Insult To Injury. You Can't Always Deduct Scam Losses Anymore

Romance scam victims can't deduct losses, but Pig Butchering victims can.

An elderly grandma loses $50,000 to a scammer that promised her he would marry her to help him pay for emergency medical bills after an "oil rig" accident. Her neighbor, a middle-aged father gets duped into transferring $300,000 to a fake cryptocurrency platform in a Pig Butchering scam.

Both victims lost their life savings, but only one of them gets to deduct those losses on their taxes.

A recently released IRS memo is revealing just how differently scam victims are treated. Romance scams, for example, are not deductible, but investment scams are.

It's a strange distinction but it happened in 2017 with the Tax Cuts and with the Big Beautiful Bill, its most likely here to stay.

Before 2017 Most Scams Were Covered

In 2017, most people could deduct personal casualty and theft losses above a certain amount. A romance scam for $50,000, for example, was covered as well as most other scams too.

But in 2017 with the Tax Cuts and Jobs Act, those deductions were eliminated to simplify the tax code. Now with the Big Beautiful Bill, those eliminations are permanent.

So why are investment scams covered, and romance scams not? It's because of "profit motive". If a victim was trying to make a profit, and they lost money than it falls under a different tax code.

So, Which Scams Are Deductible?

According to the IRS, these are scams that you can deduct from your taxes:

Investment-Related Frauds Are Covered

- **Cryptocurrency scams** - Fake investment platforms promising crypto profits
- **"Pig butchering" scams** - Elaborate investment schemes that start small and build trust
- **Fraudulent investment websites** - Fake trading platforms or investment opportunities
- **Ponzi schemes** - Where you invested expecting returns (with specific IRS safe harbor rules)

Account Protection Scams When Reinvestment Was the Goal Are Covered

- **Bank impersonation scams** - Where scammer claims your accounts are compromised and you move funds to "safer" investment accounts
- **Account compromise scams** - Where your motive was to safeguard and reinvest existing investments
- **Fraudulent financial advisor scams** - Where you believed you were moving money to legitimate new investments

Unauthorized Account Access Of Investment Accounts

- **Phishing scams** - Where criminals steal login credentials and empty investment accounts you held for profit
- **Hacked investment accounts** - Where your original investments had a profit motive

And Which Scams Are Not Deductible

Sadly, all of these scams are not tax deductible

Romance and Relationship Frauds Are Not Covered

- **Romance scams** - Online relationships where the scammer requests money for emergencies, medical bills, travel, etc.
- **Dating app scams** - Any fraud through dating platforms where money was sent for personal reasons
- **Military romance scams** - Scammers posing as deployed soldiers needing financial help

Family Emergency Scams Are Not Covered

- **Grandparent scams** - Calls claiming grandchild is in jail, hurt, or needs emergency money
- **Kidnapping scams** - Fake ransom demands (even using AI-cloned voices)
- **Family medical emergency scams** - Claims that relatives need money for urgent medical care
- **Bail money scams** - Scammers claiming family member was arrested and **needs bail**

Government and Authority Impersonation Are Not Covered

- **IRS/tax agency scams** - Claims you owe back taxes and must pay immediately
- **Social Security scams** - Claims your benefits will be suspended unless you pay
- **Court/legal scams** - Fake jury duty fines or legal penalties
- **Utility disconnection scams** - Threats to shut off services unless immediate payment

Tech Support and Service Scams Are Not Covered

- **Microsoft/Apple tech support scams** - Unless the funds were moved to "investment accounts"
- **Antivirus/computer repair scams** - Payment for fake computer fixes
- **Subscription/refund scams** - Fake refunds that require you to pay fees

Shopping and Purchase Frauds Are Not Covered

- **Online shopping scams** - Fake retailers or products that never arrive
- **Puppy/pet scams** - Advance fees for pets that don't exist
- **Rental/real estate scams** - Deposits for fake apartments or vacation rentals
- **Charity scams** - Donations to fake charitable organizations
- **All scam victims still owe taxes** on retirement account withdrawals or investment sales, even if the money was stolen

If You Cashed In Your 401K, You Still Have To Pay Taxes

But here is one interesting and final fact, if you cashed in your retirement accounts and you got scammed for any reason, even investments, you still have to pay taxes on the withdrawal.

