Restitution for Ponzi Schemes:
Are Securities Laws Consistent With Tax Law?

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Abstract:

This paper compares the restitution processes used by the Securities Investment Protection Corporation (SIPC) and the Internal Revenue Service (IRS) to deal with the aftermath of Ponzi schemes. SIPC's goal is to provide reimbursement to victims of Ponzi schemes in an equitable manner, while the IRS is principally concerned with the impact of the Ponzi scheme for taxable income. The methods currently used by SIPC and the IRS appear quite different from one another and potentially contradictory. The traditional SIPC method ignores “phantom gains” in their calculations while the IRS method includes them. Despite these differences, I show that these methods are broadly consistent with one another and reach similar ends. Nonetheless, there are difficulties and tensions that have arisen both for SIPC and the IRS in implementing their policies. The paper highlights some of these difficulties and suggests some alternatives.
I. Background

For the investors of Bernie L. Madoff, late December 2008 brought devastating news as they learned that Madoff had been running a Ponzi scheme for roughly twenty years. The investment balances shown on the statements they had received from Madoff did not correspond to real assets held by Madoff or anyone else. Existing investors were paid “returns” from new investors lured into the criminal enterprise. The revelation of the fraud meant that savings for retirement and to meet the exigencies of old age, as well as estates to be left to families or charities, disappeared overnight. As Bernie Madoff supposedly was paying a relatively steady 10-15 percent or even higher annual returns, the power of compound interest had turned many small nest eggs into grand ones, and larger investments into great fortunes. But whether the fortunes were large or small, they all disappeared.¹

There was hope that some investments could be salvaged; perhaps Madoff had assets tucked away in financial safe havens or had confederates that retained control of these assets. To the extent that there were identifiable assets, Irving H. Picard, the court-appointed bankruptcy trustee, could uncover them or take legal action to obtain them and then distribute the funds among the Madoff investors to offset some of their losses. Picard indeed was quite aggressive and would succeed in obtaining considerable funds to reimburse investors.² But how would Picard allocate these limited funds to determine which investors to reimburse and how much each investor would obtain?

Picard chose a method—now upheld through a U.S. appeals court ruling—to settle bankruptcy claims arising from Ponzi schemes based on individual investors proportion of “net

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² Picard had some major successes including recovering $7.2 billion from the estate of Jeffrey Picower, to whom Madoff paid extraordinary returns. To date, total recoveries have been approximately $11 billion of the $18 billion capital invested in Madoff operations. Picard has aggressively pursued large private investors, such as the owners of the New York Mets, for being “willfully blind” to the fraud, although he has had some setbacks in these and similar cases. Picard also did not prevail in claims against J.P. Morgan Chase & Company and UBS, firms that provided banking services to Madoff, and who Picard claimed should also have known that a fraud was being committed. Another open legal issue was the extent to which withdrawals of funds prior to the collapse of the investment enterprise were protected by statutes of limitations. See, Diana B. Henriques, “A Lasting Shadow,” New York Times, December 11, 2011 and “U.S Judge Bars a Suit for Victims of Madoff,” New York Times, November, 1, 2011.
equity” in the investment scheme. Recovery proceeds were to be shared the extent of net equity by the investors. Based on a number of legal precedents in Ponzi liquidations, Picard chose a cash in/cash out definition for “net equity.” Specifically, an investor’s net equity was defined by Picard as any payments into the Ponzi scheme less any withdrawals over the entire life of the investment. For example, if someone invested $100,000 but withdrew $80,000 over the lifetime of their engagement with the scheme, then their net equity was $20,000. Anyone with positive net equity was deemed a net loser from the Ponzi scheme. On the other hand, if someone initially invested $100,000 but pulled out $200,000 over the lifetime of their investment, they had negative net equity and were deemed to be net winners.

Picard’s reimbursement scheme first utilizes all recoverable funds to replenish the accounts of net losers—those investors with positive net equity—in proportion to their net equity. Only if additional funds became available would he then compensate net winners. In practice, the available funds would only replenish a fraction of the net equity claims of the net losers. That meant that investors with negative net equity—net winners—would receive no distribution from the bankruptcy trustee.

