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## **Someone Made Off With My Money, Now What? Tax Issues Affecting Ponzi Scheme Victims**

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### **General Background**

In 2008 it came to light that a number of high-profile investment managers, most notably Bernard L. Madoff Investment Securities LLC (BMIS), had defrauded investors by engaging in so-called “pyramid” or “Ponzi” schemes in which no actual investments were acquired with investor funds and new contributions to the fund were used to make distributions and redemption payments to existing investors.<sup>1</sup> Investors in BMIS and similar schemes received annual statements purporting to show income earned on investments, now known to be fictitious, and reported the income on their annual tax returns accordingly.<sup>2</sup>

On December 11, 2008, Madoff surrendered to federal authorities and was later charged with numerous felony counts related to investment fraud. BMIS was placed in a SIPA liquidation proceeding on December 15, 2008, after Madoff confessed to conducting a Ponzi scheme over a number of years. On March 12, 2009, Madoff pleaded guilty to 11 felony counts in swindling investors of a total amount estimated at \$60 billion.<sup>3</sup> On June 29, 2009, U.S. District Court Judge Denny Chin sentenced Madoff to 150 years in jail, the maximum allowed for his crimes. The SIPA trustee estimates recovery of only a small fraction of that amount for the thousands of BMIS investors who have filed claims. Other sources of recovery could include SIPC insurance (up to \$500,000 per “customer,” as defined in the Securities Investor Protection Act of 1970<sup>4</sup>); homeowner’s insurance; and lawsuits against investment advisers, accountants, and other third-party advisers.

The trustee has determined that, for at least 13 years, BMIS failed to acquire or trade any securities on behalf of investors. All statements sent to investors were completely fictitious. In other reported Ponzi schemes, the investment manager may initially acquire and trade securities on behalf of investors and then later engage in a fraudulent scheme to cover losses.

Some investors invested with BMIS or other schemers as individuals while others invested through family partnerships, trusts, and so-called feeder funds (typically organized as tax partnerships). Charities, IRAs, and pension plans also made investments.<sup>5</sup> Some individuals who invested with BMIS or other schemers died either before or after the fraud came to light.<sup>6</sup>

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## Tax Background

After the extent of the BMIS fraud became known, defrauded investors began seeking tax advice on the amount and timing of any loss deductions for which they might be eligible. Tax advisors soon discovered, as one commentator noted, “a poorly marked path of confusing and contradictory authorities.”<sup>7</sup>

The issues as to which clear, authoritative guidance was lacking included the following:

1. Whether a Ponzi scheme loss is a theft loss or capital loss under Section 165;<sup>8</sup>
2. If treated as a theft loss, whether the allowable loss is limited under Section 165(h) to the amount exceeding 10 percent of the taxpayer’s adjusted gross income;
3. The amount and timing of the loss if there exists a prospect for at least some recovery;
4. Whether “phantom income” reported in closed and/or open years can be added to basis for theft loss purposes or, alternatively, whether one may file amended returns to eliminate “phantom income” for open years;<sup>9</sup>
5. Whether such a loss can create or increase a net operating loss under Section 172 and, if so, what the applicable carryback period is;
6. Whether Section 1341, generally associated with the restoration of amounts previously included in income under a claim of right, applies in computing the tax in the year the loss deduction is allowed; and
7. Whether a taxpayer could benefit from the mitigation provisions of Sections 1311-1314 to adjust its tax liability in otherwise closed years.

On March 17, 2009, the Internal Revenue Service promulgated Rev. Rul. 2009-9 (the “Revenue Ruling”), generally applicable to losses from criminal fraud or embezzlement incurred in a transaction entered into for profit. The facts of the Revenue Ruling specifically address a loss from a Ponzi scheme.<sup>10</sup> Although the ruling does not mention BMIS by name, the facts are consistent with the then known facts of the Madoff scandal. Also on March 17, 2009, the IRS issued Rev. Proc. 2009-20 (the “Revenue Procedure”), which provides a “safe harbor” treatment specific to the reporting of losses from fraudulent “investment arrangements” such as Ponzi schemes and suggests that the IRS will closely scrutinize returns that claim such losses outside the safe harbor.<sup>11</sup> This article addresses, first, the guidance under the Revenue Ruling regarding the timing, amount, and character of theft loss deductions for Ponzi scheme losses and, second, the optional safe harbor treatment under the Revenue Procedure. The Revenue Ruling and other existent authorities will remain relevant to those defrauded investors who either cannot qualify for the safe harbor or elect not to use it.

## Revenue Ruling 2009-9

**Theft Loss.** Section 165 requires a taxpayer to demonstrate that a loss resulted from a taking of property characterized as a theft under state law in order to claim a theft loss deduction.<sup>12</sup> Taxpayers, for instance, are allowed to claim a theft loss deduction for personal use property, such as jewelry, provided they can demonstrate that the items were stolen and not merely lost or misplaced.<sup>13</sup> For individuals, theft losses may also arise in the context of a trade or business or a transaction entered into for profit. Under Treas. Regs. § 1.165-8(d), a “theft” for

purposes of Section 165 would include, but not be limited to, larceny, embezzlement, and robbery.<sup>14</sup> A theft loss is treated as an ordinary, not a capital, loss.<sup>15</sup>

Under the Revenue Ruling (Issue 1), a loss from criminal fraud or embezzlement in a transaction entered into for profit constitutes a theft loss under Section 165;<sup>16</sup> and a loss specific to a Ponzi scheme may qualify as a theft loss under the circumstances where the investment advisor specifically intended to, and did, deprive the investor of money by criminal acts.

**Deduction Limitations.** Under Section 165(h)(1), a theft loss deductible under Section 165(c)(3) (i.e., a so-called “personal casualty loss”) is allowable only to the extent it exceeds \$100 (\$500 for 2009 (only)). Under Section 165(h)(2), a theft loss deductible under Section 165(c)(3), to the extent exceeding “personal casualty gains,” is allowable only to the extent such excess exceeds 10 percent of the individual’s adjusted gross income. Losses under Section 165(c)(1) (trade or business losses) or Section 165(c)(2) (transaction entered into for profit) are not subject to the Section 165(h) limitations. Relying on Rev. Rul. 71-381, the IRS had concluded in a Chief Counsel Advice that Section 165(h) limitations applied to Ponzi scheme losses.<sup>17</sup> However, in at least one litigated case, the IRS had conceded that Ponzi scheme losses qualified under Section 165(c)(2) (and thus were not subject to the Section 165(h) limitations).<sup>18</sup>

The Revenue Ruling (Issue 2) clarifies that theft losses from transactions entered into for profit, including Ponzi schemes, are deductible under Section 165(c)(2), and therefore not subject to the Section 165(h) limitations.<sup>19</sup> The Ruling cites the legislative history to the Tax Reform Act of 1984 (which amended Section 165(c)(3)) to support its conclusion and declares Rev. Rul. 71-381 to be obsolete to the extent holding that a theft loss incurred in a transaction entered into for profit is deductible under Section 165(c)(3) rather than Section 165(c)(2). The Revenue Ruling also holds that such losses are not subject to the limitations on itemized deductions under Sections 67 (miscellaneous itemized deductions) or 68 (overall limitation on itemized deductions).

**Deduction in Year of Discovery Under General Principles of Section 165.** Under Sections 165(a) and (e), a theft loss deduction is allowed as a deduction in the year in which the taxpayer discovers the loss, if such loss is not “compensated for by insurance or otherwise.” In determining the year of discovery, courts have considered whether a reasonable person in similar circumstances would have realized the fact that he or she had suffered a theft loss.<sup>20</sup>

Under Treasury Regulations, a theft loss is not treated as having been “sustained” for purposes of Section 165, and no loss deduction is allowed, “if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery.”<sup>21</sup> The Regulations, in effect, impose a two-part test in determining whether a theft loss deduction will be allowed in the year of discovery for any portion of the loss: (1) whether the taxpayer has an actionable claim for recovery for any portion of the taxpayer’s loss and (2) whether the taxpayer has a reasonable prospect of recovery on such claim. The standpoint for both parts of this inquiry is that of an ordinary prudent person acting under the same or similar circumstances as those confronting the taxpayer as of the end of the year of discovery. Under this standard, assuming a legal remedy for recovery exists, taxpayers will be allowed a loss deduction only if the prospect of recovery on the claim is low, either because the likelihood of success on

the merits of the claim is poor or because the wrongdoer or responsible third party has insufficient assets to pay a judgment against it. Under exceptional circumstances, a taxpayer will be allowed a loss deduction simply because no legal remedy exists to recover its loss as of the end of the year of discovery.<sup>22</sup>

A taxpayer's decision (or indecision) whether to pursue a claim for reimbursement or recovery has only limited relevance as to whether a loss deduction is allowable in the year of discovery. In *Boehm v. Commissioner*,<sup>23</sup> the Supreme Court held that the taxpayer's reasonable and honest belief as to the merits of its claim and prospects for recovery, as supported by the taxpayer's actions, was not controlling in determining the year a loss deduction was allowed. The determination of whether a loss had been sustained, the Supreme Court noted, "requires a practical approach, all pertinent facts and circumstances being open to inspection and consideration regardless of their objective or subjective nature."<sup>24</sup> Applying *Boehm*, courts have held that pending or prospective litigation for recovery merely provides an inference that the taxpayer has a reasonable prospect of recovery, but will not be controlling.<sup>25</sup> The Sixth Circuit has noted, in dictum, that a loss deduction will be allowed, for instance, if the facts and circumstances "show such litigation to be specious, speculative, or wholly without merit."<sup>26</sup> The Tax Court has, on occasion, applied an even more flexible analysis, noting, "A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor."<sup>27</sup> Thus, the Third Circuit allowed a loss deduction notwithstanding the taxpayer's pending lawsuit against a bank in a check forgery case after determining that the taxpayer's chances of success against the bank were "remote" under the law as it existed at the end of the year the loss was discovered.<sup>28</sup> On the other hand, the taxpayer's failure to bring a claim before the end of the year of discovery will generally not support a deduction if a reasonably prudent person would have concluded that a claim was worth pursuing based upon facts known, or reasonable inferences from facts known, at that time.<sup>29</sup>

