

New Tax Relief for Victims of Ponzi Schemes

BERNARD MADOFF WAS AN EQUAL OPPORTUNITY SWINDLER. He defrauded charities and schools; fleeced the wealthy, including many prominent financial and entertainment figures; and eviscerated the retirement savings of countless lower and middle-class individuals whose pension funds unwittingly invested in his Ponzi scheme.

Recognizing this financial damage, Internal Revenue Service Commissioner Doug Shulman, appearing before the U.S. Senate Finance Committee in March 2009, announced a plan for providing tax relief to Madoff's victims:

The recent Madoff scandal has affected a very large and diverse pool of investors, some of whom are reported to have lost most of their life savings. Beyond the toll in human suffering—as entire life savings and retirements appear to have been wiped out—the Madoff case raises numerous tax and pension implications for the victims.

To help provide clarity in this very complicated and tangled matter and to assist taxpayers, the IRS is today issuing guidance articulating the tax rules that apply and providing “safe harbor” procedures for taxpayers who sustained losses in certain investment arrangements discovered to be criminally fraudulent.¹

By providing this guidance and safe harbor procedure, the IRS has helped alleviate the financial hardships suffered by taxpayers caught up in the unscrupulous investment schemes promoted by Madoff and others. At the same time, one must fully understand the recent IRS guidance, including the potential benefits and drawbacks of invoking the newly created safe harbor treatment, and be aware of potential complications of claiming Ponzi scheme losses for California tax purposes.

The IRS provides its guidance in Revenue Ruling 2009-9.² After describing how a typical Ponzi scheme operates, the ruling discusses the technical tax issues involved in claiming losses incurred from these schemes. The Internal Revenue Code allows a deduction for losses sustained during a taxable year that are not compensated by insurance or other means.³ These losses are often characterized as “theft losses.”

The question of whether losses suffered from a Ponzi scheme constitute a theft is answered by the broad interpretation given the word, both by the IRC and relevant case law. For tax purposes, theft covers any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses, and any other form of guile.⁴ A taxpayer claiming a theft loss must prove the loss resulted from a taking of property that was illegal under the law of the jurisdiction where it occurred and was done with criminal intent.⁵ The new revenue ruling cautions that, while victims of a Ponzi scheme may have incurred losses in the value of their stock portfolio, not all such losses qualify as a theft loss. If a person takes a loss in the sale of stock acquired on the open market for investment, this is generally considered a capital loss.⁶ And even if a stock declines in value because a corporate officer or director committed fraud, the loss would still not qualify as a theft loss because no one had the specific



intent to deprive shareholders of money or property.⁷ In contrast, since the U.S. Department of Justice indicted Madoff based on his actions to deprive taxpayers of money through criminal acts, his actions constituted a theft for federal tax purposes.⁸

The ruling makes clear that while a theft loss is an itemized deduction, some of the typical conditions applied to such deductions do not apply to theft losses from a Ponzi scheme. One waived condition is the 2 percent floor in determining miscellaneous itemized deductions.⁹ Also, theft losses from these schemes are not subject to the overall limitation on itemized deductions based upon a percentage of adjusted gross income or total itemized deductions.¹⁰

A taxpayer sustains a theft loss during the taxable year when it is discovered.¹¹ However, if an opportunity presents itself to obtain reimbursement that year and a reasonable prospect of recovery exists, no portion of the loss can be claimed until the year when it can be ascertained with reasonable certainty if reimbursement will actu-

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ally be received.¹² Thus, whether a reasonable prospect of recovery exists is a question of fact determined by examining all relevant facts and circumstances.¹³

The amount of the theft loss resulting from a fraudulent investment is generally the initial investment amount, plus any additional sums put in, less amounts withdrawn, if any, reduced by reimbursements or other recoveries.¹⁴ The loss amount is also reduced by claims for which there is a reasonable prospect of recovery.¹⁵ A taxpayer who has a theft loss from a Ponzi scheme would follow this calculation, including reporting amounts reported as gross income on the taxpayer's federal income tax returns during the years of investment.

