February 15, 2012

Mr. Mark Winkleman
ML Manager LLC
14040 N 83rd Ave., Suite 180
Peoria, Arizona 85381

Dear Mr. Winkleman:

You have requested the opinion of PricewaterhouseCoopers LLP ("PricewaterhouseCoopers" or "PwC") as to (1) whether the losses incurred as a result of investments that were sponsored or sold by Mortgages Ltd. and/or Mortgages Ltd. Securities, LLC qualify for treatment as provided by Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, except for the requirement set forth in Rev. Proc. 2009-20, § 6.01(3) with respect to the timing of the claim and (2) what is the "Discovery Year" of such loss as provided in Rev. Proc. 2011-58, §4.04(2). Section I of this letter (the "Opinion Letter" or "Opinion") contains the facts upon which the Opinion is based. Section II of this Opinion Letter contains representations and assumptions relied on by PwC in rendering its Opinion. Section III of this Opinion Letter contains the issues presented. Section IV of this Opinion Letter contains the Opinion of PwC. Section V of this Opinion Letter contains a discussion of the authorities and the federal income tax analysis upon which the Opinion is based. Section VI of this Opinion contains qualifications to and limitations of the Opinion.

Under Circular 230, 31 CFR Part 10, this Opinion is not a covered opinion as defined in § 10.35 (requirements for covered opinions) but rather is a limited scope opinion. This Opinion is limited solely to the issues of whether the losses incurred as a result of investments in the MLtd Investment Arrangements, as defined below, qualify for treatment as provided by Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, except that it does not discuss the requirement set forth in Rev. Proc. 2009-20, § 6.01(3) with respect to the timing of the claim. The Opinion also discusses what is the "Discovery Year" of such loss as provided in Rev. Proc. 2011-58, §4.04(2).

Additional issues may exist that could affect the tax treatment of the transaction or matter that is the subject of this Opinion and the Opinion does not consider or provide a conclusion with respect to any additional issues. With respect to any significant tax issues outside the limited scope of the Opinion, this Opinion Letter was not written, and cannot be used by the taxpayer, for the purpose of avoiding U.S. federal, state or local tax penalties that may be imposed on the taxpayer. This includes penalties that may apply if the transaction

that is the subject of this Opinion is determined to lack economic substance or fails to satisfy any other similar rule of law.

This Opinion has been prepared pursuant to a client relationship between ML Manager LLC and PricewaterhouseCoopers and is intended solely for the use and benefit of ML Manager LLC and is not for reliance by any other person.

Unless otherwise indicated, all "§" and "section" references are to the Internal Revenue Code of 1986, as amended (the "Code" or "IRC"), and all "Treas. Reg. §," references are to the final regulations promulgated thereunder (the "Regulations"). All "IRS" or "Service" references are to the Internal Revenue Service.

SECTION I - FACTS

Mortgages Ltd. ("MLtd"), an Arizona corporation, was founded and authorized to transact business in Arizona as a mortgage banker.[1] As a private mortgage lender, MLtd engaged in the business of originating, servicing, or selling loans secured by Arizona real property.[2] MLtd's sole shareholder was the SMC Revocable Trust, a trust created by Scott M. Coles.

At all times relevant to this Opinion, Scott M. Coles ("Coles") owned, operated, and managed MLtd.[3] Mortgages Ltd. Securities, LLC ("MLS"), an Arizona limited liability company, was a broker-dealer registered with the United States Securities and Exchange

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[1] The Facts stated herein are supported by the following:

1. Arizona Department of Financial Institutions Notice of Hearing to Revoke, dated Feb. 27, 2009 (the "ADFI Notice");
2. Arizona Department of Financial Institutions Consent Order dated July 27, 2009 (the "Consent Order");
3. United States Securities and Exchange Commission ("SEC") Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Revoking Broker-Dealer Registration as to Mortgages Ltd. Securities, LLC, draft circulated August 2009 ("Draft Order"; and
4. SEC Release No. 61377, Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Revoking Broker-Dealer Registration, issued January 19, 2010 ("Final Order).

References to specific paragraphs in these documents are denoted by "¶ __".

[2] *See* ADFI Notice at ¶1.

[3] *See* Draft Order at ¶3.

Commission ("SEC"). MLS also was owned solely by SMC Revocable Trust, a family trust established by Coles and of which Coles was the sole trustee.[4]

MLtd, through MLS, raised money from approximately 2,700 investors[5] that was used to purchase fractional interests in loans originated by MLtd, which were secured by real estate primarily located in Arizona. Investors had the option to either invest in specific loans ("pass-through investors") or in one of several funds that acquired interests in specific loans ("pooled fund investors").[6] For ease of reference, the investments sponsored by MLtd and sold by MLS are referred to herein as "MLtd Investment Arrangements".

Unbeknownst to the investors or the public, Coles's operations were experiencing distress. On June 2, 2008, Coles committed suicide. Soon thereafter, a local newspaper reported speculation of fraud at MLtd, a possible Ponzi scheme, and a report that Coles had been served with a grand jury subpoena the day before his death.[7]

On June 20, 2008, an involuntary petition for relief was filed against MLtd under Title 11 of the United States Code (the "Bankruptcy Code"). On June 24, 2008, the U.S. Bankruptcy Court for the District of Arizona ("Bankruptcy Court") entered an order converting the case from a Chapter 7 case to a case under Chapter 11 of the Bankruptcy Code.[8] As a result of the bankruptcy, the assets of MLtd became property of the bankruptcy estate and were subject to an automatic stay, as well as all other restrictions of the Bankruptcy Code. The Plan of Reorganization that was confirmed by the Bankruptcy Court created a liquidating trust and the Bankruptcy Court appointed a liquidating trustee with respect to the assets of MLtd. Thus, this process put the assets of MLtd under the control of a liquidating trustee.

As part of the bankruptcy Plan of Reorganization approved by the Bankruptcy Court on May 20, 2009, some investors' creditor claims were exchanged for membership interests in limited liability companies ("Loan LLCs"), which hold MLtd loans. The remaining investors' creditor claims were retained by pass-through investors. The Loan LLCs are

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[4] *See* Draft Order and Final Order at ¶1.

[5] *See* Draft Order and Final Order at ¶5.

[6] This Opinion uses the terms pass-through investor and pooled fund investor in the manner described in the SEC Draft Order and Final Order. *See* Draft Order and Final Order at ¶ 5. *See also, In Re Mortgages Ltd.,* No. 2:08-bk-7465 (Bankr. Ariz.) (June 23, 2008 sworn declaration of Laura Martini in Support of Debtor's Chapter 11 case).

[7] *See*, Dickerson, John, Scott Coles: The Story Behind the Life - and Death - of the Flamboyant Owner of Mortgages, Ltd., July 31, 2008, at http://www.phoenixnewtimes.com/content/printVersion/888670. *See also, In Re Mortgages Ltd.,* No. 2:08-bk-7465 (Bankr. Ariz.)(creditor assertions that MLtd was a Ponzi scheme).

[8] *In Re Mortgages Ltd.,* No. 2:08-bk-7465 (Bankr. Ariz.).

managed by ML Manager LLC ("ML Manager"). ML Manager, a limited liability company organized under the laws of Arizona, was established pursuant to the court approved Plan of Reorganization, to act as the manager of the Loan LLCs and was selected as the new manager for the pooled funds. Also as part of the bankruptcy Plan of Reorganzation, MLtd was renamed ML Servicing Co., Inc. ("ML Servicing").

On February 27, 2009, the Arizona Department of Financial Institutions ("ADFI") issued a Notice of Hearing to Revoke ("Notice"), which was filed with the United States Bankruptcy Court for the District of Arizona on March 2, 2009.

The Notice alleges that MLtd "made a false promise or misrepresentations or concealed an essential or material fact in the course of the mortgage banking business." (¶4i). The Notice alleges that MLtd misrepresented its true financial condition, failed to accrue a reserve for a $6 million loan to the SMC Revocable Trust whose collection was uncertain, and failed to disclose it had guaranteed a $12 million loan taken out by SM Coles LLC[9]. (¶4i). Other documents also demonstrate that monies were exchanged regularly between MLtd and other entities owned and controlled by Coles and that MLtd distributed more than $13 million to SMC Revocable Trust in the year before the bankruptcy.[10]

The Notice also states that MLtd failed to keep "correct and complete records clearly reflecting the financial condition" of MLtd. (¶4f). The Notice alleges that, among other things, MLtd "did not record a reserve for loan impairment, a doubtful receivable and demand for payment under a guarantee of another's debt ". (¶4i). As such, MLtd's financial statements did not accurately reflect the financial condition of the business.

Additionally, the Notice states that during the course of the examination, MLtd was asked to provide financial statement information on SMC Revocable Trust and SM Coles LLC because of numerous transactions between MLtd and SM Coles LLC. The information was requested to determine the impact of these transactions on MLtd but that MLtd failed to provide requested information on these transactions. (¶4l).

Without admitting liability, fault, responsibility or guilt, ML Servicing did not contest the entry of an Order. As a result, the administrative proceeding initiated by the ADFI on

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[9] Arizona Corporation records reflect that SM Coles, LLC was formed on July 11, 2003, that the SMC Revocable Trust was the sole member of SM Coles, LLC, and that, until his death, Scott M. Coles was the manager of SM Coles, LLC.

[10] *See In Re Mortgages Ltd.,* No. 2:08-bk-7465 (Bankr. Ariz.) (Statement of Financial Affairs filed by MLtd with the Bankruptcy Court on July 18, 2008, documents numerous monetary transactions between MLtd and the SMC Revocable Trust or SM Coles LLC).

February 27, 2009 was concluded with the entry of a Consent Order issued on July 27, 2009. The Consent Order immediately revoked the mortgage banking license of MLtd.

