

# The Ponzi Scheme & TAX LOSS



## Tax Refunds from Ponzi Scheme Losses Are Extremely Valuable

*Presented by*

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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.



# Richard S. Lehman, P.A.

- 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 over 35 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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# **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

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



# 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



# III. Theft Loss vs Amended Returns

- Circumstances for Amended Returns – *Statute of Limitations*
- Tax Planning for Amended Returns – *5 Year Statute and Future Income*
- I.R.S. Position
- Interest Income



## **IV. Claw Backs**

- Explanation of a Claw Back
- Internal Revenue Code §1341

# **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.*

# **The Amount & Timing Of The Theft Loss**



# Comparison of Revenue Procedure vs. Revenue Ruling



Footnote	The Determination	The Revenue Procedure & THE SAFE HARBOR	THE LAW & The Revenue Ruling
(1)	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
(2)	The Amount of the Loss (Basis) Includes Phantom Income	AGREED - Result similar to Revenue Ruling	AGREED - Result similar to Safe Harbor
(3)	The Five Year Loss Carry Back of Net Operating Losses Applies	AGREED - Result similar to Revenue Ruling	AGREED - Result similar to Safe Harbor
(4)	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
(5)	Respect for Pass Through Entities	AGREED - Result similar to Revenue Ruling	AGREED - Result similar to Safe Harbor
(6)	Year of Discovery Deductibility - 2008	Agreement by I.R.S. to a defined set of events	Taxpayer must rely on case law for similar results
(7)	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
(8)	Waiver of the Right to File Amended Returns	Potential Tax Benefit Waived	Potential Tax Benefit Available
(9)	Claw backs and the Right to Use Code Section 1341	Potential Tax Benefit Waived	Potential Tax Benefit Available
(10)	Interest Paid on Refunds	Potential Economic Benefit Waived	Potential Economic Benefit Available
(11)	I.R.S. Administrative Issues	Administrative Ease	Increased Proof Requirement Increased Audit Potential

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





# Ponzi Schemes & Theft Loss

## ***Definition of Theft:***

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.



# 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.

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



# Amount of the Loss in the Year of Discovery

## The Timing of the Deduction

Under the law a taxpayer who has suffered a theft loss shall take a theft loss deduction in the year the loss is sustained, which is the taxable year in which the taxpayer discovers the loss.



# Amount of the Loss in the Year of Discovery

## The Timing of the Deduction

However, if in the year the taxpayer discovers the loss, there exists a reasonable prospect of recovering some portion of the loss or all of the loss; the taxpayer must postpone the theft loss deduction for that portion of the loss or all of the loss that may reasonably be recovered.

If a taxpayer does not take a theft loss deduction for the entire loss in the year of discovery because the taxpayer has a reasonable prospect of recovering all or a portion of the loss, the theft loss deduction will be postponed until there is a recovery or there is a certainty that the postponed recovery will not happen. **The theft loss deduction will not be lost by virtue of it being postponed.**



# 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

## ***Definition of “Reasonable Prospect of Recovery”***

Courts have found that the deduction does need to be postponed where the financial condition of the party against whom the claim is filed is such that no recovery could be expected. The standard to be applied is primarily objective, but the taxpayer’s subjective attitude and beliefs are not to be ignored. One of the relevant factors is whether the taxpayer has filed a lawsuit to recoup the loss.



# Reasonable Prospect of Recovery

## ***Definition of “Reasonable Prospect of Recovery”***

Filing the lawsuit soon after the end of the tax year in which the loss was claimed suggests that the taxpayer did not consider the loss a closed and completed transaction. Unless litigation is speculative or without merit, where the taxpayer deems the chance of recovery sufficiently probably to warrant bringing a lawsuit and pursuing it with reasonable diligence to a conclusion, the taxpayer should postpone the loss deduction until the litigation is terminated. Another fact which can be considered is whether the taxpayer ultimately recovered as a result of a lawsuit.



# 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.



# Ascertain With Reasonable Certainty

## ***Definition of Ascertain with Reasonable Certainty :***

The requirement that a taxpayer “ascertain with reasonable certainty” means that a taxpayer must obtain a verifiable determination of the amount she will receive based on a resolution of the reimbursement claim before taking a theft loss deduction. Finally, requiring resolution of the claim with an objectively verifiable amount of loss is, as the government correctly notes, consistent with the plain meaning of “ascertain”... [as defined in a Dictionary of the English Language.]”

