ALABAMA TAX TRIBUNAL

ROBERT B. CORNELIUS JR. & DONNA CORNELIUS,	§	
Taxpayer,	§	DOCKET NO. INC. 26-0155-RC
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND POST-TRIAL PRELIMINARY ORDER

I. BACKGROUND, FACTS, AND PROCEDURAL HISTORY

The genesis of this case is a shocking financial crime against an innocent Alabama couple, Robert B. Cornelius, Jr. and Donna Cornelius (the "Taxpayers"). The jointly stipulated facts are these: at some point during 2024, an unknown person contacted the Taxpayers, claiming to be an investigator employed by the United States Bureau of Alcohol, Tobacco, Firearms and Explosives (the "ATF"). The purported ATF agent told the Taxpayers that criminals had stolen Mr. Cornelius's identity and were using it to traffic illegal narcotics over or around the border between the United States and Mexico. He convinced the Taxpayers that these unnamed traffickers had access to all the Taxpayers' sensitive personal information, including the location and amount of their investment accounts, which were thereby vulnerable to being stolen. Furthermore, this purported ATF agent said that a warrant had been issued for Mr. Cornelius's arrest for having participated in this illegal drug smuggling scheme. But fear not, the agent could both intercede with the judge and protect the Taxpayers' assets if they cooperated with him at once.

The fraud started off relatively small, with the Taxpayers withdrawing all they could from their demand deposit bank accounts, amounting to about $27,000. The Taxpayers withdrew this amount in cash and sent the cash via UPS to a confederate in Ohio. Having drained the Taxpayers' ready cash, the criminals went in for the kill. The Taxpayers were convinced to liquidate their savings held by Merrill (née Merrill Lynch) and to use the funds thus generated to buy gold bullion. Having received the gold bullion, the Taxpayers were instructed to hand the gold over to a co-conspirator in the parking lot of a local Winn-Dixie. Once the person now having the gold drove away, all further attempts to reach the supposed ATF agent failed. In all, the Taxpayers lost approximately $1,160,000.00.

Of course, these transactions had tax consequences. The liquidation of the Taxpayers' investments held by Merrill, in particular, produced taxable income to the Taxpayers, as did withdrawing previously untaxed amounts from their IRA accounts. These gains were reported on the Taxpayers' 2024 federal and Alabama income tax returns, which were filed in a timely manner. The income generated by the Taxpayers' sales and withdrawals was offset by a loss they claimed due to theft, reported as a miscellaneous itemized deduction. The Taxpayers' 2024 Alabama income tax return, as filed, showed a taxable loss of $551,940.00, and requested a $200.00 refund of income tax that had been withheld.

This is where the train began to come off the rails, as it were, at least from a tax perspective. The Taxpayers reported their loss was subject to Rev. Proc. 2009-20, 2009-1 C.B. 749 (the "Ponzi Scheme Safe Harbor"). A "Ponzi Scheme" is "[a] fraudulent investment scheme in which money contributed by later investors generates artificially high dividends or returns for the original investors, whose example attracts even larger investments. Money from the new investors is used directly to repay or pay interest to earlier investors, usu[ally] without any operation or revenue-producing activity other than the continual raising of new funds." *Ponzi Scheme*, BLACK'S LAW DICTIONARY (12th ed. 2024). A prominent example of a Ponzi Scheme is the recent case of Bernie Madoff, who "was running what turned out to be history's biggest Ponzi scheme."[1]

Losses due to fraud or theft may be deductible for federal and Alabama purposes under IRC § 165(a) and Ala. Code (1975) § 40-18-15(a). Both code sections limit the deductions for losses that individuals may recognize to three main categories. First, individuals may claim losses "incurred in a trade or business." IRC § 165(c)(1), Ala. Code (1975), § 40-18-15(a)(4). Second, individuals may claim "losses incurred in any transaction entered into for profit, though not connected with a trade or business." IRC § 165(c)(2), Ala. Code (1975), § 40-18-15(a)(5). Third, and lastly, individuals may claim "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." IRC § 165(c)(3), Ala. Code (1975), § 40-18-15(a)(6). This third category is subject to a number of limitations. Principal among these is IRC § 165(h)(5)(A), which disallows any such loss sustained after 2017 except in cases of a federally declared disaster or a state-declared disaster.

