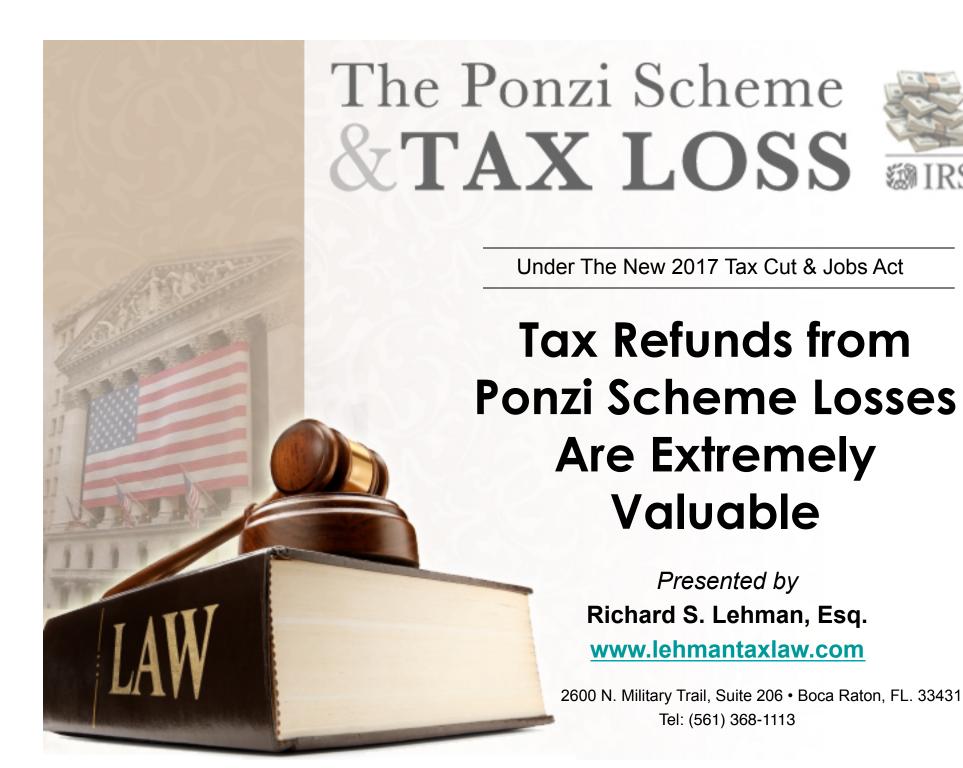
Richard S. Lehman, Esq.



ATTORNEY AT LAW
Richard S. Lehman
2600 N. Military Trail, Suite 206
Boca Raton, FL. 33431
Tel: 561-368-1113
www.LehmanTaxLaw.com

- Graduate of Georgetown Law J.D. Georgetown University
- Masters in Tax Law from New York University Law School
- U.S. Tax Court and Internal Revenue Service experience in Washington D.C.
 - » Served as a law clerk to the Honorable William M. Fay, U.S. Tax Court
 - » Senior Attorney, Interpretative Division, Chief Counsel's Office, Internal Revenue Service, Washington D.C
- The firm regularly works with law firms, accountants, businesses and individuals struggling to find their way through the complexities of the tax law.
- With nearly 55 years as a tax lawyer in Florida, Lehman has built a boutique tax law firm with a national reputation for being able to handle the toughest tax cases, structure the most sophisticated income tax and estate tax plans, and defend clients before the IRS.



Tax Refunds from Ponzi Scheme Losses Are Extremely Valuable



- Ordinary Income Loss can be used against all types of income.
- Loss Carry Backs Eliminated
- Fast Process to Receive Cash Tax Refund and Amended Returns – No Litigation Costs or Delays
- Most Secure Payer United States Government
- Can be as High as 35% Return for each Dollar Loss and more for state income tax refunds and due to the absence of deduction limitations
- Can be a lower value in future due to reduced tax rates.
- Unlimited Carry Forward
- Possibility of Receiving Interest on Tax Refunds from Prior Years

Value Can Be Lost Without Good Professional Advice The Theft Loss allows a deduction for loss sustained during the taxable year and not compensated by insurance or otherwise.



For federal income tax purposes, "theft" is a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and any other form of guile.

A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. However, a taxpayer need not show a conviction for theft.



An Investment Scheme. . .
You Were Promised Large Profits.
Received Theft Loss.





Ordinary Loss

The revenue ruling clarified the benefits of a business oriented theft loss. The Ponzi scheme loss is an ordinary <u>deduction for losses incurred in a transaction entered into for profits</u>.



The Amount of The Loss (Basis) & Phantom Income

Definition of Phantom Income:

The Revenue Ruling and the Revenue Procedure both acknowledge that:

Theft loss resulting from a Ponzi scheme is generally...

- 1. The initial amount invested in the arrangement *plus*
- 2. Any additional investments upon which taxes have been paid, less amounts withdrawn

The I.R.S. agrees that if an amount is reported to the investor as income in years prior to the **year of discovery** of the theft and the investor includes the amount in gross income; then the amount of the theft loss is increased by the purportedly reinvested amount (the "Phantom Income").



Year of Discovery

The year of discovery is very important and evidence is critical here to show exactly when and how a taxpayer can pin down this time.

We look to several examples of CASE LAW to help us to define the "year of discovery" of a theft loss.



Year of Discovery

Definition of Taxable Year of Discovery

"...any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss." A loss is considered to be discovered when a reasonable person in similar circumstances would have realized that he or she had suffered an unrecoverable loss. Although a theft loss must be considered as sustained in the year of its discovery, [The code section] does not indicate that discovery of some false representation (even amounting to theft under applicable law) creates a theft loss as of the date of the discovery of the falsity of the representation. The statue "refers to the year of discovery of the loss, not of the theft."







Reasonable Prospect of Recovery

Definition of "Reasonable Prospect of Recovery"

The taxpayer must postpone taking loss if there is a reasonable prospect of recovery.

A reasonable prospect of recovery exists when the taxpayer has a bona fide claim for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in the taxpayer's favor. The taxpayer is not, however, required to be an "incorrigible optimist" and claims with only remote or nebulous potential for success will not postpone the deduction.



Reasonable Prospect of Recovery

- In determining the reasonableness of a taxpayer's belief of loss the courts had to be practical and aware of the individual facts of a case.
- Circumstances are those that are known or reasonably could be known as of the end of the tax year for which the loss deduction is claimed. The only test is foresight, not hindsight.
- 3. Both objective and subjective factors must be examined.



Reasonable Prospect of Recovery

The taxpayer's legal rights as of the end of the year of discovery are all important and need to be studied to make a proper decision.

One of the facts and circumstances deserving of consideration is the probability of success on the merits of any claim brought by the taxpayer.