Even if a court concludes that there is a substantial possibility that a taxpayer's claims for recovery or reimbursement would be decided in its favor, the taxpayer will not have a reasonable prospect of recovery and a loss deduction ought to be allowed if the taxpayer is able to demonstrate that the wrongdoer or responsible third party does not have any (or has limited) assets to meet a judgment against it<sup>30</sup> or if (and only to the extent that) the amount of the loss exceeds the taxpayer's claims for reimbursement.<sup>31</sup> Future recoveries after the year of discovery should not be relevant in determining whether the taxpayer had a reasonable prospect of recovery at the end of the year of discovery.<sup>32</sup> A frequent point of controversy has been whether a deduction will be allowed when there is insufficient information as of the end of the year of discovery to determine whether there would be sufficient assets with which to reimburse a taxpayer for all or part of its loss. In several recent cases, the courts have required taxpayers to postpone their loss deduction to the extent of their claim for reimbursement or recovery until the year sufficient information was available to determine the extent of their loss with reasonable certainty.<sup>33</sup>

***Deduction in Year of Discovery Under Revenue Ruling.*** Under the Revenue Ruling (Issue 3), if there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no theft loss deduction is allowed for the year of discovery to the extent that the loss is "covered by" the claim. Thus, a theft loss deduction must be deferred by the entire

amount of a claim as to which a reasonable expectation of recovery exists, and not merely the taxpayer's then-current estimate of what he ultimately may recover. (This assumes, as does the discussion in the remainder of this section, including Examples 1-5 below, that the taxpayer either is ineligible to elect, or chooses not to elect, safe harbor reporting under the Revenue Procedure, described later in this article.)

**Example 1:** A taxpayer suffers a theft loss relating to an investment in a Ponzi scheme. Assume that the theft loss as computed under Rev. Rul. 2009-9 is equal to the taxpayer's entire investment of \$100x. The taxpayer files a lawsuit against a third-party financial advisor seeking damages of \$100x, but otherwise has no other claims for reimbursement having a reasonable prospect of recovery. The taxpayer estimates that the likelihood of recovering \$100x is small, and does not anticipate that he ultimately will recover more than \$25x. Under the Revenue Ruling, in determining the amount of its theft loss deduction, the taxpayer must reduce its theft loss by \$100x on account of the lawsuit.

For Ponzi scheme investors having claims in a bankruptcy proceeding involving the promoter, the IRS's position in the Revenue Ruling means that even if a taxpayer believes his chances for a full recovery from a bankruptcy claim are "between slim and none," he nevertheless is required to reduce the amount of the loss deduction for the discovery year by the entire amount of the claim if there is a reasonable prospect for some recovery and the amount of the potential recovery cannot yet be reasonably ascertained.

Where a taxpayer has a claim which, as a practical or legal matter, is clearly for less than the amount of his theft loss, the Revenue Ruling does allow a theft loss deduction in the year of discovery for the portion of the loss not covered by such claim. Alternatively, where the taxpayer's only claim is against a defendant who is "judgment proof," the Revenue Ruling would permit a full deduction in the year of discovery.

**Example 2:** A taxpayer suffers a theft loss incurred in a transaction entered into for profit. Assume that the theft loss as computed under the Revenue Ruling is equal to the taxpayer's entire investment of \$100x. The taxpayer files a lawsuit against the wrongdoer for recovery, but the wrongdoer is known to have no assets upon which to recover by execution of a judgment or otherwise. The taxpayer has no other claims for reimbursement having a reasonable prospect of recovery. Under the Revenue Ruling, the taxpayer is not required to reduce its theft loss in the year of discovery on account of the lawsuit and may claim a loss deduction in that year of \$100x.

**Example 3:** A taxpayer in Year 1 transferred \$100x to an account managed by an investment advisor, reported \$10x of income attributable to the account in each of Years 2 through 5, took no distributions, and discovered in Year 6 that the investment account was being managed as part of a Ponzi scheme. Under the Revenue Ruling, the taxpayer computes his theft loss to be \$140x. The taxpayer files a claim in the bankruptcy proceeding for \$100x pursuant to the bankruptcy trustee's instructions limiting claims to the amount of the net investment. The

taxpayer believes that there is little hope of recovering more than \$10x on the claim. If the taxpayer has no other claims for reimbursement having a reasonable prospect of recovery, the taxpayer would be able to claim a theft loss deduction in the year of discovery of \$40x (the amount by which his loss exceeds his bankruptcy claim).<sup>34</sup>

***Treatment of Subsequent Recoveries if Deduction Is Allowed in Year of Discovery.***

Under the Revenue Ruling, if the taxpayer later recovers an amount under a claim as to which no reasonable prospect of recovery initially was believed to exist, the subsequent recovery is includible in the taxpayer's gross income in the later year under the tax benefit rule to the extent the earlier deduction reduced the taxpayer's income tax.<sup>35</sup>

***Example 4:*** A taxpayer suffers a theft loss of \$100x incurred in a transaction entered into for profit. Although the taxpayer filed a lawsuit against the wrongdoer for recovery, it determined at the end of the year of discovery that there was no reasonable prospect of recovery on account of the inability to collect on any judgment against the wrongdoer, and claimed a loss deduction for the entire \$100x. The taxpayer has no other claims for reimbursement. The following year, the taxpayer discovers some hidden assets and recovers \$10x from the wrongdoer in settlement of the litigation. The taxpayer includes the \$10x in income in the year of recovery to the extent required under the principles of Section 111.

**Deduction After Year of Discovery.** Taxpayers who must defer all, or a portion of, their theft losses in the year of discovery due to a claim as to which there is a reasonable prospect of recovery may subsequently deduct all or a portion of the amount deferred in the year when it "can be ascertained with reasonable certainty whether or not such recovery will be received." Under this standard, the deferred loss will generally be deductible only when the claim is finally settled, adjudicated, or abandoned.<sup>36</sup>

Although the IRS has taken the position in litigation that no subsequent-year deduction is allowed until all pending claims have been finally resolved, the Federal Court of Claims recently rejected this approach in the last of the three companion tax cases involving Aben and Joan Johnson.<sup>37</sup> The Johnsons suffered a \$75 million theft loss in a fraudulent gem scam carried out by one John Hasson.<sup>38</sup> The Johnsons discovered their loss in 1997 and sought to claim a partial theft loss deduction in 1998, based on their advisors' and a bankruptcy trustee's estimate that they would recover no more than \$20 million from Hasson and third-party defendants. In an earlier decision,<sup>39</sup> the Court of Federal Claims denied any deduction for 1998, finding that the Johnsons could not at that time "ascertain with reasonable certainty" what the amount of any recoveries against Hasson or third parties would be. However, in Johnson III the court permitted a partial deduction in 2001, at which time various claims had been settled, various defendants had been released, and the "fixed and identifiable" maximum amount recoverable from other sources was known and determinable.

***Example 5:*** A taxpayer suffers a theft loss of \$100x incurred in a transaction entered into for profit. In the year of discovery, the taxpayer filed lawsuits against

both the wrongdoer and a third party for recovery, and determined that both claims had a reasonable prospect of recovery requiring the loss deduction to be postponed. Two years after the year of discovery, the taxpayer obtains a judgment against the wrongdoer and collects \$40x on the judgment, which she determines with reasonable certainty to be the maximum amount she will be able to collect. The taxpayer further determines at that time that her maximum recovery against the third-party defendant will be limited to \$10x. The taxpayer is entitled to a theft loss deduction of \$50x (\$100x - \$40x - \$10x) in such later year. The taxpayer may be entitled to a further theft loss deduction in a subsequent year, depending on the final resolution of the third-party claim.

**Amount of Deduction.** In the case of an investment theft loss, a taxpayer's allowable loss is limited to its adjusted basis in the lost investment, less any insurance or other reimbursement for the loss.<sup>40</sup> An issue arises whether phantom income should be included in basis for purposes of computing the taxpayer's loss deduction. Prior to the Revenue Ruling, no clear guidance had been issued as to whether taxpayers could include such amounts in the calculation of their theft loss, or alternatively, whether they could amend open-year returns to eliminate phantom income previously reported. A taxpayer clearly cannot "double dip" by filing amended returns to eliminate phantom income and then including that same phantom income in the calculation of his or her theft loss. However, if a taxpayer does not include open-year phantom income in the theft loss calculation, filing amended returns remains a possible course of action. For BMIS victims, filing amended returns was or is possible, generally, only for 2007, 2006, and 2005, the tax years open at the time when the fraud was discovered. For 2005 returns filed by April 15, 2006, taxpayers would have needed to file a protective or actual claim for the 2005 tax year by April 15, 2009, to toll the refund statute of limitations.<sup>41</sup> Victims of prior Ponzi schemes who amended open returns have found mixed results, leaving this path an uncertain one for taxpayers seeking to recover taxes paid on phantom income.<sup>42</sup>

Under the Revenue Ruling (Issue 4), taxpayers can include the phantom income from a transaction entered into for profit in computing their theft loss. The Ruling provides that a taxpayer who reported phantom income from a Ponzi-scheme investment in gross income in years prior to the year of discovery of the theft (regardless whether the income was reported in an open or closed year) may include such income in basis for purposes of determining the taxpayer's theft loss deduction. Accordingly, Ponzi-scheme victims have a basis for purposes of computing their theft loss deduction equal to (1) the initial amount invested in the arrangement, plus (2) any additional investments in the arrangement, plus (3) amounts reported to the investor and included in gross income in years prior to the year of discovery of the theft, minus (4) amounts withdrawn from the arrangement. The approach of the Ruling provides a more certain path for taxpayers, and may be viewed by some as fairly generous given the lack of clear authority prior to the ruling.<sup>43</sup> On the other hand, by filing an amended return for open years, a taxpayer will receive the benefit of interest on its refunds (see Section 6611) and may obtain a benefit by offsetting only income taxed at the highest marginal rates.<sup>44</sup>

**Net Operating Loss.** For individual taxpayers, in computing their net operating loss (NOL) under Section 172, a theft loss allowed under either Section 165(c)(2) or Section 165(c)(3) is treated as a business deduction (or, as it were, such a theft loss is not treated as a

nonbusiness deduction).<sup>45</sup> Any NOL that results from such a theft loss deduction can be carried back and/or forward under Section 172. For individuals, Section 172(b)(1)(F)(ii)(I) allows a three-year carryback for NOLs resulting from a theft loss deduction under Sections 165(c)(2) or 165(c)(3), as opposed to the generally applicable two-year carryback for other NOLs.

