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Re: Recent additional Income Tax Guidance for Victims of the Madoff Fraud and Other Ponzi Schemes

Dear Client:

In March, we alerted our clients that the Internal Revenue Service had issued important helpful guidance with respect to the claiming of federal income tax benefits for losses from the Madoff fraud and other Ponzi schemes. That guidance provided a generally favorable safe harbor for claiming a theft loss deduction in 2008 for the Madoff fraud and clarified that most Madoff victims could carry back – for a period of up to five years – resulting theft losses in excess of the taxpayer's 2008 income.

More recently – which is the reason we are sending you this alert – the New York State Department of Taxation and Finance issued a Tax Services Bulletin (TSB-M-09(7)I – a copy is attached for your convenience) stating that New York State would follow the IRS's lead with respect to Madoff losses and other Ponzi scheme losses. It was generally anticipated that the Department of Taxation and Finance would take this approach since New York State's individual income tax rules are generally linked to the federal Internal Revenue Code unless otherwise provided by New York State law. Nonetheless, the certainty provided by the TSB is welcome news for Ponzi scheme victims residing in New York who might otherwise be anxious because income tax refunds represent a crucial – and often the principal – source for recovering some portion of the Ponzi scheme losses. (For victims who are not residents of New York State and are not subject to New York State tax, the TSB is essentially irrelevant.)

Although the issuance of the TSB is generally good news, higher income Ponzi scheme victims should be aware of an unhappy reminder in the TSB. New York State has more severe limitations on itemized deductions than the limitations that apply in computing federal taxable income.

As we pointed out in March, Ponzi scheme losses are not subject to overall limitations on itemized deductions in computing <u>federal</u> taxable income. However, in computing <u>New York State</u> taxable income, itemized deductions (including Ponzi scheme theft losses) are subject to reduction. The most broadly applicable reduction provision reduces itemized deductions by up to 25%. This first tier of reductions applies to taxpayers with New York State adjusted gross income ("NYAGI") in excess of specified threshold amounts, as follows: single taxpayers with NYAGI > $100,000; heads of

households with NYAGI > $150,000; and married taxpayers filing jointly with NYAGI > $200,000. Taxpayers with incomes higher than the above thresholds face significantly greater limitations on the use of itemized deductions to reduce their NYS taxable income. For taxable year 2008, itemized deductions are reduced by up to an additional 25% – to only 50% – for taxpayers with NYAGI in excess of $475,000.

It's even worse in taxable year 2009 and subsequent taxable years for taxpayers with NYAGI in excess of $1,000,000. For those taxpayers, theft loss deductions (including theft loss deductions from Ponzi schemes) are reduced by an additional 50%, to zero, in computing NYS taxable. As a result, those clients who anticipate having significant income in 2009 and future years will need to consider the effective unavailability of theft loss deductions for New York State income tax purposes in deciding how to report their Ponzi scheme losses for federal and New York State income tax purposes. For example, the effective nondeductibility of Madoff losses in computing New York State taxable income in 2009 and future years could be an additional inducement to claim a safe harbor theft loss deduction in 2008 (when it is at least partially deductible for taxpayers with NYAGI in excess of $1,000,000) instead of claiming a theft loss in post-2008 taxable years. Additionally, clients anticipating significant income in 2009 and future years should have their accountants carefully calculate whether carrying forward a net operating loss ("NOL") to 2009 and future years may provide a significantly greater New York State income tax benefit than carrying back the NOL (which generally can be carried back up to five years).

We also wish to alert you that the Internal Revenue Service recently issued additional guidance with respect to losses from the Madoff fraud. The new guidance, Rev. Proc 2009-26 (a copy is attached for your convenience), applies to taxpayers that choose to avail themselves of the four- or five-year NOL carryback period provided by the so-called Stimulus Act that was enacted in February 2009. Although it is not nearly as significant as the IRS guidance we informed you about on March 23, 2009, Rev. Proc 2009-26 provides useful clarification of the application of the NOL carryback rules to Madoff losses. The clarification is primarily of a technical nature relevant to tax return preparers and therefore generally does not merit detailed discussion in this letter. However, we think it important that you be aware of its existence generally. We also think that one specific substantive aspect of the Rev. Proc. is worth mentioning.