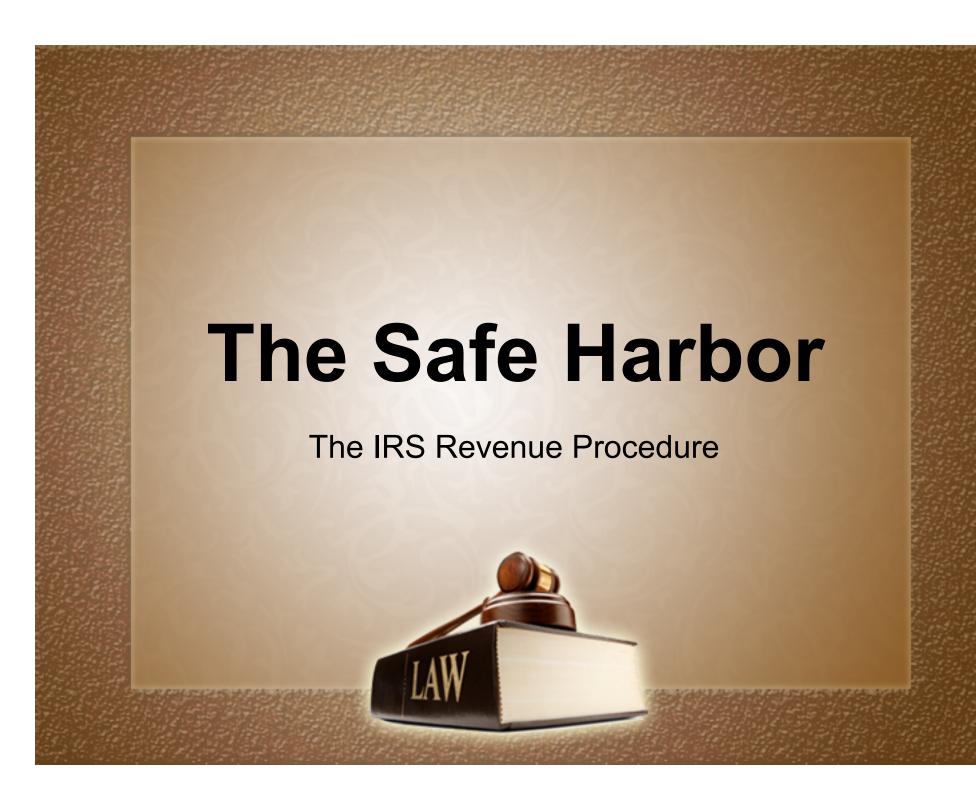
The filing of a lawsuit may give rise to an inference of a reasonable prospect of recovery. However, the inference is not conclusive nor mandatory. The inquiry should be directed to the probability of recovery as opposed to the mere possibility. A "remote possibility" of recovery is not enough; there must be "a reasonable prospect of recovery at the time the deduction was claimed, not later".



Helpful Documents

The Internal Revenue Service in the years 2009 published two very helpful documents to guide taxpayers about;

- The law of Ponzi Scheme tax recoveries (Revenue Ruling 2009-9)
- A simplified method of claiming the tax deductions so long as the financial theft met certain standards (Revenue Procedure 2009-20)

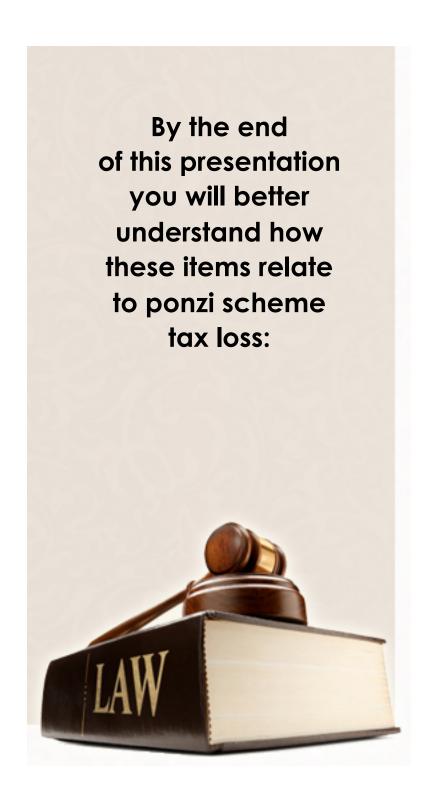




The Safe Harbor

There was also a **revenue procedure** that outlined an easy administrative process to claim refunds from **direct Ponzi losses only**. This was called the Safe Harbor.

The Safe Harbor is very meaningful for direct Ponzi Scheme victims.



THE LAW &

The Internal Revenue Ruling

THE SAFE HARBOR &

The Internal Revenue Procedure

TAX PLANNING

How the taxpayer will plan and implement his or her Ponzi scheme tax loss for maximum benefits now and in the future. This includes changes from the 2017 Tax Cut & Jobs Act.



Ponzi Schemes & Theft Loss

- Amount of the Theft Loss
- Year of Theft Loss Deduction
- Amount of Theft Loss Deduction in Year of Discovery
- Amount of Theft Loss Deduction in Later Years







- Loss carrybacks have been eliminated
- Now Unlimited carry forward as opposed to prior rules with a 20-year limitation.



Amended Returns

No Litigation Costs or Delays

- Instead of claiming a theft loss as a deduction that may be claimed in a lower tax bracket – a deduction may be obtained by amending tax returns to eliminate only the Ponzi Scheme income.
 - This may be more valuable than a theft loss deduction as an amended return from an open year will typically provide a refund from the income in a higher bracket.
- The claiming of a deduction by amending a tax return will not work if the tax year is closed.

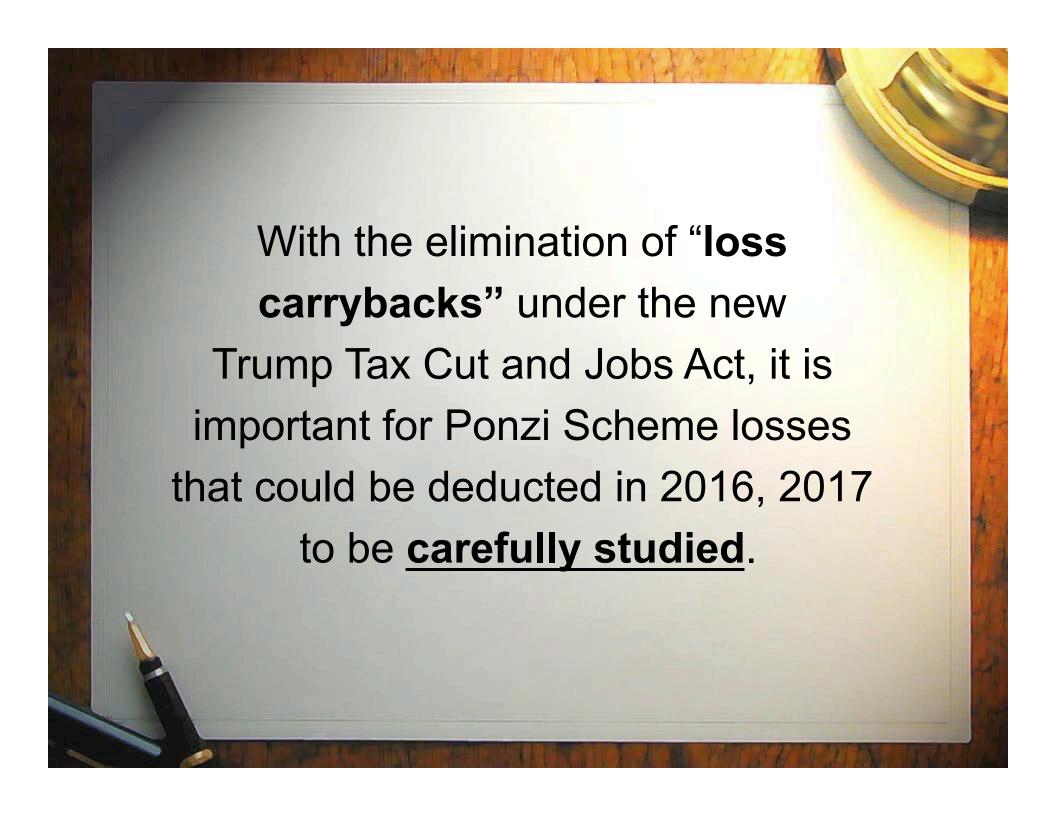
Tax Refunds from Ponzi Scheme Losses Are Extremely Valuable