That is one final insult to injury.

The harsh reality is, if you were trying to help someone and got scammed you are always going to be on the hook.

Read The Whole Memo On Following Pages

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **202511015**
Release Date: 3/14/2025

CC:ITA:B02:JHZuck
CC:ITA:B02:MLawrence
POSTS-111975-24

UILC: 165.03-00, 165.04-00

date: January 17, 2025

to: Michael R. Fiore
Area Counsel, 1 (Manhattan)
(Small Business/Self-Employed)

from: Ronald J. Goldstein
Senior Technician Reviewer, Branch 2
(Income Tax & Accounting)

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subject: Allowance of Theft Losses for Victims of Scams Under I.R.C. Section 165

This Chief Counsel Advice responds to your request for non-taxpayer specific advice regarding the allowance of theft losses under Internal Revenue Code ("Code") § 165 for victims of certain scams. We are aware that taxpayers have suffered losses from various scams perpetrated by unknown individuals operating domestically and internationally. This memorandum addresses several common scenarios; however, the actual scam may vary, and the application of this advice is dependent on the taxpayer's specific facts.

Issue

During 2024, one or more unknown individuals (referred to as "Scammer A") contacted Taxpayers 1 through 5 and perpetrated various scams through fraud and deceit. The scam victims discovered their losses and reported the scams to their financial institutions and law enforcement in 2024 but were informed that there was little to no prospect of recovering the stolen funds. Did the scam victims sustain a theft loss under § 165 that is deductible in 2024?

Conclusion

Taxpayers 1 through 5 sustained a theft loss under § 165 due to an illegal taking of property that is considered criminal theft under applicable state law. The tax consequences under the Code are as follows:

1. The year of the loss is 2024 because that is the year Taxpayers 1 through 5 discovered the theft and determined that there was no reasonable prospect of recovery.

2. The amount of the theft loss allowable under § 165(b) is the victims' basis in the stolen funds.

3. The theft loss is deductible in 2024 for Taxpayers 1, 2, and 3 because they incurred the loss in a transaction entered into for profit under § 165(c)(2).

4. The theft loss is not deductible for Taxpayers 4 and 5 because they did not incur the loss in a transaction entered into for profit. Their losses are personal casualty losses that are disallowed by the Tax Cuts and Jobs Act of 2017 ("TCJA") amendment to § 165(h)(5) that disallows most personal casualty losses for tax years 2018 through 2025.

5. Taxpayers 1 through 5 are not eligible to use the Ponzi loss safe harbor set forth in Rev. Proc. 2009-20, 2009-14 I.R.B. 749, as modified by Rev. Proc. 2011-58, 2011-50 I.R.B. 849, because the conduct of Scammer A does not satisfy the requirements that the theft loss result from a specified fraudulent arrangement that is operated by a lead figure who is indicted or the subject of a criminal complaint under state or Federal law. Additionally, Taxpayers 4 and 5 are not eligible to use the safe harbor because their losses are not deductible under § 165.

Law

Section 165(a) provides a deduction for losses actually sustained during the taxable year and not compensated for by insurance or otherwise. A loss is treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. Treas. Reg. § 1.165-1(d)(1). In the case of an individual, § 165(c) limits the deduction to (1) losses incurred in a trade or business; (2) losses incurred in a transaction entered into for profit, though unconnected to a trade or business; and (3) losses not connected with a trade or business, or a transaction entered into for profit, if such losses arise from a casualty or theft (personal casualty losses).

For purposes of § 165, the term "theft" is broadly defined to cover "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." Rev. Rul. 2009-9, 2009-14 I.R.B. 735; see also Treas. Reg. § 1.165-8(d) ("theft" includes larceny and embezzlement). To claim a theft loss, a taxpayer must establish that the loss resulted from an illegal taking of property done with criminal intent that is considered theft under applicable state law. See Rev. Rul. 2009-9; Vennes v. Commissioner, T.C. Memo. 2021-93 at *28-*29.

