Before It's Too Late: Reconsidering The IRS Relief for Madoff Losses

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In this article, Skillman analyzes the tax treatment of previously reported phantom income from a Ponzi scheme and concludes that the IRS had no legal basis to deny the applicability of section 1341. Accordingly, he recommends that Madoff investors and other Ponzi victims who have claimed safe harbor theft loss deductions under Rev. Proc. 2009-20 consider whether to relinquish those deductions when section 1341 combined with reduced theft loss deductions would provide greater tax relief, even if in a later tax year.

In early 2009, just months after the disclosure of Bernard Madoff's Ponzi scheme, the IRS issued Rev. Proc. 2009-20,[1] which offers generous and simplified tax relief to a defrauded Ponzi investor in the form of a safe harbor theft loss deduction for the tax year in which the fraud was discovered, irrespective of whether the taxpayer had a reasonable prospect in that year of recovering any portion of the loss. The theft loss allowed under the safe harbor includes fictitious phantom income reported to the investor (and to the IRS) by the Ponzi operator in years before discovery, provided the phantom income had been reported as gross income. For the Madoff scheme, which is the focus of this article, the safe harbor relief enabled investors to claim theft loss deductions for the 2008 tax year for up to 95 percent of their investments, including previously reported phantom income, less any withdrawals and potential recoveries from the Securities Investor Protection Corp. Because the IRS recognized that theft losses from profit-seeking investments are fully allowable to individuals as itemized deductions and are treated as business expenses for purposes of computing net operating losses, the safe harbor theft loss deductions available under Rev. Proc. 2009-20 provided substantial tax benefits to most Madoff investors.

However, for other Madoff investors, those theft loss deductions had limited value,[2] and in particular, the portion of their theft loss deductions attributable to previously reported phantom income may have resulted in substantially less tax reduction than the tax previously paid on the phantom income. By contrast, if section 1341 were applicable to the previously reported phantom income, it would give those taxpayers refundable payment credits equal to the income tax previously paid on the phantom income, while still allowing them theft loss deductions for the portion of their net investments (exclusive of previously reported phantom income) for which they have no reasonable prospect of recovery. Depending on individual circumstances, the combination of these two forms of tax relief could substantially exceed the value of the safe harbor theft loss deductions available to Madoff investors under Rev. Proc. 2009-20,[3] even though the tax benefits would likely be realized in a later tax year or years.

Concurrent with Rev. Proc. 2009-20, the IRS issued Rev. Rul. 2009-9,[4] which sets forth the Service's general (non-safe-harbor) position on the income tax treatment of losses from Ponzi schemes, including its view that section 1341 is inapplicable to a taxpayer's lost claim to previously reported phantom income and that such amount is properly treated as a theft loss. The IRS's rationale for denying the applicability of section 1341 is not defensible, not even close, and

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[1] 2009-14 IRB 749, *Doc 2009-5873*, *2009 TNT 50-5*.

[2] For example, an investor might have had relatively low taxable income in the years to which an NOL could be carried back and not expect to have sufficient taxable income to absorb the remaining NOL in carryforward years, or the benefit of NOLs may be diminished by alternative minimum tax rates in the applicable years. Further, in any case in which an investor's nonbusiness deductions, including state taxes, charitable contributions, and contributions to a retirement plan on behalf of a self-employed person, exceeded nonbusiness income in the loss year, the potential NOL would be reduced by that excess under section 172(b)(4).

[3] Investors claiming safe harbor theft loss deductions under Rev. Proc. 2009-20 were required to agree not to apply section 1341 to the previously reported phantom income.