Before February 28, 2009, the SEC began an investigation into the activities of MLS.[11] On or before August 31, 2009, the SEC circulated a draft of the order relating to the proceedings (the "Draft Order") and the facts contained in the Draft Order became widely known.[12] Thereafter, when the SEC accepted the Offer of Settlement submitted by MLS, the SEC publicly released a document titled Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Revoking Broker-Dealer Registration as to Mortgages Ltd. Securities, LLC (the "Final Order") dated January 19, 2010.[13] The Final Order concluded SEC enforcement activity with respect to MLS.

Among other things, the SEC's widely circulated Draft Order stated the following:

- MLS is solely owned by SMC Revocable Trust, a family trust established by Scott M. Coles, who was also the sole trustee (¶1);
- Coles owned, operated, and managed MLtd until his June 2, 2008 suicide (¶3);
- Radical Bunny, LLC, an unrelated Arizona limited liability company, raised funds from investors in a series of unregistered securities offerings and either invested or loaned the offering proceeds to MLtd (¶4);
- Between 2004 and June 2008, MLS raised approximately $741 million from approximately 2,700 investors through the offer and sale of securities issued by MLtd. Investors had the option to either invest in specific loans (pass-through investors) or in one of several funds (pooled fund investors) that purchased various loans or portions of loans originated by MLtd. Investors were both pass-through investors and pooled fund investors in MLtd. (¶5);

[11] See SEC Release No. 61377, Section IV (B) (Jan. 19, 2010) which states the Commission is not imposing a penalty against MLS based on sworn statements and affidavits by MLS regarding its financial condition made on February 28, 2009 and July 31, 2009. It is illogical to assume that MLS submitted statements of its financial condition to the SEC prior to the time the SEC investigation began.

[12] *See* 17 CFR 202.5, which describes SEC enforcement activities. The existence of the Draft Order demonstrates that SEC enforcement activities had been initiated.

[13] The findings with respect to the activities of MLS, MLtd, and Coles did not change materially between the Draft Order and the release of the Final Order.

- MLtd maintained an inventory of high interest, short-term loans it made to real estate developers which MLtd securitized and sold through eleven private placement offerings made through MLS (¶5);
- MLtd typically created an "impound account" that would take a portion of the loan amount, set it aside, and use those funds to make periodic interest payments to the investors during the term of the investment (¶5);
- MLtd paid MLS placement fees of $6,973,785 million between January 2007 and June 2008 (¶6)[14];
- MLtd provided private offering memorandum to potential investors that contained broad, general statements, including risk factors that described the investments as low risk with a high rate of return for which a first deed of trust provided security (¶¶7, 8);
- While investors received audited financial statement for MLtd for the 2005 and 2006 years, there was little discussion about MLtd's liquidity position, market risk and loan funding practices and investors received no information about Coles's financial condition. Such information became increasingly important as Coles and MLtd resorted to purchasing non-performing loans to maintain the illusion that its loans were all "performing" (¶7);
- Coles and MLtd increasingly originated significantly larger, but fewer, loans, which concentrated MLtd's loan portfolio and magnified the effects of deteriorating market conditions (¶9);
- Beginning around December 2006, Coles and MLtd became aware that some borrowers were at risk of becoming delinquent but Coles instructed MLS's sales agents to promise key aspects of the investments to induce individuals to invest. In addition, Coles sent investors newsletters containing misrepresentations concerning the safety of investments, the performance of the loan portfolio, and strength of MLtd (¶¶10, 13);
- MLtd virtually stopped originating loans by the summer of 2007 but MLtd and MLS did not stop soliciting investors (¶11);
- Conditions worsened in 2008. From January through May 2008, MLtd's chief financial officer, at Coles' direction, called Radical Bunny daily to seek funding from it and used these funds to meet MLtd's delayed funding obligations (a portion of

[14] Both the Draft Order and the Final Order state that MLS was required to pay disgorgement of the exact amount of the placement fees paid by MLtd between January 2007 and June 2008. No payment was ultimately required due to financial statements filed with the SEC.

which went to the impound account to pay investors). Still, MLtd continued to solicit and accept new investment capital until Coles' death in June 2008 (¶12);

- MLS misrepresented the performance of the MLtd loans and made misleading statements regarding loan performance, which led investors to think that their investments were safe (¶¶13, 15, 16, 17, 18, 19, 20, 22); and
- Coles and MLtd sought to maintain the illusion that the loans were current and used the impound accounts to mask nonperforming loans by making interest payments from the impound account (¶11).

Both the Draft Order and the Final Order note that in its Offer of Settlement, MLS did not admit or deny the findings. Additionally, both the Draft Order and the Final Order found that MLS willfully violated Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and Section 15(c) of the Exchange Act. (¶¶ 28, 29).[15]

SECTION II - REPRESENTATIONS AND ASSUMPTIONS

Mark Winkleman, Chief Operating Officer of ML Manager LLC, has reviewed this Opinion and has represented that to the best of his knowledge:

1. Section I of this Opinion accurately describes the assertions, allegations and statements contained in the newspaper article, Notice, Draft Order and Final Order referred to therein (but without any representation as to the truth, accuracy or completeness of such assertions, allegations and statements);

2. The facts set forth in Section I of this Opinion, exclusive of the assertions, allegations and statements referred to in clause (1) above, are true, accurate and complete; and

3. The contents of a draft of the United States Securities and Exchange Commission ("SEC") Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Revoking Broker-Dealer Registration as to Mortgages Ltd. Securities, LLC became known in August 2009 when that draft was circulated beyond the SEC and Mortgages Ltd. Securities LLC.

The following Assumptions have been made by PwC and form a material part of this Opinion. If any Assumption is incorrect, in whole or in part, the conclusions reached in this Opinion may be adversely affected.

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[15] Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase, offer, or sale of securities.

1. All persons wishing to avail themselves of the safe harbor relief provisions of Rev. Proc. 2009-20 and Rev. Proc. 2011-58 are "U.S. Persons" as defined in Section 7701(a)(30).

2. No investor had a purpose, in entering the investment program of Mr. Coles, to evade or avoid Federal income taxes.

3. No such person had actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public.

4. Each such person, directly, indirectly, or is deemed to have[16] transferred cash or property to Coles, MLtd, or MLS.

5. Such person will claim only the amount of the loss as specified in Rev. Proc. 2009-20, § 5.02.

6. Such person will follow the procedures for making the claim as specified in Rev. Proc. 2009-20, § 6.

7. The pooled funds were all established in the State of Arizona.

If these assumptions are incorrect, in whole or in part, it may impact our Opinion.

SECTION III - ISSUES PRESENTED

1. Whether the losses incurred as a result of the investments in the MLtd Investment Arrangement qualify for treatment as provided by Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, except for the requirement set forth in Rev. Proc. 2009-20, section 6.01(3) with respect to the timing of the claim?

2. What the "discovery year" of such loss is as provided in Rev. Proc.2011-58, for which the loss may be claimed?

[16] This includes the investment in cash or property of investors, who later (but before the public was generally aware of the fraudulent arrangement) contributed their investment interest to another entity, who held that interest at the time the fraudulent arrangement was uncovered.

SECTION IV - OPINION

Based upon the Facts and Representations and Assumptions set forth in Sections I and II, and the analysis set forth in Section V, and subject to the qualifications and limitations set forth in Section VI, PricewaterhouseCoopers is of the Opinion that it is more likely than not[17] that a neutral fact finder would determine that the losses incurred by the pooled funds as a result of the investments in the MLtd Investment Arrangements qualify for treatment as provided by Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, except for the requirements set forth in Rev. Proc. 2009-20, section 6.01(3) with respect to the timing of the claim.

Additionally, based upon the Facts and Representations and Assumptions set forth in Sections I and II, and the analysis set forth in Section V, and subject to the qualifications and limitations set forth in Section VI, PricewaterhouseCoopers is of the Opinion that it is more likely than not that a neutral finder would determine that pursuant to Rev. Proc. 2011-58, Section 4.02, which modified Section 4.04 of Rev. Proc. 2009-20, the discovery year of such loss incurred by the pooled funds as a result of the investment in the MLtd Investment Arrangements would be the tax year ended December 31, 2009. Consistent with our Opinion, if the losses are claimed with respect to that year, they are more likely than not allowable.

SECTION V - ANALYSIS

A. <u>General Law</u>

1. Federal Statutory and Regulatory Background

Section 165(a) permits a deduction for uncompensated losses, including theft losses, sustained during a taxable year. In the case of individuals, section 165(c) limits the amount of the loss depending upon whether the loss was incurred in a trade or business, was incurred from a transaction entered into for profit, but not connected with a trade or business, or was a loss on property not connected with a trade or business or a transaction entered into for profit. In the case of a theft loss, pursuant to section 165(e), the permitted deduction is for the taxable year in which the taxpayer discovers the theft loss.

[17] In arriving at a level of opinion confidence, all authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account. The weight of authorities is determined in light of the pertinent facts and circumstances. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. By opining that a position is "more likely than not", we are concluding that it is more likely than not that the position will prevail if challenged, that is, there is a greater likelihood that the position will be sustained than it is that it will not be sustained.

Treas. Reg. § 1.165-8(d) defines the term "theft" to include, but not be limited to, larceny, embezzlement, and robbery. Whether a loss is due to "theft" is generally determined with respect to the applicable state law.[18] Moreover, a conviction for theft is not required to conclusively establish the existence of theft under Section 165(e).[19]

Where a theft occurs, Treas. Reg. § 1.165-8(a)(1) allows a deduction for a theft loss for the year in which the loss is sustained. In turn, Treas. Reg. § 1.165-8(a)(2) provides:

> A loss arising from theft shall be treated under section 165(a) as sustained during the taxable year in which the taxpayer discovers the loss. See section 165(e). Thus, a theft loss is not deductible under section 165(a) for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss. However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, see paragraph (d) of section 1.165-1.

Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances.[20]

Finally, Treas. Reg. § 1.165-8(c) provides that the amount of a theft loss "shall be determined consistently with the manner prescribed in section 1.165-7" for determining an allowable casualty loss but that in applying the provisions of Treas. Reg. § 1.165-7(b), "the fair market value of the property immediately after the theft shall be considered to be zero."

Thus, to sustain a theft loss deduction, the taxpayer bears the burden of proving (1) the loss is due to theft, (2) the allowable amount of the loss, and (3) the taxable year the theft loss is discovered.

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[18] *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956); *Viehweg v. Commissioner*, 90 T.C. 1248, 1253 (1988); *Luman v. Commissioner*, 79 T.C. 846, 860 (1982); *Bellis v. Commissioner*, 540 F.2d. 448, 449, (9th Cir. 1976); *Monteleone v. Commissioner*, 34 T.C. 688, 692 (1960). *See also*, Rev. Proc. 2009-20, § 4.02; Rev. Rul. 72-112, 1972-1 C.B. 60 (Jan. 1, 1972).

[19] *Schroerlucke v. United States*, 100 Fed. Cl. 584 (2011). *See also*, *Vietzke v. Commissioner*, 37 T.C. 504, 510 (1961); Rev. Rul. 72-112 (taxpayer need only prove that loss resulted from a taking of property that is illegal under the law of the state where it occurred and the taking was done with criminal intent).

[20] Treas. Reg. § 1.165-1(d). *See, e.g., United States v. S.S. White Dental Mfg Co.*, 274 U.S. 398 (1927); *Halliburton Co. v. Commissioner*, 93 T.C. 758, 775 (1989), *aff'd*, 946 F.2d 395 (5th Cir. 1991); *Ramsay Scarlett and Co., Inc. v. Commissioner*, 61 T.C. 795 (1974), *aff'd*, 521 F.2d 786 (4th Cir. 1975). *See also*, Rev. Rul. 2009-9, 2009-14 I.R.B. 735 (April 6, 2009).

2. State Statutory Background

Title 13, section 1802 of the Arizona Revised Statute ("A.R.S.") defines theft under Arizona law stating, in relevant part:

> A person commits theft if, without lawful authority, the person knowingly:
>
> 1) controls property of another with the intent to deprive the other person of such property; or
>
> 2) converts for an unauthorized term or use services or property of another entrusted to the defendant or placed in the defendant's possession for a limited, authorized term or use; or
>
> 3) obtains services or property of another by means of any material misrepresentation with intent to deprive the other person of such property or services.

3. Other Federal Guidance

a. Revenue Procedure 2009-20[21]

Based on practical difficulties associated with making determinations associated with theft losses in Ponzi type investment structures, the Service released Rev. Proc. 2009-20, which provides an optional safe harbor under which investors could treat a loss as a theft loss provided certain conditions were met. The release of Rev. Proc. 2009-20 provides an avenue of relief that promoted uniformity and alleviated administrative and compliance burdens.

Under Rev. Proc. 2009-20, for taxpayers to avail themselves of the optional safe harbor, they must be a "qualified investor" that follows the process and claims a theft loss for only the amounts specified in Rev. Proc. 2009-20.[22] A "qualified investor" is defined in Section 4.03 as a U.S. person:

(1) that generally qualifies to deduct a theft loss,

(2) that did not have actual knowledge of the fraudulent nature of the investment prior to it becoming generally known to the public,

(3) that transferred cash or property to a "specified fraudulent arrangement", and

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[21] Rev. Proc. 2009-20, 2009-14 I.R.B. 749 (March 13, 2009).

[22] *Id.* at §§ 2.04 and 3.

(4) that such "specified fraudulent arrangement" is not a tax shelter as defined in §6662(d)(2)(C)(ii).

Section 4.01, in turn, defines a "specified fraudulent arrangement" as an 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 arrangement; and appropriates some or all of the investors' cash or property.

If the taxpayer is a "qualified investor" under these provisions, the IRS will not challenge a "qualified loss" if the revenue procedure is followed.[23] Section 4.02 defines a "qualified loss" as a loss arising out of the specified fraudulent arrangement in which, as a result of the conduct that caused the loss:

(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 § 165 of the Internal Revenue Code and § 1.165-8(d) of the Income Tax Regulations, 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 section 4.02(1) of this revenue procedure, 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[24].

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[23] *Id.* at § 5.01.

[24] Rev. Proc. 2009-20 does not define what constitutes a freezing of the assets of the arrangement. The dictionary defines a frozen asset as one that is "difficult to convert into cash because of court order or other legal process." Black's Law Dictionary (9th ed. 2009). Under this definition, when the assets of MLtd. came under the control of the Bankruptcy Court and became the property of the bankruptcy estate, MLtd's assets effectively were frozen as to the specified fraudulent arrangement.

A "qualified loss" is allowable in the taxpayer's "discovery year."[25] Section 4.04 defines the "discovery year" as the taxable year of the investor in which the indictment, information, or complaint described in section 4.02 of Rev. Proc. 2009-20 is filed.

Finally, the amount which is allowable is 95 percent of the "qualified investment" if the qualified investor does not pursue any potential third-party recovery, or 75 percent of the qualified investment if the qualified investor pursues third-party recovery.[26] The revenue procedure also states the process and disclosures necessary for the qualified investor to avail himself of the safe harbor, including the attachment of a statement (Appendix A to Revenue Procedure 2009-20) to the qualified investor's timely filed income tax return for the discovery year.[27]

b. Revenue Procedure 2011-58[28]

After learning that certain investors were not eligible for the safe harbor of Rev. Proc. 2009-20 because the lead figure died prior to being charged by the authorities, the IRS released Rev. Proc. 2011-58 which modified Rev. Proc. 2009-20 in two important ways.

First, Rev. Proc. 2011-58, section 4.01 modifies Rev. Proc. 2009-20, section 4.02 to add section 4.02(3), which provides that a "qualified loss" can also include a loss resulting from a specified fraudulent arrangement in which, as a result of the conduct that caused the loss, a lead figure involved in the specified fraudulent arrangement

> was the subject of one or more civil complaints (see, for example, Fed. R. Civ. P. 3, 7) or similar documents (such as a notice or order instituting administrative proceedings or other document the Internal Revenue Service designates) that a state or federal governmental entity filed with a court or an administrative agency enforcement proceeding, and
>
> (a) The civil complaint or similar document together allege facts that comprise substantially all of the elements of a specified fraudulent arrangement, as described in section 4.01 of this revenue procedure, conducted by the lead figure;

[25] *Id.* at § 5.01(2).

[26] *Id.* at § 5.02.

[27] *Id.* at § 6.01(3). The issue with respect to whether a claim can be made on an amended return, and not a timely filed return, is not a part of this limited opinion, but is the subject of a memorandum to be issued by PricewaterhouseCoopers.

[28] Rev. Proc. 2011-58, 2011-50 I.R.B. 849 (November 28, 2011).

(b) The death of the lead figure precludes a charge by indictment, information, or criminal complaint against the lead figure . . .; and

(c) A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

Second, Rev. Proc. 2011-58, section 4.02 modifies Rev. Proc. 2009-20, section 4.04, with respect to the discovery year to read as follows:

A qualified investor's discovery year is the investor's taxable year in which--

(1) The indictment, information, or complaint described in section 4.02(1) or (2) of this revenue procedure is filed; or

(2) The complaint or similar document described in section 4.02(3) of this revenue procedure is filed, or the death of the lead figure occurs, whichever is later.

Except with respect to these two matters, Revenue Procedure 2009-20 was not further modified. However, by the time of the issuance of Revenue Procedure 2011-58, it was not possible to comply with the timing requirement of Rev. Proc. 2009-20, § 6.01(3).[29]

B. Do Investor Losses in the MLtd Investment Arrangements Qualify for Treatment Under Rev. Proc. 2009-20, as Modified by Rev. Proc. 2011-58?

As indicated above in the discussion of the general requirements for relief under the safe harbor provided by Rev. Proc. 2009-20, there are numerous requirements for qualification under that safe harbor. A number of these are investor specific and are thus beyond the limited scope of this Opinion. Those elements of relief, whether factually based upon the circumstances of the investor, or future necessary actions (such as making an adequate claim) have been assumed for purposes of this Opinion. Therefore, for completeness, the following is an aggregation of the elements for a successful claim under Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, the order rearranged to be more or less chronological or logical:

(1) The investment involved a "specified fraudulent arrangement."

(2) A "qualified investor" is a U.S. person.

[29] *See* fn. 16, *supra*.

(3) The qualified investor generally qualifies to deduct a theft loss.

(4) The qualified investor did not have actual knowledge of the fraudulent nature of the investment prior to it becoming generally known to the public.

(5) With respect to the investor, the investment was not a tax shelter as defined in section 6662(d)(2)(C)(ii).

(6) The qualified investor transferred cash or property to the specified fraudulent arrangement.

(7) The loss constituted a "qualified loss."

(8) The investor will claim only the amount of the loss as specified in Rev. Proc. 2009-20, § 5.02.

(9) The investor will follow the procedures for making the claim as specified in Rev. Proc. 2009-20, § 6.01.

These elements will each be discussed in order.

1. The investment involved a "specified fraudulent arrangement."

Rev. Proc. 2009-20, § 4.01 provides the definition of specified fraudulent arrangement for purposes of qualification for the safe harbor. That definition specifies an arrangement in which (1) one party receives cash from investors, (2) purports to earn income for the investors, (3) reports income amounts to the investors which are partially or wholly fictitious, (4) makes payments, if any, of income to some investors from amounts that other investors invested, and (5) appropriates some or all of the investors' cash or property. Rev. Proc. 2009-20 also provides that the arrangement described in Rev. Rul. 2009-9[30] is a specified fraudulent arrangement. The arrangement described in Rev. Rul. 2009-9 seems to contain the same five elements described above. Both Rev. Proc. 2009-20 and Rev. Rul. 2009-9 describe the arrangements as a "Ponzi Scheme" but there is no further criteria necessary in such description other than listed above.[31]

[30] Rev. Rul. 2009-9, 2009-14 I.R.B. 735. This ruling was issued simultaneously with Rev. Proc. 2009-20.

