

Financial Bulletin

Regulations and developments affecting the financial services industry March 19, 2009

IRS provides guidance for claiming Madoff-related theft losses

The IRS has issued guidance that provides the victims of the Madoff investment fraud with clarified tax rules and a new safe harbor to claim their theft losses.

Although the new releases (Rev. Rul. 2009-9 and Rev. Proc. 2009-20) were crafted especially to provide guidance for the many investors directly impacted by the Madoff scandal, they also apply to victims of any criminally fraudulent investment arrangements that take the form of “Ponzi” schemes.

Rev. Rul. 2009-9 details current theft loss tax rules but also makes important clarifications to the existing rules governing the treatment of losses in the case of investment fraud. Rev. Proc. 2009-20 creates a new safe harbor that gives taxpayers a simplified way to determine the amount and timing of their theft losses, which otherwise can be factually difficult to establish.

General theft-loss rules

The following is a summary of the rules in Rev. Rul. 2009-9.

- **Deduction type** – Theft-loss deductions are not subject to either the two-percent or overall limit on itemized deductions.
- **Loss type** – The revenue ruling clarifies that the losses are investment theft losses incurred under section 165(c)(2) and not subject to the 10-percent adjusted gross income threshold or the \$100 limitation that would apply if the theft losses were under section 165(c)(3).
- **Loss timing** – The theft loss is deductible in the year the fraud is discovered only to the extent there is not a reasonable prospect of recovery.



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IRS provides guidance for claiming Madoff-related theft losses (continued)

- **Loss amount** – The investor can claim a loss not only for the amount invested, but also for fictitious income (amounts reported to investors and reinvested) that was included on prior-year returns.
- **Loss carryback** – Investors can generally carry back theft losses for a three-year period. Many investors may also qualify to use a four- or five-year period under the recently enacted economic stimulus law.
- **Reportable transaction rules** – The theft loss is not subject to the disclosure requirements under the reportable transaction rules.
- **Claim of right and mitigation** – A taxpayer is not entitled to use favorable provisions under the “claim of right” (the revenue ruling does not address a clawback situation) or “mitigation” rules with regard to the theft loss.

New safe harbor

Rev. Proc. 2009-20 provides a simplified method for determining the amount and timing of theft loss deductions. The following is a summary of the rules; however, the rules are very detailed and should be read carefully.

- **Safe harbor deduction** – “Qualified investors” will generally be permitted to deduct 95 percent of their net investment losses in the year the theft is discovered, including any fictitious income included on prior-year tax returns. This will eliminate the need to determine the investor’s prospect of recovery.

The deduction is reduced by any actual recovery in the year of discovery or any potential recovery through insurance, including the Securities Investor Protection Corporation.

If future recovery exceeds the five percent of the net loss that was set aside, then the excess deduction is recaptured in income. If there is no eventual recovery or the recovery is less than the five percent set aside, then the remaining loss is deducted when the prospect of recovery is gone.

Investors pursuing or intending to pursue “potential third-party recovery” will be able to deduct only 75 percent of their net loss under the safe harbor.

- **Defining a theft loss** – The IRS will deem the loss an eligible theft loss under the safe harbor if the “lead figure” was charged for crimes such as fraud or embezzlement, or was subject to the criminal complaint alleging such a crime and there is either evidence of an admission of guilt or a trustee has been appointed to freeze the assets of the scheme.
- **Qualified investors** – Qualified investors include U.S. citizens or residents, domestic partnerships and corporations, and certain trusts and estates. The safe harbor rules, however, do not apply to investors that indirectly invested amounts through intermediary funds or other entities, although the fund or entity may qualify and pass the benefits of the safe harbor through to investors by complying with the filing requirements.
- **Limitations on positions** – Taxpayers that decide to take advantage of the safe harbor must agree not to amend returns for a prior year seeking a refund for fictitious income reported, and not to apply the provisions under the “claim of right” or “mitigation” rules with regard to the theft loss.

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IRS provides guidance for claiming Madoff-related theft losses (continued)

- **Filing requirements** – In order to use the safe harbor rules, a qualified investor must attach a statement containing certain specified information to a timely filed return for the discovery year. In addition, there are specific rules for recording the loss on Form 4684, Casualties and Thefts.

Taxpayers who have already filed a return for the discovery year that is inconsistent with the safe harbor treatment are allowed to file an amended return for the discovery year that is consistent with the safe harbor rules; however, the amended return must contain additional information and must be filed no later than May 15, 2009.

State and local tax issues

Because of possible federal conformity issues, it is possible that the state and local tax treatment of losses may differ from the federal tax treatment.

Next steps

Investors who are victims of the Madoff investment fraud or a similar Ponzi scheme should carefully review this guidance when deciding how to report their theft losses. •



For more information

For more information about claiming Madoff-related theft losses, contact Cynthia Keveney at 212.624.5495 or Cynthia.Keveney@gt.com. For additional information on the Financial Services practice at Grant Thornton LLP, please visit www.GrantThornton.com.

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