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MADOFF: The IRS Has Spoken

On March 17, 2009, the IRS issued guidance to assist victims of Ponzi-type investment schemes. Although the guidance makes no mention of the Madoff scheme or Stanford case by name, new Rev. Rul. 2009-9 clarifies the favorable tax treatment to which victims of these schemes are entitled. New Revenue Procedure 2009-20 provides these taxpayers with an optional safe harbor.

Theft Loss Treatment

New Revenue Ruling 2009-9 covers the tax treatment of fraudulent investment arrangements under which income amounts that are wholly or partially fictitious have been reported as income to the investor. In this Ruling, the IRS clarifies that:

1. The investor is entitled to an ordinary theft loss rather than just a capital loss;
2. An investment theft loss is not subject to the \$100 per event (for pre-2009 years) or 10% adjusted gross income casualty loss floor; but it remains only available to those who itemize deductions;
3. The investment theft loss is deductible in the year that the fraud is discovered; subject to reduction for amounts for which a reasonable prospect for recovery remains;
4. The investment theft loss includes the investor's unrecovered investment and fictitious income that may have been reported in a past year as taxable income (and was not distributed); and
5. The investment theft loss forms part of the taxpayer's net operating loss ("NOL") that may be carried back or forward under normal NOL rules.

In lieu of taking a loss deduction, taxpayers continue to be free to file amended returns for those open years in which tax had been paid on phantom income, bogus gains, and dividends. The IRS ruled, however, that closed years will not be reopened to make these adjustments.

The IRS emphasized that "any deduction for casualty or theft losses allowable under Section 165(c)(2) or (3) is treated as a business deduction for Section 172 (NOL) purposes. Therefore, if the loss is discovered in 2008, Rev. Rul. 2009-9 treats an individual investor or proprietorship as a small business (maximum gross income may not exceed \$15 million) that is eligible for the extended 5 year NOL carry back period under the American Recovery and Reinvestment Act for any 2008 NOL.

Safe Harbor Rule

In the recent pronouncements, the IRS created safe harbor rules using two simple assumptions.

First, the IRS will deem the loss to be the result of theft if: (1) the promoter was charged with a theft type crime; and (2) there exists some evidence of an admission of guilt by the promoter or a trustee was appointed to freeze the assets of the scheme.

Second, the IRS will deem the amount of the investor's prospect of recovery, which limits the amount of the investor's theft loss deduction, to 5% of the investor's net investment plus any actual recovery in the year of discovery and the amount of any recovery expected from private or other insurance (including SIPC). The 5% amount applies to investors suing the creator or promoter of the scheme. For investors suing persons other than the promoter class, however, the prospect of recovery is raised to 25%.

If the deduction taken in the year that the theft is discovered turns out to be too large, the taxpayer must recognize income in the year that a future recovery of that excess is realized. If the initial deduction turns out to be too small because the actual loss recovered is less than anticipated, an additional deduction in the year of recovery may be taken.

The safe harbor is intended to provide a uniform approach to minimize the administrative burden placed upon the IRS and the evidentiary burden placed upon the taxpayer.

The intended benefits of the safe harbor are to provide to the taxpayer an easier road to obtaining a tax refund and for those taxpayers who qualify, an extended NOL carry back period of 5 years as compared to the existing 3 year period. Those taxpayers who forego the safe harbor route, should be prepared to overcome potentially more hurdles with the IRS in order to obtain their tax refund.

There are still a myriad of complex unanswered issues that exist even after the IRS pronouncements. For example, how are theft losses to be treated within Individual Retirement Accounts? Also, how are theft losses to be treated by trust beneficiaries that previously reported income on their individual returns from the distributable net income flowing through the trust? How are theft losses to be treated which occurred prior to a decedent's death, but were discovered later during the period of the administration of the estate? Like the foregoing, there are many more issues that require close attention.

Taxpayers seeking refunds are faced with a critical decision: (1) avail themselves of the IRS safe harbor rules or (2) file amended tax returns. The best choice must be analyzed on a case by case basis to determine which approach yields the most effective result. It may be wise to make certain protective elections to preserve the investor's opportunity to pursue the best course of action. The choice must be made by April 15,

2009, and fraud victims should consult with their tax professional to determine which course of action best suits their particular situation.

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