

IRS Issues Guidance on Tax Issues Faced by Investors Affected by Madoff and Other "Ponzi" Schemes

On March 17, 2009, the Internal Revenue Service ("IRS") issued two pronouncements designed to clarify tax issues faced by investors affected by the Bernard Madoff scandal. Without specifically mentioning Madoff, the guidance is clearly aimed at his victims, along with victims of similar "Ponzi" schemes. In Revenue Ruling 2009-9, the IRS announced how it intends to treat loss deductions claimed by such investors. In Revenue Procedure 2009-20, the IRS set forth a safe harbor providing affected taxpayers the ability to claim losses on their 2008 tax returns, provided certain conditions are met.

Revenue Ruling 2009-9 sets forth the following assumed facts, which will cover the situation of many Madoff investors:

In Year 1, A contributes to an investment account managed by B. A instructs B to reinvest any income, and later contributes additional money to the account. B issues statements to A reflecting the securities allegedly purchased for A's account, and reflecting gains and other income in A's account. A includes the gains and other items in gross income on his federal income tax return. A was able to require distributions from his account, and did receive a distribution in Year 7. In Year 8, it is revealed that B's brokerage firm was engaged in a Ponzi scheme. All of the activity reported to A, including reported income, was fictitious. When the fraud is discovered, A is unable to withdraw funds. The period of limitation for claiming a refund has expired for Years 1 through 4, but not Years 5 through 7.

Based on the foregoing, the IRS holds as follows:

- A can claim a theft loss with respect to the foregoing in Year 8, the year the loss is discovered, to the extent that the loss is not covered by a claim for reimbursement as to which A has a reasonable prospect of recovery. To the extent A's deduction is reduced by such a claim, recoveries thereon in a later year are not includible in income. If A receives a greater amount in a later year, or an amount that initially was not covered by a claim as to which there was a reasonable prospect of recovery, the recovery is includible in income in such later year, to the extent the earlier deduction reduced income tax. If less is recovered than was covered by such a claim, an additional deduction is allowed in the year the amount of recovery is ascertained with reasonable certainty.
- The loss will be deductible as an ordinary "theft" loss, rather than a capital loss, which can be offset against ordinary income as well as capital gains.
- The loss will not be subject to limitations applicable to "personal" theft losses (including a limitation reducing the deduction by 10% of adjusted gross income). The loss will also not be subject to limitations, applicable to certain other itemized deductions, that are based on an individual's adjusted gross income.
- The amount of the loss deduction should equal the amount initially invested by A in the fraudulent arrangement in Year 1, plus any additional investments, plus amounts included in gross income by A and reinvested in the arrangement; reduced by amount withdrawn from the account, and any

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reimbursements received or claims as to which there is a reasonable prospect of recovery, such as those from insurance or the Securities Investor Protection Corporation (SIPC).

- If the theft loss results in a net operating loss, that loss may be carried back three years, and carried forward 20 years. A may elect to carry back a loss claimed in 2008 for three, four or five years, if he averaged gross receipts between 2006-2008 of less than \$15 million a year.

Revenue Procedure 2009-20 outlines a procedure that will allow “qualified investors” to claim “qualified losses” with respect to “specified fraudulent arrangements” on their 2008 tax returns without challenge by the IRS. This addresses the uncertainty that has existed as to whether a loss could be claimed for that year despite potential prospects of recovery.

“Qualified investors” are United States persons who (1) are generally qualified to deduct theft losses, (2) did not have knowledge of the fraudulent nature of the investment before it became known to the general public, (3) with respect to which the fraudulent arrangement is not a tax shelter, and (4) transferred cash or property to the fraudulent arrangement. In the case of a taxpayer who did not transfer property to the fraudulent arrangement, but invested in a fund that did so, the fund, and not the taxpayer, may be a qualified investor. Accordingly, fund investors will be entitled to claim a loss to the extent the fund takes advantage of this procedure (or otherwise claims a loss) up to their allocable shares thereof.

A “qualified loss” is defined as a loss from “specified fraudulent arrangements” in which the lead figure was charged with (or, in certain cases, subject to an allegation with respect to) a crime, such as embezzlement or a similar felony, constituting theft. A “specified fraudulent arrangement” is one in which the lead figure (1) receives cash or property from investors, (2) purports to earn income for investors, (3) reports income amounts to investors that are wholly or partially fictitious, (4) makes any payments of purported income or principal to some investors from amounts others invested, and (5) appropriates some or all of the investors’ property.

Under this procedure, the taxpayer may deduct as a theft loss in the year in which the theft is discovered: (i) 95% of the loss, if the taxpayer does not pursue a claim for recovery (other than an insurance or SIPC recovery, or a claim against the parties principally responsible for the fraud) or (ii) 75% of the loss, if the taxpayer intends to pursue such a recovery. In each case, this amount must be reduced by any actual recovery or potential insurance or SIPC recovery.

By accepting this safe harbor, the taxpayer agrees not to amend returns for years that may be amended as of right (*i.e.* “open years”), nor to make any attempts to use procedures to amend years that have been closed by the statute of limitations.

If a taxpayer does not make use of the safe harbor treatment, the standard theft loss rules will be applied. This means that the taxpayer will have to prove that he or she did not have a reasonable likelihood of recovery in the year the taxpayer claims the deduction. Due to the uncertainty that surrounded the Madoff case at the close of the 2008 taxable year, this may be difficult, and the IRS may assert that the loss should more properly be claimed in a later year.

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