BNA

Daily Tax Report

Favorable Tax Consequences Related to Ponzi Schemes and the Clawback

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The definition of a Ponzi scheme is provided by the Internal Revenue Service and the legal principles governing such a scheme are found in Revenue Procedure 2009-20[1] and Revenue Ruling 2009-9.[2]

IRS calls a Ponzi scheme a ''specified fraudulent arrangement'':

> **Specified fraudulent arrangement.** A specified fraudulent arrangement is an arrangement in which (i) a party (the lead figure) receives cash or property from investors; (ii) purports to earn income for the investors; (iii) reports income amounts to the investors that are partially or wholly fictitious; (iv) makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and (v) appropriates some or all of the investors' cash or property.

Once the Ponzi scheme crashes, there are insufficient funds to meet the obligations and a trustee is appointed for the estate of the perpetrators of the Ponzi scheme. This trustee has very broad powers to recoup funds for the general estate so that the trustee can provide equity among the investors who all have been in the same investment but some have lost while others have won. This is the ''clawback.''

Clawback is a term used to describe the power that a trustee has to regain assets of a debtor that should have been available as part of the bankruptcy estate. The trustee has varying powers in this situation to recoup funds. Without explaining these laws in detail, suffice it to say, the trustee may recoup profits earned by an innocent investor in a Ponzi scheme.

The Tax Law

When this clawback occurs, generally the income clawed back from the taxpayer will be deductible by the taxpayer in the year it is paid. However, often the deduction in the year the clawback is paid may occur at a much lower tax bracket than the tax bracket that was applicable to the income when it was included in income.

To provide for tax equity under specific circumstances, the Internal Revenue Code permits a taxpayer who includes an item in gross income in one tax year and pays tax on that item, and who is compelled to return the item in a subsequent year, to calculate the deduction on the amount that is returned in a unique way. This is known as the ''mitigation'' section and is found in Section 1341 of the Internal Revenue Code[3] (the ''Code''). The mitigation provision permits a taxpayer to calculate the money that is returned either as a deduction in the year the money is repaid or at a higher tax

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[1] Rev. Proc 2009-20, 2009–14 I.R.B. 749.
[2] Rev. Rul 2009-9, 2009-14 I.R.B. 735.
[3] Code Section 1341.

rate in the year that the refunded sum was previously included in income.

The answer to whether a taxpayer may recover under the mitigation section starts with the legal principle known as the "claim of right doctrine."

The answer to whether a taxpayer may recover under the mitigation section starts with the legal principle known as the "claim of right doctrine." It was enunciated in 1932 by the Supreme Court and stands for the proposition that income received in a particular year is subject to tax when received even though it may be returned in a later year[4]:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income [on] which he is required to [pay tax], even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

The mitigation provision was needed to cure the inequities caused by this rule. Since the passage of the mitigation provision, several judicial doctrines have evolved and controversies still exist in interpreting the mitigation section. Some of these have lasted for more than 50 years. There are still different judicial views of certain of the requirements that need to be met to enjoy the benefits of Code Section 1341.

The case of *Pennzoil-Quaker State Co. v. United States*, first decided in the taxpayer's favor by the Court of Federal Claims in 2004[5] and later reversed by the Court of Appeals for the Federal Circuit in 2008,[6] clarified matters in this area of the law a great deal but also, to some extent, continued the controversy. Together, the two courts defined the five separate requirements that must be met to enjoy the benefits of the mitigation section and the judicial doctrines that have developed to clarify the law. The two analyses by these courts are helpful in better understanding this mitigation section. The two courts together explored each requirement of the section thoroughly.

The Requirements of Section 1341(a)

A clawback may require both a repayment of the taxpayer's previously taxed income earned from the Ponzi scheme and a repayment of a taxpayer's principal investment. The mitigation section does not seem applicable to a clawback of a principal payment invested in a Ponzi scheme, since the principal payment does not represent the taxpayer's "income" from the Ponzi scheme. This article focuses only on the clawback of "income items" reported by a taxpayer that arise from a Ponzi scheme.

