Madoff and Other Fraudulent Schemes: Tax and Planning Implications

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Overview

The following discussion highlights the various tax and planning implications that arise as a result of investment in the Madoff Ponzi scheme. This White Paper should be viewed as an evolving document—it will be updated on an ongoing basis as guidance is issued. In fact, on March 17, 2009, the IRS issued guidance on how to treat theft losses resulting from investments in fraudulent schemes and provided a safe harbor for computing such losses (see page 7).[1] Although this White Paper focuses on the Madoff situation, the discussion is also applicable to investments in other fraudulent schemes.

Madoff Ponzi Scheme

The SEC contends that Bernard L. Madoff, and his firm, Bernard L. Madoff Investment Securities, LLC, (BMIS) perpetrated a giant Ponzi scheme in which principal from new investors was utilized to make income and redemption payments to other investors. This scheme enabled Madoff and his firm to deliver fraudulent strong investment results and defraud investors out of an estimated $50 billion.

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Bankruptcy Recovery and Clawbacks

Before one can understand the tax implications associated with the Madoff scandal, one must have at least a cursory knowledge of the bankruptcy proceedings and the potential "clawbacks" under the bankruptcy law. The Securities Investor Protection Corporation (SIPC), having taken over BMIS in conjunction with the Bankruptcy Court, has appointed Irving Picard as Trustee to oversee the orderly liquidation of the assets of BMIS and related entities. (Surprisingly enough, in a SIPC type proceeding, Picard's fees and the fees of lawyers, accountants, and other experts will be paid by SIPC and not from the assets of the investors.)

In the course of this proceeding, Trustee Picard will work diligently to discover the assets within and outside of the United States. Those assets, including Madoff's market making business, will be liquidated with investors receiving an extremely limited recovery. At this time, it has been reported that recovery of less than $1 billion has been made compared to the $40 - $50 billion that was believed to be invested

with Madoff immediately before the fraud was discovered. In any event, it seems unlikely that the eventual recovery will exceed 10 to 15 percent.

Perhaps the greater concern coming from the bankruptcy is that of clawbacks. Although not a technical financial term, but rather a term of art, the phrase clawback refers to a trustee's legal ability to require investors to repay distributions to the bankruptcy estate. Although a technical discussion of the law surrounding clawbacks is beyond the scope of this tax analysis, it suffices to say that some investors will be required to repay the trustee. On February 21, 2009, Picard and his counsel, David Sheehan, hosted an investors meeting, followed by questions and answers. In the course of this meeting, no clear guidance was given as to exactly how the clawbacks would work. However, several things became clear:

1. Investors with inside or special knowledge would have a greater risk of clawback.

   Example 1: Xavier, a very sophisticated investor and personal friend of Madoff, withdrew funds from BMIS on December 10, 2008, the day before the scandal became public. In this instance, because of the timing, relationships, and familiarity, it would seem highly likely that this distribution would be subject to a clawback.

2. Investors who were "net winners" would also have a more likely chance of clawback compared to investors who were "net losers."

   Example 2: Clara, a widow, invested $5 million with BMIS in 2000 and each year beginning in 2001 (eight years in total) she withdrew $250,000, for a total of $2 million. Based upon statements made by Picard, it would seem unlikely that she would be subject to a clawback.

   Example 3: David, a single individual, likewise invested $5 million with BMIS in 2000 and withdrew $700,000 a year for a total of $5.6 million. In this instance, based upon the statements made by Picard, it would seem that David would have a clawback exposure.

3. The prudent course of action for tax attorneys or CPAs is to recommend to their clients that they seek separate bankruptcy counsel for advice regarding clawbacks.

Computation of Eventual Recovery

In the question-and-answer session hosted by Picard and Sheehan, they specifically discussed the following examples:

Example 4: An investor had $800,000 invested with Madoff, received a SIPC recovery of $500,000 and was entitled to a 50-percent bankruptcy recovery. What is the total amount recoverable? The amount would ordinarily be the sum of the two amounts, or $900,000. However, because this amount would exceed the total investment, recovery would be limited to $800,000.

Example 5: Using the same general fact pattern as in Example 4, if the bankruptcy recovery was only 10 percent (a more realistic assumption), the investor would receive a $500,000 payment from SIPC and an $80,000 recovery from the trustee.

SIPC Recovery

As explained in more detail below (see page 4), a theft loss deduction is ordinarily taken in the year the theft is discovered. If the taxpayer has a claim for reimbursement in that year, however, the portion of the loss that may be reimbursed cannot be deducted until the tax year in which it is reasonably certain that reimbursement will not be received. Such recovery could come from either the bankruptcy estate (described above) or from SIPC.

As a broker-dealer registered with the SEC, Bernard L. Madoff Investments Securities LLC (BMIS) is a member of SIPC. SIPC membership is not voluntary but is required by law. SIPC is a nonprofit, private membership corporation to which most registered brokers and dealers are required to belong. SIPC was created by the Securities Investor Protection Act of 1970 (SIPA) and insures customers of SIPC members in case a broker-dealer liquidates. SIPC proceedings are a specialized form of bankruptcy.[2] A trustee and counsel are designated by SIPC and appointed by the federal District Court. The case is then referred to the appropriate federal Bankruptcy Court for all purposes.

Bernard Madoff was arrested by the FBI on December 11, 2008, and charged with securities fraud in violation of Exchange Act Rule 10b-5. On December 15, 2008, SIPC filed an application with the federal District Court seeking a decree

adjudicating the customers of BMIS in need of the protections afforded under SIPA. The U.S. District Court for the Southern District of New York entered an order placing BMIS's customers under the protections of SIPA. The Protective Order appointed the Trustee for the liquidation of the business of BMIS and removed the SIPA liquidation proceeding to the federal Bankruptcy Court for the Southern District of New York.

Unsecured claimants in a SIPA liquidation are generally classified as either "customers" or general unsecured creditors of SIPC. As a result, a SIPA proceeding generally involves two estates from which customer claims and general unsecured claims are satisfied. The first is the general estate, which is the only estate from which general unsecured creditors can seek satisfaction of their claims. The second, and relevant estate, is the customer estate. The customer estate is a fund consisting of customer property and is limited exclusively to satisfying customer claims.[3] Accordingly, customers, as defined by SIPA, enjoy a preferred status and are afforded special protections under SIPA.[4] A denial of customer status relegates an investor to the status of a general unsecured creditor.

The SIPC may advance up to $500,000 per customer on account of missing securities, of which up to $100,000 may be based on a claim for cash. SIPC does not protect against market loss. The maximum amount is $500,000, even if the valid amount of the claim is much higher. The amount of recovery beyond the amount advanced by SIPC will depend on the amount of customer property the trustee is able to recover. Customer property is never used to pay any administrative costs in a SIPC proceeding.

SIPA defines "customer," in relevant part, as any person who has deposited cash with the debtor for the purpose of purchasing securities. The mere act of entrusting cash to the debtor for the purpose of effecting securities transactions triggers customer status. A recent U.S. Bankruptcy Court case clarified that the investment needed to establish customer status under SIPA is triggered at the moment the funds are deposited in the firm's account.[5] Thus, an investor who wired $10 million to Madoff's firm six days before Madoff was arrested for securities fraud was a customer of the firm within the meaning of SIPA, even though the fund was closed until the New Year and no trade ever took place. According to the court, the funds were wired and held in the Madoff firm's account for the purpose of investing when the funds reopened. Regardless of whether the funds were to be invested immediately or upon the investor's authorization, reasoned the court, the fact remained that the sole purpose of wiring the funds to the firm's account was to effectuate future securities transactions. The customer relinquished all control over the funds once the wire was processed.

SIPA defines "customer property," in relevant part, as cash and securities at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted. Essentially, the fund of customer property includes all property that was or should have been set aside for customers and includes bank accounts containing customer funds. Under SIPA, the trustee is explicitly directed to distribute customer property pro rata among claimants who qualify as customers. Any contrary distribution of the funds would preclude the trustee from exercising his or her statutorily mandated duties and run afoul of the clear command of SIPA.

As set by the Bankruptcy Court, Madoff customer claims had to be filed by March 4, 2009. However, SIPA allows a six-month time period for filing customer claims. Any claim of a customer or other creditor of the debtor that is received by the trustee after the expiration of the six-month period beginning on the date of publication of notice will not be allowed, except in certain circumstances. The court may grant a reasonable, fixed extension of time for the filing of a claim by the United States, by a State or political subdivision thereof, or by an infant or incompetent person without a guardian. Thus, it is clear from the face of the statute that the six-month time limit for filing is subject to extension at the discretion of the court in only three specified instances, none of which is applicable to the Madoff liquidation.

Claims of customers must actually be received by the trustee within the six-month period from the date of publication of notice. The six-month time limit is the absolute outer limit. Thus, all Madoff claims must be received on or before July 2, 2009. The Instructions for completing the Madoff customer claim form note that claims received after March 4, 2009, but on or before July 2, 2009, may result in less protection. The claims are subject to delayed processing and to being satisfied on less favorable terms.[6]

Analysis of Tax Issues

Theft Loss

Code Sec. 165 allows an income tax deduction for "any loss sustained during the taxable year and not compensated by insurance or otherwise."[7] To be allowable as a deduction under Code Sec. 165(a), a loss must be (1) evidenced by closed and completed transactions, (2) fixed by identifiable events, and (3) with certain exceptions (e.g., for theft losses), actually sustained during the taxable year.[8] If the taxpayer is an individual, Code Sec. 165(c) imposes an additional limitation. The loss is deductible only if:

1. it is incurred in a trade or business (Code Sec. 165(c)(1));
2. it is incurred in a transaction entered into for profit (Code Sec. 165(c)(2)); or
3. it arises from fire, storm, shipwreck, or other casualty, or from theft (Code Sec. 165(c)(3)).

The IRS and the courts have generally taken the position that losses from Ponzi schemes and similar frauds should be claimed as theft losses under Code Sec. 165(c)(3).[9]

Definition of Theft Loss

The term "theft" has been defined very broadly. In Rev. Rul. 72-112,[10] the IRS stated that theft includes *"any felonious taking of money or property by which a taxpayer sustains a loss…Thus, to qualify as a "theft" loss…the taxpayer needs only to prove that his loss resulted from a taking of property that is illegal under the law of the state where it occurred and that the taking was done with criminal intent.*[11] Similarly, in *A.C. Edwards Exr.,*[12] the U.S. Court of Appeals for the Fifth Circuit noted that for tax purposes *"'theft' is not…a technical word of art with a narrowly defined meaning but is, on the contrary, a word of general and broad connotation…covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile."*

This is not to say that there are not significant limits on a taxpayer's ability to take a theft deduction, however. An essential element of theft under the law of most states is specific intent to obtain the victim's property. Implicit in this requirement is a relationship of privity between the perpetrator and the victim. Lack of privity has been held to bar a theft deduction in a number of cases.[13] In the context of securities fraud, where taxpayers purchased stock in reliance on fraudulent representations by corporations, theft loss deductions have not been allowed where the taxpayer purchased the stock on the open market.[14] Nor was a deduction allowed where a taxpayer purchased stock from a broker that subsequently became worthless due to the fraudulent actions of corporate officers because the taxpayer could not prove that the broker had guilty knowledge or intent to deceive.[15] Thus, the case law suggests that there must be a direct buyer-seller relationship between the buyer and the perpetrator. This might block recovery for victims who invested through brokers or feeder funds. Although federal securities laws do not always require privity, they do not help the taxpayer because there must be a theft under state law.

