

## **(0.) INTRODUCTION**

We analyze here the US-tax implications for an interesting 2008 theft loss. The loss is from an individual's brokerage account (in the taxpayer's name) managed by Bernard Madoff. Assume that the victim's taxes were timely filed for all previous years. Further assume that there were no profits or losses in the managed accounts in question, but rather money was transferred from one client account to another in order to redeem account holders, without their knowledge or approval. If this is not true, then the actual profits and losses will bear on the taxation.

In Section (1.), we discuss three avenues to recoup money paid in taxes on income from this account, where that income did not exist. In Section (2.) we discuss the principal legal paradigm that should be used by the Bankruptcy Court in the Southern District of Manhattan.

## **(1.) RECOVERY OF PREVIOUS-PAID TAX**

First, the loss in this account is an IRS Code Section 165 ordinary loss, which reduces the taxpayer's 2008 ordinary income. This loss will be the amount stolen from their account(s), minus any SIPC payment(s). If this ordinary loss results in a net operating loss for 2008, then he or she may carry back the net loss against taxes paid in 2005, 2006 and 2007, and forward for up to 20 years.

Second, the taxpayer can amend his or her 2005, 2006, and 2007 tax returns to reflect any income reported from that brokerage account(s) that did not in fact occur. He or she may then file, under Section 6511, for a refund from the taxes paid in 2006, 2007, and 2008, based on those carrybacks losses and amended returns.

Third, the taxpayer can also deduct, on their 2008 return, tax paid in any previous year on items (e.g., Madoff brokerage account income that did not exist), that meet the criteria of Section 1234 (a). There is no time limit on such previous year. This obscure section allows the taxpayer to reduce their tax payment, in the current year, by the greater of the reduction in tax paid: from the item being removed from that previous tax year, or from it being a deduction in the current tax year.

### **(1.1) THEFT LOSS IN 2008**

The loss from theft of an asset, purchased in any transaction entered into for profit, is governed by Section 165. Theft loss occurs for tax purposes in the tax year it is discovered. That is 2008 for the loss in question.

*"Sec. 165 Losses*

*(a) General rule*

*There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.*

*(b) Amount of deduction*

*For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.*

*(c) Limitation on losses of individuals*

*In the case of an individual, the deduction under subsection (a) shall be limited to--*

*(1) losses incurred in a trade or business;*

*(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and*

*(3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.*

*(d) Wagering losses*

*Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.*

*(e) Theft losses*

*For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss."*

Since these losses in question are not those of Section 165 (c) (3), they are not "personal casualty losses" as defined in Section 165 (h) (4) (B), and thus are not subject to the excess over \$100 and to the excess over 10% of the tax payer's AGI, that is defined in that paragraph. In Section 165 (b), Section 1011 values the loss at its cost basis.

### **(1.2) CARRY-BACK & CARRY FORWARD 2008 NET-OPERATING LOSS**

SECTION 172 (a) and (b) governs the length of time from: (i.) filing a tax return in a given year, to the (ii.) filing of a request for a refund of taxes, paid for that given year, based on a net operating loss in a subsequent year. Note that in this particular process no amendment is filed for the given year that the refund is requested from. Section 172 (b) (A), as modified by (F) (i) and F (ii) (I), allows loss "from theft" to be carried back 3 years rather than 2 years, and then forward for 20 years. Regulation 1.172-4 (b) (1) tells us the carry backs and carry forward loss is always to the oldest available year first.

"Sec. 172 Net operating loss deduction

(a) *Deduction allowed*

*There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.*

(b) *Net operating carrybacks and carryovers*

(1) *Years to which loss may be carried*

(A) *General rule*

*Except as otherwise provided in this paragraph, a net operating loss for any taxable year--*

- (i) *shall be a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and*
- (ii) *shall be a net operating loss carryover to each of the 20 taxable years following the taxable year of the loss."*

.....

