General Corporate — Commentary — Articles — English — Vern Krishna —, 2009-01-14 -- Scheme Sets Up Legal, Tax Mess

2009-01-14

Search Details

Search Query: Table of Contents

Delivery Details

Date: January 8, 2019 at 3:15 p.m.
Delivered By: VERN KRISHNA
Client File: GAAR

A "Ponzi" scheme is a straightforward concept - you rob Peter to pay Paul. The schemer entices investors with above-average financial returns. He uses the principal that each investor brings into the arrangement to pay earlier investors. The schemer returns the earlier investor's principal but camouflages it as earnings.

Scheme Sets Up Legal, Tax Mess
Date: January 14, 2009
Vern Krishna

Madoff's Victims Scramble with Bankruptcy Laws

A "Ponzi" scheme is a straightforward concept—you rob Peter to pay Paul. The schemer entices investors with above-average financial returns. He uses the principal that each investor brings into the arrangement to pay earlier investors. The schemer returns the earlier investor's principal but camouflages it as earnings.

There are three essential ingredients to a good scheme: First, a gutsy schemer; second, gullible and greedy investors; and third, somnolent regulators. The pyramid will stand as long as there are new investors prepared to be duped!

Charles Ponzi gave the pyramid scheme his name in 1921 when he duped New England residents into investing in postage stamp speculation. Mr. Ponzi told investors he could provide a 40% return in just 90 days based on differentials in foreign currency rates. This compared with the 5% banks were paying on savings accounts. Investors were so enamoured of Mr. Ponzi's plan that he collected US$1-million during one three-hour period. The pyramid eventually collapsed. Mr. Ponzi had invested only $30 in international mail coupons.

The alleged scheme now unfolding around Bernard L. Madoff satisfied all three requirements of a good Ponzi scheme, and will destroy innumerable lives. Mr. Madoff's investors included some of the financial world's most sophisticated bankers and advisors. Yet, they believed he could consistently deliver 12% to 14% so-called annual "earnings," regardless of market conditions.

Naturally, his investors were ecstatic and gave him even more money. Little did they know they were simply receiving a return of someone else's principal. The only difference between Mr. Ponzi and Mr. Madoff is that Mr. Madoff allegedly managed to dupe his investors of a much larger amount—US$50- billion.

Although the allegations have not yet been proven, Mr. Madoff himself has made admissions of guilt. He has been charged and remains free on bail. Mr. Madoff, 70, ran his scheme for more than 20 years right under the noses of regulators, including the Securities & Exchange Commission and the Financial Industry Regulatory Authority. The Madoff pyramid makes the earlier high-profile US$400-million scheme by Connecticut hedgefund company Bayou Group LLC seem paltry.

To make matters worse, investors would declare their fictitious "earnings" as income for tax purposes and pay taxes. Thus, governments also made a substantial killing (about US$3-billion each year) by collecting taxes on non-existent earnings.

 © 2019 Thomson Reuters Canada Limited.

The list of victims in the Madoff scheme reads like a Who's Who of the rich and famous. Mort Zuckerman (a real estate magnet), Elie Wiesel Foundation for Humanity, Fred Wilpon (New York Mets owner), Yeshiva University, Grupo Santander (a large Spanish bank) and UBS AG are on the list. Others will no doubt emerge.

Mr. Madoff managed to keep his project going for 20 years and grew the scheme to US$50-billion. Inevitably, one asks: “How did he get away with fooling hundreds of sophisticated financial people for so long? Where were the regulators?” Faced with huge losses and little hope of recovering their assets, investors must now scramble with a myriad of complex tax and bankruptcy laws.

They will need to establish that their so-called declared “earnings” on their income tax returns were not in fact income at all, but merely non-taxable returns of their own capital. Establishing the details of earlier transactions will require considerable time and effort of shifting through documents that may or may not exist.

The Securities and Exchange Commission has now moved in and is trying to identify Mr. Madoff's assets. Paul will not generally complain when one robs Peter to pay Paul. In this case, however, there could be worse news downstream for the investors who have already lost millions of dollars. An additional wrinkle to the scandal is the United States Federal Bankruptcy Court decision in the Bayou case. That case held that earlier investors must give back the money that they “earned” from the Ponzi.

Payments by Mr. Madoff to the earlier investors were fraudulent conveyances—an illegal transfer of property with the intent of committing fraud. The earlier investors were, in fact—albeit innocently—beneficiaries of the fraudulent scheme. The investors must refund their improperly earned money into the pool of assets from which all—old and new—victims will share, if there is anything to share. Thus, we can expect to hear a lot of complaining from Paul.

Vern Krishna, CM, QC, FRSC is Tax Counsel, Borden Ladner Gervais, LLP, and Professor of Common Law and Executive Director of the Tax Research Centre, University of Ottawa.

vern.krishna@taxchambers.ca

Copyright 2009 Vern Krishna. Reproduced by permission.

End of Document © 2019 Thomson Reuters Canada Limited.