[31] The SEC describes a "Ponzi Scheme" as follows: "A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors and to use for personal expenses, instead of engaging in any legitimate investment activity." *See* SEC Website, Ponzi Schemes - Frequently Asked Questions at http://www.sec.gov/answers/ponzi.htm.

The activities of the Coles' Entities, as alleged by the ADFI and the SEC contained substantially all the elements of the specified fraudulent arrangement. The documents filed in the bankruptcy proceeding and facts alleged in subsequent civil suits are consistent with the facts alleged by the ADFI and SEC.

(a) Receiving cash from investors.

Scott M. Coles owned and operated MLtd. MLS, an Arizona limited liability company that was a broker-dealer registered with the SEC, also was an entity controlled by Coles. Between 2004 and June 2008, MLS raised approximately $741 million from approximately 2,700 investors through the offer and sale of securities issued by MLtd. Investors had the option to either invest in specific loans (pass-through investors) or in one of several funds (pooled fund investors) that purchased various loans or portions of loans originated by MLtd. As a result, individuals could be pass-through investors in the MLtd Investment Arrangements, pooled fund investors in the MLtd Investment Arrangements, or both. Thus, the MLtd Investment Arrangements received cash from investors.

(b) Purports to earn income for investors.

Not all of the activities of the MLtd Investment Arrangements were fraudulent, at least not initially. As described by the prospectuses, and we believe followed in practice initially, the funds obtained from the investors were aggregated to provide loans primarily to the Arizona real estate development industry. Thus, MLtd maintained an inventory of high interest, short-term loans it made to real estate developers which MLtd securitized and sold through eleven private placement offerings made through MLS. The MLtd Investment Arrangements loaned money to the developers, and contracted to provide further loans to the developers, in order to buy, improve, and construct buildings and other real estate projects.

However, not all the money obtained from investors was directed to the loans to be made to the developers. When investor money was received, MLtd typically created an

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The name of this scheme arose from Charles Ponzi, who duped thousands of New England residents into investing in a postage stamp speculation scheme back in the 1920s. At a time when the annual interest rate for bank accounts was five percent, Ponzi promised investors that he could provide a 50% return in just 90 days. Ponzi initially bought a small number of international mail coupons in support of his scheme, but quickly switched to using incoming funds to pay off earlier investors. *Id.*

An article says an investor suit brought against MLtd's law firm described the Coles' arrangement as a typical Ponzi Scheme. Beck, Susan, Ponzi Investor Suit Targets Greenberg Traurig, Quarles & Brady, May 12, 2010 at http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202458107106&Ponzi_Investor_Suit.

"impound account" that would take a portion of the loan amount, set it aside, and use those funds to make periodic interest payments to the investors during the term of the investment.

To the extent that income was earned on such investments and loans, it appears that Coles initially reported income to the investors. However, as time went on, a number of the development projects failed and stopped producing income. Beginning around December 2006, Coles and MLtd became aware that some borrowers were at risk of becoming delinquent but Coles instructed MLS's sales agents to promise key aspects of the investments to induce individuals to invest. In addition, Coles sent investors newsletters containing misrepresentations concerning the safety of investments, the performance of the loan portfolio, and strength of MLtd. Coles and MLtd sought to maintain the illusion that the loans were current and used the impound accounts to mask nonperforming loans by making interest payments from the impound account.

Thus, at some point in the process, Coles and MLtd purported to be earning income for the investors, only some of which was accurate.

(c) Reports income amounts which are partially or wholly fictitious.

As the MLtd Investment Arrangements were failing, Coles and MLtd sought to maintain the illusion that the loans were current and used the impound accounts to mask nonperforming loans by making interest payments from the impound account. Thus, Coles and MLtd purported to be earning income for investors from the investments, but some of those earnings were fictitious. The ADFI Notice states that MLtd "made a false promise or misrepresentations or concealed an essential or material fact in the course of the mortgage banking business." In reaching this determination, the ADFI Notice alleges that MLtd. misrepresented its true financial condition. The ADFI Notice also states that MLtd failed to keep "correct and complete records clearly reflecting the financial condition" of MLtd. Finally, the ADFI Notice alleges that because of MLtd's failure to record certain reserves, MLtd's reported financial statements did not accurately reflect the financial condition of the business.

(d) Makes payments, if any, of income to some investors from amounts that other investors invested.

As described in the SEC Draft Order, MLtd virtually stopped originating loans by the summer of 2007 but MLtd and MLS did not stop soliciting investors. Instead, the MLtd Investment Arrangements continued to seek capital investment until Coles' death in 2008. MLtd used the proceeds from investors to pay "earnings" of the old investors. In addition, Coles and MLtd used the impound accounts to mask nonperforming loans by making interest payments from the impound account. In essence, these were not earnings but return of original investments masked as earnings.

(e) <u>Appropriates some or all of the investors' cash or property.</u>

Documents introduced in the bankruptcy proceeding demonstrate that monies were regularly exchanged between MLtd and other entities owned and controlled by Coles. For example, the Statement of Financial Affairs filed by MLtd with the Bankruptcy Court on July 18, 2008, documents numerous monetary transactions between MLtd and the SMC Revocable Trust or SM Coles LLC, which suggest that Coles used funds of MLtd as his own.[32] That Statement also documents MLtd distributions to the SMC Revocable Trust in the year immediately preceding the bankruptcy of $13,732,701.[33]

Coles lived a publically lavish lifestyle. As noted in local newspaper account published a month after Coles' suicide:

> Coles' stated income in 2003 was $240,000, according to records filed in divorce court. Just three years later, he had spent more than $50 million on mansions and other properties, friends say. Records show Coles bought homes in Aspen, Coronado, Las Vegas, and the Biltmore neighborhood in Phoenix, totaling $35 million. He also bought five condos, for about $1 million each, in the Esplanade high-rise. Coles also paid millions to have his Rockridge mansion completely remodeled and to have a neighboring mansion demolished to make way for his golf course.
>
> A collection of exotic cars, including a Bentley, Maserati, Porsche, and classic Mercedes, also grew during Coles' final years, as did his use of a private jet and the hiring of salaried personal employees, including around-the-clock security, more than a dozen groundskeepers, two housekeepers, a personal assistant, and an executive assistant.
>
> . . .
>
> Even as Coles struggled to fund loans and find investors to keep his machine running, he maintained his lavish lifestyle. In July 2007, he purchased more than $31 million in real estate from Michael Peloquin — even though Peloquin owed Mortgages Ltd. and its investors more than $70 million.

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[32] See *In Re Mortgages Ltd.*, No. 2:08-bk-7465 (Bankr. Ariz.).

[33] *Id.*

County records show that acquisition included a $10.1 million Biltmore mansion next door to another $11.3 million mansion Coles purchased (both are separate from Rockridge Estates).[34]

While the facts alleged by the ADFI and SEC do not explain how all these funds were taken by Coles, they do state that MLtd paid MLS placement fees of approximately $7 million between January 2007 and June 2008 and there were loans of at least $6 million from MLtd to the SMC Revocable Trust, and that MLtd guaranteed a $12 million loan taken out by SM Coles LLC. Thus, we conclude that Coles appropriated some of the investors' cash or property.

f. Specified Fraudulent Arrangement Conclusion

Based on the foregoing analysis, we conclude that the activities of the MLtd Investment Arrangements satisfy, in all respects, the definition of a specified fraudulent arrangement.

Introduction - Who is the "qualified investor".

A "qualified investor" is a key term in the determination of qualification to use Rev. Proc. 2009-20 because only a "qualified investor" can claim the benefits of the safe harbor set forth in the procedure. See Section 5.01: "If a *qualified investor* follows the procedures described in section 6 of this revenue procedure, the Service will not challenge the following treatment by the *qualified investor*...." [emphasis supplied]. The definition of a "qualified investor" is detailed and the next five criteria involve the meeting of that definition. Thus, it is critical to determine *who* is considered a potential "qualified investor" in the MLtd Investment Arrangements.

As described above, 2,700 investors initially invested in the MLtd Investment Arrangements through the offer and sale of securities issued by MLtd. The investors had the option to either invest in specific loans (pass-through investors) or in one of several funds (pooled fund investors) that purchased various loans or portions of loans originated by MLtd. Thus, investors were both pass-through investors and pooled fund investors in MLtd Investment Arrangements. However, as detailed in the second portion of the analysis, prior to the discovery of the theft under Arizona law, on June 20, 2008, an involuntary petition for relief was filed against MLtd under the Bankruptcy Code and on June 24, 2008, the U.S. Bankruptcy Court for the District of Arizona entered an order converting the case from a Chapter 7 case to a case under Chapter 11 of the Bankruptcy Code. The Plan of

[34] *See* Dickerson, John, Scott Coles, the millionaire owner of Mortgages Ltd., leaves behind broke investors, unbuilt buildings and lot of unanswered questions, Sept. 18, 2008 at http://www.phoenixnewtimes.com/content/printVersion/843956.

Reorganization that was confirmed by the Bankruptcy Court created a liquidating trust and the Bankruptcy Court appointed a liquidating trustee with respect to the assets of MLtd.

MLtd's assets, including the assets owned directly by the pass-through investors were placed under the control of the Bankruptcy Court beginning June 20, 2008. As part of the Plan of Reorganization approved by the Bankruptcy Court on May 20, 2009, some investors' creditor claims, including all of the pooled fund claims, and many of the pass-through investors were exchanged for membership interests in the Loan LLCs, which then held interests in the MLtd loans.[35] Thus, at the time of the discovery of the theft by Coles, many of the interests in loans were owned by the Loans LLCs and not the original investors (or pooled funds). Therefore, a question arises whether the original investors or the Loan LLCs, who may have held the interests at the time of discovery of the theft, are to be examined under the revenue procedure for qualification as "qualified investors."