(F) *Retention of 3-year carryback in certain cases*

(i) *In general*

*Subparagraph (A)(i) shall be applied by substituting "3 taxable years" for "2 taxable years" with respect to the portion of the net operating loss for the taxable year which is an eligible loss with respect to the taxpayer.*

(ii) *Eligible loss*

*For purposes of clause (i), the term "eligible loss" means--*

- (I) *in the case of an individual, losses of property arising from fire, storm, shipwreck, or other casualty, or from theft,*
- (II) *in the case of a taxpayer which is a small business, net operating losses attributable to federally declared disasters (as defined by subsection (h)(3)(C)(i)), and*
- (III) *in the case of a taxpayer engaged in the trade or business of farming (as defined in section 263A(e)(4)), net operating losses attributable to such federally declared disasters.*

### **(1.3.) FILING FOR REFUND OF TAX OVERPAYMENTS IN ANY PREVIOUS YEAR**

Section 6511 (a) governs the maximum length of time between (i.) a tax payer filing for a credit or refund of previous overpayment of taxes; and (ii.) the date that such original filing was made or paid. It allows refund for such overpayment of tax for 2005, 2006, and 2007.

"(a) *Period of limitation on filing claim*

*Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid. Claim for credit or refund of an overpayment of any tax imposed by this title which is required to be paid by means of a stamp shall be filed by the taxpayer within 3 years from the time the tax was paid."*

#### **(1.4) AMEND CURRENT RETURN FOR PREVIOUS OVERPAYMENT OF TAX**

The income reported in prior years, that did not occur, clearly fits the criteria of Section 1341 (a) (1) and (2). Thus, the taxpayer is free to amend his or her returns for such years. Note that this involves the the current year's tax, and not an amendment of or refund of a previous year.

*"Sec. 1341 Computation of tax where taxpayer restores substantial amount held under claim of right*

*(a) General rule*

*If--*

- (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;*
- (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and*
- (3) the amount of such deduction exceeds \$3,000,*

*then the tax imposed by this chapter for the taxable year shall be the lesser of the following:*

- (4) the tax for the taxable year computed with such deduction; or*
- (5) an amount equal to--*

*(A) the tax for the taxable year computed without such deduction, minus*

*(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years)."*

After such a reduction in tax for the current tax year is established, it is like any other loss. It can be carried back and forward just like any other loss. Thus under Section 172.

*(b) Special rules*

- (1) If the decrease in tax ascertained under subsection (a)(5)(B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.*

#### **(3.) LEGAL PARADIGM**

The losses in question are not that of a partner of a hedge fund or an investor in a mutual fund that lost money. Rather the losses are money stolen from the individual brokerage account of the victim. The stolen funds were the direct property of the victim, just as if it were money in their house that was stolen. Thus, analogies made in the press between the Madoff theft and that of the Bayou Fund thief, discovered in 2005, are misplaced. There, the victims had ownership of partnership shares of a hedge fund, which in turn, owned the stolen assets. The usual bankruptcy paradigm is appropriate for the Bayou Fund, but not for the Madoff-managed individual accounts. One does not use the usual bankruptcy paradigm for a thief that stole money from many peoples' houses, but it is fine for a partnership that is bankrupt from theft. Of course many victims of a burglar might sue burglar, and end up in court over the now-bankrupt thief's assets, that were not stolen property.

However, the theft at hand was stealing money from one client and giving it to another. Thus, in a stolen-property paradigm, the court should return the stolen property from the holder to the rightful owner. For the Madoff victims, that would be the court taking money from victims, who received

out more money than they put into their accounts, and giving it (in some pro-rata manner) to those victims that took out less than they put in to their accounts. The first complicating factor is that some former victims are in foreign countries and out of reach of the court. The second complicating factor is that there might have been some trading that made or lost money in some accounts. This would require an accounting. If that is not practical, then some rough assumption should be made, e.g., trading did not occur.