As one would expect, there are several problems of proof that victims of a Ponzi Scheme face when attempting to get the tax benefit of their losses, such as "how much income reported in prior years was fictitious or a return of capital." *Ponzi Scheme Safe Harbor*, § 2.04. The Ponzi Scheme Safe Harbor is meant to "alleviate[] compliance and administrative burdens on both taxpayers and the [IRS]." *Id.* Among other things, the Ponzi Scheme Safe Harbor defines to whom it applies ("qualified investors"), to the investments made ("qualified investments" in "specified fraudulent arrangements"), and to the losses

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1 https://www.fbi.gov/history/cases-and-criminals/bernie-madoff (last visited August 19, 2026).

sustained ("qualified losses"). If taxpayers meet the definitions and take the steps outlined in the Ponzi Scheme Safe Harbor, the IRS "will not challenge the following treatment by the qualified investor of a qualified loss – (1) The loss is deducted as a theft loss; (2) the taxable year in which the theft was discovered within the meaning of § 165(e) is the discovery year described in section 4.04 of this revenue procedure; and (3) the amount of the deduction is the amount specified in section 5.02 of this revenue procedure." *Ponzi Scheme Safe Harbor*, § 5.01. Taxpayers not taking advantage of the Ponzi Scheme Safe Harbor may be challenged on one or more of these points and thus have to prove the same with competent evidence.

The Department reviewed the Taxpayers' 2024 return and determined that they did not qualify for the Ponzi Scheme Safe Harbor. The Department states that "[w]hile unfortunate, the fraud the Taxpayers fell victim to is not a Ponzi-type scheme and does not meet the definition of a 'specified fraudulent arrangement' as defined by Rev. Proc. 2009-20, because the cash and property (gold) was not transferred to the perpetrators to earn income for the Taxpayers." *Department's Answer*, at 6. The Department cited other areas in which the Taxpayers' situation did not align with the Ponzi Scheme Safe Harbor in addition. Because the Ponzi Scheme Safe Harbor did not apply, the Department determined that the Taxpayers' loss was a loss "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 theft." As stated above, this third category of loss is limited after 2017 to declared disasters. Clearly, the criminal scheme to which the Taxpayers fell victim is terrible, but it was not a declared disaster by the federal or state government. Therefore, in the Department's opinion, the loss they claimed was non-deductible. The disallowance of the loss deduction led to the assessment at issue in this appeal, which was entered on February 23, 2026, in the amount $28,862.33, consisting of tax of $27,223.00 and pre-final assessment interest of $1,639.33. The Taxpayers timely appealed the Department's final assessment to this Tribunal.

The Tax Tribunal held a hearing in person on August 19, 2026. Ryan Corley, Esq., represented the Department of Revenue, accompanied by Revenue Tax Accountant Joni Jackson. Virginia O'Donnell, Esq., represented the Taxpayers, and was accompanied by Mr. Cornelius.

II. ANALYSIS

At the August 19 hearing, the Taxpayer's counsel stipulated to the obvious, which is that the Taxpayers' situation did not meet the definitions required in the Ponzi Scheme Safe Harbor. Ponzi Schemes are well-known fraudulent endeavors, and what the criminals in this case did to the Taxpayers, while reprehensible, does not resemble a Ponzi Scheme. Thus, we will dispense with a detailed analysis of the Ponzi Scheme Safe Harbor and the ways in which the Taxpayers fail to meet its definitions and requirements.

However, that is not the end of the inquiry, and the Department erred in stopping its analysis at that point. "Safe harbor" provisions are just that; they substitute for obligations a party would otherwise have to show or prove something. They operate as exceptions carved out of broader legal obligations. *See* Merit Mgmt. Group, LP v. FTI Consulting, Inc., 583 U.S. 366, 379 (2018). In the context of an ERISA case, the court held "a plan that falls outside of the safe harbor exception does not necessarily fall within the jurisdiction of ERISA." Shipley v. Provident Life and Accident Ins. Co., 352 F. Supp. 2d 1213, 1216 (S.D.

Ala. 2004) *quoting* Anderson v. UNUM Provident Corp., 369 F. 3d 1257, 1264 (11th Cir. 2004). To extend the metaphor, just as a ship might hazard to unload its cargo on a rocky shore instead of in the safety of a calm harbor, so may a taxpayer endeavor to bear evidentiary or procedural burdens it might otherwise avoid through the use of safe harbor provisions.