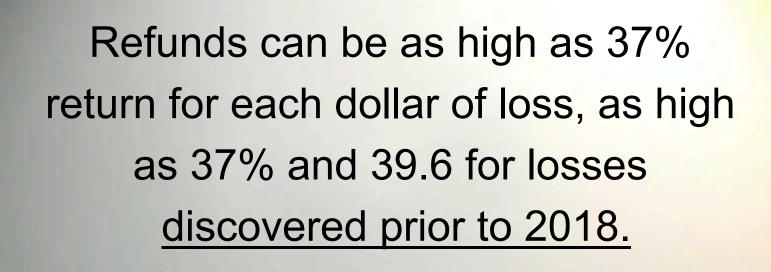




Summary

- 1. A financial theft occurs
- In the year the loss is discovered a business deduction can be claimed.
- 3. The amount that can be claimed in the year of discovery may be limited if there is a reasonable prospect of recovery.
- 4. Those deductions that could not be taken because there was a "reasonable prospect of recovery" can be taken when it is "ascertained with a reasonable certainty" that they no longer can be recovered.





Plus additional refunds from state income taxes.



Non-Business

Another new change in the Trump tax bill which does not effect Ponzi Scheme Losses, but needs to be known, non-business theft losses are no longer deductible.

The 2017 Tax Cut & Jobs Act will no longer allow a theft loss deduction for non-income producing endeavors.

IT IS CRITICAL if you have higher tax bracket losses prior to the year 2018 that the taxpayer claim as much of these losses in the proper pre 2018 years as possible.



Non-Business

This means for most taxpayers that carryback refunds can be achieved for Ponzi Scheme theft losses in the years 2016, 2017 and possible 2015.

It is also critical to be able to substantiate the discovery of the fraud in a prior year and to maximize the amount to be recovered.

This depends upon when the "reasonable prospect" of recovery no longer exists.



The Revenue Ruling (The Law) and the Revenue Procedure (The Safe Harbor)

THEFT LOSS DEDUCTIONS

 The revenue ruling defined the word "theft" for tax purposes and held that a Ponzi scheme loss was a theft loss that resulted from a "transaction entered into for profit". It was not a capital loss.



ORDINARY LOSS

 The revenue ruling clarified the benefits of a business oriented theft loss. The Ponzi scheme loss is an ordinary deduction for losses incurred in a transaction entered into for profits.



DEDUCTION IS NOT SUBJECT TO CERTAIN LIMITATIONS ON ITS USE

 As an ordinary loss, the Ponzi Theft Loss is not subject to the limits on personal deductions or the limits on itemized deductions.



DEDUCTIBLE IN YEAR OF DISCOVERY

 The theft loss is deductible in the year the loss is discovered.

AMOUNT OF THEFT LOSS IN A PONZI SCHEME



Ascertainable Standard

How much might still be recovered?

Once the taxpayer has deducted all that could be deducted in the year of discovery by reducing the loss for all reasonable prospects of recovery the tax in year two, after the discovery year, from this point on will be able to claim continuing theft loss deductions until the loss is recovered in full.

 However, at this point the taxpayer cannot deduct any more of his or her un-deducted theft loss unless the deduction can be <u>"ascertained with a reasonable certainty"</u>. This is a higher standard of proof.



Other Reductions to Qualified Investment Loss

SAME FOR SAFE HARBOR OR THE LAW

- 1. Loss Reduced by Actual Recovery Received in the year of Discovery
- 2. Loss Reduced by Insurance policies In the name of the Qualified investor
- 3. Loss Reduced by Contractual arrangements that guarantees or otherwise protects against loss of the qualified investment
- Loss Reduced by Certain Amounts Payable from the Securities
 Investor Protection Corporation (SPIC)

Quantifying the Amount of Theft Loss Deduction in Year of Discovery

The IRS Revenue Procedure SAFE HARBOR	COMPARISON OF LOSS PERMITTED	The IRS Revenue Ruling THE LAW
100%	TOTAL AMOUNT OF QUALIFIED INVESTMENT LOSS	100%
95% Loss Allowed (Loss Reduced by 5%)	"RESPONSIBLE GROUP" RECOVERY SOUGHT	Loss Reduced by any Potential Recovery from the Ponzi Scheme "Responsible Group"
75% Loss Allowed (Loss Reduced by 25%)	THIRD PARTY RECOVERY SOUGHT	Loss Reduced by any Potential Third Party Recovery

The Elimination of Non-business

Theft losses and the continued availability of the "for profit" theft loss.

The new Trump Tax law will no longer allow a theft loss deduction for non income producing endeavors.





