Checkpoint Contents
Federal Library
Federal Editorial Materials
WG&L Journals
Practical Tax Strategies/Taxation for Accountants (WG&L)
Practical Tax Strategies
2009
Volume 82, Number 05, May 2009
Articles
TAX IMPLICATIONS OF INVESTMENT LOSSES FROM THE MADOFF PONZI SCHEME, Practical Tax Strategies, May 2009

PONZI SCHEME LOSSES

TAX IMPLICATIONS OF INVESTMENT LOSSES FROM THE MADOFF PONZI SCHEME

While tax professionals speculated about the appropriate tax return choices for bilked investors, the IRS issued guidance that includes safe-harbor rules for deducting the losses.

Author: AGATHA E. JEFFERS, CPA, and LEONARD J. LAURICELLA, Attorney and CPA

AGATHA E. JEFFERS, Ph.D., CPA, and LEONARD J. LAURICELLA, LL.M., CPA, are associate professors in the Department of Accounting, Law & Taxation at Montclair State University in New Jersey.

[pg. 271]

In a massive Ponzi scheme, hailed as the scam of the century, Bernard Madoff made off with over $50 billion of funds invested by innocent investors. This scam has come on the heels of the biggest credit crunch in decades. Many ordinary people, institutions, money managers, and even sophisticated investors and hedge fund managers fell prey to Madoff's Ponzi scam and became victims. This loss is catastrophic to numerous parties. The scam has wiped out generations of wealth and the savings of many hard-working people. It has negatively affected numerous investors at all levels of the economic strata. Thousands of individuals have lost their retirement savings. Others have lost a large part of their investments. Educational institutions have lost endowments that were earmarked for students' scholarships. Many philanthropic organizations have lost money that was set aside to serve the public. In addition, this will translate into increased unemployment because numerous jobs will be eliminated as a result of the financial reverses.

Madoff Ponzi scheme

Madoff allegedly bought large cap stocks as well as options on these stocks. These hedges created both losses and gains. Madoff, however, allegedly made money even when the market went down. Essentially, in many cases, Madoff made no or very few actual trades. Instead, he took money from the later group of investors and gave it to the earlier group of investors. Madoff showed a consistent 12%, five-year rate of return. In addition, he combined these alleged incredible returns with numerous testimonials from very high-profile clients. When the financial crisis hit, new investors no longer had money to invest. With very little new funds coming in, Madoff could not continue to pay the old investors their expected returns. This caused the scheme to unravel and collapse under its own weight.

Tax implications of investor losses

Numerous tax implications emanate from the loss to investors. The facts of the transactions are still being uncovered, and many of the tax consequences are fact specific, including the possibility of recovery of losses from litigation or

government funds. Under normal circumstances it is quite possible that many of the tax consequences may not be finalized for several

[pg. 272]

years. In an effort to ease the burden on investors, some of whom have lost their life savings, and to facilitate the administration of the claims for refunds of taxes, in mid-March the IRS issued Rev. Rul. 2009-9 [1] and elective Rev. Proc. 2009-20. [2] The Ruling provides guidance on many of the contentious tax issues, and the Procedure contains a safe harbor for qualified investors as to the timing, character, and deduction amount, provided the taxpayer complies with the requirements.

Qualified investors are taxpayers:

- Who otherwise are able to deduct theft losses under Section 165.
- Who had no prior actual knowledge of the fraudulent nature of the Madoff scheme.
- With respect to whom the scheme is not a tax shelter.
- Who transferred cash or property directly to Madoff rather than through a fund or other entity.

Foreigners and tax-exempt entities, such as charities, will of course receive no tax benefit for any losses. Investors who put money into the Madoff organization through tax-deferred entities will derive a tax benefit from losses, if at all, only when the entity is completely liquidated—and even then only if the beneficiary has an adjusted basis in the entity.

