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Salt Lake City, UT 84111
T 801.364.6233 | F 801.355.9926
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Memo

TO:	Rust Rare Coin Investors	FROM:	Vernon L. Calder
SUBJECT:	Theft Loss/Claims Analysis	DATE:	March 20, 2020

The following is a discussion regarding the prescribed treatment for investors if it is determined that the Rust Rare Coin, Inc. et. al. ("Rust Rare Coin") operation is a Ponzi Scheme. Each Investor's financial and tax situation is unique. This document shall, in no way, be considered to be tax advice provided by Berkeley Research Group, the Receiver or any of his professionals.

PLEASE CONSULT A COMPETENT TAX ADVISOR REGARDING TAX TREATMENT OF YOUR INVESTMENT IN RUST RARE COIN.

In order to determine tax treatment of losses sustained by investors in Rust Rare Coin (collectively "Investors") the specific tax law which provides for the deduction of losses associated their investment in Rust Rare Coin must be identified. Internal Revenue Code ("IRC") Section 165 states:

> 165(a) – There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> 165(b) – For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.
>
> 165(c) – In the case of an individual, the deduction under subsection (a) shall be limited to –
>
> (1) – losses incurred in a trade or business;
> (2) -- losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
> (3) – except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck or other casualty, or from theft.

Under the Tax Cuts and Jobs Act, the personal casualty and theft loss deduction provided for in IRC Section 165(c)(3) is suspended, except for personal casualty losses incurred in a federally declared disaster. However, statutes governing the deduction of losses incurred by an individual in a trade or business, or in a transaction entered into for profit, though not connected with a trade or business, remain unaffected by the Tax Cuts and Jobs Act. In general, Investors in the Rust Rare Coin operation should reasonably fall under the provisions of either IRC Section 165(c)(1) or (c)(2).

Deduction Limitations

Pursuant to IRC Section 165(e), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss. For federal income tax purposes, "theft" is a word of general and broad connotation, covering criminal appropriation of another's property, including theft by swindling, false pretenses and any other form of guile, including through a Ponzi scheme.

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Under Treasury Regulation ("Treas. Reg." or "Reg.") 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 settlement, adjudication, or abandonment of the claim. Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances.

Amount of Deduction

The amount of a theft loss resulting from a Ponzi scheme, or similar fraudulent investment arrangement, is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery. If an amount is reported to the investor as income in years prior to the year of discovery of the theft, the investor includes that amount in gross income, and the investor reinvests the amount in the arrangement, this amount increases the deductible theft loss. On the other hand, if the income that was included in the gross income of the investor is paid out to the investor, the amount of the deductible theft loss is not increased by the amount included in gross income.

Net Operating Losses

The deduction of a theft loss arising from a Ponzi scheme may result in a Net Operating Loss ("NOL") to the Investor. The Tax Cut and Jobs Act made several changes to the provisions governing the utilization on NOLs which may arise from the deduction of theft losses associated with the Rust Rare Coin case:

- NOLs which arise in tax years ending after 2017 may not be carried back to prior tax years;
- NOLs arising in a tax year beginning after 2017 may only reduce 80 percent of taxable income in a carryforward tax year;
- Unused NOL may be carried forward indefinitely.

Example 1

Investor A invested $100,000 with Rust Rare Coin relating to a silver/metals account(s) managed by Gaylen Rust in 2014 – no additional investments were made. Although Gaylen Rust provided information to the investor indicating that the account balance increased over subsequent years, no income related to the investment in the metals account was reported on the investor's income tax return. Investor A has received cash payments totaling $30,000 from the metals account. In 2019, it was discovered that Rust Rare Coin was utilizing the metals accounts as part of a Ponzi Scheme.[1] The amount of the theft loss incurred by Investor A is computed as follows:

Theft Loss Computation

- Initial Investment $100,000
- Less: Amounts Withdrawn (30,000)
- Theft Loss Amount $ 70,000

Claim in Receivership

- Initial Investment $100,000
- Less: Amounts Withdrawn (30,000)
- Amount of Claim $ 70,000

[1] See *Discovery Year* definition pursuant to Rev. Proc. 2009-20 below.

Under this scenario, assuming that the amount of Investor A's claim in the receivership case is $70,000, as illustrated above, and assuming that there is a reasonable prospect of recovering the full amount of the claim, Investor A would not be entitled to a theft loss deduction in 2019 (year of discovery) due to the fact that there is a reasonable prospect of recovering the full amount of the claim. If at some point in time there no longer exists a reasonable prospect of recovering all or a portion of the $70,000 receivership claim, theft loss amounts may become deductible.