Theft losses are treated as business deductions¹⁶ and may be included in net operating losses that are carried back and carried forward.¹⁷ Taxpayers claiming net operating losses for the 2008 tax year are eligible for a net operating loss carryback period of up to a five years, rather than the usual three-year carryback period for casualty or theft losses.¹⁸ However, this five-year net operating loss carryback period is restricted to "eligible small businesses" or corporations or partnerships having average annual gross receipts not exceeding \$15 million for the three taxable years ending with the last taxable year.¹⁹ For theft losses incurred in years other than 2008, a taxpayer may carry such losses back three years and forward up to 20 years.²⁰

The New Safe Harbor

Although the ruling clarifies the law relating to a loss suffered from a Ponzi scheme, the optional safe harbor treatment provides a higher degree of certainty on theft loss claims and reduces the administrative burden on both taxpayers and the IRS in filing and processing claims. Revenue Procedure 2009-20²¹ provides taxpayers with a means for claiming losses pursuant to the stated safe harbor and describes how the IRS will treat a return that includes a deduction for these losses when not following the safe harbor.²² The IRS recognizes that determining the availability of a theft loss and calculating the amount of such losses incurred in a Ponzi scheme during the year when the scheme is uncovered are highly fact specific.²³ The optional safe harbor avoids this dilemma by enabling qualified investors to deduct this loss as a theft loss when certain conditions are met and provides a uniform manner for determining the amount of the losses. Investors no longer face the potentially difficult problem of proving how much income reported in prior years or a return of capital was illusory and alleviates compliance.²⁴

The safe harbor applies to a "specified fraudulent arrangement" which is defined as

an arrangement where the "lead figure" or perpetrator 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.²⁵

The safe harbor only covers qualified losses. These losses result from a "specified fraudulent arrangement" where the perpetrator was charged by indictment or information under state or federal law with committing fraud, embezzlement, or a similar crime which, if proven, would meet the definition of theft under the IRC.²⁶ The safe harbor also applies when the perpetrator was the subject of a state or federal criminal complaint and that individual admitted the crime or a receiver or trustee has been appointed to take jurisdiction over the perpetrator's assets.²⁷

The rules of the safe harbor establish a four-part test in defining who is a "qualified investor." Under this definition, a qualified investor is a U.S. citizen, resident, domestic entity, or qualified trust²⁸ that 1) was generally qualified to deduct theft losses under the IRC, 2) lacked actual knowledge of the fraudulent nature of the investment arrangement before it became known publicly, 3) invested in a specified fraudulent arrangement that was not a tax shelter as defined by the IRC,²⁹ and 4) transferred cash or property to a specified fraudulent arrangement.³⁰ A qualified investor excludes anyone who contributed to a fund or entity that then invested in the specified fraudulent arrangement; however, the fund or entity may fall within the revenue procedure's definition of a qualified investor.³¹ For example, a partnership or other pass-through entity formed to invest in what subsequently turns out to be a specified fraudulent arrangement may avail itself of the safe harbor on behalf of its partners, members, or shareholders. When a pass-through entity is involved, care must be taken to make sure the appropriate person (e.g., tax matters partner, managing member, etc.) can satisfy the qualified investor test on behalf of the entity. Another consideration is whether the 5-year carryback period for losses claimed in 2008 is available to the indirect qualified investors because the entity cannot exceed \$15 million of average annual gross receipts during the previous three years.³²

Under Revenue Procedure 2009-20, a qualified investor's discovery year is the taxable year in which the indictment, information, or complaint was filed against the perpetrator or lead figure.³³ For victims of the Madoff Ponzi scheme, the safe harbor clearly

requires losses be claimed in 2008. Madoff was arrested in December 2008 for crimes constituting a theft under the IRC, his alleged crimes were included in a criminal complaint where Madoff confessed to running a "giant Ponzi scheme," and by the end of 2008, a federal judge had ordered that his business operations be placed within the jurisdiction of the court and liquidated.³⁴ This means that victims of the Madoff scheme will need to file amended 2008 returns to take advantage of the safe harbor if they did not claim the losses on their original 2008 returns.

