

Bernie Madoff “Made Off” with My Investment: Evaluating the Tax Options Available for Victims of Fraudulent Investments

By Andrea S. Kramer and Thomas P. Ward

Andrea Kramer and Thomas Ward explain the complicated situation facing taxpayers who have suffered losses resulting from fraudulent investment schemes.

I. Introduction

The year 2008 was a big year for Ponzi schemes. An estimated \$20 billion of “investments” evaporated at Bernard Madoff in December 2008,¹ and investors lost an estimated \$8 billion at R. Allen Stanford,² \$550 million at Greenwood/Walsh,³ \$350 million at Arthur Nadel and more than \$160 million at Westgate Capital Management LLC operated by James Nicholson.⁴ In a Ponzi scheme, the investment advisor purports to invest cash or property on behalf of investors, reports income amounts that are partially or wholly fictitious, and makes purported income or principal payments to investors funded, at least in part, from amounts that other investors invest in the fraudulent arrangement. The investment advisor perpetrating the fraud criminally appropriates some or all of the investors’ cash or property.

In addition to worrying about investment advisors’ bankruptcies and obligations to return their “investments,” victims are now scurrying to find meaningful tax relief. But Ponzi scheme losses present difficult tax issues. And taxes already paid on fictitious gains (phantom income) are not easily recovered.

To provide guidance to victims of Ponzi schemes, the IRS issued Rev. Rul. 2009-9⁵ (the Ruling) and

Rev. Proc. 2009-20⁶ (the Safe Harbor) on March 17, 2009.⁷ This guidance came a little more than three months after the Madoff scheme was discovered on December 10, 2008, a rapid response by the IRS that underscores the importance of these tax issues to many taxpayers. But the fact pattern in the Ruling is a relatively straightforward case and most cases will not have such straightforward facts. Moreover, the IRS guidance—welcome as it is—comes at a price.

Most basically, if the Ruling or Safe Harbor is followed, victims are assured the ability to deduct their “total loss,” but only against income in the year the fraud is discovered and generally in the three prior tax years.⁸ In other words, to obtain the certainty of deductions in specified years, victims must give up their arguable right under current law to deduct their losses against income in all years in which they paid taxes on phantom income.⁹ Furthermore, while victims electing the Safe Harbor can obtain theft losses on phantom income, they will not be entitled to interest on overpayments in open tax years.¹⁰

Thus, electing to accept the Safe Harbor is not a simple choice. The choice is made even more difficult because the Ruling (on which the Safe Harbor is based) appears to discredit certain tax principles that might otherwise be available to victims, raising the prospect of tax audits for taxpayers seeking to recoup their losses under neither the Ruling nor the Safe Harbor.

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II. Rev. Rul. 2009-9: the Ruling

In the Ruling, the IRS addresses the victim of a Ponzi scheme who “invested” with someone who held himself out as an investment advisor and securities broker (promoter). The Ruling describes a fraudulent Ponzi scheme in which an individual (A) contributed \$100X in 2001 to an investment account with B, who held himself out as an investment advisor and securities broker. A is a cash-basis taxpayer, who files federal tax returns on a calendar-year basis. A instructed B to reinvest any income and gains earned on his “investments.” In 2003, A contributed an additional \$20X to the account. Since 2001, B issued periodical account statements to A. From that time forward, B also issued tax reporting statements to A and to the IRS, reflecting purported gains and losses in A’s account. In this example, B reported that A earned \$10X of income (interest, dividends and capital gains) in each of the years 2002 through 2007. A took a single distribution of \$30X from his account in 2007.

In 2008, B’s investment advisory and brokerage activities were found to be a fraudulent Ponzi scheme, and B’s actions were criminal fraud or embezzlement under the laws of the jurisdiction in which the transactions occurred. Until it was revealed in 2008, A had no knowledge that B’s activities were fraudulent. At that time, B had only a small fraction of the funds it had reported on A’s account statements. A did not receive any reimbursement or other recovery for the loss in 2008. A’s period of limitation on filing a claim for refund has not yet expired for the tax years 2005 through 2007, but it has expired for 2001 through 2004. For this hypothetical victim A, a discussion of the key IRS rulings follow.

Theft Loss

The victim is entitled to a theft loss under Code Sec. 165(a)¹¹ because the loss resulted from an illegal “taking of property” done with criminal intent to deprive the taxpayer of money or property. The loss results in an ordinary—rather than a capital—deduction and is not subject to capital loss limitations. This is important because while an individual can generally deduct capital losses up to the full amount

of capital gain, an individual can only offset any unused net capital loss against only \$3,000 of ordinary income each year, a punitive limitation that would make relief practically nonexistent if the loss were capital.¹² Further, while an individual’s unused capital losses can be carried forward without limitation, such unused capital losses for individuals for a tax year cannot be carried back.¹³ Despite being unhampered by capital loss restrictions, there are limitations that can apply to theft loss deductions as discussed in the following section.