Investors who invested indirectly through feeder organizations or other entities are not qualified investors directly covered by the Procedure (although the investing entity itself may be covered as a qualified investor), so those investors will have to await receipt of their Forms K-1 to see how the investing entity treated the losses. At that point they can determine whether to take a different tax position from that shown on the K-1, presumably using the requisite disclosure on Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR). The following discussion covers some of the more significant tax consequences for individual U.S. investors.

Theft loss deductions

The first question typically addressed was whether the loss from the Madoff Ponzi scheme could be treated as a theft loss. Section 165(a) provides that a deduction is allowed for any loss that is not covered by insurance. Theft losses include—but are not necessarily limited to—larceny, embezzlement, and robbery. [3]

Whether a theft has occurred is determined under state law. The IRS position has been not to allow a theft loss for declines in value or worthlessness of stock acquired on the open market when the corporation's officers or directors were guilty of fraud. The theory was that there was no specific intent to deprive the investors of money or property. [4] In the Ruling, however, the IRS distinguished Ponzi schemes, such as the Madoff situation, by stating that in those cases the investment advisor intended to and did in fact deprive the investor of money by criminal acts. Thus, a theft loss is the appropriate classification under those circumstances. The Procedure goes on to describe cases where theft characterization would not be challenged. This includes, for example, the situation of a lead figure being charged under state or federal law with fraud, embezzlement, or similar crimes that, if proven, would meet the definition of theft.

Timing of the deduction. The next question to be addressed was the timing of the deduction. Mr. Madoff was arrested in December 2008. The time for claiming a theft deduction is generally the year the theft is discovered. [5] This would be 2008, and the IRS confirmed this in the Ruling. While the time of discovery was always thought to be fairly clear, it was anticipated that the ability to take the deduction in 2008 would be severely complicated. Notwithstanding the rule regarding the year of discovery, the regulations basically postpone deductibility until there is reasonable certainty that the loss will not be covered by insurance or otherwise. [6] This would normally be a question of fact in each case.

Given the complicated nature of the Ponzi scheme; the significant possibility that claims for recovery would be made from the government; and that lawsuits would be filed against the Madoff organization, the auditors, and other investment advisors who may have channeled investors' money into the Madoff organization, the IRS could have reasonably asserted that investors (on whom the burden falls) could not prove with reasonable certainty what amount they would definitely not recover. The Ruling confirms that the loss is deductible in the year of discovery but only to the extent that the loss is not covered by a claim for reimbursement or other recovery as to which the investor has a reasonable prospect of recovery.

Specifically, section 5.02 of Rev. Proc. 2009-20 greatly simplifies this by providing that

[pg. 273]

investors who are not currently suing or planning to sue any third parties (e.g., feeder-fund advisors or auditors) may deduct 95% of their qualified investment (see discussion below), less any actual recoveries in the discovery year and any potential recovery from insurance or under the Securities Investor Protection Corporation. Even investors suing or planning to sue third parties can deduct 75% of their qualified investment. Section 8 of the Procedure warns taxpayers who do not elect the safe-harbor treatment that they must establish not only the amount of any loss but also that there is no reasonable prospect of recovery for any portion of the loss claimed.

Originally the timing of the discovery of the Madoff scheme in late December was thought to be unfortunate because taxpayers would normally have to file their 2008 returns within a few months of discovery. A consoling fact was that it would be possible to file an amended 2008 return at a later date when more facts had been developed. The more serious concern was for potential claims for the refund of 2005 taxes that had been paid on phantom income (discussed below). Those claims would have had to be filed by 4/15/09 unless the taxpayer had extended the due date of the 2005 return prior to filing. The Ruling and Procedure relieved some of this pressure.

Deductible amount. The amount deductible is limited to the adjusted basis (not the fair market value) of the investment. [7] This would normally include any funds invested with the Madoff organization and any legal fees expended to try to recover money lost under the scheme. It was also thought that this amount should, as discussed below, include any increase to basis for phantom income reported on prior tax returns. Fortunately for investors, the Ruling confirms this result even for phantom income on years that are closed under the limitations period. Per the Ruling and Procedure, these amounts will then be reduced by any withdrawals from the investment, along with any actual recovery in the year the theft is discovered and any anticipated recovery from SIPC or from insurance.

