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BERNARD MADOFF LOSSES: TAX SUMMARY

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With individual investors, banks and institutions having disclosed more than $27 billion in combined exposure to Bernard Madoff's firm, talk is now turning to how such losses can be managed. The following is a brief overview of tax strategies for handling these losses.

Casualty Losses
Theft and embezzlement losses fall into the category of casualty losses that are deductible to the extent they exceed 10% of adjusted gross income (AGI) plus $100. There is an exception for transactions entered into for profit, such as investing transactions with an investment manager or with a hedge fund. In those situations they are deductible in full without the 10% plus $100 limitations.

Casualty losses are deducted on Schedule A or your individual tax return but are not limited by the 2% of AGI threshold or the itemized deduction phase, or affected by the alternative minimum tax.

Losses not deducted can be carried back as a net operating loss (NOL) deduction, but they can be carried back three years (not the two years for NOLs), and can be carried forward for up to twenty years.

Discovery and Recovery
Theft losses are deductible in the later of the year the loss is discovered or the year it is finally determined that it won't be recovered. Notification that a loss might have occurred constitutes a discovery, but the tabulation of the actual amounts of the loss could take quite a long time, and then the recovery process takes its time.

If there is a chance of recovery, the IRS will not permit a deduction. If a loss is known but a final calculation is not made for many years and you are in danger of exceeding the normal three year statute of limitations (for tax year 2005 the statute expires April 15, 2009 for timely filed returns and a maximum of October 15, 2009 for extended returns), then you may want to consider filing a protective claim for refund to keep the statute open.

Addressing Fraudulent Income
An issue to consider is whether part of the loss was from fraudulently recorded income in a prior year that has been taxed and added to the investment balance. In those situations it might be appropriate to file amended returns for the prior years' reducing those amounts from income since those amounts weren't actually income. Generally tax years 2005, 2006 and 2007 are still open for amended returns.

Managing Grantor Trusts
Grantor trusts that have interests in Madoff investments can distribute the investments to the beneficiaries who will assume the basis of the trust. This will enable the beneficiary to be able to claim the loss rather than the grantor.

Obviously theft losses are serious matters and they should be given careful thought as to the proper strategy. There are various ways to proceed and the right way for you should be analyzed appropriately. It is highly recommended that you seek professional counsel from a trusted accountant.

[1]IRC Section 165c(2) or (3)