January 26, 2009

About This Series…

A periodic update of the tax, due diligence, and business fraud issues for those clients and friends of the firm affected by the alleged fraud of Bernard L. Madoff and his business.

MADOFF MATTERS

Decision in Ponzi Scheme Case Could Shed Light on Future Madoff Lawsuits

How will investment advisors and feeder funds defend against lawsuits that may be brought against them by Bernard Madoff investors? A decision in the case of "South Cherry Street v Hennessee Group" gives a clue about how future cases might play out.

In the case, hedge fund consulting firm The Hennessee Group advised investment firm South Cherry Street LLC to invest $1.5 million with the Bayou Hedge Fund. The Bayou Fund later was discovered to be operating a Ponzi scheme. South Cherry alleged that Hennessee did not do the proper due diligence when it recommended the Bayou Fund.

The suit was thrown out by a U.S. District court. The judge said that Bayou had deceived the entire investment community and it was doubtful Hennessee's due diligence would have uncovered the fraud.

"The Hennessee Group's failure to discover the fraud merely places it alongside the SEC, the IRS, and every other interested party that reviewed Bayou's finances," wrote Judge Colleen McMahon. She went on to write that "failure to conduct due diligence is not the same thing as knowing of, or closing one's eye to, a known 'danger.'"

Retirement account losses may not be eligible for theft loss deduction

One of the possible avenues of recovery of taxes paid is a theft loss deduction. However, those who had their IRA or other retirement account invested with Madoff likely will not be eligible for a theft loss deduction.

For more on theft loss deductions, see the firm's January 12 Madoff Matters issue: http://www.holtzrubenstein.com/090112_Madoff_Matters.pdf.

One of the provisions of the tax code that concerns theft losses limits the amount of the loss to the taxpayer's adjusted basis in the assets. Money invested in 401(k)s and other retirement plans (including rollover IRAs) is not included in a taxpayer's income. Neither is the income or appreciation accumulated in the account over the years. Therefore, the taxpayer has no tax basis in the account and would not be entitled to a theft loss deduction.

Possible exceptions to this would be nondeductible IRAs or Roth IRAs. In those cases, the portion of the accounts representing contributions might be eligible for the deduction.

SIPC claim forms

Reminder: The SIPC claim forms must be received by the Trustee by March 4, 2009. Get a copy of the SIPC claim form at http://www.sipc.org/cases/sipccasesopen.cfm. It is recommended that you use certified mail, return receipt requested.

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