It is our belief, based upon the rules of theft losses, and the language and purpose of the revenue procedures that a "qualified investor" is intended to describe the original investors, before any transfers required or permitted by a Bankruptcy Order. Thus, the Loan LLCs, which were created under the jurisdiction of the Bankruptcy Court in order to obtain the greatest value from, and then liquidate the underlying assets, are not to be considered "investors" for this purpose. Therefore, despite the fact that the Loan LLCs may have held most of the underlying interests in what remained of the fraudulent arrangement at the time that theft became known, it is the original investors, i.e., the pooled funds, and the pass-through investors, that are to be tested as qualified investors. If so qualified, the original investors (that is, the persons who held the interest immediately before the creation of the bankruptcy estate) are the persons or entities that may be entitled to claim the theft losses under the revenue procedure.

First, the revenue procedures contemplate and to some extent require the existence of transferees such as the Loan LLCs, and the procedures treat those transferees incompatibly with the concept of investors. Section 4.02(b) of Rev. Proc. 2009-20, both before and after modification by Rev. Proc. 2011-58, requires, as part of the definition of "Qualified Loss" (with respect to the indicted lead figures), that a receiver or trustee be appointed with respect to the fraudulent arrangement's assets. As modified by Rev. Proc. 2011-58, § 4.01, an identical provision now in § 4.02(3) provides likewise with respect to unindicted but

[35] As part of the First Amended Plan of Reorganization, the pass-through investors, who held fractional interests in underlying real property or mortgages had the option of continuing to hold their interests in ML Notes and Deeds of Trust or to transfer those interests into the Loan LLCs. The Bankruptcy Order permitting the pass-through investors time to extend the period to transfer their interest into the Loan LLCs was successively ordered September 18, October 14, and November 2, 2009. We assume that many pass-through investors made those transfers sometime between August and November 2009. Some, however, continued to hold their fractional interests directly.

deceased lead figures. If entities established under the authority of bankruptcy trustees or managers could be investors displacing the original investors for theft law purposes, the revenue procedures would not serve the purposes for which they were created. Both procedures were designed to provide efficient administrative relief to those who were victimized, not for entities that were created to satisfy claims and liquidate the remaining investments of the fraudulent arrangement. In no event can these bankruptcy liquidation entities be considered investors or victims of the scheme because these entities did not exist at the time the theft occurred and, therefore, are not the victim of that theft.

The original investors did not create the Loan LLCs as a vehicle to hold their investment in the MLtd Investment Arrangements. That is, unlike the pooled funds, which were voluntarily chosen by the investors to hold the interests in the arrangement, the Loan LLCs were created by the Plan of Reorganization approved by the Bankruptcy Court to manage the liquidation of the remaining assets and satisfy debts to the extent possible. Thus, the Court approved and authorized the creation of the Loan LLCs for these purposes and directed that the pooled funds' (described as MP Funds) interests be transferred to the Loan LLCs. As provided by the Court's Order Confirming Investors Committee's First Amended Plan of Reorganization Dated March 12, 2009[36]:

> The Court finds that the transfer of the MP Fund fractional interests in the ML Loan Documents, including the ML Notes and ML Deeds of Trust, to the applicable Loan LLCs is not a change in business purpose under the MP Fund operating agreements and does not require any further vote of the MP Fund Investors in any MP Fund. The Court further finds that, among other things, based upon the balloting of the MP Fund Investors as reflected in the Ballot Report and based upon the terms of the Plan, the Debtor will be replaced as the manager of each of the MP Funds on the effective date and ML Manager LLC shall be deemed to be the new manager of each MP Fund. The Court finds that the MP Funds may transfer such fractional interests to the applicable Loan LLC.[37]

In addition, the Bankruptcy Court's Order Confirming Investors Committee's First Amended Plan of Reorganization Dated March 12, 2009 states:

> Pursuant to the Plan, from and after the Effective Date, the Liquidating Trustee, as to the Causes of Actions and Avoidance Actions relating to the Liquidating Trust, and the ML Manager LLC and/or Loan LLCs, as to the Causes of Action and Avoidance Actions relating to the Loan LLCs and/or ML Manager LLC and the ML Notes and ML Loan Documents, *shall be the successor of and the representative of the Estate*...

[36] United States Bankruptcy Court of the District of Arizona, case No. 2:08-bk-07465-RJH, In Re Mortgages Ltd, Debtor, Order dated May 20, 2009.

[37] *Id.* at ¶ 21. See also ¶ G.

Such Causes of Action and Avoidance Actions shall vest in the Liquidating Trust, or as applicable the ML Manager LLC and/or Loan LLCs, as the *successor and the representative of the Estate.*[38]

Based on these items, the transfers to the Loan LLCs were clearly designed to be part of the bankruptcy liquidation. Therefore, the Loan LLCs were intended to be successors to MLtd's assets in order to liquidate them for the benefit of the investors. Despite the treatment of the investors as "members" for purposes of distributions and other matters, the Loan LLCs were not intended to be successors of the investors for tax purposes, and should not be treated as investors themselves for such purpose.

Further, like the bankruptcy documents, Rev. Proc. 2009-20 treats the entities created by the bankruptcy estate as succeeding to, and therefore aligned as part of, the fraudulent arrangement itself. Rev. Proc. 2009-20 defines a "Responsible Group" for purposes of describing the entities and persons which are part of the fraudulent arrangement of the lead figure for purposes of the "Qualified Investment" which can be deducted under this relief.[39] Thus, Responsible Group is defined as including "[a] liquidation, receivership, bankruptcy or similar estates established with respect to individuals or entities who conducted the specified fraudulent arrangement, in order to recover assets for the benefit of investors or creditors."[40] Given that the purpose of the revenue procedure was to benefit the victims of theft, and the requirement that the investor benefitting from the safe harbor be the person who made the transfer to the fraudulent arrangement,[41] treatment of the bankruptcy-created holder of the interests as the "qualified investor" should not be possible. In no event would the recipient of the interests (i.e., the Loan LLCs in this case) be the transferor of money or property to the fraudulent arrangement that could appropriately be treated as a qualified investor. Thus, the revenue procedure logically contemplated that it would be the original investors, not any entity formed as part of the bankruptcy, that would be a qualified investor.

Further, the revenue procedure cannot be taken as changing the party entitled to theft losses. The procedure is clear as to what traditional element of the theft loss deduction it intended to change, i.e., to provide uniform treatment for determining the losses of the investors, and to avoid "difficult problems of proof in determining how much income

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[38] *Id,* at ¶ K.

[39] The procedure contemplates that persons or entities that conducted the fraudulent arrangement will come under the auspicious of the bankruptcy estate and trustees or receivers may undertake activities that may ultimately be deducted or offset against recoveries by the investors other than left losses. Thus, § 5.02(a) and (b) define such amounts as not recoverable under this safe harbor.

[40] Rev. Proc. 2009-20, § 4.05(3).

[41] See Rev. Proc. 2009-20, § 4.03(4) discussed *infra.*

reported in prior years was fictitious or a return of capital..."[42] Thus, only the amount of the loss to be claimed and the year such loss can be claimed were intended to be changed from prior theft loss rules. The person who should claim the loss was not purported to be changed, so the revenue procedure on this element must be interpreted in accordance with the ordinary rules of theft losses.

Under normal rules of claiming losses as provided by 165(a), it is the taxpayer who *sustained* the loss who deducts the loss.[43] This is not changed by section 165(e), which provides that "for purposes of subsection [165] (a), any loss arising from theft *shall be treated as sustained* during the taxable year in which the *taxpayer* discovers the loss." [emphasis added]. Thus, the taxpayer against whom the loss occurs, i.e., who sustained the loss, is the person who claims the deduction. Section 165(e) then *creates the fiction* that the taxpayer sustained the loss in the year it was discovered. The person who claims the loss is not changed, only the time for claiming the loss by that person is changed by the discovery rule.[44]

The case law also is consistent with this analysis. A theft loss deduction may be claimed only by the taxpayer who owned the property *at the time it was taken.*[45] Thus, as to who can claim the loss, the focus is on the action of the theft and not the action or time of discovery. In contrast, the timing of the loss is not determined by the action of theft but by discovery of the theft. A theft loss may be claimed only in the year in which it is discovered.[46] It is the owner of the interest at the time of the theft that claims the theft loss.[47] The focus is on the victim of the crime, not the holder of the property at the time of discovery who is entitled to claim the loss. Thus, in *River City Ranches No. 1, Ltd. v Commissioner,*[48] the Court held that a partnership could not take a theft loss deduction because the perpetrator of the fraud had made false representations to the partners to induce them to become partners; thus it was the partners who were entitled to claim the theft losses regardless that

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[42] Rev. Proc. 2009-20, § 2.04.

[43] Section 165(a).

[44] See Treas. Reg. § 1.165-8(a)(1) and (2) which is also consistent with this analysis.

[45] *Mannette v. Commissioner*, 69 T.C. 990, 994 (1978); *Rink v. Commissioner*, 51 T.C. 746, 753 (1969); *Jensen v. Commissioner*, T.C. Memo. 1979-379; *Kahl v. Commissioner*, T.C. Memo. 1986-240.

[46] Section 165(e); Treas. Reg. § 1.165-1(d)(1); *Asphalt Industries, Inc. v. Commissioner*, 411 F.2d 13 (3d Cir. 1969); *Marine v. Commissioner*, 92 T.C. 958 (1989).

[47] *See* e.g., *Grothes v. Commissioner*, T.C. Memo. 2002-287 (corporation and not shareholders was entitled to theft loss because the funds stolen were owned by the corporation, a separate legal entity *at the time of the embezzlement.* The fact that the economic loss fell upon the shareholders, who were required to later replace the property did not make them the persons to claim the theft loss.)