The highly publicized Ponzi scheme allegedly perpetrated by Texas financier R. Allen Stanford may also lead to loss claims under the revenue procedure's safe harbor provisions. Stanford was indicted on June 19, 2009, for conducting an \$7 billion Ponzi scheme that attracted money from more than 30,000 investors around the world.³⁵ Earlier, on February 17, 2009, a federal district court judge entered an order freezing his assets and appointed a receiver to marshal these assets.³⁶ Thus, a qualified investor defrauded by the alleged Stanford Ponzi scheme should be able to claim a loss under the safe harbor for the 2009 tax year.

The sum of the investment in a Ponzi scheme qualifying under the safe harbor is calculated as follows: The total amount of cash or basis of property that the qualified investor invested in the arrangement in all years plus the total amount of net income "earned" from the specified financial arrangement that, consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for years prior to the discovery year (including the taxable years when a refund would be barred by the statute of limitations) minus the total amount of cash or property that the qualified investor withdrew in all years from the specified fraudulent arrangement.³⁷

Under the rules, a qualified investment excludes 1) amounts borrowed from the operator of the scheme and invested in the specified fraudulent arrangement if they were not repaid when the theft was discovered, 2) fees paid to the operator and deducted for federal income tax purposes, 3) amounts reported to the qualified investor as taxable income that were not included in gross income on that investor's tax returns, or 4) cash or property that the qualified investor invested in a fund or entity that invested in a specified fraudulent arrangement.³⁸

Two specific amounts can be claimed as losses in the year of discovery under the safe harbor. A taxpayer victimized by a Ponzi scheme is permitted to take a loss equal to 95 percent of the qualified investment provided the taxpayer does not seek any third-party

recovery for theft loss tax purposes. Alternatively, a qualified investor may claim 75 percent of the deductible loss if that investor is pursuing or intends to pursue a third-party recovery.³⁹ In addition, the amount being deducted must be reduced by any actual recovery the taxpayer receives in the discovery year and any potential insurance or Securities Investor Protection Corporation recovery.⁴⁰ Lastly, the qualified investor may have income or an additional deduction in a year subsequent to the discovery year, depending on the actual amount of the loss that is eventually recovered.⁴¹

A taxpayer must comply with the procedures outlined in Revenue Procedure 2009-20 to claim safe harbor treatment. The taxpayer must mark “Revenue Procedure 2009-20” at the top of the IRS form used to report casualty and theft losses.⁴² Also, the taxpayer must complete and sign an Appendix A like that attached to the revenue procedure.⁴³ By executing Appendix A, the taxpayer agrees to not 1) deduct in the discovery year any amount of the theft loss exceeding the deduction permitted under the revenue procedure, 2) file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year, 3) apply under the Claim of Right Statute,⁴⁴ and 4) apply the doctrine of equitable recoupment or any form of statutory mitigation⁴⁵ with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred for filing a claim for refund under the statute of limitations.⁴⁶

Taxpayers Not Claiming the Safe Harbor

Revenue Procedure 2009-20 effectively directs taxpayers to follow the safe harbor treatment by reminding them of the burden of claiming a theft loss outside its provisions. This burden includes establishing that 1) the loss was from activities that qualify as a theft under the IRC, 2) the theft was discovered in the year the taxpayer claims the deduction, 3) the amount of the claimed loss, and 4) no claim for reimbursement of any portion of loss exists for which there is a reasonable prospect of recovery in the year in which the taxpayer claims the loss. Finally, the taxpayer filing amended returns attempting to exclude income in prior years must show that the income was not actually or constructively received by the taxpayer.⁴⁷

A potential downside may exist in choosing safe harbor treatment over the filing of amended returns to reverse “phantom income” previously reported from Madoff’s fraudulent brokerage statements. While a taxpayer maintains the burden of proving the income did not actually exist, federal authorities and others familiar with the