PROFESSIONAL Tax Planning

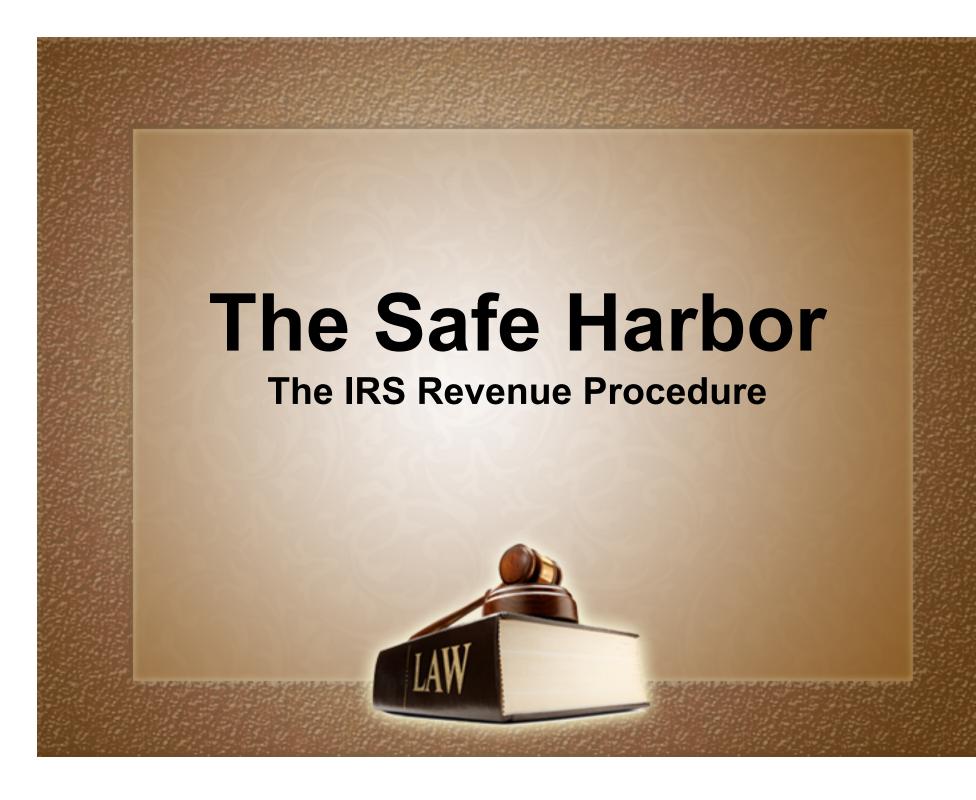
With the professional team in place, the steps generally will be as follows:

- 1. Records
- 2. Basis Calculations
- 3. Sources of Recovery
- 4. Loss in Year of Discovery
- 5. Accounting Schedules and Forecasts

These projections will be critical.

Quantifying the Amount of Theft Loss Deduction in Year of Discovery

The IRS Revenue Procedure SAFE HARBOR	COMPARISON OF LOSS PERMITTED	The IRS Revenue Ruling THE LAW 100% Loss Reduced by any Potential Recovery from the Ponzi Scheme "Responsible Group"		
100%	TOTAL AMOUNT OF QUALIFIED INVESTMENT LOSS			
95% Loss Allowed (Loss Reduced by 5%)	"RESPONSIBLE GROUP" RECOVERY SOUGHT			
75% Loss Allowed (Loss Reduced by 25%)	THIRD PARTY RECOVERY SOUGHT	Loss Reduced by any Potential Third Party Recovery		





The Safe Harbor

The Safe Harbor requires that the Ponzi scheme victims forego the opportunity to file amended returns for those years that are still open by the statute of limitations.

However, by amending a prior return instead of taking a theft loss deduction, a taxpayer can eliminate only the taxpayer's Ponzi scheme "phantom income" from the taxable income in the prior years. This will typically be the high bracket income.



Qualified Loss

(1.) The lead figure (or one of the lead figures, if more than one) was charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud, embezzlement or a similar crime that, if proven, would meet the definition of theft for purpose of the Internal Revenue Code and of the Income Tax Regulations, under the law of the jurisdiction in which the theft occurred; **or**



Qualified Loss

- (2.) The lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in this revenue procedure, and either
 - ✓ The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or
 - ✓ A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.



Qualifying For Safe Harbor

In the event the taxpayer **does not qualify** for the Safe Harbor which is often the case since many Ponzi Schemes do not reach the level of the perpetrators being found to be criminals.

There is still the distinct possibility that victims of Ponzi Schemes may recover under the Code Section in the Internal Revenue Code that permits the deduction of a theft loss that is incurred in a trade or business or a theft "transaction" entered into for profit.



Qualifying For Safe Harbor

It is very helpful when seeking the deduction to make use of a **criminal attorney** who will look at the **fact pattern of the theft** and be able to opine that the theft loss rises to the level that may warrant criminal prosecution even though the authorities have not proceeded in that direction.

NOTE: Under the 2017 Tax Cut & Jobs Act a theft loss that is **not** a result of a trade or business loss or a loss incurred in **a transaction entered into for profit** will **no longer** be the subject of **a theft loss deduction**.

Comparison of Revenue Procedure vs Revenue Ruling

The Determination	The Revenue Procedure & THE LAW & THE SAFE HARBOR VS. The Revenue Ruling					
A Ponzi Scheme Loss is a Theft Loss Deductible as an Ordinary Loss	AGREED - Result similar to Revenue Ruling	AGREED - Result similar to Safe Harbor				
The Amount of the Loss (Basis) Includes Phantom Income	AGREED - Result similar to Revenue Ruling	AGREED – Result similar to Safe Harbor				
NO Loss Carry Back of Net Operating Losses Applies for years after taxable year 2018	AGREED - Result similar to Revenue Ruling	AGREED - Result similar to Safe Harbor				
The Deduction is not Reduced by the Application of Certain Percentage or Dollar Limitations. It is a 100% Loss	AGREED – Result similar to Revenue Ruling	AGREED – Result similar to Safe harbor				
Respect for Pass Through Entities Taxpayer is not the entity	AGREED -Result similar to Revenue Ruling	AGREED - Result similar to Safe Harbor				

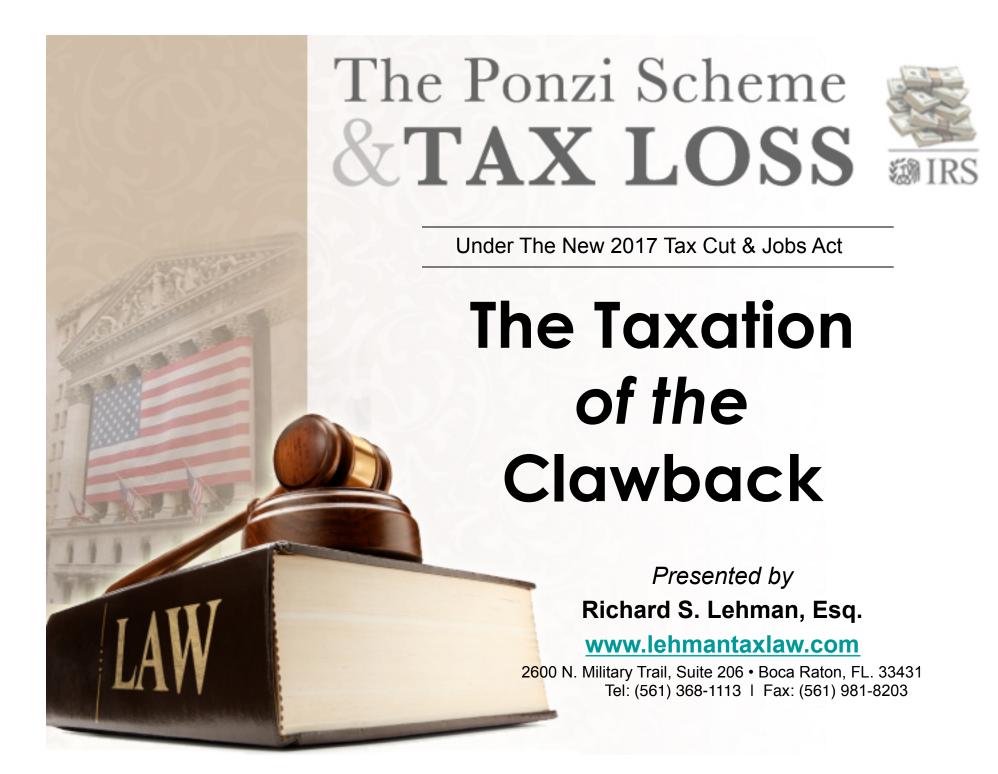
Comparison of Revenue Procedure vs Revenue Ruling