Those taxpayers who wish to avail themselves of the four- or five-year carryback period for a 2008 NOL arising from Madoff losses should be aware – and should confirm that their accountant is aware – that the four- or five-year carryback period generally must be elected no later than October 15, 2009 (six months after the due date for the 2008 tax return, without regard to extensions). The reason this is worthy of mention is that

many accountants are familiar with the general rule that a NOL carryback must be elected within 12 months after the taxable year of the carryback (December 31, 2009 for a calendar year taxpayer's 2008 tax return). However, some accountants may not be aware of the shorter election period, i.e., October 15, 2009, for electing the special four- or five-year carryback period. Missing the deadline could be an expensive mistake.

This letter is being provided as general advice regarding the income tax consequences of the Madoff fraud and should not be relied upon for any specific situation without consulting us. Should you have a specific situation that you wish to discuss, please contact us.

Sincerely yours,

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New York State Income Tax Treatment of Losses from *"Ponzi-type"* Fraudulent Investment Arrangements

General

The Internal Revenue Service (IRS) recently issued Revenue Ruling 2009-9, which describes the tax rules that apply to losses from "Ponzi-type" fraudulent investment arrangements. The IRS also issued Revenue Procedure 2009-20, providing an optional "*safe harbor*" procedure for computing and reporting losses for which the discovery year is a taxable year beginning after December 31, 2007. The Department will recognize the federal safe harbor for purposes of computing New York itemized deductions for personal income tax purposes. Accordingly, if the federal theft loss deduction is computed based upon the safe harbor, that amount is to be used in computing the New York itemized deduction. For New York State purposes, itemized deductions are subject to certain limitations, including those described below.

New York State limitations on itemized deductions

Deductions for theft losses attributable to a fraudulent investment arrangement are subject to the limitations of section 615(f) of the Tax Law. Under section 615(f), itemized deductions for a single taxpayer with New York State adjusted gross income (NYAGI) in excess of $100,000 are reduced by up to 25%. This reduction also applies to married taxpayers filing jointly with NYAGI in excess of $200,000, and heads of household with NYAGI exceeding $150,000. For all taxpayers with NYAGI above $475,000, itemized deductions are reduced by up to an additional 25%.

For the 2009 and subsequent tax years, noncharitable itemized deductions of a taxpayer whose NYAGI is over $1,000,000 are reduced by an additional 50 percent under section 615(f)(3), bringing them to zero. Accordingly, for taxpayers with NYAGI over $1,000,000, New York itemized deductions are limited to 50% of federal charitable contributions.

Net operating losses

For federal purposes, theft loss deductions that exceed income can generate net operating losses that can be carried forward or backward to other tax years. For resident taxpayers, any federal net operating loss is also allowed for state purposes. For nonresidents, any federal net operating loss will be allowed in the federal amount column on Form IT-203, Nonresident and Part-Year Resident Income Tax Return. However, in computing New York source income (the New York State amount column on Form IT-203), net operating losses are computed using only New York items of income, gain, loss and deduction. Accordingly, any net operating loss attributable to a theft loss would be allowed only if the loss is attributable to a business, trade, profession, or occupation carried on in New York. The losses from *Ponzi-type* fraudulent investment arrangements generally would not qualify. Also, nonresident individuals may not

carry New York State net operating losses forward or backward to a year in which the individual was a resident of New York State.

Filing Procedure

Taxpayers filing pursuant to the safe harbor rules should complete the "special condition code" space on their New York State income tax return or amended income tax return with the condition code "56." Taxpayers should also attach to their tax return a copy of their federal Form 4684, and a copy of the statement executed pursuant to Revenue Procedure 2009-20.

Scope

The guidelines outlined above will also apply to estates and trusts, shareholders of S-Corporations, partners in partnerships, and members of LLCs, based on the rules for attributing pro rata shares of such losses.

NOTE: A TSB-M is an informational statement of existing department policies or of changes to the law, regulations, or department policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions, Tax Appeals Tribunal decisions, or changes in department policies could affect the validity of the information presented in a TSB-M.

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, §§ 172, 6411)

Rev. Proc. 2009-26

SECTION 1. PURPOSE

.01 In February 2009, the American Recovery and Reinvestment Tax Act of 2009, Div. B of Pub. L. No. 111-5, 123 Stat. 115 (the Act) was signed into law. Section 1211 of the Act allows an eligible small business (ESB) to elect to carry back a 2008 net operating loss (NOL) for a period of 3, 4, or 5 years to offset taxable income in those preceding taxable years. Prior to the Act, taxpayers generally could carry back an NOL only two taxable years. On March 16, 2009, the Internal Revenue Service and Treasury Department issued Rev. Proc. 2009-19, 2009-14 I.R.B. 747, advising taxpayers how to elect the 3-, 4-, or 5-year carryback.