[4] 2009-14 IRB 735, *Doc 2009-5872*, *2009 TNT 50-6*.

its willingness to treat a lost claim to fictitious income as a theft does not mean taxpayers must abide by that characterization. At least for the Madoff fraud, it is indisputable that such income was fraudulently misrepresented, not misappropriated, which was the ''get real'' basis of court decisions in the Madoff bankruptcy that rejected some investors' claims to phantom income. Because Madoff investors who claimed safe harbor theft loss deductions under Rev. Proc. 2009-20 did not enter into closing agreements or otherwise irrevocably commit themselves to the safe harbor relief, those who claimed safe harbor theft loss deductions may wish to reevaluate their reporting position, with particular focus on section 1341, before it is too late to amend their 2008 tax returns.[5]

Overview of Section 1341

Section 1341 was added to the code in 1954 to lessen the inequity of income inclusions under the claim of right doctrine when a taxpayer loses the right to that income in a subsequent tax year.[6] Recognizing that a later-year deduction was often insufficient to compensate for the tax cost of claim of right income under an annual tax accounting system,[7] Congress provided for a payment credit for the taxes previously paid on the claim of right income when that amount is greater than the tax reduction resulting from a current deduction (including refunds from any loss carryback) for the lost income.[8]

For section 1341 to apply, an item must have been included in gross income in a prior tax year ''because it appeared that the taxpayer had an unrestricted right to such item'' (section 1341(a)(1)), and a deduction must be allowable in a later tax 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'' (section 1341(a)(2)).[9] For purposes of section 1341, it makes no difference whether a taxpayer's allowable deduction would otherwise be limited as a miscellaneous itemized deduction.[10] The regulations use the term ''restoration'' to describe the deduction event in section 1341(a)(2),[11] but, as explained below, section 1341(a)(2) is not confined to allowable deductions involving a taxpayer's obligation to repay income that was reported in an earlier year.

Because section 1341 is confined to previously reported income, its applicability to Ponzi investors would not affect (or be affected by) their right to claim theft loss deductions for the portion of their actual investments that were misappropriated and for which they have no reasonable prospect of recovery. In other words, if section 1341 applies, their tax relief would be split between the lost claim to phantom income and the loss of their invested capital. Section 1341 would apply to the former in the year when a deduction was allowable because the investor ceased to have a claim to the previously reported phantom income; the latter would be deductible as a theft loss in the year when the extent of the investor's recovery prospects was determined.[12] Contrary to the impression of some, section 1341 is not an elective provision that taxpayers may waive or choose to ignore. When applicable, a taxpayer's income tax liability for the tax year in which a deduction is otherwise allowable must be determined under section 1341.[13]

The IRS has a well-known history of antipathy to section 1341,[14] having advanced a series of limiting

[5]The IRS has informally confirmed that Rev. Proc. 2009-20 was not intended to operate as an irrevocable election, and those taxpayers who claimed safe harbor theft loss deductions thereunder are free to amend their tax returns and relinquish the benefit of the safe harbor.

[6]The enactment of section 1341 was precipitated by the Supreme Court's decision in *United States v. Lewis*, 341 U.S. 923 (1951), in which a taxpayer was denied a refund of tax paid on an excess bonus that he was required to repay in a subsequent year.

[7]H.R. Rep. No. 83-1337, at 86-87 (1954); S. Rep. No. 83-1622, at 118-119 (1954).

[8]Section 1341(a)(4) and (5). The payment credit is fully refundable if the tax previously paid on the income exceeds the income tax that would otherwise be paid for the later year. Section 1341(b)(1).

[9]Section 1341(a)(3) further requires that the amount of the allowable deduction exceed $3,000, which is a given in the circumstances considered here.

[10]Section 67(b)(9) excludes from the definition of a miscellaneous itemized deduction ''the deduction under section 1341.'' Because section 1341 does not itself allow any deduction, section 67(b)(9) can mean only that allowable deductions described in section 1341(a)(2) are not classified as miscellaneous itemized deductions.

[11]Reg. section 1.1341-1(a)(2).

[12]*See* reg. section 1.165-1(d)(2)(i) and -8(a)(2).

[13]Because the applicability of section 1341 depends on the tax effect for the individual taxpayer, it is not a partnership item controlled by a partnership return. This implies that a partnership's agreement under Rev. Proc. 2009-20 not to apply section 1341 would not have been binding on its taxpayer-partners. However, in the absence of an amended partnership return, a partner claiming a payment credit under section 1341 partially in lieu of a theft loss shown on a partnership return would need to consider the treatment of partnership items under subchapter C of chapter 63 of the code.