Under the Revenue Ruling (Issue 5), if a 2008 theft loss gives rise to an NOL, a taxpayer that qualifies as an “eligible small business” can elect either a three-, four-, or five-year carryback for an “applicable 2008 net operating loss” pursuant to Section 172(b)(1)(H) as amended by Section 1211 of the American Recovery and Reinvestment Act of 2009.<sup>46</sup> An “eligible small business,” following the definition of “small business” under Code Section 172(b)(1)(F) (iii), means a corporation or partnership which meets the gross receipts test of Section 448(c) for the taxable year of the loss, or, in the case of a sole proprietorship, which would meet such test if the proprietorship were a corporation, substituting “\$15 million” for “\$5 million” in applying such test. A theft loss sustained by an individual is treated as a loss arising from a sole proprietorship for purposes of determining whether the individual is an eligible small business.<sup>47</sup> Under Section 172(b)(1)(H) the five-year carryback period is available only for losses incurred in a tax year either beginning or ending in 2008 (but not both). This limitation may make the safe harbor treatment under the Revenue Procedure, discussed below, more attractive, particularly for Ponzi scheme victims who can claim “applicable 2008 net operating losses.”<sup>48</sup>

**Application of Section 1341.** Under Section 1341, if a taxpayer included an item of gross income in one taxable year “because it appeared that the taxpayer had an unrestricted right to such item,” and in a subsequent taxable year becomes entitled to a deduction because it “did not have an unrestricted right to such item or to a portion of such item,” and the amount of the deduction is in excess of \$3,000, the tax in the subsequent year is reduced by either (1) the tax attributable to the deduction or (2) the decrease in the tax for the prior year attributable to the removal of the item, whichever is greater.<sup>49</sup> The computation of tax under Section 1341, if applicable, is mandatory. Under the rule in *Lewis v. United States*,<sup>50</sup> the taxpayer is entitled to the deduction only in the year it is established that the taxpayer did not have an unrestricted right to the item.<sup>51</sup> If under Section 1341 the tax in the later year is reduced by the decrease in tax for the earlier year of inclusion, and the decrease in tax exceeds the tax imposed for the taxable year (computed without the deduction), such excess shall be considered a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited as if it were an overpayment for such taxable year.<sup>52</sup>

As the courts have noted, the statutory language “is ambiguous in that it does not explain ‘how a taxpayer or the IRS is supposed to establish that the taxpayer does not have an unrestricted right to income.’”<sup>53</sup> Prior to the issuance of the Revenue Ruling, it was unclear whether the so-called “claim of right” doctrine might apply to offer taxpayers some relief for phantom income reported in closed years on the theory that the taxpayer no longer had an unrestricted right to such income upon discovery of the fraud. Under the Revenue Ruling (Issue 6), however, the IRS held that for Section 1341 to apply, the deduction allowed in the later year must arise because the taxpayer is under an obligation to restore the income. In the example included in the Ruling, the taxpayer’s theft loss deduction does not arise from an obligation on the taxpayer’s part to restore any income, and, therefore, under the Ruling, the taxpayer is not entitled to the tax benefits of Section 1341 with regard to its theft loss deduction.



In cases where the deduction arises because the taxpayer is under an obligation to restore the income, and the other statutory requirements are met, Section 1341 would seemingly apply. Some Ponzi-scheme victims, for instance, may be eligible for a loss deduction on account of being required to restore income to the bankruptcy trustee under federal or state fraudulent conveyance laws. The Revenue Ruling does not address these facts and provides no reason why Section 1341 should not apply in such a case.<sup>54</sup>

**Example 6:** An individual, A, transfers \$100x to an account with an investment advisor, B, who purports to purchase and sell securities on A's behalf. A takes distributions each year equal to the amount of income reported to A and included in gross income on A's federal income tax returns. Over several years, A reports income of \$120x and takes distributions of the same amount. Within two months of discovering that B's purported investment advisory business was in fact a Ponzi scheme, A withdrew an additional \$50x from his account. A is subsequently required to restore a portion of his prior distributions to the bankruptcy trustee under the state law fraudulent conveyance statute. Arguably, Section 1341 applies to all or a portion of any payment by the taxpayer to the trustee representing a restoration of previously reported income.

**Mitigation Provisions.** The mitigation provisions under Sections 1311 through 1314 permit the IRS or a taxpayer in certain circumstances to correct an error made in a closed year by adjusting the tax liability in years that are otherwise barred by the relevant statute of limitations. Section 1311(a) authorizes an adjustment of tax for a closed year, provided certain conditions are met, when there is a "determination" described in one or more of the paragraphs in Section 1312 and on the date of determination, "correction of the effect of the error" is prevented "by the operation of any law or rule of law" (other than Sections 1311-1314 or Section 7122 (relating to compromises)). An adjustment authorized under Section 1311(a) resulting in an amount credited or refunded to the taxpayer shall be made in the same manner as if it were an overpayment claimed by the taxpayer for the taxable year or years with respect to which the adjustment is made, and as if on the date of determination one year remained before the expiration of the statute of limitations for filing a claim for refund for such year or years. A "determination" for purposes of the mitigation provisions includes, among others, a decision by the Tax Court, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final, or a closing agreement under Section 7121.

The conditions necessary for an adjustment under Section 1311(a) vary depending on the type of determination. For determinations of basis, any adjustment that would result in a refund or credit to the taxpayer under the mitigation provisions requires that "there is adopted in the determination a position maintained by the Secretary" and such position is "inconsistent with" the erroneous inclusion of income in the closed year. Prior to the issuance of the Ruling, consideration was given to the possibility that the Secretary might take the position that phantom income did not increase basis for purposes of determining a taxpayer's theft loss deduction. To the extent that there was a determination to this effect, arguably the IRS would be taking a position inconsistent with the prior inclusions of phantom income.<sup>55</sup>

Under the Revenue Ruling (Issue 7), however, relief under the mitigation provisions of Sections 1311-1314 is not available since there is no inconsistency in the IRS's position with respect to the prior inclusion of income and the amount of the theft loss deduction. The taxpayer is entitled to an investment theft loss under Section 165(c)(2) that includes amounts previously reported in income in years prior to the year of discovery of the theft, which is consistent with the position that the amounts were properly included in income in the earlier years.

### **The Safe Harbor—Rev. Proc. 2009-20**

Rev. Proc. 2009-20 provides an optional safe harbor method for computing and reporting losses from Ponzi schemes while introducing an assortment of new terminology. For Madoff victims, the principal benefit of the safe harbor is certainty regarding the timing (2008) and amount (either 95 percent or 75 percent of basis for 2008) for a current theft loss deduction. The timing issues may be particularly important to some defrauded investors given that net operating losses arising from a large 2008 theft loss deduction will qualify for the longer five-year carryback period only if the loss is an “applicable 2008 net operating loss” under Section 172(b)(1)(H).<sup>56</sup> This section of the article provides a detailed analysis of the safe harbor and, through a series of examples, highlights some unresolved issues and some situations where use of the safe harbor might not be the best course.

Under the lexicon of the Revenue Procedure, “qualified investors” who suffer a “qualified loss” of a “qualified investment” from a “specified fraudulent arrangement” may claim a theft loss deduction for a substantial portion of such loss in the “discovery year.” If the qualified investor complies with the terms of the Revenue Procedure, it will be able to claim a loss deduction in the discovery year equal to the excess of (1) 95 percent of the qualified investment, for a qualified investor that does not pursue any “potential third-party recovery,” or 75 percent of the qualified investment for a qualified investor that is pursuing or intends to pursue any potential third-party recovery, over (2) any “actual recovery” and any “potential insurance/SIPC recovery.” The Revenue Procedure applies only to losses for which the discovery year is a taxable year beginning after December 31, 2007. 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. The IRS notes that treatment under the Revenue Procedure “provides qualified investors with a uniform manner for determining their theft losses” and “alleviates compliance and administrative burdens on both taxpayers and the Service.”

To claim a loss deduction under the Revenue Procedure, a qualified investor must agree to comply with the following conditions:<sup>57</sup>

1. Not to deduct in the discovery year any amount of the theft loss in excess of the deduction permitted under the Revenue Procedure;
2. Not to 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. Not to apply the alternative computation in Section 1341 with respect to the theft loss deduction allowed by the Revenue Procedure; and
4. Not to apply the doctrine of equitable recoupment or the mitigation

provisions in Sections 1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations on filing a claim for refund under Sections 6511.<sup>58</sup>

**Specified Fraudulent Arrangement.** Under the Revenue Procedure, a “specified fraudulent arrangement” means “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.”<sup>59</sup> The Revenue Procedure is clearly intended to apply to Ponzi schemes, and in particular to BMIS. The Revenue Procedure cites as an example of a “specified fraudulent arrangement” the scheme described in Revenue Ruling 2009-9.

*Example 7:* An individual, A, opened an investment account with B in Year 1, contributed cash to the account, and provided B with a power of attorney to use the cash to purchase and sell securities on A’s behalf. In Year 8 it was discovered that B’s purported investment advisory and brokerage activity was in fact a fraudulent investment arrangement known as a Ponzi scheme. Under this scheme, B purported to invest cash or property on behalf of each investor, including A, in an account in the investor’s name, and for each investor’s account reported investment activities and resulting income amounts that were partially or wholly fictitious. In some cases, in response to requests for withdrawal, B made payments of purported income or principal to investors, which payments were made, at least in part, from amounts that other investors had invested in the fraudulent arrangement. B’s actions constituted criminal fraud or embezzlement under the law of the jurisdiction in which the transactions occurred. The investment arrangement should constitute a specified fraudulent arrangement.

Because reported income can be “partially or wholly” fictitious, an arrangement where an investment adviser began making actual investments and then engaged in a Ponzi scheme to cover losses should constitute a “specified fraudulent arrangement” for purposes of the safe harbor.