# **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.

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

# Claw Backs





# Claw Backs

## ***Claw Backs and the Right to Use Code Section 1341***

Generally in a Ponzi scheme there is a Trustee, usually in bankruptcy. The Trustee has what is called a “claw back” right to recoup funds from Ponzi scheme from investors who have received distributions from Ponzi scheme of funds that belonged to others who had invested in the scheme.



# Claw Backs

**Example:** A claw back of \$500,000 that provides a tax refund of only 15% in a year when income is low, (\$75,000); might provide a cash return at the 35% high tax bracket from a prior high tax bracket year of (\$175,000). The difference of 20% in the brackets is \$100,000 of real money.

Furthermore, the interest paid on a refund going back in years could be significant. By waiving the benefits of Code Section 1341 the taxpayer eliminates the potential for these increased earnings from tax refunds.

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**NOTE: The Safe Harbor insists that the taxpayer waive their right to Internal Revenue Code Section 1341**

# Comparison of Revenue Procedure vs Revenue Ruling

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I.R.S. Administrative Issues	Administrative Ease	Increased Proof Requirement Increased Audit Potential

# **Estate, Gift & Trust – Theft Deduction Rules**





# Estates & Trusts Deductions Available

The income or estate tax deductions available depend on when the loss was incurred and when it was discovered.

***There are three common situations:***

1. the theft occurs before the decedent dies and is discovered during estate administration;
2. the theft occurs and is discovered during estate administration; and
3. the theft occurs after the accounts have been distributed.



# Estates & Trusts Deductions Available

## Situation 1:

*The theft occurs before the decedent dies and is discovered during estate administration*

Under these facts, the estate can claim an income tax deduction even though the loss occurred during a tax year of the decedent. An estate tax deduction is allowable only for losses that occurred during estate administration.



# Estates & Trusts Deductions Available

## Situation 2:

*The theft occurs and is discovered during estate administration*

Such a loss is deductible as an estate tax deduction or an income tax deduction.



# Estates & Trusts Deductions Available

## **Situation 3:**

*The theft occurs after the accounts have been distributed*

In this situation, the losses cannot be deducted by the estate as income or estate tax deduction. The losses would be deductible by the beneficiary, but only for income tax purposes. If estate administration is unduly prolonged, the estate may not be able to deduct the loss even if it still holds the asset. An argument could be made that the estate would no longer be holding the asset for the estate but as an agent for the beneficiary.



# **Estates & Trusts Deductions Available**

## **The tax lawyers helps analyze avenues of recovery:**

For example, there may be a fairly recent estate involved in which an estate tax has been paid on the Ponzi scheme funds that were inherited. If this is the case, this must be considered in the calculations as the estate tax deduction, if available, may have a value of 45% to the taxpayer versus the 35% benefit of the income tax deduction.

# Tax Planning

*Value can be lost without good professional advice.*





# 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.

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**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.

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



# 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

A **litigation counsel** as part of the team is critical to a successful professional product for several reasons:

1. Each Ponzi scheme victim should understand every possible means of recovery that might be applied to the individual.
2. Recoveries from SIPC and the IRS are not the only avenues of recovery that will be considered.
3. As the facts unfold there may be more culprits of economic substance that can be a target of recovery.



# PROFESSIONAL Tax Planning

The **tax lawyer** is an essential expert who will need to coordinate all of the matters in light of the taxpayer's objectives and various legal standards that will need to be met to achieve those objectives.

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The theft loss tax benefits that one does not claim immediately will not necessarily be lost but may be realized at a later point in time when there is finality to each respective area of recovery that a victim has chosen to pursue.



# 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.**



# 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

1. 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.
2. One of the facts and circumstances deserving of consideration is the probability of success on the merits of any claim brought by the taxpayer.
3. 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".

# 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.

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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.

# Comparison of Revenue Procedure vs Revenue Ruling

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# Quantifying the Amount of Theft Loss Deduction in Year of Discovery

The IRS Revenue Procedure <b>SAFE HARBOR</b>	<b>COMPARISON OF LOSS PERMITTED</b>	The IRS Revenue Ruling <b>THE LAW</b>
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

# **Tax Planning For Maximum Use Of Loss**





# 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)



# 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”).

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