Notably, the amount is not reduced by any potential recovery from the people directly responsible for causing the loss or from third parties. As discussed below, the Procedure then allows a 95% or 75% deduction of this final amount depending on whether the taxpayer is pursuing recovery from third parties.

For individuals, a theft loss normally would be an itemized deduction. Theft losses not incurred in a trade or business, or not in connection with a transaction entered into for profit, are first reduced by $100 ($500 for 2009 only) and then deductible to the extent they exceed 10% of a taxpayer's adjusted gross income (AGI). [8]

Example 1. An investor with AGI of $600,000 has a theft loss of $500,000 for 2008. The investor's deduction is limited to $439,900 ($500,000 - $100 - ($600,000 × 10%)).

In Rev. Rul. 71-381, [9] the IRS had previously taken the position in loan transactions involving Ponzi schemes that the loss was not derived from a transaction entered into for profit because the expected return was in the nature of interest and not profit. This would limit the loss deduction, per Section 165(c)(3), as indicated. There was thought to be a strong argument, however, that these Madoff-related losses were deductible under Section 165(c)(2) as a transaction entered into for profit because the anticipated return was from the buying and selling of stocks, bonds, and options—not just collecting interest as in the loan situation.

If the Madoff investment is characterized as a transaction entered into for profit, the losses are not subject to either the $100/$500 floor or the 10% of AGI limitation. Using the facts of the previous example, the full $500,000 would be deductible. The Ruling confirms this result by indicating that the opening of an investment account giving an

investment advisor a power of attorney to buy and sell securities is a transaction entered into for profit. Rev. Rul. 71-381 is declared obsolete to the extent it held that theft losses incurred in a transaction entered into for profit were deductible subject to the Section 165(c)(3) limitations. The Ruling also helpfully indicates that claiming a theft loss in a transaction entered into for profit under Section 165(c)(2) is not a loss transaction requiring reporting under the Section 6011 regulations covering reportable transactions.

The Ruling also confirmed, as expected, that the loss was not a miscellaneous itemized deduction subject to the 2%-of-AGI limitation [10] and not subject to the overall limit on itemized deductions of Section 68. This also results in the deduction not being disallowed under the alternative minimum tax. [11]

If the theft loss exceeds the taxpayer's income, the result is a net operating loss (NOL), which under special rules for casualty

[pg. 274]

and theft losses can be carried back three years (not the normal two-year rule for NOLs) and forward 20 years. [12] The general two-year NOL carryback has recently been extended to up to five years by section 1211 of the American Recovery and Reinvestment Act of 2009 for an eligible small business that incurs an applicable 2008 NOL (i.e., an NOL that either begins or ends in 2008). [13]

There was some question as to whether Ponzi scheme investment losses would qualify under this new provision. The Ruling helpfully concludes that it does by treating investors incurring these losses as sole proprietors, so as long as the investor has gross receipts of less than $15 million in the year the loss arose, the provision would apply. [14] Thus, these taxpayers can elect to carry an NOL back five, four, or three years, or to renounce all carrybacks and just carry the loss forward.

The problem with the theft generating an NOL is that in computing an NOL for an individual, nonbusiness deductions have to be added back to taxable income. These deductions include alimony, IRA contributions, and most itemized deductions to the extent they exceed nonbusiness income (such as interest, dividends, and annuities). [15] The benefit of the theft loss is, therefore, reduced to the extent these deductions are otherwise lost. It should be noted that for calendar-year individuals, losses discovered in 2009 (e.g., the Robert Allen Stanford scheme) do not qualify for the extended up-to-five-year carryback since they will not have an applicable 2008 NOL.

Example 2. A taxpayer who is well into the 35% marginal tax bracket and has alimony and itemized deductions for interest and taxes of $100,000 would get a $35,000 benefit from those deductions. If the taxpayer has a theft loss in excess of the taxpayer's income, the excess theft loss results in the carryover of an NOL. The $35,000 benefit from the itemized deductions, however, will be lost.

