KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

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Key Legal and Transactional Issues in a Secondary Private Equity Fund Transaction

The secondary market for private equity partnership interests has grown dramatically in both size and complexity over the last decade. The recent liquidity crunch and turmoil in the financial markets are driving many institutional investors with stakes in private equity funds, including pension funds, university endowment funds, corporations and funds of funds, to seek to "cash out." Investors are seeking to liquidate some or all of their fund interests to reallocate their assets, gain liquidity, reduce contingent funding liabilities, and manage key general partnership relationships.

Investors in private equity funds typically acquire their interest directly from a fund in a "primary" transaction, by subscribing for partnership interests at the original launch of the fund. In a "secondary" transaction, an investor in a fund sells its interest in one or more funds to a third-party buyer at a negotiated price.

Secondary sales of private equity interests involve three sophisticated parties: the buyer, the seller, and the fund itself. These transactions are usually subject to the consent of the fund's manager or the general partner due to various restrictions on the transfer of interests contained in the fund's governing documents. The buyer in a secondary transaction assumes the obligations (including capital-call obligations) of the seller under the fund's partnership agreement, and provides representations and warranties to the general partner that are substantially identical to the representations made by the original investor in a fund's subscription agreement.

Unlike the initial investors in a fund, secondary buyers are investing not just in the fund's management team and track record, but also in its existing portfolio companies. This provides the opportunity for careful due diligence and analysis of each of the fund's portfolio companies.

Purchase Price

The purchase price is based on the value of interests being sold as of a particular date (the "cut-off date"). The cut-off date is tied to the date of most recent valuation of portfolio investments by the underlying fund. At the closing, the purchase price is usually adjusted for capital contributions made by the seller (increase in purchase price) and distributions received by seller (decrease in purchase price) since the cut-off date.

Even though the price is based on a fund's portfolio valuations, particular timing considerations are important. For example, a buyer will often prefer to receive a distribution shortly after closing, rather than obtain a purchase price reduction, so that the buyer can record the distribution as a gain on investment and include it in its internal rate of return calculations.

Purchase and Sale Agreement

One of the commonly-negotiated provisions is a "material adverse change" ("MAC") clause that will permit a buyer to back out of the deal if the fund (principally, its portfolio investments) undergoes material changes before the closing. These clauses range from very broad coverage to more tailored provisions. In the current environment, buyers may demand broad MAC clauses because of their concerns about the fund's performance before the deal closes.

Other important negotiated terms include the "clawback" provision, return of distributions by limited partners, transfer of "threshold funds," and completion of "staple transactions." A "clawback" provision in a partnership agreement requires the general partner to return distributions to the partnership under certain conditions. Also, if a partnership makes "wrongful" distributions to limited partners, limited partners are required to return such distributions to the partnership. The general partner may insist that both buyer and seller be liable for such obligations. These issues are often addressed by the parties agreeing that the seller will repay the buyer (if wrongful distribution occurs), or the buyer will repay the seller (if clawback occurs).

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Where a buyer is acquiring a portfolio of different fund interests from a seller, threshold funds are sometimes specified, which must be transferred before the buyer will be required to close on the purchase of any other funds in the portfolio. This provides the buyer with the comfort that it will not be forced to buy only the less-attractive interests in a portfolio.

In a staple transaction, a general partner will seek to require that a secondary buyer commit to invest in a new fund sponsored by the same fund manager in order to obtain consent for the transfer of the interest in the existing fund. Buyers will often resist this provision because they do not want to be forced into making a primary investment.

Another commonly-negotiated issue is indemnification. General partners request indemnification for breaches of representations, warranties and covenants in transfer agreements. Buyers and sellers will typically seek to limit these indemnification requirements. Additionally, general partners will typically seek indemnification with respect to future lawsuits claiming that they failed to make disclosures about the fund or its portfolio companies.

