NEW IRS RELEASES ON THE TREATMENT OF INVESTOR LOSSES FROM PONZI SCHEMES

On March 17, 2009, the Internal Revenue Service (the "Service") issued two releases regarding the tax treatment of theft losses arising from so-called "Ponzi" schemes, such as the fraud conducted by Bernard Madoff. For investors who have lost money in such schemes, the Service has provided an optional safe harbor for theft losses discovered in taxable years beginning after 2007 and also has clarified general tax rules for deducting theft losses resulting from frauds of this type.

In summary, Revenue Procedure 2009-20 provides that a taxpayer may for federal income tax purposes treat a loss suffered from a Ponzi scheme as a "theft loss," a classification that generally will be favorable for taxpayers, without risking an audit challenge from the Service if (1) the taxpayer is a U.S. person generally qualified to deduct theft losses for tax purposes who has invested in a fraudulent investment arrangement that is not a tax shelter and in which the party perpetuating the fraud received cash or property from investors, purported to earn income for investors and reported to investors income amounts that were wholly or partially fictitious; (2) the party perpetuating the fraud made payments of principal or income to investors using cash or property that other investors invested in the fraudulent arrangement and criminally appropriated some or all of the investors' cash or property; (3) the party perpetuating the fraud was either (a) charged under state or federal criminal law with fraud, embezzlement or a similar crime or (b) the subject of a criminal complaint alleging fraud, embezzlement or a similar crime and either the complaint alleged an admission by the party perpetuating the fraud or a receiver or a trustee was appointed and the assets of the investment arrangement were frozen; (4) the investor did not have actual knowledge of the fraudulent scheme prior to its discovery by the general public; and (5) the investor did not invest in the scheme through a fund or other entity separate from the investor. Although this last requirement would seem to exclude fraud victims who invested through a feeder fund or a fund of funds, in some cases the fund or other entity through which people invested indirectly in the fraud may be eligible to avail itself of the safe harbor if such fund or other entity meets the requirements.

If the requirements of Revenue Procedure 2009-20 are satisfied, an investor may deduct, in the year in which the charge or complaint is filed against the party perpetuating the fraud, either 95 percent or 75 percent of the amount of the Qualified Investment Amount, depending upon certain requirements discussed below, less (1) any actual recovery from any source that the investor receives during the year of the discovery of the fraud and (2) any potential recovery from insurance or the Securities Industry Protection Corporation (the "SIPC") (or a similar entity). Potential recovery from insurance or the SIPC includes the amounts of all actual and potential claims for reimbursement that as of the last day of the year of discovery are attributable to an insurance policy in the name of the qualified investor, a contractual arrangement other than insurance that guaranteed or otherwise protected against the loss or amounts payable from the

SIPC. The Qualified Investment Amount is (a) the total amount of cash (or the basis of property) that the investor invested in the arrangement in all years, plus (b) the total amount of net income that the investor included in income in previous years (including years for which a refund is barred by the statute of limitations) as a result of information received from the fraudulent arrangement, less (c) the total amount of cash or property that the investor withdrew in all years from the fraudulent arrangement. The Qualified Investment Amount does not include (a) amounts borrowed from the party responsible for the fraud and invested in the fraudulent arrangement, to the extent not repaid at the time the theft was discovered, (b) amounts such as fees that were paid to the party perpetuating the fraud and were deducted for tax purposes from gross income, (c) amounts reported to the investor but not included for tax purposes in gross income or (d) cash or property that the investor invested in a fund or other entity separate from the investor that in turn invested in the fraudulent arrangement.

An investor is entitled to claim a deduction in the amount of 95 percent of the investor's Qualified Investment Amount if the investor does not pursue any potential third-party recovery. An investor is entitled to claim a deduction in the amount of 75 percent of the investor's Qualified Investment Amount if the investor is pursuing or intends to pursue any potential third-party recovery for actual or potential claims for a qualified loss, as of the last day of the discovery year, that are not insurance- or SIPC-related claims and are not actual or potential claims against the parties responsible for the fraud, including employees, directors, the bankruptcy estate, etc. The deductible amounts would be reduced by any actual recovery and any potential insurance or SIPC recovery as described above.