Timing of Loss Deduction

Theft losses are generally treated as arising in the tax year in which they are discovered.[16] Thus, a theft loss is not deductible in the year it occurs unless that is also the year in which the theft is discovered. If, in the year of discovery, the taxpayer has a claim for reimbursement with respect to which there is a reasonable prospect of recovery, however, the portion of the loss that may be reimbursed cannot be deducted until the tax year in which it becomes reasonably certain, no reimbursement will be made.[17] A loss is treated as discovered when a reasonable person in similar circumstances would have realized that he or she had suffered a loss.[18]

Reasonable Prospect of Recovery

Whether there is a reasonable prospect of recovery is a question of fact to be determined by looking at all the circumstances of the case.[19] In general, there is a reasonable prospect of recovery when the taxpayer has a bona fide claim for recoupment and there is a substantial possibility that the claim will be decided in the taxpayer's favor.[20] Although there is bright line rule for making the determination, the courts have laid down some helpful guidelines. First, whether a taxpayer has a reasonable prospect of recovery is determined at the time the deduction is claimed and not later with the benefit of hindsight.[21] Second, the standard to be applied is primarily objective, although a taxpayer's subjective attitude and beliefs are not to be ignored.[22] Third, some courts have found that filing a lawsuit soon after the tax year in which the loss is claimed suggests that the taxpayer did not consider the loss a closed and completed transaction.[23] Other courts have noted, however, that taxpayers sometimes bring lawsuits, even when

their chances of prevailing are quite low (e.g., 10 percent).[24] Moreover, filing a proof of claim in a bankruptcy proceeding is considered a ministerial act and carries less weight than filing a lawsuit.[25] Fourth, the burden of proof is on the taxpayer to show that there was no reasonable prospect of recovery in the year the theft loss deduction was claimed.[26] Fifth, courts may consider whether the taxpayer ultimately won on the lawsuit.[27] Finally, although the term "reasonable prospect is difficult to quantify, the U. S. Court of Appeals for the Third Circuit has noted that a 40- to 50-percent chance of recovery might be a reasonable standard.[28]

Reasonable Prospect of Recovery Bars Amount of Theft Loss Deduction

In *Ramsay Scarlett & Co.*[29] the Tax Court held that the amount of the theft loss deduction is equal to the excess of the total loss claimed on the return over the amount the taxpayer has a reasonable prospect of recovering. The portion of the loss for which there is a reasonable prospect of recovery will not be considered to be sustained at that time, and it will not be deductible until the tax year in which it is determined with reasonable certainty that such reimbursement will not be obtained.[30]

Amount and Character of the Deduction

If the theft involves personal use property (i.e., Code Sec. 165(c)(3) applies), the amount of the deductible loss is the lesser of the property's fair market value (FMV) immediately before the theft or its adjusted basis.[31] This amount is then reduced by the amount of insurance or other compensation received or recoverable.[32] Two limitations must then be applied. First, the initial $100 of loss on each theft is disallowed.[33] The remaining amount is then netted against any personal casualty gains and any net loss is deductible only to the extent it exceeds 10 percent of adjusted gross income (AGI).[34]

Example 6: Assume that Tom suffers a personal theft loss. The stolen asset had a basis and FMV of $20,000.[35] Tom has AGI of $50,000. The first limitation reduces Tom's loss from $20,000 to $19,900 ($20,000 - $100). This amount is then deductible to the extent it exceeds 10 percent of Tom's AGI ($5,000). Thus, the theft deduction is $14,900 ($19,900 - $5,000). The $14,900 is an itemized deduction against ordinary income.

If the theft involves business or investment property, the amount of the deduction is the adjusted basis of the property reduced by insurance or other compensation recoverable, but the $100 and 10-percent-of-AGI floors do not apply.[36] Thus, whether the loss is properly deductible under Code Sec. 165(c)(2) or 165(c)(3) is important.

Deduction under Code Sec. 165(c)(2) or 165(c)(3)?

As noted above, Code Sec. 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit, while Code Sec. 165(c)(3) allows a deduction for losses of property not connected with a trade or business or a transaction entered into for profit if such loss arises from fire, storm, shipwreck, or other casualty or from theft. It is not clear whether Code Sec. 165(c)(2) or Code Sec. 165(c)(3) would apply to theft losses arising from a Ponzi scheme or similar fraud. The uncertainty results from the fact that, although Code Sec. 165(c)(3) refers specifically to losses from theft, it also excludes transactions, like Ponzi scheme investments, that were entered into for profit.

In Rev. Rul. 71-381,[37] the IRS took the position that theft losses resulting from transactions entered into for profit are deductible only under Code Sec. 165(c)(3), subject to the $100 and 10-percent-of-AGI floors. Subsequent developments cast doubt on the IRS position, however. In *Z. Premji*,[38] the Tax Court suggested that when a taxpayer enters into a transaction for profit, Code Sec. 165(c)(2) controls not Code Sec. 165(c)(3), stating that *"[t]he parties agree that Mr. Premji and Mr. Norby sustained theft losses (Sec. 165(a) and (e)). They also agree that Mr. Premji and Mr. Norby incurred losses in transactions entered into for profit. Hence, section 165(c)(2) controls the reporting of their theft losses."*

Prior to 1984, Code Sec. 165(c)(3) provided that a theft loss was deductible:

> (3) except as provided in subsection (h) losses of property not connected with a trade or business if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

The Deficit Reduction Act of 1984[39] added the underlined language, making Code Sec. 165(c)(3) to read as follows:

> (3) except as provided in subsection (h) losses of property not connected with a trade or business

> or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

The change would seem to strengthen the case for application of Code Sec. 165(c)(2) rather than Code Sec. 165(c)(3) to theft losses. Not only does Code Sec. 165(c)(2) specifically apply to transactions entered into for profit, but Code Sec. 165(c)(3) now specifically excludes transactions entered into for profit.

In CCA 200451030, the IRS came close to acknowledging that the position it took in Rev. Rul. 71-381[40] might not be correct but noted that the official IRS position had not changed:

> Since the investors entered into the loan transactions with an expectation of profit, arguably their losses are deductible under §165(c)(2), not §165(c)(3)—although the timing of the loss would still be governed by §165(e). See, for example, the government's apparent concession to this effect in Premji. However, the official position of the Service is that such a loss is deductible only under §165(c)(3). See Rev. Rul. 71-381. As such, it is subject to the limitations in §165(h).

Thus, the bottom line appears to be that, although taxpayers would have a strong argument for claiming Madoff losses under Code Sec. 165(c)(2) and avoiding the $100 and 10-percent limitations, they might expect to be challenged by the IRS.

To report the full amount of a theft loss without applying the $100 and 10-percent-of-AGI floors, a return preparer would ordinarily either need to have substantial authority for taking the position or a reasonable basis plus disclosure.[41] If a significant purpose of the deduction is the avoidance of tax (the IRS would probably argue this), the threshold would be the more likely than not standard. Note that disclosure is not required merely for taking a position contrary to a ruling (in this case Rev. Rul. 71-381),[42] but only for taking a position contrary to a regulation.

Phantom Income and the Open Transaction Doctrine

In addition to claiming a theft loss, investors may be able to amend tax returns filed in prior years to eliminate income or treat it as a return of capital. Assuming a tax year is still open, returns may be amended to get rid of amounts reported as income that were not in fact actually or constructively received.[43] It may also be possible to eliminate income that was received by treating it as a return of capital under the open transaction doctrine.

The open transaction doctrine was first enunciated in *Burnet v. Logan*,[44] in which a taxpayer sold stock for cash plus a royalty of 60 cents per ton on all ore that the purchaser of the stock received from a certain mine. Because the amount to be received on the sale was uncertain, the taxpayer argued that it should not recognize any taxable income until the total amount received exceeded basis and the court agreed.

There are numerous cases and rulings in which taxpayers have attempted to apply the open transaction doctrine to income reported from fraudulent transactions. Sometimes taxpayers have won[45] and sometimes they have lost.[46] The key variables are (1) whether recovery was uncertain, (2) whether the taxpayer was an innocent investor, and (3) whether the amounts received were in the nature of interest or capital gain income or merely payments from later investors to conceal fraud.

Uncertainty of Recovery. The rationale for using the open transaction doctrine is that the seller or investor does not know the amount that will ultimately be received. The IRS takes the position that the open transaction doctrine can apply to Ponzi scheme payments, but only those payments received after discovery of the fraud. The rationale is that the typical investor would ordinarily not conclude that recovery of principal was uncertain until that time.[47] Moreover, some courts have held that receipts from a fraudulent scheme were income in the year received where the taxpayer could not establish that recovery of the principal amount was uncertain.[48]

Innocent Investor. The IRS will deny open transaction treatment where the taxpayer is not an innocent investor. Early investors who are also promoters or who expect to make money because of money collected from later investors will not receive return of capital treatment.[49]

Income vs. Payments from Other Investors. Interest income has been defined as compensation for the use or forbearance of money.[50] Where payments received in a Ponzi scheme were not for the use or forbearance of money, but rather payments from later investors made to conceal fraud, the payments were return of capital and not income.[51] Trustee Picard has stated that "*there is no evidence to indicate securities were purchased for* customer accounts in the past 13 years." Thus, it appears that payments received in the Madoff fraud were made to conceal the fraud.

Statute of Limitations. The statute of limitations for amending income tax returns is generally three years. Thus, for 2008, the 2005, 2006, and 2007 returns are open for amendment.[52] States have their own statutes of limitations for filing amended returns. Some examples are: Wisconsin, four years; Michigan, four years; Illinois three years; and Minnesota, 3.5 years. Both federal and state protective claims should be filed to keep these years open.

What about the interaction of amending returns and claiming net operating loss (NOL) carryovers? One strategy would be to file amended returns for the open years first and protective NOL claims for "open years" basis.

Pre-2005 Phantom Income. As explained above, it may be possible to amend returns back to 2005 to reverse out phantom income or treat amounts received as return of capital, but what about income reported by taxpayers in tax years prior to 2005? Is it possible to add closed-year income to the 2008 theft loss? There are several theories that might prove successful: (1) mitigation of the effect of the limitations period under Code Secs. 1311-1314, (2) common law estoppel to prevent unjust enrichment, (3) claim of right doctrine or Code Sec. 1341[53] or (4) equitable recoupment.

Planning to Maximize Deductions. There are two potential strategies. One would be to file amend returns for open years reversing phantom income and to file a protective claim for reportable basis. The theft loss could still be carried back three years and forward 20 years. For smaller investors and investors who need immediate cash this may be the most favorable approach. The other would be to claim a theft loss for accumulated investment (principal plus earnings less withdrawals). Under this alternative, the taxpayer would not file amended returns for the open years because the phantom income would already be included in the theft. This theft loss could then be carried back three years and forward 20 years.[54] It would be necessary to file a protective claim for the phantom income. CCA 200451030 may provide some authority for this position. The American Recovery and Reinvestment Act extends the NOL carryback period to five years for qualified small businesses (including pass-through entities).[55]

IRS Guidance on Ponzi Schemes

On March 17, 2009, the IRS issued guidance to assist victims of Ponzi-type investment schemes.[56] Although the guidance makes no mention of the Madoff scheme by name, new Rev. Rul 2009-9 clarifies the favorable tax treatment to which these and other similarly situated "investors" are entitled. New Rev.Proc 2009-20 provides these taxpayers with an optional safe harbor that greatly alleviates burden-of-proof issues. IRS Commissioner Douglas Shulman at a press conference on March 17, 2009, noted that the guidance "assist[s] taxpayers who are victims of losses from Ponzi-type investment schemes." The guidance is not specific to the Madoff case, he indicated.

Theft Loss Treatment

Rev. Rul. 2009-9 covers the tax treatment of fraudulent investment arrangements under which income amounts that are wholly or partially fictitious have been reported as income to the investors. The IRS clarified that:

1. The investor is entitled to an ordinary theft loss rather than just a capital loss.
2. An investment theft loss is not subject to the $100 per event (for pre-2009 years) or 10-percent adjusted gross income personal casualty loss floors; but it remains available only to those who itemize deductions.
3. The investment theft loss is deductible in the year that the fraud is discovered, subject to reduction for amounts for which a reasonable prospect for recovery remains.
4. The investment theft loss includes the investor's unrecovered investment and fictitious income that may have been reported in a past year as taxable income (and was not distributed).
5. The investment theft loss forms part of the taxpayer's NOL that may be carried back or forward under normal NOL rules.

In lieu of taking a loss deduction, taxpayers continue to be free to file amended returns for those open tax years in which tax had been paid on phantom income, bogus gains and dividends. The IRS, however, ruled that closed years will not be reopened to make these adjustments.

The IRS emphasized that "any deduction for casualty or theft losses allowable under Code Sec. 165(c)(2) or (3) is treated as a business deduction for Code Sec. 172 [NOL] purposes." Therefore, if the loss is discovered in 2008, Rev. Rul. 2009-9 treats an individual investor or proprietorship as a small business that is eligible for the extended five-year NOL carryback period under the American Recovery Act for any 2008 NOL. If the taxpayer's $15 million maximum gross income limit is not met for purposes of qualifying for the extended American Recovery

and Reinvestment Act NOL carryback, the regular three-year NOL carryback arising for casualty or theft losses may be taken.

Safe Harbor Rule

In recognition of the magnitude of recently discovered fraudulent investment arrangements, the IRS announced safe harbor treatment using two simplifying assumptions.