Deduction Limitations

The Ruling concludes that A entered into the transactions with B for profit. Because the transactions were entered into “for profit,” A’s theft loss is not subject to the disadvantageous limitations that apply to loss deductions from theft of personal property. Practitioners voiced early concern regarding whether the victim’s investments constituted personal property or “for profit” activity. Code Sec. 165(h) limits the amount of deductions for personal property investments to amounts exceeding 10 percent of the taxpayer’s adjusted gross income¹⁴ and

only if the taxpayer’s loss exceeds \$100 in 2008 (or \$500 in 2009.)¹⁵ Because the Ruling specifies that the loss will be attributed to “for profit” activities under Code Sec. 165(c)(2), A can deduct the full amount of the theft loss even if it does not exceed 10 percent of his adjusted

gross income. And, A’s theft loss is not subject to limitations on itemized deductions¹⁶ (such as no limitation by the two-percent floor¹⁷ and no phase-out rule on adjusted gross income¹⁸).

Year of the Deduction

The theft loss is generally deductible in the year it is discovered. The amount of the allowable theft loss is reduced by any claim for reimbursement to which there is a reasonable prospect of recovery that exists in the year the theft is discovered. Any subsequent recovery is not includible in the taxpayer’s income except to the extent that the taxpayer recovers more than his expected reimbursements. If the amount expected to be recovered is not recovered, such amount is deductible in the tax year in which there is

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no longer a reasonable prospect of recovery. But how and when does an investor know whether any portion of his loss has a reasonable prospect of recovery? Because many civil and criminal investigations are ongoing, a victim might find it difficult, if not impossible, to ascertain all of the facts needed to establish the likely prospect of recovery under the Ruling. This means that for Madoff victims, 2008 is certainly the year for discovering the fraud but might not be the year for knowing the amount of their loss.

Amount of Deduction

Under the Ruling, the amount of a theft loss is determined in an advantageous manner. The allowable loss is: (1) the amount initially invested *plus* (2) additional investments (including “profits” reinvested in the account on which taxes have been paid) *minus* (3) amounts withdrawn, *minus* (4) reimbursements or other recoveries and *minus* (5) claims as to which there is a reasonable prospect of recovery. Applied to the fact pattern of the Ruling, the amount of A’s theft loss includes A’s original investment in 2001 (\$100X) and A’s additional investment in 2003 (\$20X). A’s loss also includes the amount that A reported as gross income on A’s federal income tax returns for 2002 through 2007 (\$60X), and is reduced by the amount of money distributed to A in 2007 (\$30X). Assuming A has no claim for reimbursement for which there is a reasonable prospect of recovery, A’s theft loss in 2008 would be \$150X. Thus, a Ponzi scheme victim can include in his theft loss the actual money invested plus all phantom income on which taxes were paid from both open and closed tax years.

Loss Carryback and Carryforward

The Ruling provides that any theft loss deduction under a Ponzi scheme is treated as a business deduction for determining loss carryback and carryforward. But all is not roses for the Ponzi scheme victim. If the victim cannot deduct his full theft loss in the year of discovery (because, for example, the loss far exceeds his current income—not an unusual circumstance for many Madoff investors), he can carry back the unused portion of the theft loss only for three years, although for losses discovered in 2008, he might be able to carry them back for four or five years under the American Recovery and Reinvestment Act of 2009 depending on his average gross revenues for the carryback years.¹⁹

The victim will not get interest on the amount he overpaid in a carryback year because the deduction

is considered a net operating loss (NOL),²⁰ rather than an overpayment of taxes subject to interest.²¹ The Code defines an NOL as the excess of deductions over gross income.²² This is a disadvantage for a Ponzi scheme victim who essentially overpaid his taxes in all years in which he paid taxes upon phantom income. As a result, by couching relief in terms of a theft loss deduction, victims lose the ability to claim interest on overpayments of taxes paid upon phantom income in previous years.

If the taxpayer cannot use all of his theft losses against income in the carryback years, he can carry them forward for 20 years. This is a significant benefit for a victim with the likelihood of substantial taxable income in future years. But for a victim unable to use all of his loss against income in the carryback years, and whose future earning prospects are modest (such as a retiree), the 20-year carryforward is cold comfort.

Claim of Right and Mitigation

The Ruling provides that a Ponzi scheme victim cannot get around the carryback/carryforward limitations by invoking the “claim of right doctrine” or the “mitigation provisions.” The IRS states flatly in the Ruling that neither is available with respect to a Ponzi scheme loss.