The courts in the *Pennzoil* case considered the availability of Code Section 1341 in a situation where Pennzoil, in response to a lawsuit, refunded certain amounts of money to independent crude oil producers for alleged price fixing. Pennzoil ultimately settled the lawsuit for $4.4 million, which it tried to deduct in the prior years when the crude oil was sold instead of the year of payment. Because of the particular facts, the court in the *Pennzoil* case had to deeply analyze each one of the first four requirements of Code Section 1341 to determine its applicability in Pennzoil's situation.

At first the Court of Federal Claims ruled in favor of Pennzoil, the taxpayer, and permitted the deduction and the mitigation treatment of Code Section 1341. However, the appellate court eventually found in favor of IRS and that Pennzoil could not use Code Section 1341. Ultimately, the Federal Court of Appeals decided that though Pennzoil may have met many of the requirements of Code Section 1341, it was not entitled to 1341 treatment. The discussion of the requirements of the statute by the two courts is invaluable.

The two *Pennzoil* cases were ultimately decided on two principles, one of which was the "inventory exception." There is an exception in Code Section 1341 that does not permit the mitigation section to apply to refunds of items related to "inventory income."[7] This is because the income tax treatment of "inventory items' have their own tax framework to allow for corrections.

The Court of Federal Claims decided not to take this "inventory" exception into account. However all of the appellate court judges agreed that the overpriced oil was "inventory" to Pennzoil—that the repayment by Pennzoil was a cost to Pennzoil that would be reflected in its inventory accounting. Therefore, Pennzoil could not use Section 1341.

The appellate court also decided the *Pennzoil* case on another principle of law. As will be discussed, a divided Federal Court of Appeals, with one dissent, decided that the reason for denying Pennzoil the benefits of the mitigation section should also come under a different exception to the mitigation provision.

In spite of their differences, the *Pennzoil* courts both agreed that the language of Section 1341 requires the Plaintiff to prove that five factors have been met. The emphasis supplied below was the courts':

- an "item" must have been included in gross income for a prior taxable year (or years)[8];
- "because it appeared that the taxpayer had an unrestricted right to such item"[9];
- a "deduction" must be "allowable for the taxable year" in which the item is repaid[10];
- 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[11]; and
- "the amount of such deduction" must exceed $3,000.[12]

[4] *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932) (dictum).
[5] *Pennzoil-Quaker State Co. v. United States*, 62 Fed.Cl. 689 (2004).
[6] *Pennzoil-Quaker State Co. v. United States*, 511 F.3d 1365 (Fed. Cir. 2008).
[7] Code Section 1341(b)(2).
[8] Code Section 1341(a).
[9] Code Section 1341 (a)(1).
[10] Code Section 1341(a)(2).
[11] Code Section 1342(a)(2).
[12] Code Section 1341(a)(3).

ISSN 0092-6884

These requirements seem to be relatively straightforward and certainly there can be no question about the interpretation of the fifth requirement. However, several of these requirements are not as straightforward as they look. Each has to be understood within the tax world, where often there are exceptions to make sure special provisions, like the mitigation provision, apply only to those that are legally deserving of them. The fact that two very learned courts, the Court of Federal Claims and the Federal Court of Appeals, differed on whether the requirement of an ''item'' of income has been met shows how exacting this section is.

We will look at each of these requirements and whether they are met in the payment of a Ponzi scheme clawback.

