Tax Treatment of Investors in Ponzi Schemes

IRS Issues Guidance to Ponzi Scheme Victims on Theft Loss Deductions, Including a Safe Harbor for the Computation of Losses

SUMMARY
The unprecedented number of investors affected by the Ponzi scheme conducted by Bernard Madoff has brought the tax implications of such schemes into recent focus. Previously, the positions taken by the IRS regarding the type and amount of deductions available to defrauded investors were not altogether consistent and were insufficient to assure defrauded taxpayers that their tax positions would be respected by the IRS. The guidance, released yesterday, clarifies the applicable rules and provides a safe harbor to allow U.S. investors defrauded in the Madoff scheme to claim a theft loss deduction on their 2008 tax returns. Under the safe harbor, investors will generally be permitted to claim deductions in the year the theft is discovered in an amount equal to 95% of their net loss (for investors who do not pursue third-party claims) or 75% of their net loss (for investors who intend to pursue third-party claims). For this purpose, a taxpayer’s net loss will generally equal the sum of the amount invested and amounts previously reported as income, less distributions, recoveries and available SIPC and insurance claims.

In the event these losses result in a net loss in 2008, affected taxpayers may, in many cases, be able to carry these losses back to the prior three to five taxable years (depending upon the taxpayer’s situation) to obtain refunds of taxes paid in those years, and, to the extent not carried back, taxpayers may carry losses forward 20 years. Under the guidance, individuals who invested in the Madoff scheme indirectly (for example, through a feeder fund) will not directly report the loss; instead, the direct investor (for example, a feeder fund) will report the loss on its return and the individual taxpayer would then report his or her allocable share of the feeder fund’s loss on his or her individual return.
BACKGROUND

The IRS has previously taken inconsistent positions as to whether, and to what extent, deductions or refunds were available for victims of Ponzi schemes. In particular, the deductibility of (a) the capital invested in a Ponzi scheme and (b) “phantom” income reported to investors and included by investors as gross income on federal income tax returns, but “reinvested” in the scheme, was uncertain.

The IRS set forth its guidance which, as IRS Commissioner Douglas Shulman stated in Congressional testimony, applies to all similar Ponzi schemes (not just the Madoff situation), in Revenue Ruling 2009-9, which describes the substantive legal conclusions, and in Revenue Procedure 2009-20, which provides a safe harbor for reporting purposes.

REVENUE RULING 2009-9

The Revenue Ruling reviews and clarifies the applicable law as follows:

1. A defrauded Ponzi scheme investor may claim a ordinary theft loss deduction (rather than a capital loss) because the investment was a transaction entered into for profit.

2. An investor’s theft loss is deductible under Section 165(c)(2) and is therefore not subject to certain limitations that would apply if the transaction was not entered into for profit.¹

3. A Ponzi scheme investor may deduct the theft loss in the year the theft loss is discovered (to the extent of the safe harbor provided in Revenue Procedure 2009-20, as described below, or provided that the investor has no reasonable prospect of recovery).

4. A defrauded investor’s deductible theft loss includes both (i) cash and property invested by the investor (net of any prior distributions) and (ii) any phantom income reported to the investor and included on the investor’s tax returns.² The amount claimed as a theft loss must be reduced by any claim for reimbursement with respect to which there is a reasonable prospect for recovery.

5. A net operating loss (“NOL”) resulting from theft may generally be carried back three years and forward 20 years.³ However, the theft loss of an individual is considered a loss from a “sole proprietorship” and an individual taxpayer may therefore be permitted to elect up to a five-year NOL carryback with respect to 2008 NOLs if the individual does not have more than $15 million in average gross income for the three-year period ending with the year in which the loss occurs.⁴ Claiming a carryback will, in most cases, result in the taxpayer receiving a refund of taxes paid in the years to which the losses are carried back. Although not entirely clear from the guidance, it appears that the determination whether the five-year carryback period is available will be made at the feeder fund level (not the individual taxpayer level) for individuals who invested through a feeder fund.