First, the IRS will deem the loss to be the result of theft if: (1) the promoter was charged under federal or state law with the commission of fraud, embezzlement, or a similar theft-type crime or was subject to a criminal complaint alleging the commission of such a crime and (2) there exists some evidence of an admission of guilt by the promoter or a trustee was appointed to freeze the assets of the scheme.

Second, the IRS will deem the amount of the investor's prospect of recovery, which limits the amount of the investor's immediate theft loss deduction, to five percent of the investor's net investment plus any actual recovery in the year of discovery and the amount of any recovery expected from private or other insurance (including insurance under SIPC). The five-percent amount applies to investors suing the creator of the scheme. For investors suing persons other than the promoter class, however, the five-percent prospect amount is raised to 25 percent.

According to IRS Commissioner Douglas Shulman, the safe harbor will provide a uniform approach that avoids difficult burdens of proof in determining the amount of fictitious income, and minimizes compliance burdens on taxpayers and administrative burdens on the IRS.

At a press briefing, IRS officials commented that investors who participated in a Ponzi scheme through a "feeder fund" cannot use the safe harbor directly. The fund can use the safe harbor to determine its total losses. If the fund is a partnership, it will report a share of the losses to each investor on Schedule K-1. Further, noted officials, investors who do not use the safe harbor may claim a loss under the "standard rules," applied on a case-by-case basis. These rules are less clear than the safe harbor.

Future Recoveries. If the deduction taken in the year that the theft is discovered turns out to be too large, the taxpayer must recognize income in the year that a future recovery of that excess is realized. If the initial deduction turns out to be too small because the actual loss recovered is less than anticipated, an additional deduction in the year of recovery may be taken.

Safe-Harbor Statement. Rev. Proc. 2009-20 contains the sanctioned safe harbor statement —in fill-in-the-blank format— that the IRS will require for a taxpayer to use the safe harbor assumptions. An investor claiming the safe harbor recovery amount must claim the entire loss for the year of discovery. An investor who previously filed original or amended prior year returns to claim the investment losses may claim the safe harbor amount but must identify the inconsistent prior year returns on Appendix A of Rev. Proc. 2009-20.

See the Appendix for the full-text of Rev. Rul. 2009-9 and Rev. Proc. 2009-20.

Estates and Trusts

Thus far, we have been assuming that the theft loss is discovered while the investor is alive. If the investor dies before the loss is discovered, the tax consequences become more complicated.

Deductions Available

The income or estate tax deductions available depend on when the loss was incurred and when it was discovered. There are three common situations:

1. the theft occurs before the decedent dies, but is discovered during estate administration;
2. the theft occurs and is discovered during estate administration; and
3. the theft occurs after the accounts have been distributed.

Situation 1. Under these facts, the estate can claim an income tax deduction under Code Sec. 165(c), even though the loss occurred during a tax year of the decedent.[57] An estate tax deduction is allowable only for losses that occurred during estate administration, however.[58]

Situation 2. Such a loss is deductible on either Form 706 (U.S. Estate (and Generation-Skipping Transfer) Tax Return) as an estate tax deduction or on Form 1041 (U.S. Income Tax Return for Estates and Trusts) as an income tax deduction.[59] The default rule is that theft losses are claimed as an estate tax deduction under Code Sec. 2054, but a special election can be made to instead claim an income tax deduction under Code Sec. 165. If the election is made, the estate must file a statement reciting that the items in question have not been deducted under Code Sec. 2053 or 2054 and that the right to claim deductions

under these Code Sections has been waived.[60] Once made, the election is irrevocable.[61]

Situation 3. In this situation, the losses cannot be deducted by the estate under either Code Sec. 165(c) or Code Sec. 2054.[62] The losses would be deductible by the beneficiary, but only for income tax purposes.[63] If estate administration is unduly prolonged, the estate may not be able to deduct the loss even if it still holds the asset. An argument could be made that the estate would no longer be holding the asset for the estate but as an agent for the beneficiary.

Repayment to the Bankruptcy Estate

As explained above (see page 2), the Trustee of the Madoff estate may file clawback suits against investors who received distributions from Madoff. If such investors died before the scheme was discovered, the bankruptcy trustee may try to collect from their estates. Practitioners should explore the possibility of deducting such repayments under Code Secs. 2053 or 2054. Estates should also file both income tax and estate tax protective claims.

Refunds

If a taxpayer has phantom income resulting from a Ponzi scheme, the proper tax treatment probably depends on when the taxpayer dies. If the taxpayer died before the fraud was discovered, an argument can be made that income tax refunds would not be part of the gross estate for estate tax purposes. On the other hand, if the taxpayer died after the loss was discovered, any future income tax refunds would presumably be included in the gross estate.

Carrybacks and Carryforwards

Under the general rule, taxpayers can carry theft losses back three years and forward 20.[64] A special rule extends the carryback period to three years for casualty and theft losses, however.[65] If a theft loss was discovered before a taxpayer's death, any further carryforwards would probably be lost. The taxpayer has filed his or her last Form 1040 (U.S. Individual Income Tax Return) and there are no further tax years to which the loss could be carried forward. This would leave only the three-year carryback period. Moreover, taxpayers dying before April 18, 2009, probably could not take advantage of the five-year extended carryback period under the American Recovery and Reinvestment Act.[66] Again, filing protective claims is extremely important.

Value of Brokerage Accounts in the Estate

If the theft loss was discovered before death, the reduced value of brokerage accounts should be reflected in their estate tax value regardless of whether the date of death or alternate valuation date value was used. If the loss was discovered after the date of death but before the six-month alternate valuation period, the alternate valuation date could be used to reflect the lower value. Note, however, that if an executor elects the alternate valuation date, any estate tax deduction for administration expenses under Code Sec. 2053(b) or for theft or casualty losses under Code Sec. 2054 is disallowed to the extent the item in question is, in effect, taken into account by using the alternate valuation method.[67] In other words, there can be no double dipping.

Tax Planning for Trusts

Trusts with assets invested in a Ponzi scheme will generally have much larger losses in the current year than they can use. Income tax planning for such trusts involves using the losses as soon as possible and making sure all of them can be utilized. To accomplish this, the trust must generate more taxable income. There are several ways this can be accomplished. First, additional gifts can be made to the trust. More trust assets means more income and the more income, the faster the losses can be used up. Second, leveraged sales can be made to the trust. Assuming that the assets sold to the trust produce a total return in excess of the interest rate on the note, the value of the trust will increase. Finally, wills can be amended to increase trust funding.

IRAs

In discussing the tax implications for Madoff investors, we cannot forget those individuals who invested through Madoff with their IRAs or qualified plans.[68]

Deduction for IRA Losses

For purposes of determining the taxation of IRA distributions, all traditional IRAs maintained for an individual must be aggregated and treated as one IRA.[69] An IRA loss may be recognized only if *all* of an individual's IRAs have been distributed and the amounts distributed are less than the individual's unrecovered basis.[70] The basis in a traditional IRA is the total amount of the nondeductible contributions in the IRAs.[71] If an IRA owner has a zero basis in the IRA because all of the contributions were deductible, then there will be no loss available.

However, Roth IRAs do have basis and, therefore, a loss would be available. In order to recognize a loss on a Roth IRA, all of an individual's Roth IRA accounts must be distributed and the amounts distributed must be less than the individual's unrecovered basis.[72]

An IRA loss is claimed as a miscellaneous itemized deduction, subject to the two-percent-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040 (U.S. Individual Income Tax Return).[73] Any IRA losses, however, are added back to taxable income for purposes of calculating the alternative minimum tax.[74] This creates a real problem, in essence making a large loss valueless.

IRAs may also be subject to clawbacks. If the funds being repaid were previously reported as income on the taxpayer's prior income tax returns, as would have been the case for IRA required minimum distributions from IRAs, the taxpayer may be able to take a deduction for the repaid funds on his or her current income tax return under the claim of right doctrine. In the alternative, taxpayers may be able to increase their Code Sec. 165 theft loss deduction for these amounts.

Code Sec. 1341 and Reg. §1.1341-1 set forth the requirements for a deduction under the claim of right doctrine. In order to claim a deduction under Code Sec. 1341, the following five requirements must be satisfied:

1. The item was included in gross income in a previous taxable year;
2. The inclusion occurred because the taxpayer appeared to have an unrestricted right to the item;
3. In a later year, the taxpayer is entitled to a deduction;
4. The deduction is allowed because it was established after the close of the year of inclusion that the taxpayer did not have an unrestricted right to the item; and
5. The amount of the deduction exceeds $3,000.

One question that will need to be answered is whether the taxpayer had an unrestricted right to the IRA distributions or an absolute right in the year received, and whether a deduction for the clawback is allowed under other statutory provisions, such as Code Sec. 165.[75] Although it is not certain yet if a deduction under the claim of right doctrine would prevail, the prudent advisor should be aware of the possibility and review their client's facts accordingly.

Recovery of IRA Losses and Rollovers

In the event that a taxpayer is able to recover some of the IRA losses from SIPC or the bankruptcy estate, it is likely the taxpayer will be able to obtain a private letter ruling allowing the replacement of these monies into the IRA as a restorative payment. Restorative payments are payments made to restore losses to a plan resulting from actions by a fiduciary for which there is reasonable risk of liability for breach of a fiduciary duty under Title I of the Employee Retirement Income Security Act of 1974 (ERISA)[76] or under other applicable federal or state law, where plan participants who are similarly situated are treated similarly with respect to the payments.[77] Generally, payments to a defined contribution plan are restorative payments only if the payments are made in order to restore some or all of the plan's losses due to an action (or a failure to act) that creates a reasonable risk of liability for such a breach of fiduciary duty (other than a breach of fiduciary duty arising from failure to remit contributions to the plan).[78] In contrast, payments made to an IRA to make up for losses due to market fluctuations or poor investment returns are generally treated as contributions and not as restorative payments.

In IRS Letter Rulings 200738025 and 200705031, the IRS ruled that amounts received by the taxpayers from a company pursuant to an arm's length settlement of a good faith claim of liability constituted a restorative payment rather than additional contributions. Therefore, the payments were eligible to be placed into the IRAs and constituted valid transactions without regard to the limitations placed on IRA contributions.

In these rulings, the IRS noted that a determination of whether settlement proceeds should be treated as a replacement payment, rather than an ordinary contribution, must be based on all the relevant facts and circumstances surrounding the payment of the settlement proceeds. It cited Rev. Rul. 2002-45[79], which applies a facts and circumstances test to determine whether a payment to a qualified plan is a restorative payment to a plan as opposed to a plan contribution, and felt it appropriate to apply the same reasoning to IRAs.

Example 7: John suffered $500,000 of losses in his IRA due to Madoff investments. More than 60 days after the loss, John recovered $50,000 of his losses through SPIC and $100,000 through the bankruptcy estate. If he obtained a favorable

letter ruling, he could roll over the $150,000 to his IRA and not be subject to any income taxes or excess contribution penalty.

Any letter ruling request on this subject would ask that (1) the payments received be considered restorative payments and, thus, not subject to the IRA contribution limits and (2) that the taxpayer be granted an extension of the 60-day rollover period to place such amounts into the IRA. It is our hope that the IRS would issue guidance that would clearly allow taxpayers to place these restorative payments in the IRA without the need to seek a costly private letter ruling.

Phantom Income

If a taxpayer reported income that never really existed on a prior income tax return, a practitioner should consider amending the prior income tax returns to remove the phantom income (i.e., the overstated income) for open years. In the case of a traditional IRA, however, the taxpayer generally will have actually received the monies that triggered the reported income, thus making the phantom income argument more difficult. Prudence would suggest filing protective claims in the event this option is determined to be available in the event of a clawback.

Roth Conversions

If individuals converted their traditional IRA to a Roth IRA and the Roth has since declined in value (in this case, because of a Madoff investment), they can recharacterize the Roth back to a traditional IRA no later than October 15 of the year following the year of the conversion.[80] If the taxpayer recharacterizes the Roth IRA, he or she can obtain a refund of the taxes paid on the conversion. If the October 15 deadline has passed, taxpayers should consider applying for a private letter ruling to allow for a late recharacterization.

Reg. §301.9100-3 permits the IRS to grant an extension of time to make a regulatory election, when such extension does not meet the requirements of an automatic extension. The IRS, in Announcement 99-57,[81] ruled that a recharacterization constitutes a regulatory election.

