

## REVENUE DEPARTMENT OFFERS GUIDANCE ON FRAUDULENT INVESTMENT SCHEMES

In response to taxpayer inquiries regarding fraudulent investment schemes and losses as they relate to Pennsylvania personal income tax, the Department of Revenue provides the following guidance.

Pennsylvania's treatment of losses from such schemes, often referred to as Ponzi schemes, differs from **federal income tax treatment**.

For Pennsylvania personal income tax purposes, a loss from a fraudulent investment scheme must be reported as a loss from the sale, exchange or disposition of property on the PA-40 Schedule D.

This rule applies to direct and indirect investors in S corporations and partnerships. A direct investor is one whose investment was an ownership interest in the fraudulent investment scheme or in the assets purportedly to be purchased in the investor's name by the perpetrator of the investment fraud. An indirect investor is one who was exposed through fund investments diversified in some of the fraudulent investment scheme or who was exposed through investments in third party funds (such as "funds of funds") with unreported investments in the fraudulent investment scheme.

An investor experiences a loss upon a disposition of direct or indirect investment to the extent the taxpayer's basis in the investment is greater than the amount recovered from the investment. The investor's basis in the investment is the initial investment and any subsequent actual or fictitious income from the investment – reported by the investor and on which PA personal income tax was paid – less any distributions and losses utilized by the taxpayer in Pennsylvania or any other state. If the investment is in a partnership, the basis of a partner's interest is determined using Pennsylvania personal income tax rules as explained in **Chapter 16 of the PA Personal Income Tax Guide**. Chapter 16 also discusses stock basis adjustments for S corporations. In addition, **PIT Bulletin 2005-02 Gain or Loss Derived from the Disposition of a Going Concern** provides income sourcing rules.

If a taxpayer reported fictitious income from a fraudulent investment scheme in a prior tax year, the department will not accept an amended return to remove such income from the prior tax year. Rather, such income increases the taxpayer's basis in the investment. Consequently, upon final disposition of the investment, any loss will be greater because of the basis increase from fictitious income reported in prior years.

A loss from a direct or indirect investment in a fraudulent investment scheme can only be reported in the year in which some identifiable event closed and completed the transaction and fixed the loss amount so there is no possibility of eventual recoupment. Any recovery from a direct or indirect investment is considered a distribution and reduces taxpayers' basis in the investment. Any recovery in excess of basis is reported as gain from the disposition of property and is reported on PA-40 Schedule D. The recovery period is considered final at the conclusion of all court and legal action to obtain recovery on the investment, when the taxpayer receives notification all proceeds have been paid out of existing funds, and/or when any other legal or final acts dissolve the investment.

Losses are only recognized on transactions entered into for profit, such as investments, business property and real estate. Losses are not recognized on the sale of property that was not acquired as an investment or for profit. Carry-forward or carry-back of any unused losses on the sale, exchange or disposition of property is not permitted.

If your investment was held in any entity other than a S corporation or partnership, please contact the department for further guidance.

Questions on reporting or calculating losses from fraudulent investment schemes may be directed to 717-787-8201.