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. A loss has not been sustained, and no portion of the loss is deductible, if at the end of the year there is a reasonable prospect of recovery. Treas. Reg. §§ 1.165-1(d)(2), (d)(3) and 1.165-8(a)(2); Rev. Rul. 2009-9; Vennes, T.C. Memo. 2021-93 at *34-*35 (“theft loss will not be considered sustained until it becomes reasonably certain that reimbursement will not be received”). Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances. Treas. Reg. § 1.165-1(d)(2)(i); Vennes, T.C. Memo. 2021-93 at *30, *33-*35.

“A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor.” Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811 (1974), aff'd, 521 F.2d 786 (4th Cir.1975). A taxpayer claiming the loss makes a determination as to their prospect of recovery based on the facts available as of the end of the tax year, and need not establish that there is no possibility of recovery nor need they be an “incorrigible optimist.” Jeppsen v. Commissioner, 128 F.3d 1410, 1415-16 (10th Cir. 1997) (quoting Ramsay Scarlett & Co., 61 T.C. at 811-12) (citing U.S. v. S.S. White Dental Mfg. Co., 274 U.S. 398, 402-03 (1927)).

The amount of a loss that is allowed as a deduction is generally limited to the taxpayer’s adjusted basis in the property (generally the amount paid) under § 1011 and not the fair market value of the property at the time of the loss. See § 165(b); Treas. Reg. § 1.165-1(c). This means that a taxpayer generally may not take a loss deduction for income, or the unrealized gain from an investment, that has not been included in gross income for tax purposes.[1]

For tax years 2018 through 2025, § 165(h)(5) disallows § 165(c)(3) personal casualty losses except to the extent of personal casualty gains or unless attributable to a Federally declared disaster. Personal casualty losses include losses from theft that are not connected with a trade or business, or a transaction entered into for profit.

[1] See Washington Mutual. Inc. v. United States, 636 F.3d 1207, 1217 (9th Cir. 2011) (“Generally, a taxpayer's basis in an asset is equal to the cost to the taxpayer of acquiring the asset.”); Black & Decker Corp. v. United States, 436 F.3d 431, 435 (4th Cir. 2006) (“[T]he basis of property shall be the cost of such property.”); Borg v. Commissioner, 50 T.C. 257, 263 (1968) (Taxpayer had no basis in a note representing the right to the payment of his salary because he had not previously reported and recognized the income); O'Meara v. Commissioner, 8 T.C. 622, 632–33 (1947) (“A taxpayer may not take a loss in connection with an income item unless it has been previously taken up as income in the appropriate tax return.”).

Section 165(h)(3)(B). Personal casualty gains are defined as recognized gains from any involuntary conversion of property arising from fire, storm, shipwreck, or other casualty, or from theft. Section 165(h)(3)(A).[2] As a result, individual taxpayers who sustain a theft loss in tax years 2018 through 2025 are generally allowed a § 165 deduction only if the theft loss is incurred in a transaction entered into for profit.

There is no statutory definition of "a transaction entered into for profit;" however, courts have analyzed this phrase and held that a primary profit motive is required under § 165(c)(2). See Helvering v. National Grocery Co., 304 U.S. 282, 289 n. 5 (1938); Dewees v. Commissioner, 870 F.2d 21, 33 (1st Cir. 1989); Fox v. Commissioner, 82 T.C. 1001, 1021 (1984); Ewing v. Commissioner, 20 T.C. 216 (1958), aff'd 213 F.2d 438 (2d Cir. 1954); Wright v. Commissioner, T.C. Memo. 2024-100, *6.[3]

Rev. Proc. 2009-20 provides an optional safe harbor that allows taxpayers to claim a § 165 theft loss in limited circumstances even if the loss would otherwise not be allowed due to the taxpayer having a reasonable prospect of recovery. See Rev Proc. 2009-20, as modified by Rev. Proc. 2011-58. Specifically, the safe harbor applies to losses from a criminally fraudulent investment arrangement, commonly known as a "Ponzi scheme," if specific requirements set forth in the revenue procedure are satisfied.