Relief will be granted when the taxpayer provides the evidence to establish to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government.[82]

A taxpayer is deemed to have acted reasonably and in good faith if, the taxpayer:

1. Requests relief under this section before the failure to make the regulatory election is discovered by the IRS;
2. Failed to make the election because of intervening events beyond the taxpayer's control;
3. Failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election;
4. Reasonably relied on the written advice of the IRS; or
5. Reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.[83]

Under Reg. §301.9100-3(c)(1)(i), the interests of the government are deemed to be prejudiced if granting relief would result in a taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election than the taxpayer would have had if the election had been timely made (taking into account the time value of money). Similarly, if the tax consequences of more than one taxpayer are affected by the election, the government's interests are prejudiced if extending the time for making the election may result in the affected taxpayers, in the aggregate, having a lower tax liability than if the election had been timely made.

If a taxpayer had timely made the election to recharacterize the Roth IRA, the tax liability would not have been more than if the late recharacterization is allowed under this ruling request. The interests of the government are ordinarily prejudiced if the taxable year in which the regulatory election should have been made or any taxable years that would have been affected by the election had it been timely made are closed.[84]

A taxpayer, however, will not be deemed to have not acted reasonably or in good faith if the taxpayer uses hindsight in requesting relief. If specific facts that make the election advantageous to a taxpayer have changed since the due date for making the election, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.[85]

It is difficult to say whether the IRS would allow taxpayers to make late recharacterizations under a

Madoff scenario or whether it would consider the taxpayer to be acting in hindsight. If the dollars are large enough, attempting to obtain a ruling may be worthwhile in order to recapture the tax paid on the original Roth conversion. If a recharacterization is not available, a deduction for basis will be available, or even better, perhaps open years could be amended to revalue the original conversion to its true value. However, this will be a difficult case because the fraud was not discovered until 2008.

Theft Loss

A theft loss could potentially be available in relation to a Roth IRA since a Roth IRA has basis. Any loss arising from theft is allowable as a deduction under Code Sec. 165(a). There is currently no guidance from the IRS on whether this is a remedy available to a Roth IRA or traditional IRA with basis, but practitioners should consider filing protective claims to leave this possibility open.

Preparing Income Tax Returns

At the time of this writing, the IRS has not provided guidance with regard to the proper tax treatment of the theft loss, phantom income, and IRA issues. This creates a tremendously complex situation for CPAs and tax attorneys preparing and providing advice to Madoff investors. The most pressing issue is filing amended returns, or at least protective claims, with regard to the 2005 phantom income. For federal tax purposes, the statute of limitations on most 2005 returns will lapse on April 15, 2009. Naturally, once the statute of limitations has lapsed, those years will now be "closed" for tax purposes and taxpayers will be barred from making future claims. As discussed above (see page 6), many practitioners believe that an amended return should be filed to remove the phantom income from an individual's return. To accomplish this, one would file a Form 1040-X (Amended U.S. Individual Income Tax Return), removing the "income" from the return. Although it is impossible to say for certain because of *Greenberg and Taylor*, discussed above, it would appear that substantial authority exists for this position. Further, to the extent that the client would like to receive 2006 and 2007 refunds in a timely manner, amended returns could also be filed for those years, as well. Unlike the carryback of the theft loss, to be discussed below, the refunds, if any, associated with the 2005, 2006 and 2007 returns, will carry interest. However, unlike the 45-day rule for the theft loss, the IRS does not have a time frame, in which they have to answer the amended return.

If a person is not comfortable filing these amended returns but would prefer to wait for guidance from the IRS, a protective claim should be filed. The protective claim, when filed properly, tolls the statute of limitations until the IRS responds. If the IRS responds denying the claim, then the taxpayer would be able to file a suit in federal District Court or in the U.S. Court of Claims. Because there is not a tax due per se, but rather a refund is being requested, it appears that one could not file a petition in the U.S. Tax Court.

The Theft Loss Itself

Assuming that practitioners can get to the point where they believe a theft loss is warranted, they would prepare a 2008 return claiming the theft loss. To the extent that the theft loss exceeded 2008 income, they would then have a choice of carrying the theft loss back three years and/or forward for a period of 20 years. Further, some investors, in small business partnerships, may be able to carry the loss back for a period of five years.[86]

To take a simple example, if a taxpayer invested $5 million in late 2008, never reported any gains or losses, and is expecting a SIPC recovery of $500,000 and a bankruptcy recovery of $100,000, he or she would take a theft loss deduction of $4.4 million. The taxpayer would also file a protective claim for the remaining $600,000. The protective claim allows for the possibility that there is no further SIPC or bankruptcy recovery.

This loss could then be carried forward or carried back, based upon the taxpayer's personal tax strategy. In the event that the taxpayer reported substantial capital gains in earlier years, with very little ordinary income, it may not be prudent to carry the loss back. However, if the taxpayer reported substantial ordinary income from other investments in earlier years, carrying the loss back may be a good idea and would result in a timely refund. The tax preparer will need to carefully analyze the benefit of removing phantom income and carrybacks or carryforwards. Modeling various scenarios will be advisable until a somewhat optimal mathematical solution can be determined.

Perhaps the most important thing to remember will be to always file protective claims for alternative positions. For example, if a person following *Greenberg*[87] and *Taylor*[88] were to file a return removing phantom income, they would also file a protective claim adding the phantom income to their total theft loss.

Although taxpayers need to be careful not to double count by removing income and availing themselves of the theft loss deduction for the same income, they must also be cautious not to let a particular statute of limitations lapse.

Reportable Transactions

Code Sec. 6662A provides for a $10,000 penalty, per year, if the individual fails to report a transaction on the IRS reportable transaction list. Surprisingly, one of the items on the list is a theft loss. Although there is an exception for theft losses reported under Code Sec. 165(a)(3), there is no exception for theft losses reported under Code Sec. 165(a)(2). Accordingly, if a taxpayer is taking a theft loss under Code Sec. 165(a)(2) that exceeds $2 million in a particular year, or $4 million over a series of years, the taxpayer will be required to file Form 8886 (Reportable Transaction Disclosure Statement) with the IRS. It is also important to note that unless the authority for a reportable transaction exceeds more likely than not, it is necessary to file a Form 8275 (Disclosure Statement) to disclose the transaction.

Preparer Penalties

While being a strong advocate for his or her client, the practitioner must always be mindful of the ethical responsibilities to the profession and to the law. Each position that a practitioner takes, whether it is removing phantom income, calculating the theft loss, addressing the 10-percent rule, just to name a few, must be measured against the need to have substantial authority to sign a return without disclosure. Further, as discussed above, when a transaction is a reportable transaction, the standard changes from substantial authority to more likely than not.

These losses will be substantial, and it is very likely that they will be carefully reviewed by the IRS. In many cases, there will be very little harm in disclosing the transaction and disclosure will reduce the risk both to the taxpayer and to the preparer. By disclosing, the client may avoid the 20-percent accuracy penalty under Code Sec. 6662 and the tax professional may avoid preparer penalties. In the ideal world, the IRS would issue a notice, discussing its positions and would provide some "guardrails" for the IRS, the investors, and tax preparers.[89]

Tax Planning

On a going forward basis, it is very likely that many Madoff investors will have substantial carryforwards. This is especially true in the case of trusts created for the benefit of children and grandchildren. See the discussion above on tax planning for trusts (see page 9).

On individual returns, the first question will be whether the individual, during the course of the next 20 years will be able to utilize the carryforwards. The next question will be how additional income can be shifted to these taxpayers. A variety of ideas have surfaced including family members setting up a trust for the benefit of the Madoff investor, with the trustee distributing income on an annual basis. The trust income distributed would then be offset by a theft loss carryforward. It has also been suggested that defective trusts be used as a way to shift income to the taxpayer with the loss carryforward while preserving assets in trust for the benefit of future generations.[90]

Tax planning strategies for trusts with large theft loss carryforwards will develop over time. However, preparers who have created *inter vivos* trusts that reflect the intentions in their testamentary estate plan should consider modifying their wills and revocable trusts, to leave property to the existing trusts with large loss carryforwards. Later income from the property bequeathed to the trust, including items of income in respect to the decedent will be sheltered by virtue of the theft loss carryforward.

Endnotes

* The authors thank Mark Heroux, JD and Otis Damron, EA, MBA of Virchow Krause & Company, LLP for their contributions to this White Paper.

1 Rev. Proc. 2009-20, to be published in I.R.B. 2009-14, dated April 6, 2009, and Rev. Rul. 2009-9, to be published in I.R.B. 2009-14, dated April 6, 2009. This White Paper will be updated to incorporate the new IRS guidance. The text of the Rev. Proc. and Rev. Rul. are included in the Appendix, along with the prepared testimony of IRS Commissioner Douglas Shulman before the Senate Finance Committee on March 17, 2009.

2 A SIPC proceeding is initiated by the filing of an application by SIPC for a protective decree adjudicating the customers of a SIPC member in need of the protections provided under SIPA. An application is filed if SIPC determines that a member has failed or is in danger of failing to meet its customer obligations and finds that one or more conditions under the Act is satisfied. If the SIPC member fails to contest or consents to the application, or the court determines that one or more of the conditions enumerated in SIPA exists, the court must issue the protective decree. Upon the issuance of the protective decree, the court is required to appoint a trustee who will liquidate the business of the SIPC member and distribute Customer Property to Customers on a pro rata basis.

3 See *In re Adler, Coleman Clearing Corp. (Alder Coleman II)*, 216 B.R. 719, 722 (Bankr. S.D.N.Y. 1998).

4 See *New Times Secs. Servs., Inc.*, 463 F3d 125, 127 (2d Cir. 2006)

ENDNOTES

[5] *SIPC v. Bernard L. Madoff Investment Securities LLC,* US Bankruptcy Court, SD NY, No. 08-01789 (BRL), Feb 24, 2009).

[6] The Madoff SIPA liquidation presents unique challenges because of the theft of customer assets on an unprecedented scale and that the customer statements sent to investors bore little or no relation to reality. The records sent to customers were inaccurate when compared to the inventory of securities actually held by the brokerage firm. For that reason, it was not possible to transfer all or part of any customer's account to another solvent brokerage firm. Instead, pursuant to SIPA, the Trustee, Irving Picard, was authorized by the bankruptcy court to publish a notice to customers and creditors and to mail claim forms to them.

The Trustee has also requested information from each customer as to the sums given to the Madoff firm and sums withdrawn from the firm in order to assist in the analysis of what each customer is owed. There are some situations, particularly if the investors have not made withdrawals, where it will be relatively easy to determine exactly how much a claimant put into the scheme. In other situations, the extended time period of the deception, coupled with numerous deposits with, or withdrawals of, assets from the brokerage firm over time may make that reconstruction very difficult. SIPC and the Trustee are committed to using all available resources to resolve these issues quickly. See testimony of SIPC CEO Stephen Harbeck before the Senate Banking Committee, Jan. 27, 2009.

[7] Code Sec. 165(a).

[8] Reg. § 1.165-1(b).

[9] Rev. Rul. 71-381, 1971-2 CB 126.

[10] 1972-1 CB 60.

[11] Rev. Rul. 72-112, 1972-1 CB 60.

[12] *A.C. Bromberg, Exr., CA-5, 56-1 USTC ¶9448,* 232 F2d 107, 110.

[13] See, for example, *R. A. De Fusco,* 38 TCM 920, Dec. 36,129(M), TC Memo. 1979-230 ; *D. W. Crowell,* 51 TCM 1556, Dec. 43,208(M), TC Memo. 1986-314 (California law); and *H. Barry,* 37 TCM 925, Dec. 35,205(M), TC Memo. 1978-215 (New York law).

[14] *L. Paine,* 63 TC 736, 740, Dec. 33,113; *H. Barry,* 37 TCM 925, Dec. 35,205(M), TC Memo. 1978-215.

[15] *J. Bellis,* 61 TC 354, Dec. 32,257.

[16] Code Sec. 165(e) and Reg. § 1.165-8(a)(2).

[17] Reg. §§ 1.165-8(a)(2) and 1.165-1(d); *White Dental Mfg. Co.,* SCt, 1 USTC ¶235, 274 US 398.

[18] *J.U. Elliot,* 40 TC 304, Dec. 26,118(Acq.).

[19] Reg. § 1.165-1(d)(2)(i).

[20] *Ramsay Scarlett & Co., Inc.,* 61 TC 795, Dec. 32,507, aff'd , CA-4,75-2 USTC ¶ 9634, 521 F2d 786.

