

**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1411**

**Date:** 04-Feb-09  
**From:** Steve Leimberg's Estate Planning Newsletter  
**Subject:** Baskies on Madoff - Part II – The Lurking Income Tax Issues

LISI is going to provide members *two* newsletters on tax planning for Madoff transactions. The first will be by **Jeff Baskies**. The second will be by **Bob Keebler** and will follow immediately. Between the two, you should have a wealth of tax information and planning guidance that – unlike an investment with Uncle Bernie - you *can* count on.

LISI Estate Planning Newsletter # 1384 ("The Day The Music Died") by **Jeff Baskies** discussed many of the issues raised by the alleged fraud perpetrated by Bernard Madoff. Jeff's commentary touched on the impact to individual investors, hedge funds and charities, and briefly addressed a few of the tax issues.

In *this* Newsletter, Jeff sharpens his focus, and looks at the various income tax issues that investors and their advisors will no doubt be wrestling with this tax season.

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### **EXECUTIVE SUMMARY:**

With the start of a new year, many have begun to think about their 2008 income tax returns. Because start of a new year signals the start of a new tax season, it seems appropriate to take a closer look at the income tax issues raised by the Madoff Mess, which is particularly timely for investors who suffered losses. The following commentary contains a list of filing tips, as well as a discussion of some of issues clients and their advisors will need to wrestle with, if they haven't done so already.

### **MORE ON MADOFF TO FOLLOW. BUT FIRST, A CLARIFICATION ON OUR LITCHFIELD FACTS AND ANALYSIS.**

There was mention made of the status of the Jelke case. Please note that **Byrle Abbin** (who will be adding his expertise and insight into Litchfield lessons) reported in Estate Planning Newsletter 1351 that on October 6<sup>th</sup>, 2009, the Supreme Court *denied* the government's petition in Jelke for a Writ of Certiorari (it was hoping to obtain a reversal of several taxpayer-favorable circuit court decisions involving the discount in the value of a corporation's

stock due to the inherent built-in gain (BIG) tax where the fair market value of the corporation's assets exceeds its basis.) In Litchfield, the discount taken was (wisely) not fully dollar-for-dollar (and the court put off a decision on the appropriateness of dollar-for-dollar for that reason), it considered the expected holding periods for the corporate assets including future appreciation and a reasonable discount to present value.

Also, only *one* of the two corporations, in Litchfield, was an S corporation. The other was a C corporation.

## **NOW BACK TO JEFF BASKIES AND MADOFF MADNESS!**

### **FACTS:**

#### **NOTICE TO INVESTORS: GATHER ALL THE INFORMATION YOU HAVE**

Madoff investors should be gathering all of their statements and as much documentation regarding contributions and withdrawals as they can. Investors should try to locate and preserve monthly statements, year-end statements, 1099s, trade confirmations, and any other reporting information they may have. This material will be important for SIPC claims, for tax positions and for possibly defending actions by the receiver to return funds (the "claw-back" issue).

#### **CONSIDER FILING AMENDED TAX RETURNS**

Investors may have reported and paid taxes for allegedly-fraudulently income on portfolios. As a result, investors should consider filing amended income tax returns to eliminate incorrect items of income and/or capital gains, for years 2005, 2006 and 2007.

For clients who held taxable accounts – not retirement accounts – directly with Madoff, the refund claim would be filed on an IRS Form 1040X, calculating what the tax would have been in those years with and without the Madoff income.

As it now appears all of the alleged income and gain was fictitious, the amended returns should likely eliminate all items of income and/or capital gains. Moreover, a protective claim for refund of income taxes attributed to any Madoff investment income or gain should be requested on the return (the Form 1040X).

Here's an important point regarding amending returns: the amended return for 2005 may need to be filed before April 15, 2009, to protect against potentially expiring statutes of limitations.

Moreover, a protective claim for refund of income taxes attributed to any Madoff investment income or gain should be requested on the return (the Form

1040X). While there is no assurance a refund will be granted, a timely filed amended return and claim for refund will at least avoid having the statute of limitations run for 2005.

Amended 2006 and 2007 returns might be necessary as well. On one hand, there would seem to be some degree of synergy, and maybe cost savings, doing all three years at once.

However, as the statutes of limitations for those won't run until April 2010, it might be prudent to wait and see if the IRS makes any pronouncements or rulings in light of the 2005 returns and any other pressure that may come to bear on the IRS.

For example, if guidance is issued, it might direct clients not to prepare amended returns for all 3 years' at the same time. Thus, preparing amended returns for all 3 years at once might turn out to be a waste of professional fees, not a savings.

For clients with Madoff losses in taxable accounts invested via so-called "feeder funds" a similar process should be available. While technically a client may wait for an amended K-1 before filing a claim, it seems likely many of these funds may be slow to issue them or may not issue them at all. Thus, feeder-fund investors will likely use the same process outlined above to seek a refund, noting that the K-1 was erroneous. Assuming a client will file before receiving an amended K-1, then it is likely that a Form 8082 should also be filed outlining the reasons why the taxpayer is reporting tax on amounts that are different than those reflected on the K-1.

### **CONSIDER TAKING CASUALTY LOSS TAX DEDUCTIONS**

Many clients are considering taking ordinary tax deductions for losses of principal as theft losses under Section 165. There has been speculation in the media about how to treat Madoff losses, and many commentators are counseling clients to consider the theft-loss route. However, investors face many uncertain and controversial issues if they head down this road.