*Example 8:* A corporation, C, collects funds from various investors. In return, C promises investors exceptionally high interest rates. Investors are told that the funds are used to purchase business equipment for resale. C began operations as a legitimate business buying and selling business equipment, but then disintegrated into a Ponzi scheme, after which time no equipment was purchased and, instead, funds obtained from later investors were used to pay early investors their promised returns. The scheme should constitute a specified fraudulent arrangement.

Not all theft losses are covered by the safe harbor treatment.<sup>60</sup> A simple case of a financial advisor defrauding a single person should not, for instance, constitute a specified fraudulent arrangement.

**Example 9:** An individual, D, transfers money to a trusted financial advisor who promises to invest the money on D's behalf. The adviser accepts the money with the intention of stealing it and uses the money to pay off his own personal debts. D has a theft loss subject to the general rules regarding the timing and amount of his loss under Section 165.<sup>61</sup>

**Qualified Loss.** For purposes of the Revenue Procedure, a “qualified loss” means

a loss resulting from a specified fraudulent arrangement in which, as a result of the conduct that caused the loss—

1. The lead figure (or one of the lead figures, if more than one) was 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 meet the definition of theft for purposes of § 165 of the Internal Revenue Code and § 1.165-8(d) of the Income Tax Regulations, under the law of the jurisdiction in which the theft occurred; or
2. The lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in section 4.02(1) of this revenue procedure, and either—
  - (a) The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or
  - (b) A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.<sup>62</sup>

**Example 10:** The U.S. Attorney files an indictment charging a promoter of a Ponzi scheme with federal mail and wire fraud violations. A loss from the scheme should be treated as a qualified loss.

A loss not connected with a specified fraudulent arrangement is not a qualified loss for purposes of the Revenue Procedure.

**Example 11:** The U.S. Attorney files an information charging a promoter of a fraudulent real estate scheme with federal mail and wire fraud violations based on fraudulently obtained appraisals. If the scheme does not constitute a “specified fraudulent arrangement,” a loss resulting from the fraudulent scheme is not a qualified loss.

**Qualified Investor.** Under the Revenue Procedure, a “qualified investor” means a United States person, as defined in § 7701(a)(30)<sup>63</sup> —

1. That generally qualifies to deduct theft losses under § 165 and § 1.165-8;

2. That did not have actual knowledge of the fraudulent nature of the investment arrangement prior to its becoming known to the general public;<sup>64</sup>
3. With respect to which the specified fraudulent arrangement is not a tax shelter, as defined in § 6662(d)(2)(C)(ii); and
4. That transferred cash or property to a specified fraudulent arrangement.<sup>65</sup>

Persons who invested in a fund which, in turn, transferred cash to a specified fraudulent arrangement are not qualified investors on account of the investment in the fund. The Revenue Procedure provides, “A qualified investor does not include a person that invested solely in a fund or other entity (separate from the investor for federal income tax purposes) that invested in the specified fraudulent arrangement. However, the fund or entity itself may be a qualified investor within the scope of this revenue procedure.”<sup>66</sup>

**Example 12:** A United States person invests in a fund that is treated as a domestic partnership for federal tax purposes, and the fund, in turn, transfers cash to a specified fraudulent investment, resulting in a loss. The fund may be eligible to compute and report its loss under the Revenue Procedure. Persons who transferred money to the fund are not qualified investors for purposes of the Revenue Procedure. Such persons, however, should receive Schedules K-1 from the fund permitting them to report their allocable shares of the fund’s theft loss deduction on their individual tax returns.<sup>67</sup>

**Example 13:** A foreign person invests in a specified fraudulent arrangement through an offshore fund treated as an association for federal tax purposes. Neither the foreign investor nor the offshore fund is a qualified investor for purposes of the Revenue Procedure.

**Discovery Year.** Under the Revenue Procedure, “discovery year” means “the taxable year of the investor in which the indictment, information, or criminal complaint” described above is filed.<sup>68</sup> Since the discovery year for purposes of the Revenue Procedure will invariably be no earlier than, and often later than, the year of discovery as determined under general Section 165 principles (i.e., the year a reasonable person in similar circumstances would have realized that he or she had suffered a theft loss), the Revenue Procedure serves to protect taxpayers from the government’s arguing that the theft loss deduction should have been claimed in an earlier year.<sup>69</sup>

**Example 14:** In Year 1, an individual, E, invests money in a Ponzi scheme constituting a specified fraudulent arrangement. In Year 2, the Securities Commission of State X begins investigating the arrangement, and the promoter in the same year files a bankruptcy petition on behalf of the operation while the debtor remains in possession. In Year 3, a criminal complaint is filed charging the promoter with fraud and a receiver is appointed by the bankruptcy court to administer the bankruptcy estate. The discovery year for purposes of the Revenue Procedure is Year 3.

**Qualified Investment.** Under the Revenue Procedure, “qualified investment” means the excess, if any, of—

- (a) The sum of—
  - (i) The total amount of cash, or the basis of property, that the qualified investor invested in the arrangement in all years, plus
  - (ii) The total amount of net income with respect to the specified fraudulent arrangement that, consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for all taxable years prior to the discovery year, including taxable years for which a refund is barred by the statute of limitations; over
- (b) The total amount of cash or property that the qualified investor withdrew in all years from the specified fraudulent arrangement (whether designated as income or principal).<sup>70</sup>

Under the Revenue Procedure, “qualified investment” does *not* include

- (a) Amounts borrowed from the “responsible group” and invested in the specified fraudulent arrangement to the extent the borrowed amounts were not repaid at the time the theft was discovered;
- (b) Amounts such as fees that were paid to the responsible group and deducted for federal income tax purposes;
- (c) Amounts reported to the qualified investor as taxable income that were not included in gross income on the investor’s federal income tax returns; or
- (d) Cash or property invested in a fund or other entity (separate from the qualified investor for federal income tax purposes) that invested in a specified fraudulent arrangement.<sup>71</sup>

For purposes of the Revenue Procedure, the “responsible group” for any specified fraudulent arrangement includes (1) the individual(s) (including the lead figure) who conducted the specified fraudulent arrangement; (2) any investment vehicle or other entity that conducted the specified fraudulent arrangement, and employees, officers, or directors of that entity or entities; (3) a liquidation, receivership, bankruptcy, or similar estate established with respect to individuals or entities who conducted the specified fraudulent arrangement, in order to recover assets for the benefit of investors and creditors; or (4) parties subject to claims brought by a trustee, receiver, or other fiduciary on behalf of the liquidation, receivership, bankruptcy, or similar estate described in (3).<sup>72</sup>

**Example 15:** In Year 1, an individual, F, opened an investment account with G and contributed \$100x to the account. In Year 3, F contributed an additional \$20x to the account. G reported to F that no income was earned in Year 1 and that for each of Years 2 through 7 the investments earned \$10x of income (interest, dividends, and capital gains), which F included in gross income on F’s federal income tax return. F took a single distribution of \$30x from the account in Year 7. F’s qualified investment for purposes of the Revenue Procedure is \$150x, equal to the excess of (a) the sum of (1) \$120x (the total amount of cash that F invested in

the arrangement in all years) plus (2) \$60x (the total amount of net income with respect to the arrangement that F reported for federal income tax purposes for all taxable years prior to the discovery year), over (b) \$30x (the total amount of cash or property that the qualified investor withdrew in all years from the arrangement).

**Example 16:** An individual, H, transferred \$50x to a family limited partnership, which invested the cash with a specified fraudulent arrangement. Regardless whether H is otherwise a qualified investor in his individual capacity on account of having also made a direct investment with the arrangement, the \$50x is not included as part of H's qualified investment. If the partnership is a qualified investor, the \$50x is included in determining the partnership's qualified investment and H's allocable share thereof.

If filing under the Revenue Procedure, qualified investors must include a statement with their return for the discovery year certifying under penalties of perjury that they have written documentation to support the amounts used to compute their qualified investment, including total amounts invested and withdrawn for all years and total income reported for all years prior to the discovery year. Qualified investors with incomplete records may need to obtain this information from the trustee or receiver administering the bankruptcy estate of the arrangement. Investors may need to request a copy of prior years' tax returns from the IRS or their tax return preparer.<sup>73</sup>

**Claims for Recovery and Reimbursement.** The Revenue Procedure distinguishes among four types of compensation for a qualified loss: (1) "actual recovery," (2) "potential insurance/SIPC recovery," (3) "potential direct recovery," and (4) "potential third-party recovery."

**Actual Recovery.** "Actual recovery" means "any amount a qualified investor actually receives in the discovery year from any source as reimbursement or recovery for the qualified loss."<sup>74</sup>

**Potential Insurance/SIPC Recovery.** "Potential insurance/SIPC recovery" means the sum of the amounts of all actual or potential claims for reimbursement for a qualified loss that, as of the last day of the discovery year, are attributable to—

1. Insurance policies in the name of the qualified investor;
2. Contractual arrangements other than insurance that guaranteed or otherwise protected against loss of the qualified investment; or
3. Amounts payable from the Securities Investor Protection Corporation (SIPC), as advances for customer claims under 15 U.S.C. § 78fff-3(a), or by a similar entity under a similar provision.<sup>75</sup>

Under the Revenue Procedure, potential insurance/SIPC recovery includes potential claims for reimbursement, without regard to whether insurance claims are, in fact, filed.

**Example 17:** A qualified investor, J, is potentially insured for \$50x of his theft loss with respect to a specified fraudulent arrangement under J's homeowner

insurance policy. Even if J has no intention of filing a claim under the policy, if J is filing under the Revenue Procedure he must reduce the amount of his theft loss deduction by the \$50x of coverage.<sup>76</sup>

**Potential Direct Recovery.** Under the Revenue Procedure, “potential direct recovery” means “the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year, against the responsible group.”<sup>77</sup> Claims against the bankruptcy estate of the lead figure or entity conducting the specified fraudulent arrangement should fall under this heading.

**Potential Third-Party Recovery.** “Potential third-party recovery” means “the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year,” that are not described as potential insurance/SIPC recovery or potential direct recovery.<sup>78</sup> Claims for reimbursement against, for instance, banks or advisory firms that steered qualified investors to invest in a specified fraudulent arrangement should ordinarily fall under this category.

