

The Ponzi Scheme & TAX LOSS



Tax Refunds from Ponzi Scheme Losses Are Extremely Valuable

Presented by

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 - » 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 over 38 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.

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By the end
of this presentation
you will better
understand how
these items relate
to ponzi scheme
tax loss:



THE SAFE HARBOR & The Internal Revenue Procedure

—

THE LAW & The Internal Revenue Ruling

—

TAX PLANNING

How the taxpayer will plan and implement
his or her Ponzi scheme tax loss for
maximum benefits now and in the future.

**Tax Refunds from
Ponzi Scheme Losses Are
Extremely Valuable**



Tax Refunds from Ponzi Scheme Losses Are Extremely Valuable



- Ordinary Income Loss can be used against all types of income.
- 3 - 5 Year Carry Back
- 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 higher value in future with higher taxes
- 20 Year Carry Forward
- Possibility of Receiving Interest on Tax Refunds from Prior Years

**Value Can Be Lost Without Good
Professional Advice**



PROFESSIONAL Tax Planning

The final professional product should provide the taxpayer with appropriate projections of the use of the tax losses under differing circumstances that are legally feasible to obtain. The client will be able to understand the financial effect of various options that the tax loss and litigation recoveries may provide for.

Since the theft loss may be carried back three years and carried forward 20 years, it is extremely valuable.

The Safe Harbor

The IRS Revenue Procedure





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.

Ponzi Schemes & Theft Loss



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.





Ponzi Schemes & Theft Loss

- The Theft Loss
- Privity of Investor
- Character of Loss
- 5 Year Statute of Limitations/New Legislation
- Limitations on Deductions



II. 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 and Recoveries in Excess of Theft Loss Deductions
- The Johnson Cases — A Case Study



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

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 statute “refers to the year of discovery of the loss, not of the theft.”



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.

The Amount & Timing Of The Theft Loss





Reasonable Prospect of Recovery

Definition of “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

1. 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.
2. 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".



Ascertainable Standard

- 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 “ascertained with a reasonable certainty”. This is a higher standard of proof.



Tax Planning

The major principle seen in each of the court's decisions is that victims of the fraud who want to take the theft loss deduction in the year of discovery, must be well advised to separately consider each of their potential sources of recovery.

Value can be lost without good professional advice.



PROFESSIONAL Tax Planning

Tax planning should result in a professional work product that will most likely accompany an amended return or similar type of I.R.S. filing.

The document will most likely be the work product of at least three of the client's advisors:

1. THEIR ACCOUNTANT
2. A TAX ATTORNEY
3. LITIGATION COUNSEL



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.

The Safe Harbor

The IRS Revenue Procedure



Comparison of Revenue Procedure vs Revenue Ruling

| The Determination | The Revenue Procedure & THE SAFE HARBOR | THE LAW & The Revenue Ruling |
|---|--|--|
| Year of Discovery Deductibility - | Agreement by I.R.S. to a defined set of events | 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 case law for similar results |
| Waiver of the Right to File Amended Returns | Potential Tax Benefit Waived | Potential Tax Benefit Available |
| Claw backs and the Right to Use Code Section 1341 | Potential Tax Benefit Waived | Potential Tax Benefit Available |
| Interest Paid on Refunds | Potential Economic Benefit Waived | Potential Economic Benefit Available |
| I.R.S. Administrative Issues | Administrative Ease | Increased Proof Requirement Increased Audit Potential |

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 |



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
4. Loss Reduced by Certain Amounts Payable from the Securities Investor Protection Corporation (SPIC)

Theft Loss vs Amended Returns





Amended Returns

A deduction obtained from amending tax returns to eliminate only the Ponzi scheme income may be more valuable than a theft loss deduction.

Furthermore, refunds from amended returns may carry interest from the year of overpayment.

Clawbacks



Comparison of Revenue Procedure vs Revenue Ruling

| The Determination | The Revenue Procedure & THE SAFE HARBOR | THE LAW & 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 |
| The 3-5 Year Loss Carry Back of Net Operating Losses Applies | 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 | AGREED – Result similar to Revenue Ruling | AGREED – Result similar to Safe harbor |
| Respect for Pass Through Entities | AGREED -Result similar to Revenue Ruling | AGREED - Result similar to Safe Harbor |

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The Claim of Right Inequity

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.

| <u>Year</u> | <u>Income Repayment</u> | <u>Tax Rate</u> | <u>Tax Paid</u> | <u>Refund Received</u> |
|-------------|-----------------------------|-----------------|-----------------|------------------------|
| 2006 | \$100,000 | 40% | \$40,000 | \$40,000 |
| 2011 | (\$100,000) | 20% | \$20,000 | \$20,000 |

Requirements of Mitigation

- (1) an “*item*” must have been “*included in gross income for a prior* taxable year (or years)”;
- (2) “because it *appeared* that the taxpayer had an unrestricted right to such item”;
- (3) a “*deduction*” must be “allowable for the taxable year” in which the item is repaid;
- (4) “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”; and
- (5) “the amount of such deduction” must exceed \$3,000.

Item of 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)

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

- Gross income derived from business;
- gains derived from dealings in property;
- interest;
- rents;
- royalties;
- dividends;
- annuities;
- 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.

**INTERNAL REVENUE
CODE SECTION 61**

Appearance Of A Right

It appeared that the taxpayer had an unrestricted right to such item.

Claim Of Wrong Exception

The I.R.S. position is that a taxpayer cannot have any right to income for purposes of Code Section 1341, even an “apparent” right to income, if the original claim of the income was “wrongfully obtained”.

Deduction In Year Of Payment

The third requirement for mitigation is that a deduction must be allowable for the taxable year in which the item is repaid

I.R.S. – Clawback

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.

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 from "Clawbacks".

“Safe Harbor” – Waiver Of Rights

The Revenue Procedure requires the Taxpayer to waive their rights to use the Code Section 1341 Mitigation section.

Established No Unrestricted Right

The fourth requirement for mitigation treatment is that the funds must be restored “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”

Establish - Settlement

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.

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