

Madoff Losses – What To Do Next?

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Certainly one of the most prominent occurrences of the recent economic crisis was the unraveling of the Madoff Ponzi scheme. As a consequence, thousands of victims of Bernie Madoff's \$65 billion scam, and other similarly uncovered Ponzi schemes, have been able to claim "theft losses" and get an immediate deduction on their 2008 tax returns.

By issuing Revenue Ruling 2008-9 and Revenue Procedure 2009-20, the IRS provided very specific guidelines on how Madoff victims should reflect their losses on their 2008 tax returns. For those who have not yet filed their 2008 returns, the deduction to be taken is up to 95 percent of the total loss.

With the IRS updated positions, victims no longer have to wait to file and claim losses until they know with reasonable certainty what the final numbers would be. Instead, these losses can be taken immediately, and essentially be treated like business losses. This means that these affected taxpayers who lost large sums could possibly get back all of the tax they paid in the last three years, offsetting the assumedly fictitious income from the accounts with Madoff.

The ruling further clarifies that the losses resulting from Madoff may be deducted against 2008 adjusted gross income provided that there is not a claim for reimbursement or recovery of the loss through a legal proceeding. The amount of the theft loss resulting from fraud is determined through the following formula: (i) initial amount

invested; (ii) plus additional investments; (iii) less amounts withdrawn; (iv) less amounts that are anticipated to be recovered through reimbursement or other claims. Any unused portion of the theft loss may be carried back for a period of up to three years and carried forward for a period up to twenty years.

Revenue Procedure Ruling provides a safe harbor for investors to deduct 95 percent of the losses when they choose not to pursue any potential third-party recovery and a deduction of 75 percent for an investor whose intention is to pursue any potential third-party recovery. Any monies recovered are to be subtracted from the latter option. The loss amount is basically determined by adding the initial investment made, plus additional investments, less amounts withdrawn

It is critical at this point for those Madoff victims, who have filed their 2008 returns and taken the losses, to focus on the most tax efficient strategy in terms of the carryback of these losses which is allowed for three years (normally only 2 years) for those victims specifically, or carrying them forward for 20 years for use against future income. Most importantly would be the benefit of offsetting, as mentioned earlier, the potentially fictitious income that was generated from the Madoff accounts and therefore erasing past tax liabilities.

A few items to note: (1) certain "eligible small businesses" affected by Madoff may elect a three, four or five-year carry back depending on certain factors; and (2) those investors who didn't invest directly through Madoff, but through an investment company, cannot

take the losses themselves. In those cases, the investment entity would be eligible to take these losses, and potentially pass them on to the investors.

In terms of amending Federal tax returns from a procedural perspective, taxpayers can choose to file Form 1040X or 1045. Form 1045 is the fastest method for processing a refund as the IRS has 90 days to respond to your refund request. In submitting Form 1045, a series of schedules from prior year returns are required as well. The filing of Form 1045 should be completed before December 31, 2009.

It should be further noted that loss carry forwards and carry backs are treated differently at the state level. In April 2009, the State of New Jersey issued a press release stating, "The New Jersey Gross Income Tax Act does not follow Federal law regarding carry forward losses and carry back losses and the loss on the 2008 New Jersey return is limited to the category of 'Net Gains' or income from disposition of property. Therefore, the loss cannot be taken on a prior year's New Jersey income tax return." In comparison, the New York State Department of Taxation and Financing issued a press release in May 2009, indicating that deductions for theft losses attributable to a fraudulent investment arrangement are subject to existing limitations whereby the deduction is limited for residents whose income exceeds \$100,000.

Beyond the application of loss carry backs and carry forwards and dealing with the various tax issues, one of the critical developments coming out of the Madoff era will be the importance of having objective investment oversight.

Such oversight should be based on a relationship with a consultant that does not necessarily have custody of assets, nor necessarily directly manages the assets, but rather oversees money managers being used by clients. An "oversight" advisor can also review the strategies being employed by the money managers.

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This oversight role can take on a comprehensive set of services, including rudimentary matters such as setting up asset allocations, but perhaps more importantly, providing ongoing reporting of performance and activity and an examination of the tax efficiency of client portfolios and investment strategies.

The procedure for employing carry backs should be addressed immediately by taxpayers, once the losses have been accurately depicted on their 2008 tax return. Furthermore, a strategic review of employing a more effective methodology for asset management going forward is critical.