Madoff Swindle Could Cost Uncle Sam $17 Billion in Taxes

RACHEL BECK / AP 18dec2008

NEW YORK — Even Uncle Sam may get burned by Bernard Madoff. Investors who lost their fortunes in Madoff's alleged Ponzi scheme will end up paying far less in taxes and may even be eligible for refunds, according to accounting experts. By some estimates, the Internal Revenue Service could be out as much as $17 billion in lost tax revenue.

Bernard Madoff,
American Dream Destroyer

"This is one more thing federal, state and local officials will have to deal with," said John Berrie, a tax partner at the law firm Bryan Cave in New York City. "It's another heavy box on their back."

In addition, investors may be counting on a federally mandated insurance fund to bail them out, but that program lacks the money to pay for all the claims that are likely to come.

The timing couldn't be worse. Unemployment has surged, meaning fewer workers are paying payroll taxes. And housing prices have dropped, reducing property taxes.

The recession so far has cost the federal government $200 billion in tax revenues for the 12 months that ended in November, according to estimates by Moody's Economy.com.

The Madoff case, which reportedly involves $50 billion, adds another layer to the fiscal crisis gripping the nation.

In New York, for instance, where thousands of workers have lost jobs on Wall Street and big-name investment firms have tallied massive losses, State Comptroller Thomas P. DiNapoli has estimated tax revenues will be down at least $3.5 billion by March 2010.

In wealthy enclaves nationwide, Madoff's investors are desperately seeking ways to get some of their money back. Some refunds might come from the Securities Investor Protection Corp., an industry-funded organization set up by the government to protect investors from fraud. Investors who qualify could get as much as $500,000 from the SIPC.

But that will not replace the millions of dollars than many lost, and such payments, if they come, will not happen fast. SIPC officials this week said the books of Bernard L. Madoff Investment Securities LLC are in complete disarray. It could take six months or more to untangle them.

In addition, there are concerns that SIPC does not have enough money to pay out claims. It currently has $1.6 billion to make payouts, though the agency can tap a $1 billion line of credit and a $1 billion injection from the Treasury Department to get more money.

That's why some investors are considering the option of reporting "theft losses" under the IRS rules. Taxpayers who are defrauded by investment advisers or brokers can claim a deduction, as well as offset tax liabilities from the past.

Under the rules, an investor who lost $20 million with Madoff and whose adjusted gross income was $10 million can claim a theft loss of about $19 million.

To calculate the theft loss, investors must reduce the amount of the loss by 10 percent of their adjusted gross income plus $100, according to Robert Willens, an expert on tax and accounting issues for Wall Street clients.

That theft loss would wipe out the $3.5 million in taxes that would otherwise be payable on the $10 million in income. The losses can be carried back for three years or carried forward for 20 years.

If the losses wipe out current, past or future taxes, the end result is the same: The government loses money.

"I think the $50 billion of Madoff's losses, if they really are that big and we're not sure, could cost the government $15 to $17 billion in lost tax revenues," Willens said.

Investors are not automatically eligible for such deductions. They must prove to the IRS that they cannot recover their Madoff investments. The IRS also has not indicated yet whether Madoff's investors can apply the theft provision.

"The IRS is aware of the situation, but beyond that, we have no comment," the federal agency said in a statement Thursday.

Another potential recourse for investors would be to claim that the past taxes they paid on "fictitious income" from Madoff should be recouped, said Stephen Brietstone of the law firm Meltzer Lippe Goldstein & Breitstone who is representing Madoff investors on taxation issues.

The hurdle there is the three-year statute of limitations on amending a tax return, so that would limit investors to only the recent past even if the Madoff fraud existed long before that.

"A lot of investors put all their eggs in one basket, and they have been wiped out, so going back and getting a tax refund might be a remedy for them," Brietstone said.

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