'Item' Included in Gross Income

The first requirement for mitigation is that an ''item'' must have been included in gross income for a prior taxable year (or years). Both courts in *Pennzoil* addressed this two-part question, first by determining whether the taxpayer possessed an ''item,'' and next whether that item was ''included in gross income.''[13]

Guidance as to what is an ''item'' of gross income is found in Code Section 61. That Code section provides a specific definition for gross income and a general one. Another Code section, Section 161, provides an allowance for deductions that are also specifically listed in the Code. The income ''items'' that might be included in income in a Ponzi scheme might include any of the following found in Code Section 61.[14]

''Except as otherwise provided . . . gross income means all income from whatever source derived, including (but not limited to) the following items'':

- compensation for services, including fees, commissions, fringe benefits, and similar items;
- gross income derived from business;
- gains derived from dealings in property;
- interest;
- rents;
- royalties;
- dividends;
- annuities;
- alimony and separate maintenance payments;
- income from life insurance and endowment contracts;
- pensions;
- income from discharge of indebtedness;
- distributive share of partnership gross income;
- income in respect of a decedent; and
- income from an interest in an estate or trust.

There are in fact different tax treatments insofar as the mitigation provision is concerned when it comes to Ponzi scheme losses. The ''profits'' that create the false income in some Ponzi schemes could very well be excluded from the mitigation provision because they are a result of phony ''inventory sales.'' However, as to others types of phony profits, generally this ''phantom income'' (income that never really existed), will consist of interest, dividends, or many of the other ''items'' listed as income in the Code section.

The 'Same Circumstances' Test

The issue of whether a clawback payment represents an ''item'' of gross income for purposes of mitigation goes a step further than simply qualifying as an item under Code Section 61. In addition, the courts will review the ''item'' to determine whether the item resulted from the same circumstances as those of the original inclusion. This is known as the ''same circumstances'' test.

In short, where the later payment arises from a different commercial relationship or obligation, and thus is not a counterpart or complement of the item of income originally received, the same circumstances test precludes application of Section 1341.

The Court of Federal Claims in the *Pennzoil* case originally found that Pennzoil's repayment to its suppliers as a result of Pennzoil's alleged price fixing was from the same circumstances as the original inclusion of funds. However, the appellate court reversed the lower court and, in addition to finding Pennzoil could not use Section 1341 due to the ''inventory exception,'' found that Pennzoil's repayment did not meet the same circumstances test, which the court defined as follows:

> ''The 'claim of right' interpretation of the tax laws has long been used to give finality to [the annual accounting] period, and is . . . deeply rooted in the federal tax system.'' *Lewis*, 340 U.S. at 592. Section 1341 is an exception to the claim of right doctrine. The ''same circumstances'' test, formulated by the Tax Court, ''provides appropriate, workable limits'' to that exception. *Dominion Res. Inc. v. United States*, 219 F.3d 359, 367 (4th Cir. 2000). The limitations are that '' 'the requisite lack of an unrestricted right to an income item permitting deduction must arise out of the circumstances, terms and conditions of the original payment of such item to the taxpayer.' '' Id. (quoting *Pahl*, 67 T.C. at 290).[15]

This same circumstances test would seem to not be an issue in any Ponzi clawback situation. Nevertheless it needs to be understood. The appellate court reviewed several examples of this principle. In *Bailey v. Commissioner* case,[16] the taxpayer received dividends, salary, and bonuses as the officer of a corporation, and later paid a civil penalty for violating a Federal Trade Commission order in the work he did for the company. The taxpayer claimed that his payment of the penalty restored an item of income included in his gross income in previous years. The Court of Appeals for the Sixth Circuit then invoked the ''same circumstances'' test to deny Section 1341 relief, reasoning that the FTC penalty ''arose from the fact that Bailey violated the consent order, and not from the circumstances, terms and conditions of his original receipt of salary and dividend payments'' and that ''the amount of the penalty was not computed with reference to the amount of his salary, dividends and bonuses, and bears no relationship to those amounts.''

[13] Code Section 1341.
[14] Code Section 61(a).
[15] *Pennzoil-Quaker State* (2008) (supra).
[16] *Bailey v. Commissioner*, 756 F.2d 44, (6th Cir. 1985).

It would seem that the "same circumstances" test is generally going to be satisfied on the very face of the Ponzi clawback transaction. Had it not been for the Ponzi scheme investment, there would be no tax on, or reporting and payment of, the income that is returned in a clawback. The Ponzi investment and the clawback are directly related to each other from the same circumstances.