General Partner's Consent and Other Transfer Provisions in Partnership Agreements

A fund's limited partnership agreement typically requires the general partner's consent to the transfer of the fund's interests. Some agreements provide that the general partner's consent cannot be unreasonably withheld, while in others the determination is to be made at the general partner's sole discretion. Also, general partners will often screen new limited partners to ensure that they are able to satisfy future capital calls. Transfers to affiliates, subsidiaries, parent companies, and transfers between limited partners are often carved out from the general partner's consent requirement.

Limited partnership agreements often require the delivery of a legal opinion by the transferor to the effect that the transfer will not violate the Securities Act of 1933, as amended (the "Securities Act") or any state "blue sky" laws, will not require the fund to register under the Investment

Company Act of 1940, as amended (the "1940 Act"), or the general partner to be registered under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and will comply with certain tax regulations as applicable to the fund. Some agreements also require a notice of assignment within a certain time prior to the proposed transaction.

In order to execute a transfer, an instrument of assignment is usually required in a form satisfactory to the general partner, and the general partner typically has the right to request other documentation from the transferee. Furthermore, to become a substituted limited partner, the transferee usually must execute a subscription agreement and any other documents requested by the general partner (such as a counterpart to a limited partnership agreement), pay any transfer expenses if requested, and be admitted as such by the general partner.

Limited partners often seek to modify transfer provisions in the limited partnership agreement via side letters. Side letters may include provisions requiring the general partner to consent to certain special transfers and to accept such transferees as substituted limited partners, waive the legal opinion requirement or other transfer restrictions, or agree to accept an in-house counsel's opinion. Buyers typically seek to obtain the benefits of these and any other side letters to which the seller was a party.

Tax and Regulatory Transfer Restrictions

Every transfer of limited partnership interests must comply with the fund's limited partnership agreement, federal and state securities laws, and any other applicable regulations. The parties must ensure that a secondary sale does not alter the fund's tax status, and the fund's and other parties' reliance on exemptions from the registration requirements under the Securities Act, the 1940 Act, the Advisers Act, the Employee Retirement Income Security Act ("ERISA"), and any other regulatory exemptions on which they rely.

To avoid having a fund classified as a publicly-traded partnership (and subject to taxation as a corporation), interests in the fund cannot be considered to be "readily tradable on a secondary market." Ordinarily, purchases of partnership interests by secondary funds will qualify for "safe harbors" under the tax regulations, and thus will not cause the interest to be readily tradable on a secondary market.

The sale of a partnership interest is a sale of a security that must qualify for an exemption from registration under the Securities Act. The fund and the transferors must ensure that secondary investors are "accredited investors" as defined in Regulation D promulgated thereunder, and no public advertising can be used in soliciting potential purchasers.
Moreover, depending on whether the fund relies on exemption from registration under Section 3(c)(7) or 3(c)(1) of the 1940 Act,[1] the transferee must be either a "qualified purchaser" as defined in the 1940 Act, or the transfer cannot result in the fund having more than 100 partners, respectively. Funds that rely on the "100 or fewer" owner exception under Section 3(c)(1) of the 1940 Act must be particularly aware of the so-called "look-though" rules. The 1940 Act limits the use of multi-tiered pooled investment vehicles to avoid the 100-partner limit by "looking though" an entity that invests in a 3(c)(1) fund to count the beneficial owners of the investing entity's securities as if they were direct owners of the securities of the 3(c)(1) fund.

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One such circumstance is where an investing entity that itself relies on Section 3(c)(1) or 3(c)(7) of the 1940 Act, or is a registered investment company, owns 10% or more of the 3(c)(1) fund.[2] Thus, in a 3(c)(1) fund, a buyer and seller may be required to reduce the amount of interests transferred to ensure that the seller entity will not be "looked-through," and the fund will not lose its exemption under Section 3(c)(1).

Furthermore, depending on the regulatory status of the transferee, the fund may be required to comply with other regulations. For example, if the transferee is an ERISA-regulated entity or a subsidiary of a bank holding company, the fund must comply with the applicable provisions of ERISA or the Bank Holding Company Act of 1956 as if the transferee were an original investor in the fund.
As the marketplace for these transactions becomes more sophisticated and competitive, it is important for buyers, sellers and fund managers to understand the dynamics of a secondary transaction and to be prepared for the issues that will arise.