[14]*See* Burgess J.W. Raby and William L. Raby, ''Civil Settlements and Section 1341 Credits,'' *Tax Notes*, Nov. 15, 2004, p. 957, *Doc 2004-21791*, or *2004 TNT 219-70* (''the IRS only grudgingly makes available the benefits of section 1341''); Edward J. Schnee, ''*Dominion Resources*: Powering Section 1341 Toward Equity,'' 16

(Footnote continued on next page.)

interpretations, some of which have been repeatedly rejected by the courts. It has contended that section 1341 does not apply when the taxpayer had an ''actual'' or ''unchallengeable'' as distinguished from a merely ''apparent'' right to the income reported in the earlier year,[15] when the loss of the right to the income was attributable to subsequent events that did not exist in the year the income was reported,[16] when the taxpayer did not have a rightful claim to the income because he procured it through wrongdoing,[17] when the deduction allowable in the later year did not involve the same circumstances or have a sufficient nexus to the previously reported income,[18] and when the taxpayer voluntarily relinquished the previously reported income and thus failed to show that it was ''established'' that the taxpayer had no right to the income.[19] Notably, however, none of the IRS's previously articulated grounds for opposing the applicability of section 1341 are apposite to a taxpayer who has paid tax on fictitious investment income reported to him by a Ponzi operator and who subsequently lost the right to receive that income. This should be the first clue that Rev. Rul. 2009-9 went astray badly in concluding that section 1341 does not apply in this context.

Claim of Right Income Under Section 1341(a)(1)

Based on Rev. Rul. 2009-9, the IRS appears to accept, at least implicitly, that previously reported phantom income from a Ponzi scheme constitutes an item that was included in gross income for a prior tax year because it appeared that the taxpayer had an unrestricted right to the item described in section 1341(a)(1). Rev. Rul. 2009-9 states that phantom income was properly included by Ponzi investors,[20] and there can be no doubt that it was included because it merely ''appeared'' to those taxpayers that they had an actual right to the income.[21]

Since the previously reported phantom income under the Madoff scheme was entirely fictitious, the IRS might have contended that it was not properly included as gross income, which would have left taxpayers with no tax relief for phantom income reported in closed years, if the mistaken reporting of the income meant that taxpayers derived no tax basis in those amounts. However, there is at least a colorable argument that the income had been constructively received. It has long been recognized that constructively received income, even under a legally void arrangement, is properly included as gross income under the claim of right doctrine,[22] and Rev. Proc. 2009-20 intimates that the constructive receipt doctrine is applicable to phantom income under a Ponzi scheme.[23] Since Madoff cashed out the account balances of customers who wanted to take their money elsewhere, any customer who chose to do so clearly received his share of the phantom income under claim of right. It would logically follow that any customer who chose not to withdraw had constructively received his share of the phantom income under claim of right. That Madoff lacked the financial resources to distribute the phantom income to all his customers does not mean that any individual customer was not in constructive receipt of the phantom income he could have withdrawn; constructive receipt is not a group concept.

Regardless of whether the IRS would assert the constructive receipt doctrine to deny a claim for refund of tax paid in an open tax year on nonexistent phantom income, it is understandable that the Service did not want to tell other taxpayers that it was just a mistake and irremediable bad luck that they paid tax in closed years on phantom income that they dutifully reported. In any case, having stated in Rev. Rul. 2009-9 that the phantom income was properly included in an investor's gross income, the IRS would be hard-pressed to explain

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Akron Tax J. 133, 152 (2001) (''from its inception, IRS has attempted to limit use of the Section'').

[15]*See* Rev. Rul. 68-153, 1968-1 C.B. 371. *But see WICOR Inc. v. United States*, 263 F.3d 659, 663 (7th Cir. 2001), *Doc 2001-21756*, *2001 TNT 159-5*; *MidAmerican Energy Co. v. Commissioner*, 271 F.3d 740, 744 (8th Cir. 2001), *Doc 2001-28694*, *2001 TNT 222-7*; *Dominion Resources Inc. v. United States*, 219 F.3d 359, 364 (4th Cir. 2000), *Doc 2000-20314*, *2000 TNT 148-5*.

