March 17, 2009

HOLTZ RUBENSTEIN REMINICK

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

IRS Issues Guidance to Madoff Investors

Earlier today, the IRS issued two separate items of guidance in order to assist victims of the Madoff (and other Ponzi) schemes.

Item of Guidance #1: Losses from criminal fraud or embezzlement. The following are some of the specific items of note:

- A loss related to criminal fraud or embezzlement entered into for profit is a theft loss, not a capital loss.

- Such a theft loss will not be subject to the $100 and 10% of adjusted gross income ("AGI") limitations.

- The loss is deductible in the year the loss is discovered (2008 in the Madoff case) provided that it is not covered by a claim for reimbursement or recovery where there is a reasonable expectation for recovery. The amount of the deduction must be reduced by such claims. If the taxpayer recovers a greater amount in a later year, that amount will be included in income in the year it was received. If the taxpayer recovers a lesser amount, the difference is a deduction in the year the amount of the recovery is ascertained with reasonable certainty.

- The amount of the loss is the amount invested plus amounts reported to investors in prior years as income and reinvested, less the amounts withdrawn, reimbursements or other recoveries, and claims to which there is a reasonable expectation of recovery.

- The loss can be carried back up to 3 years and forward 20 years. However, in this type of case, the loss will be considered a business deduction from a sole proprietorship for net operating loss purposes. Therefore, if the individual had average annual gross receipts (for 2006, 2007, and 2008) of $15 million or less, he/she would be able to carry back the loss up to 5 years.

  Note that the definition of "annual gross receipts" is not clear for a Madoff investor.

- Neither the claim of right doctrine nor the mitigation provisions included in the Internal Revenue Code would apply to this case .

Item of Guidance #2: Safe harbor procedures.

- If an investor follows the procedures outlined, the Internal Revenue Service will not challenge the claim.

- The safe harbor procedures apply only to direct investors. Those investing through a fund or some other entity do not qualify. However, the other entity may itself qualify under the procedures.

- The loss in this case would be a 2008 theft loss, not subject to the $100 and 10% of AGI limitations, nor be impacted by the alternative minimum tax ("AMT").

- To calculate the amount of the deduction you would take the sum of all investments made, plus amounts reported by the investor in prior years as income and reinvested, less withdrawals.

  That amount would be multiplied by 95% for investors with no potential third party recovery, and 75% for investors with potential third party recovery. Actual recoveries received and potential insurance/SIPC recoveries would be subtracted from this. The result would be the deductible theft loss.

- By using the safe harbor method, the taxpayer agrees:
  – not to deduct an amount in excess of the amount allowed under the safe harbor procedure,
  – not to file returns or amended returns that recharacterize related income reported in prior years, and
  – not to apply the code sections dealing with the claim of right doctrine or mitigation provisions.

- Those not following the safe harbor provisions would be subject to all of the generally applicable provisions governing deductibility of losses.

- All investors' tax returns are subject to examination by the IRS.

To date, the IRS has issued no comments on the tax effects of possible future clawbacks.

What to Do Now

April 15th is only 4 weeks away. The statute of limitations for the 2005 tax year will expire on that date for anyone who filed their return without an extension. Even considering today's guidance, it is imperative that any **Madoff-affected taxpayers file a protective claim for their 2005 Federal and State income tax returns**.

This will preserve the taxpayer's right to take a position contrary to the guidance issued by the IRS if they so choose.

For more information on any of the above, contact Stephen Aponte, Senior Tax Manager and a member of the firm's Madoff Response Team, at (212) 697-6900, SAponte@hrrllp.com.

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