An investor who uses the safe harbor must follow extremely specific tax return requirements not detailed here. It should be noted that among these requirements is the execution of a written waiver in which the taxpayer agrees, among other things, to neither file amended returns for prior years to exclude the income that was reported with respect to the investment scheme in those years nor apply certain alternative computation methods or mitigation provisions. In addition, if, prior to April 17, 2009, the investor has filed a tax return for the year of discovery or amended returns for a prior year that are inconsistent with the revenue procedure, the deadline to adopt the safe harbor is May 15, 2009.

Investors who choose not to use the safe harbor will be subject to the general rules applicable to theft loss deductions. Those investors who decide to amend their tax returns for the years for which the statute of limitations has not yet expired to exclude amounts reported as taxable income will have to prove that these amounts were not income actually or constructively received by the investor. For years for which the statute of limitations has expired, the Service will not challenge an investor's inclusion in basis of amounts included in the investor's gross income in determining the amount of theft loss allowed, provided the investor can establish the amount of net income from the fraudulent arrangement that was reported and included in gross income.

Revenue Ruling 2009-9, published simultaneously with Revenue Procedure 2009-20, describes general rules applicable to various aspects of theft loss deductions. This ruling applies in particular to investors who have experienced a theft loss but are unable to or choose not to use the safe harbor of Revenue Procedure 2009-20.

Revenue Ruling 2009-9 provides that for purposes of the theft loss deduction, "theft" has broad connotations, covering any criminal appropriation of another's property for the taker's own use. In order to claim a theft loss, an investor must prove that the loss resulted from an illegal taking of property and the property was taken with criminal intent. The revenue ruling determines that investors' losses from fraudulent investment arrangements, such as Ponzi schemes, are theft losses rather than capital losses because the promoter of the Ponzi scheme specifically intended to, and did, deprive the investors of money by a criminal act. As a theft loss, the loss is an itemized deduction that is not subject to the limitations imposed on certain other types of itemized deductions.

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 a year prior to the year of discovery of the theft, and the investor includes the amount in gross income and reinvests the amount in the arrangement, this amount increases the deductible theft loss.

To the extent that an investor's deduction is reduced by a claim for reimbursement, the investor's recovery of all or a portion of such claim in a later year is generally not includible in the investor's income in that later year, and if the investor does not recover the full amount of the claim, an additional deduction will be allowed in that later year. If the investor recovers in a later year more than the claim amount, or recovers an amount that was not covered by a claim with a reasonable prospect of recovery, that recovery is includible in the investor's gross income in the later year to the extent the earlier deduction reduced the investor's income tax.

Pursuant to Revenue Ruling 2009-9, an individual suffering such a fraudulent loss sufficient to create a net operating loss can, in general, carry the loss back up to three years and forward up to 20 years. However, according to Revenue Ruling 2009-9, due to a provision in the recently enacted American Recovery and Reinvestment Act of 2009, in the case of a net operating loss arising in 2008 from a theft loss from a fraudulent investment arrangement discovered in 2008, an individual would be eligible to elect to carry the net operating loss back for three, four or five years, provided that for 2008 and the two prior years the individual had average annual gross receipts of $15 million or less, and forward up to 20 years.

Revenue Ruling 2009-9 also concludes that certain tax mitigation remedies are not available to investors who have lost money in a fraudulent investment arrangement.

It is strongly suggested that investors who may have been affected by recent Ponzi schemes consult their personal tax advisors regarding their particular situation, as the requirements of Revenue Procedure 2009-20 and Revenue Ruling 2009-9 are specific and detailed, and the requirements laid down can be time-sensitive. The Revenue Procedure and Revenue Ruling are only briefly summarized here.

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March 23, 2009

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