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The Revenue Ruling also clarified that an investor may not use a claim of right theory or mitigation provisions to adjust tax liability in the case of a Ponzi scheme.5

REVENUE PROCEDURE 2009-20

Revenue Procedure 2009-20 provides an optional safe harbor, for both individuals and entities (for example, partnerships that serve as feeder funds), to report a theft loss deduction for Ponzi scheme investments. The Revenue Procedure explicitly applies in the case of the Ponzi scheme described in Revenue Ruling 2009-9 (that is, the Madoff situation), and applies to similar schemes which fit within a general description given in the Revenue Procedure.

Under the safe harbor, an individual who invested directly in the Ponzi scheme will report the loss on his or her individual (or joint) return, while an individual who invested through a feeder fund would not directly report the loss. Instead, the feeder fund would report the loss and the individual would report his or her distributive share of the feeder fund’s loss. The safe harbor generally provides that the IRS will not challenge a reported deduction of Ponzi scheme losses if the direct investor (including an entity through which indirect investors invested) complies with the following procedures:

1. The investor must deduct the loss as a theft loss;

2. The taxable year in which the investor discovers the theft6 must be the same taxable year in which an indictment or similar allegation is made at the state or federal level against the promoter of the scheme; and

3. The amount of the deduction claimed by the defrauded investor must be:

   a. if the investor does not pursue any potential third-party recovery, 95% of the amount of the “qualified investment” (generally, the principal investments and all phantom income reported in any year by the investor, reduced by any distributions made to the investor), or

   b. if the investor is pursuing (or intends to pursue) any potential third-party recovery, 75% of the amount of the “qualified investment”;

   minus:

   a. any amount actually received as reimbursement or recovery (from any source) in the year of discovery, and

   b. any actual or potential claims for reimbursement as of the end of the year from the investor’s insurance policies, guarantees or other protections against loss of the investment, or amounts payable from the Securities Investor Protection Corporation (“SIPC”).
Fees paid to certain parties related to the promoter and deducted, or amounts borrowed from those parties and invested in the arrangement, are not deductible under the safe harbor, nor are amounts reported to the investor but not previously included in gross income on the investor’s federal tax returns.

In order to utilize the safe harbor provided in the Revenue Procedure, an investor must attach a statement (provided in an appendix to the Revenue Procedure) to its timely filed tax return, including extensions, for the tax year in which the theft is discovered. In doing so, the investor must agree not to deduct any amount of theft loss in excess of the safe harbor deduction, not to file or amend returns excluding phantom income reported in taxable years before the discovery year, not to apply claim of right, and not to apply equitable recoupment or mitigation.

If a taxpayer does not elect to use the safe harbor provided in the Revenue Procedure, the taxpayer must, under the otherwise generally applicable provisions of Section 165, establish facts showing the year the theft was discovered, the amount of the loss, and that no claim for reimbursement of any portion of the loss exists with respect to which there is a reasonable prospect of recovery in the year the loss is claimed.

The Revenue Procedure is generally applicable to losses for which the year of discovery is a taxable year beginning after December 31, 2007.

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These limitations are applicable to losses under Section 165(c)(3) and are described in Section 165(h). Revenue Ruling 2009-9 holds Revenue Ruling 71-381 obsolete to the extent that Revenue Ruling 71-381 held that a theft loss incurred in a transaction entered into for profit was deductible under Section 165(c)(3). All “Section” references are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), or to the regulations issued thereunder.

The IRS based this holding on Treasury Regulations Sections 1.165-8(c) and 1.165-7, under which the amount of an investment theft loss is the basis of the property (or the amount of money) that was lost, explaining that reinvested amounts increased the amount of the theft loss.

A deduction for casualty or theft losses allowable under Section 165(c)(2) is treated as a business expense under Section 172(d)(4)(C).

Section 172(b)(1)(H)(iv); Section 448(c). Entities qualifying as an “eligible small business” may also be able to elect up to a five-year NOL carryback.

See Section 1341, Sections 1311-1314.

If a taxpayer has already filed a return for the year in which the theft was discovered, or has filed an amended return for a prior year, and has taken a position inconsistent with the safe harbor treatment (such as excluding phantom income from gross income), the statement required to be filed under the Revenue Procedure must disclose this fact. In this case, the statement required by the Revenue Procedure to utilize the safe harbor must be filed by May 15, 2009 with the return (or amended return) for the year in which the theft was discovered.