### **WHEN MAY A CASUALTY LOSS BE TAKEN?**

In general, a casualty loss is claimed in the year a taxpayer discovers the loss. For virtually all Madoff investors, that would be 2008. However, if there is a "reasonable expectation" that some recovery may be received either via insurance or a bankruptcy or legal proceeding, then the timing of taking the deduction should be postponed until the amount of the recovery, and the extent of the loss, has been determined with reasonable certainty.

Obviously, given all the receivers will need to do, this could take years. And no one even knows how SIPC will respond to claims. Thus, it is unclear whether a theft loss claim can be taken in 2008.

However, absent any Treasury/IRS guidance in the next couple months, it seems likely that most Madoff investors will take as much of a deduction as

they can in 2008 and "let the chips fall where they may" with the IRS.

### **WHAT IS THE MEASURE OF THE LOSS?**

Quantifying the size of an investor's "loss" could be very difficult. Is the loss suffered equal to the alleged account value just prior to Madoff's arrest? Or, is that an inflated figure that never really existed, with there being no reasonable basis on which to claim a loss?

Alternatively, is the claim for loss limited to the amount contributed to the Madoff account, minus amounts withdrawn over the years? Is the claim instead somehow defined in relation to the client's "basis" in the account? Or, is the value for the loss increased by the amounts reported as income over the years, as well as income that might have been taxed?

It's not clear whether definitive answers exist, although an argument could be made that the value of the loss ought to be calculated as: contributions + taxable income – withdrawals (i.e. the total amount contributed historically, plus any amounts reported as income, minus any amounts withdrawn by the client. This would appear to be the most logical way to calculate the loss.

In addition, there should be some consideration for subtracting from that total a reserve for the potential recovery from SIPC (for those clients likely to receive something – see discussion below) and/or for some other potential payments from the receiver; however, those amounts should also logically be reduced by some consideration of the likelihood of a "claw-back" if the client did receive distributions in the last 2-6 years. For those who directly invested, the SIPC recovery (see below) is probably foreseeable enough that it must be taken into consideration; however, given how speculative any recovery in the litigations (the receivership and the securities cases) appear to be, that most clients will not apportion much value – if any – to the potential recovery.

### **HOW DOES SIPC COVERAGE FACTOR INTO THE EQUATION?**

If the investor held a brokerage account that likely qualifies for SIPC coverage, does that vitiate the ability to claim a loss in 2008? Alternatively, can the investor reduce the claim by the anticipated recovery (\$500,000) and deduct the balance of the loss 2008?

The latter approach seems logical. As there appear to be arguments that the recovery from the receiver/bankruptcy will be so insignificant as to be impossible to determine, clients may be likely to peg their recovery at the SIPC level – the \$500,000 - and claim the rest as a theft loss. However, if a future recovery is made, then it would appear such must be reported as ordinary income; a natural and logical corollary to taking an ordinary loss.

The SIPC mailed claim forms to all customers on January 2, 2009, and the SIPC's website states that March 4, 2009 is the "Customer Claim Deadline," while July 2, 2009 is the "Deadline for All Claims." LISI readers can click this link to access additional SIPC claim information:

<http://www.sipc.org/cases/sipccasesopen.cfm>

### **WHEN TO DEDUCT THE CLAIM**

If a claim can be deducted in 2008, then it will be used to off-set income for 2008. This may create a refund for some clients and it may obviate the need to file a January 15 estimated payment. Thus, a timely examination of this issue is imperative.

The theft loss likely should be reported on a IRS form 4684, which then passes the loss onto IRS Form 4797, and the ordinary loss (expressed as a negative amount) would then be reported on the Form 1040.

### **DON'T OVERLOOK THE IMPACT OF NET OPERATING LOSSES**

Assuming a deduction is available for 2008, if the loss exceeds the client's 2008 income, the deduction of a casualty loss creates a Net Operating Loss (NOL) for 2008. The NOL should then be available for a 3 year carry back to reduce taxable income reported in the past 3 years.

This could get interesting, as the client is probably already planning to file amended returns to reduce taxable income for those years as discussed above. Therefore, there may be a need to file for additional tax refunds.

If that's the case, then filing sooner may be the better way to go, although the expenses of incurring some professional fees must be weighed in exchange for a sooner filed claim for refund. Also, there should be an expedited refund procedure available for refunds based on NOLs if they are accompanied by the filing of an IRS Form 1045.

### **CONSIDER THE IMPACT ON QUALIFIED RETIREMENT ACCOUNTS**

What happens if the loss was in a 401(k), IRA or some other type of qualified retirement plan account? Is there any recourse? At first blush, it would seem that there is no way to take a deduction for funds in a qualified retirement account since they were not yet taxed. If you are allowed to put the money away and have it "grow" on a tax preferred basis, it wouldn't seem possible to also have a claim for a deduction if you lose that money.

### **COMMENT:**

As the foregoing demonstrates, there appear to be many uncertainties regarding the income tax treatment of clients who suffered investment losses as a result of Bernard Madoff's actions. This commentary reviewed a number of key issues including: when can a loss deduction be claimed, will SIPC recoveries have to be netted out, if the potential recovery from the receiver negates any claim for deduction, and how much to claim as a loss. All of these issues could be clarified, and perhaps the IRS will issue some much needed guidance to investors and practitioners.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!**

# Jeff Baskies

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