**Example 18:** An individual, K, invests in a fund that is a domestic partnership for federal tax purposes, which, in turn, invests the cash in a specified fraudulent arrangement under the direction of the general partner. Individual K is not a qualified investor with respect to the arrangement. K and other limited partners file a “derivative” action in the name of the partnership against the general partner for breach of fiduciary duty. The partnership’s derivative claim for reimbursement should fall under the category of potential third-party recovery.

Potential third-party recovery includes actual or potential claims for recovery regardless of whether such claims have a “reasonable prospect of recovery.”

**Amount of the Theft Loss Deduction.** For qualified investors filing under the safe harbor, the amount of the theft loss deduction is calculated as follows:

1. Multiply the amount of the qualified investment by—
  - 95 percent, for a qualified investor that does not pursue any potential third-party recovery; or
  - 75 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery; and
2. Subtract from this product the sum of any actual recovery and any potential insurance/SIPC recovery.<sup>79</sup>

The amount of the deduction computed under the safe harbor is not further reduced by any potential direct recoveries or potential third-party recoveries.<sup>80</sup>

**Example 19:** A qualified investor, L, computes his qualified investment to be \$150x. L files a customer claim with the bankruptcy trustee for \$90x, equal to the excess of the total amount of cash invested in the specified fraudulent arrangement over the total amount of cash withdrawn for all years of the



investment. L does not pursue any potential third-party recovery. If L elects to file his return for the discovery year under the Revenue Procedure, L's theft loss deduction in that year with respect to the arrangement is equal to \$142.5x (95 percent of \$150x) minus any actual recovery and any potential insurance/SIPC recovery.

A qualified investor filing under the safe harbor who claims a deduction based on 95 percent of its qualified investment is obligated to sign a statement attached to the tax return declaring that "I have not pursued and do not intend to pursue any potential third-party recovery, as that term is defined" under the Revenue Procedure.<sup>81</sup>

**Example 20:** Same as Example 19, except that L is aware at the time of filing his federal tax return for the discovery year that several opt-out type class action lawsuits have been filed that include him as a member. L does not intend to opt out of these lawsuits. L should compute his deduction under the Revenue Procedure based on 75 percent of his qualified investment.

In some cases, it may be unclear whether a claim for reimbursement is more appropriately described as potential direct recovery or potential third-party recovery, making it uncertain whether the loss deduction under the Revenue Procedure is based on 75 percent or 95 percent of the qualified investor's qualified investment.

**Example 21:** A qualified investor, M, has a claim against an investment advisory firm that steered her and other clients to invest money in a specified fraudulent arrangement. M expects to participate in an opt-out type of class action lawsuit against the investment advisory firm, charging that firm with helping to conduct the fraudulent arrangement. If the claim is properly described under "potential direct recovery" (in effect claiming that the firm is part of the "responsible group") M's deduction under the Revenue Procedure should be computed based on 95 percent of her qualified investment. On the other hand, if the claim is properly described as a potential third-party recovery, M's deduction in the discovery year should be computed based on 75 percent of the qualified investment.

In cases where individual investors participated in a specified fraudulent arrangement through a fund, and the fund is a qualified investor, the Revenue Procedure does not require the fund to consider any claims for potential third-party recovery that the partners may have in computing the amount of the fund's theft loss deduction.

**Example 22:** N, an individual, transfers cash to a fund treated as a domestic partnership for federal tax purposes on the advice of an investment adviser. The fund invests the cash in a specified fraudulent arrangement. N participates in various lawsuits against the investment adviser and other third parties seeking reimbursement for N's loss. None of the lawsuits are filed under the name of the fund. The fund, if a qualified investor, is not required under the Revenue Procedure to consider N's claims for reimbursement in computing its deduction.

A qualified investor that withdrew cash in excess of amounts invested in the specified fraudulent arrangement (a so-called net winner) and which has no claims for reimbursement outside the bankruptcy proceeding should carefully consider its options before filing under the Revenue Procedure. If filing under the Revenue Procedure, such an investor would still be required to compute its deduction based on 95 percent of its qualified investment, notwithstanding having no potential claims for reimbursement.

**Example 23:** A qualified investor, O, invested a total of \$120x in a specified fraudulent arrangement in all years; reported an aggregate \$60x in income for all years prior to the discovery year, based on information received from the specified fraudulent arrangement; and withdrew \$130x from the arrangement. O's qualified investment under the Revenue Procedure is \$50x. O files a protective claim with the bankruptcy trustee but the trustee has announced that net winners such as O will receive \$0 from the bankruptcy estate. If O does not pursue any potential third-party recovery, O is required under the Revenue Procedure to claim a deduction of only \$47.5x (95% of \$50x), rather than her total loss of \$50x for which she may be eligible under general principles of Section 165.

**Outside the Safe Harbor.** Notwithstanding a slightly lower loss deduction in the discovery year, investor O in Example 23 may still have good reason to file under the Revenue Procedure. The Revenue Procedure notes that taxpayers that choose not to apply the safe harbor treatment provided by the Revenue Procedure will be subject to "all of the generally applicable provisions governing the deductibility of losses under § 165." Taxpayers, for example, will be required to establish that the loss was from theft; that the year the deduction was claimed was the year of discovery for purposes of Section 165(e); the amount of the claimed loss; and that no claim for reimbursement of any portion of the loss with respect to which there is a reasonable prospect of recovery existed in the taxable year in which the taxpayer claims the loss.

The Revenue Procedure further provides that any taxpayer that chooses not to apply the safe harbor treatment of the Revenue Procedure and files or amends federal income tax returns for years prior to the discovery year to exclude amounts reported as income to the taxpayer from the investment arrangement must establish that the amounts sought to be excluded in fact were not income that was actually or constructively received by the taxpayer (or accrued by the taxpayer, in the case of a taxpayer using an accrual method of accounting). The IRS, however, will not challenge the taxpayer's inclusion of any income reported in closed years in basis for determining the amount of any allowable theft loss, whether or not the income was genuine.

**Example 24:** A qualified investor, P, invested \$100x in a specified fraudulent arrangement during Years 1 through 8. In each of Years 2 through 7, P reported \$10x of income from the arrangement. P withdrew an aggregate of \$30x from the arrangement over all years. P discovered the loss in Year 8. P files a refund claim excluding the \$10x of income reported in each of Years 5 through 7. The IRS will not challenge P's inclusion of the \$30x of income reported in Years 2 through 4 (the closed years under Section 6511) as part of P's theft loss deduction on the theory that P's basis was not increased by such income.

The Revenue Procedure by its terms does not prohibit a fund that is a qualified investor from claiming a loss deduction for the discovery year based on the Revenue Procedure even though partner-investors in the fund may have filed refund claims for open years with respect to their share of the fund's income attributable to the arrangement (i.e., by filing an Administrative Adjustment Request<sup>82</sup> with respect to that partner's share of the fund's items of income).

**Example 25:** In Year 1, an individual, Q, transfers \$100x to a fund treated as a domestic partnership for federal tax purposes that, in turn, transfers the cash to an investment account with an investment advisor, R. R is given a power of attorney to use the cash to purchase and sell securities on the fund's behalf. In each of Years 2 through 7 the fund allocates \$10x of income from the account to Q. In Year 8, it is discovered that R's investment activity is a specified fraudulent arrangement. Q files a claim for refund, Form 8082, with respect to Q's share of the fund's items of income attributable to the fund's account with R for Years 5 through 7. The fund does not pursue any potential third-party recovery and, under the terms of the Revenue Procedure, claims a theft loss deduction in the discovery year based on 95 percent of its qualified investment.

## **Bernie Versus the Bear: Policy Perspectives**

The policy justification for casualty and theft losses is that such losses clearly reduce the ability of a victim to pay tax. Less clear is the reason why such losses are permitted more favorable ordinary loss treatment while other losses, which likewise reduce one's ability to pay tax (e.g., bad debts, worthless investments), are relegated to capital loss status and often are of limited use to taxpayers.<sup>83</sup> Indeed, in the context of the Madoff Ponzi scheme some commentators have suggested that the more favorable tax treatment of wealthy Madoff victims, compared to average folks with stock market losses from the bear market which commenced in October of 2007, represents another example of the tax code being tilted in favor of the wealthiest taxpayers.<sup>84</sup>

While this "spin" on the theft loss deduction is debatable, our final example points out that some Madoff victims, as a result of SIPC insurance and tax refunds, may end up faring not so badly compared to those who suffered losses in "real" investments.

**Example 26:** For over a decade, a 50-something professional couple (let's call them David and Linda) have earned sufficient salaries to qualify for the highest federal tax bracket on their joint return. They live in a state with a relatively high tax rate. Most of their savings have been through their respective employers' 401(k) plans. (David and Linda also spend a lot.) On October 9, 2007 (the day the S&P 500 peaked), David inherited \$1,500,000 from his mother's estate, and he and Linda sought out two financially savvy friends for advice on investing their windfall. Friend A recommended a low-fee S&P 500 index fund as the best vehicle for long-term growth. Friend B said, "I don't tell this to everyone, but I can place people in the fund managed by investment guru Bernie Madoff." As of March 17, 2009 (the day the IRS issued Revenue Procedure 2009-20), would David and Linda have been better off following the advice of Friend A or of

Friend B? (Assume (1) no legal claim could be pursued against Friend B if David and Linda followed her advice; (2) \$30,000 of “phantom income” would be reported on a BMIS investment through December 31, 2007; and (3) 6.66 percent of one’s out-of-pocket investments with BMIS will ultimately be recovered through the SIPA trustee.)