For a claim of right, Code Sec. 1341 provides an alternative tax computation formula to provide special tax treatment for a taxpayer who included a specific income item on his return in a previous year based on the taxpayer’s belief that the taxpayer had an unrestricted right to that income item. Code Sec. 1341 applies if: (1) an item was included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to the item; (2) a deduction is allowable for the current tax year because the taxpayer did not have an unrestricted right to the item or a portion thereof; and (3) the deduction exceeds \$3,000. If Code Sec. 1341 applies, tax for the current tax year is the lesser of: (a) the tax for the tax year, computed with the current deduction, or (b) the tax for the repayment year, computed without the deduction minus the decrease in tax that would have resulted for the earlier year if the repaid amount had been excluded from that year’s gross income. Because the taxpayer is not receiving a refund, the taxpayer is not entitled to any interest under a claim of right computation.

Under Code Sec. 1341, a deduction only results when the taxpayer is under an obligation to “restore

income" to its rightful owner.²³ If available, the claim of right would be a valuable tool to recover taxes paid in years prior to carryback years. With that said, the Ruling states the doctrine is not applicable to Ponzi scheme victims because A's claim does not result from A's obligation to restore income, but instead from B's fraud.

The mitigation provisions of Code Secs. 1311 through 1314 allow the IRS (or the taxpayer, in certain situations) to correct an error made in a closed tax year by adjusting the tax liability in years otherwise closed by the statute of limitations. Because mitigation operates as an exception to the statute of limitations, it is administered sparingly. As applied to a Ponzi loss, such an adjustment is only allowed when, in relevant part, a determination is made (such as by a court or adoption of a new regulation) that is inconsistent with the erroneous prior tax treatment of the income item in question.²⁴ To prevail, the taxpayer would need to establish that the IRS (the party against whom a mitigation adjustment is sought) acted inconsistently (i) in connection with the original erroneous tax treatment of an item and (ii) in connection with the determination that establishes such treatment as error.

For fraudulent investments, the IRS sees no inconsistency in its position. As a result, the Ruling says that the allowance of a theft loss in the year of discovery is consistent with the IRS's position that investors properly included phantom income in previous years.

Reportable Transactions

The last bit of (minor) good news for a victim is that the amount of the theft loss is not taken into account in determining whether a transaction is a "reportable transaction" under Reg. §1.6011-4(b)(5), which applies to loss transactions of certain sizes.²⁵ As a result, the victim need not file a separate disclosure statement on Form 8886 when claiming his theft loss. If the amount of a taxpayer's Ponzi scheme loss could be taken into account for purposes of Reg. §1.6011-4(b)(5), and the taxpayer failed to properly disclose this type of reportable transaction on Form 8886, then Code Sec. 6707A(b)(1) imposes a \$10,000 penalty in the case of an individual, and \$50,000 in any other case.

III. Rev. Proc. 2009-20: the Safe Harbor

The IRS offers an optional Safe Harbor to qualifying Ponzi scheme victims. While the Safe Harbor is

intended to allow a victim to avoid the compliance burdens and difficult factual determinations involved in the Ruling, it is not a free lunch.

The Safe Harbor is only available to certain "qualified investors" to deduct certain "qualified losses" from a "specified fraudulent arrangement."²⁶ A "qualified loss" is a loss where either: (a) the promoter has been 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 be a tax law theft under the jurisdiction where the crime occurred; or (b) the promoter was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging fraud, embezzlement or a similar theft crime, and (i) either the complaint alleged that the promoter admitted to the crime (or executed an affidavit admitting the crime), or (ii) a receiver or trustee is appointed with respect to the arrangement or assets of the arrangement were frozen.²⁷

A "qualified investor," is a U.S. person (as defined in Code Sec. 7701(a)(30))²⁸: (1) that generally qualifies to deduct theft losses under Code Sec. 165, (2) that did not have actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public, (3) with respect to which the specified fraudulent arrangement is not a tax shelter²⁹ and (4) that transferred cash or property to a specified fraudulent arrangement. A qualified investor only includes those persons who made a direct investment in a fraudulent arrangement and does not include those persons who invested in a fund or entity that, in turn, invested in a fraudulent arrangement. Such funds or entities, however, might themselves be qualified investors for purposes of the Safe Harbor.³⁰

If a qualified investor with a qualified loss elects the Safe Harbor in the year in which the loss was discovered, the IRS will not challenge: (a) the deducted loss as a theft loss; (b) the discovery year as the taxable year in which the indictment, information or complaint described in the definition of qualified loss is filed; or (c) the amount of the deduction determined in accordance with the following paragraphs.³¹ By electing the Safe Harbor, the qualified investor agrees not to: (i) deduct more than the amount determined under the next paragraphs, (ii) file amended returns for pre-discovery open years or (iii) pursue any equitable recoupment, claim of right or mitigation arguments with respect to the losses.³²

The Safe Harbor theft loss deduction amount is determined as follows. First, the amount of the tax-

payer's "qualified investment"³³ is multiplied by a specified percentage.