Taxpayers are eligible for the Ponzi safe harbor if they establish that they are (1) a "qualified investor" who (2) incurred a "qualified loss" from (3) a "qualified investment" in (4) a "specified fraudulent arrangement," as those terms are defined in Rev. Proc. 2009-20. The safe harbor election must be made in the discovery year, defined as the taxable year the "lead figure" was charged by indictment or information under state or Federal law that, if proven, would meet the definition of theft under § 165 and the regulations thereunder. See Rev. Proc. 2009-20; as modified by Rev. Proc. 2011-58.

For purposes of the Ponzi safe harbor, a "specified fraudulent arrangement" is defined in Section 4.01 of Rev. Proc. 2009-20 as:

> [A]n arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent

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[2] For tax years 2018 through 2025, § 67(g) disallows all miscellaneous itemized deductions for individuals, including § 165(c)(2) and (3) losses other than those from casualty, theft, and wagering. See §§ 62, 63, 67(b)(3) and (g). As theft losses under § 165(c)(2) and (3) are not miscellaneous itemized deductions, the disallowance in § 67(g) is inapplicable.

[3] The Tax Court has applied a five-factor test focused on the taxpayer's motive when determining whether a transaction has been entered into primarily for profit. See Wright v. Commissioner, T.C. Memo. 2024-100, *6-*7 (citing Ewing v. Commissioner, 91 T.C. 396, 417-18 (1988)).

arrangement; and appropriates some or all of the investors' cash or property.

For purposes of the Ponzi safe harbor, a "qualified loss" is defined in section 4.02 of Rev. Proc. 2009-20. For a loss to be a "qualified loss," the lead figure (or one of the lead figures if there is more than one) of the "specified fraudulent arrangement" must have been charged by indictment or information under state or Federal law with a crime that would meet the definition of theft for purposes of § 165, or the lead figure must have been the subject of a state or Federal criminal complaint alleging commission of theft 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.

Section 408(d)(1) provides that any amount paid or distributed out of an individual retirement account (IRA) is generally included in gross income by the payee or distributee in the manner provided under § 72. Neither the Code nor applicable regulations define the terms "distributee" or "payee" as used in § 408(d)(1); however, the payee or distributee of an IRA account is generally the individual or beneficiary who is eligible to receive funds from the IRA account. Nevertheless, in cases involving fraudulent withdrawals from an IRA account, courts have considered as crucial factors whether the taxpayer requested and authorized the distribution or received an economic benefit to determine if the distribution results in taxable income.[4]

Discussion

Scammer A perpetrated scams against Taxpayers 1 through 5 through fraud and deceit that constituted criminal fraud, larceny, or embezzlement under the law of the state where the victims reside. In addition, Scammer A's true identity was unknown, the transfers of funds were irreversible, the losses were not covered by insurance, the victims had no legal recourse against any third party, and law enforcement stated that there was little to no prospect of any recovery. Accordingly, as of December 31, 2024, Taxpayers 1 through 5 had no reasonable prospect of recovery and sustained an actual theft loss under § 165. See S.S. White Dental Mfg. Co., 274 U.S. at 402-03; Jeppsen, 128 F.3d at 1415-16; Ramsay Scarlett & Co., 61 T.C. at 811-12.

Taxpayers 1 through 5 invested funds in IRA and non-IRA brokerage type accounts that generally invest in securities, and other financial products, the purchase

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[4] See Roberts v. Commissioner, 141 T.C. 569, 582 & n.19 (2013) (Taxpayer not required to include in his gross income amounts that his wife fraudulently withdrew from his IRA accounts and used for her own benefit without his knowledge because the distributions were unauthorized and solely for the wife's benefit); Balint v. Commissioner, T.C. Memo. 2023-118 (Taxpayer not liable for tax on amounts that had been withdrawn from his IRA account because the funds had been misappropriated by his former spouse using a power of attorney at a time when he was in jail).

of which is considered *prima facie* evidence of a profit motive.[5] See Weir v. Commissioner, 109 F.2d 996, 997-98 (3d Cir. 1940) (if a transaction is one ordinarily thought of as giving rise to profit, courts will presume a profit motive).[6] It is undisputed that the taxpayers' investments had profit potential that supports the conclusion that they had a profit motive. See Ewing, 91 T.C. at 417-18 (discussing the guidelines set forth in Fox for determining whether a transaction is entered into primarily for profit); see also Miller v. Commissioner, 836 F.2d 1274, 1278–79 (10th Cir. 1988) (Taxpayer must have an ultimate objective and intention of producing taxable income). The Taxpayers' investments in securities and financial products had profit potential, with a clear intention of producing income. As such, the taxpayers' original investments, before encountering Scammer A, were transactions entered into for profit.