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1 These are the most common exemptions utilized by private investment funds.

2 See Section 3(c)(1)(A) of the 1940 Act. Furthermore, the SEC staff has indicated that a 3(c)(1) fund must count toward the 100-owner limit all investors in any investing entity that was "formed for the purpose of investing" in such 3(c)(1) fund. An investing entity generally will be deemed to have been formed for the purpose of investing in a 3(c)(1) fund if, among other factors, 40% or more of its committed capital is invested in such fund.

Certain Investment Funds Are Now Eligible for Loans Under the U.S. Federal Reserve's Term Asset-Backed Securities Loan Facility

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In recent weeks, the U.S. Federal Reserve (the "Federal Reserve") and the U.S. Treasury Department (the "Treasury Department") disclosed important details relating to the operation of the Federal Reserve's Term Asset-Backed Securities Loan Facility ("TALF"). Most significantly, the Federal Reserve and the Treasury Department announced that certain investment funds will be eligible to borrow funds under TALF. The Federal Reserve Bank of New York (the "New York Fed") began accepting loan requests under TALF on March 17, 2009, and the facility's first loans will be funded on March 25, 2009.

TALF was initially intended to provide loans from the New York Fed to investors in asset-backed securities ("ABS") secured by automobile loans, student loans, credit card loans and small business loans. On February 10, 2009, U.S. Treasury Secretary Timothy Geithner announced the Treasury Department's joint effort with the Federal Reserve, known as the Consumer & Business Lending Initiative, that will, among other things, increase the aggregate amount of funds available under TALF from $200 billion to up to $1 trillion, and expand the scope of TALF to include loans to purchasers of commercial mortgage-backed securities ("CMBS") secured by commercial mortgage loans.

The Problem – A Paucity of Available Credit for Consumers and Businesses

The interest rate spreads on the highest-rated tranches of ABS secured by automobile loans, student loans and credit card loans (collectively, "Consumer Loans"), and small business loans, sponsored by the U.S. Small Business Administration (the "SBA") and fully guaranteed as to principal and interest by the full faith and credit of the U.S. government ("SBA Loans"), have widened to levels that do not correspond with the levels of default the ABS industry expects for such Consumer Loans and SBA Loans. Likewise, spreads on CMBS secured by commercial mortgage loans ("Commercial Mortgage Loans") have also widened.

The widening spreads are indicative of a significant reduction in demand for ABS secured by Consumer Loans and SBA Loans, and CMBS secured by Commercial Mortgage Loans since the end of the second quarter of 2008. The ABS markets historically have financed a substantial portion of Consumer Loans and SBA Loans, and the CMBS market, likewise, financed most Commercial Mortgage Loans. The reduction in demand for ABS and CMBS, consequently, has resulted in a drastic decline in the volume of such ABS and CMBS issuances, and a concomitant decline in the availability of credit to U.S. consumers and businesses.

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The Proposed Solution – Increase Available Credit for Consumers and Businesses

The aim of TALF is to increase the availability of credit to U.S. consumers and businesses by facilitating the renewed issuance of ABS secured by Consumer Loans and SBA Loans, and CMBS secured by Commercial Mortgage Loans. TALF will provide financing for investors to purchase such ABS and CMBS from banks and dealers in the primary and secondary markets. The Federal Reserve and the Treasury Department anticipate that ABS and CMBS investors will be willing to accept reduced spreads on ABS secured by Consumer Loans and SBA Loans, and CMBS secured by Commercial Mortgage Loans in the secondary market because TALF will be able to provide these investors with access to attractive financing similar to that once provided by other sources.

The Federal Reserve and Treasury Department expect that TALF financings and the resultant decline in spreads should increase the volume of issuances of ABS and CMBS. As a result of the anticipated increase in volume of issuances, lenders will be able to obtain additional funds from the sale of their Consumer Loans, SBA Loans and Commercial Mortgage Loans into ABS and CMBS structures, and such funds can then be used by the lenders to make new Consumer Loans, SBA Loans and Commercial Mortgage Loans to consumers and businesses.