The Determination	The Revenue Procedure & THE LAW & The Revenue Ruling					
Year of Discovery Deductibility -	Agreement by I.R.S. to a defined set of events/ Criminal behavior	Taxpayer must rely on case law for similar results				
Amount of Loss Recognized in Year of Discover	Agreement by I.R.S. to specific percentage amounts	Taxpayer must rely on on case law for the setting of deductible amounts.				
Waiver of the Right to File Amended Returns	Potential Tax Benefit Not Available	Potential Tax Benefit Available				
I.R.S. Administrative Issues	Administrative Ease	Increased Proof Requirement Increased Audit Potential				



Estates & Trusts

- The theft occurs before the decedent dies and is discovered during estate administration; the estate may claim the income tax deduction.
- The theft occurs and is discovered during estate administration; the estate may claim an income tax deduction or an estate tax deduction.
- The theft occurs after the accounts have been distributed. The estate may not claim either deduction.



Deduction of Clawback & Exclusion of Clawback



GAO

nited States Government Accountability Office

Report to Congressional Requesters

The U.S.
Government
Accountability Office
(GAO) is an
independent,
nonpartisan agency that
works for Congress.
Often called the
"congressional
watchdog," GAO
investigates how the
federal government
spends taxpayer
dollars.

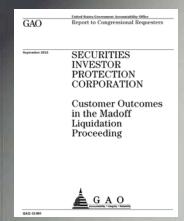
September 2012

SECURITIES INVESTOR PROTECTION CORPORATION

Customer Outcomes in the Madoff Liquidation Proceeding



GAO-12-991



Friday, October 5, 2012

Subject: GAO Madoff report

Dear Mr. Lehman,

I know it's been a while since we spoke, but I wanted to follow up with you and send a copy of our recent report.

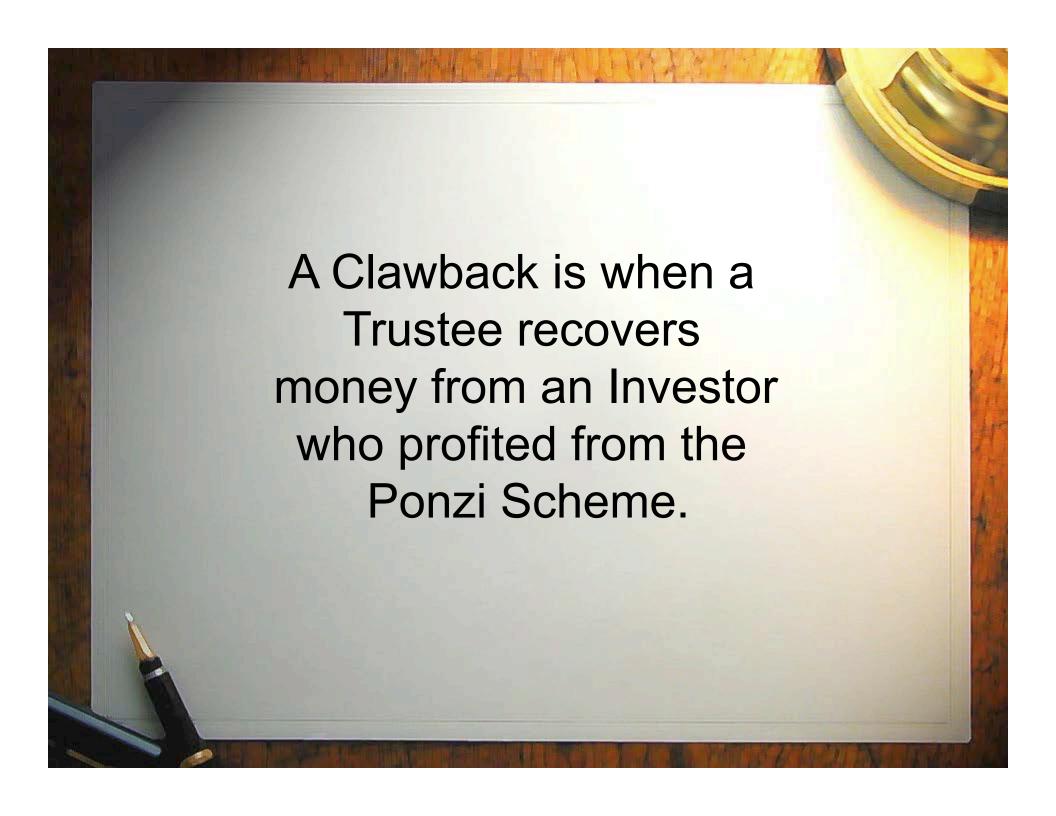
I'd like to thank you again for the help you gave us. In this case, your assistance helped produce instant results – as a direct result of the conversations we had with private sector tax professionals, the IRS issued new guidance on treatment of clawbacks. We were prepared to recommend the agency do so, but when they saw what we were going to report, they immediately issued the guidance on their own.

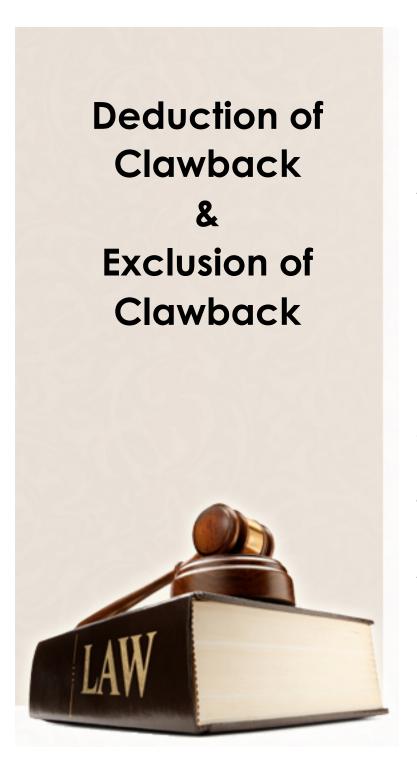
It doesn't often happen that change comes so quickly, and this wouldn't have been possible if you didn't lend us some of your expertise.