[16]*See* Rev. Rul. 67-48, 1967-1 C.B. 50. *But see Dominion Resources*, 219 F.3d 359; *Van Cleave v. United States*, 718 F.2d 193, 197 (6th Cir. 1983).

[17]*See* Rev. Rul. 65-254, 1965-2 C.B. 50; *Culley v. United States*, 222 F.3d 1331 (Fed. Cir. 2000), *Doc 2000-21823*, *2000 TNT 163-9*. *But see Barrett v. Commissioner*, 96 T.C. 713 (1991).

[18]*See Pahl v. Commissioner*, 67 T.C. 286 (1976); *Blanton v. Commissioner*, 46 T.C. 527 (1966), *aff'd*, 379 F.2d 558 (5th Cir. 1967); Rev. Rul. 2004-17, 2004-1 C.B. 516, *Doc 2004-2618*, *2004 TNT 26-10*.

[19]*See Kappel v. United States*, 437 F.2d 1222 (3d Cir. 1971); *Pike v. Commissioner*, 44 T.C. 787 (1965).

[20]In addressing the inapplicability of the mitigation provisions of sections 1311 to 1314, Rev. Rul. 2009-9 says that it is the IRS's position that the taxpayer properly included the phantom income credited to the taxpayer in closed tax years.

(Footnote continued in next column.)

[21]The IRS has said that section 1341(a)(1) refers to income items to which a taxpayer had a ''semblance'' of an unrestricted right, which perfectly describes reported phantom income under a Ponzi scheme. Rev. Rul. 68-153, 1968-1 C.B. 371.

[22]*Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940). *See also Barker v. Magruder*, 95 F.2d 122 (D.C. Cir. 1938) (claim of right doctrine applies to an accrual of income though legally uncollectible).

[23]Section 8 of Rev. Proc. 2009-20 states that a taxpayer who chooses not to follow the safe harbor and files amended returns to exclude previously reported phantom income ''must establish that the amounts sought to be excluded in fact were not income that was actually or constructively received.''

how this could be true only for purposes of allowing theft loss deductions and not for purposes of section 1341(a)(1). The phantom income either was or was not properly reported, regardless of what tax remedy is applicable to a taxpayer's lost right to that income. In short, the IRS has effectively renounced any argument that section 1341(a)(1) does not encompass phantom income from a Ponzi scheme.

Applicability of Section 1341(a)(2)

Section 1341 does not itself provide for the allowance of any deduction, and section 1341(a)(2) requires that a deduction otherwise be allowable.[24] Nonetheless, long before the enactment of section 1341, the IRS and the courts recognized that a taxpayer is entitled to a deduction when he must repay or relinquish the right to an amount that has been included in gross income under claim of right,[25] and Congress assumed the allowability of such a deduction when section 1341 was enacted. The early authorities that recognized the allowance of an offsetting deduction did not tie the deduction to any particular code provision, and it is arguable that the allowance of such a deduction is required as a matter of transactional equity under an annual accounting system. That is, just as the common law tax benefit rule requires, as a matter of transactional equity, that a previously deducted item be included in gross income when an event in a later year is fundamentally inconsistent with the basis of the earlier deduction,[26] the same rationale may implicitly mandate the allowance of a deduction when a taxpayer loses the right to income previously reported under claim of right, irrespective of whether it is allowable under a specific provision of the code.[27] However, in the one case in which that issue was squarely posed, it was held (although not persuasively) that an offsetting deduction must be allowable under a specific provision of the code.[28]

For a Ponzi investor, this issue should not matter: An individual is allowed a deduction under section 165, not to exceed his adjusted basis, for any loss incurred in a transaction entered into for profit.[29] Such an investor was obviously seeking profit, and Rev. Rul. 2009-9 stipulates that an investor derives adjusted basis from previously reported phantom income. The case law also recognizes that a taxpayer has adjusted basis in previously reported income that has not been received.[30] For example, if a taxpayer previously reported compensation income as constructively received, it seems clear that he would be allowed a loss deduction under section 165 in the subsequent year in which it was established that he did not in fact have a right to receive that income, and that the deduction would be one described in section 1341(a)(2).