Fortunately, in this case, the IRS itself has given guidance relating to taxpayers who fall victim to fraudulent schemes that are becoming more common with time. The Department referred to, and provided a copy of, IRS Chief Counsel Memorandum 202511015 (Jan. 17, 2025), entitled "Allowance of Theft Losses for Victims of Scams Under I.R.C. Section 165" (The "Fraud CCM"). As will be seen below, the Fraud CCM was prescient in its description of the Taxpayers' dilemma.

The Fraud CCM posits five hypothetical fraud victims, one each for different types of increasingly common fraudulent schemes. Of particular note is the hypothetical "Taxpayer 1" who fell victim to a "Compromised Account Scam." *Fraud CCM*, at 6. The situation comprising a Compromised Account Scam is as follows:

> 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. Scammer A stated that Taxpayer 1's computer and bank accounts had been compromised and attempts were made to withdraw funds. 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. 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.

Fraud CCM, at 7. Of course, the Taxpayer's case is slightly different in some details, but footnotes to the above-quoted paragraph provide further clarity. The person that contacted the Taxpayers pretended to be with law enforcement, not their bank. Footnote 8 states "[t]here 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 a 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." *Fraud CCM*, at 6, n. 8 (emphasis added).

Additionally, the Taxpayers in this case did not transfer their funds to another account but rather converted it into a mixture of cash and gold bullion, which they then physically delivered to the criminals. A separate footnote states "[a]nother 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 … obtains the cryptocurrency or gold, making the funds unrecoverable. This intermediary step does not affect the analysis or conclusion." *Fraud CCM*, at 7, n. 10 (emphasis added).

It does not take a seasoned criminal investigator to see that this "Compromised Account Scam" is exactly what befell the Taxpayers. The first question answered by the Fraud CCM is whether the losses suffered are casualty or theft losses governed by IRC § 165(c)(3). If they are, then for these Taxpayers and most individuals, such losses would be non-deductible, as they did not arise out of a governmentally-declared disaster as required by IRC § 165(h)(5)(A). Fortunately, the IRS does not believe this to be the case, saying:

> 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 of which is considered *prima facie* evidence of a profit motive. See Weir v. Commissioner, 109 F.2d 996, 997-98 (3rd Cir. 1940) (if a transaction is one ordinarily thought of as giving rise to profit, courts will presume a profit motive). It is undisputed that the taxpayers' investments had profit potential that supports the conclusion that they had a profit motive. [internal citations omitted]. 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.
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> For taxpayers who authorized distributions and transfer 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.

Fraud CCM, at 5-6. Consequently, the significant limitations of IRC § 165(h)(5)(A) will not apply to the Taxpayers' claimed loss. Addressing the question of the timing and amount of the losses suffered by Taxpayer 1, the Fraud CCM states:

> 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). 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.
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> 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 the 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.

Fraud CCM, at 7. The Fraud CCM reads as if it was drafted for these Taxpayers specifically, which is fortunate in that it clearly answers the questions the Tribunal must ask, and unfortunate in how often this scheme must occur for this memorandum to have been created.

The Tribunal sees no reason to disagree with the analysis of the IRS's Office of Chief Counsel, and knows of no consequential distinction between federal and Alabama law on this point that would require a different result. The Department's counsel stated at the hearing that it agrees that the Fraud CCM accurately describes the Taxpayers' situation. The Tribunal will take this opportunity to avoid adding insult to considerable injury. The Taxpayers may have lost a substantial amount of their life savings; they will not in addition be indebted to the state for taxes on gold bars last seen speeding away in the trunk of a white 2020 Lexus from the Chelsea Winn-Dixie.

III. CONCLUSION

The Department is directed to recalculate the Taxpayers' 2024 Alabama income tax by allowing the Taxpayers' claimed loss under Ala. Code (1975), § 40-18-15(a)(5) incorporating by reference IRC § 165(c)(2). The Department is further directed to communicate the recalculated tax or refund due to the Tribunal and to the Taxpayer on or before **September 25, 2026**. Appropriate action will then be taken.

This is not a final opinion subject to appeal under Ala. Code (1975), § 40-2B-2(m). The Final Order, when rendered, will be subject to appeal under that same provision.

Entered August 25, 2026.

/s/ *Ralph M. Clements, III*
RALPH M. CLEMENTS, III
Associate Judge
Alabama Tax Tribunal

rc:ml
cc: Robert & Donna Cornelius
Virginia O'Donnell, Esq.
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