[21] Rev. Rul. 59-388, 1959-2 CB 76; *Ramsay Scarlett & Co., Inc.,* 61 TC 795, Dec. 32,507, aff'd , CA -4, 75-2 USTC ¶ 9634, 521 F2d 786; Rev. Rul. 59-388, 1959-2 CB 76.

[22] *L. Boehm,* SCt, 45-2 USTC ¶9448, 326 US 287.

[23] *L. Scofield Est.,* CA-6, 59-1 USTC ¶9363, 266 F2d 154, 159; *E.C. Dawn,* CA-9, 82-1 USTC ¶9373, 675 F2d 1077, 1078.

[24] *Parmelee Transportation Co.,* CtCls, 65-2 USTC ¶9683, 351 F2d 619, 628. The court noted that taxpayers may bring lawsuits even when the probability of recovery is quite low (e.g., 10 percent).

[25] *H. Jeppsen,* 70 TCM 199, Dec. 50,781(M), TC Memo. 1995-342.

[26] *L. Gale,* 41 TC 269, Dec. 26, 405.

[27] *L. Gale,* 41 TC 249, Dec. 26,405.

[28] *Rainbow Inn, Inc.,* CA-3, 70-2 USTC ¶9671, 2d 640. The U.S. Supreme Court has also suggested that the likelihood of recovery must be fairly significant, stating that the prospects for recovery need not be viewed through the eyes of the "incorrigible optimist" (*White Dental Mfg. Co.,* SCt, 1 USTC ¶235, 274 US 398, 403.

[29] *Ramsay Scarlett & Co., Inc.,* 61 TC 795, Dec. 32,507.

[30] See *Kaplan v. Commissioner,* 100 AFTR 2d 5674 (2007, MD Fla).

[31] Reg. § 1.165-8(c). Given that the property stolen in a Ponzi scheme is presumably the flat basis cash invested, basis and FMV should be the same.

[32] Reg. § 1.165-8(c).

[33] Code Sec. 165(h)(1).

[34] Code Secs. 165(c)(3) and 165(h)(2).

[35] If Tom had both personal casualty gains and personal casualty losses, the gains and losses for the year would be aggregated and any excess of losses over gains would be deductible subject to the $100 and 10-percent-of-AGI limitations.

[36] Code Secs. 165(c)(2), 165(c)(3) and 165(h)

[37] Rev. Rul. 71-381, 1971-2 CB 126.

[38] *Z. Premji,* 72 TCM 16, Dec. 51, 431(M), TC Memo. 1996-304.

[39] P.L. 98-369, §711(c)(2)(A)(i).

[40] 1971-2 CB 126

[41] Notice 2008-13, I.R.B. 2008-3, 282. Reasonable basis has generally been interpreted to mean a 20-percent chance of success and substantial authority a 40-percent chance of success.

[42] If the taxpayer takes a position contrary to a regulation, disclosure would be required regardless of the taxpayer's confidence level in the position taken.

[43] CCA 200811016, June 22, 2007.

[44] *Burnet v. Logan,* SCt, 2 USTC ¶736, 283 US 404.

[45] *M. Greenberg,* 71 TCM 3191, Dec. 51, 407(M), TC Memo. 1996-281; *D. Taylor,* DC Tenn., 98-1 USTC ¶ 50,354; *O. Kooyers,* 88 TCM 605, Dec. 55, 826(M), TC Memo. 2004-281.

[46] *D. Parrish,* 74 TCM 964, Dec. 52,311(M), TC Memo.1997-474, aff'd CA-8, 99-1 USTC ¶50,293, 168 F3d 1098; *Z. Premji,* 72 TCM 16, Dec. 51, 431(M), TC Memo. 1996-304, aff'd CA-10, in an unpublished order, 98-1 USTC ¶50,218, 139 F3d 912; *M. Wright,* 58 TCM 369, Dec. 46, 087(M), TC Memo. 1989-557, affd. CA-9, unpublished opinion 931 F2d 61; *B. Murphy,* 40 TCM 524, Dec. 37, 027(M), TC Memo. 1980-218, affd. per curiam, CA-4, 81-2 USTC ¶9556, 661 F2d 299; *R. Harris,* DC-VA, 77-1 USTC ¶9414, 431 FSupp 1173.

[47] CCA 200451030, September 30, 2004 and CCA 200811016, June 22, 2007.

[48] *M. Wright,* 58 TCM 369, Dec. 46, 087(M), TC Memo. 1989-557, affd. CA-9, unpublished opinion 931 F2d 61; *B. Murphy,* 40 TCM 524, Dec. 37, 027(M), TC Memo. 1980-218, affd. per curiam, CA-4, 81-2 USTC ¶9556, 661 F2d 299; *Z. Premji,* 72 TCM 16, Dec. 51, 431(M), TC Memo. 1996-304, aff'd CA-10, in an unpublished order, 98-1 USTC ¶50,218, 139 F3d 912.

[49] CCA 200305028, December 27, 2002. See also, *D. Parrish,* 74 TCM 964, Dec. 52,311(M), TC Memo.1997-474, aff'd CA-8, 99-1 USTC ¶50,293, 168 F3d 1098.

[50] *Deputy v. Du Pont,* SCt, 40-1 USTC ¶9161, 308 US 488, 498 (1940).

[51] *M. Greenberg,* 71 TCM 3191, Dec. 51, 407(M), TC Memo. 1996-281; *D. Taylor,* DC Tenn., 98-1 USTC ¶ 50,354; *O. Kooyers,* 88 TCM 605, Dec. 55, 826(M), TC Memo. 2004-281.

[52] This assumes that a refund is otherwise available.

[53] Code Sec. 1341 is basically a codification of the claim of right doctrine.

[54] Note that the American Recovery and Reinvestment Act of 2009 extended this period to five years for qualified small business (including pass through entities.

[55] P.L. 111-5.

[56] Rev. Proc. 2009-20, to be published in I.R.B. 2009-14, dated April 6, 2009, and Rev. Rul. 2009-9, to be published in I.R.B. 2009-14, dated April 6, 2009.

[57] Reg. § 1.165-8(b).

[58] Reg. § 20.2054-1.

[59] Code Secs. 165(h)(4)(D) and 2054 and Reg. §20.2054-1.

[60] Reg. §1.642(g)-1.

[61] *J.Darby Est.,* CA-10, 63-2 USTC¶12,186, 323 F2d 793.

[62] Reg.§20.2054-1.

[63] Code Sec. 165(c). and Reg. § 20.2054-1.

[64] Code Sec. 172(b)(1)(A). Note again the special five-year rule created by the American Recovery and Reinvestment Act of 2009 (P.L. 111-5).

[65] Code Sec. 172(b)(1)(F).

[66] P.L. 111-5, February 17, 2009.

[67] Reg. § 20.2032-1(g).

[68] Versions of this article were originally printed in Steve Leimberg's LISI Estate Plan-

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ning Newsletter # 1412 (February 4, 2009) and LISI Estate Planning Newsletter # 1420 (February 18, 2009) at http://www.leimberg-services.com; and in Trusts and Estates.

[69] Code Sec. 408(d)(2)(A).

[70] Notice 89-25, 1989-1 CB 662.

[71] IRS Pub. 590, Individual Retirement Arrangements (2008), p. 41.

[72] IRS Pub. 590, Individual Retirement Arrangements (2008), p. 42.

[73] IRS Pub. 590, Individual Retirement Arrangements (2008), p. 42.

[74] Code Sec. 56; IRS Pub. 590, Individual Retirement Arrangements (2008), p. 42.

[75] Natalie Choate, *Life and Death Planning for Retirement Benefits* §2.1.04 (6th ed).

[76] 88 Stat. 829, P.L. 93-406.

[77] Reg. § 1.415(c)-1(b)(2)(ii)(C) regarding limitations for defined contribution plans.

[78] Id.

[79] Rev. Rul. 2002-45, 2002-2 CB 116.

[80] Code Sec. 408A(d)(6), Reg. § 1.408A-5.

[81] Announcement 99-57, 1999-1 CB 1256.

[82] Reg. §301.9100-3(a).

[83] Reg. § 301.9100-3(b).

[84] Reg. § 301.9100-3(c)(1)(ii).

[85] Reg. § 301.9100-3(b)(3).

[86] American Recovery and Reinvestment Act of 2009 (P.L. 111-5).

[87] *M. Greenberg.*, 71 TCM 3191, Dec. 51, 407(M), TC Memo. 1996-281.

[88] *D. Taylor*, DC Tenn., 98-1 USTC ¶ 50,354

[89] The IRS has received a number of requests from such guidance from well known tax practitioners. One such letter was from former N.Y. Governor George Pataki.

[90] The trust would be treated as owned by the Madoff victim under Code Sec. 678(a).

Appendix

Rev. Rul. 2009-9 and Rev. Proc. 2009- 20, released by the IRS on March 17, 2009, contain IRS guidance on the tax treatment of losses resulting from investments in Ponzi schemes. Both are scheduled to be published in I.R.B. 2009-14, dated April 6, 2009.

Also reproduced is the prepared testimony of IRS Commissioner Douglas Shulman before the Senate Finance Committee on March 17, 2009.

Rev. Rul. 2009-9

Part I

Section 165.—Losses.

26 CFR: § 1.165-8: Theft losses.
(Also: §§ 63, 67, 68, 172, 1311, 1312, 1313, 1314, 1341)

Rev. Rul. 2009-9

ISSUES

(1) Is a loss from criminal fraud or embezzlement in a transaction entered into for profit a theft loss or a capital loss under § 165 of the Internal Revenue Code?

(2) Is such a loss subject to either the personal loss limits in § 165(h) or the limits on itemized deductions in §§ 67 and 68?

(3) In what year is such a loss deductible?

(4) How is the amount of such a loss determined?

(5) Can such a loss create or increase a net operating loss under § 172?

(6) Does such a loss qualify for the computation of tax provided by § 1341 for the restoration of an amount held under a claim of right?

(7) Does such a loss qualify for the application of §§ 1311-1314 to adjust tax liability in years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511?

FACTS

A is an individual who uses the cash receipts and disbursements method of accounting and files federal income tax returns on a calendar year basis. B holds himself out to the public as an investment advisor and securities broker.

In Year 1, A, in a transaction entered into for profit, opened an investment account with B, contributed $100x to the account, and provided B with power of attorney to use the $100x to purchase and sell securities on A's behalf. A instructed B to reinvest any income and gains earned on the investments. In Year 3, A contributed an additional $20x to the account.

B periodically issued account statements to A that reported the securities purchases and sales that B purportedly made in A's investment account and the balance of the account. B also issued tax reporting statements to A and to the Internal Revenue Service that reflected purported gains and losses on A's investment account. B also reported to A that no income was earned in Year 1 and that for each of the Years 2 through 7 the investments earned $10x of income (interest, dividends, and capital gains), which A included in gross income on A's federal income tax returns.

At all times prior to Year 8 and part way through Year 8, B was able to make distributions to investors who requested them. A took a single distribution of $30x from the account in Year 7.

In Year 8, it was discovered that B's purported investment advisory and brokerage activity was in fact a fraudulent investment arrangement known as a "Ponzi"

scheme. Under this scheme, B purported to invest cash or property on behalf of each investor, including A, in an account in the investor's name. For each investor's account, B reported investment activities and resulting income amounts that were partially or wholly fictitious. In some cases, in response to requests for withdrawal, B made payments of purported income or principal to investors. These payments were made, at least in part, from amounts that other investors had invested in the fraudulent arrangement.

When B's fraud was discovered in Year 8, B had only a small fraction of the funds that B reported on the account statements that B issued to A and other investors. A did not receive any reimbursement or other recovery for the loss in Year 8. The period of limitation on filing a claim for refund under § 6511 has not yet expired for Years 5 through 7, but has expired for Years 1 through 4.

B's actions constituted criminal fraud or embezzlement under the law of the jurisdiction in which the transactions occurred. At no time prior to the discovery did A know that B's activities were a fraudulent scheme. The fraudulent investment arrangement was not a tax shelter as defined in § 6662(d)(2)(C)(ii) with respect to A.

LAW AND ANALYSIS

Issue 1. Theft loss.

Section 165(a) allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise. For individuals, § 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit, and § 165(c)(3) allows a deduction for certain losses not connected to a transaction entered into for

profit, including theft losses. Under § 165(e), a theft loss is sustained in the taxable year the taxpayer discovers the loss. Section 165(f) permits a deduction for capital losses only to the extent allowed in §§ 1211 and 1212. In certain circumstances, a theft loss may be taken into account in determining gains or losses for a taxable year under § 1231.

