

March 6, 2001

Re: Investors in the Heartland Companies with claims against them by Heartland

Dear Investor:

The purpose of this letter is to address frequently asked tax questions regarding your investment losses in Heartland. This letter provides general information and possible examples regarding the tax treatment of losses expected to be incurred by investors. Please be aware, this letter addresses the general tax treatment applicable to a "Ponzi scheme." Therefore, in no way should this letter be relied upon by individual investors as their sole source of information and investors should seek individual tax advice from their own tax professional and/or the Taxpayers Advocate Service office discussed below. In addition, this letter in no way represents a "tax opinion letter" on this matter and the RECEIVERSHIP CANNOT PROVIDE YOU WITH TAX ADVICE.

Available guidance on the subject indicates that investor losses from "Ponzi schemes" are properly characterized as theft losses subject to **IRC § 165. PREMJI v. COMM., 81 AFTR 2d 98-861 (139 F.3d 912) affirming Zahirudeen Premji, et ux. v. Commissioner, TC Memo 1996-304; JENSEN, DAVID S v. COM. 76 AFTR 2d 95-8066 affirming David Jensen, TC Memo 1993-393; Fenimore Storch, TC Memo 1985-17.** Theft losses are reported on Form 4684 and Schedule A of Form 1040 and can result in negative taxable income available for net operating loss (NOL) carryback and/or carryforward. It is important to note, per IRC § 165(e), the theft loss shall be treated as sustained during the taxable year in which the taxpayer discovers the loss and not in the year the theft occurs.

Our office has determined that the option of amending returns previously filed by investors which reported such interest, dividend, and capital gain income is generally not available. This includes returns filed within the past three (open) taxable year returns. Treasury Regulation § 451-2(a) requires the reporting of income when cash basis taxpayers have "actual or constructive receipt." The Service's Field Service Advice 1999-942, which addresses "Ponzi Schemes" in general, does elaborate by stating "taxpayers cannot file an amended return to adjust such income as a result of the subsequent theft of the funds when they previously had constructive receipt of those funds."

There are several departures from the above treatment worthy of a caveat. First, tax law requires "non-business bad debt," as defined under IRC § 166, be treated as short-term capital loss subject to a \$3,000 deduction limit on excess short term capital losses. Heartland and related

companies did extend promissory notes to some investors. It appears however, these instruments were simply "bridge notes" pending the effective date of Initial Public Stock Offerings (IPO's) in which to be invested. Each investor should examine their intentions regarding these promissory notes and consult with their tax professional about whether their losses are indeed "theft" or possibly "non-business bad debt" losses.

Secondly, we have examined the tax treatment for those investors who may have reported interest, dividend and/or capital gain income in their individual tax returns resulting from receipt of a 1099-INT or 1099-DIV from Heartland or related companies. Some investors failed to receive actual cash distributions and we believe their eventual loss deduction is increased for the income reported without cash remuneration. Other investors did receive cash dividends and may have reinvested those proceeds in Heartland and related companies. We believe investors in the latter case have an increased basis in losses to the extent of the income recognized, with a decrease to the loss basis to the extent cash was received, and finally any cash reinvested resulting in an increase in loss basis.

Examples follow:

Investors with claims against them by Heartland:

	<u>Investor A</u>	<u>Investor B</u>	<u>Investor C</u>
Actual invested funds	\$ 100,000	\$ 100,000	\$ 100,000
Dividends received	(5,000) (1)	(5,000) (1)	(5,000) (1)
Gains and profits received	(10,000) (1)	N/A	N/A
Gains and profits "reinvested"	N/A	10,000 (2)	10,000 (3)
Account closed and principal returned	(100,000)	(100,000)	(100,000)
Accumulated account balances (claim against investor)	<u>(15,000) (4)</u>	<u>(5,000) (4)</u>	<u>(5,000) (4)</u>
Previously taxed income	15,000	15,000	5,000
Tax loss for theft loss deduction	<u>\$ 15,000</u>	<u>\$ 15,000</u>	<u>\$ 5,000</u>

(1) Investor received and paid tax on funds

(2) Investor reported and paid tax on \$10,000 of "phantom" income

(3) Investor did not pay tax on \$10,000 of "phantom" income

(4) This portion of the tax deduction is contingent upon investors settling their claim with the Receivership and is deductible in the year the claim is liquidated.

It should be noted that in the case of Investor A & C, the reporting of the loss matches the claim against them. However, in the case of Investor B, the loss basis is increased by previously taxed income not actually received by the investor. The burden of proof and documentation for this will rest with the investor (taxpayer).

Finally, of primary importance is whether Heartland and related companies have an obligation to prepare amended 1099's for all years in question. Our analysis indicates that Heartland and related companies are not required to provide amended 1099's to investors. This determination is congruent with the theft loss provisions generally applicable to most investors, which essentially render any requirement of amending tax returns with amended 1099's pointless. For those investors inquiring about matters such as these, we recommend contacting the Taxpayer Advocate Service office referred to in the Receiver's letter dated January 10, 2001. This office has been specifically assigned to this matter due to its size and complexity. We do not recommend investors contact their local IRS office or the national help line, as these contacts may not be familiar with the Heartland case. Once again, we strongly suggest that all investors also consult a tax professional to resolve their tax issues.

In conclusion, you can easily see the complexity that each individual investor is potentially confronted with. It is our hope that this letter provides you with a better comprehensive understanding of all the tax issues that exist, and an appreciation for the need for each investor to consult with their individual tax professional. Please contact our office (only for questions regarding your account balance and claim account) if we can be of further assistance in this matter. REMEMBER, NIETHER NEITHER THE RECEIVER NOR HIS ACCOUNTANTS CAN GIVE TAX ADVICE.

BIRK GROSS BELL & COULTER, P.C.  
Court appointed Accountants for the  
Heartland Companies Receivership

