

Some good news for Madoff victims

The IRS has issued timely guidance on how to claim “safe harbor” for theft losses

By Robert N. Gordon

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The release of Internal Revenue Service Ruling 2009-9 and Revenue Procedure 2009-20 before the April 15 filing deadline has granted timely guidance to victims of Bernard Madoff. For those accepting the government's safe-harbor offer, there will be no need to file amended returns or to make protective filings.

The advice was needed because many issues were unclear. Most practitioners are aware that a theft loss need not be a capital loss, but instead can be used as an ordinary loss under Internal Revenue Code Section 165.

This is helpful to all but a few victims who might still want to take the loss as capital. The ordinary loss from Section 165 can be carried back if the loss exceeds this year's income and can be carried forward 20 years as well.

Among tax advisers, the most contentious Madoff-related issue was whether the theft loss was to be governed by Section 165(c)2 or 165(c)3 of the tax code. If 165(c)3 prevailed, the deduction would be reduced by 10% of the victim's adjusted gross income.

There was standing for the government to take this position, but generously, it didn't.

The latest rulings make clear that the theft loss is covered by Section 165(c)2 and thus isn't limited by the AGI limit. What's more, the loss isn't limited as an itemized deduction.

The government was again generous in applying the carry-back period under Section 172.

Normally, a theft loss can be carried back only three years. The rulings suggest that a Madoff investor can use the five-year carry-back that was inserted in the stimulus bill to help small businesses.

Under the rulings, an individual can claim to be a sole proprietorship and carry back up to five years as long as the individual has less than \$15 million in gross receipts. If losses exceed the income to which they can be carried back, they can be used for the next 20 years.

Theft losses are generally deductible once the victim can ascertain exactly how much has been lost, an issue that has caused confusion as to when the loss can be taken. Not only do the rulings grant clarity that the losses can be taken in 2008, they allow a deduction of 95% of loss.

Investors who are suing (or who plan to sue) third parties for recovery are allowed a 75% of investment theft loss. Victims will be executing a document that both binds them not to sue and also not to refile a tax return later using a different method to calculate loss or carry-back periods.

If the victims recover more than they deducted, the excess will be taxable upon receipt.

Exactly how much each Madoff investor lost is a point of contention. There is prior law to suggest that only the amount invested can be taken as a theft loss.

Here again, the government did the right thing by allowing a deduction not only for the amount invested but also for the "phantom income" taken as taxable income over the years (without a time limitation). This is the equitable solution.

Had this not been the case, victims would be losing even more than they invested, because they would be out the taxes paid on their phantom income.

Investors in feeder funds will receive K1s from the feeder funds, indicating the amount of theft loss available. Investors will have to conform to the information of the K1.

If the feeder fund is suing third parties, the K1 will reflect a 75% deduction. The investor can't then file with the 95% loss just because he or she isn't suing anyone.

Also, the \$15 million gross-receipts test will be applied at the feeder-fund level, so it is possible that feeder-fund investors may be limited to a three-year carry-back.

Victims who invested with Mr. Madoff through their individual retirement accounts will get no deduction. Victims who held Madoff funds through a derivative to achieve capital gains status will instead have capital losses (not theft losses).

Only those who think that they can't use the theft losses within the prescribed time — as a result, perhaps, of their advanced years or of having no hope of ever making that kind of money — could consider rejecting the government's offer. These investors may try to use IRC Section 1341 or Sections 1311-1314 to carry back losses further than the five years granted to individuals as sole proprietorships.

We applaud the government for its conclusions and for taking timely action, considering all that is on its plate right now.

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