Example 2

If the fact pattern in *Example 1* is changed by making the assumption that, Investor A made subsequent investments totaling $30,000 and received no withdrawals related to his/her Rust Rare Coin metals account, the amount of theft loss incurred is computed as follows:

Theft Loss Computation

• Initial Investment	$100,000
• Additional Investment	30,000
• Less: Amounts Withdrawn	0
• Theft Loss Amount	$130,000

Claim in Receivership

• Initial Investment	$100,000
• Additional Investment	30,000
• Less: Amounts Withdrawn	0
• Amount of Claim	$130,000

Under this scenario, assuming that the amount of Investor A's claim in the receivership case is $130,000, as illustrated above, and assuming that there is a reasonable prospect of recovering the full amount of the claim, Investor A would not be entitled to a theft loss deduction in 2019 (year of discovery) due to the fact that there is a reasonable prospect of recovering the full amount of the claim. If at some point in time there no longer exists a reasonable prospect of recovering all or a portion of the $130,000 receivership claim, theft loss amounts may become deductible.

IRS Revenue Procedure 2009-20

In response to a multitude of Ponzi schemes and similar fraudulent arrangements that came to light a decade ago, not the least of which was the Madoff case, the IRS issued Revenue Procedure ("Rev. Proc.") 2009-20 to provide investors in fraudulent arrangements with a safe harbor provision that would give them the ability to utilize the theft loss rules of IRC Section 165 to deduct a certain portion of theft losses in the year of discovery, even though a reasonable prospect of recovery may still exist with regard to the associated theft loss.

On March 17, 2009 the IRS issued Rev. Proc. 2009-20 that provides for a substantial change in the manner of deducting theft losses resulting from fraud, embezzlement or other similar crimes and how those losses may be treated for tax purposes. The discussion below will briefly discuss alternative safe harbor rules for deduction of Theft Losses. This discussion does not outline every element of Rev. Proc. 2009-20, as there are many complicated details, but it is an attempt to set forth the main provisions in a manner which is hopefully understandable.

All italicized words are defined terms in Rev. Proc. 2009-20.

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This memorandum is intended to outline the safe harbor provisions for deduction of theft losses resulting from a *Specified Fraudulent Arrangement*, pursuant to Rev. Proc. 2009-20.

In early March, 2009 the IRS issued Rev. Rul. 2009-09, which firmly establishes the general rules for deduction of theft losses. These general rules do not allow for the deduction of any portion of a theft loss for which the taxpayer has a claim for reimbursement with respect to which there is a reasonable prospect of recovery. This has been the procedure under which the IRS has viewed theft losses for a number of years.

However, on March 17, 2009, Rev. Proc. 2009-20 was issued wherein the IRS provided an optional safe harbor treatment for taxpayers that experienced losses in certain investment arrangements discovered to be fraudulent. (A safe harbor is simply that – a provision under application of the law wherein a taxpayer can reduce their tax liability if a party complied with the general provisions of the safe harbor and acted in good faith in doing so). Under these safe harbor provisions, a *Qualified Investor* may deduct 95% of their *Qualified Investment* in the *Discovery Year* if he/she does not pursue any *Potential Third-Party Recovery*. A 75% deduction is available in the *Discovery Year* if a *Qualified Investor* is pursuing or intends to pursue any *Potential Third-Party Recovery*.

Qualified Investment is defined as:

(1) The sum of –

(a) The total amount of cash, or the basis of property, that the *Qualified Investor* invested in the arrangement in all years; plus

(b) The total amount of net income with respect to the *Specified Fraudulent Arrangement* that, consistent with information received from the *Specified Fraudulent Arrangement*, the *Qualified Investor* included in income for federal tax purposes for all taxable years prior to the *Discovery Year*, including taxable years for which a refund is barred by the statute of limitations; over

(2) The total amount of cash or property that the *Qualified Investor* withdrew in all years from the *Specified Fraudulent Arrangement* (whether designated as income or principal).

It appears that the Rust Rare Coin situation will qualify as a *Specified Fraudulent Arrangement*. Once all the requirements are met, there may be the potential for Investors to take deductions for theft losses. The safe harbor provisions of Rev. Proc. 2009-20 may be applied in the *Discovery Year*. *Discovery year* is defined to be the taxable year of the investor in which the indictment, information, or complaint in which-

(1) the lead figure (or one of the lead figures, if more than one) was charged by indictment or information (not withdrawn or dismissed) 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 Section 165 of the Internal Revenue Code under the law of the jurisdiction in which the theft occurred; or

(2) the lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in (1) above, 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.

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Agreement of Taxpayers -

By electing to utilize the safe harbor provisions of Rev. Proc. 2009-20 the taxpayer agrees --

(1) Not to deduct in the *Discovery Year* any amount of the theft loss in excess of the 95%/75% rule, less the sum of any *Actual Recovery* and any *Potential Insurance/SIPC Recovery;*

(2) Not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year;

(3) Not to apply the alternative computation in IRC Section 1341 with respect to the theft loss deduction allowed by this revenue procedure (Rev. Proc. 2009-20); and

(4) Not to apply the doctrine of equitable recoupment or the mitigation provisions in IRC Sections 1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations on filing a claim for refund under IRC Section 6511.

The *Qualified Investor* may have income or an additional deduction in a year subsequent to the *Discovery Year* depending on the actual amount of the loss that is eventually recovered.