The clawback repayment is a direct result of the same circumstances and the same Ponzi scheme that caused the clawback victim to report income in the first place.

The Ponzi scheme clawback that represents an income item is typically going to be an "income" item listed in or encompassed by Code Section 61. The clawback is going to represent a repayment of the very same item, all from the same Ponzi scheme.

As a practical matter, any settlement agreement that is being reached in a Ponzi scheme should include language to clarify the "item" being refunded. For that matter, any settlement agreement including a clawback should be reviewed by tax counsel prior to finalization.

Included in Gross Income

The second part of the first requirement for mitigation is that the "item" must have been included in gross income for a prior taxable year. This in fact means included in gross income and subject to taxation in that prior year. This is typically not controversial in the case of a Ponzi scheme as the income from the scheme, whether actual or phantom, will have been reflected in the tax returns.

Apparent, Unrestricted Right to Such Item

The next item requires that the taxpayer had an apparent right to the gross income that the taxpayer reported in the prior year.[17] The *Pennzoil* Court of Claims found that the mitigation statute was ambiguous in defining an "apparent right" to the included income. The court turned to the legislative history of Section 1341.

The legislative history does provide guidance as to the meaning of the term "apparent" in Section 1341. In the House and Senate committee reports, the Legislature states that Section 1341 will apply "[if] the taxpayer included an item in gross income in one taxable year, and in a subsequent taxable year he becomes entitled to a deduction because the item or a portion thereof is no longer subject to his unrestricted use."[18]

Though the *Pennzoil* Court of Claims case was reversed, it was not reversed as to this finding and the court's analysis is still very helpful.

The reasoning of the court is important here because the court stressed that since the mitigation provision is remedial it should be interpreted in favor of the taxpayer. Therefore, Section 1341 should be interpreted broadly to effectuate congressional goals. Any doubts regarding the plain meaning of the statute must be resolved against the government and in favor of the taxpayer:

> [Section] 1341 is a relief provision. . . . This would encourage taxpayers to return funds they may have received inappropriately by neutralizing all negative tax impacts of the prior taxation. It should be remembered that Section 1341 is not a tax deduction provision. It does not grant taxpayers a tax benefit for amounts that are not otherwise deductible.

As to the issue of whether a taxpayer has an apparent right to income, *Pennzoil* may even stand for the proposition that when a taxpayer reports an "item" as taxable income in a tax return, a prima facie case is made that the taxpayer believed the income was the taxpayer's. As the court in *Pennzoil* put it:

> Since Quaker State took into income the [item] it is clear that Quaker State believed that it had a right to that income.

Certainly in the case of the Ponzi scheme, every objective indication is that there is an apparent right to income that is being reported by that investor. The "clawed back" income is reported on the investor's tax return, was available for distribution to investors until the crash came and, as can be seen by the many lives devastated by Bernard Madoff and other perpetrators, the funds were counted on by the Ponzi investor as real and critically important to their lives.

The Claim of Wrong Exception

To be entitled to the mitigation, a taxpayer must not only have had an apparent right to the reported income; the taxpayer must have not wrongfully obtained that income. This means that if the taxpayer had no right at all to the income when it was received, the taxpayer could not receive mitigation treatment if later that income was refunded.[19]

The IRS position is that a taxpayer cannot have any right to income for purposes of Code Section 1341, and therefore claim a deduction for its repayment, if the original income was "wrongfully obtained."[20]

Thus, Code Section 1341 does not apply to the repayment of embezzled funds because embezzled funds are included in gross income under an invalid claim of right but not under an unrestricted claim of right as is required by Code Section 1341.[21]

Not only does Code Section 1341 not apply to embezzled income, it also does not apply to any type of "ill-gotten" gains,[22] such as smuggling and kickbacks.[23] For example, in *Parks v. United States*,[24] the court held that Code Section 1341 was not available to a taxpayer who had sold a business for a fraudulently inflated price, had paid taxes on the resulting gain, had been sued by the buyer, and had repaid the inflated portion of the sales price to the buyer. The court explained that because Code Section 1341 does not apply unless it "appeared that the taxpayer had un unrestricted right" to the income, it cannot apply to the repayment of

[17] Treasury Regulations Sections 1.1341(a)(1) and (a)(2) and *Pennzoil Quaker State v. United States* (2004) (supra).