.02 The Service has received many claims from taxpayers that seek a 3-, 4-, or 5-year carryback but that inadvertently have not made a valid election in accordance with

Rev. Proc. 2009-19. These inadvertent failures may be due to the fact that the enactment of § 1211 and issuance of Rev. Proc. 2009-19 occurred midway through the current tax return filing season.

.03 To provide certainty to taxpayers and to implement the intent of Congress in providing an extended carryback period, this revenue procedure modifies Rev. Proc. 2009-19 to provide that an ESB may elect a 3-, 4-, or 5-year carryback period simply by filing a Form 1045, Form 1139, or amended return that carries back the NOL for 3, 4, or 5 years. Although Forms 1045 and 1139 ordinarily are due within 12 months after the taxable year of the NOL, § 172(b)(1)(H)(iii) requires that the taxpayer elect a 3-, 4-, or 5-year carryback within 6 months after the due date (excluding extensions) of the return for the taxable year of the NOL. Thus, a taxpayer that seeks to make a timely § 172(b)(1)(H) election using Form 1045, Form 1139, or an amended return must file the form in advance of its ordinary due date.

.04 This revenue procedure also prescribes: (1) how a taxpayer elects a 3-, 4-, or 5-year carryback if the taxpayer previously filed an election to forgo an NOL carryback period; and (2) how a taxpayer elects a 3-, 4-, or 5-year carryback if the taxpayer is a partner of an ESB that is a partnership, a shareholder of an ESB that is an S corporation, or a sole proprietor.

SECTION 2. BACKGROUND

.01 Section 172(a) allows a deduction equal to the aggregate of the NOL carryovers and carrybacks to the taxable year. Section 172(b)(1)(A)(i) provides that an NOL for any taxable year generally must be carried back to each of the 2 years preceding the

taxable year of the NOL. Section 172(b)(3) provides that any taxpayer entitled to a carryback period under § 172(b)(1) may make an irrevocable election to relinquish the carryback period with respect to an NOL for any taxable year.

.02 Section 6411(a) provides that a taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by an NOL carryback from any taxable year. Section 6411(a) also provides that the application must be filed on or after the date of filing for the return for the taxable year of the NOL from which the carryback results and within a period of 12 months after that taxable year or, with respect to any portion of a business credit carryback attributable to an NOL from a subsequent taxable year, within a period of 12 months from the end of the subsequent taxable year. Section 6411(b) provides a 90-day period during which the Service will make a limited examination of the application to discover omissions and errors of computation and determine the amount of the decrease in tax attributable to the carryback. The Service may disallow, without further action, any application that contains errors of computation that cannot be corrected within the 90-day period or that contains material omissions. The decrease in tax attributable to the carryback will be applied against unpaid amounts of tax. Any remainder of the decrease will, within the 90-day period, be credited or refunded.

.03 Section 172(b)(1)(H) permits an ESB to carry back its applicable 2008 NOL to 3, 4, or 5 years preceding the taxable year of the NOL, as the ESB elects.

.04 Section 172(b)(1)(H)(iv) provides that the term “eligible small business” has the meaning given by § 172(b)(1)(F)(iii), except that § 448(c) is applied by substituting “$15

million" for "$5 million" each place it appears. Section 172(b)(1)(F)(iii) provides that a small business is a corporation or partnership that meets the gross receipts test of § 448(c) for the taxable year in which the loss arose (or in the case of a sole proprietorship, that would meet such test if the proprietorship were a corporation).

.05 Section 448 generally prohibits certain taxpayers from using the cash receipts and disbursements method of accounting. Section 448(b)(3) provides an exception to this requirement in the case of any corporation or partnership if, for all prior taxable years beginning after December 31, 1985, the entity (or any predecessor) met the $5 million gross receipts test of § 448(c). Section 448(c)(1) provides that a corporation or partnership meets the $5 million gross receipts test for any prior taxable year if the average annual gross receipts of the entity for the 3-taxable-year period ending with that prior taxable year does not exceed $5 million. Section 448(c)(2) (aggregation rules) generally provides that all persons treated as a single employer under subsection (a) or (b) of § 52 or subsection (m) or (o) of § 414 are treated as one person for purposes of § 448(c)(1).