Lest there be any doubt on this point, the regulations provide that section 1341 applies in the tax year in which a taxpayer must relinquish his right to income that was constructively received under a claim of right and reported as gross income in a prior year.[31] Similarly, the legislative history of section 1341 provides that if an accrual basis taxpayer has accrued an item of income that is never received, section 1341 applies when the deduction accrues in the later year "although there is, of course, no amount to be repaid."[32] Thus, the concept of a "restoration" of income under section 1341(a)(2) is not confined to repayments or repayment obligations, but includes other deductions that are allowed "because it was established" that the taxpayer "did not have an unrestricted right" to the income.[33] It follows that if it is established in a subsequent tax year that a Ponzi investor has no right to receive previously reported phantom income, he should be allowed a deduction in that year, and that deduction should be recognized as one described in section 1341(a)(2).

How, then, could the IRS conclude otherwise? Devoting all of two sentences to the analysis, Rev. Rul. 2009-9 asserts that section 1341 does not apply

[24]*See United States v. Skelly Oil Co.*, 394 U.S. 678, 683 (1969).

[25]*See North American Oil Consolidated v. Barne*, 286 U.S. 417, 424 (1932). *See also Healy v. Commissioner*, 345 U.S. 278, 284 (1952); GCM 16730 (1936).

[26]*See Hillsboro Nat'l Bk. v. Commissioner*, 460 U.S. 370, 383 (1983) (noting that the purpose of the tax benefit rules is to eliminate transactional inequities that would result from strict adherence to an annual accounting system).

[27]By analogy, proposed regulations under section 409A would allow an unspecified deduction when a taxpayer has reported gross income under section 409A that is ultimately never received. Prop. reg. section 1.409A-4(g)(1).

[28]*National Life & Accident Ins. Co. v. United States*, 244 F. Supp. 135 (M.D. Tenn. 1965), *aff'd*, 385 F.2d 832 (6th Cir. 1967) (involving the deductions available to life insurance companies for years before the Life Insurance Company Tax Act of 1959).

[29]Section 165(b) and (c).

[30]*See United States v. Kleifgen*, 557 F.2d 1293 (9th Cir. 1977); *Alsop v. Commissioner*, 34 T.C. 606 (1960), *aff'd*, 290 F.2d 726 (2d Cir. 1961); *Kikalos v. Commissioner*, T.C. Memo. 1998-92, *Doc 98-8085*, *98 TNT 42-9*; *Reno Turf Club Inc. v. Commissioner*, T.C. Memo. 1979-381.

[31]Reg. section 1.1341-1(e).

[32]H.R. Rep. No. 88-1337, *supra* note 7, at A294; S. Rep. No. 83-1622, *supra* note 7, at 451.

[33]The concept of a restoration of income under section 1341 can thus be analogized to the concept of a recovery of a prior year deduction under the common law tax benefit rule. The latter hinges on the occurrence of a later-year event that is fundamentally inconsistent with the premise on which the prior-year deduction was allowed and does not necessitate an actual recovery of money or property. *Hillsboro Nat'l Bk.*, 460 U.S. 370.

on the ground that a Ponzi investor's lost claim to phantom income does not arise from an ''obligation to restore'' income, which the ruling says is necessary under section 1341(a)(2). Neither section 1341 nor the regulations thereunder speak of any requisite obligation, and the cases cited by the IRS that do refer to an obligation involve income that a taxpayer has previously received.[34] In that circumstance, an obligation to restore is necessary to show that it was established that the taxpayer did not have a right to retain the income. A taxpayer obviously cannot have an obligation to make repayment, or to do anything else, when it is established that he has no right to receive income that was previously constructively received or accrued but never reduced to his possession. Because the ''obligation to restore'' argument would make section 1341 inapplicable to all such income, this part of the IRS's rationale is just plain wrong.