Alternatively, even if nonbusiness deductions do not exceed nonbusiness income, some of the theft loss will be used to offset income that would otherwise be taxed at the lowest marginal rates. This would be especially true if the taxpayer had significant net capital gain or qualified dividend income, which would have been taxed at 15% [16]

The NOL may also have some adverse collateral consequences as a result of reducing income in the year to which the NOL is carried. For example:

- The taxpayer may have taken a foreign tax credit, which is limited to the U.S. tax on foreign-source income. If all the income is wiped out by the NOL carryback, the taxpayer will have no foreign-source income and, therefore, no foreign tax credit for the year. The credit may be carried back one year and forward ten, [17] but these credits may be difficult to use (particularly if the foreign transaction was a one-shot deal), and the benefit may be postponed or ultimately lost.
- Similarly, other nonrefundable credits could be lost if taxable income is eliminated.
- The taxpayer may have made charitable contributions in the year the NOL arises using long-term capital gain securities. If so, the charitable contribution deduction is normally limited to 30% of AGI. [18] Excess charitable contributions may be carried forward for five years, [19] but any current-year contribution must be used first.

Charitable contribution limitations do not have to be recomputed as a result of an NOL carryback, [20] but NOL carryforwards will reduce AGI and, therefore, the contribution base and the ability to use any charitable contribution carryforwards.

- Any deduction for the excess of capital losses over capital gains in the carryover year may, depending on the size of the NOL being carried back, also be lost.
- The deduction for personal exemptions could also be lost. [21]

Furthermore, a taxpayer who carries back an NOL that results in the elimination of taxable income in the carryover year will, as was the case in the year the NOL was created, probably be using at least some deductions against income that is taxed at the lower brackets.

Capital loss deductions

Initially there was some thought that the IRS might argue strenuously that the Madoff scheme did not involve a theft loss, and that the victims had a worthless security deduction under Section 165(g). This unfavorable result would have the losses treated as capital losses. Individuals can deduct capital losses, [22] but only against capital gains and up to $3,000 ($1,500

[pg. 275]

for married filing separately) of excess capital losses against ordinary income annually. [23] These losses carry forward (but not back) indefinitely, but given the size of the expected losses for some taxpayers and the current state of the stock market, this would be a disastrous tax result. Absent a significant reversal in the stock market, many victims may not be able to use most of these losses for many years, significantly reducing the benefit from those deductions due to the time value of money. While some investors were hopeful for a change in the law allowing a larger deduction, this expectation was tempered against the background of the huge federal deficits. Once again the Ruling resolves this in a taxpayer-friendly manner as an ordinary loss.

Deductions for phantom income and gains

Some of the facts coming to light now indicate that although investors with the Madoff organization may have reported taxable income in prior years, no actual taxable transactions may, in fact, have occurred. The income that was being reported is typically referred to as phantom income or gains because the investor had taxable income even though the investment produced no cash to pay the tax. This raised several interesting tax complications.

Undoubtedly some taxpayers reported income in prior years and paid tax on it, and the normal three-year limitations period for claiming refunds [24] may not yet have expired. The earliest of these years, however, is likely to be 2005. The limitations period for tax returns filed by the normal due date for that year ended on 4/15/09. In contrast, the limitations period has not yet expired for 2006 returns filed in 2007.

The most likely choices for a taxpayer to recoup the tax paid on the phantom income were thought to involve filing an amended return to remove the income and request a tax refund, or attempting to get relief under the claim-of-right doctrine. Implications of these two alternatives are discussed below, but the Ruling and the Procedure made the limitations period expiration date less important.