For taxpayers who authorized distributions and transfers to new accounts or directly to Scammer A, we look to their motive in doing so to determine the character of the transactions. Taxpayers who establish that their motive was to transfer their investment funds from existing investment accounts to new investment accounts, i.e., to safeguard existing investments or to engage in new investments, had a profit motive when authorizing the distributions and transfers. These actions qualify as a transaction entered into for profit under § 165(c)(2), to which the theft loss relates, regardless of any intermediate steps taken at the direction of Scammer A. For taxpayers who were motivated to transfer funds to Scammer A as part of a non-investment scam, i.e., the romance scam and kidnapping scam, there is no profit motive for the transaction, and the loss is a disallowed personal casualty loss. For taxpayers who did not authorize any distribution or transfer, the loss does not result from the actions of the taxpayer so that the relevant transaction for determining the character of the loss is the original investment and the motive of the taxpayer at that time.[7]

Taxpayer 1—Compromised Account Scam

Taxpayer 1 was the victim of a compromised account scam involving an impersonator. Scammer A contacted Taxpayer 1 claiming to be a "fraud specialist" at Taxpayer 1's financial institution.[8] Scammer A stated that Taxpayer 1's computer and

[5] For purposes of this memo, it is assumed all the IRA accounts that are invested in by Taxpayers 1 through 5 are traditional, tax-deferred IRA accounts and Taxpayers 1 through 5 have no basis in these accounts.
[6] Section 183 and the regulations thereunder also provide guidance as to when an activity is considered engaged in for profit. See § 183; Treas. Reg. § 1.183-2.
[7] See U.S. v. Gilmore, 372 U.S. 39, 49 (1963) (holding that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer," is the controlling test to determine whether the liability is of a type that may be deducted); Deputy v. du Pont, 308 U.S. 488, 494 (1940) ("it is the origin of the liability out of which the expense accrues which is material" in analyzing deductibility of an expense).
[8] There are many variations of the impersonator scam, and they generally involve the victim being contacted by someone posing as an employee of a financial institution or government agency. The scam targets an individual's retirement and non-retirement accounts by convincing the victim that their accounts have been compromised, or are otherwise in danger, and the victim must immediately move the funds to a new account to safeguard the funds.

bank accounts had been compromised and attempts were made to withdraw funds.[9] Having gained Taxpayer 1's trust and created a sense of urgency, Scammer A fraudulently induced Taxpayer 1 to authorize distributions from IRA and non-IRA accounts and to transfer all the funds into new investment accounts created by Scammer A.[10] Scammer A created and had access to the new investment accounts and immediately transferred the funds to an overseas account. At this point in 2024, Taxpayer 1 discovered that the accounts were empty, and Scammer A had stolen the funds. Taxpayer 1 contacted their financial institution and law enforcement and was informed that the distribution to an unknown person with an overseas account could not be undone and there was little to no prospect of recovery.

Taxpayer 1 authorized the distributions and transfers with the motive to safeguard and reinvest all of the funds in new accounts in the same manner as before the distributions. Therefore, the losses resulting from the scam were incurred in a transaction entered into for profit under § 165(c)(2).[11] Accordingly, Taxpayer 1 is entitled to deduct the loss in tax year 2024 because it qualifies as a theft loss and there is no reasonable prospect of recovery.[12]

The amount of the loss allowable as a deduction is limited to the taxpayer's basis in the property. In this case, Taxpayer 1 is liable for Federal income tax on the IRA account distribution and will recognize gain or loss from the disposition of assets in the non-IRA account, giving Taxpayer 1 basis in all of the stolen funds for purposes of calculating the amount of the deductible theft loss.

Taxpayer 2—Pig Butchering Investment Scam

Taxpayer 2 is an individual who in 2024 was the victim of a pig butchering investment scam.[13] Taxpayer 2 received an unsolicited email from Scammer A advertising an investment opportunity in cryptocurrency and promising large profits.