In fact, the situation was potentially much worse for them. Net winners were actually in financial jeopardy because under recognized bankruptcy law, Picard could “clawback” any of their negative net equity and redistribute it to the net losers. Imagine the shock of first learning that your retirement nest egg has disappeared over night and then learning that the bankruptcy trustee may pursue you for additional funds. The only protection for net winners who were not complicit in Madoff’s crime were statutes of limitations limiting Picard’s reach to clawback past withdrawals and the legal costs of pursuing relatively small net winners. But large net winners, those who made relatively recent withdrawals, and those whom Picard expected were complicit with Madoff’s fraud were in serious financial and potentially legal jeopardy.

How did Picard justify his actions against net winners in the Ponzi scheme liquidation? Picard’s reasoning was that the Ponzi scheme was a fraudulent criminal enterprise. Since there were no true underlying investments in assets but mere transfers of funds from one party to another (with Madoff skimming funds off the top), winners from the Ponzi scheme gained at
the expense of losers. Thus, it was appropriate to clawback funds from winners to compensate the losers. In practice, Picard did not file legal claims against relatively small net winners, but concentrated his attention on investors who apparently profited immensely from the Ponzi scheme and larger net winners. While small net winners may have been spared the agony of facing a clawback lawsuit, they nonetheless were dismayed that they were not going to receive any payments from the bankruptcy trustee in the liquidation.

Picard was not operating in a vacuum. The basic regulatory structure governing the restitution for the Madoff Ponzi scheme traces back to 1970 when Congress passed the Securities Investors Protection Act (SIPA) and created the Securities Investors Protection Corporation (SIPC). SIPC was designed to promote securities markets by making customers of security firms whole in case of fraud or broker insolvency. It collected dues from brokerage firms, who in turn could advertise to investors that they would receive SIPC protection. This protection included priority for investors ahead of other claimants in bankruptcy claims as well as advances, up to $500,000 for claims for securities and up to $250,000 for cash claims covered by SIPC. SIPC was not designed to protect stockholders or other creditors of brokerage firms—just their customers who had purchased securities from them.

SIPC did cover the Madoff fraud, although that outcome was not a foregone conclusion. Bernie Madoff effectively operated two businesses. The first was a highly regarded brokerage firm, clearly covered by SIPC, but the second was his shadowy investment operation. SIPC was designed to protect investors from rogue or bankrupt brokers. It was not designed to protect investors from general losses in the market. Nonetheless, SIPC decided that Madoff’s dual role required them to bring the Madoff fraud under their umbrella. SIPC designated Irving Picard as the Trustee, with the appointment made by a federal district judge and the proceedings overseen in bankruptcy court.

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3 There were several major investors who earned well beyond the 11-15% range and who later became the target of Picard.
4 SIPC’s rules should be read in conjunction with the basic SEC rules designed to insure financial responsibility and proper recordkeeping. These require, roughly, that broker’s segregate customer accounts from other activities and establish special reserve accounts for customers. For a discussion of these and related points, see Dombalagian, Onnig H. (2010) “Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation,” Indiana Law Journal: Vol. 85: Iss. 3, Article 2 at 786-787.
Picard’s position that net winners profited from the fraudulent scheme also led him to deny SIPC advances to these individuals, despite the fact that their balances in their investment accounts disappeared. Thus, they were doubly hit—not able to tap into SIPC advances and potentially liable for clawback lawsuits.

SIPC only covered direct investors with Madoff. It did not cover investors who placed funds with Madoff indirectly through so-called “feeder funds.” Madoff relied heavily on these feeder-funds to minimize attention to himself from the Securities and Exchange Commission. Madoff charged very small commissions to the feeder funds and, in turn, let them charge their investors typical hedge-fund fees including management fees (normally 2 percent) and often up to 20 percent of any gain. This gave the feeder funds strong incentives to seek new investors, which helped keep the Madoff scheme going.