[18] H.R. Rept. No. 83-1337, at A294.

[19] Section 1341(a)(1); Treas. Reg. Section 1.1341-1(a)(1), (2).

[20] Field Service Advice 200036011, FSA 200036006, FSA 200036017.

[21] *McKinney v. United States*, 574 F.2nd 1240 (5th Cir. 1978), *cert. denied*, 429 U.S. 1072 (1979); *Yerkie v. Commissioner*, 67 T.C. 388 (1976); *O'Hagan v. Commissioner*, 70 T.C.M. 498 (1995); *Snavely v. Commissioner*, 67 T.C.M. 3056 (1994).

[22] *Perez v. United States*, 553 F. Supp. 558 (M.D. Fla. 1982); *Hankins v. United States*, 403 F.Supp.257 (N.D. Miss. 1975), *aff'd by unpub. opinion* (5th Cir. 1976)

[23] *Wood v. Commissioner*, 863 F.2d 417 (5th Cir. 1989) and *Culley v. United States*, 2000-2 USTC ¶ 50,662 (Fed. Cir. 2000); *Zadoff v. United States*, 86-2 USTC 9567.

[24] 945 F.Supp. 865. (W.D. Pa. 1996).

   ISSN 0092-6884

amounts originally obtained by the taxpayer through fraud.

This doctrine has been applied in cases of embezzlement, smuggling, kickbacks, and ill gotten gains and rarely in a civil fraud setting. However, one thing that is clear about the ''claim of wrong doctrine'' is that the doctrine cannot exist in a civil situation where there is no intentional wrongdoing.

One thing clear about the "claim of wrong doctrine" is that it cannot exist in a civil situation where there is no intentional wrongdoing.

The claim of wrong exception certainly does not apply for the typical Ponzi scheme victim. A taxpayer who loaned or invested money with a highly respected and presumably trustworthy and wealthy member of the community (who turned out to be a con man) is a victim, not a wrongdoer.

The court in *Pennzoil* explained why the claim of wrong doctrine did not apply to Pennzoil:

> [IRS] argues that [Pennzoil's] alleged price-fixing means that [Pennzoil] could not have believed [it] had an unrestricted right to the income it earned between 1981 and 1995. [This] position is buttressed by the Federal Circuit's decision in *Culley*, in which the court held that a plaintiff could not have believed that he had an unrestricted right to income, since the income was gained through an intentional wrongdoing. However, [Pennzoil] has been neither indicted nor convicted, and [Pennzoil] asserts that it ''believed at the time it made the payments to the independent oil producers that it paid them a fair and honorable sum.'' In fact, in the antitrust settlement, [Pennzoil] did not even admit liability.

The taxpayer who is subject to a clawback in the typical Ponzi scheme is much more pristine than Pennzoil. Ponzi victims invest money, are paid interest or other types of income for their loans or investments, actually receive their investment income, pay tax on that income, and then must give it all back through no fault of their own. The claim of wrong doctrine is not appropriate to such a situation.

Deduction Allowable for Year Item Repaid

The third requirement is that in the actual year of payment when the taxpayer pays the clawback, the payment must be a permitted deduction that is allowable for that taxable year. Simply put, it means that a clawback paid in the year 2011, for example, must be allowed as a deduction for that payment in the year 2011. If the clawback represents a payment of profits earned in 2006, which is repaid in 2011 and is allowed as a deduction in 2011, that payment will be allowed to be deducted at the rates applicable for 2006.