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[9] Scammers often impersonate bank employees, tech support, and other officials while utilizing genuine looking emails, paper correspondence, and spoofed phone numbers to gain the victim's trust and create a sense of urgency.

[10] Another common technique utilized by scammers is to have the victim transfer the funds to a "temporary account" or "locker," or convert the funds to cryptocurrency or physical gold, as an intermediary step prior to being reinvested in new investment accounts. The scammer controls the account, or obtains the cryptocurrency or gold, making the funds unrecoverable. This intermediary step does not affect the analysis or conclusion.

[11] Scammers often falsely state that distributed IRA account funds will be rolled over into a new qualifying account that maintains its tax-deferred status and has no Federal income tax consequences.

[12] A theft loss from a transaction entered into for profit is reported on Form 4684, Section B, Business and Income Producing Property.

[13] Investment scams vary but generally promise large returns from non-existent investments. The "pig butchering" variant is so named in that it aims to get every last dollar by "fattening up" the victim with fake returns to induce larger investments. Many cryptocurrencies have recently increased in value by 100%-1000%, leading taxpayers to seek out large "too good to be true" returns from new cryptocurrencies and scammers promising "get rich quick" investments.

The email directed Taxpayer 2 to the website of a new platform that would ostensibly invest in cryptocurrencies using proprietary methods to generate large profits.

Taxpayer 2 visited the advertised website, which appeared to be legitimate, and deposited a small amount of cash to invest. Within a few days, the account balance increased in value, and Taxpayer 2 decided to withdraw the money from the website. Taxpayer 2 received the payout, reinforcing the belief that the website was legitimate, and then deposited a larger amount of cash to invest. The investment increased in size and Taxpayer 2 once again successfully withdrew the funds.

After the success of these investments, Taxpayer 2 invested significantly more money in the scheme with funds taken from IRA and non-IRA accounts that were transferred to the website. After the account balance increased significantly in value, Taxpayer 2 decided to liquidate the investment and withdraw cash from the website. Taxpayer 2 attempted to withdraw the funds but received an error message, and customer support did not respond.[14] Taxpayer 2 began searching online to see whether other investors had similar problems and discovered claims from several people saying they had been defrauded by the website and Scammer A.

At this point in 2024, Taxpayer 2 contacted law enforcement and the financial institution from which the original funds were withdrawn and was informed that the transfer to the website's overseas account could not be undone and there was little to no prospect of recovery. Scammer A was never identified or charged with any state or Federal crime.

Taxpayer 2 transferred the funds from the IRA and non-IRA accounts to the website for investment purposes. Therefore, the losses from the scam were incurred in a transaction entered into for profit under § 165(c)(2). Accordingly, Taxpayer 2 is entitled to deduct the loss in tax year 2024 because it qualifies as a theft loss and there is no reasonable prospect of recovery.

As was the case with Taxpayer 1, Taxpayer 2 will be liable for Federal income tax on the IRA account distribution and will recognize gain or loss from the disposition of assets in the non-IRA account, giving Taxpayer 2 basis in all of the stolen funds for purposes of calculating the amount of the deductible theft loss.

Taxpayer 3—Phishing Scam

Taxpayer 3 is an individual who in 2024 was the victim of a phishing scam involving an impersonator. Taxpayer 3 received an unsolicited email from Scammer A claiming that Taxpayer 3's accounts had been compromised. The email contained official looking letterhead and was digitally signed by a "fraud protection analyst." The

[14] In some investment scams, the taxpayer is told they have to pay various fees, taxes, or other amounts to be able to withdraw their funds, thereby increasing the amount of the loss.

email contained a link, phone number, and directions to call the analyst to ensure Taxpayer 3's funds would be protected.