For federal income tax purposes, "theft" is a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and any other form of guile. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); see also § 1.165-8(d) of the Income Tax Regulations ("theft" includes larceny and embezzlement). A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. Rev. Rul. 72-112, 1972-1 C.B. 60. However, a taxpayer need not show a conviction for theft. Vietzke v. Commissioner, 37 T.C. 504, 510 (1961), acq., 1962-2 C.B. 6.

The character of an investor’s loss related to fraudulent activity depends, in part, on the nature of the investment. For example, a loss that is sustained on the worthlessness or disposition of stock acquired on the open market for investment is a capital loss, even if the decline in the value of the stock is attributable to fraudulent activities of the corporation’s officers or directors, because the officers or directors did not have the specific intent to deprive the shareholder of money or property. See Rev. Rul. 77-17, 1977-1 C.B. 44.

In the present situation, unlike the situation in Rev. Rul. 77-17, B specifically intended to, and did, deprive A of money by criminal acts. B's actions constituted a theft from A, as theft is defined for § 165 purposes. Accordingly, A's loss is a theft loss, not a capital loss.

Issue 2. Deduction limitations.

Section 165(h) imposes two limitations on casualty loss deductions, including theft loss deductions, for property not connected either with a trade or business or with a transaction entered into for profit.

Section 165(h)(1) provides that a deduction for a loss described in § 165(c)(3) (including a theft) is allowable only to the extent that the amount exceeds $100 ($500 for taxable years beginning in 2009 only).

Section 165(h)(2) provides that if personal casualty losses for any taxable year (including theft losses) exceed personal casualty gains for the taxable year, the losses are allowed only to the extent of the sum of the gains, plus so much of the excess as exceeds ten percent of the individual's adjusted gross income.

Rev. Rul. 71-381, 1971-2 C.B. 126, concludes that a taxpayer who loans money to a corporation in exchange for a note, relying on financial reports that are later discovered to be fraudulent, is entitled to a theft loss deduction under § 165(c)(3). However, § 165(c)(3) subsequently was amended to clarify that the limitations applicable to personal casualty and theft losses under § 165(c)(3) apply only to those losses that are not connected with a trade or business or a transaction entered into for profit. Tax Reform Act of 1984, Pub. L. No. 98-369, § 711 (1984). As a result, Rev.

Rul. 71-381 is obsolete to the extent that it holds that theft losses incurred in a transaction entered into for profit are deductible under § 165(c)(3), rather than under § 165(c)(2).

In opening an investment account with B, A entered into a transaction for profit. A's theft loss therefore is deductible under § 165(c)(2) and is not subject to the § 165(h) limitations.

Section 63(d) provides that itemized deductions for an individual are the allowable deductions other than those allowed in arriving at adjusted gross income (under § 62) and the deduction for personal exemptions. A theft loss is not allowable under § 62 and is therefore an itemized deduction.

Section 67(a) provides that miscellaneous itemized deductions may be deducted only to the extent the aggregate amount exceeds two percent of adjusted gross income. Under § 67(b)(3), losses deductible under § 165(c)(2) or (3) are excepted from the definition of miscellaneous itemized deductions.

Section 68 provides an overall limit on itemized deductions based on a percentage of adjusted gross income or total itemized deductions. Under § 68(c)(3), losses deductible under § 165(c)(2) or (3) are excepted from this limit.

Accordingly, A's theft loss is an itemized deduction that is not subject to the limits on itemized deductions in §§ 67 and 68.

Issue 3. Year of deduction.

Section 165(e) provides that any loss arising from theft is treated as sustained during the taxable year in which the taxpayer discovers the loss. Under §§ 1.165-

8(a)(2) and 1.165-1(d), however, if, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is sustained until the taxable year in which it can be ascertained with reasonable certainty whether or not the reimbursement will be received, for example, by a settlement, adjudication, or abandonment of the claim. Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances.

A may deduct the theft loss in Year 8, the year the theft loss is discovered, provided that the loss is not covered by a claim for reimbursement or other recovery as to which A has a reasonable prospect of recovery. To the extent that A's deduction is reduced by such a claim, recoveries on the claim in a later taxable year are not includible in A's gross income. If A recovers a greater amount in a later year, or an amount that initially was not covered by a claim as to which there was a reasonable prospect of recovery, the recovery is includible in A's gross income in the later year under the tax benefit rule, to the extent the earlier deduction reduced A's income tax. See § 111; § 1.165-1(d)(2)(iii). Finally, if A recovers less than the amount that was covered by a claim as to which there was a reasonable prospect of recovery that reduced the deduction for theft in Year 8, an additional deduction is allowed in the year the amount of recovery is ascertained with reasonable certainty.

Issue 4. Amount of deduction.

Section 1.165-8(c) provides that the amount deductible in the case of a theft loss is determined consistently with the manner described in § 1.165-7 for determining the

amount of a casualty loss, considering the fair market value of the property immediately after the theft to be zero. Under these provisions, the amount of an investment theft loss is the basis of the property (or the amount of money) that was lost, less any reimbursement or other compensation.

The amount of a theft loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery. If an amount is reported to the investor as income in years prior to the year of discovery of the theft, the investor includes the amount in gross income, and the investor reinvests the amount in the arrangement, this amount increases the deductible theft loss.

Accordingly, the amount of A's theft loss for purposes of § 165 includes A's original Year 1 investment ($100x) and additional Year 3 investment ($20x). A's loss also includes the amounts that A reported as gross income on A's federal income tax returns for Years 2 through 7 ($60x). A's loss is reduced by the amount of money distributed to A in Year 7 ($30x). If A has a claim for reimbursement with respect to which there is a reasonable prospect of recovery, A may not deduct in Year 8 the portion of the loss that is covered by the claim.

Issue 5. Net operating loss.

Section 172(a) allows as a deduction for the taxable year the aggregate of the net operating loss carryovers and carrybacks to that year. In computing a net operating

loss under § 172(c) and (d)(4), nonbusiness deductions of noncorporate taxpayers are generally allowed only to the extent of nonbusiness income. For this purpose, however, any deduction for casualty or theft losses allowable under § 165(c)(2) or (3) is treated as a business deduction. Section 172(d)(4)(C).

Under § 172(b)(1)(A), a net operating loss generally may be carried back 2 years and forward 20 years. However, under § 172(b)(1)(F), the portion of an individual's net operating loss arising from casualty or theft may be carried back 3 years and forward 20 years.

Section 1211 of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (February 17, 2009), amends § 172(b)(1)(H) of the Internal Revenue Code to allow any taxpayer that is an eligible small business to elect either a 3, 4, or 5-year net operating loss carryback for an “applicable 2008 net operating loss.”

Section 172(b)(1)(H)(iv) provides that the term “eligible small business” has the same meaning given that term by § 172(b)(1)(F)(iii), except that § 448(c) is applied by substituting “$15 million” for “$5 million” in each place it appears. Section 172(b)(1)(F)(iii) provides that a small business is a corporation or partnership that meets the gross receipts test of § 448(c) for the taxable year in which the loss arose (or in the case of a sole proprietorship, that would meet such test if the proprietorship were a corporation).

Because § 172(d)(4)(C) treats any deduction for casualty or theft losses allowable under § 165(c)(2) or (3) as a business deduction, a casualty or theft loss an individual sustains after December 31, 2007, is considered a loss from a “sole

proprietorship" within the meaning of § 172(b)(1)(F)(iii). Accordingly, an individual may elect either a 3, 4, or 5-year net operating loss carryback for an applicable 2008 net operating loss, provided the gross receipts test provided in § 172(b)(1)(H)(iv) is satisfied. See Rev. Proc. 2009-19, 2009-14 I.R.B. (April 6, 2009).

To the extent A's theft loss deduction creates or increases a net operating loss in the year the loss is deducted, A may carry back up to 3 years and forward up to 20 years the portion of the net operating loss attributable to the theft loss. If A's loss is an applicable 2008 net operating loss and the gross receipts test in § 172(b)(1)(H)(iv) is met, A may elect either a 3, 4, or 5-year net operating loss carryback for the applicable 2008 net operating loss.

Issue 6. Restoration of amount held under claim of right.

Section 1341 provides an alternative tax computation formula intended to mitigate against unfavorable tax consequences that may arise as a result of including an item in gross income in a taxable year and taking a deduction for the item in a subsequent year when it is established that the taxpayer did not have a right to the item. Section 1341 requires that: (1) an item was included in gross income for a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to the item, (2) a deduction is allowable for the taxable year because it was established after the close of the prior taxable year or years that the taxpayer did not have a right to the item or to a portion of the item, and (3) the amount of the deduction exceeds $3,000. Section 1341(a)(1) and (3).

If § 1341 applies, the tax for the taxable year is the lesser of: (1) the tax for the taxable year computed with the current deduction, or (2) the tax for the taxable year computed without the deduction, less the decrease in tax for the prior taxable year or years that would have occurred if the item or portion of the item had been excluded from gross income in the prior taxable year or years. Section 1341(a)(4) and (5).

To satisfy the requirements of § 1341(a)(2), a deduction must arise because the taxpayer is under an obligation to restore the income. Section 1.1341-1(a)(1)-(2); Alcoa, Inc. v. United States, 509 F.3d 173, 179 (3d Cir. 2007); Kappel v. United States, 437 F.2d 1222, 1226 (3d Cir.), cert. denied, 404 U.S. 830 (1971).

When A incurs a loss from criminal fraud or embezzlement by B in a transaction entered into for profit, any theft loss deduction to which A may be entitled does not arise from an obligation on A's part to restore income. Therefore, A is not entitled to the tax benefits of § 1341 with regard to A's theft loss deduction.

Issue 7. Mitigation provisions.

The mitigation provisions of §§ 1311-1314 permit the Service or a taxpayer in certain circumstances to correct an error made in a closed year by adjusting the tax liability in years that are otherwise barred by the statute of limitations. O'Brien v. United States, 766 F.2d 1038, 1041 (7th Cir. 1995). The party invoking these mitigation provisions has the burden of proof to show that the specific requirements are satisfied. Id. at 1042.

Section 1311(a) provides that if a determination (as defined in § 1313) is described in one or more of the paragraphs of § 1312 and, on the date of the

determination, correction of the effect of the error referred to in § 1312 is prevented by the operation of any law or rule of law (other than §§ 1311-1314 or § 7122), then the effect of the error is corrected by an adjustment made in the amount and in the manner specified in § 1314.

Section 1311(b)(1) provides in relevant part that an adjustment may be made under §§ 1311-1314 only if, in cases when the amount of the adjustment would be credited or refunded under § 1314, the determination adopts a position maintained by the Secretary that is inconsistent with the erroneous prior tax treatment referred to in § 1312.

A cannot use the mitigation provisions of §§ 1311-1314 to adjust tax liability in Years 2 through 4 because there is no inconsistency in the Service's position with respect to A's prior inclusion of income in Years 2 through 4. See § 1311(b)(1). The Service's position that A is entitled to an investment theft loss under § 165 in Year 8 (as computed in Issue 4, above), when the fraud loss is discovered, is consistent with the Service's position that A properly included in income the amounts credited to A's account in Years 2 through 4. See § 1311(b)(1)(A).

HOLDINGS

(1) A loss from criminal fraud or embezzlement in a transaction entered into for profit is a theft loss, not a capital loss, under § 165.

(2) A theft loss in a transaction entered into for profit is deductible under § 165(c)(2), not § 165(c)(3), as an itemized deduction that is not subject to the personal loss limits in § 165(h), or the limits on itemized deductions in §§ 67 and 68.

(3) A theft loss in a transaction entered into for profit is deductible in the year the loss is discovered, provided that the loss is not covered by a claim for reimbursement or recovery with respect to which there is a reasonable prospect of recovery.

(4) The amount of a theft loss in a transaction entered into for profit is generally the amount invested in the arrangement, less amounts withdrawn, if any, reduced by reimbursements or recoveries, and reduced by claims as to which there is a reasonable prospect of recovery. Where an amount is reported to the investor as income prior to discovery of the arrangement and the investor includes that amount in gross income and reinvests this amount in the arrangement, the amount of the theft loss is increased by the purportedly reinvested amount.