The percentage is 95 percent if the qualified investor does not pursue any actual or potential claims for recovery for a qualified loss as of the last day of the discovery year (other than potential insurance/Securities Investor Protector Corporation (SIPC) recoveries or actual or potential claims for recovery against the promoter group).³⁴

The percentage of the qualified loss available to the qualified investor drops to 75 percent, however, if the qualified investor is pursuing (or intends to pursue) any actual or potential claims for recovery for a qualified loss as of the last day of the discovery year (other than potential insurance/SIPC recoveries or actual or potential claims for recovery against the promoter group).³⁵

Second, the product of the qualified investment multiplied by the applicable percentage is then reduced by the sum of any actual recovery and any potential insurance or SIPC recovery.³⁶

Procedures set out in Rev. Proc. 2009-20 illustrate the appropriate way to claim the Safe Harbor, which includes a statement (provided in Appendix A of Rev. Proc. 2009-20) that the taxpayer must complete, sign and attach to the timely filed federal income tax return (including extensions) for the discovery year. Electronic filers meet the filing requirements by submitting the necessary documents as PDF files and naming them pursuant to an IRS guidance.³⁷ Any investors seeking Safe Harbor protections should carefully review Rev. Proc. 2009-20 (and Appendix A thereto) and, if e-filing, the IRS guidance.

The clear advantage of electing the Safe Harbor is that the IRS will not challenge either the theft loss deduction or the discovery year. The clear disadvantage of the Safe Harbor is that the theft deduction is limited to either 95 percent or 75 percent. Both Safe Harbor limitations are *reduced by* the amount of any actual recovery and potential insurance or SIPC recovery *but are not further reduced by* potential direct or potential third-party recovery.³⁸ A victim who is not personally pursuing third-party claims is eligible for the 95-percent limitation, presuming he is not a member of a class-action lawsuit. The IRS guidance is silent on whether being a member of a class action counts as pursuing third-party claims sufficient to limit a victim to 75-percent recovery. However, choosing not to opt-out of the class likely indicates a pursuance of third-party claims. An investor should consider opting out of the class to

ensure the ability to recover 95 percent of his loss under the Safe Harbor.

Apart from the 95-percent and 75-percent limitations, the loss calculations and the carryback and carryforward provisions are the same in the Safe Harbor and the Ruling.³⁹ Thus, assuming a victim's tax choice is limited to the Ruling or the Safe Harbor (not necessarily a realistic assumption), two conclusions follow from this. First, a victim in the 95-percent category might well choose the Safe Harbor to buy peace of mind and finality for the five-percent haircut. And second, a victim with substantial and reasonably favorable claims against third parties is likely to reject the Safe Harbor with its mandatory 25-percent haircut.

If an investor chooses not to apply the Safe Harbor to a Ponzi scheme loss (such as, he wants to invoke equitable recoupment, claim of right or mitigation or wants to claim a larger theft loss than the loss available under the Safe Harbor), the taxpayer must establish that the loss it is deducting was from theft, that the theft was discovered in the year the taxpayer claims the deduction and the amount of the loss.⁴⁰ Also, to the extent the taxpayer takes a position inconsistent with the Ruling, it may be required to disclose that fact on its tax return to avoid understatement penalties under Code Sec. 6662 (and the tax return preparer needs to advise the taxpayer of this fact to avoid potential penalties under Code Sec. 6694). Furthermore, the taxpayer's return is subject to IRS examination.⁴¹

IV. Additional Considerations

Partnerships

Taxpayers who invest in partnerships or feeder funds that, in turn, invest in Ponzi schemes cannot rely on either the Safe Harbor or the Ruling. These victims did not participate directly in the fraudulent schemes and were not defrauded directly by the promoters. Rather, the partnerships or feeder funds in which they invested should pursue their own recovery and should pass through theft losses, where available, to their partners on Schedule K-1s.

