Internal Revenue Service

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MEMORANDUM FOR DISTRICT COUNSEL

FROM: Alan C. Levine
Chief, Branch 1 (General Litigation)

SUBJECT: Taxpayer X, et al.

This responds to your memorandum dated December 21,1998. This document is not to be cited as precedent.

LEGEND:

District Counsel
Taxpayer X
Taxpayer Y
Taxpayer Z
Amount A
Amount B
Date A
District A
Trustee A

ISSUE:

Whether a corporation must include income from amounts received in a Ponzi scheme. 1/

CONCLUSION:

1/ The memo from District Counsel posed the question whether the funds received should be taxable income to the bankruptcy estate under I.R.C. § 1398. Section 1399 provides that no separate taxable entity is established in a corporate bankruptcy. Accordingly, section 1398 does not apply to corporations but the trustee must file returns on behalf of the corporation. Treas. Reg. § 1.6012-3(b)(4).

The corporation must include income from amounts received in a Ponzi scheme in the year received.

FACTS:

Taxpayer X, Taxpayer Y, and Taxpayer Z were engaged in a "Ponzi" scheme. 2/ During the early 1990's, the corporations received millions from investors who were lured by the possibility of investing in medical accounts receivable. According to the bankruptcy trustee, the corporate officers and other employees absconded with the proceeds. The corporations went into bankruptcy and the defrauded investors filed Amount A in unsecured claims with the bankruptcy court. The trustee has recouped Amount B and wants to pay the investors. The trustee filed returns for the years in question reporting interest income but did not report the amounts received from the investors as corporate income.

The trustee attached the following statement to the returns at issue:

> The above-referenced taxpayer filed for protection under Chapter 7 of the U.S. Bankruptcy Code on Date A in the District A. Trustee A was appointed as Bankruptcy Trustee for the Debtor corporation.

The Debtor corporation ("the taxpayer") obtained funds from customers and creditors in accordance with express agreements to return those funds to the customers and creditors. Some of those funds were in fact returned. However, certain principals, officers and employees misappropriated these funds for their own personal benefit and not for the benefit of the corporation in a Ponzi-type scheme. The corporation has not included any funds obtained from the customers and creditors in its gross income.

Based upon this information, the Bankruptcy Trustee respectfully requests that the Internal Revenue Service accepts this tax return as filed.

LAW AND ANALYSIS

I.R.C § 61(a) provides the general rule that gross income includes all income from all sources. This definition is a broad one and includes all "accessions to wealth." Commissioner v. Glenshaw Glass, 348 U.S. 426, 431 (1955). Gross income includes amounts unlawfully taken from another in the year received, notwithstanding a legal obligation to repay those amounts. James v. United States, 366 U.S. 213 (1961).

2/ Ponzi schemes are schemes in which investors are lured to invest money on promises of large returns. The early investors are generally paid with money from the later investors. When the source of new investments evaporates, the investment scheme collapses. See Cunningham, Trustee of Ponzi v. Brown, 265 U.S. 1 (1924).

Income from Ponzi schemes has been held to be includible in gross income despite arguments that the amounts taken by the perpetrators were loans. In Rochelle v. United States, 384 F.2d 748 (5th Cir. 1967), cert. denied 390 U.S. 946 (1968), the Fifth Circuit held that the bankruptcy trustee was required to pay tax on income received by a bankrupt individual who persuaded others to invest in his scheme by promises of large returns. The trustee had argued that the amounts received were nontaxable because they were loans to the debtor. As stated succinctly by Judge Wisdom:

> Is money obtained from a swindle taxable income to the swindler? We hold that it is. And it makes no difference if the swindle is in the form of a loan and the "lenders" so beguiled that they really believe they have made bona fide loans.

384 F.2d at 749.

This conclusion has been sustained in numerous other cases. See. e.g., Moore v. United States, 412 F.2d 974 (5th Cir. 1969); Kleinman v. Commissioner, T.C. Memo. 1994-19; Smith v. Commissioner, T.C. Memo. 1995-402. .

The Eighth Circuit considered a case similar to Rochelle except that the swindle involved a corporation. In In re Diversified Brokers Co., Inc, 487 F.2d 355 (8th Cir. 1973), the Government argued that the corporation realized income when it was used by its officers as the "borrower" in a Ponzi-type swindle, giving promissory notes to "lenders" lured by exorbitant interest rates and misrepresentations as to corporate business activity, repaying notes with ever-increasing "borrowings", and being unable at any time to pay all outstanding notes. The court, in a 2-1 decision, concluded that the corporation was merely a conduit and the officers were the real beneficiaries of the swindle. Accordingly, the court held that "no taxable income was realized by anyone until [the corporate officers] diverted funds to themselves. Until then, the funds in the hands of the corporation were nothing more than loans and were treated as such by the corporation and the lenders." 487 F.2d at 358.

We do not agree with the Eighth Circuit's opinion in Diversified Brokers. Instead, we agree with the dissent in that case and believe that the court was wrong on two counts. First, the overwhelming weight of authority is that amounts characterized as investments in these types of schemes are not non-taxable loans to the recipient but income. As the court in Rochelle noted, "were we to hold otherwise, confidence men could avoid the tax consequences of their transactions by merely adding a false promise to repay to their other representations." 384 F.2d at 752. Second, while the funds may well have been diverted to the private use of the corporate officers, they were, first, income to the corporation. The majority opinion ignored a line of cases such as Union Stock Farms v. Commissioner, 265 F.2d 712 (9th Cir. 1959) (illegal payments related to corporation sales held to be taxable income to the corporation even though

they were channeled directly to a corporate officer and not reflected on the corporation's books) and Asphalt Industries, Inc. v. Commissioner, 384 F.2d 229 (3rd Cir. 1967) (funds sent to a corporation in payment of the corporation's accounts receivable constituted income to the corporation for tax purposes even though such funds were embezzled by a corporate officer and never actually passed into the corporation's treasury). See In re Diversified Brokers Co., Inc., AOD CC-1973-146 (4/20/73). While the AOD related to the lower court decision that the Government ultimately also lost on appeal, we agree with its rationale.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As noted above, we do not agree with the Eighth Circuit's opinion in Diversified Brokers, and, for the reasons stated in the Action on Decision, believe this issue should continue to be litigated. [redacted], then this is a strong argument that those amounts were income to the corporation even if later diverted by the officers.

While we believe the Eighth Circuit to be incorrect, we believe that Diversified Brokers does present a significant hazard of litigation. Additionally, a claim by the Internal Revenue Service (the "Service") for tax on the full amount would put the United States in direct competition with swindled citizens for collection of amounts that would not have been income (and thus not taxable) to the corporation, absent it stealing the money from those citizens. See 487 F.2d at 359 (concurring opinion). [redacted] Additionally, while we recognize that such assessments might be uncollectible, the Service could pursue the corporate officers and employees for tax on the amounts diverted to their personal use or accounts.

Another hazard here is that it could be argued that the diversions constituted theft losses deductible under I.R.C. § 165. See Arc Electrical Construction Co. v. Commissioner, T.C. Memo. 1988-592. We believe, however, that if the amounts were diverted by corporate officers with authority to act for the corporation, the diversions would be more properly classified as dividends not deductible to the corporation but taxable to the recipients.

[redacted]

If you have any further questions, please call 202-622-3610.