Rev. Rul. 2009-9 goes on to state that when a taxpayer ''incurs a loss from criminal fraud or embezzlement . . . any theft loss to which [the taxpayer] may be entitled does not arise from an obligation on [the taxpayer's] part to restore income.'' It is almost certainly true that section 1341 does not apply to a theft of previously reported income, if that is all this statement is intended to convey. However, the IRS's willingness to allow a theft loss deduction cannot make real that which never existed, a point brought home in the Madoff bankruptcy litigation. Because the income credited to Madoff's customers was entirely fictitious, the trustee appointed to oversee the liquidation of Madoff's brokerage firm determined that customers' claims would be limited to their net investments (actual investments, less withdrawals) and thus that claims for phantom income would not be recognized. The trustee's determination was challenged by some of Madoff's customers who partially relied on the IRS guidance, arguing that the IRS recognized the fictitious profits as real income. In upholding the trustee's determination and dismissing that argument,[35] the bankruptcy court politely described the IRS's position as ''temporal, rather than part of an established statutory scheme.'' The Second Circuit affirmed, indicating that the position of the objecting customers would be appropriate if it involved property that had in fact been ''converted'' by Madoff[36] but ''would have the absurd effect of treating fictitious and arbitrarily assigned paper profits as real and would give legal effect to Madoff's machinations.''[37]

It would be no less absurd for the IRS to persist in the view that section 1341 is inapplicable based on the implicit premise that the fictitious income was real and thus that a theft had occurred. Rev. Rul. 2009-9 itself says that the word ''theft'' is defined for federal income tax purposes as a ''criminal appropriation of *another's property* to the use of the taker,''[38] and the courts have sustained the government's position that no theft loss is allowable absent proof that the property or income actually existed.[39] As confirmed by the Second Circuit, the Madoff investors were denied claims to phantom income not because it had been stolen, but because there was never any income to which they had an actual right. Whether under section 165 or general tax principles, the IRS should accept that the loss of the right to receive the previously reported phantom income gives rise to an allowable deduction squarely within the cross hairs of section 1341(a)(2).

Tax Year in Which Section 1341 Applies

The particular tax year in which a deduction for lost phantom income would be allowable and trigger the applicability of section 1341 is a separate question, and one that will matter to any Madoff investor who may wish to amend a 2008 tax return and relinquish the safe harbor theft loss deduction in favor of a section 1341 claim. If section 1341 applies in a post-2008 tax year, interest owed on repayment of a refund generated in 2008 would reduce and might exceed the comparative tax benefit of section 1341. In general, to be allowable as a deduction, a loss must be evidenced by a closed and completed transaction and there must be no claim for reimbursement for which there is a reasonable

[34]*Alcoa Inc. v. United States*, 509 F.3d 173 (3d Cir. 2007), *Doc 2007-26265*, *2007 TNT 230-10*; *Kappel v. United States*, 437 F.2d 1222 (3d Cir. 1971). The *Kappel* opinion explained that a legal obligation to restore funds was ''necessary to distinguish between cases where one never in fact had a right to an item of income and may not continue to use it as he pleases, and situations where regardless of the doubtfulness of his right to the item, *he may nevertheless continue to exercise dominion over the item*.'' 437 F.2d at 1226 (emphasis added). The *Kappel* analysis is scarcely apposite to an income item that a taxpayer has never received and over which he may not continue to exercise dominion. The *Alcoa* decision merely quotes from *Kappel*, and the court's analysis in no way suggests that section 1341 requires a restoration ''obligation.''

[35]*In Re Bernard L. Madoff Investment Securities LLC*, 424 B.R. 122, 137 (Bankr. S.D.N.Y. 2010), *Doc 2010-4596*, *2010 TNT 42-15*, *aff'd*, 654 F.3d 229 (2d Cir. 2011).

[36]*In Re Bernard L. Madoff Investment Securities LLC*, 654 F.3d at 238.

[37]*Id.* at 235.

[38]*Edwards v. Bromberg*, 232 F.2d 107, 110 (5th Cir. 1956) (emphasis added).

[39]*Kaplan v. United States*, 100 AFTR 2d 2007-5674 (M.D. Fla. 2007); *Blodgett v. Commissioner*, T.C. Memo. 2003-212, *Doc 2003-16822*, *2003 TNT 137-30*.

prospect of recovery.[40] These principles presumably govern the allowance of a deduction for a lost claim to previously reported phantom income.