.06 The $5 million gross receipts test of § 448(c) is applied to a taxpayer's prior taxable year by determining the average annual gross receipts for the 3-year period that ends with that prior taxable year. Under §172(b)(1)(F)(iii), in order to be a small business, a taxpayer must meet the gross receipts test of § 448(c) for the taxable year in which the NOL arose. Consequently, to determine if a taxpayer is a small business for purposes of § 172(b)(1)(F)(iii), the taxable year in which the NOL arose is the last taxable year of the 3-year period to which the test is applied.

.07 Section 172(b)(1)(H)(ii)(I) provides that the term "applicable 2008 net operating loss" means the taxpayer's NOL for any taxable year ending in 2008. However, under § 172(b)(1)(H)(ii)(II), the taxpayer may elect instead to have the term mean the taxpayer's NOL for any taxable year beginning in 2008.

.08 Section 172(b)(1)(H)(iii) provides that any election under § 172(b)(1)(H) is required to be made in such a manner as may be prescribed by the Secretary, and must be made by the due date (including extension of time) for filing the taxpayer's return for the taxable year of the NOL. The election is irrevocable and may be made only for one taxable year.

.09 Section 1211(d)(2) of the Act provides that in the case of an applicable 2008 NOL for a taxable year ending before the date of enactment of the Act (February 17, 2009), (A) a previous election made under § 172(b)(3) for the NOL may be revoked on or before April 17, 2009; (B) the § 172(b)(1)(H) election for the NOL is treated as timely if made on or before April 17, 2009; and (C) an application under § 6411(a) with respect to the NOL is treated as timely if filed on or before April 17, 2009.

SECTION 3. SCOPE

This revenue procedure applies to any taxpayer that is an ESB, a partner of a partnership that is an ESB, a shareholder in an S corporation that is an ESB, or a sole proprietor of a business that is an ESB, and that incurred an NOL for any taxable year ending in 2008 or beginning in 2008.

SECTION 4. APPLICATION

.01 Time and manner of making the election under § 172(b)(1)(H).

(1) In general. A taxpayer within the scope of this revenue procedure that has an applicable 2008 NOL may make the election under § 172(b)(1)(H) by following the procedure described in either section 4.01(2) or section 4.01(3) of this revenue procedure.

(2) Electing on original return. A taxpayer may make the election under § 172(b)(1)(H) by attaching a statement to the taxpayer's timely filed federal income tax return for the taxable year in which the applicable 2008 NOL arises. The statement must state that the taxpayer is electing to apply § 172(b)(1)(H) and specify the length of the NOL carryback period elected by the taxpayer (3, 4, or 5 years). If the taxpayer's taxable year of the applicable 2008 NOL ends before February 17, 2009, the taxpayer must make the election on or before the later of the due date (including extensions of time) of the taxpayer's return for that taxable year or April 17, 2009.

(3) Electing on an appropriate form. A taxpayer that did not make the election under § 172(b)(1)(H) using the procedures of section 4.01(2) of this revenue procedure, and did not elect to forgo the NOL carryback period under § 172(b)(3), may make the election under § 172(b)(1)(H) as follows:

(a) What to file.

(i) A taxpayer may make the election under § 172(b)(1)(H) by filing the appropriate form applying the NOL carryback period chosen by the taxpayer. No statement or label is required with the appropriate form. The appropriate form is:

(A) For corporations: Form 1139, Corporation Application for Tentative Refund, or Form 1120X, Amended U.S. Corporation Income Tax Return.

(B) For individuals: Form 1045, Application for Tentative Refund, or Form 1040X, Amended U.S. Individual Income Tax Return.

(C) For estates or trusts: Form 1045, or amended Form 1041, U.S. Income Tax Return for Estates and Trusts.

(ii) A taxpayer that makes the election under § 172(b)(1)(H) by filing an amended return must file the return for the earliest taxable year to which the taxpayer is carrying back the applicable 2008 NOL. The taxpayer should not file an amended return for the applicable 2008 NOL taxable year.

(b) When to file. The appropriate form must be filed on or before the later of the date that is 6 months after the due date (excluding extensions) for filing the taxpayer's return for the taxable year of the applicable 2008 NOL or April 17, 2009.

(c) Additional rules. If a taxpayer makes the election by filing an appropriate form that amends a prior refund claim, the amendment also will apply to a carryback of any alternative tax NOL for the same taxable year. In the case of an amended application for a tentative carryback adjustment, the 90-day period described in § 6411(b) will begin on the date the amended application is filed.