(5) A theft loss in a transaction entered into for profit may create or increase a net operating loss under § 172 that can be carried back up to 3 years and forward up to 20 years. An eligible small business may elect either a 3, 4, or 5-year net operating loss carryback for an applicable 2008 net operating loss.

(6) A theft loss in a transaction entered into for profit does not qualify for the computation of tax provided by § 1341.

(7) A theft loss in a transaction entered into for profit does not qualify for the application of §§ 1311-1314 to adjust tax liability in years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511.

DISCLOSURE OBLIGATION UNDER § 1.6011-4

A theft loss in a transaction entered into for profit that is deductible under § 165(c)(2) is not taken into account in determining whether a transaction is a loss transaction under § 1.6011-4(b)(5). See § 4.03(1) of Rev. Proc. 2004-66, 2004-2 C.B. 966.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 71-381 is obsoleted to the extent that it holds that a theft loss incurred in a transaction entered into for profit is deductible under § 165(c)(3) rather than § 165(c)(2).

DRAFTING INFORMATION

The principal author of this revenue ruling is Andrew M. Irving of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Irving at (202) 622-5020 (not a toll-free call.)

Rev. Proc. 2009-20

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105 Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

(Also Part I, §§ 165; 1.165-8(c))

Rev. Proc. 2009-20

SECTION 1. PURPOSE

This revenue procedure provides an optional safe harbor treatment for taxpayers that experienced losses in certain investment arrangements discovered to be criminally fraudulent. This revenue procedure also describes how the Internal Revenue Service will treat a return that claims a deduction for such a loss and does not use the safe harbor treatment described in this revenue procedure.

SECTION 2. BACKGROUND

.01 The Service and Treasury Department are aware of investment arrangements that have been discovered to be fraudulent, resulting in significant losses to taxpayers. These arrangements often take the form of so-called "Ponzi" schemes, in which the party perpetrating the fraud receives cash or property from investors, purports to earn income for the investors, and reports to

the investors income amounts that are wholly or partially fictitious. Payments, if any, of purported income or principal to investors are made from cash or property that other investors invested in the fraudulent arrangement. The party perpetrating the fraud criminally appropriates some or all of the investors' cash or property.

.02 Rev. Rul. 2009-9, 2009 I.R.B (April 6, 2009), describes the proper income tax treatment for losses resulting from these Ponzi schemes.

.03 The Service and Treasury Department recognize that whether and when investors meet the requirements for claiming a theft loss for an investment in a Ponzi scheme are highly factual determinations that often cannot be made by taxpayers with certainty in the year the loss is discovered.

.04 In view of the number of investment arrangements recently discovered to be fraudulent and the extent of the potential losses, this revenue procedure provides an optional safe harbor under which qualified investors (as defined in § 4.03 of this revenue procedure) may treat a loss as a theft loss deduction when certain conditions are met. This treatment provides qualified investors with a uniform manner for determining their theft losses. In addition, this treatment avoids potentially difficult problems of proof in determining how much income reported in prior years was fictitious or a return of capital, and alleviates compliance and administrative burdens on both taxpayers and the Service.

SECTION 3. SCOPE

The safe harbor procedures of this revenue procedure apply to taxpayers that are qualified investors within the meaning of section 4.03 of this revenue procedure.

SECTION 4. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure.

.01 Specified fraudulent arrangement. A specified fraudulent arrangement is an arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors' cash or property. For example, the fraudulent investment arrangement described in Rev. Rul. 2009-9 is a specified fraudulent arrangement.

.02 Qualified loss. A qualified loss is a loss resulting from a specified fraudulent arrangement in which, as a result of the conduct that caused the loss—

(1) The lead figure (or one of the lead figures, if more than one) was charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement or a similar crime that, if proven, would meet the definition of theft for purposes of § 165 of

the Internal Revenue Code and § 1.165-8(d) of the Income Tax Regulations, under the law of the jurisdiction in which the theft occurred; or

(2) The lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in section 4.02(1) of this revenue procedure, and either –

(a) The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or

(b) A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

.03 Qualified investor. A qualified investor means a United States person, as defined in § 7701(a)(30) --

(1) That generally qualifies to deduct theft losses under § 165 and § 1.165-8;

(2) That did not have actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public;

(3) With respect to which the specified fraudulent arrangement is not a tax shelter, as defined in § 6662(d)(2)(C)(ii); and

(4) That transferred cash or property to a specified fraudulent arrangement. A qualified investor does not include a person that invested solely in a fund or other entity (separate from the investor for federal income tax purposes) that invested in the specified fraudulent arrangement. However, the fund or entity itself may be a qualified investor within the scope of this revenue procedure.

.04 Discovery year. A qualified investor's discovery year is the taxable year of the investor in which the indictment, information, or complaint described in section 4.02 of this revenue procedure is filed.

.05 Responsible group. Responsible group means, for any specified fraudulent arrangement, one or more of the following:

(1) The individual or individuals (including the lead figure) who conducted the specified fraudulent arrangement;

(2) Any investment vehicle or other entity that conducted the specified fraudulent arrangement, and employees, officers, or directors of that entity or entities;

(3) A liquidation, receivership, bankruptcy or similar estate established with respect to individuals or entities who conducted the specified fraudulent arrangement, in order to recover assets for the benefit of investors and creditors; or

(4) Parties that are subject to claims brought by a trustee, receiver, or other fiduciary on behalf of the liquidation, receivership, bankruptcy or similar estate described in section 4.05(3) of this revenue procedure.

.06 Qualified investment.

(1) Qualified investment means the excess, if any, of --

(a) The sum of --

(i) The total amount of cash, or the basis of property, that the qualified investor invested in the arrangement in all years; plus

(ii) The total amount of net income with respect to the specified fraudulent arrangement that, consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for all taxable years prior to the discovery year, including taxable years for which a refund is barred by the statute of limitations; over

(b) The total amount of cash or property that the qualified investor withdrew in all years from the specified fraudulent arrangement (whether designated as income or principal).

(2) Qualified investment does not include any of the following—

(a) Amounts borrowed from the responsible group and invested in the specified fraudulent arrangement, to the extent the borrowed amounts were not repaid at the time the theft was discovered;

(b) Amounts such as fees that were paid to the responsible group and deducted for federal income tax purposes;

(c) Amounts reported to the qualified investor as taxable income that were not included in gross income on the investor's federal income tax returns; or

(d) Cash or property that the qualified investor invested in a fund or other entity (separate from the qualified investor for federal income tax purposes) that invested in a specified fraudulent arrangement.

.07 Actual recovery. Actual recovery means any amount a qualified investor actually receives in the discovery year from any source as reimbursement or recovery for the qualified loss.

.08 Potential insurance/SIPC recovery. Potential insurance/SIPC recovery means the sum of the amounts of all actual or potential claims for reimbursement for a qualified loss that, as of the last day of the discovery year, are attributable to--

(1) Insurance policies in the name of the qualified investor;

(2) Contractual arrangements other than insurance that guaranteed or otherwise protected against loss of the qualified investment; or

(3) Amounts payable from the Securities Investor Protection Corporation (SIPC), as advances for customer claims under 15 U.S.C. § 78fff-3(a) (the Securities Investor Protection Act of 1970*),* or by a similar entity under a similar provision.

.09 Potential direct recovery. Potential direct recovery means the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year, against the responsible group.

.10 Potential third-party recovery. Potential third-party recovery means the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year, that are not described in section 4.08 or 4.09 of this revenue procedure.

SECTION 5. APPLICATION

.01 In general. If a qualified investor follows the procedures described in section 6 of this revenue procedure, the Service will not challenge the following treatment by the qualified investor of a qualified loss—

(1) The loss is deducted as a theft loss;

(2) The taxable year in which the theft was discovered within the meaning of § 165(e) is the discovery year described in section 4.04 of this revenue procedure; and

(3) The amount of the deduction is the amount specified in section 5.02 of this revenue procedure.

.02 Amount to be deducted. The amount specified in this section 5.02 is calculated as follows—

(1) Multiply the amount of the qualified investment by—

(a) 95 percent, for a qualified investor that does not pursue any potential third-party recovery; or

(b) 75 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery; and

(2) Subtract from this product the sum of any actual recovery and any potential insurance/SIPC recovery.

The amount of the deduction calculated under this section 5.02 is not further reduced by potential direct recovery or potential third-party recovery.

.03 Future recoveries. The qualified investor may have income or an additional deduction in a year subsequent to the discovery year depending on the actual amount of the loss that is eventually recovered. See § 1.165-1(d); Rev. Rul. 2009-9.

SECTION 6. PROCEDURE

.01 A qualified investor that uses the safe harbor treatment described in section 5 of this revenue procedure must –

(1) Mark "Revenue Procedure 2009-20" at the top of the Form 4684, Casualties and Thefts, for the federal income tax return for the discovery year. The taxpayer must enter the “deductible theft loss” amount from line 10 in Part II of Appendix A of this revenue procedure on line 34, section B, Part I, of the Form 4684 and should not complete the remainder of section B, Part I, of the Form 4684;

(2) Complete and sign the statement provided in Appendix A of this revenue procedure; and

(3) Attach the executed statement provided in Appendix A of this revenue procedure to the qualified investor’s timely filed (including extensions) federal income tax return for the discovery year. Notwithstanding the preceding sentence, if, before April 17, 2009, the taxpayer has filed a return for the discovery year or an amended return for a prior year that is inconsistent with the safe harbor treatment provided by this revenue procedure, the taxpayer must indicate this fact on the executed statement and must attach the statement to the return (or amended return) for the discovery year that is consistent with the safe harbor treatment provided by this revenue procedure and that is filed on or before May 15, 2009.

.02 By executing the statement provided in Appendix A of this revenue procedure, the taxpayer agrees—

(1) Not to deduct in the discovery year any amount of the theft loss in excess of the deduction permitted by section 5 of this revenue procedure;

(2) Not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year;

(3) Not to apply the alternative computation in § 1341 with respect to the theft loss deduction allowed by this revenue procedure; and

(4) Not to apply the doctrine of equitable recoupment or the mitigation provisions in §§ 1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511.

SECTION 7. EFFECTIVE DATE

This revenue procedure applies to losses for which the discovery year is a taxable year beginning after December 31, 2007.

SECTION 8. TAXPAYERS THAT DO NOT USE THE SAFE HARBOR TREATMENT PROVIDED BY THIS REVENUE PROCEDURE

.01 A taxpayer that chooses not to apply the safe harbor treatment provided by this revenue procedure to a claimed theft loss is subject to all of the generally applicable provisions governing the deductibility of losses under § 165. For example, a taxpayer seeking a theft loss deduction must establish that the loss was from theft and that the theft was discovered in the year the taxpayer claims the deduction. The taxpayer must also establish, through sufficient documentation, the amount of the claimed loss and must establish 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 taxable year in which the taxpayer claims the loss.

.02 A taxpayer that chooses not to apply the safe harbor treatment of this revenue procedure to a claimed theft loss and that files or amends federal income tax returns for years prior to the discovery year to exclude amounts reported as income to the taxpayer from the investment arrangement must establish that the amounts sought to be excluded in fact were not income that was actually or constructively received by the taxpayer (or accrued by the taxpayer, in the case of a taxpayer using an accrual method of accounting). However, provided a taxpayer can establish the amount of net income from the investment arrangement that was reported and included in the taxpayer's gross income consistent with information received from the specified fraudulent arrangement in taxable years for which the period of limitation on filing a claim for refund under § 6511 has expired, the Service will not challenge the taxpayer’s inclusion of that amount in basis for determining the amount of any allowable theft loss, whether or not the income was genuine.

.03 Returns claiming theft loss deductions from fraudulent investment arrangements are subject to examination by the Service.

SECTION 9. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-0074. Please refer to the Paperwork Reduction Act statement

accompanying Form 1040, U.S. Individual Income Tax Return, for further information.

DRAFTING INFORMATION

The principal author of this revenue procedure is Norma Rotunno of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Rotunno at (202) 622-7900.

APPENDIX A

Statement by Taxpayer Using the Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement

Part 1. Identification

1. Name of Taxpayer _____

2. Taxpayer Identification Number _____

Part II. Computation of deduction

(See Rev. Proc. 2009-20 for the definitions of the terms used in this worksheet.)