Thanks again, and best regards,

CHS

Christopher H. Schmitt, Senior analyst U.S. Government Accountability Office 441 G Street NW, Washington, DC 20548





A clawback can come many years after, and what will typically happen in a clawback is, after a taxpayer has paid the clawback, there is a deduction for the money paid to make the clawback payment in the year of payment.

That deduction can reduce the taxes in the year of the deduction and excess losses can be carried forward to be used against future income for an unlimited time period.

As a result of the new **Trump 2017 Tax Cut** and **Jobs Act**, these losses cannot be carried back.

Clawback Settlement

A clawback of <u>profits</u> earned from the Ponzi scheme or a clawback of invested <u>principal</u>.

As you will see there is a distinctly different tax treatment between the two clawbacks . . . and as a general rule.

Clawbacks allocated to profit losses may be more valuable for larger refunds but also may be more treacherous to deal with.

The Valuable Tax Refunds From "Clawback" Repayments

- I. Clawbacks
- II. Mitigation
- III. Ponzi Loss Summarize
- IV. Clawback Tax Profits
- V. Clawback Principal
- VI. Net Operating Losses

Mitigation Section

Internal revenue code section 1341

taken as an ordinary income deduction in the year in which the clawback income was originally taxed even if the year is closed by the statute of limitations; while another type of clawback payment may be deductible only in the year of payment.

CLAWBACK, REFUND OR CARRY FORWARD

IRS code section 165(c)(2)

There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Limitation on losses of individuals

In the case of an individual, the [loss] deduction . . .

Shall be limited to losses incurred in any transaction entered into for profit . . .

Theft Loss

"For federal income tax purposes, theft is a word of general and broad connotation covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and any other form of guile. A taxpayer claiming a theft loss must prove that the loss resulted from the taking of property that was illegal under the law of the jurisdiction in which it occurred, and was done with criminal intent. However, a taxpayer need not show a conviction or theft or even the bringing of an action".

A Unique I.R.S.Code Section

Since the "<u>mitigation section</u>" is complicated we are going to look at each of the elements that must be met if one is to benefit from it and why a Ponzi scheme clawback meets those definitions.

One has to understand this code section to appreciate how valuable it is.

Internal Revenue Code Section 1341

Designed to allow someone who pays funds back in a clawback to be able to go back to the year that the clawback income was earned for tax purposes and exclude that income to calculate which tax result would be more valuable.

> This permits the taxpayer to use the clawback; in the year in which the highest tax bracket and tax value is found.

Chart 1

	2022	2023	2024	2025	2026	2027	2028
Ponzi Income Other Income	200,000	0 200,000	0 200,000	0 100,000	0 100,000	0 50,000	0 50,000
Taxable Income	400,000	200,000	200,000	100,000	100,000	50,000	50,000
Average Tax Rate	30%	25%	25%	20%	20%	15%	15%
Taxes Paid	120,000	50,000	50,000	20,000	20,000	7,500	7,500
Total Tax Benefit							[7,500] + Carry Forwar

COMPARISON

Use of Mitigation	200,000	0	0	0	0	0	60,000
-------------------	---------	---	---	---	---	---	--------

Claim of Right Doctrine

The study of the mitigation section starts with "the claim of right doctrine".

✓ This tax doctrine states that if a taxpayer receives income in a particular year, but was forced to repay it in another year, the taxpayer cannot go back to the original year and correct the original year in which the income was earned. The original year most often was closed by the statute of limitations and it was impossible to unwind the statute of limitations.

Mitigation Section

The **mitigation section** has four important requirements and one requirement that is outdated by now.

They are:

- 1. An item of income must have been included in a prior taxable year.
- 2. <u>Because it appeared</u> that the taxpayer had unrestricted right to that item of income.
- 3. The taxpayer must be able to claim that in the year that the clawback was made, a deduction would be allowed for the payment.
- 4. The fourth important requirement is that it must be established <u>after</u> the close of the prior taxable year that the taxpayer did not have an unrestricted right to the income that was refunded.
- 5. The fifth requirement is that the amount of the deduction must exceed \$3,000.

The word "item" is defined in the law

In the internal revenue code, there is a definition of the word **item of gross income**, and certain specific items are listed. However, that definition is not limited just to the specific items listed. The word "income" includes all income from whatever source it is derived.

The code 61 section defines income as:

"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;

Code Section 61

- Gross income derived from business;
- Gains derived from dealings in property;
- Interest;
- Rents:
- Royalties;
- Dividends;
- Annuities;
- Income from life insurance and endowment contracts;
- Distributive share of partnership gross income;
- Income in respect of a decedent; and
- Income from an interest in an estate or trust



It is very important to keep in mind that the inventory of a taxpayer's business or transaction entered into for profit is accounted for under its own unique set of tax principals and is not within the mitigation provisions

Apparent right to the income

The legislation is designed to make sure that

- (1) no one can "voluntarily" use the mitigation section and
- (2) that income subject to mitigation was subject to the taxpayer's unrestricted right at the time of reporting.

Apparent right to the income

The mitigation section does not apply unless the taxpayer included the item in gross income in a previous year because it appeared that the taxpayer had an unrestricted right to the income.

The taxpayer must have some right to the income but need not have an unchallengeable right in the year of inclusion.

Apparent right to the income

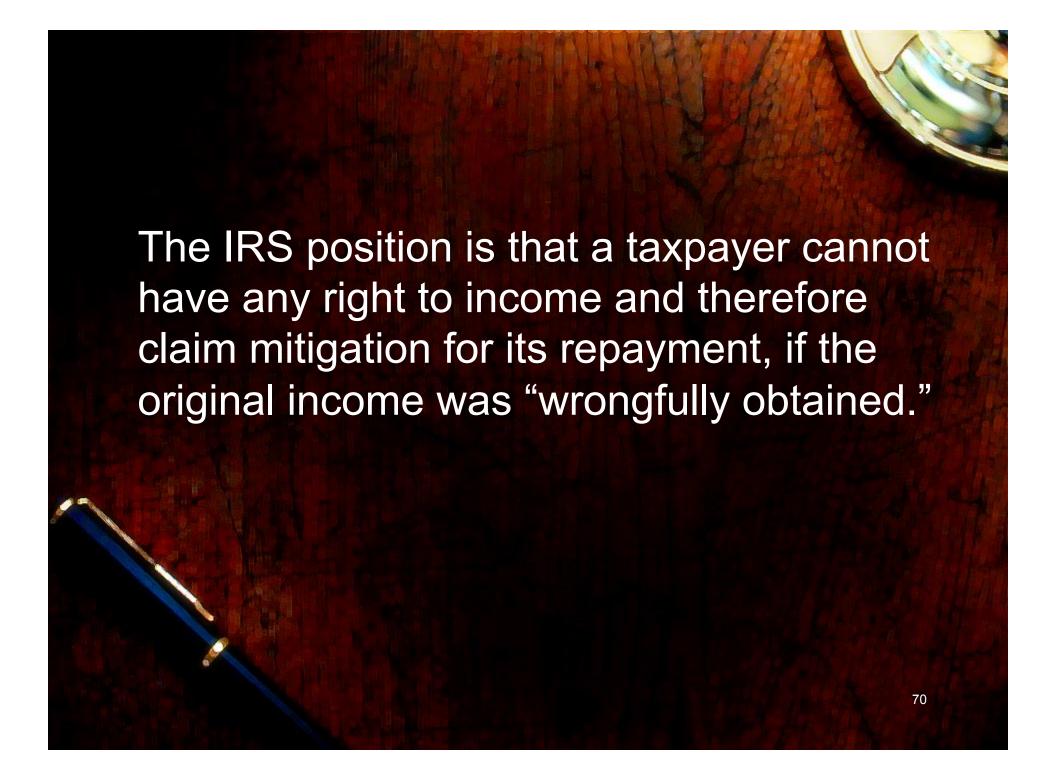
One court stated an apparent right to income may exist because a taxpayer reports an item as taxable income in a tax return, holding that a *prima facie* case is made that the taxpayer believed the income was the taxpayer's.

