The Internal Revenue Service issued guidance yesterday to assist Madoff investors and other victims of Ponzi-like schemes. In short, investors will be able to deduct up to 95% of their theft loss in 2008 and apply the unused portion towards seeking tax refunds for prior taxes potentially as far back as 2003. Please find attached PDF files with bookmarks for the Revenue Procedure 2009-20 and Revenue Ruling 2009-09 issued by the Service to resolve the uncertainty surrounding how and when taxpayers can deduct investment losses on their tax returns. Revenue Procedure 2009-20 provides a safe-harbor method of computing and reporting the losses and Revenue Ruling 2009-09 clarifies the income tax law governing the treatment of losses in this type of investment fraud. I will summarize the key points as follows:

**IRS Revenue Procedure 2009-20**

This revenue procedure is intended to provide the following:

1. Provide a uniform approach for determining the proper time and amount of the theft loss;
2. Avoid problems of verification in determining how much income reported from the investment scheme was “fictitious”, and how much was real; and
3. Reduce compliance burdens on taxpayers and administrative burdens on the IRS.

Revenue Procedure 2009-20 provides two simplifying assumptions of theft loss and prospect of recovery that taxpayers may utilize to report their investment losses. First, the revenue procedure provides that the IRS will deem the loss to be the result of theft if the promoter was charged with fraud or embezzlement and there is some evidence of an admission of guilt or a trustee has been appointed to freeze the assets of the scheme. Second, the “prospect of recovery” limits the amount of the investor’s theft loss deduction. This revenue procedure provides an optional safe harbor to permit taxpayers to deduct the loss in the year of discovery (for Madoff investors this would be 2008) by deducting 95% of the “net investment” reduced by the amount of any actual recovery in the year of discovery and the amount of any recovery expected from private or other insurance (such as a claim with the Securities Investment Protection Corporation). A special rule applies to investors that are pursuing legal recourse against persons other than the promoter (such as accountants or investment advisers). These investors will compute their deduction under the safe harbor approach by substituting in the formula 75% for the 95%.

If future recoveries differ from the loss claimed in the year of discovery, then the qualified investor would have income or additional deduction in the later year.

For the computation of the deduction, please see “Appendix A” on page 13 of Revenue Procedure 2009-20. In addition, to elect the safe harbor method, the taxpayer will be required to attach an executed statement to their timely filed return (including extensions) for the year of discovery as reported in Revenue Procedure 2009-20, Appendix A. By executing this statement, the taxpayer agrees: (1) Not to deduct in the year of discovery year any amount of the theft loss in excess of the deduction permitted by section 5 of Revenue Procedure 2009-20; (2) Not to file returns or amended returns to exclude or re-characterize the income reported from the investment in taxable years prior to the year of discovery; (3) Not to apply the alternative computation under I.R.C. §1341 (claim of right doctrine) with respect to the theft loss deduction allowed under Revenue Procedure 2009-20; (4) Not to apply the doctrine of equitable recoupment or the mitigation provisions under I.R.C. §§1311-1314 with respect to the investment that was reported in taxable years that are barred by the period of limitations for filing a claim for under to I.R.C. §6511.

On the 2008 Form 4684, Casualties and Thefts, the taxpayer must write at the top of the page “Revenue Procedure 2009-20”. The “deductible theft loss” (computed on Appendix A, Line 10 of the revenue
procedure) will be entered on the Form 4684, Page 2, Section B, Part 1, and Line 34. You are not required to complete the remainder of Form 4684, Section B, Part I.

If the taxpayer chooses not to apply the safe harbor treatment to a claimed theft loss provided under Revenue Procedure 2009-20, the taxpayer will be subject to all of the provisions governing the deductibility of losses under I.R.C. §165.

**IRS Revenue Ruling 2009-9**

In this revenue ruling, the IRS and Treasury Department set forth their legal position as follows:

1. The investor is entitled to a theft loss;
2. The “investment” theft losses are not subject to the limitations that are subject to personal casualty and theft losses. That is, the loss is deductible as an itemized deduction, but is not subject to the 10% AGI reduction or the $100 reduction;
3. Theft loss is deductible in the year of discovery;
4. Theft loss includes the investor’s unrecovered investment and the income reported in prior tax years;
5. Safe harbor approach promoted by the IRS in the guidance is conditioned on taxpayers NOT AMENDING PRIOR YEAR RETURNS. We are working with other professionals to confirm for taxpayers that have already filed amended tax returns for prior years, if a letter can be executed to request these returns NOT be processed by the IRS to avoid filing amending tax returns again to comply with the safe harbor approach prior to the May 15, 2009 deadline; and
6. Theft loss that creates a net operating loss can be carried back 3 years and forward 20 years (I.R.C. §172(b) (1) (F)). Section 1211 of the American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5, 123 Stat. 115 (February 17, 2009)) amends I.R.C. §172(b)(1)(H) to allow any taxpayer that is an eligible small business to elect either a 3, 4 or 5 year net operating loss carry back for an “applicable 2008 net operating loss”. §172(b) (1) (H) (iv) provides that an “eligible small business” has the same meaning as §172(b) (1) (F) (iii), except that §448(c) is applied by substituting $15 million for $5 million. A small business under §172(b) (1) (F) (iii) is a corporation or a partnership that meets the gross receipts test under §448(c) for the taxable year of the loss (or in the case of a sole proprietorship, that would meet such test if the proprietorship were a corporation). Therefore, an individual may elect either a 3, 4 or 5 year net operating loss carry back for a 2008 net operating loss, provided that the gross receipts test under §172(b)(1)(H)(iv) is satisfied. Ineligible investors can carry unused theft losses back 3 years. All investors can carry unused theft losses forward 20 years.

**Conforming with Safe Harbor Approach if Client Has No Records**

To complete the Appendix “A” of Revenue Procedure 2009-20, the client will need to know the amount of “fictionitious income”, total contributions and total withdrawals reported in prior years. Many clients do not have brokerage statements or tax returns back to the initial year of the investment. To assist these clients, we are working with other professionals to confirm if the theft loss deduction under the safe harbor approach can be calculated using the methodology of calculating the “tax basis” in the Madoff account equal to the fair market value on November 30, 2008 statement. This amount reports all contributions and withdrawals (if any), together with earnings that were reported as income federal tax purposes. The taxpayer will need to reduce the balance downward by the 2008 Madoff earnings not reported by the taxpayer. Please see the attached PDF file labeled “Madoff Tax Basis Methodology”. This concept for the “tax basis” is supported by the position that Madoff would have the investments in the account liquidated at year end and invest the proceeds in U.S. Treasury obligations. By liquidating the stock investments each calendar year, each investor would have short-term capital gain or loss. This reported capital gain or loss, plus any other investment income (interest and dividends), would be reported on the investor’s tax return.