Amended tax returns. Prior to the recent IRS guidance, one frequently discussed course of action was for taxpayers to file an amended return on Form 1040X and reduce the income reported by the phantom income for those earlier years if the limitations period had not yet ended. A separate Form 1040X would have to be filed for each year. This could possibly result in the adverse tax consequences similar to those discussed above with respect to NOLs. The hope was that the IRS would agree with the claim, the taxpayer would receive a refund of the tax paid on the phantom income, and that part of the case would be closed.

If the taxpayer had withdrawn money from the Madoff organization during the period the phantom income was reported, there was concern the IRS might argue that it was the phantom income that was being withdrawn, and

therefore the refund would be disallowed. In that case, the phantom income would have to be added to the taxpayer's adjusted basis (thus increasing the claim for the theft loss) and then the withdrawal would reduce the taxpayer's adjusted basis.

Alternatively, the funds withdrawn could be viewed as not reducing the adjusted basis of the investment in the Madoff assets because they represented a return of income previously taxed, which income had never been added to basis. The increase in basis from the phantom income might create or add to an NOL which, as indicated above, could then be carried back to offset the phantom income. This may or may not reach a similar result to the amended return given the above comments about the potential loss of itemized and other nonbusiness deductions, but it appears that, at best, the investor would break even between the two methods. Thus, taxpayers were thought to be better off starting with the amended return and only going with the NOL carryback if the refund from the amended return is denied.

The Ruling and the Procedure provide for straightforward relief by allowing any phantom income reported to investors in 2008 to be excluded from the 2008 return and for phantom income for all prior years (even closed years) to be added to the taxpayer's adjusted basis and used in determining the theft loss. The Procedure requires the taxpayer to agree not to amend prior returns to claim a refund

[pg. 276]

on the phantom income. Section 8.02 of the Procedure even goes so far as to allow taxpayers who decide not to elect under the Procedure to add phantom income from closed years to basis in determining their theft loss, presumably with the understanding that they would not also file for a refund of prior years' taxes on that phantom income.

Claim-of-right doctrine. Another possible course of action, which did not have a 4/15/09 deadline, was to attempt to use the claim-of-right doctrine. [25] This doctrine is normally employed when a taxpayer receives income and pays tax on it, but in a later year the taxpayer is required to pay the money back because it is determined that he or she was not entitled to it in the first place.

Example 3. An agent who is compensated by sales commissions receives $20,000 in December of year 1. The agent includes the $20,000 in income and pays $7,000 of tax on it. In the following year (year 2), the customer returns the item and the agent is required to return the $20,000 to his or her employer. Section 1341 applies if the repayment exceeds $3,000. The agent is given a choice:

(1) Deduct the $20,000 in year 2.
(2) Calculate the tax in year 2 without the deduction, and reduce the year 2 tax by the tax increase caused by the inclusion of the income in year 1 (i.e., $7,000).

If, for instance, the agent's marginal tax rate in year 2 was 25%, the $20,000 deduction would reduce his or her tax by $5,000. Instead the agent would not deduct the $20,000, but would reduce the year 2 tax by $7,000.

How would this be applied to the Madoff investors? The argument was that the taxpayers included the phantom income in the earlier years and paid tax on it. Now because of the theft, they have in effect paid the money back. There are a couple of benefits to this argument:

(1) Taxpayers would not be limited to claiming a refund for the phantom income included in the last three years under the normal limitations period rules; instead they could go back to cover all years.
(2) By not claiming a theft loss for the phantom income, they reduce the risk of losing the benefit of nonbusiness deductions due to an NOL.

Practitioners who thought that the IRS would contest this extension of the claim-of-right doctrine to the Madoff facts were correct. The Ruling sets forth the IRS's argument about why the claim-of-right doctrine does not apply in this case. Section 1341(a)(2) requires that the deduction must arise because the taxpayer was under an obligation to restore the income. The Ruling concludes that when an investor incurs a loss from criminal fraud or embezzlement in a transaction entered into for profit, the investor's theft loss deduction does not arise from an obligation on the investor to restore the income.

Taxpayers electing under the Procedure must agree not to pursue a refund based on a claim of right. All other taxpayers can anticipate the IRS will contest any refund request based on that doctrine, except possibly amounts repaid under the fraudulent conveyance statute as discussed below.