Madoff case may have disclosed enough information to show that Madoff did not engage in any real trading and that his brokerage statements were fraudulent. Based on this, a taxpayer could claim that income included in prior tax returns should actually not have been reported and those returns that are still open by statute—three years from the filing of the federal tax returns and four years from the filing of state income tax returns—should be amended accordingly. If successful, refunds would accrue statutory interest from the filing of the subject returns. These refunds would be more beneficial than refunds following the safe harbor provisions because the latter only accrue interest from the year of discovery. Moreover, refunds from amended returns will typically be paid from higher tax brackets than refunds from the carryback of theft losses claimed under the safe harbor, which must offset income from the lowest tax bracket to the highest, before being carried into another year. A taxpayer would be well advised to have an accountant calculate the refunds, including interest owed by amending returns, compared with claiming a theft loss under the safe harbor provision.

A taxpayer claiming the safe harbor must also waive any deductions or claims that may be available under the Claim of Right Doctrine.⁴⁸ Under this doctrine, if a taxpayer pays the tax on income in an earlier year

and in a subsequent year the taxpayer is required to repay the income, the taxpayer may claim a deduction for such repayment.⁴⁹ Recently, the trustee for Madoff’s bankrupt company began suing investors to claim tax refunds as compensation for fraud victims. These so-called clawback lawsuits seek to recover tax refunds on the theory that these same investors previously received distributions from Madoff that are now subject to disgorgement. As of August 2009, the IRS had not yet ruled on whether an investor who took advantage of the safe harbor and agreed to waive the benefits under the Claim of Right Doctrine can thereafter make such a claim when faced with a repayment of monies to the Madoff bankruptcy estate.

California Tax Treatment

The California Franchise Tax Board has announced that it will follow IRS guidance to taxpayers who suffer losses from Ponzi schemes.⁵⁰ The FTB will accept Appendix A to Revenue Procedure 2009-20 for those choosing the optional safe harbor provision; however, a taxpayer who takes advantage of this provision for federal purposes is not required to do so for California.⁵¹ Also, California does not currently allow carrybacks of net operating losses, and carry forwards of such losses have been suspended until 2010.⁵² Therefore, California taxpay-



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ers may only claim a theft loss in the year of discovery and carry it forward beyond 2010, assuming state law will then allow net operating losses to be deducted.

The IRS has responded to the plea for relief from the many individuals that Madoff victimized by creating safe harbor provisions that make it easier, both substantively and procedurally, to claim losses from Ponzi schemes. The IRS should be lauded for its expeditious response to one of the most devastating frauds in U.S. history. However, taxpayers should consult with their tax professionals to determine whether the safe harbor relief is the best alternative when compared to other options. ■

¹ *Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation: Hearing before S. Finance Comm.* (Mar. 17, 2009) (Testimony of Doug Shulman, Commissioner, Internal Revenue Service).

² Rev. Rul. 2009-9, 2009-14 I.R.B. 735.

³ I.R.C. §165(a).

⁴ *Edwards v. Bromberg*, 232 F.2d 107 (5th Cir. 1956); see also Treas. Reg. §1.165-8(d).

⁵ Rev. Rul. 72-112, 1972-1 C.B. 60.

⁶ I.R.C. §165(g).

⁷ See Rev. Rul. 77-17, 1977-1 C.B. 44.

⁸ I.R.C. §165.

⁹ See I.R.C. §67(b)(3), which excepts theft losses under I.R.C. §165(c)(2) from the definition of miscellaneous itemized deductions.

¹⁰ I.R.C. §68(c)(3) states that losses deductible under I.R.C. §165(c)(2) are excluded from the itemized deduction limitation.

¹¹ I.R.C. §165(e).

¹² Treas. Reg. §§1.165-8(a)(2) and 1.165-1(d); *Huey v. Commissioner*, 50 TCM 430 (1985); *Ramsay Scarlett & Co. v. Commissioner*, 61 TC 795 (1974), *aff'd*, 521 F.2d 786 (4th Cir. 1975).