Derivative Products

Taxpayers are not eligible for theft losses if they enter into swaps and other derivative products, the values of which were determined by reference to direct investments in fraudulent schemes. These victims did not participate directly in the Ponzi scheme and

were not defrauded directly by the promoters. For example, many investors sought returns based on Madoff “profits” through a Total Return Swap (TRS), in which the TRS specifies a Madoff feeder fund as the “Reference Fund” for the investment. Such investors are not eligible for theft losses because, when entering into the TRS, they did not rely on misrepresentations of the counterparty in the transaction. Most likely, discovery of the fraud will constitute an “extraordinary event” or “disruption event,” sufficient under the contract to result in an “early termination.” Upon an early termination, there is usually a cash settlement that must be paid by the investor to the counterparty and is treated as a capital loss to the investor, subject to the capital-loss limitations discussed previously.⁴² Notional principal contracts (NPCs), bullet swaps and forwards are all examples of derivative products that result in capital losses upon termination.⁴³ As previously discussed, capital losses represent a highly undesirable situation for most individual victims.

Retirement Plans

Tax-deferred investments (including pre-tax contributions to employer-sponsored retirement plans and traditional IRAs) are not generally eligible for theft deductions because contributions to the accounts were deducted by whoever made them (owner or employees), which means that the owners or employees have a zero tax basis in the accounts. Deductions are possible for IRAs (traditional or Roth) in very limited circumstances.⁴⁴ First, victims must liquidate all IRAs of a particular type: all traditional IRAs or all Roth IRAs must be liquidated.⁴⁵ Second, the tax basis in the liquidated IRAs must exceed the amounts withdrawn on liquidation.⁴⁶ Given these requirements, holders of Roth IRAs are much more likely than holders of traditional IRAs to be able to take advantage of a theft loss because Roth IRAs are likely to have tax basis. But, third, losses are limited by the limitations on miscellaneous itemized deductions and the two-percent adjusted gross income floor.⁴⁷ Further, such losses must be added back to taxable income to calculate the alternative minimum tax (which makes the loss useless in most situations.)⁴⁸

Like traditional IRAs, since Code Sec. 401(k) plans (hereinafter, “401(k) plans”) are funded with pre-tax amounts there should generally be no tax basis against which to claim a theft loss. However, each individual 401(k) plan account investor that invested directly with the promoter of the fraudulent scheme should consider filing a separate claim with SIPC. Since the

individual has the power to invest and reinvest, the individual account holder can argue that he or she should be treated as a separate account eligible for SIPC recovery. SIPC, on the other hand, might rely on *SIPC v. Morgan-Kennedy & Co.*,⁴⁹ to assert that only one claim is available for each employer, not allowing one claim per individual employee account. This case, however, did not address a 401(k) plan where participants can choose their investments. So SIPC reliance on *Kennedy* might not preclude a recovery in those instances.

Private Foundations

Although private foundations are exempt from income taxes, Ponzi schemes pose serious risks for these institutions. Foundations are subject to excise taxes under Code Sec. 4944 if their investments jeopardize their charitable purposes. An investment jeopardizes a charitable purpose if the foundation managers have failed to exercise “ordinary business care and prudence” in providing for the financial needs of the business to carry-out its exempt purpose(s).⁵⁰ Assuming a fraudulent investment scheme jeopardizes a charitable purpose, an initial 10-percent penalty tax of the amount invested during the tax year in question might be imposed upon the foundation.⁵¹ An initial 10-percent penalty might also be applied on any foundation manager who agreed to the investment, knowing it would jeopardize the foundation’s tax-exempt purpose.⁵² An additional 25-percent penalty could also be imposed on those private foundations that do not attempt to recover their funds.⁵³ Officers, directors and trustees can also face an additional five-percent penalty tax if they refused to remove the offending investment from the foundation’s portfolio in order to restore the foundation’s investment portfolio to harmony with the foundation’s exempt purposes.⁵⁴ Fines for individuals (foundation managers) are capped at \$10,000 for initial fines and \$20,000 for additional fines, although these fines are levied on each investment.⁵⁵

V. Recent News: the Guidance Applied

On April 6, 2009, New York Attorney General Andrew Cuomo filed a civil suit against J. Ezra Merkin, a prominent New York financier who had invested over \$2 billion of his clients’ money in Madoff investments.⁵⁶ That same day, Mortimer Zuckerman, publisher and real estate executive, filed a civil

lawsuit against Merkin alleging that Zuckerman lost \$25 million in investments made by Zuckerman's charitable trust and \$15 million in his own private investment in Madoff's Ponzi scheme.⁵⁷ The New York complaint accuses Merkin of making false and misleading statements regarding the role of Madoff investments in the portfolio; the safety of Madoff funds; and that he had not properly investigated his investments with Mr. Madoff.⁵⁸

These lawsuits raise interesting questions regarding the applicability of the new IRS guidance: Will Merkin's clients be eligible for the Ruling or Safe Harbor? That seems unlikely given that Merkin's investors did not hold direct investments with Madoff. However, the Merkin funds that *did* directly invest in the Madoff funds, for example, almost all of the Ascot funds and approximately 25 percent of the funds invested in Merkin's Ariel and Gabriel accounts,⁵⁹ are eligible to claim the Safe Harbor and pass the resulting theft loss through to their partners.