If David and Linda followed the position of Friend B, their financial position on March 17, 2009, includes (1) \$500,000 in a potential SIPC Recovery; plus (2) an estimated recovery of 6.66 percent, or \$100,000, from the SIPA trustee; plus (3) a theft loss deduction with a value of \$381,400<sup>85</sup>, less (4) \$12,000 of taxes paid on phantom income (.4 x \$30,000); and less (5) \$9,400 of additional tax on the ultimate recovery from the SIPA trustee. Thus, listening to Friend B, David and Linda would have a net financial position on March 17 of \$960,000.<sup>86</sup> If they had instead invested their \$1.5 million in the S&P 500 Index Fund, with a market decline of 38.5% as of March 17, 2009, the value of their assets would have sunk to \$922,500. They would have received cumulative dividends of approximately \$30,000 (based on the average S&P 500 dividend payment for the period), less \$6,000 of tax (combined federal and state rate of 20%) paid on those dividends. Their net position on March 17, 2009, would be \$946,500—plus a potential tax benefit from a capital loss if they were to sell their stocks. For this benefit to be valued at more than a \$3,000 deduction each year for the rest of their lives, David and Linda would need to have significant future capital gains to offset. Looking at these calculations, David and Linda may actually be somewhat better off had they invested with Madoff than if they had invested in the S&P 500 Index Fund.<sup>87</sup>

## Conclusion

The guidance provided by the IRS in March of 2009 did much to resolve practitioners’ questions regarding the timing and amount of the theft loss deduction, the treatment of phantom income, and the application of Section 165(h) limitations. The guidance resolved a number of issues in a favorable manner for many Ponzi scheme victims, including those defrauded by BMIS, and the Revenue Procedure provides ample detail regarding the proper procedure for taxpayers to follow to claim a substantial theft loss deduction in the year of discovery with a substantial degree of certainty. At the same time, the guidance leaves open some tricky interpretive issues, particularly where the qualified investor is a “feeder fund.” Moreover, taxpayers not qualifying for the Revenue Procedure safe harbor or who choose to seek a better result under the Revenue Ruling and the existing case law are still left with difficult issues regarding the “reasonable prospect of recovery” and whether to amend open returns. Given the number of new Ponzi schemes that seem to be coming to light on a regular basis,<sup>88</sup> these tax issues will remain with us for many years to come.

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<sup>1</sup> Ponzi schemes are not new. The scheme that gave rise to the name was a phony investment plan promoted by one Charles Ponzi in 1920. In 2001, a major West Coast Ponzi scheme carried out by Reed Slatkin came to light; it involved almost \$240 million and hundreds of investors. A \$450 million scheme involving The Bayou Hedge Fund Group came to light in 2005. However, the size (over 5,000 direct and an unknown number of indirect investors) and scope (perhaps \$60 billion in losses) of the Madoff scheme, together with the notoriety of some victims (not to mention the perpetrator’s bizarrely apt last name—pronounced “made off”) have given rise to much greater coverage about the case in both the popular and business media and also created fodder for late-night television comedians. The technical tax issues affecting investors have also received substantial coverage in the business press. See, e.g., Arden Dale, “Getting Personal: IRS Guidance on Madoff May Be Elusive,” *Dow Jones Factiva*, Feb. 26, 2009, available at

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- <http://online.wsj.com/article/BT-CO-20090226-712735.html>; Arden Dale, “Update: IRS Says it Will Issue Guidance Soon,” Dow Jones Business News, Mar. 13, 2009, available at [H<http://online.wsj.com/article/BTCO-20090313-713572.html>](http://online.wsj.com/article/BTCO-20090313-713572.html). Of course, not all of Madoff’s victims were famous or particularly wealthy, and while the potential tax benefits discussed in this article may provide some degree of relief for those victims, the financial devastation caused by the scheme remains difficult to overstate. This is particularly the case for charities and pension plans that invested with BMIS as they will receive no tax recoveries absent substantial unrelated business taxable income.
- <sup>2</sup> BMIS purported to use a sophisticated “split strike option conversion” strategy (a strategy which, despite the name, is apparently unrelated to the sport of bowling) to produce returns in the range of 10 percent to 20 percent each year in both up and down stock markets. Criminal Information, U.S. v. Bernard L. Madoff, 9 Cr. 213 (S.D.N.Y. Mar. 10, 2009).
- <sup>3</sup> The total figure includes annual returns from sham profits, so that the actual out-of-pocket amount invested with BMIS was much less. See “Evil Madoff Gets 150 Years in Epic Fraud,” Wall St. J., June 30, 2009, available at <http://online.wsj.com/article/SB124604151653862301.html>.
- <sup>4</sup> 15 U.S.C. § 78fff-3(a).
- <sup>5</sup> This article is limited in scope to tax issues involving U.S. citizens or residents who invested with BMIS or similar schemers either directly or through “feeder funds” taxed as domestic tax partnerships and does not address tax issues relevant to trusts, estates, and IRAs that believed they had investments with BMIS. This article also does not address state income tax issues relevant to Ponzi scheme victims. Tax advisers will need to check the relevant laws regarding theft losses and net operating losses in the particular state where a victim resides as many states’ rules vary from the federal rules.
- <sup>6</sup> Sadly, at least one of these deaths was a suicide, which occurred after the fraud came to light. See “Madoff Investor Found Dead of Possible Suicide,” L.A. Times, Dec. 24, 2008, available at [H<http://www.latimes.com/business/investing/la-fiH-madoff-suicide24-2008dec24.0.5669572.story>](http://www.latimes.com/business/investing/la-fiH-madoff-suicide24-2008dec24.0.5669572.story).
- <sup>7</sup> Arden Dale, “Getting Personal: Madoff Tax Break May Mean Fewer Lawsuits,” Wall St. J., Mar. 19, 2009, available at [H<http://online.wsj.com/article/BT-CO-20090319-710254.html>](http://online.wsj.com/article/BT-CO-20090319-710254.html), in which one of the authors is quoted to that effect regarding pre-March 17, 2009, authorities.
- <sup>8</sup> Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the IRC).
- <sup>9</sup> Phantom income refers to amounts reported as income on fictitious investments and for which no distributions were received. BMIS victims believed this income was being “reinvested” with BMIS.
- <sup>10</sup> 2009-14 IRB 735 (Mar. 17, 2009).
- <sup>11</sup> 2009-14 IRB 749 (Mar. 17, 2009).
- <sup>12</sup> Rev. Rul. 72-112, 1972-1 CB 60.
- <sup>13</sup> See *Elliott v. Comm’r*, 40 TC 304 (1963).
- <sup>14</sup> See also *Edwards v. Bromberg*, 232 F.2d 107, 110 (5<sup>th</sup> Cir. 1956) (“Theft” for purposes of IRC § 165 is “a word of general and broad connotation intended to cover and covering any criminal appropriation of another’s property to the use of the taker, particularly including swindling, false pretenses, and any other form of guile”).
- <sup>15</sup> Cf. Rev. Rul. 77-17, 1977-1 CB 44 (loss on stock acquired in open market is capital loss, even if attributable to insider fraud, because insiders lacked specific intent to deprive shareholder of money).
- <sup>16</sup> See also *Berardo v. Comm’r*, 54 TCM (CCH) 344 (1987) (misappropriation of funds by promoter of real estate pyramid scheme was theft under state law and therefore entitled taxpayer to theft loss deduction); *Jensen v. Comm’r*, 66 TCM (CCH) 543 (1993) (taxpayer who invested in a Ponzi scheme through conduit third-party sustained theft loss).
- <sup>17</sup> CCA 200451030 (Sept. 30, 2004).
- <sup>18</sup> See, e.g., *Premji v. Comm’r*, 72 TCM (CCH) 16 (1996).
- <sup>19</sup> The ruling also confirms that a § 165(c)(2) loss is not taken into account in determining whether a transaction is a loss transaction for purposes of the “reportable transaction” rules under Regs. § 1.6011-4(b)(5), citing § 4.03(1) of Rev. Proc. 2004-66, 2004-2 CB 966.
- <sup>20</sup> See, e.g., *Cramer v. Comm’r*, 55 TC 1125 (1971).
- <sup>21</sup> Treas. Regs. §§ 1.165-8(a)(2) and 1.165-1(d)(3). Where a fraudulent scheme itself is operated as a partnership (i.e., a scheming general partner solicits funds from limited partners and conducts a Ponzi scheme in the name of the partnership), the issue arises as to whose discovery of the fraud triggers a § 165 loss. In *Marine v. Comm’r*, 92 TC 958 (1989), the court held that the theft loss occurs in the year the limited partners learn of it because the general partner is not acting on behalf of the partnership when defrauding the limited partners.
- <sup>22</sup> *U.S. v. S. S. White Dental Mfg. Co.*, 274 U.S. 398, 403 (1927) (loss deduction allowed in 1918 after assets of