[48] T.C. Memo. 2003-150.

the money was taken from the partnership.[49] Under this analysis, the original investors, i.e., the pass-through investors and the pooled funds, would be entitled to claim the theft loss, not the Loan LLCs, as the Loan LLCs came into the existence only after the death of Coles, when presumably the thefts had ceased. Thus, the thefts would have occurred when the investments were held by the original investors.

We are aware of cases in which a successor to the original investor is entitled to claim the theft loss. However, these cases involve normal successors at law, such as estates following the death of the investor,[50] and those cases result from the estate taking all attributes from the decedent and continuing in his stead.[51] In contrast, although there are literally hundreds of reported tax cases as to theft losses resulting from securities or embezzlement fraud, many of which imply later transfers to liquidating trusts or other entities, we could find no suggestions that the transfers for collection made those entities the proper party for claiming the loss.

In this case, it was the original investors, i.e., the pass-through investors and the pooled funds, to whom the fraudulent statements were made and who held the investment when the theft occurred. Thus, it is they, and not the Loan LLCs that are the "qualified investors" that may be entitled to take the theft losses and avail themselves of the Rev. Proc. 2009-20 safe harbor.

2. A "qualified investor" is a U.S. person.

Rev. Proc. 2009-20, § 4.03 provides that the safe harbor only applies to investors who are United States persons as defined in section 7701(a)(30). In general terms, this means a citizen or resident of the United States, a domestic partnership, corporation, or estate, and any trust under the supervision of courts of the United States and with one or more trustees who themselves are United States persons.

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[49] The facts, as known, do not suggest that the pooled funds were themselves part of the fraudulent arrangement but rather that the pooled funds invested into the fraudulent arrangement when their money was invested into MLtd loans. If it subsequently is determined that the pooled funds were themselves part of the fraudulent arrangement, the pooled funds would not be "qualified investors" because they would have had actual knowledge of the fraudulent nature of the investment. See Rev. Proc. 2009-20, §4.03(2). In that case, it may be that the persons who invested into the Pooled Funds are the "qualified investors". Such a hypothetical is beyond the scope of this Opinion.

[50] *See e.g., Estate of Moragne v. Commissioner*, T.C. Memo. 2011-299 (Estate may take theft loss perpetrated against the decedent in an earlier year when the discovery of the theft is after the decedent's death and all other criteria are proven.)

[51] *See* Treas. Reg. § 1.165-8(b) which specifically permits an estate to claim a theft loss which occurred to the decedent.

The investors in the MLtd Investment Arrangements were numerous. Between 2004 and June 2008, MLS raised approximately $741 million from approximately 2,700 investors through the offer and sale of securities issued by MLtd. Investors had the option to either invest in specific loans (pass-through investors), or in one of several funds that purchased various loans or portions of loans originated by MLtd (pooled fund investors). Both the pass-through investors and the pooled funds originally were direct investors in the MLtd Investment Arrangements.

The pooled funds were all established in the State of Arizona and would thus be "U.S. Persons." We are not aware of citizenship or residency status of the 2,700 investors. It has been assumed that all of the investors wishing to avail themselves of the safe harbor relief provisions of Rev. Proc. 2009-20 and Rev. Proc. 2011-58 are U.S. persons. Accordingly, this Opinion would only be applicable to those who meet that assumption.

3. The qualified investor generally qualifies to deduct a theft loss.

Rev. Proc. 2009-20, § 4.03(1) provides that a qualified investor "generally qualify for a theft loss under section 165 and Treas. Reg. § 1.165-8." It is not clear what this requirement is intended to add to the other requirements already listed. If an arrangement satisfies the first criteria of a "specified fraudulent arrangement," as described in Rev. Rul. 2009-9, an investor in such arrangement would be entitled to claim a theft loss at some particular point in time under section 165 and Treas. Reg. 1.165-8. The definition of an otherwise "qualified investor" in the revenue procedure indicates the general requirements of section 165 and Treas. Reg. § 1.165-8 for an investment in such arrangement which has not been recovered. The requirement of a qualified investment in the revenue procedure also reiterates that requirement of an investment and provides a calculation for the amount of such loss, including amounts which cannot be considered part of the theft loss. The requirements that the investor being the target of the fraud and the theft occurring while the investor holds the investment, while not specifically identified in section 165 and Treas. Reg. § 1.165-8, are also satisfied by other required elements.

Finally, the last two typical requirements of a theft loss, i.e., the timing of the loss and the "completed transaction", that is no reasonable expectation of recovery by insurance or otherwise, are modified in major part by the revenue procedure itself and therefore would not need to be specifically proven to be entitled to the theft loss under the safe harbor. The timing is set forth in the definition of "discovery" discussed in detail below, and the "reasonable expectation of recovery" element is waived by the revenue procedure in exchange for a specified percentage of the amount of the loss to be claimed. See § 5.02. Thus, we see no other requirements in the Code and Treasury Regulations which would not be satisfied in the instant case. Therefore, we conclude that this element is satisfied.

4. The qualified investor did not have actual knowledge of the fraudulent nature of the investment prior to it becoming generally known to the public.

Rev. Proc. 2009-20, § 4.03(2) provides that the investor cannot have had knowledge of the fraudulent nature of the arrangement before the general public. This provision is obviously intended to prevent associates of the lead figure, or those who may have participated in the fraud from benefitting from the safe harbor provisions.

The theft by Coles was not known generally until after his death. While there may be investors who had greater knowledge than the general public, we have made the assumption that the investors did not have actual knowledge of the fraudulent nature of the investment prior to it becoming generally known to the public. Accordingly, this Opinion would only be applicable to those who meet that assumption.

5. The investment was not a tax shelter as defined in §6662(d)(2)(C)(ii).

Rev. Proc. 2009-20, § 4.03(2) provides the investment cannot have been a tax shelter as provided in section 6662(d)(2)(C)(ii). This section describes a tax shelter as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a *significant purpose* of the plan or arrangement was the *avoidance or evasion* of Federal income tax. In analyzing this factor, we take the investor's point of view in entering into the investment and thus look solely to the investor's purpose. See Rev. Rul. 2009-9, facts section. The fact that the promoter of the MLtd Investment Arrangements, Mr. Coles, may have intended to defraud others, perhaps including the United States, is not material in this question.

We have made the assumption that no investor had a purpose, in entering the MLtd Investment Arrangements, to evade or avoid Federal income taxes. We have also reviewed the prospectuses for the programs and have seen no description of any intended benefits of the program that are directed at reducing or eliminating income taxes. We therefore conclude that there was no significant purpose of the MLtd Investment Arrangements to avoid or evade income taxes, and the investment is therefore not a tax shelter as defined in section 6662(d)(2)(C)(ii).

6. The qualified investor, or its predecessor, transferred cash or property to the specified fraudulent arrangement.

Rev. Proc. 2009-20, § 4.03(4) provides that the investor must have "transferred cash or property to the specified fraudulent arrangement." As we have established that the persons that are to be tested are the original investors, this criteria adds little to the equation in this case. All of the 2,700 original investors made transfers, some direct and some indirect, to the

fraudulent arrangement. However, this criteria is intended to draw a distinction between investors who directly invested in the fraudulent arrangement and investors who invested in the fraudulent arrangement through another entity, and to permit only the direct investors to be classified as "qualified investors". Thus, the subsequent sentence states "A qualified investor does not include a person that invested solely in a fund or other entity (separate from the investor for federal income tax purposes[52]) that invested in the fraudulent arrangement."

As applied to this case, those pass-through investors who owned fractional interests in the MLtd Investment Arrangements would be the "qualified investors" satisfying this requirement because they directly invested into the MLtd Notes or Deeds of Trust. Those investors that transmitted their funds to the pooled funds would <u>not</u> satisfy this requirement and would not be "qualified investors" themselves. Rather, the pooled funds themselves that further transmitted the investments to the fraudulent arrangement would satisfy this criteria and would be the qualified investors eligible to directly benefit from the safe harbor. Of course, as partnerships, those theft losses claimed by the pooled funds would be allocated to the partners via partnership allocations on Schedules K-1 so that the individual partners would ultimately receive the benefits of the theft losses.

7. The loss constituted a "qualified loss."

Rev. Proc. 2009-20, § 4.02(3), as modified by Rev. Proc. 2011-58, provides that a qualified loss is a loss arising from a specified fraudulent arrangement (as discussed above) in which the lead figure or associated entity was (1) the subject of one or more civil complaints or similar documents, (2) filed by an administrative agency enforcement proceeding, and in which (3) the civil complaint or similar documents allege facts comprising substantially all of the elements of a specified fraudulent arrangement (as discussed above), (4) the death of the lead figure precluded indictment, and (5) a receiver was appointed with respect to the arrangement or the assets of the arrangement were frozen.

The first three of these criteria are discussed at length below with respect to the determination as to the discovery year for the theft loss claim. Suffice it to say that these elements are established under the facts of this case. Likewise, the last two criteria are also established, i.e., on June 2, 2008, Coles committed suicide prior to any criminal investigation precluding an indictment for theft and on June 20, 2008, an involuntary petition for relief was filed against MLtd under the Bankruptcy Code and on June 24, 2008, the U.S. Bankruptcy

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[52] We believe that the "separate from the investor" language was inserted to respect the possibility that the individual could have invested through his disregarded entity, which would not be separate from the individual for income tax purposes, and therefore the individual would have been considered to make the transfer. At the same time, the individual who invested through a wholly owned corporation, which is a distinct separate entity, would not be a qualified investor because the corporation would be entitled to the theft loss. *See e.g.*, *Grothes v. Commissioner*, T.C. Memo. 2002-287.