Eligible Investment Funds

TALF funds will be available to all investment funds that are (a) organized under the laws of the United States or a political subdivision or territory thereof and (b) managed by an investment manager that has its principal place of business in the United States. Notwithstanding the foregoing, any investment fund that is controlled by a foreign government or is managed by an investment manager controlled by a foreign government will not be eligible to request loans under TALF. An entity is deemed to be controlled by a foreign government if, among other things, the government owns, controls or holds with power to vote twenty-five percent (25%) or more of a class of voting securities of the entity.

The TALF Facility

Generally, TALF loans will have a term of three (3) years and will be non-recourse to the borrowers, except in respect of breaches of representations, warranties and covenants in the loan documents. Interest on TALF loans will be payable monthly, and principal will be pre-payable at any time, in whole or in part, at the option of the borrower without penalty. If a borrower makes a partial prepayment, Eligible Collateral (as defined below) securing its loan will be released on a *pro rata* basis. The New York Fed will cease making new loans under TALF on December 31, 2009, or on such earlier date as loans totalling the maximum program size of TALF have been made.

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Eligible Collateral

A borrower must pledge Eligible Collateral to the New York Fed in order to receive a loan under TALF. The Federal Reserve and the Treasury Department have not yet provided details regarding the criteria that CMBS must conform with in order to be considered Eligible Collateral. However, the criteria for ABS have been announced.

In order to qualify as "Eligible Collateral," ABS generally must be issued on or after January 1, 2009, and must satisfy the following conditions, among others: (a) the ABS must be U.S. dollar-denominated cash ABS; (b) the ABS must be rated the highest investment grade by a major, nationally-recognized statistical rating organization (an "NRSRO") and cannot have a credit rating below the highest investment-grade rating category from any NRSRO; (c) the underlying credit exposures of

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the ABS must be Consumer Loans or SBA Loans; (d) ninety-five percent (95%) or more of the dollar amount of the credit exposures underlying the ABS securing a TALF loan must derive from U.S.-domiciled obligors; (e) the credit exposures underlying the ABS must have been originated on or after certain prescribed dates; and (f) the credit exposures that secure the ABS must be originated and securitized by a third party that is unrelated to the borrower of the TALF loan.

Both fixed- and floating-rate ABS will be eligible for financing under TALF. A borrower may pledge any combination of eligible ABS as collateral for a single TALF Loan. However, a fixed-rate ABS must be pledged against a fixed-rate loan and a floating-rate ABS against a floating-rate loan. A borrower will not be permitted to substitute collateral during the term of its TALF loan (unless the collateral is found not to be Eligible Collateral) and will not be subject to re-margining or mark-to-market requirements that otherwise would require a borrower to pledge additional collateral.

Borrower Request Procedure

The New York Fed will announce monthly TALF loan subscription and settlement dates on the first Tuesday of each month. Each borrower that requests a loan from TALF must use a primary dealer as its agent to access TALF. On each subscription date, borrowers that are interested in borrowing under TALF may request one or more TALF loans by indicating for each loan the Eligible Collateral they expect to pledge, the desired loan amount and the interest rate format corresponding to the Eligible Collateral to be pledged, be it fixed or floating. The minimum size for each TALF loan will be $10 million.

Pricing and "Haircuts"

Under TALF, the New York Fed will lend to each borrower an amount equal to the market value of the pledged Eligible Collateral minus a "haircut." The interest rate on TALF loans will vary depending on the asset class of the ABS securing the loan. TALF loans secured by ABS backed by government-guaranteed student loans will have an interest rate equal to 50 basis points over 1-month LIBOR. The interest rate on TALF loans secured by Small Business Administration Development Company Participation Certificates will be 50 basis points over the 3-year LIBOR swap rate. In the case of TALF loans secured by any other fixed rate Eligible Collateral, the interest rate will be 100 basis points over the 3-year LIBOR swap rate. For TALF loans secured by any other floating-rate Eligible Collateral, the interest rate will be 100 basis points over 1-month LIBOR. The New York Fed also will assess an administrative fee equal to 5 basis points of the loan amount on the settlement date of each loan transaction.