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- taxpayer's German subsidiary were seized by the German government and any recovery was dependent upon outcome of World War I. The taxing act "does not require the taxpayer to be an incorrigible optimist"). Accord, *Halliburton v. Comm'r*, 93 TC 758 (1989), aff'd, 946 F.2d 395 (5<sup>th</sup> Cir. 1991) (loss deduction allowed in 1979 for expropriation of taxpayer's stock and debt in Iranian private joint stock company by Iranian government, notwithstanding U.S. freeze of Iranian government's assets within the United States.)
- <sup>23</sup> 326 U.S. 287 (1945).
- <sup>24</sup> See also *Ramsay Scarlett & Co. v. Comm'r*, 61 TC 795 (1974), aff'd, 521 F.2d 786 (4<sup>th</sup> Cir. 1975) (Tax Court rejected taxpayer's argument that loss deduction should be allowed on the basis that taxpayer's attorney advised that claims for recovery would probably be unsuccessful, citing *Boehm*).
- <sup>25</sup> See, e.g., *Dawn v. Comm'r*, 675 F.2d 1077 (9<sup>th</sup> Cir. 1982) (citing *Est. of Scofield v. Comm'r*, 266 F.2d 154 (6<sup>th</sup> Cir. 1959), rev'g in relevant part 25 TC 774 (1956)). Courts have held, on the other hand, that the filing of a proof of claim in a bankruptcy case does not create a similar inference of a reasonable prospect of recovery. See, e.g., *Jensen v. Comm'r*, 66 TCM (CCH) 543 (1993) (finding filing of proof of claim in a bankruptcy case to be "merely a ministerial act that did not require the same degree of effort as pursuing a lawsuit"). But see *Kaplan v. U.S.*, 100 AFTR 2d, 2007-5674 (M.D. Fla. 2007) (citing *Jensen* but then determining that, under the facts of the case, filing of proofs of claim in a bankruptcy case gave rise to an inference of a reasonable prospect of recovery).
- <sup>26</sup> *Est. of Scofield v. Comm'r*, supra note 25.
- <sup>27</sup> *Ramsay Scarlett & Co. v. Comm'r*, supra note 24. A few courts have attempted to put "reasonable prospect of recovery" into percentage terms. See, e.g., *Parmelee Transportation Co. v. U.S.*, 351 F.2d 619 (Ct. Cl. 1969), noting that the test whether a taxpayer has a reasonable prospect of recovery "should be directed to the probability of recovery as opposed to the mere possibility. Analyzing the rule in percentage terms, we should consider a 40 to 50 percent or better chance of recovery as being 'reasonable.' A lawsuit might well be justified by a 10 percent chance." *Id.* at 628. Cited with approval in *Rainbow Inn, Inc. v. Comm'r*, 433 F.2d 640 (3d Cir. 1970), rev'g 28 TCM (CCH) 1160 (1969).
- <sup>28</sup> *Rainbow Inn, Inc. v. Comm'r*, supra note 27.
- <sup>29</sup> *Premji v. Comm'r*, 72 TCM (CCH) 16 (1996), aff'd, 139 F.3d 912 (10<sup>th</sup> Cir. 1998) (no loss deduction where taxpayer (Mr. Norby) brought no suit for recovery under belief that claims would be futile but where the Tax Court determined, objectively, that the prospects of recovering at least part of his investment were better than remote); *Qureshi v. Comm'r*, 53 TCM (CCH) 414 (1987) (no loss deduction allowed in year of discovery where taxpayer, although not aware of all relevant facts as of the end of year of discovery, had been presented with enough information to arouse "sufficient suspicion" to continue his investigation of third party's fraudulent activity).
- <sup>30</sup> See *Jensen v. Comm'r*, supra note 25 (finding that it was not reasonable for taxpayers to expect to recover their investment because of the extent of the liabilities of the broker). See also *Gottlieb Realty v. Comm'r*, 28 B.T.A. 418 (1933), acq. XII-2 C.B. 6 (holding that a lawsuit against the perpetrator of a fraud did not require postponement of a deduction where the financial condition of the wrongdoer was such that no recovery could be had by execution on a judgment or otherwise, and the taxpayer had no other insurance or claims for reimbursement).
- <sup>31</sup> See *Ramsay Scarlett & Co. v. Comm'r*, supra note 24 (allowing a loss deduction in the year of discovery to the extent the taxpayer's claimed theft loss exceeded its claims for reimbursement having a reasonable prospect of recovery). See also CCA 200305028 (Dec. 27, 2002) (citing *Ramsay Scarlett* for the principle that the excess of a theft loss over the potential claim for recovery can be deducted in the year of discovery, even if there is a reasonable prospect of recovery for the amount of the potential claim).
- <sup>32</sup> *Ramsay Scarlett & Co. v. Comm'r*, supra note 24 (wherein the Tax Court noted the fact of a future settlement or favorable judicial action on the claim does not "control our determination"); *Jeppsen v. Comm'r*, 128 F.3d 1410 (10<sup>th</sup> Cir. 1997), aff'g 70 TCM (CCH) 199 (1995).
- <sup>33</sup> See *Kaplan v. U.S.*, supra note 25 (no loss deduction allowed where amount to be recovered in bankruptcy proceeding was unknowable as of end of year of discovery); *Vincentini v. Comm'r*, 96 TCM (CCH) 400 (2008) (no loss deduction allowed where taxpayer was beneficiary of restitution order and failed to demonstrate that no assets could be recovered). But see *Bubb v. U.S.*, 72 AFTR2d 93-5857 (W.D.Pa. 1993) (allowing taxpayer a loss deduction for 95 percent of total investment where the possibility of recovering more than 5 percent of investment under bankruptcy reorganization plan was remote).
- <sup>34</sup> This assumes that the taxpayer does not file amended returns for any open years to eliminate phantom income, thereby reducing its theft loss accordingly. A Madoff victim electing to amend open-year returns and not to use the "safe harbor" under the Revenue Procedure should still be entitled to a 2008 theft loss deduction equal to his or her phantom income from closed years under the Revenue Ruling. This is because the SIPA trustee has stated

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that recoveries will be capped at an investor's out-of-pocket investment. Thus, there appears to be no reasonable prospect of recovery for closed-year phantom income. *See also* CCA 200451030 (Sept. 30, 2004). Section 8.02 of the Revenue Procedure confirms that a taxpayer can amend returns for open years and still include phantom income from closed years in determining the amount of his or her theft loss.

<sup>35</sup> Rev. Rul. 2009-9 (Issue 3), citing IRC § 111 and Treas. Regs. § 1.165-1(d)(2)(iii).

<sup>36</sup> Treas. Regs. § 1.165-1(d)(2)(i).

<sup>37</sup> 80 Fed. Cl. 96 (Fed. Cl. 2008) (“Johnson III”).

<sup>38</sup> The fraud was not a Ponzi scheme as described in the Revenue Ruling and the Revenue Procedure because the Johnsons were the only victims.

<sup>39</sup> *Johnson v. U.S.*, 74 Fed. Cl. 360 (Fed. Cl. 2006) (“Johnson I”).

<sup>40</sup> IRC § 165(b); Treas. Regs. § 1.165-8(c). Recovery under SIPC for investors in brokerage accounts may offer protection up to a total of \$500,000 per “customer.” Homeowner’s or other insurance policies may also cover some portion of the loss. These recoverable amounts are subtracted from the amount of the theft loss.

<sup>41</sup> IRC § 6511(a).

<sup>42</sup> In obtaining refunds for fictitious income, taxpayers who did not withdraw their “profits” may have a stronger case. Compare *Kaplan v. U.S.*, *supra* note 25 (Ponzi scheme victim was refunded taxes paid on phantom income by amending open-year returns in connection with a settlement) with CCA 200451030 (Sept. 30, 2004) (IRS did not allow retroactive recharacterization of Ponzi scheme interest payments withdrawn in open years as a nontaxable return of capital after discovery of fraud). But see *Greenberg v. Comm’r*, 71 TCM (CCH) 3191 (1996) (purported interest payments from a Ponzi scheme treated as a return of taxpayer’s investment, where the Tax Court determined that the payments were made to conceal the promoter’s misappropriation of the taxpayer’s investment). For a recent non-Ponzi scheme theft-loss case where the taxpayer was able to successfully apply the rationale in *Greenberg*, see *Johnson v. Comm’r*, 79 Fed. Cl. 266 (Ct. Fed. Cl. 2007) (the second of three cases in the Johnson tax litigation discussed earlier in this article).

<sup>43</sup> The facts recited in Rev. Rul. 2009-9 include the following: “at all times prior to [the year of discovery] and part way through [the year of discovery] B [the schemer] was able to make distributions to investors who requested them.” Although the ruling does not directly address the point, the statement suggests that in the IRS’s view the taxpayer was in constructive receipt of such income as a result of his ability to receive distributions upon request. Indeed, in Section 8.02 of Rev. Proc. 2009-20, the IRS cautions that taxpayers who elect to forego the safe harbor and amend returns for open years must “establish that the amounts sought to be excluded in fact were not income that was actually or constructively received by the taxpayer.” The safe harbor is discussed in more detail later in this article.

<sup>44</sup> The “split strike option conversion” strategy which BMIS purported to use generally produced short-term capital gains taxed at ordinary income rates as well as some interest and dividends. If a Madoff victim also had substantial tax-favored dividends or long-term capital gains in open years, an amended return which eliminates only the high-rate “phantom income” could be more beneficial than a net operating loss carryback which would be applied to income of all character. The taxpayer in such a situation might also elect to waive the carryback altogether.

<sup>45</sup> IRC § 172(d)(4)(C); Rev. Rul. 2009-9 (Issue 5).

<sup>46</sup> P.L. No. 111-5, 123 Stat. 115 (Feb. 17, 2009).

<sup>47</sup> It is not clear how other income of an individual who is deemed to be a sole proprietor for this purpose is counted for purposes of the \$15 million test, which is based upon three-year average “gross receipts.” Under Regs. § 1.448-1T(f)(2)(i) the term “gross receipts” is defined broadly, at least for corporations and partnerships, to include gross sales as well as income from investments (e.g., dividends, rents, royalties). However, gross receipts are reduced by tax basis where a taxpayer sells a capital asset. All persons treated as a single employer under IRC § 52(a) or (b) or IRC § 414(m) or (o) (or who would be so treated if they had employees) are aggregated, and treated as a single person, for purposes of the gross receipts test. The Regulations under IRC § 448(c) do not address sole proprietorships, and it is not clear how those Regulations should apply to such form of business. In an informal conversation with one of the authors, an IRS representative involved in drafting the Revenue Ruling expressed his view that income (including phantom income) from the fraudulent scheme would count toward gross receipts but, in the case of an individual investor, other unrelated investment income or wages of the individual would not. For a partnership, the gross receipts test applies at the partnership level. Thus, those Madoff victims who invested through large feeder funds may not qualify for the five year carryback. (See “Little Relief for Feeder-Fund Investors,” *Wall St. J.*, Jun. 29, 2009, available at <http://online.wsj.com/article/SB124623441944466541.html>.) Moreover, a partner who invested through a family partnership also may have

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difficulty qualifying for a five-year carryback if there are other family businesses that would be treated as a single employer with his partnership under the aggregation rule.

<sup>48</sup> As further discussed in the section of this article covering the safe harbor, given the timing of the criminal charges brought against Madoff, BMIS victims who use the safe harbor under the Revenue Procedure will be able to claim a substantial theft loss deduction that in many cases will give rise to an applicable 2008 NOL. Victims who do not elect the safe harbor may find their 2008 theft loss deduction reduced or eliminated under the general rule of Treas. Regs. § 1.165-8(a)(2) discussed earlier in this article. If deductions are postponed to 2009 or later years, victims will not be eligible for the temporary five-year NOL carryback.

<sup>49</sup> IRC § 1341(a).

<sup>50</sup> 340 U.S. 590 (1951).

<sup>51</sup> S. Rep. No. 83-1622, accompanying H.R. 8300, at 451.

<sup>52</sup> IRC § 1341(b)(1).

