Qualified investment means the excess, if any, of: (a) the sum of – (i) cash or the basis of property that the qualified investor invested in the arrangement in all years; plus (ii) the income with respect to the specified fraudulent arrangement that the investor included in income for federal tax purposes for all taxable years prior to the discovery year; over (b) the total amount of cash or property that the qualified investor withdrew in all years from the arrangement. The amount to be deducted is calculated as follows: (i) 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 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery; and (ii) subtract from this product the sum of any actual recovery and any potential insurance/SIPC recovery.

A taxpayer that chooses not to apply the safe harbor treatment and who 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 (or accrued) by the taxpayer. However, provided a taxpayer can establish the amount of net income from the arrangement that was reported in the taxpayer's gross income consistent with information received from the arrangement in taxable years for which the period of limitation on filing a claim for refund has expired, the IRS will not challenge the taxpayer's inclusion of that amount in basis for determining the amount of any allowable theft loss.

Revenue Ruling 2009-09

Rev. Rul. 2009-9 (April 6, 2009), describes the proper income tax treatment for losses resulting from these "Ponzi" schemes. This treatment provides qualified investors with a uniform manner for determining their theft losses. In addition, the treatment avoids potentially difficult problems of proof in determining how much income reported in prior years was fictitious or a return of capital, and it eases compliance and administrative burdens on both taxpayers and the IRS.

The holdings of Rev. Rul. 2009-09 include the following:

(1) a loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss rather than a capital loss, under § 165;

(2) a theft loss in a transaction entered into for profit is deductible under § 165(c)(2) rather than § 165(c)(3), as an itemized deduction that is not subject to the personal loss limitations under § 165(h) or the limitations on itemized deductions under §§ 67 and 68;

(3) a theft loss in a transaction entered into for profit is deductible in the year the loss is discovered provided the loss is not covered by a claim for reimbursement or recovery;

(4) the amount of a theft loss in a transaction entered into for profit is generally the amount invested in the arrangement, less amounts withdrawn reduced by reimbursements, recoveries or claims as to which there is a reasonable prospect of recovery (moreover, where an amount is reported to the investor as income prior to discovery of the arrangement and the investor includes that amount in gross income and reinvests this amount in the arrangement, the amount of the theft loss is increased by the purportedly reinvested amount); and

(5) a theft loss in a transaction entered into for profit may create or increase a net operating loss under § 172 that can be carried back up to three years and forward up to 20 years.

Quick Hits

Obama Proposal on Reducing Charitable Tax Deductions

One recent Obama tax proposal might entail a decrease of as much as $3.87 billion for the nonprofit sector. President Obama proposes to cut the tax deductions that wealthy Americans can claim for their charitable donations by arguing that the shift would not have an adverse effect on giving. In a press conference last week, Obama defended his budget plan by stating, "there's very little evidence that this has a significant impact on charitable giving." However, a report from the Center on Budget and Policy Priorities said total charitable contributions would decline by about 1.3 percent, while the Center on Philanthropy at Indiana University calculated that overall giving would drop by 2.1 percent and that the highest-income households would decrease their giving by 4.8 percent, or $3.87 billion. Under Obama's proposal, the tax deduction for those with incomes over $250,000 (currently 35 cents on the dollar) would be limited to 28 percent, returning to the rate that existed under the Reagan administration. Obama said that the provision would affect about 1 percent of Americans. Nonprofits that rely heavily on large donations from wealthy individuals are more likely to be affected by Obama's proposal than are those that raise money in smaller amounts.

Congress to Consider Legislation on National Service

The Edward M. Kennedy Serve America Act (H.R. 1388, S. 277), currently being considered by Congress, would improve and expand national and community service programs and thereby bolster the infrastructure for volunteerism within the nonprofit community. The Act would increase the number of service volunteers to 250,000 and would offer service opportunities for all ages, targeting areas such as veterans services, the environment, disaster relief and arts education. The bill also would create a nationwide community-based infrastructure fund to leverage investments in service. It would create a volunteer generation fund to assist nonprofits with the coordination, training and management of volunteers. The Senate passed the Act on March 26 (the companion act, known as GIVE, or the "Generations Invigorating Volunteerism and Education Act," was passed by the House on March 18). The House version of the bill would prohibit individuals and organizations that participate in National Service programs from engaging in lobbying and advocacy activities outside of National Service programs. The Senate version restricts the types of activities for which national service positions can be used, preventing participants from engaging in activities such as voter registration drives, political or legislative advocacy and abortion services; however, nonprofit organizations would continue to be able to utilize their own funds to advocate for causes in which they believe. Additionally, the Senate has agreed to include an amendment to set up a program in the Corporation for National and Community Service to expand organizational development assistance to small and midsize nonprofit organizations.

Study Finds Few Higher Education Executives Making More than $1 Million

According to a study by the Chronicle of Higher Education released February 23, colleges' chief executives are not making as much as others at private institutions, such as football coaches and medical school professors. Congress and other watchdogs recently have criticized colleges for excessive pay to chief executives. However, according to the study, chief executives accounted for only 11 of the 88 private college employees who made $1 million or more in the 2006-2007 fiscal year. The information was gathered from the financial reports filed by more than 600 private colleges and included employees' total compensation of pay plus benefits. Among almost 300 employees who earned $500,000 or more each year, fewer than half were college presidents. Sen. Charles Grassley in November raised the issue of requiring an annual payout for the wealthiest colleges and universities and has applauded the increased reporting requirements on charitable spending on the new Form 990.

United Way Receives Almost $9 Million in Federal Funds

The Ohio United Way is scheduled to receive approximately $8.9 million in federal funds under

the Emergency Food and Shelter Program, a federal program that provides funding for food, shelter and supportive services for homeless and hungry residents. According to Barbara Sykes, president and CEO of the Ohio United Way, Ohio has been awarded the seventh largest state allocation. More than 90 percent of the funding will go directly to the counties through a national board, with 68 counties qualified to receive the direct allocation. The remaining $716,159 will be allocated by a state-level committee made up of Sykes and representatives from the following organizations:

- The Salvation Army;
- American Red Cross;
- Ohio Jewish Communities;
- Catholic Conference of Ohio;
- the Ohio Council of Churches;
- Ohio Association of Second Harvest Food Banks;
- Children's Hunger Alliance;
- the Coalition on Homelessness and Housing;
- Ohio Association of Community Action Agencies;
- Ohio State Legal Services;
- the departments of aging, development, and job and family services.

The funds will be allocated to the remaining 20 counties that did not qualify for the direct allocation. According to Sykes, "in many cases Emergency Food and Shelter funds are the only resource nonprofit and community based organizations have to meet basic needs, and in these particularly tough times the additional money this program has received will be put to good use in helping to address the emergency needs of low and moderate income residents."

Exempt Organization Audits Triggered by State Agency Actions

According to a statement made March 5 at a Washington Nonprofit & Legal Tax Conference, the IRS intends to use state agencies to trigger review of charities. Marcus Owens, an attorney with Caplin & Drysdale, Washington, D.C., said that "the linkage between state and federal filings cannot be overstated." As the IRS expands its reach in an effort to perform audits in ways other than the traditional Form 990, it has reached out to state regulatory agencies. In addition, the National Association of Attorneys General has become more focused on state charity law enforcement and how IRS reporting might be utilized for these purposes. Owens recommends that charities in making their state filings should consider how such filings would be interpreted by IRS officials.

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