



One Minute Memo[®]

Some States (Most Recently, New York State) Have “Weighed In” on Tax Treatment of Madoff-Related and Other Ponzi Scheme Losses

As described in our previous Management Alert, *Some Tax Guidance (and Tax Relief) for Madoff (and Other Ponzi Scheme) Victims* (03/19/2009), and our follow-up One Minute Memo, *May 15, 2009 Deadline For Certain Taxpayers with Madoff/Other Ponzi Scheme Losses (Follow-up to March 19, 2009 Management Alert)* (03/31/2009), the Internal Revenue Service issued on March 17, 2009 both: (a) Revenue Ruling 2009-9, which sets forth the Internal Revenue Service's view of the United States federal income tax treatment of Madoff-related and other Ponzi scheme losses; and (b) Revenue Procedure 2009-20, which provides a “safe harbor” procedure for taxpayers to compute and report such losses.

Since the Internal Revenue Service's issuance of Revenue Ruling 2009-9 and Revenue Procedure 2009-20, some states have issued guidance on the tax treatment of Madoff-related and other Ponzi scheme losses for state income tax purposes, with New York State being the most recent state to do so. Set forth below are those states that have issued such guidance to date and a general summary of such guidance.¹

New York: On May 29, 2009, the New York State Department of Taxation and Finance issued guidance (TSB-M-09(7)I) on the reporting of Madoff-related or other Ponzi scheme losses. In general, New York State will recognize the Revenue Procedure 2009-20 safe harbor. Thus, if a taxpayer computes his/her federal theft loss deduction based on this safe harbor, then such deduction amount will be used in computing the taxpayer's New York State itemized deduction.² In addition to individuals, these guidelines also apply to estates and trusts, S corporation shareholders and partners/members of partnerships/limited liability companies (based on the rules for attributing pro rata shares of such losses). This guidance also provides that, in addition to the general prohibition against New York nonresidents carrying back or forward a net operating loss (NOL) to a year during which they were New York residents, New York nonresidents would also generally not be permitted to carry back or forward any NOL attributable to a Madoff-related or other Ponzi scheme loss since such loss would not qualify as a loss attributable to a business, trade, profession or occupation carried on in New York. Taxpayers desiring to take advantage of this guidance 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” and should attach to such return a copy of their federal Form 4684 and the statement executed pursuant to Revenue Procedure 2009-20.

¹ A taxpayer with Madoff-related or other Ponzi scheme losses should consult with the actual state guidance before taking any position/undertaking any action viz. that state's income tax law.

² To this end, New York tax law reduces the itemized deductions by up to: (a) 25% for single taxpayers with New York adjusted gross income (NY AGI) in excess of \$100,000, married taxpayers filing jointly with NY AGI in excess of \$200,000 and heads of household with NY AGI in excess of \$150,000; and (b) an additional 25% for taxpayers with NY AGI in excess of \$475,000. For 2009 and subsequent taxable years, taxpayers with NY AGI in excess of \$1,000,000 may not claim non-charitable itemized deductions.

Connecticut: On April 9, 2009, the Connecticut Department of Revenue Services released Connecticut Announcement No. 2009(7), which describes the effect for Connecticut income tax purposes of the reporting of Madoff-related or other Ponzi scheme losses under the Revenue Procedure 2009-20 safe harbor and under Revenue Ruling 2009-9. In general, Connecticut does not allow federal itemized deductions for Connecticut income tax purposes. Thus, any theft loss deduction claimed by a taxpayer under the Revenue Procedure 2009-20 safe harbor will not affect a taxpayer's 2008 Connecticut income tax liability. However, if the amount of a taxpayer's theft loss deduction allowed under Revenue Ruling 2009-9 or Revenue Procedure 2009-20 creates an NOL, then the taxpayer must file amended Connecticut income tax return(s) for the year(s) to which such NOL may be carried back for federal income tax purposes. Such amended returns must be filed within 90 days after amending the taxpayer's federal income tax returns. Taxpayers that did not rely on the Revenue Procedure 2009-20 safe harbor or that did not report losses in accordance with Revenue Ruling 2009-9 (but instead chose to file amended federal income tax returns for years for which the statute of limitations has not yet expired) are required to file amended Connecticut income tax returns within 90 days of amending their federal income tax returns. If amending federal income tax returns for open years creates an NOL, a taxpayer must file amended Connecticut income tax returns for the carryback years within 90 days after amending the taxpayer's federal income tax returns.

New Jersey: On April 2, 2009, the New Jersey Division of Taxation had issued guidance on the treatment of Madoff-related or other Ponzi scheme losses for New Jersey gross income tax purposes. Under this guidance, taxpayers are allowed a theft loss deduction for New Jersey gross income tax purposes in an amount equal to the original investment plus the income reported in prior years minus distributions received in prior years. New Jersey does not allow NOL carrybacks or carry forwards. Taxpayers that have already filed their 2008 New Jersey gross income tax returns may file amended 2008 returns to include the Madoff-related or other Ponzi scheme loss deduction.

California: On March 25, 2009, the California Franchise Tax Board announced that the federal guidance (Revenue Ruling 2009-9 and Revenue Procedure 2009-20) regarding the treatment of Madoff-related or other Ponzi scheme losses would be generally applicable for California purposes. However, to the extent that federal and California law differ, California law will control. To this end, California law does not currently allow carrybacks or carry forwards of NOLs. Taxpayers may use the form provided in Appendix A to Revenue Procedure 2009-20 to report Madoff-related or other Ponzi scheme losses for California income tax purposes.

Massachusetts: On March 20, 2009, Massachusetts issued: "Notice—Individual Investors; Investments in Criminally Fraudulent Ponzi-type Schemes and Reporting of Fictitious Investment Income." Massachusetts did not adopt the Revenue Procedure 2009-20 safe harbor in the case of individual investors since Massachusetts tax law does not recognize the theft loss deduction provided under federal tax law. Pending further guidance, taxpayers that paid income tax in prior years for fictitious income reported from a Madoff-related or other Ponzi scheme may submit a claim for refund by applying for an abatement of tax. The application for abatement must be filed on Massachusetts Form CA-6 within the longer of: (i) three years from the due date of the return (without regard to extensions); (ii) two years from the date the tax was assessed; or (iii) one year from the date the tax was paid. The application must be accompanied by adequate substantiation.

For more information on the recent state-issued guidance as to the state income tax treatment of Madoff-related or other Ponzi scheme losses, please contact the Seyfarth Shaw attorney with whom you work, or any Tax attorney on our website.