Mitigation provisions

The IRS also dismissed any argument that taxpayers might claim a refund under the complicated mitigation provisions of Sections 1311 through 1314. These provisions attempt to prevent either the taxpayer or the IRS from getting whipsawed by their opponent. The rules generally apply when one party takes a position and the limitations period closes on the year the position was taken. The same party then asserts the opposite position in a later year in an attempt to get a double benefit.

Example 4. An investor claims a theft loss in 2008, and the IRS does not challenge the claim. After the limitations period for 2008 expires, a court determines that the correct year for claiming the loss is 2009. The taxpayer then claims the same loss on an amended return for 2009. The taxpayer has taken an inconsistent position with respect to 2009. The IRS would be allowed an offset under the mitigation rules even though 2008 was a closed year.

The Ruling sets forth the IRS view that Madoff investors cannot use the mitigation rules to claim a loss for those years now closed by the limitations period when phantom income was reported, because the IRS is allowing those amounts to be added to the theft loss in the year the fraud is discovered. This is consistent with the IRS position that the income was properly reportable in the earlier years.

[pg. 277]

Fraudulent conveyance

Recipients of monies may be sued. If there has been a fraudulent conveyance, victims can go back six years or more. Earlier investors may have to repay the later investors. Apparently, some investors realized the 12% returns from their investments. These earlier investors benefited from the later investors. Whether these earlier investors will be required to pay back the later investors is a question that needs to be investigated. If this were to occur, the details and procedures involved could become extremely complicated.

If investors are required to return any funds received, a good argument can be made for applying the above-discussed claim-of-right doctrine in the year of repayment. Clearly the taxpayer will make the payment only if obligated to do so. Thus, the IRS argument stated above in the phantom income situation would not seem to be applicable. If the taxpayer chooses to deduct the repayments in the year made, there is an issue as to the character of the deduction. Under the *Arrowsmith* doctrine, [26] the character of the repayments will track the character of the income reported in the earlier years. Thus if the income in the earlier years was, for example, short-term capital gains, the deductions will be short-term capital losses.

No capital loss carryback is available, however, for individuals. In this case, the claim-of-right credit in the year of repayment might reduce the adverse impact of the repayments being characterized as capital losses. As indicated above, election under the Procedure requires taxpayers to agree that they will not apply the alternative computation in Section 1341 with respect to the theft deduction. However, this presumably should not apply to payments that the taxpayer is required to make under the fraudulent conveyance or similar rules.

Procedural requirements

Section 6 of the Procedure sets forth several procedural requirements that must be complied with if taxpayers are to avail themselves of the safe-harbor treatment. Among other things taxpayers must mark "Revenue Procedure 2009-20" at the top of Form 4684, Casualties and Thefts, for the discovery year. Specific instructions are given as to where to enter the deductible theft loss on the form. The taxpayer must also complete and sign the statement provided in Appendix A of the Procedure, which contains the calculation of the deductible theft loss and indicates whether the taxpayer intends to pursue any third-party recovery actions. For taxpayers who had filed returns or amended returns

prior to issuance of the IRS guidance, the taxpayer must list the year or years covered and the dates filed, and the taxpayer must agree to any adjustments necessary to satisfy the conditions of the Procedure. The Attachment must be affixed to the return for the year of discovery, and any returns filed before the IRS issued guidance, which took positions inconsistent with the requirements of the Procedure, must be corrected by 5/15/09.

As indicated above, the taxpayer must agree not to pursue claims under the claim-of-right doctrine for the mitigation provisions, not to deduct any amount of the theft loss in excess of the amount allowed in the Procedure, and not to file any returns or amended returns to

[pg. 278]

exclude or recharacterize the income reported in years prior to the discovery year.