Taxpayer 3 immediately called the number in the email and communicated with Scammer A, who claimed to be the fraud analyst handling the case. Scammer A directed Taxpayer 3 to click on the link in the email, and then log into Taxpayer 3's tax-deferred retirement account so Scammer A could inspect the account for any issues. By clicking the link in the email, Taxpayer 3 gave Scammer A access to Taxpayer 3's computer. Scammer A was able to identify Taxpayer 3's account username and password as it was entered into the login screen. Scammer A also convinced Taxpayer 3 to do the same with Taxpayer 3's non-IRA account. The next day, Taxpayer 3 logged into the retirement account and the investment account to find that all funds had been distributed to an overseas account. Taxpayer 3 did not authorize the distributions of the funds from the accounts. Taxpayer 3 contacted law enforcement and the financial institutions and was informed that the distribution to the overseas account could not be undone and there was little to no prospect of recovery.

Unlike Taxpayers 1 and 2, Taxpayer 3 did not authorize the transactions in which funds from the IRA and non-IRA accounts were distributed or transferred to Scammer A. These transactions would generally be looked to for purposes of determining the character of the loss. However, in this case, because the transactions were not authorized by the taxpayer, we look to the stolen property, i.e., securities held in investment accounts, and determine whether they were connected to the taxpayer's trade or business, were invested in for profit, or held as general personal property.[15]

Taxpayer 3 contributed to the IRA and to the non-IRA accounts for the purpose of investing and growing the funds to provide income to Taxpayer 3 in retirement, thereby establishing a profit motive. The theft of property while invested establishes that Taxpayer 3's loss was incurred in a transaction entered into for profit for purposes of § 165(c)(2). Accordingly, Taxpayer 3 is entitled to deduct the loss in tax year 2024 because it qualifies as a theft loss and there is no reasonable prospect of recovery.

The amount of the loss allowable as a deduction is limited to Taxpayer 3's basis in the property. In this case, basis will be established to the extent Taxpayer 3 is liable for Federal income tax on the IRA account distribution and recognizes gain or loss from the disposition of assets in the non-IRA account.

Taxpayer 4—Romance Scam

Taxpayer 4 is an individual who in 2024 was the victim of a romance scam involving an impersonator. Taxpayer 4 received an unsolicited text message from

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[15] A less common scam/theft is a loss resulting from a "hacked" account. Through various means, hackers obtain access to an account and cause an unauthorized distribution of a taxpayer's account funds. The analysis and Federal income tax consequences are the same as for victims of phishing scams.

Scammer A and proceeded to develop a virtual romantic relationship.[16] Scammer A convinced Taxpayer 4 that a close relative was in dire need of medical assistance, but Scammer A could not afford the expensive medical bills. Taxpayer 4 authorized distributions from an IRA account and a non-IRA account to a personal bank account, and then transferred the money to Scammer A's overseas account to cover the purported medical expenses. After Taxpayer 4 transferred the money, Scammer A stopped responding to messages. At this time, in late 2024, Taxpayer 4 realized that the romantic relationship with Scammer A was not real, and that Scammer A had stolen Taxpayer 4's funds. Taxpayer 4 contacted their financial institution and law enforcement and was informed that the distribution to the overseas account could not be undone and there was little to no prospect of recovery.

Taxpayer 4's motive was not to invest or reinvest any of the distributed funds from the IRA and non-IRA accounts but, rather, to voluntarily transfer the funds to Scammer A, albeit under false pretenses. Notwithstanding the fraudulent inducement, Taxpayer 4 did not have a profit motive when authorizing the distributions and transfers. Therefore, the losses were not incurred in a transaction entered into for profit and were instead personal casualty losses under § 165(c)(3). Personal casualty losses sustained in 2018 through 2025 are disallowed under § 165(h)(5), except to the extent of personal casualty gains or unless attributable to a Federally declared disaster. Because Taxpayer 4 had no personal casualty gains and the loss was not attributable to a Federally declared disaster, Taxpayer 4's theft loss is not deductible in 2024. Furthermore, the distribution from the IRA account is subject to Federal income tax and Taxpayer 4 is required to recognize gain or loss from the disposition of assets in the non-IRA account.

<u>Taxpayer 5—Kidnapping Scam</u>

Taxpayer 5 is an individual who in 2024 was the victim of a kidnapping scam involving an impersonator. Scammer A contacted Taxpayer 5 by text and phone and claimed to have kidnapped Taxpayer 5's grandson for ransom.[17] Taxpayer 5 demanded to speak to Taxpayer 5's grandson and heard his voice over the phone begging for help. Scammer A directed Taxpayer 5 to transfer money to an overseas account and not to contact law enforcement. Taxpayer 5 did not know that Scammer A had used artificial intelligence to clone the grandson's voice and that no kidnapping had taken place.