Court for the District of Arizona entered an order converting the case from a Chapter 7 case to a case under Chapter 11 of the Bankruptcy Code. As a result of the bankruptcy, the assets of MLtd became property of the bankruptcy estate and were subject to Bankruptcy Court control and an automatic stay, as well as all other restrictions of the Bankruptcy Code. The Plan of Reorganization that was confirmed by the Bankruptcy Court created a liquidating trust and the Bankruptcy Court appointed a liquidating trustee with respect to the assets of MLtd. Thus, this process put the assets of MLtd under the control of a liquidating trustee and MLtd's assets effectively were frozen.[53] Therefore, we conclude that the loss of the qualified investors constitutes a "qualified loss" as provided by Rev. Proc. 2009-20, § 4.02(3).

8. **The investor will claim only the amount of the loss as specified in Rev. Proc. 2009-20, § 5.02.**

The amount of loss that can be claimed under the safe harbor is set forth in Rev. Proc. 2009-20, § 5.02. As the claim calculated under these provisions will be different for each qualified investor, no opinion can be provided here as to whether the amount for our particular investor is correct. Accordingly, this Opinion would only be applicable to those who meet that requirement.

9. **The investor will follow the procedures for making the claim as specified in Rev. Proc. 2009-20, § 6.01.**

The method in which the claim can be made is specified in Rev. Proc. 2009-20, § 6.01. Among other criteria is that the claim be identified as being made under Revenue Procedure 2009-20 at the top of Form 4684, and completion of the statement provided in Appendix A of the revenue procedure. We have assumed that the investors will follow the procedures outlined, except as noted below. Accordingly, this Opinion would only be applicable to those investors who meet that assumption.

However, one additional criteria for filing such claim is that a statement be filed with the "investor's timely filed (including extensions) federal income tax return for the discovery year." At the time of this writing, that date has long passed. Accordingly, no Opinion can be given with respect to that criteria.[54]

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[53] *See* Footnote 24, *supra.*

[54] However, that criteria is discussed and a recommendation made as to how to make the claims at this time in a memorandum to be issued after this Opinion.

C. What is the Discovery Year For Which The Losses May Be Claimed?

1. General Law

In general, Section 165 permits the deduction of a loss sustained during the taxable year so long as the taxpayer is not compensated for the loss either by insurance or some other means. With respect to theft losses, however, the loss is treated as being sustained in the year that the theft is discovered.[55] Moreover, a theft loss is not deductible in the year of discovery if in the year the loss is discovered there remains a reasonable prospect for recovery.[56] The standard for determining whether a reasonable prospect for recovery exists is an objective standard that must be made as of the close of the taxable year for which a deduction is claimed.[57]

Thus, the year a taxpayer may deduct a theft loss requires an inherently subjective factual inquiry to determine when the taxpayer discovered the theft loss and whether a reasonable prospect of recovery exists. Given the practical difficulties associated with making factual determinations associated with theft losses, in 2009, when the IRS became aware of fraudulent arrangements resulting in significant losses to many taxpayers, the IRS released Rev. Proc. 2009-20, which provided a safe harbor under which "qualified investors" could treat a loss as a deductible theft loss so long as certain objective conditions were met.

2. Rev. Proc. 2009-20 as modified by Rev. Proc. 2011-58

Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, provided that the "discovery year" is the qualified investor's taxable year in which:

(1) The indictment, information, or complaint described in section 4.02(1) or (2) of this revenue procedure is filed; or

(2) The complaint or similar document described in section 4.02(3) of this revenue procedure is filed, or the death of the lead figure occurs, whichever is later.

As discussed in Section B(2), *supra*, the pass-through investors and the pooled fund investors are qualified investors who suffered a qualified loss as the result of a specified

[55] Treas. Reg. § 1.165-8(a)(2). *See also Cramer v. Commissioner*, 55 T.C. 1125, 1134 (March 29, 1971) (loss is considered discovered when a reasonable man in similar circumstances would have realized the fact that he had suffered a theft loss).

[56] *Id. See also*, Treas. Reg. § 1.165-1; *United States v. S.S. White Dental Mfg Co.*, 274 U.S. 398 (1927); *Halliburton Co. v. Commissioner*, 93 T.C. 758, 775 (1989), *aff'd*, 946 F.2d 395 (5th Cir. 1991); *Ramsay Scarlett and Co., Inc. v. Commissioner*, 61 T.C. 795 (1974), *aff'd*, 521 F.2d 786 (4th Cir. 1975). *See also*, Rev. Rul. 2009-9, 2009-14 I.R.B. 735 (April 6, 2009).

[57] *See, e.g., Halliburton*, 93 T.C. at 777; *Ramsay Scarlett*, 93 T.C. at 811-812.

fraudulent arrangement at the hands of Coles. On June 2, 2008, prior to the actions of Coles coming to light, Coles committed suicide.

Because Coles died prior to being the subject of an indictment, information, or complaint described in section 4.02(1) or (2) of Rev. Proc. 2009-20, the discovery year is the qualified investor's taxable year in which a complaint or similar document described in section 4.02(3) of Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, is filed.

Section 4.02(3) of Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, provides that the lead figure or an associated entity involved in the specified fraudulent arrangement was the subject of one or more civil complaints or similar documents that a state or federal governmental entity filed with a court or in an administrative agency enforcement proceeding and

(a) The civil complaint or similar document together allege facts that comprise substantially all of the elements of a specified fraudulent arrangement, as described in section 4.01 of this revenue procedure, conducted by the lead figure;[58]

(b) The death of the lead figure precludes a charge by indictment, information, or criminal complaint against the lead figure as described in section 4.02(1) or (2) of this revenue procedure; and

(c) A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

As discussed below, the facts demonstrate that these three criteria have been met by 2009.

(a) <u>Complaint or Similar Document</u>

We note that the phrase "administrative agency enforcement proceeding" is an undefined phrase in Rev. Proc. 2011-58. That phrase is similarly undefined in the Code, Treasury Regulations, or other IRS guidance. Where an undefined term must be construed, it

[58] As discussed, *supra*, Rev. Proc. 2009-20, section 4.01 defines a "specified fraudulent arrangement" as an 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 arrangement; and appropriates some or all of the investors' cash or property.

[59] *See Fed. Deposit Ins. Corp. v. Meyer*, 510 U.S. 471, 476 (1994); *Smith v. United States*, 508 U.S. 223, 228, (1993); *United States v. Moses*, 137 F.3d 894, 899 (6th Cir. 1998).

generally should be given its ordinary and natural meaning.[59] Additionally, in determining the meaning of an undefined term, the maxim of *noscitur a sociis*—it is known from its associates—directs us to look to accompanying words to deduce the undefined word's meaning.[60] While section 7430(c)(5) defines an "administrative proceeding" to mean any procedure or other action before the IRS, by its terms, Rev. Proc. 2011-58 encompasses more than proceedings before the IRS. We, therefore, conclude that it is reasonable to read the undefined phrase as being consistent with Administrative Procedure Act ("APA")[61] or similar state statute (i.e., statutes that govern administrative proceedings). The APA defines an "agency proceeding" to mean any process respecting a license, including the revocation, suspension, or withdrawal of a license, or the formulation of an order, whether affirmative, negative, injunctive or declaratory in form, of an agency matter.[62] We do not read this term to require conformity with any particular federal or state agency process, nor to conform to the title given a particular proceeding by any particular agency, but rather to require a more generalized process designed to ensure fundamental fairness and correctness in the proceeding.

Under this definition, we conclude that four documents constitute "similar documents" in agency enforcement proceedings. The first is the ADFI Notice, the second is the ADFI Consent Order, the third is the SEC Draft Order, and the fourth is the SEC Final Order. Consistent with the general law governing theft losses, we further conclude that as soon as substantially all of the elements that comprise a specified fraudulent arrangement are discovered, this criteria is satisfied notwithstanding the fact that additional, subsequent similar documents also may allege facts that comprise elements of the fraudulent arrangement.

The ADFI issued a Notice of Hearing to Revoke[63] on February 27, 2009. That Notice is a complaint filed by a state administrative agency in an enforcement proceeding as described in Rev. Proc. 2009-20, section 4.02(3).

Similarly, the ADFI Consent Order concludes a state administrative agency enforcement proceeding and, as such, it is a "similar document" as described in Rev. Proc. 2009-20, section 4.02(3). We note that the facts described in the Consent Order already were

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[59] *See Fed. Deposit Ins. Corp. v. Meyer*, 510 U.S. 471, 476 (1994); *Smith v. United States*, 508 U.S. 223, 228, (1993); *United States v. Moses*, 137 F.3d 894, 899 (6th Cir. 1998).

[60] *See Parker v. Metro. Life Ins. Co.*, 121 F.3d 1006, 1014 (6th Cir. 1997).

[61] 5 U.S.C. §551 *et. seq.*

[62] *Id.* at §551.

[63] ML Servicing, the successor to MLtd did not contest the entry of an Order. As a result, the administrative proceeding initiated by the ADFI was concluded with the entry of a Consent Order issued on July 27, 2009, which immediately revoked the mortgage banking license of MLtd.

discovered by the investors through the release of the ADFI Notice. As such, we conclude that the ADFI Notice was the first document to allege certain elements of a specified fraudulent arrangement and, as a result, citation to the Consent Order is neither helpful nor required.

While we do not know the exact date the SEC began its investigation into the activities of MLS, we know MLS proffered a Statement of Financial Condition in support of its Offer to Settle on February 28, 2009.[64] As such, SEC enforcement activities had been initiated no later than that date.[65] As a result of the SEC enforcement activities, the SEC circulated the Draft Order in late August 2009 and the facts contained in the Draft Order became widely known. We conclude the Draft Order is a "similar document" described in Rev. Proc. 2009-20, section 4.02(3) because it is a document evidencing a federal administrative agency enforcement proceeding that put the investors on notice of the SEC's findings. As such the Draft Order may be relied upon to allege facts that comprise the elements of a specified fraudulent arrangement.