However, what if a Merkin fund does not elect the Safe Harbor or it was required to take a 25-percent haircut? Could Merkin investors be eligible to take a theft loss with respect to its direct investment in the Merkin fund? Assuming the allegations against Merkin are true, the tax issue under Code Sec. 165 is whether his misrepresentations rise to the level of theft under applicable state or federal law. Larceny is defined as the taking of another's property with the intent to deprive the owner of his property.⁶⁰ Specifically, a person is guilty of larceny by false promise if, pursuant to a scheme to defraud, the person obtains the property of another by misrepresentation (express or implied) that he will engage in certain conduct in the future when he does not intend to actually engage in said conduct.⁶¹ So, do Merkin's actions constitute a theft under the law? Based on the allegations, he certainly engaged in misrepresentations by denying to investors that his Ascot funds were invested in Madoff entities, when in fact Ascot funds had been almost entirely invested with Madoff.⁶² But were these misrepresentations made with an intent to defraud? For that to be the case, it seems necessary for Merkin to have known about the fraudulent nature of the Madoff investments. If not, Merkin's actions amount to poor investment choices, not plans to defraud. As a result, it seems unlikely, although possible, that Merkin investors will be eligible for theft loss relief with respect to their direct investment in the Merkin funds that in turn invested in Madoff.

VI. Conclusion

For a haircut of five or 25 percent (depending on whether the victim takes actions against third parties other than SPIC or the investment advisor), the Safe Harbor offers victims administrative simplicity. But a victim needs to keep in mind that deductions—under the Ruling and the Safe Harbor—are only available for the discovery year, the carryback years (generally three years, but possibly four or five years for losses discovered in 2008) and the carryforward years (20 years). Interest is not available.

A victim is at a substantial disadvantage under these IRS positions if the victim lost most of his life's savings in the Ponzi scheme, has limited income in the discovery year, had limited income in the carryback years and is anticipated to have limited income in the carryforward years. Because these IRS positions preclude victims from obtaining refunds for phantom income in *closed* tax years, such a victim might well be forced to choose a very risky tax course by not following the Safe Harbor or the Ruling.

And, what about amounts Ponzi scheme victims are required to pay back to a SIPC receiver or bankruptcy trustee out of amounts previously distributed from the fraudulent scheme, so called "clawbacks"?⁶³ The Ruling and Safe Harbor are silent on this point, but it is likely to become a serious issue. Are clawback payments theft losses in the year of repayment? On this issue, everyone is flying blind, but it would seem appropriate that clawbacks should be considered theft losses. The formula for determining the amount of the theft deduction under the Ruling removes the value of any funds distributed. These funds are then clawed back by the trustee, so the investor is, in effect, out the same amount of money as an investor who did not take distributions over the life of the investment. Until the IRS provides some guidance on this point, however, an investor facing a clawback should consult his tax advisors.

Without question, the Ruling provides victims of Ponzi schemes with the IRS's views on important tax positions. And the Safe Harbor provides simplified procedures to such victims. But both IRS pronouncements carry a price, which is a particularly heavy price for long-term investors who paid significant taxes on phantom income in closed years and whose significant income-producing years are now well behind them.

Lastly, the IRS presented a neat and tidy case in its Ruling addressing taxpayer A. But in reality, Ponzi

scheme cases will hardly be as easy to analyze. In Stanford funds, for example, some investments were legitimate, while others were not. How should a victim calculate the amount of his theft deduction in cases where his funds were invested in both legitimate and fraudulent investments? How will the

victim be able to determine which investments are legitimate and which are fraudulent? Many more questions will be raised in applying the Ruling and Safe Harbor and investors and their advisors are urged to proceed cautiously as they navigate these choppy waters.

ENDNOTES

- * The authors would like to thank Julie M. Skelton for her assistance. To comply with IRS requirements, any U.S. federal tax advice contained in this article is not intended or written to be used, and cannot be used, for the purposes of (1) avoiding penalties under the Internal Revenue Code or (2) promoting, marketing, or recommending to another party any transaction or matter.
- ¹ *How Bernie Did It*, TIME Magazine, May 11, 2009. As noted in the TIME article, while \$65 billion is the mostly widely cited figure for the size of the Madoff heist, the actual figure (after excluding decades of fabricated returns) is probably closer to \$20 billion.
 - ² See Clifford Kraus, Phillip Zweig, and Julie Creswell, *Texas Firm Accused of \$8 Billion Fraud*, THE N.Y. TIMES, Feb. 17, 2009.
 - ³ See Jacqueline Doherty, *Two Charged in Securities Fraud Case*, available online at online.barrons.com, Feb. 25, 2009.
 - ⁴ See Steve Lieberman, *Nicholson Indicated in \$160M Investor Fraud*, available online at www.LoHud.com (Apr. 24, 2009).
 - ⁵ Rev. Rul. 2009-9, IRB 2009-14, 735. A revenue ruling is a public ruling by the IRS that applies tax law to particular factual situations. It can be relied on by other taxpayers.
 - ⁶ Rev. Proc. 2009-20, IRB 2009-14, 749. A revenue procedure is an official statement of a procedure that affects the rights or duties of taxpayers under the law. It provides return filing and other instructions concerning the IRS position.
 - ⁷ In February 2009, a House bill (H.R. 1159) was introduced to amend the tax code to provide tax relief to individuals harmed by Ponzi schemes. Given the recent IRS guidance, the status of this bill is uncertain.
 - ⁸ For a more detailed discussion, see *infra* sections: *Year of the Deduction and Loss Carryback and Carryforward*.
 - ⁹ See *infra* sections: *Rev. Rul. 2009-9 and Rev. Proc. 2009-20*.
 - ¹⁰ See *Rev. Proc. 2009-20, infra*.
 - ¹¹ All Code Sec. references refer to the Internal Revenue Code of 1986, as amended ("the Code") and the Regulations promulgated thereunder.
 - ¹² Code Sec. 1211(a). Legislation ("The Capital Loss Deduction Limitation Bill") was proposed on May 5, 2009, to raise the annual amount of capital losses a taxpayer can deduct against ordinary income to \$10,000, and then index it for future inflation.
 - ¹³ Code Sec. 1212(b)(1).
 - ¹⁴ Code Sec. 165(h)(2).
 - ¹⁵ Code Sec. 165(h)(1). The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) amended Code Sec. 165(h)(1) for tax year 2009 to raise the amount from \$100 to \$500, but the amount of the deduction floor is scheduled to return to \$100 in years after 2009.
 - ¹⁶ Code Sec. 68(c)(3).
 - ¹⁷ Code Sec. 67(b)(3). As the deduction is not considered a miscellaneous itemized deduction, it is also not subject to the alternative minimum tax. Code Sec. 56(b)(1)(A)(i).
 - ¹⁸ Code Sec. 68(f).
 - ¹⁹ See P.L. 111-5, Act Sec. 1211 (Feb. 17, 2009).
 - ²⁰ Code Sec. 172(d)(4)(C).
 - ²¹ Code Sec. 6611(a).
 - ²² Code Sec. 172(c).
 - ²³ Reg. §1.1341-1(a)(1) and (2). See *Alcoa, Inc.*, CA-3, 2007-2 USTC ¶ 50,824, 509 F3d 173.
 - ²⁴ Code Sec. 1311(b)(1); Code Sec. 1313(a). A taxpayer need not establish an inconsistent position when an adjustment is sought on account of double exclusion of an item of gross income under Code Sec. 1312(3)(B) and double disallowance of a deduction or credit under Code Sec. 1312(4). Code Sec. 1311(b)(1).
 - ²⁵ The IRS is following Rev. Proc. 2004-66, 2004-2 CB 966, which exempted theft losses from the reportable transaction requirement for loss transactions well before the Ruling did so.
 - ²⁶ A "specified fraudulent arrangement" is 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. Rev. Proc. 2009-20, IRB 2009-14, 749, § 4.01.
 - ²⁷ *Id.* at § 4.02
 - ²⁸ Code Sec. 7701(a)(30) defines a "U.S. Person," not a "qualified investor."
 - ²⁹ Revenue Procedure 2009-20 defines a "tax shelter" by reference to Code Sec. 6662(d)(2)(C)(ii); that is, as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."
 - ³⁰ Rev. Proc. 2009-20, IRB 2009-14, 749, § 4.03. The fund or entity may take advantage of the Ruling or Safe Harbor and pass through the benefits to the investors.
 - ³¹ *Id.* at § 5.01.
 - ³² *Id.* at § 6.02.
 - ³³ For a qualified investor, the term "qualified investment" means the excess, if any, of (a) the sum of the total amount of cash (or the basis of property) invested in the arrangement in all years plus the total amount of net income included in income (including years barred by the statute of limitations) over (b) the total amount of cash or property withdrawn in all the years from the arrangement. *Id.* at § 4.06(1). The term does not include (i) invested amounts borrowed from the investment advisor to the extent not repaid, (ii) fees paid to the advisor and deducted and (iii) amounts reported as taxable income but not included in gross income on the qualified investor's federal income tax return. *Id.* at § 4.06(2).
 - ³⁴ *Id.* at §§ 5.02(1)(a), 4.10 (definition of "Potential third-party recovery").
 - ³⁵ *Id.* at §§ 5.02(1)(b), 4.10 (definition of "Potential third-party recovery").
 - ³⁶ SIPC has committed over \$116 million in distributions to individual victims of Madoff's Ponzi scheme. Of these distributions, most were for \$500,000, the maximum protection provided under the SPIC law. See Diana B. Henriques, *Hedge Funds Agree to Return \$235 Million in Madoff Case*, THE N.Y. TIMES, May 27, 2009. SPIC only covers victims that invested directly in SIPC insured Madoff securities accounts.
 - ³⁷ E-File for Large and Midsize Corporations – Frequently Asked Questions, Q30, June 2009, available online at www.irs.gov/businesses/article/0,,id=177619,00.html#4.
 - ³⁸ Rev. Proc. 2009-20, IRB 2009-14, 749, § 5.02(2).
 - ³⁹ See *Rev. Rul. 2009-9, supra*; see *Rev. Proc. 2009-20, supra*.
 - ⁴⁰ *Id.* at § 8.01.
 - ⁴¹ *Id.* at § 8.03.
 - ⁴² See *Theft Loss, supra*.
 - ⁴³ Proposed Reg. § 1.1234A-1.
 - ⁴⁴ See, generally, Kathryn J. Kennedy, *IRAs, 367 Tax Mgmt.* (BNA) U.S. Income, § III.F, 2009.

