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Ponzi Scheme Victims Get a Tax Break

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WASHINGTON—The Internal Revenue Service announced unprecedented tax relief for victims of Ponzi schemes, saying those affected can deduct up to 95% of their losses immediately.

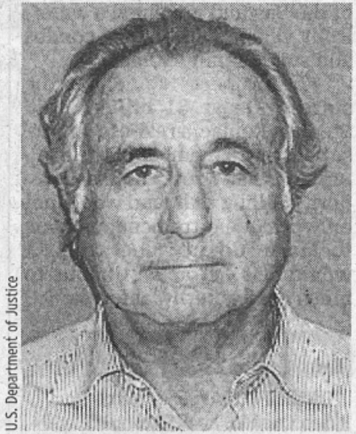
The move, which corresponded with a congressional hearing on the issue Tuesday, represents a significant relaxation of longstanding limits on tax relief for victims of investment scams. It reflects the pressure officials are feeling to help individuals who have been hurt in the current financial crisis, particularly at a time when public resentment is growing over the billions of dollars the government is directing into troubled banks and other big corporations.

The IRS action drew praise from lawmakers, who have been pondering legislation to help victims of swindlers such as Bernard Madoff, who has pleaded guilty to securities fraud and other charges, after confessing to running a $65 billion Ponzi scheme. "It's a rare day when someone can be happy with the IRS," said Sen. Charles Schumer (D., N.Y.) at the hearing held by the Senate Finance Committee.

The IRS guidance is more favorable to victims than prior positions the agency has taken, said Robert Willens, a New York tax adviser.

In broad terms, the IRS said Ponzi scheme victims who aren't suing to recover their losses can generally deduct up to 95% of their qualified losses—minus any potential recoveries from insurance or the Securities Investor Protection Corp.—in the year the fraud is discovered. Those pursuing third-party recoveries can deduct 75% of relevant investments, after potential recoveries. The Securities Investor Protection Corp., or SIPC, is an organization designed to help investors at failed brokerage firms.

The IRS said victims wouldn't be subject to limits that apply to personal casualty or theft losses and could carry back net operating losses five years to offset taxes paid, or forward 20 years. Under prior rules, many investors had to subtract $100 and 10% of their adjusted gross income from their loss deductions,



U.S. Department of Justice

Mugshot of Bernard Madoff

and could carry back losses only three years, or forward 20 years.

In another change, the IRS said investors can include their principal, as well as any so-called phantom income they have received over the years, in their theft-loss deductions. Previously, the IRS allowed some Ponzi scheme victims to deduct only their principal as a theft loss, not phantom income.

The changes left open a number of questions, including how to help people who had invested in Ponzi schemes through nontaxable accounts such as Individual Retirement Accounts. People who invested indirectly through feeder funds potentially face a more complex situation in getting relief under the changes.

Sen. Charles Grassley of Iowa, the ranking Republican on the Senate Finance Committee, said he was concerned that the guidance would "encourage tax cheats to take abusive deductions."

IRS Commissioner Douglas Shulman said any taxpayers who seek the new relief must file special forms identifying themselves as Ponzi victims. That will make it easier for the IRS to monitor claims and "look behind these, so we don't have a lot of fraud," he said.

The government has also limited tax-loss claims by individual investors that apply to normal losses from trading, due to concerns that it could result in a large loss of government revenue. But Sen. Maria Cantwell (D., Wash.) Tuesday said Congress should consider liberalizing those rules to help more consumers.