IRS itself has ruled that a direct loss from a Ponzi scheme is deductible. In the year 2009, IRS, in response to all of the pending claims for refund generated by the Madoff situation, produced two public documents, a revenue procedure and revenue ruling. Those documents make it clear that victims of a Ponzi scheme are entitled to deductions for their theft losses relating to that Ponzi scheme.

IRS has also found that a Ponzi scheme is a transaction entered into for profit.[25] Certainly a loss, such as the clawback, that is related to the taxpayer's investment in a Ponzi scheme is a result of an investment entered into for profit. Revenue Ruling 2009-9 makes it clear that Code Section 165(c)(2) applies to Ponzi schemes as transactions entered into for profit. Clearly a deduction for a theft loss would be available in 2011 to the clawback. The clawback payment should not be treated differently than the underlying Ponzi fraud.

The Deduction, the Safe Harbor, The Waiver of the Mitigation Provisions?

The revenue procedure that IRS issued in 2009 outlined an easy administrative procedure to obtain deductions resulting from a Ponzi scheme loss. A taxpayer may find that he or she wishes to use the safe harbor and that taxpayer may also be subject to a clawback. Taxpayers should not use the revenue procedure without professional advice if they are expecting a clawback.

The safe harbor requires the taxpayer to waive the right to use Code Section 1341.[26] The question is whether the waiver of Code Section 1341 is a waiver only of that right to use 1341 on a direct Ponzi theft loss, or is it a waiver of the right to use Code Section 1341 for a clawback payment in that year also?

It is not settled whether this waiver, required by the safe harbor, applies only to Ponzi scheme loss claims or also to clawbacks in general. Revenue Ruling 2009-9, which legally justifies a theft loss deduction for Ponzi schemes in the year of discovery, addressed the use of Code Section 1341 by Ponzi scheme victims applying for a direct theft loss deduction on their Ponzi scheme losses. The revenue ruling said that Code Section 1341 does not apply in the direct Ponzi loss situation.

However, that revenue ruling implies that a clawback may very well be distinguishable from a direct theft loss and may not be prohibited by the waiver of Code Section 1341 that is required by the safe harbor. This is because, as IRS points out, there is no ''restoration of funds'' in a Ponzi scheme loss. Whereas, in a clawback just such a restoration of funds does exist:

> To satisfy the requirements of § 1341 . . . a deduction must arise because the taxpayer is under an obligation to restore the income.
>
> When A incurs a loss from criminal fraud or embezzlement by B in a transaction entered into for profit, any theft loss deduction to which A may be entitled does not arise from an obligation on A's part to restore income. Therefore, A is not entitled to the tax benefits of § 1341 with regard to A's theft loss deduction.[27]

This is an accurate statement of the law on Ponzi losses. However, Revenue Ruling 2009-9, in denying that Code Section 1341 would apply to ''theft losses'' from Ponzi schemes, did not consider theft losses that result from payments of clawbacks.

In fact the revenue ruling seems to confirm that Code Section 1341 would apply to clawbacks since all that was missing according to the revenue ruling was an

[25] Rev. Rul. 2009-9, Issue 1.
[26] Rev. Proc. 2009-20, Section 6.02.
[27] Rev. Rul. 2009-9, Issue 6.

''obligation to restore.'' This is exactly what is present in a clawback, the restoration of funds.

The revenue ruling only considered direct losses from Ponzi schemes where no additional payments were required. That is not the taxpayer's case in a Ponzi scheme clawback. In a clawback situation, the losses come after the Ponzi scheme has failed and they are a result of a forced repayment, not an original payment.

Funds Restored Because Taxpayer Lacked Unrestricted Right

The fourth requirement of Section 1341 is that income is restored to another person because it was established after the close of a prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).[28] In the fourth requirement, the statute requires that when the taxpayer refunded the clawback monies, it must be clear that the taxpayer did not voluntarily return funds in order to profit from the mitigation provisions.[29]

There was a good deal of litigation on just what was meant by the ''established'' requirement. This also was clarified by the Court of Claims in the *Pennzoil* case. The bottom line is that funds cannot be ''voluntarily repaid'' and the best proof of this will be a good faith settlement agreement reached with the clawback trustee.