⁴⁵ Notice 89-25, 1989-1 CB 662; IRS Pub. 590, *Individual Retirement Arrangements (2008)*, at 41.

⁴⁶ *Id.*

⁴⁷ IRS Pub. 590, *Individual Retirement Arrangements (2008)*, at 42.

⁴⁸ Code Sec. 56; IRS Pub. 590, *Individual Retirement Arrangements (2008)*, at 42.

⁴⁹ *SIPC v. Morgan-Kennedy & Co., Inc.*, 533 F2d 1314 (2nd Cir. 1976).

⁵⁰ Reg. §53.4944-1(a)(2)(i).

⁵¹ Code Sec. 4944(a)(1).

⁵² Code Sec. 4944(a)(2). A manager "knows" an investment jeopardizes the foundation's exempt purpose when 1) the manager has actual knowledge, 2) is aware that an investment in such circumstances may jeopardize the foundation's purposes, and 3) negligently fails to make reasonable attempts to determine whether the investment will jeopardize the foundation's exempt purposes. Reg. §52.4944-1(b)(2)(i).

⁵³ Code Sec. 4944(b)(1).

⁵⁴ Code Sec. 4944(b)(2).

⁵⁵ Code Sec. 4944(d)(2).

⁵⁶ See, generally, Diana B. Henriques, *Cuomo Sues Over Madoff Investments*, THE N.Y. TIMES, April 27, 2009; James Quinn, *Former GMAC Financial Services Chairman Ezra Merkin Sued Over Madoff Investments*, THE TELEGRAPH, April 7, 2009.

⁵⁷ See, generally, Patricia Hurtado, *Zuckerman Sues Merkin Over \$40 Million Madoff Loss (Update 3)*, available online at BLOOMBERG.COM, April 6, 2009.

⁵⁸ Complaint ¶¶ 48-60, *Cuomo v. Merkin*, Supreme Ct of NY, April 6, 2009.

⁵⁹ *Id.* ¶ 26.

⁶⁰ NY Code Art. 155.05.

⁶¹ *Id.*

⁶² See, Complaint ¶¶ 48-54, *supra* n58. The Complaint alleges several fund managers, including Madoff, were primarily responsible for all investment decisions despite offering materials, quarterly statements, and other statements made by Merkin and his

employees indicating Merkin had primary management of all investments. *Id.* ¶ 62.

⁶³ The Madoff trustee recently sued the Fairfield Greenwich Group (FGG), seeking recovery of over \$3.2 billion in transfers made from Madoff funds to FGG from 2002 to the Madoff collapse in 2008. See Diana B. Henriques, *Trustee Sues Hedge Funds Over Losses to Madoff*, THE N.Y. TIMES, May 18, 2009; Complaint ¶ 44, *In re: Bernard L. Madoff Investment Securities, LLC v. Fairfield Sentry Limited, et al*, No. 08-01789 (BRL), May 18, 2009. The complaint alleges 10 different counts for recovery including fraud. *Id.* ¶¶ 49-104. The Madoff trustee had recent success in retrieving \$235 million withdrawn from Madoff funds by hedge fund Banco Santander in the three months before the Madoff scheme collapsed. Diana B. Henriques, *Hedge Funds Agree to Return \$235 Million in Madoff Case*, THE N.Y. TIMES, May 27, 2009.

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