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Madoff Investors May Recover More From IRS Than From His Firm

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By Thom Weidlich and Cynthia Cottis

Jan. 21 (Bloomberg) -- Bernard Madoff's customers may recoup more of their investment losses by using tax strategies than by suing the man accused of bilking them in a \$50 billion Ponzi scheme or his bankrupt firm.

"If they invested a lot, then they could possibly recover 40 percent of everything" through U.S. and state tax laws, Micah Bloomfield, a tax specialist at New York law firm Stroock & Stroock & Lavan LLP, said.

U.S. tax law allows Madoff's customers to take income deductions for losses caused by theft if they prove their money was stolen, Bloomfield said. Madoff's alleged estimate of the size of the fraud didn't specify if it included principal or how much was lost by charities not subject to taxation.

Madoff, 70, was charged with securities fraud in New York Dec. 11 after allegedly confessing the crime to federal investigators. So-called Ponzi schemes pay early investors with money from later participants. Madoff faces as much as 20 years in prison, a \$5 million fine and forfeiture of his assets. He hasn't formally responded to the charges or entered a plea.

Madoff lawyer Ira Sorkin declined to comment on the tax consequences of losses linked to his client.

"If an investor loses money to a Ponzi scheme, that can be claimed as a theft loss for tax purposes," said Martin Shulkin, managing partner of law firm Duane Morris LLP's Boston office. "The claim should be made for the year you discover the loss, and is subject to a reasonable expectation of recovery."

Shulkin represents about 30 Madoff investors, most of whom invested directly with Madoff's brokerage, Bernard L. Madoff Investment Securities LLC. The firm is being liquidated by the Securities Investor Protection Corp., a U.S. agency set up four decades ago to cover losses when brokerages fail.

SIPC Option

Direct customers of Madoff have the option of filing loss claims with SIPC, he said. If they have reasonably determined they are unlikely to recover their loss through a SIPC claim, they may opt to use a theft-loss deduction instead, Shulkin said.

Under the theft-loss provision, eligible victims who don't file a SIPC claim would have their deductions lowered by the \$500,000 cap on SIPC coverage for securities losses, said Bloomfield. Kevin McCue, a spokesman for Irving Picard, the lawyer hired by SIPC to oversee brokerage claims, declined to comment on the tax process.

The Internal Revenue Service has taken the position that the loss from a single occurrence has to exceed \$100 and that the total loss has to be more than 10 percent of an individual's adjusted gross income for the year the deduction is claimed, Bloomfield said.

"Under disclosure rules, IRS can't discuss any specific cases," the agency said in statement e-mailed by spokeswoman Theresa Branscome.

In the IRS view, someone with an income of \$500,000 wouldn't be able to deduct the first \$50,100 in losses. Bloomfield said he disagrees that the \$100/10 percent limitation applies to a theft-loss deduction, given amendments to the tax code.

20-Year Carry Forward

If the loss is greater than the taxpayer's income the year the theft is discovered, it can be carried back three years and forward 20 years to reduce taxable income.

The theft-loss deduction is also an option for people who gave their money to so-called feeder funds, such as hedge fund Fairfield Greenwich Group, that invested with Madoff, Shulkin said.

"We believe it is unlikely that investors in Madoff feeder funds will be successful in recovering SIPC claims," he said.

Taxpayers may also file amended returns going back as much as three years to adjust for income they didn't actually earn.

"People have been filing income tax returns reporting gains and income that were phantom," Stephanie Casteel, a tax partner at Atlanta law firm King & Spalding LLP, said in a phone interview.

Bloomfield said someone who gave, say, \$1 million to Madoff to invest and then recorded gains of \$3 million over the years, might have paid tax on that amount. A taxpayer might claim a \$4 million theft-loss deduction, using the gain and the \$1 million principal, he said.

A Refund Instead

If the IRS denies the deduction for the fake \$3 million, the taxpayer could try for a refund claim. Refunds might be claimed on reported income going back further than the typical three year limit, he said.

Mortner Law Office PC in New York is running an ad on Google Inc.'s Web site that offers help to investors with getting money back from the IRS under the headline: "Madoff - Tax Refunds." According to the Mortner Web site, "These are not simple claims."

The IRS has been a beneficiary of Madoff's alleged scheme because it received taxes on what may have been billions of dollars in reported phony profits, said Brad Friedman, a securities litigator at Milberg LLP in New York.

"That's where most of the money went," he said.

Not everyone agrees the theft-loss tax route will be more fruitful than filing SIPC, bankruptcy claims or lawsuits.

It Depends

"It's going to depend on people's individual situations, and whether legislation gets enacted that lets people restate their taxes for more than three years," Friedman said.

"I think, through the claims process, if done properly, people will recover a lot more," said Blair Fensterstock, a trial lawyer at Fensterstock & Partners LLP in New York who has been tracking the Madoff litigation and hasn't yet filed any claims for clients. "I also think the government isn't in any mood to give back money to taxpayers, especially wealthy taxpayers."

The SIPC case is Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC, 08-01789, U.S. Bankruptcy Court, Southern District of New York (Manhattan). The criminal case is U.S.A. v. Madoff, 1:08-mj-02735, and the SEC case is Securities and Exchange Commission v. Madoff, 1:08-cv-10791, both U.S. District Court, Southern District of New York (Manhattan).

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