Losses Related to Eligible Collateral

TALF has been structured so that any losses related to Eligible Collateral will be shared by the related borrower, the Treasury Department and the Federal Reserve. Because a TALF loan will be structured as a non-recourse loan to the borrower, a borrower's risk of loss on any Eligible Collateral pledged as collateral for a TALF loan will be limited, and the first loss related to any such Eligible Collateral will be borne by such borrower in an amount up to the haircut applied to the class of assets that secures the Eligible Collateral. In the event that any Eligible Collateral incurs losses that exceed the loss of the borrower described above, the related borrower will be permitted to put the Eligible Collateral to the New York Fed in full satisfaction of the borrower's obligations to pay to the New York Fed the principal and interest on the related TALF loan. In turn, any losses related to Eligible Collateral in excess of the loss borne by the related borrower will be borne by the Treasury Department and the Federal Reserve.

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FAS 157 and IAS 39 — The Emperor's Old Clothes, But Every Cloud Has a Silver Lining

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In the Hans Christian Anderson fairy tale "The Emperor's New Clothes," the no doubt well-dressed Emperor was seduced by charlatans, hoping to make a quick profit from a fraud. They ultimately convinced him, through pretending to cut and sew imaginary fabric for his new suit, that the new suit was the best ever – and that only fools could not see the beautiful new clothes. Not wanting to admit that he could see nothing, and therefore must be a fool, the Emperor paraded around with no clothes in front of an accepting crowd, who, likewise not wanting to be seen as fools, pretended to see wonderful clothes where there were none. Only the unself-conscious little boy had the courage, or more probably naïveté, to proclaim, "the Emperor has no clothes."

While the Emperor in the story no doubt could, with embarrassment of course, put on his old clothes and resume life a little wiser, if perhaps sadder, we who know that IAS 39[1] and FAS 157[2] leave us naked and vulnerable to crowd whim cannot don our old clothes (cost-based accounting, rather than "fair-value accounting") so readily. Whether the Emperor had clothes was an objective reality, apart from what the crowd might think. Our situation is quite a bit worse, however. Whether we have any clothes at all (the fair value of our assets) is now up to the crowd, *i.e.*, the volatile market sentiment, which changes at a whim and, in times of market uncertainty and anxiety like today, can force an institution, company or individual required to use fair-market value accounting to mark down assets to levels that bear no relation to what the assets in fact have sold for in the past, their cost, or the actual sale price in the future. In other words, our economy and society are now subject to the reverse of Alan Greenspan's "irrational exuberance," as mark-to-market accounting can often appear to be "mark to today's liquidation value," based on the last sale price in an uncertain market.

As currently interpreted and applied, fair-value accounting in a time of market anxiety and declining prices seems obviously as flawed as were the Emperor's new clothes. Given such mayhem, one would have thought the first response of the International Accounting Standards Board ("IASB"), the Financial Accounting Standards Board ("FASB") and governments around the world, to a fundamental principle of society that caused this

Clearly, the experiment in fair-value accounting has been catastrophic. Thus, amendment at least should continue to be a priority for the IASB, the FASB and governments around the world.

[1] IAS 39 are accounting standards adopted by the European Commission that apply to companies stating the fair value of financial derivatives. The regulation requires companies to restate the value of their financial derivatives at the market price, instead of its purchase price.

[2] FAS 157 are accounting standards adopted in the U.S. that established the primacy of "fair value" accounting, based not on the "cost," *i.e.*, the entry value of an investment on the day of the valuation, but rather on the "exit value" of assets (and liabilities); *i.e.*, the price at which a nondistress disposition in the most favorable market between sophisticated buyers would occur.

much carnage, would be immediate amendment or repeal, as with U.S. Prohibition. It is striking that within one year of mandatory adoption in the U.S. of FAS 157, reactions by governments was surprisingly limited, with hearings in the U.S. Congress, for example, held only recently, in March 2009. The FASB in March 2009 also proposed urgent amendments to FAS 157 seeking to temper the impact of asset valuations based on distressed or forced sales in "inactive markets" by broadening the availability in certain cases of "mark-to-model" (based on economic factors such as discounted cash flow, *e.g.*) treatment where various factors suggest a "mark-to-last-sale-price" approach does not fairly reflect an asset's value.

