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Tax Law

ALERT

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IRS Issues Favorable Guidance for Taxpayers Who Suffered Madoff Related Losses

The IRS has issued much anticipated guidance regarding the deductibility of losses incurred by taxpayers who invested with Bernie Madoff. The guidance is in two parts: 1) Revenue Ruling 2009-9 sets forth the IRS' view of the tax law applicable where an investor loses money in a "Ponzi scheme" type of fraud; and 2) Revenue Procedure 2009-20 provides a safe harbor under which taxpayers who qualify may deduct a substantial portion of their loss in 2008. While the guidance was issued as a result of the Bernie Madoff Ponzi scheme, it may be applicable to other Ponzi scheme investment frauds as well.

Summary of Revenue Ruling 2009-9

Revenue Ruling 2009-9 contains several determinations on the part of the IRS that are highly favorable to taxpayers. These include the following:

a) The investor's loss is a theft loss and is therefore an ordinary loss as opposed to a more limited capital loss.

b) The theft loss is considered to be incurred in a transaction entered into for profit, and therefore will not be subject to the limitations applied to personal theft losses that can only be deducted to the extent they exceed $100 ($500 for 2009) and 10% of the taxpayer's adjusted gross income ("AGI").

c) The deduction for the loss is not subject to either the 2% of AGI floor or the overall limitation on itemized deductions, and is deductible for purposes of the alternative minimum tax.

d) The loss may be deducted in the year in which it is discovered to the extent not covered by a claim for reimbursement or recovery with respect to which there is a reasonable chance of recovery. Revenue Procedure 2009-20, discussed below, provides a safe harbor with respect to this issue.

e) The amount deductible is the sum of all of the amounts that the taxpayer invested, increased by income that the taxpayer included in his tax returns for years prior to the year in which the theft was discovered, and reduced by the amounts withdrawn from the investment and the amount of and claims for reimbursement or recovery with respect to which there is a reasonable prospect of recovery.

f) For purposes of computing the taxpayer's net operating loss the theft loss is considered to be attributable to a business. This means that under the provisions of the American Recovery and Reinvestment Act of 2009, for losses deducted in 2008, the taxpayer may elect to carry back the loss for three, four or five years, provided his average gross receipts for taxable years 2005, 2006 and 2007 do not exceed $15 million. If his average gross receipts exceed this amount, the loss may be carried back three years. In both cases, any portion of the loss not used by carrying it back may be carried forward for 20 years.

The only aspects of the ruling that may be unfavorable to taxpayers are the IRS' conclusions that taxpayers may not use the "claim of right" doctrine under IRC Section 1341 to re-compute prior tax years or the mitigation provisions of IRC Sections 1311 – 1314 which permit the IRS or taxpayers to open earlier years that are otherwise now closed by the statute of limitations. What the IRS is really trying to say here is that, in their view, the proper tax treatment is the deduction of the loss in the year of discovery and not the amendment of prior year returns to remove items of income from the fraudulent investment.

What You Can Deduct In 2008

The greatest uncertainty surrounding the deductibility of Madoff related losses has been the year in which the loss is deductible. As of the end of 2008, it appears that between SIPC, Mr. Madoff's assets and clawback claims there was some reasonable prospect of recovery (or at least it was not certain there was none). In such case, an investor may not have been entitled to any deduction until the amount recoverable is resolved. Revenue Procedure 2009-20 establishes a "safe harbor" for determining the year of deduction. Taxpayers are not required to follow the revenue procedure but are subject to the general rules if they do not, and may risk a challenge from the IRS if they claim a loss for 2008.

Under the Revenue Procedure, the loss is considered to be realized in 2008 because: i) a criminal complaint was filed against Mr. Madoff in 2008; and ii) a receiver was appointed with respect to the fraudulent arrangement in 2008. To take advantage of the Revenue Procedure, a taxpayer must be a "qualified investor" – that is, a United States person who had no actual knowledge of the fraudulent nature of the investment and directly transferred cash or property to the fraudulent arrangement. An indirect investor through a "feeder fund" may not rely on the Revenue Procedure, but the feeder fund itself may be a qualified investor which can claim the deduction and pass it through to its fund's investors. These funds will no doubt be deluged by calls from their investors regarding whether they intend to follow the Revenue Procedure.

Under the Revenue Procedure, a qualified investor's 2008 deduction is equal to:

i) 95% of the total loss (which is then reduced by its SIPC and other direct insurance claims) if the qualified investor is not pursuing claims against third parties; or

ii) 75% of the total loss (which is then reduced by its SIPC and other direct insurance claims) if the qualified investor is or intends to pursue third party claims.

A qualified investor's loss for this purpose does not include amounts borrowed from Mr. Madoff to the extent not repaid when the fraud was discovered nor amounts paid as fees that were deducted on its income tax returns in prior years. The amount subsequently recovered may generate income or additional losses for the qualified investor in a later tax year.

Interesting issues arise when you try to apply the above criteria to a feeder fund. Investors may have claims against the fund or the general partner/manager of the fund. If the fund is the qualified investor and it is being sued by its own investors and the fund does not (or cannot) pursue claims against a third party, the fund may literally qualify for the 95% deduction since the qualified investor (the fund) is not itself pursuing third party claims. Similarly, if the investors merely pursue claims against the fund general partner/manager or other third party advisors, the fund may still qualify for the 95% deduction if it is not pursuing any third party claims. However, in some cases investors have brought derivative actions on behalf of the funds in which they had invested against the fund's general partner/ manager. In that case, the fund should be considered to be pursuing third party claims and should only qualify for the 75% deduction. Issues like this may require further clarification from the IRS.

How To Adopt the Safe Harbor

To rely on the safe harbor of the Revenue Procedure, the qualified investor must mark "Revenue Procedure 2009-20" at the top of Form 4684 "Casualties and Thefts" that is attached to its 2008 Federal income tax return. In addition, the qualified investor must complete and sign a statement set forth in the Revenue Procedure and attach the signed statement to its timely filed 2008 Federal income tax return, agreeing to abide by the provisions of the Revenue Procedure, not to file amended returns for prior periods, and to waive any claims under IRC Sections 1341 and 1311 – 1314, with respect to the Ponzi scheme.

If a qualified investor has already filed amended returns for prior years, one of the provisions of the statement that must be signed is that the investor agrees to any adjustments or actions necessary to comply with the provisions of the Revenue Procedure. This means that any refunds claimed in prior years on such amended returns will be disallowed. The investor must also disclose the prior years that have been amended.

Please feel free to contact us regarding any questions you may have about your best course of action.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

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