Pennzoil states that the ''established'' requirement is met under the following circumstances:

> The general rule is that a good faith, non collusive settlement agreement entered into to terminate litigation will ''establish'' a liability to return income, thereby establishing a lack of an unrestricted right to income for purposes of Section 1341.

The *Pennzoil* case analyzed the two landmark cases at the time that had decided this issue and the standard that must be met for a deduction under the ''established'' requirement. The *Pennzoil* case analyzed both the *Barrett* case[30] and the *Pike* case,[31] which some courts had indicated were in contradiction. However, *Pennzoil* pointed out there was no contradiction. In doing so, *Pennzoil* clarified another ''doctrine'' that has developed in the mitigation provision—the doctrine of ''voluntary payment.''

The *Pennzoil* case clarified that doctrine in this area of law, and in so doing made it perfectly clear that a taxpayer's good faith efforts in the Ponzi scheme to resist repayments of money in a fraud should meet the ''established'' requirement of the law.

[28] Section 1341 (a)(2).
[29] *Griffiths v. United States*, 54 Fed.Cl. 198 (2002).
[30] *Barrett v. Commissioner*, 96 T.C. 713 (1991).
[31] *Pike v. Commissioner*, 44 T.C. 787 (1965), *acq.* 1968-2 C.B.2. See also *Elbo Coals Inc. v. Commissioner*, T.C. Memo 1987-2.

In *Barrett*, the taxpayer had included profit from the sale of stock options in one year and then, in a later year, the Securities and Exchange Commission brought administrative proceedings against him on the basis of alleged insider trading. The taxpayer settled the case without admitting liability and claimed that the settlement payment deserved Section 1341 treatment. *Barrett* held that a settlement made at arm's length and in good faith can satisfy the ''establishment'' requirement of Section 1341, stating:

> The source of the obligation [to repay] need not be a court judgment; however, there must be a clear showing . . . of the taxpayer's liability to repay.

In contrast to *Barrett* was the *Pike* case, which involved a taxpayer who bought and sold corporate stock in one year, after which an investigator found that the profit from said stock should have gone to the corporation and not the taxpayer. The taxpayer then paid the money to the corporation, without admitting that the profits belonged to the corporation, and avoiding controversy so that he did not suffer harm to his professional career.

The *Pike* court stated that, although ''a judicial determination of liability is not required . . . it is necessary under section 1341 for a taxpayer to demonstrate at least the probable validity of the adverse claim to the funds repaid.''

Although the holdings in *Pike* and *Barrett* are different due to distinguishable facts, the point of law that they stand for is not. The primary distinction is that in *Pike* there was no suit against the plaintiff for repayment of money, which makes it more likely that the taxpayer acted voluntarily in paying the money and less likely that the taxpayer can ''demonstrate at least the probable validity of the adverse claim.'' Voluntary restitution will not meet the establishment requirements.

In *Barrett*, an actual settlement was made with the plaintiff(s) who had filed suit, the taxpayer denied liability when entering into the settlement, and there was no indication that the settlement was not made at arm's length. Under these circumstances, the taxpayer has met the establishment test. This is going to be the typical scenario in a clawback situation.

Chief Counsel Advice 200808019,[32] though not authority, is an excellent statement of the law on this issue. It also establishes standards that are all met in the case of the Ponzi scheme ''clawback victim.''

Deduction Sought Must Exceed $3,000

In a bit of an anachronism for today's times, the mitigation section also requires that the amount of the requested deduction must exceed $3,000.[33]

[32] Nov. 13, 2007.
[33] *Schwartz v. Commissioner*, 68 T.C.M. 63 (1994), Code Section 1341 (a) (3).

   ISSN 0092-6884