Under immense duress, Taxpayer 5 authorized distributions from an IRA account and a non-IRA account, then directed those funds to be deposited in the overseas account Scammer A provided, hoping to ensure the safety of Taxpayer 5's grandson.

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[16] In a common variation to the romance scam, the scammer establishes the romantic relationship and then directs the victim to a fraudulent investment scheme. At that point the analysis would be the same as for Taxpayer 2 and the pig butchering investment scam.

[17] A similar scam, with the same analysis and conclusion, involves a scammer posing as law enforcement and informing the victim that a family member has been arrested and money is needed to secure the family member's release.

Later the next day, Taxpayer 5 was able to contact other family members and Taxpayer 5's grandson and learned that no kidnapping had taken place. Taxpayer 5 immediately contacted law enforcement and their financial institution but was informed that the distribution to the overseas account could not be undone and there was little to no prospect of recovery.

Taxpayer 5's motive was not to invest any of the funds distributed from the IRA and non-IRA accounts but, rather, to voluntarily transfer the funds to Scammer A, albeit under false pretenses and duress. Notwithstanding the fraudulent inducement and duress, Taxpayer 5 did not have a profit motive; therefore, the losses were not incurred in a transaction entered into for profit and were instead personal casualty losses under § 165(c)(3). Personal casualty losses sustained in 2018 through 2025 are disallowed under § 165(h)(5), except to the extent of personal casualty gains or unless attributable to a Federally declared disaster. Because Taxpayer 5 had no personal casualty gains and the loss was not attributable to a Federally declared disaster, Taxpayer 5's theft loss is not deductible in 2024. Furthermore, the distribution from the IRA account is subject to Federal income tax and Taxpayer 5 is required to recognize gain or loss from the disposition of assets in the non-IRA account.

<u>Ponzi Safe Harbor</u>

We conclude that Taxpayers 1 through 5 are not entitled to use the Ponzi loss safe harbor provided in Rev. Proc. 2009-20. Taxpayers 1, 3, 4, and 5 are not eligible for the safe harbor because the theft losses induced by Scammer A were not the result of a "specified fraudulent arrangement," commonly referred to as a Ponzi scheme. Scammer A as the "lead figure," did not "purport to earn income" for these taxpayers. Rather, Taxpayer 1 transferred funds to new investment accounts which were promptly stolen by Scammer A, the funds of Taxpayer 3 were stolen directly from their accounts by Scammer A, and Taxpayers 4 and 5 transferred funds directly to Scammer A. Scammer A never purported to "earn income or report fictitious income amounts" to these particular taxpayers.

Further, Scammer A did not make payments "of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement" because the funds were immediately stolen without any such payments being made. Accordingly, Taxpayers 1, 3, 4, and 5 did not invest in a "specified fraudulent arrangement" and are not eligible to claim a theft loss using the safe harbor in any taxable year. Because these taxpayers have not satisfied this threshold requirement, we need not address the other requirements set forth in Rev. Proc. 2009-20.

In addition to the analysis set forth above, the theft losses of Taxpayers 4 and 5 are not allowed under § 165 because they are personal casualty losses disallowed under § 165(h)(5). The Ponzi safe harbor is available only to taxpayers with an allowable theft loss who otherwise meet the requirements set forth in Rev. Proc. 2009-20.

While the scam to which Taxpayer 2 fell victim may have arguably been a "specified fraudulent arrangement" as defined in Rev. Proc. 2009-20, eligibility to use the safe harbor also depends on the loss being a "qualified loss." Because Scammer A, as the "lead figure," was never identified, charged with any state or Federal crime, or the subject of a state or Federal criminal complaint, Taxpayer 2's loss is not a "qualified loss," and Taxpayer 2 is not eligible to use the safe harbor provided in Rev. Proc. 2009-20.

If you have any questions, please contact Jordan Zuck or Morgan Lawrence at (202) 317-7011.

Sincerely,

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