DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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April 26, 2010

Number: **2010-0227**
Release Date: 12/30/2010

CONEX-113514-10

UIL: 165.04-00

The Honorable Orrin G. Hatch
United States Senate
Washington, DC 20510

Attention:

Dear Senator Hatch:

I am responding to your letter, dated March 10, 2010, on behalf of your constituents, . wrote about the differences in the tax treatment between the losses direct and indirect investors sustained from the fraud Mr. Bernard L. Madoff perpetrated. said they lost funds in their personal savings, a charitable remainder trust, and their Individual Retirement Accounts (IRAs).

Revenue Ruling 2009-9 explains the income tax law that applies to investors who lost money in a fraudulent investment arrangement and are entitled to a theft loss deduction. Revenue Procedure 2009-20 provides an optional safe harbor treatment for qualified investors who lost money in certain fraudulent investment arrangements.

Qualified investors under the revenue procedure include only investors that transferred cash or property to the perpetrators of the fraudulent scheme. These direct investors include individuals, partnerships, limited liability corporations, and other "persons" as defined in section 7701(a)(30) of the Internal Revenue Code (the Code). The primary reason for the restriction to direct investors in Rev. Proc. 2009-20 is because they are the party from which the perpetrator of the fraudulent arrangement stole money or property, and thus the proper party to compute and claim a theft-loss deduction under section 165 of the Code.

However, this restriction does not prevent indirect investors from benefitting from the safe harbor treatment. For example, partners in a feeder fund can deduct their share of a theft-loss deduction the fund claimed. A charitable remainder trust (CRT) is exempt from federal income tax (although it may be subject to excise taxes). CRTs differ from IRAs and section 401(k) retirement plans in that a CRT is an entity separate from its

grantor for income tax purposes, with its own separate return filing requirements. Because under current law, only a direct investor may claim theft losses arising from a Ponzi scheme, only a trustee, on behalf of a CRT, may claim losses arising from the Ponzi scheme. However, the CRT must be a qualified investor under Revenue Procedure 2009-20, which would affect the amount and character of the distributions made to its beneficiaries.

For investments held in tax-deferred vehicles such as IRAs, the Code limits a loss or other deduction to the taxpayer's cost or other "basis" to prevent multiple deductions or exclusions for the same amount. If taxpayers have basis in a tax-favored retirement plan or IRA (for example, because they made after-tax contributions to an IRA), they can take a miscellaneous itemized deduction to the extent they have unrecovered basis after their entire interest in the plan or IRA is distributed.

If taxpayers have no basis in the retirement plan or IRA (for example, because they claimed a deduction for IRA contributions or because we have not taxed the growth in value in the IRA), they cannot take a deduction for the economic loss in the plan or IRA. In this situation, the tax effect of the economic loss is that economic income that we never taxed, or we taxed but then an IRA deduction offset it, will not be taxed now or in the future. Allowing taxpayers with no basis in a retirement plan or IRA to take a loss deduction for amounts that they deducted or excluded from gross income would provide those taxpayers two deductions, or both a deduction and an exclusion, for the same dollars. Two deductions also would put those taxpayers in a more favorable tax position than other taxpayers who contributed to a retirement plan or IRA on an after-tax basis and sustained a Ponzi scheme economic loss of the same or a similar amount (and thus received only one tax deduction).

I hope this information is helpful. If you have additional questions, please contact or at .

Sincerely,

John P. Moriarty
Chief, Branch I
(Income Tax & Accounting)