

Madoff Securities Task Force Update: IRS Issues Helpful Guidance

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Client Advisory

March 18, 2009 by Howard J. Barnett, Jr., Steven J. Glusband, Faith Colish, Michael I. Frankel, James Gadsden, Guy P. Lander, Patricia Matzye, Gary D. Sesser, Michael Shapiro, Andris J. Vizbaras and Robert J.A. Zito

The IRS today issued guidance for investors seeking to claim tax refunds as a result of losses suffered in Ponzi schemes run by Bernard Madoff or others. Overall, the guidance is favorable to taxpayers, in that it (i) generally allows taxpayers to claim a theft loss deduction in 2008 (in the case of Madoff, because it is the year criminal charges were filed) and (ii) treats such loss as investment-related and therefore not subject to various limitations that would otherwise be applicable. If the loss produces a net operating loss for 2008, such loss can be carried back at least three years, and certain taxpayers can carry it back up to five years. The guidance does however state that the IRS does not agree with several theories which have been advanced that might produce, in effect, an unlimited carryback.

The guidance takes two different forms. One document is Revenue Ruling 2009-9, in which the IRS states its interpretation of the applicable tax law. The other is Revenue Procedure 2009-20, which offers taxpayers a “safe harbor” format for filing tax refund claims. If a taxpayer files under the Revenue Procedure, the IRS will not raise legal objections to the refund claims.

Among the legal issues addressed by the IRS in Rev. Rul. 2009-9 are the following:

- A loss from a criminally fraudulent Ponzi scheme is a theft loss, not a capital loss.
- The theft loss is deductible under Section 165(c)(2) of the Internal Revenue Code, rather than (c)(3), with the beneficial result that it is not subject to Section 165(h) (which allows losses only to the extent they exceed 10% of adjusted gross income). The ruling also confirms that the loss is not subject to the 2% floor of Section 67(a) or the overall limit of Section 68 as some had feared.
- The amount of the tax loss includes income reported to the investor in prior years and included in income by the investor. Of course, the amount of the loss is reduced by distributions paid to the investor in prior years. It is also reduced by the amount of any claim for reimbursement with respect to which there is a reasonable prospect of recovery.
- If the theft loss produces a net operating loss for 2008, because the Madoff-related loss exceeds the taxpayer’s current income, the NOL can be carried back at least three years, and forward twenty. In many cases investors, including individuals, will qualify for a special five-year carryback enacted earlier this year for 2008 NOLs of “eligible small businesses” (as generously interpreted by the IRS). This will be especially helpful for investors who have lost most of their income-producing assets in the Madoff fraud.
- The IRS denied the efficacy, however, of two other strategies that had been advanced by advocates for taxpayers seeking to unlock taxes paid on phantom income more than three (or five) years ago. The IRS ruled that neither the “claim of right” rule (Section 1341) nor the “mitigation” rules (Sections 1311-14) are applicable in the circumstances.

In Rev. Proc. 2009-20 the IRS offered taxpayers a clear path through the maze, but at the price of waiving some more aggressive possible remedies. The procedure applies to innocent victims, including direct investors and feeder funds. (Investors in feeder funds would benefit only indirectly, as the loss claimed by the fund is reported on the investor's IRS Form K-1.) Under the procedure, the IRS will not challenge a tax filing for 2008 in which the taxpayer claims a theft loss for the amount of the "qualified investment" multiplied by either 95% (if the taxpayer is not pursuing any third party recovery) or 75% (if he is pursuing or intends to pursue such recovery), less the amounts payable under SIPC and any private insurance or contractual protection. The "qualified investment" is generally equal to the amount invested, plus the aggregate net income which the taxpayer included for all tax years prior to 2008, less the amount of distributions or withdrawals. The principal concessions by the IRS under this safe harbor are that: (a) 2008 is the proper year for deducting the theft loss and (b) the amount of the loss does not need to be reduced on account of potential claims against Madoff or third parties such as accounting firms and investment advisers. Both these issues could be challenged by the IRS in the case of a taxpayer who does not follow all the conditions of the Revenue Procedure.

In order to benefit from the safe harbor, a taxpayer must agree (with respect to the investment in the Ponzi scheme): (1) not to deduct any amount greater than the amount allowed, (2) not to file amended returns for prior years, (3) not to utilize Section 1341 (claim of right) or Sections 1311-14 (mitigation). These are significant waivers by taxpayers, and every investor—but particularly long-term Madoff investors for whom even the five-year carryback is insufficient to absorb the NOL generated in 2008—should consult a tax adviser to consider whether to forgo the safe harbor of Rev. Proc. 2009-20, especially considering the favorable rulings contained in Rev. Rul. 2009-9.

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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