Katten
KattenMuchinRosenman LLP

ClientAdvisory

March 20, 2009

# IRS Guidance Addresses Theft Loss Deduction for Investors in Ponzi Schemes

The IRS has issued guidance clarifying the tax law rules relating to theft loss deductions and providing a "safe harbor" for U.S. investors who suffered losses from investments in Ponzi schemes to claim a theft loss deduction. While the IRS guidance was prompted by the widely reported Madoff Ponzi scheme, it applies to investors who suffered investment losses in any Ponzi scheme.

Revenue Procedure 2009-20 provides a safe harbor under which a U.S. investor in a Ponzi scheme can claim a theft loss deduction in the year the Ponzi scheme promoter is indicted, or becomes the subject of a criminal complaint if the investment assets are frozen or placed under the supervision of a receiver or trustee. This should allow investors who suffered losses in the Madoff Ponzi scheme to claim a theft loss deduction for 2008.

Under the IRS safe harbor, an investor who is not seeking to recover from third parties other than the promoter of the scheme may deduct 95% of his net investment, including amounts previously reported for tax purposes but later discovered to have been fictitious, reduced by all prior cash distributions or withdrawals and by amounts recovered or recoverable from private insurance or the SIPC. Claims against the promoter of the fraudulent scheme do not reduce the amount that may be claimed as a theft loss. If the investor is seeking to recover from persons other than the promoter of the scheme, then the safe harbor limits the deduction to 75%, rather than 95%, of the foregoing net investment amount. In either case, because the investor will receive the benefit of a theft loss deduction as to income or gain previously reported, an investor claiming the safe harbor deduction does not have to, and indeed must agree not to, file amended tax returns for prior years in which such income or gain was reported.

The safe harbor only applies to direct investments in the fraudulent scheme and is not available to indirect investors in the scheme, such as investors in a fund of funds vehicle which itself invested in the scheme. However, funds or entities that were direct investors in a Ponzi scheme may deduct their investment losses under the safe harbor. It is unclear whether or how the 75% safe harbor limitation would apply to a theft loss deduction claimed by an investment vehicle that is allocable to an investor in the vehicle who is independently seeking to recover his loss from, say, that vehicle's own investment manager.

The IRS simultaneously issued Revenue Ruling 2009-9, which clarifies that:

- a theft loss deduction claimed with respect to investment losses is an ordinary loss, rather than a capital loss, and is not subject to the 10% of adjusted gross income reduction applicable to non-investment theft losses;
- the deduction is not subject to the federal income tax limitations normally applicable to miscellaneous itemized deductions (but it is still an itemized deduction, as to which limitations may be imposed for state and local income tax purposes, depending on the tax laws of the applicable jurisdiction);
- a theft loss may be claimed not only for the net amount invested but also for fictitious income and gain reported in prior years, including years that are otherwise time-barred; and
- any net operating loss ("NOL") created by the claimed theft loss deduction may be carried back three years (or, for certain investors, three, four or five years if the NOL arose in 2008), and forward 20 years.

For further information regarding the IRS guidance or theft loss deductions generally, please contact:


**New York**

| | | |
|---|---|---|
| Jill E. Darrow | 212.940.7113 | jill.darrow@kattenlaw.com |
| Robert Loewy | 212.940.6303 | robert.loewy@kattenlaw.com |

**Chicago**

| | | |
|---|---|---|
| Saul E. Rudo | 312.902.5664 | saul.rudo@kattenlaw.com |
| Reid A. Mandel | 312.902.5246 | reid.mandel@kattenlaw.com |
| Ziemowit T. Smulkowski | 312.902.5651 | ziemowit.smulkowski@kattenlaw.com |





Katten

KattenMuchinRosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK PALO ALTO WASHINGTON, DC

*Katten Muchin Rosenman LLP is an Illinois limited liability partnership including professional corporations that has elected to be governed by the Illinois Uniform Partnership Act (1997).*
*London affiliate: Katten Muchin Rosenman Cornish LLP.*

3/20/09