For Madoff investors, it is questionable whether a deduction for the previously reported phantom income would have been allowable in 2008; it may be that too few known facts had firmly ''established'' the absence of an ''unrestricted right'' or reasonable claim to such income by the end of 2008. However, a Madoff investor would have strong grounds to contend that the previously reported phantom income became deductible by 2009, when it became clear that the bankruptcy trustee would not recover more than the net investments (actual cash investments, less withdrawals) of Madoff's customers and the trustee determined that claims for phantom income would not be recognized. Although the trustee's determination was not upheld by the bankruptcy court until 2010 (and that decision was not affirmed by the Second Circuit until 2011),[41] the case law indicates that the existence of ''a reasonable prospect of recovery'' must be judged by an objective standard and not through the eyes of an ''incorrigible optimist.''[42] Given the strong equities for the trustee's determination, any of Madoff's customers who hoped to obtain partial reimbursement of their previously reported phantom income would have had little objective basis for optimism that the trustee's 2009 determination would be overturned. As the bankruptcy court explained, this was ''a zero-sum game . . . [a]ny dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested.''[43] For that reason, even if the trustee's determination had been overturned, the effect would have been to ensure that most of Madoff's customers would recover an even smaller portion of their net investments and none of their previously reported phantom income.

Therefore, it would appear that all or most Madoff investors could properly apply section 1341 to their lost claims to phantom income in the 2009 tax year, but absent the safe harbor provided by Rev. Proc. 2009-20, they would not be entitled to theft loss deductions until the year in which the recovery prospects for their net investments could be determined with reasonable certainty. As events have unfolded in the Madoff bankruptcy, investors are eventually expected to recover substantially more than half of their net investments, but the full extent of their recoveries is unlikely to be determined until sometime after 2012. Thus, except for those who will have liquidated their claims by assignments to third parties, investors who relinquish their safe harbor theft loss deductions will be entitled to diminished theft loss deductions five or more years later than the safe harbor deductions permitted under Rev. Proc. 2009-20. Significantly, however, those investors will also avoid recognition of ordinary income under the tax benefit rule on recovery of amounts previously deducted as theft losses. Depending on individual circumstances and applicable tax rates, elimination of tax at ordinary rates on that recapture income may substantially more than offset the tax cost (including interest) of relinquishing safe harbor theft loss deductions.[44]

Conclusion

The IRS has rightly earned considerable praise for its willingness to provide timely, substantial, and certain tax relief to victims of the Madoff fraud and other Ponzi schemes. It is likely that the safe harbor theft losses allowed by the IRS will have produced greater tax relief and in an earlier tax year for most of those taxpayers than would have resulted from the application of section 1341 to their lost claim for phantom income and the allowance of a theft loss deduction for the loss of their actual net investments. They should be grateful. However, there is no ''greatest good for the greatest number'' principle under which the applicability of section 1341 can be denied to those Ponzi investors for whom it would provide greater tax relief than the IRS's expansive concept of a theft loss. It is one thing for the IRS to say that the loss of phantom income may be treated as a theft loss, as it did in Rev. Proc. 2009-20; it is quite another for the IRS to assert that tax characterization to the exclusion of any other, as it has done in Rev. Rul. 2009-9. Because there does not appear to be any legitimate basis to deny the applicability of section 1341 in this context, the IRS should reconsider and officially reverse its position. There is no reason why this issue need be resolved by the courts.

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[40]Reg. section 1.165-1(d).

[41]*In Re Bernard L. Madoff Investments Securities LLC*, 654 F.3d 229.

[42]*See, e.g.*, *Ramsay Scarlett & Co. v. Commissioner*, 61 T.C. 795 (1974), *aff'd*, 521 F.2d 786 (4th Cir. 1975).

[43]*In re Bernard L. Madoff Investment Securities LLC*, 424 B.R. at 141. Most of those who challenged the trustee's determination were the so-called net winners who had withdrawn more than their investments. If their claims to phantom income had been recognized, the claims of most of the so-called net losers (who had withdrawn less than their investments) would have been materially diluted.

[44]We are aware of several individual Madoff cases in which, apart from the applicability of section 1341, the tax savings from eliminating recapture income under the tax benefit rule will exceed the tax cost (including interest) of relinquishing the safe harbor theft loss deductions for 2008.