The court stated:

"Since [the taxpayer] took into income the item, it is clear that [the taxpayer] believed that it had a right to that income."

The claim of wrong exception to the claim of right principal

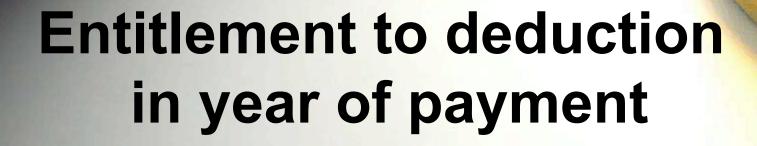
To be entitled to mitigation, a taxpayer must not only have had an apparent right to the reported income; the taxpayer must have not wrongfully obtained that income. This means that if the taxpayer had no right at all to the income when it was received, the taxpayer could not receive mitigation treatment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



The claim of wrong exception could not apply to the typical Ponzi Scheme victim.

 This is 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). This clawback payer is a victim, not a wrongdoer.

Nonetheless, every settlement agreement should include statements about the clawback victim's innocence and non-involvement in the Ponzi Scheme. And must be accompanied by a Trustee's letter attesting to the amount and nature of the clawback.



The third requirement is that the actual year of payment when the taxpayer pays the clawback, the payment <u>must be a permitted deduction in that payment year</u>.



It is not a tax deduction provision

It does not grant taxpayers a tax benefit for amounts that are not otherwise deductible.



Clawback losses are a <u>repayment</u> that was paid as profits or it is a payment of principal that was previously repaid to the Ponzi scheme investor.

Using Mitigation Section

There must be a close relationship between the item of gross income that's originally recorded and the item of gross income that is being refunded and for which a deduction has been claimed.

One court's statement about this doctrine is helpful.

"The requirement that there be a nexus is inherent in the concept of "restoration" itself".

The Ponzi Scheme Clawback & "Same Circumstances"

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 clawbacks repayment certainly seems to be a direct result of the same circumstances and the same Ponzi scheme that caused the clawback victim to report income in the first place.

Repayment because lack of unrestricted right established

- If the taxpayer in the past should have never included the funds in income
- or if the taxpayer included the income under an absolute right and makes the repayment for reasons other than a determination that no right existed the mitigation section will not apply.

One case 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.

- In Barrett Case, 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 the taxpayer 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 that was made at arm's length and in good faith could satisfy the "establishment" requirement of section 1341

- The Pike case; a taxpayer bought and sold corporate stock in one year, after which an investigator found that the profit from said stock should have gone in 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."

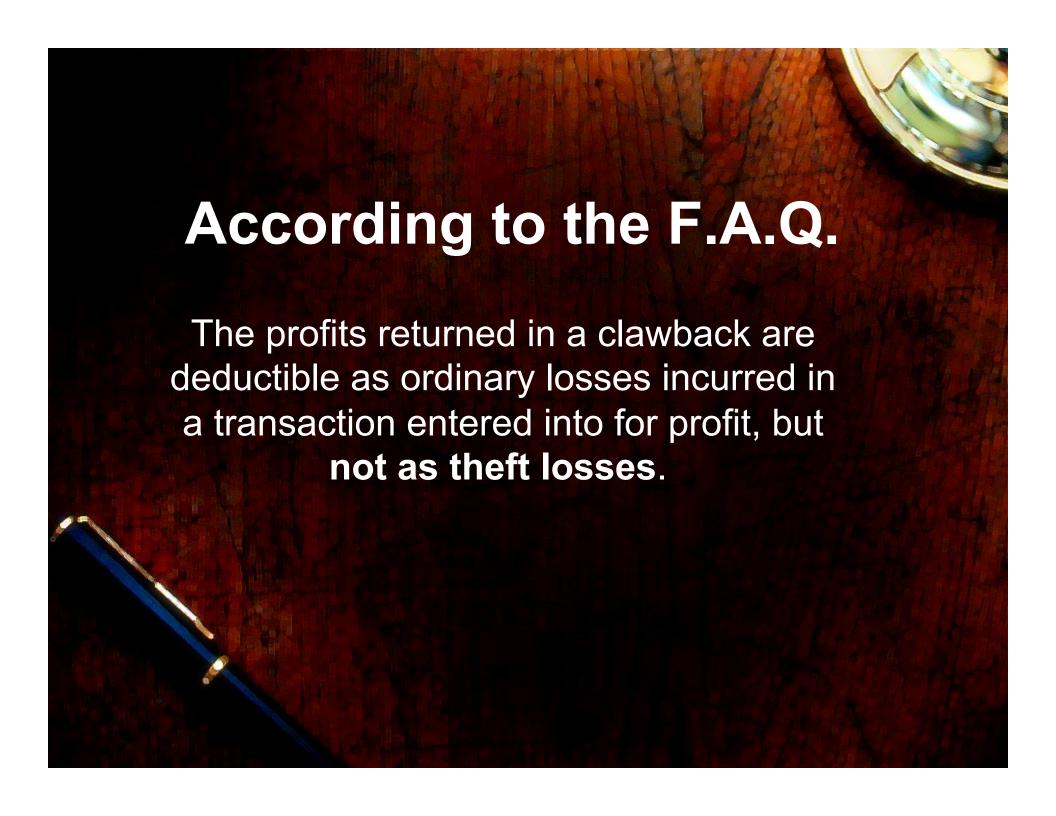
Summary The Clawback of Profits

- The Ponzi Scheme clawback of profits passes all of the tests of the Mitigation Section.
- The perpetrators promise extraordinary returns in almost every one of the many types of listed income "items".
- The taxpayer believes he or she has the right to take the item into income and does so, paying tax on the income.
- The year in which the taxpayer pays the clawback will be a year in which the taxpayer will receive a deduction for the repayment and the successful trustee in a clawback will have established there was no right to the income.

The I.R.S. FAQ

- The FAQ considered only the tax treatment of the clawback of Ponzi Scheme ("profits"), upon which taxes have been paid.
- The FAQ does not consider the treatment of the clawback of an investor's principal investment.

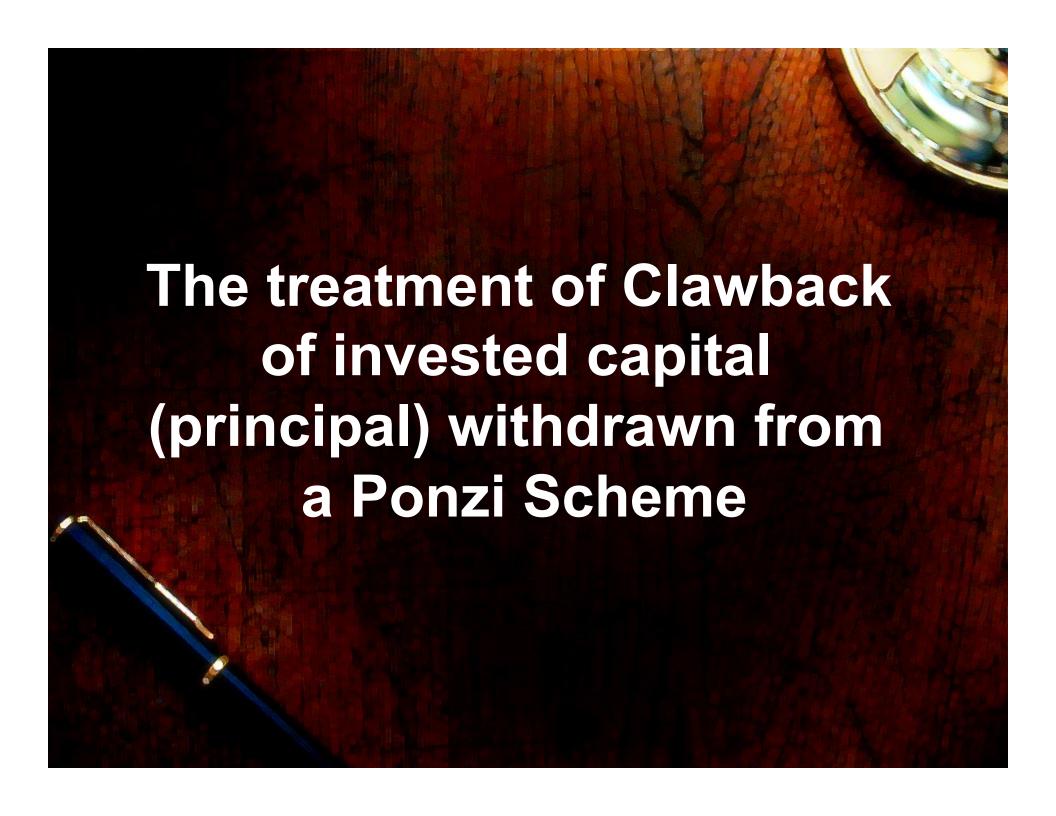
F.A.Q. Directly states that the F.A.Q. Is dealing with "repayments of amounts previously reported as income from a Ponzi Scheme".





 It is clear that though clawback repayments of amounts previously reported as income from a Ponzi Scheme are not additional theft loss deductions.

Instead, they are repayments of claim of right income that result in either a deduction as a non-theft investment loss, or a credit, whichever results in lower tax.





- The F.A.Q does not deal directly with a Clawback payment that pays to the trustee any original principal paid in to the Ponzi Scheme and has been withdrawn from the scheme.
- This clawback payment represents the investor's principal investment that is lost at a later point in time than the discovery of the theft.



Any settlement agreement that is being reached in a Ponzi Scheme should include . . .

1.Language to clarify the item being clawed back, the amount of the Clawback and other tax issues.

2.Tax counsel prior to finalization should review settlement agreements involving a Clawback.

Loss Carries Over & Carries Back

There is no Loss Carryback of deductions from Ponzi Schemes or deduction from a Clawback under the new 2017 Trump Tax Cut & Jobs Act.

- Clawbacks are still permitted to use the Mitigation Section or Clawback funds, and if the Mitigation section is used there can be carrybacks and carry-overs.
- However, the deduction of Clawback funds, starting in 2018 cannot be carried back to prior years.



 The F.A.Q. ruled that the Clawback of income was entitled to be treated as a loss resulting from the transaction and the IRS has ruled that the loss of principal is unlike the loss of profits because there is no "repayment of income", such as we had in the Clawback of profits.

Ponzi losses of principal and profits are both treated as ordinary losses.

- Loss of principal, whether it be lost as part of the direct Ponzi Scheme loss or whether it be lost as a result of a clawback that forces the taxpayer to replace principal previously withdrawn, are both treated identically.
- Losses are both incurred directly as a result of investing in a Ponzi Scheme.

The Mitigation Section

A section of the internal revenue code that corrects an injustice in the tax law.

 This injustice occurs if the profits being returned in the clawback are deducted in a year when they were of little value because the tax rates were low in the year of payment; and yet the income that is paid back was earned in a year in which the taxes were high.

The Mitigation Section

The tax value of clawed back profits <u>may be</u> <u>calculated</u> as the <u>higher of</u> the <u>tax value</u> of the deduction in the year the Clawback is paid or the value of the deduction if one assumes that the profits that were repaid as a result of the Clawback; <u>should never have been taxed</u> in the year they were taxed in the first place.

Profits

- The Clawback of profits is not a theft loss. It is an ordinary loss from a transaction entered into for profit. The losses can not be carried back but can be carried forward under the new Trump Tax Cut & Jobs Act. This is similar to other profit motive deductions that are carried forward with no time limits.
- The value of this Clawback is entitled to be calculated under tax rules that maximize the Clawback's tax value whether (i) it was deductible in the year it was paid; or (ii) excluded as income in the year it was first considered as taxable income.



The Clawback of principal is deductible as an ordinary loss, deductible only in the year of discovery.

No loss carryback and indefinite period of years to carry forward.

Adjustments to a liability of previous year

In the case of Clawbacks of profits:

In recomposing the tax liability for the year in which the income item was included under the claim of right doctrine, the taxpayer must take into account any redeterminations, deficiencies, credits, and refunds attributable to that year, in addition to the tax liability shown on the return for that previous year.

The I.R.S. Distinction

It is important to note that the I.R.S. has made a distinction between. . .

- a) losses of a Clawback that is considered to be a "repayment" of profits earned in a Ponzi Scheme; and
- b) losses that result from invested principal that is lost as a result of a Ponzi Scheme Clawback.

Value can be lost without good professional advice.

Richard S. Lehman, Esq.

TAX ATTORNEY AT LAW

2000 Glades Road, Suite 312 Boca Raton, FL. 33431

Tel: 561-368-1113

www.LehmanTaxLaw.com