Additional possible relief

The large losses resulting from the Madoff and other Ponzi schemes have raised many questions as to the options that are available to investors, creditors, and others—and whether they can recoup the large losses that they have incurred as a result of these frauds. Undoubtedly, most of the defrauded investors will be able to recoup only a small portion of their investments. Various additional forms of relief, however, are available to defrauded investors.

SIPC insurance. The Securities Investors Protection Corporation (SIPC), under its insurance program, is required to provide restitution of up to $500,000 per investor. Within this amount, however, the cash limit is only $100,000. The Madoff investors may be limited to the $100,000 cash maximum because evidence indicates that for the past 13 years Mr. Madoff may not have executed a single trade, but instead only shifted money around. To qualify for the restitution and recoup funds, investors, creditors, and others must adhere to the very strict filing deadlines imposed by the SIPC and provide records proving their loss. Furthermore, this will take years to settle.

Lawsuits. As discussed above, some investors may be able to recover up to $500,000 by filing a claim with the SIPC. Undoubtedly, investors will also go after Mr. Madoff personally, even if the funds that he managed do not have much in the way of assets. Furthermore, the possibility of lawsuits against accountants, attorneys, and financial advisors (among others) seems certain.

PLANNING TIP

The tax treatment of any amounts recouped either from SIPC or from lawsuits will depend on whether the taxpayer has previously been successful in deducting the losses in prior years. Taxpayers electing under the Procedure deduct either 75% or 95% of the qualified investment. The deductible amount in this case, of course, is reduced by any actual recoveries, or potential recoveries, from SIPC or insurance.

As indicated in the Ruling, the first recoveries will be tax free up to the nondeductible loss. For any recovery in excess of this amount, the *Arrowsmith* doctrine will apply. The character of the recovery will be the same as the character of the loss deduction. Thus, in the likely case that the losses generated ordinary deductions, the recovery would be taxed at the regular tax rates. If the deductions were characterized as capital losses, the recovery would be characterized as capital gains. Any amount not eventually recovered, or deductible in the year of discovery, will be deductible at such time as the amounts to be recovered can be ascertained with reasonable certainty, hence leaving any remaining amount uncollectible.

Conclusion

The losses incurred by numerous investors from the Madoff and other Ponzi schemes has renewed interest in the tax implications for victims of such fraudulent schemes. As the global financial environment increases in its complexity, many new and innovative instruments and vehicles will continue to be used by companies and investment managers trying to maintain their competitive advantage. These will undoubtedly result in the proliferation of additional frauds and scams. Several tax strategies, discussed above, may be effectively used by victims to wrest some level of tax

relief on account of the losses. The above discussion involves the federal tax rules. Taxpayers clearly also need to consider any applicable state tax consequences, which may be very different.

1

2009-14 IRB 735.

2

2009-14 IRB 749.

3

Reg. 1.165-8(d).

4

Rev. Rul. 77-17, 1977-1 CB 44.

5

Section 165(e).

6

Regs. 1.165-8(a)(2) and 1.165-1(d)(2).

7

Section 165(b).

8

Sections 165(c)(3), and (h)(1) and (2).

9

1971-2 CB 126.

10

Section 67(b)(3).

11

Section 56(b).

12

Section 172(b)(1)(F)(ii)(I).

13

Section 172(b)(1)(H)(ii). See Rev. Proc. 2009-19, 2009-14 IRB 747; "Guidance on NOL Carryback Extensions for Small Businesses," this issue, page 316.

14

Section 172(b)(1)(H)(iv).

15

Section 172(d).

16

Sections 1(h)(1) and (11).

17

Section 904(d).

18

Section 170(b)(1).

19

Section 170(d)(1).

20

Section 170(b)(1)(F).

21

Reg. 1.172-5(a)(1).

22

Section 165(f).

23

Section 1211(b)(1).

24

Section 6511(a).

25

Section 1341.

26

Arrowsmith, 42 AFTR 649, 344 US 6, 97 L Ed 6, 52-2 USTC ¶9527, 1952-2 CB 136 (1952).

END OF DOCUMENT -

© 2009 Thomson Reuters/RIA. All rights reserved.