Line	Computation of Deductible Theft Loss Pursuant to Rev. Proc. 2009-20		
1	Initial investment		
2	Plus: Subsequent investments		
3	Plus: Income reported in prior years		
4	Less: Withdrawals	( )	
5	Total qualified investment (combine lines 1 through 4)		
6	Percentage of qualified investment (95% of line 5 for investors with no potential third-party recovery; 75% of line 5 for investors with potential third-party recovery)		
7	Actual recovery		
8	Potential insurance/SIPC recovery		
9	Total recoveries (add lines 7 and 8)		( )
10	Deductible theft loss (line 6 minus line 9)		

Part III. Required statements and declarations

1. I am claiming a theft loss deduction pursuant to Rev. Proc. 2009-20 from a specified fraudulent arrangement conducted by the following individual or entity (provide the name, address, and taxpayer identification number (if known)).
_____

2 I have written documentation to support the amounts reported in Part II of this document.

3. I am a qualified investor as defined in § 4.03 of Rev. Proc. 2009-20.

4. If I have determined the amount of my theft loss deduction under § 5.02(1)(a) of Rev. Proc. 2009-20, I declare that I have not pursued and do not intend to

pursue any potential third-party recovery, as that term is defined in § 4.10 of Rev. Proc. 2009-20.

5. If I have already filed a return or amended return that does not satisfy the conditions in § 6.02 of Rev. Proc 2009-20, I agree to all adjustments or actions that are necessary to comply with those conditions. The tax year or years for which I filed the return(s) or amended return(s) and the date(s) on which they were filed are as follows:

_____
_____
_____
_____

Part IV. Signature

I make the following agreements and declarations:

1. I agree to comply with the conditions and agreements set forth in Rev. Proc. 2009-20 and this document.

2. Under penalties of perjury, I declare that the information provided in Parts I-III of this document is, to the best of my knowledge and belief, true, correct and complete.

Your signature here _____ Date signed: _____
Your spouse's signature here _____ Date signed: _____

Corporate Name _____
Corporate Officer's signature _____
Title _____
Date signed _____

Entity Name _____
S-corporation, Partnership, Limited Liability Company, Trust
Entity Officer's signature _____
Date signed _____

Signature of executor _____
Date signed _____

Testimony of IRS Commissioner Douglas Shulman

PREPARED TESTIMONY OF
DOUG SHULMAN
COMMISSIONER
INTERNAL REVENUE SERVICE
BEFORE THE
SENATE FINANCE COMMITTEE
TAX ISSUES RELATED TO PONZI SCHEMES AND AN UPDATE ON OFFSHORE TAX EVASION LEGISLATION
MARCH 17, 2009

INTRODUCTION

Mr. Chairman, Ranking Member Grassley and Members of the Committee, I want to thank you for the opportunity to testify today on tax issues related to Ponzi schemes and the Internal Revenue Service's ongoing efforts to detect and stop unlawful offshore tax avoidance.

It is unfortunate in these otherwise difficult economic times that we are here today to discuss a situation where thousands of taxpayers have been victimized by dozens of fraudulent investment schemes.

These too-good-to-be true investment ruses have often taken the form of so-called "Ponzi schemes." The perpetrator of the fraud promises returns, and sometimes even provides official-looking statements showing interest, dividends, or capital gains, some or all of which is fictitious.

According to news reports, the recent Madoff scandal has affected a very large and diverse pool of investors, some of whom are reported to have lost most of their life savings. Beyond the toll in human suffering – as entire life savings and retirements appear to have been wiped out – the Madoff case raises numerous tax and pension implications for the victims.

To help provide clarity in this very complicated and tangled matter and to assist taxpayers, the IRS is today issuing guidance articulating the tax rules that apply and providing "safe harbor" procedures for taxpayers who sustained losses in certain investment arrangements discovered to be criminally fraudulent. I will discuss each one separately. The IRS will provide a copy of the guidance for the hearing record.

Mr. Chairman, turning to the second subject of today's hearing, international issues are a major strategic focus of the IRS. It is of paramount importance to our system of voluntary compliance with the tax law that citizens of this country have confidence that the system is fair. We cannot allow an environment to develop where wealthy individuals can go offshore and avoid paying taxes with impunity. As you will hear from my testimony today, the IRS is aggressively pursuing these individuals and institutions that facilitate unlawful tax avoidance.

These issues are so important to the IRS that I have both increased the number of audits in this area over the last five months and prioritized stepped-up hiring of international experts and investigators. This occurred during a time when staffing levels were effectively frozen because of the Continuing Resolution.

While it is true that IRS agents and investigators will ultimately generate net enforcement revenues for the government, we view our international compliance strategy to date as much more focused on protecting approximately $2 trillion in revenue that the IRS collects than the incremental enforcement revenue that we collect from these specific activities. We cannot allow corrosive behavior to undermine the fundamental fairness of our tax system. Going forward, the administration will be outlining further initiatives to step up international tax enforcement and improve our revenue collection.

Moreover, seen through the prism of the current economic crisis, it is scandalous that wealthy individuals are hiding assets overseas and unlawfully avoiding US tax. It is an affront to the honest taxpayers of America, many of whom are struggling to pay their bills, who play by the rules and expect others to do the same.

PONZI SCHEME PUBLISHED GUIDANCE

Summary

The IRS is issuing two guidance items to assist taxpayers who are victims of losses from Ponzi-type investment schemes. While I recognize that the Committee is today focused on one specific case, the IRS guidance is not specific to this case. The first item is a revenue ruling that clarifies the income tax law governing the treatment of losses in such schemes. The second is a revenue procedure that provides a safe-harbor method of computing and reporting the losses.

The revenue ruling is important because determining the amount and timing of losses from these schemes is factually difficult and dependent on the prospect of recovering the lost money (which may not become known for several years). In addition, it clarifies the reach of older guidance on these losses that is somewhat obsolete.

The revenue procedure simplifies compliance for taxpayers (and administration for the IRS) by providing a safe-harbor means of determining the year in which the loss is deemed to occur and a simplified means of computing the amount of the loss.

Revenue Ruling

The revenue sets forth the formal legal position of the IRS and Treasury Department:

- **The investor is entitled to a theft loss, which is not a capital loss.** In other words, a theft loss from a Ponzi-type investment scheme is not subject to the normal limits on losses from investments, which typically limit the loss deduction to $3,000 per year when it exceeds capital gains from investments.

- **The revenue ruling clarifies that "investment" theft losses are not subject to limitations that are applicable to "personal" casualty and theft losses.** The loss is deductible as an itemized deduction, but is not subject to the 10 percent of AGI reduction or the $100 reduction that applies to many casualty and theft loss deductions.

- **The theft loss is deductible in the year the fraud is discovered, except to the extent there is a claim with a reasonable prospect of recovery.** Determining the year of discovery and applying the "reasonable prospect of recovery" test to any particular theft is highly fact-intensive and can be the source of controversy. The revenue procedure accompanying this revenue ruling provides a safe-harbor approach that the IRS will accept for reporting Ponzi-type theft losses.

- **The amount of the theft loss includes the investor's unrecovered investment – *including income as reported in past years.*** The ruling concludes that the investor generally can claim a theft loss deduction not only for the net amount invested, but also for the so-called "fictitious income" that the promoter of the scheme credited to the investor's account and on which the investor reported as income on his or her tax returns for years prior to discovery of the theft.

  Some taxpayers have argued that they should be permitted to amend tax returns for years prior to the discovery of the theft to exclude the phantom income and receive a refund of tax in those years. The revenue ruling does not address this argument, and the safe-harbor revenue procedure is conditioned on taxpayers not amending prior year returns.

- **A theft loss deduction that creates a net operating loss for the taxpayer can be carried back and forward according to the timeframes prescribed by law to generate a refund of taxes paid in other taxable years.**

Revenue Procedure

In light of the number of investment arrangements recently discovered to be fraudulent and the number of taxpayers affected, the revenue procedure is intended to: (1) provide a uniform approach for determining the proper time and amount of the theft loss; (2) avoid difficult problems of proof in determining how much income reported from the scheme was fictitious, and how much was real; and (3) alleviate compliance burdens on taxpayers and administrative burdens on the IRS that would otherwise result.

The revenue procedure provides two simplifying assumptions that taxpayers may use to report their losses:

- **Deemed theft loss.** Although the law does not require a criminal conviction of the promoter to establish a theft loss, it often is difficult to determine how extensive the evidence of theft must be to justify a claimed theft loss.

  The revenue procedure provides that the IRS will deem the loss to be the result of theft if: (1) the promoter was charged under state or federal law with the commission of fraud, embezzlement or a similar crime that would meet the definition of theft; or (2) the promoter was the subject of a state or federal criminal complaint alleging the commission of such a crime, and (3) either there was some evidence of an admission of guilt by the promoter or a trustee was appointed to freeze the assets of the scheme.

- **Safe harbor prospect of recovery.** Once theft is discovered, it often is difficult to establish the investor's prospect of recovery. Prospect of recovery is important because it limits the amount of the investor's theft loss deduction. Prospect of recovery is difficult to determine, particularly where litigation against the promoter and other potentially liable third parties extends into future taxable years.

  The revenue procedure generally permits taxpayers to deduct in the year of discovery 95 percent of their net investment less 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 that provided by the Securities Investor Protection Corporation (SIPC). A special rule applies to investors who are suing persons other than the promoter. These investors compute their deduction by substituting "75 percent" for "95 percent" in the formula above.

IRS Enforcement: Tightening the Net

Mr. Chairman, I am also pleased to be here today to describe the unprecedented focus that the Internal Revenue Service has placed on detecting and bringing to justice those who unlawfully hide assets overseas to avoid paying tax.

In today's economic environment, it is more important than ever that citizens feel confident that individuals and corporations are playing by the rules and paying the taxes that they owe.

When the American public is confronted with stories of financial institutions helping US citizens to maintain secret overseas accounts involving sham trusts to improperly avoid US tax, they should be outraged, as I am. But they should also know that the US government is taking new measures, and there is much more in the works.

In the wake of some recent well-publicized cases, the media has been full of speculation from those who are advising US taxpayers who have undeclared offshore accounts and income.

My advice to those taxpayers is very simple. The IRS has been steadily increasing the pressure on offshore financial institutions that facilitate concealment of taxable income by US citizens. That pressure will only increase under my watch. Those who are unlawfully hiding assets should come and get right with their government through our voluntary disclosure process

An Integrated Approach

Mr. Chairman, there is no "silver bullet" or one strategy that will alone solve the problems of offshore tax avoidance. Rather, an integrated approach is needed, made up of separate but complementary programs that will tighten the net around these tax cheats.

I am pleased to discuss several proposals that we are currently considering to improve our existing administrative programs.

First, I can also tell you that offshore issues are high priority to the President and his Administration. The President's budget committed to identifying $210 billion in savings over the next decade from international enforcement, reforming deferral and other tax reform policies. It also includes funding for a robust portfolio of IRS international tax compliance initiatives. The Administration will have more detailed and specific announcements in this area in the near future.

Second, the IRS is already devoting significant resources to international issues. As previously noted, I have both increased the number of audits in this area over the last five months and prioritized stepped-up hiring of international experts and investigators.

Third, the IRS is exploring how to improve information reporting and sharing. In this regard, the IRS is looking closely at how to continue to improve our Qualified Intermediary – or Q.I. – program. QI gives the IRS an important line of sight into the activities of US taxpayers at foreign banks and financial institutions that we previously did not have.

As with any large and complex program, we must strive to continuously improve the QI system, and address weaknesses as they become apparent. Accordingly, the IRS and Treasury Department are considering enhancements to strengthen the QI program, including:

- Expanding information reporting requirements to include more sources of income for US persons with accounts at QI banks
- Strengthening documentation rules to ensure that the program is delivering on its original intent
- Requiring withholding for accounts with documentation that is considered insufficient

Additionally, the IRS has already proposed changes that would shore up the independent review of the QI program in substantial ways. This proposal is currently out for comment, and the IRS looks forward to reviewing these comments.

As you can see, the IRS and Treasury are considering a wide range of measures to ensure that the QI program is working as intended. However, there will always be instances where the IRS discovers a potential violation of the tax law after the fact. In these cases, there are administrative and legislative changes that may be helpful to the IRS as we investigate potential wrongdoing.

Draft Legislation

Mr. Chairman, we understand that you are considering legislation designed to improve tax compliance with respect to offshore transactions.

My staff and I look forward to working with you and other members of this committee on such legislation.

Conclusion

Mr. Chairman, I want to thank you for this opportunity to provide an update on IRS' efforts to clarify issues relating to issues involving Ponzi schemes and also our activities to combat illegal tax avoidance schemes relating to offshore accounts and transactions. I would be happy to respond to your questions.