

Investors in Bernard Madoff's Ponzi Scheme Will Get Tax Relief

For the investors who appear to have been swindled in the Bernard L. Madoff Ponzi scheme, there may be some tax relief.

Generally, investors who suffered losses in the Bernard Madoff investment fraud are allowed to claim a theft loss in the year they discovered the loss. Keep in mind that if there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received can be deducted until the year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received. A deduction for a theft loss on property held for income (investment) is not reduced by 10% of the taxpayer's adjusted gross income. Additionally, investors whose theft losses exceed their income in the year the loss is claimed may be able to carryback the excess loss against the three prior years' income as a net operating loss.

It is unclear at this time whether the IRS will allow the investors to amend the tax returns for the prior three years to reverse the income reported from Madoff in those years.

"Claim of Right"

Another possible approach to realizing a tax benefit for the victims of the alleged investment fraud is to claim a theft loss for the income reported in all the prior years the taxpayer invested with Bernard Madoff under the "claim of right" doctrine. Generally, the investors would receive a Federal and New York State tax refund equal to the income tax attributable to the investment earnings reported from Madoff in all of the prior years. Note that other states may have a similar rule in connection with "claim of right" income.

In order to claim the benefits of the "claim of right" doctrine, a taxpayer must meet the following requirements:

- the item was included in gross income in a previous taxable year;
- the inclusion occurred because the taxpayer appeared to have an unrestricted right to the item;
- in a later year, the taxpayer is entitled to a deduction;
- 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
- the amount of the deduction exceeds \$3,000.

It should be noted that it is not clear if the IRS will allow taxpayers to obtain the benefits of the "claim of right" doctrine in this case.

We will keep you informed with respect to any rulings issued by the Internal Revenue Service in this matter. For more information, contact Tax Partner, Timothy Mulcahy at 631-719-3325, or tmulcahy@hrrllp.com.