¹³ Treas. Reg. §1.165-1(d)(2)(i); see *Scotfield Estate v. Commissioner*, 266 F.2d 154 (6th Cir. 1959).

¹⁴ Treas. Reg. §1.165-8(c); see also Treas. Reg. §1.165-8(f).

¹⁵ Treas. Reg. §§1.165-8(a)(2) and 1.165-1(d); see also *Jeppsen v. Commissioner*, 128 F.3d 1410 (10th Cir. 1997), *cert. denied*, June 8, 1998.

¹⁶ I.R.C. §172(d)(4)(C).

¹⁷ I.R.C. §172(a).

¹⁸ I.R.C. §172(b)(1)(H), *amended by* The American Recovery and Reinvestment Act of 2009 §1211, Pub. L. No.111-5, 123 Stat. 115 (Feb. 17, 2009).

¹⁹ See I.R.C. §§172(b)(1)(H)(iv), 172(b)(1)(F)(iii), and 448(c), *amended by* The American Recovery and Reinvestment Act of 2009.

²⁰ I.R.C. §172(b)(1)(F).

²¹ Rev. Proc. 2009-20, 2009 I.R.B. Lexis 141.

²² Rev. Proc. 2009-20 §1.

²³ Rev. Proc. 2009-20 §2.03.

²⁴ Rev. Proc. 2009-20 §2.04.

²⁵ Rev. Proc. 2009-20 §4.01.

²⁶ I.R.C. §165; Treas. Reg. §1.165-8(d).

²⁷ Rev. Proc. 2009-20 §§4.02(1) and (2).

²⁸ See I.R.C. §7701(a)(30).

²⁹ See the definition of "Tax Shelter" in I.R.C. §6662(d)(2)(C)(ii).

³⁰ Rev. Proc. 2009-20 §4.03(1)-(4).

³¹ *Id.* at §4.03(4).

³² See I.R.C. §§172(b)(1)(H)(iv), 172(b)(1)(F)(iii), and 448(c), *amended by* The American Recovery and Reinvestment Act of 2009.

³³ Rev. Proc. 2009-20 §4.04.

³⁴ *The Madoff Case: A Timeline*, WALL ST. J., Mar. 12, 2009.

³⁵ *Stanford, 5 Others Face Ponzi Charges*, WALL ST. J., June 20, 2009.

³⁶ Press Release 2009-26, SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme, U.S. Securities and Exchange Commission, Feb. 17, 2009.

³⁷ Rev. Proc. 2009-20 §4.06(1).

³⁸ Rev. Proc. 2009-20 §4.06(2)(a)-(d).

³⁹ Rev. Proc. 2009-20 §§5.02(1) and 4.10.

⁴⁰ Rev. Proc. 2009-20 §§5.02(2), 4.07, and 4.08.

⁴¹ Rev. Proc. 2009-20 §5.03 (citing Treas. Reg. §1.165-1(d) and Rev. Rul. 2009-9).

⁴² Rev. Proc. 2009-20 §6.01(1); see Internal Revenue Service Form 4684, Casualties and Thefts.

⁴³ Rev. Proc. 2009-20 §6.01(2).

⁴⁴ See I.R.C. §1341.

⁴⁵ See I.R.C. §§1311-1314.

⁴⁶ Rev. Proc. 2009-20 §6.02. The statute of limitation for claims for refund is set forth in I.R.C. §6511.

⁴⁷ Rev. Proc. 2009-20 §§8.01 and 8.02.

⁴⁸ See I.R.C. §1341.

⁴⁹ I.R.C. §1341(a)(2)-(5).

⁵⁰ Press Release, FTB Follows IRS Guidance For Theft Loss Deductions From Ponzi Schemes, California Franchise Tax Board, July 2, 2009.

⁵¹ *Id.*

⁵² See REV. & TAX. CODE §17276.9(a) for suspension of carryover losses for individuals and REV. & TAX. CODE §24416.9(a) for suspension of losses for corporations.

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