Finally, on January 19, 2010, the SEC public enforcement proceeding was concluded when the SEC accepted MLS's Offer of Settlement, which is reflected in SEC Release No. 613777. The Final Order revoked MLS's broker-dealer registration. The Final Order disclosed the same facts that had been circulated in the Draft Order. As such, the Final Order also is a "similar document" described in Rev. Proc. 2009-20, section 4.02(3).

The SEC Final Order does not allege new facts not already stated in the SEC Draft Order. Additionally, as the Draft Order was circulated widely as part of an administrative agency enforcement proceeding, the SEC Final Order only reiterates factual allegations with respect to the elements that comprise a specified fraudulent arrangement that were already discovered by the investors through the release of the Draft Order. To ascribe greater weight to the Final Order, where both the Draft Order and Final Order allege the same findings and the findings contained in both documents were known to the investors, would delay the discovery year. Nothing in Rev. Proc. 2009-20 or Rev. Proc. 2011-58 suggest the IRS was attempting to delay the discovery year when it provided the safe harbor in Rev. Proc. 2009-20.[66] As such, we conclude that the Draft Order is the first "similar document" to allege

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[64] *See* Draft Order, Section IV(B), circulated to ML Servicing on or about August 27, 2009. *See also*, SEC Release No. 61377, Section IV (B) (Jan. 19, 2010) .

[65] Investigations and more formalized actions to impose remedial sanctions or to initiate injunctive relief are described as SEC enforcement activities. *See* 17 CFR 202.5.

[66] *See* Rev. Proc. 2009-20, sections 2.03 and 2.04. Ascribing equal weight to the Draft Order and the Final Order also decreases investor risk with respect to the period of limitations. If greater weight was ascribed to the Final Order, and the IRS was to disagree, it is possible that the period of limitation for the earlier year could close before claims were filed. By ascribing equal weight to both years, claims will be made in the earlier year and the risk associated with an expired period of limitation is eliminated.

certain elements of a specified fraudulent arrangement and that citation to the SEC Final Order is neither helpful nor required.

Having concluded which documents constitute a complaint or "similar document" as described in Rev. Proc. 2009-20, section 4.02(3), we now consider when those documents disclosed substantially all of the elements that comprise a specified fraudulent arrangement. As discussed more fully in Section B(1) of this Opinion, a specified fraudulent arrangement is an arrangement where (1) one party receives cash from investors, (2) purported to earn income for the investors, (3) reports income amounts which are partially or wholly fictitious, (4) makes payments, if any, of income to some investors from amounts that other investors invested, and (5) appropriates some or all of the investors' cash or property.

(1) One party receives cash from investors

The SEC Draft Order, circulated in August 2009, recounts how the MLtd Investment Arrangements received cash from investors. Those monies were invested for a specific purpose - to acquire various loans. As such, when the SEC Draft Order was circulated, the first element of a specified fraudulent arrangement was alleged.

(2) Purports to earn income for the investors

The MLtd Investment Arrangements issued reports that alleged to be earning income for the investors. But, as the SEC Draft Order alleges, when a number of the loans failed, Coles and MLtd sought to maintain the illusion that the loans were current and used the impound accounts to mask nonperforming loans by making interest payments from the impound account. When the SEC Draft Order was circulated, the second element of a specified fraudulent arrangement first was alleged.

(3) Reports income amounts which are partially or wholly fictitious

The ADFI Notice alleges, MLtd "made a false promise or misrepresentations or concealed an essential or material fact in the course of the mortgage banking business." In reaching this determination, the ADFI Notice alleges that MLtd. misrepresented its true financial condition. As such MLtd's financial statements did not accurately reflect the financial condition of the business. Thus, ADFI Notice alleged facts with respect to the third element of a specified fraudulent arrangement.

(4) Makes payments, if any, of income to some investors from amounts that other investors invested

The MLtd Investment Arrangements made payments of income to some investors from amounts that other investors invested. As the SEC Draft Order describes, MLtd

stopped originating most loans by the summer of 2007 but MLtd and MLS did not stop soliciting investors. Instead, the MLtd Investment Arrangements continued to seek capital investment until Coles' death in 2008 and placed a portion of such investments in an impound account.. The MLtd Investment Arrangements used the cash from these investors to pay "earnings" of the old investors. In addition, Coles and MLtd used the impound accounts to mask nonperforming loans by making interest payments from the impound account. As a result, the Draft SEC Order first alleges the fourth element of a specified fraudulent arrangement.

(5) Appropriates some or all of the investors' cash or property

The SEC Draft Order notes, MLtd paid MLS, an entity wholly owned by Coles, almost $7 million in placement fees. Similarly, the ADFI Notice alleges that MLtd loaned $6 million to the SMC Revocable Trust, a trust in which Coles was the sole trustee, and guaranteed a $12 million loan taken out by SM Coles LLC, another Coles entity. As such the ADFI Notice and the SEC Draft Order allege that Coles appropriated some of the investors' cash or property, which constitutes the fifth element of a specified fraudulent arrangement.

(b) Death of Lead Figure

Having concluded that the ADFI Notice and the SEC Draft Order together allege facts that comprise substantially all of the elements of a specified fraudulent arrangement, which satisfies the first criteria of Rev. Proc. 2009-20, section 4.02(3), we turn to the second criteria, that the death of the lead figure precludes a charge by indictment, information or criminal complaint. Coles died on June 2, 2008. It is without question that death precludes a charge by indictment, information, or criminal complaint.[67] Thus, the second criteria of Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, section 4.02(3), is satisfied.

(c) Assets were Placed Under Control of a Trustee and Effectively Frozen

On June 20, 2008, MLtd went into bankruptcy. As a result of the bankruptcy, the assets of MLtd became property of the bankruptcy estate and were subject to Bankruptcy Court control and an automatic stay, as well as all other restrictions of the Bankruptcy Code. The Plan of Reorganization that was confirmed by the Bankruptcy Court created a liquidating trust and the Bankruptcy Court appointed a liquidating trustee with respect to the assets of MLtd. Thus, this process put the assets of MLtd under the control of a liquidating trustee. When the assets of MLtd. came under the control of the Bankruptcy Court and became the property of the bankruptcy estate, MLtd's assets effectively were frozen as to the

[67] *See Ex parte Schreiber*, 110 U.S. 76, 80 (1884) (actions upon penal statute do not survive death).

specified fraudulent arrangement.[68] As a result, the third criteria of Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, section 4.02(3), is satisfied.

(d) Discovery Year Conclusion

As discussed above, the criteria provided in Rev. Proc. 2009-20, as modified by Rev. Proc. 2011-58, section 4.02(3) were satisfied. First, the ADFI Notice and the SEC Draft Order allege facts that comprise substantially all of the elements of a specified fraudulent arrangement. Second, Coles' death on June 2, 2008 precluded his being charged with his crimes. Third, when MLtd went into bankruptcy and the Plan of Reorganization approved by the Bankruptcy Court, MLtd's assets were placed in the hands of a trustee and the assets effectively were frozen because they were no longer under the control of the specified fraudulent arrangement.

Because the criteria described in Rev. Proc. 2009-20, section 4.02(3) have been satisfied, Rev. Proc. 2009-20, § 4.04(2) controls the discovery year. That section provides that the discovery year is the taxable year in which the complaint or similar document, as described in section 4.03 of the revenue procedure is filed or the death of the lead figure, whichever is later. In this case, Coles died in June, 2008 and the ADFI Notice and the SEC Draft Order are 2009 documents. As such, we conclude that the discovery year is the taxable year ending December 31, 2009.

SECTION VI - QUALIFICATIONS AND LIMITATIONS

The Opinion of PricewaterhouseCoopers expressed in Section IV hereof is subject to the following qualifications to, and limitations of, its validity and effectiveness:

The conclusions reached in this Opinion represent and are based upon our best judgment regarding the application of federal income tax laws arising under the Internal Revenue Code, judicial decisions, administrative regulations, published rulings and other tax authorities existing as of the date hereof. This Opinion is not binding upon the Internal Revenue Service or the courts and there is no assurance or guarantee that the Internal Revenue Service will not successfully assert a contrary position.

No assurance can be given that future legislative or administrative changes, on either a prospective or retroactive basis, would not adversely affect the accuracy of the conclusions stated herein. PricewaterhouseCoopers LLP undertakes no responsibility to

[68] *See* Footnote 24, *supra.*

advise you or anyone else of any new developments in the application or interpretation of the federal income tax laws.

This Opinion does not address any federal, state, local, foreign or other tax consequences of, or that may result from, the matters or transactions set forth herein, or related or proximate matters or transactions except as specifically set forth herein. In addition, PricewaterhouseCoopers LLP expresses no opinion on non-tax matters, such as issues arising under corporate or securities laws.

This Opinion has been prepared pursuant to an engagement between PricewaterhouseCoopers LLP and ML Mangers LLC and is intended solely for the use and benefit of ML Managers LLC and not for reliance by any other person without our prior written consent. This Opinion may not be relied upon by any person in any other matter or transaction without our prior written consent.

This Opinion is based upon the facts and assumptions that have been included or referenced herein and the assumption that such information is accurate, true, and authentic. This Opinion does not address any matters or transactions other than those described herein. This Opinion does not address any matters or transactions whatsoever unless all were consummated as described herein without waiver or breach of any material provision thereof or if any of the assumptions set forth herein are not true and accurate at all relevant times. In the event any of the facts or assumptions is incorrect, in whole or in part, one or more of the conclusions reached in this Opinion might be adversely affected.

This Opinion supersedes and replaces any and all prior written or oral advice (including, without limitation, electronic communications) and all such prior communications, if any, should not be relied upon by any other party to the transaction or matters described herein for any purpose whatsoever.

In various sections of this Opinion, for ease of understanding and as a stylistic matter, terms such as "is" or "will" may be used. Such language should not be construed to alter the "Conclusions" section of this Opinion.

Very truly yours,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers