The Ponzi Scheme & TAX LOSS

IRS

Under The New 2017 Tax Cut & Jobs Act

The Taxation *of the* Clawback

Presented by

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Deduction of Clawback
&
Exclusion of Clawback

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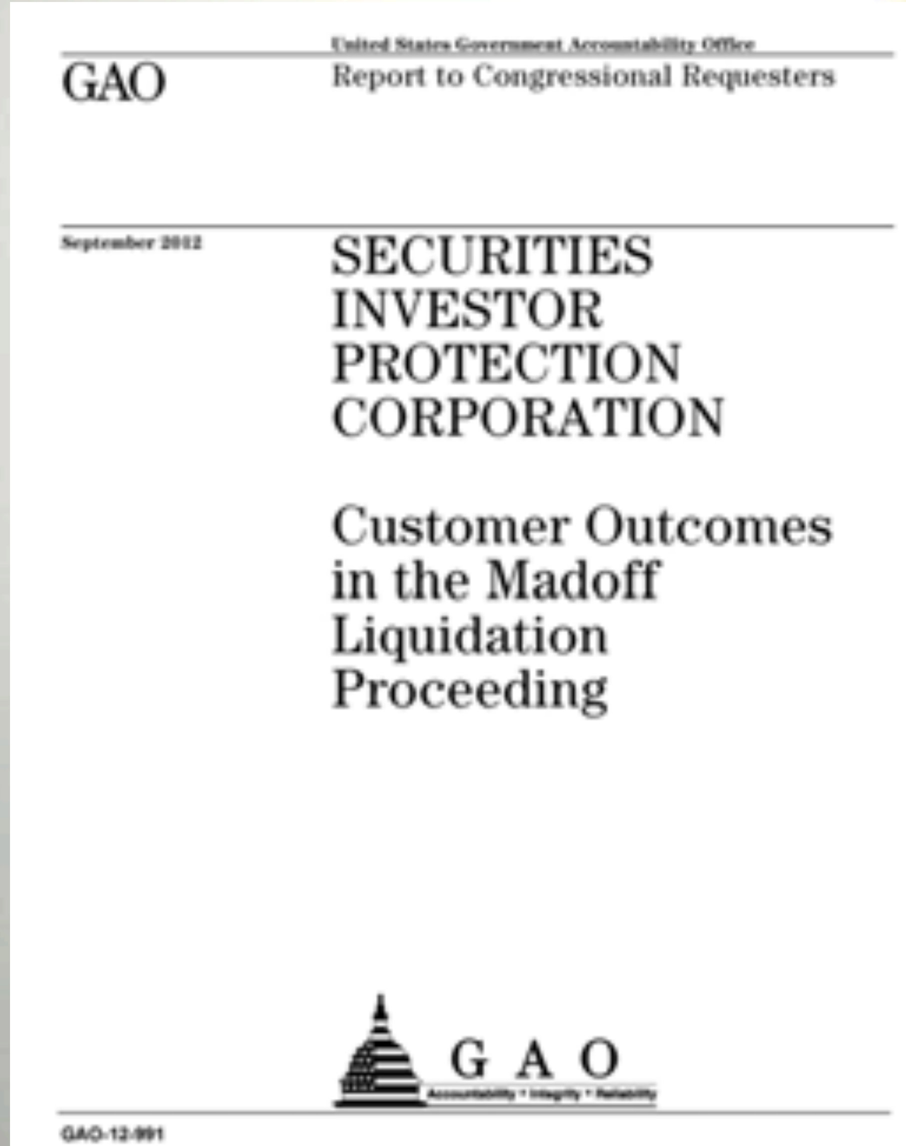
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Report to Congressional Requesters

September 2012

SECURITIES INVESTOR PROTECTION CORPORATION

Customer Outcomes in the Madoff Liquidation Proceeding

GAO

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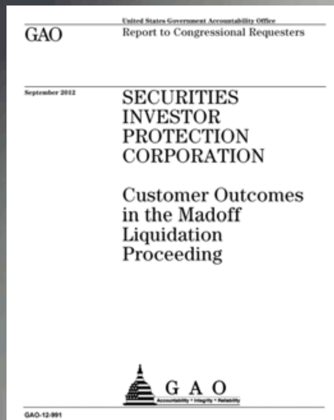
GAO-12-991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Friday, October 5, 2012
Subject: GAO Madoff report

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 is when a Trustee recovers money from an Investor who profited from the Ponzi Scheme.

Deduction of Clawback & Exclusion of Clawback

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

. . . .permits one type of the clawback payment to be 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 <u>claiming a theft loss must prove </u>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 "mitigation section" 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	200,000	0	0	0	0	0	0
Other Income	200,000	200,000	200,000	100,000	100,000	50,000	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 Forward

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. Because it appeared 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 after 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.

<u>The code 61 section defines income as:</u>

"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;
- 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

Code Section 61

Inventory

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 IRS position is that a taxpayer cannot have any right to income and therefore claim mitigation for its repayment, if the original income was “wrongfully obtained.”

The claim of wrong exception could <u>not apply to the typical Ponzi Scheme victim</u>.

- 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.

Entitlement to deduction in year of payment

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

The mitigation section is a relief provision.

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 not lost directly in the Ponzi scheme.

Clawback losses are a repayment 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*".*

According to the F.A.Q.

The profits returned in a clawback are deductible as ordinary losses incurred in a transaction entered into for profit, but **not as theft losses**.

The I.R.S. FAQ

- 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 treatment of Clawback of invested capital (principal) withdrawn from a Ponzi Scheme

The I.R.S. FAQ

- 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.

Settlement Agreement

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 I.R.S. FAQ

- 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 may be calculated as the higher of the tax value 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; should never have been taxed 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.

Principal

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.

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