.02 Revocation of the election to waive NOL carryback period. A taxpayer within the scope of this revenue procedure that previously elected under § 172(b)(3) to forgo the carryback period for an applicable 2008 NOL for a taxable year ending before February

17, 2009, may revoke that election and make the election under § 172(b)(1)(H). Any revocation of the election to forgo the NOL carryback period also will apply to a carryback of any alternative tax NOL for the same taxable year. The taxpayer makes the revocation and election by following the procedures of section 4.01(3) of this revenue procedure. In addition, the taxpayer should type or print across the top of the appropriate form "Revocation of NOL Carryback Waiver Pursuant to Rev. Proc. 2009-19." The taxpayer must file the revocation and new election under § 172(b)(1)(H) on or before April 17, 2009.

.03 Partnerships, S corporations, and sole proprietorships.

(1) If the taxpayer is a partner in a partnership that qualifies as an ESB, the taxpayer may make the § 172(b)(1)(H) election for its distributive share of the qualifying ESB partnership income, gain, loss, and deduction that is both allocable to the taxpayer under § 704 and allowed in calculating the taxpayer's applicable 2008 NOL.

(2) If the taxpayer is a shareholder in an S corporation that qualifies as an ESB, the taxpayer may make the § 172(b)(1)(H) election for its pro rata share of the qualifying ESB S corporation income, gain, loss, and deduction under § 1366 that is allowed in calculating the shareholder's applicable 2008 NOL.

(3) If the taxpayer is an owner of a sole proprietorship that qualifies as an ESB, the taxpayer may make the § 172(b)(1)(H) election for the qualifying ESB sole proprietorship income, gain, loss, and deduction that is allowed in calculating the taxpayer's applicable 2008 NOL.

(4) In determining whether a partnership, S corporation, or sole proprietorship qualifies as an ESB, the gross receipts test applies at the partnership, corporate, or sole proprietorship level. The aggregation rules of § 448(c)(2) apply to determine whether the partnership, S corporation, or sole proprietorship meets the gross receipts test of § 448(c).

(5) The amount of the taxpayer's applicable 2008 NOL that the taxpayer may carry back under §172(b)(1)(H) is limited to the lesser of:

(a) The taxpayer's items of income, gain, loss or deduction that are allowed in calculating the taxpayer's applicable 2008 NOL and are from one or more partnerships, S corporations or sole proprietorships that qualify as ESBs, or

(b) The taxpayer's applicable 2008 NOL.

(6) Examples.

(a) Example 1. Partnerships A, B, and C have average annual gross receipts of $10 million, $12 million, and $14 million, respectively. Partner T owns a 40% interest in each partnership. None of the partnerships is required to be aggregated with any other entity for purposes of the aggregation rules of § 448(c)(2). Subject to the limitations in section 4.03(5) of this revenue procedure, Partner T may apply its election under § 172(b)(1)(H) to the portion of its applicable 2008 NOL attributable to its distributive share of the income, gain, loss, and deduction of each of Partnerships A, B, and C.

(b) Example 2. The facts are the same as in Example 1, except that Partnerships A and B are under common control within the meaning of § 52(b)(1).

Accordingly, Partnerships A and B are treated as one person under the aggregation rules of § 448(c)(2). Because the aggregated average annual gross receipts of Partnerships A and B exceed $15 million, Partnerships A and B do not qualify as ESBs. Partner T may not apply its election under § 172(b)(1)(H) to the portion of its applicable 2008 NOL attributable to its distributive share of the income, gain, loss, and deduction of Partnerships A and B. However, subject to the limitations in section 4.03(5) of this revenue procedure, Partner T may apply its election under § 172(b)(1)(H) to the portion of its applicable 2008 NOL attributable to its distributive share of income, gain, loss, and deduction of Partnership C.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2009-19 is modified and, as modified, is superseded.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for NOLs arising in taxable years ending after December 31, 2007.

SECTION 7. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under the following control numbers: 1545-0074 Form 1040 (U.S. Individual Income Tax Return) and Form 1040X (Amended U.S. Individual Income Tax Return); 1545-0123 Form 1120 (U.S. Corporation Income Tax Return); 1545-0132 Form 1120X (Amended U.S. Corporation Income Tax Return);1545-0092 Form 1041 (U.S. Income Tax Return for Estates and Trusts); 1545-

0098 Form 1045 (Application for Tentative Refund); 1545-0582 Form 1139 (Corporation Application for Tentative Refund). For further information, please refer to the Paperwork Reduction Act statements accompanying these forms.

DRAFTING INFORMATION

The principal author of this revenue procedure is Seoyeon Park of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Ms. Park at (202) 622-4960 (not a toll-free call).