<sup>53</sup> *Alcoa, Inc. v. U.S.*, 509 F.3d 173 (3d Cir. 2007), *aff'g* 406 F. Supp.2d 580 (D.C. Pa. 2005) (citing *Chernin v. U.S.*, 149 F.3d 805, 815 (8<sup>th</sup> Cir. 1998)).

<sup>54</sup> The legislative history to IRC § 1341 provides that that section “will apply to cases of transferee liability such as *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).” See S. Rep. No. 83-1622, accompanying H.R. 8300, at 452, cited with approval by the Third Circuit in *Alcoa, Inc. v. U.S.*, *supra* note 52.

<sup>55</sup> See IRC § 1312(7).

<sup>56</sup> See discussion of IRC § 172(b)(1)(H) in the section of this article on NOLs. The safe harbor may also be attractive, or even compelling, for those victims who need cash quickly to restore their current finances. Such victims can file IRS Form 1045 and claim the tentative carryback adjustment to expedite receipt of refunds arising from NOL carrybacks.

<sup>57</sup> Rev. Proc. 2009-20, § 6.02.

<sup>58</sup> Notwithstanding these general conditions, § 6.01 of the Revenue Procedure provides that if before April 17, 2009, a taxpayer has filed a return for the discovery year or an amended return for an open year that is inconsistent with these requirements, the taxpayers may still use the safe harbor by filing a return (or amended return) for the discovery year which is consistent with the safe harbor on or before May 15, 2009. The authors are aware of a number of taxpayers who, on or before April 15, 2009, filed protective amended returns for 2005 (to keep the statute of limitations open) in order to take advantage of the additional 30-day grace period under the Revenue Procedure before finally determining whether or not to elect the safe harbor.

<sup>59</sup> Rev. Proc. 2009-20, § 4.01.

<sup>60</sup> Some advisors have questioned whether Rev. Proc. 2009-20 could apply where taxpayers engaging in like-kind exchanges under IRC § 1031 entrusted exchange funds to so-called “qualified intermediaries” (QIs) (as defined in Treas. Regs. § 1.1031(k)-1(g)(4)) and the QIs misappropriated the funds. According to a Tax Notes report of a meeting of the District of Columbia Bar Tax Section, one IRS representative expressed her view that Rev. Proc. 2009-20 was inapplicable to QI defalcations (presumably because QIs are retained primarily to facilitate exchanges and not as investment managers), although a theft loss deduction might still be available if the QI engaged in criminal conduct. See Statement of Donna Crissalli, Special Counsel, IRS Office of Associate Chief Counsel (Income Tax and Accounting) reported at 123 Tax Notes 156 (April 13, 2009).

<sup>61</sup> See Rev. Rul. 2009-9.

<sup>62</sup> Rev. Proc. 2009-20, § 4.02.

<sup>63</sup> IRC § 7701(a)(30) provides,

The term “United States person” means—

(A) a citizen or resident of the United States,

(B) a domestic partnership,

(C) a domestic corporation,

(D) any estate (other than a foreign estate, within the meaning of paragraph (31)), and

(E) any trust if—

(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and

(ii) one or more United States persons have the authority to control all substantial decisions of the trust.

<sup>64</sup> Several “feeder funds” that invested their clients’ money with BMIS have been accused in civil complaints filed by state attorneys general of violating state securities laws by, among other things, disregarding fiduciary



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duties to investors and misrepresenting their relationship with BMIS. See *In the Matter of Fairfield Greenwich Advisors LLC, Commonwealth of Massachusetts, Securities Division* (Docket No. 2009-0028) and *People of New York v. Ezra Merkin and Gabriel Capital Corporation* (Docket No. 450879/09). If the allegations in these complaints are accurate, it appears that these funds may have known of BMIS's fraud at least some time prior to the fraud's being known to the general public.

<sup>65</sup> Rev. Proc. 2009-20, § 4.03.

<sup>66</sup> Rev. Proc. 2009-20, § 4.03(4).

<sup>67</sup> It is the fund, however, as the qualified investor, which must make the decision as to whether or not to elect safe harbor treatment under the Revenue Procedure.

<sup>68</sup> Rev. Proc. 2009-20, § 4.04. (cross-referencing the definition of "qualified loss" in § 4.02 of the Revenue Procedure).

<sup>69</sup> While the Revenue Procedure focuses on the filing of criminal charges in order to provide a "bright line" test for determining whether a theft is discovered for IRC § 165 purposes, a number of anomalous situations have since arisen that point out the arbitrary nature of the line drawn. For example, on December 24, 2008, Joseph Forte, a Philadelphia-area investment manager, confessed to the FBI that he was running a \$40 million Ponzi scheme. While Forte investors clearly knew of the scheme before December 31, 2008, no criminal charges were brought until January 8, 2009, due in part to the intervention of the Christmas and New Year's holidays. See Harold Brubaker, "Charges Filed Against Forte," *The Philadelphia Inquirer*, Jan. 8, 2009, available at [H\[http://www.philly.com/philly/hp/news\\\_Hupdate/37322999.html\]\(http://www.philly.com/philly/hp/news\_Hupdate/37322999.html\)](http://www.philly.com/philly/hp/news_Hupdate/37322999.html). Under the Revenue Procedure, therefore, 2009 appears to be the "discovery year" although Forte investors likely can claim a 2008 theft loss under general IRC § 165 authorities. An even more curious case involved Bruce Kramer, a North Carolina investment manager, who committed suicide once it became clear that his \$20 million Ponzi scheme would come to light but before any criminal charges were brought. See Mike Baker, "Feds: Suicide Helps Regulators Uncover NC Man's Ponzi Scheme," *Associated Press*, Mar. 18, 2009 available at [H\[http://articles.wm.com/view/2009/3/19/Feds\\\_suicide\\\_helps\\\_regulators\\\_uncover\\\_NC\\\_H\\\_man's\\\_Ponzi\\\_scheme\\\_t/\]\(http://articles.wm.com/view/2009/3/19/Feds\_suicide\_helps\_regulators\_uncover\_NC\_H\_man's\_Ponzi\_scheme\_t/\)](http://articles.wm.com/view/2009/3/19/Feds_suicide_helps_regulators_uncover_NC_H_man's_Ponzi_scheme_t/). For victims of Kramer's scheme, the "discovery year" under the Revenue Procedure apparently may never occur. Of course, theft loss deductions may still be filed under general IRC § 165 principles.

<sup>70</sup> Rev. Proc. 2009-20, § 4.06(1).

<sup>71</sup> Rev. Proc. 2009-20, § 4.06(2).

<sup>72</sup> Rev. Proc. 2009-20, § 4.05.

<sup>73</sup> A Madoff victim's "qualified investment" should equal the amount shown on the victim's account statement as of December 31, 2007, plus or minus any additional investments/withdrawals during 2008, assuming such person reported the "phantom income" earned in all years.

<sup>74</sup> Rev. Proc. 2009-20, § 4.07.

<sup>75</sup> Rev. Proc. 2009-20, § 4.08. For Madoff victims with \$500,000 or more in out-of-pocket investments with BMIC, SIPC insurance should provide a \$500,000 recovery. See *supra* note 40.

<sup>76</sup> Taxpayers filing outside the safe harbor may not be required to reduce their theft loss deduction by potential claims for reimbursement that are not, in fact, pursued. See *Hills v. Comm'r*, 76 T.C. 484 (1981) (reviewed by the court), *aff'd* 691 F.2d 997 (11<sup>th</sup> Cir. 1982); and *Miller v. Comm'r*, 733 F.2d 399 (6<sup>th</sup> Cir. 1984), *aff'g* 42 TCM (CCH) 665 (1981).

<sup>77</sup> Rev. Proc. 2009-20, § 4.09.

<sup>78</sup> Rev. Proc. 2009-20, § 4.10.

<sup>79</sup> Rev. Proc. 2009-20, § 5.02.

<sup>80</sup> *Id.*

<sup>81</sup> Rev. Proc. 2009-20, § 6.01(a) and Appendix A.

<sup>82</sup> See IRC § 6227(d)(1).

<sup>83</sup> See, e.g., Bittker, McMahon & Zelenak, *Federal Income Taxation of Individuals*, ¶14.01 (Warren, Gorham & Lamont, Third Edition). For a criticism of the casualty and theft loss deductions on the ground that they discourage the purchase of insurance, see Kaplow, "The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions," 79 *Cal. L. Rev.* 1485 (1991). Perhaps one reason for distinguishing between theft losses and bad debt or worthless securities losses is that individuals who make a loan or purchase a security voluntarily take on a risk. That distinction arguably is clearer where a theft loss arises from a robbery or embezzlement as opposed to making an investment in what turns out to be a Ponzi scheme.

<sup>84</sup> See, e.g., the tax blog of Linda Beale, "A Taxing Matter," dated December 18, 2008.

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- <sup>85</sup> Calculated as follows: 40% (combined federal and state tax rate) of the excess of (a) \$1,453,500 (equal to 95% of \$1,530,000 (amount of D&L's qualified investment)), over (b) \$500,000 (amount of SIPC Recovery) = \$381,400.
- <sup>86</sup> Since David and Linda deferred a deduction of \$76,500 using the 95 percent safe harbor, there will be an additional tax when they ultimately receive \$100,000 from the SIPA trustee. This tax will equal 40 percent of the excess of \$100,000 over \$76,500, or \$9,400. Thus their net financial position equals \$960,000 (\$500,000 + \$100,000 + \$381,400 – \$12,000 – \$9,400).
- <sup>87</sup> Again, these calculations are not meant to minimize the financial devastation suffered by many Madoff victims. Unlike David and Linda in our example, victims who invested greater sums with BMIS or remained “invested” for longer periods will fare much worse than they would have with an equivalent investment in the stock market.
- <sup>88</sup> See, e.g., Derek Kravitz, “Mini-Madoffs Nabbed in Alleged Ponzi Schemes,” Washington Post, Jan. 27, 2009, available at [http://voices.washingtonpost.com/washingtonpostinvestigations/2009/01/mini-madoffs\\_hotbed\\_for\\_allege.html](http://voices.washingtonpost.com/washingtonpostinvestigations/2009/01/mini-madoffs_hotbed_for_allege.html); Jason Szep, “U.S. Regulator Probing ‘Rampant Ponzimonium,’” Reuters, Mar. 20, 2009.