The virtues of fair-value accounting in a liquid, confident, rising and stable market seemed to blind the world to its obvious unforeseen risks in a falling, volatile, and often illiquid market, like today's.

Certain U.S. individuals, principally conservative political commentators, urge repeal of fair-value accounting. Yet it is in Europe where the "interpretation" of the rules first returned to asset accounting some connection between valuation and business fundamentals, such as discounted cash flow, *etc*. This is reflected in the permission, given to certain banks recently, to value certain financial assets that will be held to maturity without marking them to market. In the U.S., the Securities and Exchange Commission has moved marginally by suggesting the need for relief, in cases where the market value cannot be readily determined, through models that take fundamentals into account. The recent FASB proposals referenced above address this issue and represent, on the whole, a reasonable, if quite cautious, effort in the right direction.

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To the extent a broad societal recognition of the problem can be achieved, a broad political solution seems plausible, rather than today's approach of narrow regulatory steps. Meanwhile, lawyers, working with accountants, can provide clients the best insights and support for their efforts to protect their portfolios from the devastation that fair-market accounting causes in volatile market conditions like today's.

Every product liability problem arises from a product that presumably has very positive effects in certain circumstances. The problem is unforeseen side effects, or side effects with unforeseen consequences. The virtues of fair-value accounting in a liquid, confident, rising and stable market seemed to blind the world to its obvious unforeseen risks in a falling, volatile, and often illiquid market, like today's. Obviously, the watchwords for all of us are stay tuned, as no doubt there will be major developments in the fair-value accounting arena in an attempt to restabilize financial markets decimated in part by fair-value accounting.

Every cloud has a silver lining. Obviously, mark-to-market accounting in a sometimes illiquid, volatile and declining market produces in many cases excessive write-downs. As a result, holders of excessively marked-down assets needing to sell for financial reasons can do so without further write-downs, thereby perhaps creating extraordinary opportunities for fund managers who can see past a marked-to-market balance sheet to real values, in a future rational world.

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IRS Issues Guidance on Tax Issues Faced by Investors Affected by Madoff and Other "Ponzi" Schemes

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On March 17, 2009, the Internal Revenue Service ("IRS") issued two pronouncements designed to clarify tax issues faced by investors affected by the Bernard Madoff scandal. Without specifically mentioning Madoff, the guidance is clearly aimed at his victims, along with victims of similar "Ponzi" schemes. In Revenue Ruling 2009-9, the IRS announced how it intends to treat loss deductions claimed by such investors. In Revenue Procedure 2009-20, the IRS set forth a safe harbor providing affected taxpayers the ability to claim losses on their 2008 tax returns, provided certain conditions are met.

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Revenue Ruling 2009-9 sets forth the following assumed facts, which will cover the situation of many Madoff investors:

In Year 1, A contributes to an investment account managed by B. A instructs B to reinvest any income, and later contributes additional money to the account. B issues statements to A reflecting the securities allegedly purchased for A's account, and reflecting gains and other income in A's account. A includes the gains and other items in gross income on his federal income tax return. A was able to require distributions from his account, and did receive a distribution in Year 7. In Year 8, it is revealed that B's brokerage firm was engaged in a Ponzi scheme. All of the activity reported to A, including reported income, was fictitious. When the fraud is discovered, A is unable to withdraw funds. The period of limitation for claiming a refund has expired for Years 1 through 4, but not Years 5 through 7.

