



## Madoff: What the Estate Planning Attorney Really Needs to Know

By: Robert S. Keebler, CPA, MST, DEP



### Overview

By now, everyone on the planet is aware that Bernard Madoff is alleged to have orchestrated a massive ponzi scheme in which investors were bilked out of an estimated \$50 billion dollars. Although the story began over 25 years ago, the latest chapter began on December 11, 2008, when the SEC in conjunction with the FBI and U.S. attorney arrested Mr. Madoff and subsequently placed his company, Bernard L. Madoff Investment Securities, LLC, into a SIPC receivership. The Bankruptcy Court appointed a trustee, Mr. Irving Picard, who is demonstrating not only tremendous legal and financial acumen, but seemingly just plain decency in administering a fraud that has left thousands devastated.

Although this article specifically addresses the Madoff fraud, some of the general principles discussed below will apply to other frauds, your clients, and perhaps some of the issues your referral sources may ask about.

The first thing a person needs to understand is that Bernard L. Madoff Investment Securities, LLC, participated in the Securities Investor Protection Corporation which will likely provide up to \$500,000 of coverage per account. There does, however, exist a somewhat overwhelming issue of whether SIPC's \$1.5 billion dollars in assets will cover all of the losses.

Additionally, it is likely that there will be some limited recovery from the bankruptcy estate. Although at this point it is impossible to determine the exact degree of recovery, a ten percent recovery would seem optimistic. To add insult to injury, it is very possible that some investors will be subject to a clawback. Although not a technical, financial or legal term, a clawback simply refers to the bankruptcy trustee's ability, in conjuncture with the Bankruptcy Court, to require investors to repay distributions from Bernard L. Madoff Investment Securities, LLC. Under New York law, it appears the trustee has the discretion to reach back up to

six years in exercising his clawback rights. In statements by Mr. Picard, it appears that he will try to separate the "winners from the losers" and that individuals that have taken funds in excess of their original investment from their Madoff investments will have a higher exposure to the clawback.

### Tax Implications

The estate planning attorney must also be aware of the potential income and estate tax implications for individuals that have invested both their outside investment accounts and their IRAs with Mr. Madoff. From a big picture perspective, the tax issues can be boiled down to two questions:

1. How does one handle "phantom income" reported in earlier years?
2. How does one properly treat the theft loss?

It is important to recognize that many investors have reported income on both closed and open year returns that can best be described as "phantom income". Simply put, what these investors believe to be income was in truth a return of their own capital. Based upon the dozens of clients we are representing, most people had such a high degree of confidence in Mr. Madoff that they withdrew very little funds from his investments over the years.

Furthermore, accordingly the question becomes "can I take the 2005, 2006 and 2007 income off of my tax returns, and secondarily, what do I do with the income I reported in years that are now closed for tax purposes?" We are hoping the IRS issues guidance on these issues. While substantial authority exists for amending the 2005 to 2007 returns to remove the "phantom income", very limited guidance exists on what to do with the closed years.

Additionally, to the extent that a taxpayer has income tax basis, they will be allowed to deduct their basis as a theft

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loss under IRC section 165. Like anything in the tax law, the amount of the deduction or even its timing is far from clear. The deduction first must be adjusted for a reasonable prospect of recovery and the timing may be affected if an investor is seeking legal recourse against anyone other than SIPC and through the Bankruptcy Court.

The deduction also gives rise to a number of tax compliance issues such as what protective claims need to be filed, whether substantial authority exists for these positions, and lastly whether these transactions give rise to a reportable transaction. A comprehensive outline is available on our website which addresses these issues<sup>1</sup>.

The estate planning attorney may also see Madoff type issues arise in the context of an estate he or she is administering. The death of an individual makes these issues very complex for estate tax purposes in that one needs to take a position as to the value of the Madoff investments on the date of the client's death. While no precise guidance exists on this, it would seem prudent to immediately make a protective claim that the security was worthless and that it should not be subject to estate tax. Furthermore, additional protective claims for a theft loss should be taken in that under IRC section 2054 theft losses are available, for estate tax purposes, during the administration of the estate. Lastly, if either of these two positions fail, an income tax deduction should be available either on the decedent's final 1040, the estate's 1041, or on the beneficiary's income tax returns. For the estate planning attorney confronted with Madoff issues a host of difficult issues arises from both the SIPC rules, the Bankruptcy Code and lastly under the Tax Code. Most importantly, the estate planning attorney will need to show care and compassion for families that have lost several generations of wealth and hard work.

*Robert S. Keebler, CPA, MST, DEP is a partner with Virchow, Krause & Company, LLP and chair of the Virchow, Krause Estate and Financial Planning Group. He is a 2007 recipient of the prestigious Distinguished Estate Planners award from the National Association of Estate Planning counsels. From 2003 to 2006, Mr. Keebler has been named by CPA Magazine as one of the top 100 most influential practitioners in the United States. His practice includes*

*family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. Mr. Keebler frequently represents clients before the IRS National Office in the private letter ruling process and in estate, gift and income tax examinations and appeals, and he has received more than 150 favorable private letter rulings including several key rulings of "first impression." He is the Editor-in-Chief of CCH's Journal of Retirement Planning and a member of CCH's Financial and Estate Planning Advisory Board. Mr. Keebler is the author of over 75 articles and columns and is the editor, author or co-author of many books and treatises on wealth transfer and taxation.*

<sup>1</sup> Please visit the Virchow Krause website at:  
<http://services.virchowkrause.com/virchowservices/Tax/Estate+Planning/>

Subsequent to the writing of this article, the Internal Revenue Service issued Revenue Ruling 2009-9 and Revenue Procedure 2009-20 as guidance regarding the reporting of theft losses for federal income tax purposes. The reader should review both the Revenue Ruling and Revenue Procedure in tandem with this article.