

Madoff Securities Task Force Update: Claiming Tax Benefits for Losses

January 09, 2009

Client Advisory

January 9, 2009 by Howard J. Barnet, Jr.

Investors who have lost large sums of money in the Ponzi scheme run by Bernard Madoff have naturally turned their attention to the tax refunds that might mitigate their losses. While it is likely that most U.S. taxable investors will be able to claim significant tax benefits, the precise mechanics for seeking a refund will depend upon a number of factors, including (a) the particular form of investment, i.e., through a fund or as a separate account, (b) the individual history of investment and withdrawals (if any), (c) the reporting of taxable income for prior years, and (d) a resolution of the date on which there is "no reasonable prospect of recovery" of the investment. In addition, of course, it is not yet known precisely how Madoff operated the scheme, and such details could affect the appropriate tax treatment. Compounding the uncertainty, the relevant law is not entirely settled.

At present, the most likely avenues for investors to pursue appear to be:

1. Amend Prior Years' Returns. An investor might re-file tax returns for prior years, excluding all Madoff-generated income and gains. The basis for such filing would generally be that most if not all of the reported income and gains were in fact illusory. If, however, the investor actually received cash returns from his investment, and perhaps even if returns were credited to his account which he could have withdrawn but chose to "reinvest," the IRS might well deny a tax refund on this basis. Generally, a taxpayer may amend a tax return only within three years of filing such return, so investors could re-file for 2005 through 2007.
2. Claim Theft Loss. A deduction may be claimed under Section 165 of the Code for (i) the "principal" amount invested with Madoff and (ii) any returns that have been reinvested and on which income taxes have been paid. It is likely that such losses qualify as "theft" losses, which are treated in certain respects more favorably than normal capital losses. First, they are treated as ordinary losses. Second, to the extent that such losses exceed a taxpayer's gross income, the resulting loss can be carried back up to three years (and forward up to twenty years). The loss must be claimed on the tax return for the year in which the theft was discovered (2008) or (if later) the year when there is no longer any reasonable prospect for recovery. If an investor's only prospect for recovery were a SIPC claim, then a deduction could be claimed for all but \$500,000 of the loss. However, it is not clear that as of December 31, 2008, an investor will be able to assert that there was no reasonable prospect of recovery beyond that amount.

The best tactical approach, or combination of approaches, will depend upon an investor's individual circumstances. If it appears in a particular situation that neither of these routes is likely to produce significant tax refunds, there are other legal theories that might be pursued. It is also possible, in view of the scope of the Madoff fraud, that the IRS will choose to issue guidance on some of the issues discussed herein. **[January 28 Update: In hearings yesterday, several members of the Senate Banking Committee indicated that they would support efforts to encourage the IRS to provide tax guidance to Madoff victims.]** In the meantime, if you have any questions, please contact Howard Barnet or any other member of the CL&M Madoff Securities Task Force (below), or your CL&M attorney.

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