Based on the foregoing, the IRS holds as follows:

- A can claim a theft loss with respect to the foregoing in Year 8, the year the loss is discovered, to the extent that the loss is not covered by a claim for reimbursement as to which A has a reasonable prospect of recovery. To the extent A's deduction is reduced by such a claim, recoveries thereon in a later year are not includible in income. If A receives a greater amount in a later year, or an amount that initially was not covered by a claim as to which there was a reasonable prospect of recovery, the recovery is includible in income in such later year, to the extent the earlier deduction reduced income tax. If less is recovered than was covered by such a claim, an additional deduction is allowed in the year the amount of recovery is ascertained with reasonable certainty.

- The loss will be deductible as an ordinary "theft" loss, rather than a capital loss, which can be offset against ordinary income as well as capital gains.

- The loss will not be subject to limitations applicable to "personal" theft losses (including a limitation reducing the deduction by 10% of adjusted gross income). The loss will also not be subject to limitations, applicable to certain other itemized deductions, that are based on an individual's adjusted gross income.

- The amount of the loss deduction should equal the amount initially invested by A in the fraudulent arrangement in Year 1, plus any additional investments, plus amounts included in gross income by A and reinvested in the arrangement; reduced by amount withdrawn from the account, and any reimbursements received or claims as to which there is a reasonable prospect of recovery, such as those from insurance or the Securities Investor Protection Corporation (SIPC).

- If the theft loss results in a net operating loss, that loss may be carried back three years, and carried forward 20 years. A may elect to carry back a loss claimed in 2008 for three, four or five years, if he averaged gross receipts between 2006-2008 of less than $15 million a year.

Revenue Procedure 2009-20 outlines a procedure that will allow "qualified investors" to claim "qualified losses" with respect to "specified fraudulent arrangements" on their 2008 tax returns without challenge by the IRS. This addresses the uncertainty that has existed as to whether a loss could be claimed for that year despite potential prospects of recovery.

"Qualified investors" are United States persons who (1) are generally qualified to deduct theft losses, (2) did not have knowledge of the fraudulent nature of the investment before it became known to the general public, (3) with respect to which the fraudulent arrangement is not a tax shelter, and (4) transferred cash or property to the fraudulent arrangement. In the case of a taxpayer who did not transfer property to the fraudulent arrangement, but invested in a fund that did so, the fund, and not the taxpayer, may be a qualified investor. Accordingly, fund investors will be entitled to claim a loss to the extent the fund takes advantage of this procedure (or otherwise claims a loss) up to their allocable shares thereof.

Revenue Procedure 2009-20 outlines a procedure that will allow "qualified investors" to claim "qualified losses" with respect to "specified fraudulent arrangements" on their 2008 tax returns without challenge by the IRS.

A "qualified loss" is defined as a loss from "specified fraudulent arrangements" in which the lead figure was charged with (or, in certain cases, subject to an allegation with respect to) a crime, such as embezzlement or a similar felony, constituting theft. A "specified fraudulent arrangement" is one in which the lead figure (1) receives cash or property from investors, (2) purports to earn income for investors, (3) reports income amounts to investors that are wholly or partially fictitious, (4) makes any payments of purported income or principal to some investors from amounts others invested, and (5) appropriates some or all of the investors' property.

Under this procedure, the taxpayer may deduct as a theft loss in the year in which the theft is discovered: (i) 95% of the loss, if the taxpayer does not pursue a claim for recovery (other than an insurance or SIPC recovery, or a claim against the parties principally responsible for the fraud) or (ii) 75% of the loss, if the taxpayer intends to pursue such a recovery. In each case, this amount must be reduced by any actual recovery or potential insurance or SIPC recovery.

By accepting this safe harbor, the taxpayer agrees not to amend returns for years that may be amended as of right (*i.e.* "open years"), nor to make any attempts to use procedures to amend years that have been closed by the statute of limitations.

If a taxpayer does not make use of the safe harbor treatment, the standard theft loss rules will be applied. This means that the taxpayer will have to prove that he or she did not have a reasonable likelihood of recovery in the year the taxpayer claims the deduction. Due to the uncertainty that surrounded the Madoff case at the close of the 2008 taxable year, this may be difficult, and the IRS may assert that the loss should more properly be claimed in a later year.

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