A coalition of net winners challenged Picard’s reading of the SIPC law. While the SIPC statutes dictate that compensation should be governed by “net equity,” this term is not clearly defined in the law. Moreover, recent case law makes specific reference to honoring “legitimate expectations” of investors. Helen Davis Chairman, one of Picard’s sharpest critics, testified in Congress and litigated against Picard. One of her primary arguments was that SIPC should honor investors’ final balances in their Madoff accounts, which totaled $64.8 billion overall.5

In her view, the final balances in customer accounts were the investors’ “legitimate expectations” that SIPC should honor. This position implied that that net winners would not only share in any liquidation proceeds through the bankruptcy process, but also be eligible for SIPC advances. Picard and his legal team responded that the final balances in the customer accounts were fictitious. Moreover, since the amount the Trustee could recover would eventually be a determinate sum of money, directing any liquidation proceeds to the winners would necessarily come at the expense of net losers from the Ponzi scheme. Restitution in this sense is a zero sum proceeding. Picard’s methodology prevailed first in federal bankruptcy court and then in the Second Circuit of the United States Court of Appeal.6

5 Based on the Trustee’s estimate as of November 30, 2008.
6 See, In re Bernard L. Madoff Inv. Sec. LLC, 122 (Bankr. S.D.N.Y. 2010) and In re: Bernard L. Madoff Inv. Sec LLC, Docket No. 10-2378 (Second Circuit, 2011)
During the time frame of the litigation, the Internal Revenue Service (IRS) issued its own restitution plan for Madoff investors, Revenue Ruling 09-09 and Revenue Procedure 09-20. As we discuss below, the IRS method for restitution does take into account fictitious gains to the extent that taxes had been paid on these gains.

Chaitman highlighted several tax issues in her appellant brief before the Second Circuit. Her brief referenced investors who had paid federal and state taxes on gains reinvested in the fund; other investors who held their Madoff investments in IRAs and were forced to make minimum distributions, which were then subject to tax; and individuals who received inheritance from estates containing Madoff investments on which estate and gift taxes were paid.

Chaitman’s brief also highlighted a recent case, S.E.C v. Byers, 637 F. Supp. 2d 166 (S.D.N.Y 2009)(Chin, J.) in which the SEC recommended that the district court approve the distribution to investors based on each investor’s initial investment plus reinvestment earnings. She noted that “the court with, the SEC’s blessing, used a formula equivalent to an investor’s tax basis.” She also noted that the IRS had recently adopted a similar approach in their Revenue Ruling on theft losses arising from Ponzi schemes. Chaitman argued that Picard’s cash in/cash out method for determining net equity was inconsistent with the approach adopted by the IRS.

Aside from these technical legal issues, other considerations have permeated the legal and extra-legal proceedings. Questions of equity, procedural fairness or justice, and ease of administration have also been raised. For example, does Picard’s interpretation of net equity result in a fair allocation of liquidation proceeds or are there superior alternatives? Do the methods of IRS and the bankruptcy trustee reach similar ends and should they? And from a practical point of view, are both methodologies workable and easily adopted for future cases?

The next section discusses the key legal issues raised by the Trustee’s cash in/cash out definition of net equity and describes some of the tensions that the SEC and SIPC now face with regard to SIPC coverage in a recent case. We then turn to the tax treatment of losses stemming from the Madoff Ponzi scheme. We demonstrate that the approach taken by the IRS

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7 Brief for Appellant, Helen Davis Chaitman, Esq. United States Court of Appeal for the Second Circuit, In Re: Bernard L. Madoff Investment Securities LLP.
8 See, Chaitman, op cit., at 39.
is similar in spirit to the Trustee methodology, despite its apparent surface differences. However, the implementation of IRS regulations has been plagued with practical difficulties. In addition, although the IRS and the Trustee aspire to similar ends, it is not clear that they are the most equitable methods to resolve a Ponzi scheme. To investigate this issue, we report the results of a simulation comparing the outcomes of alternative rules for distributing the proceeds of a failed Ponzi scheme. The simulation sheds light on the alternative methods that have been proposed. Finally, as recent events have challenged both SIPC and IRS, we explore some alternative approaches to Ponzi scheme restitutions.

II. Defining Net Equity

In a SIPA bankruptcy liquidation, available funds are distributed to customers pro rata based on their net equity. The term “Net Equity” is defined in Section 78lll(11) of SIPA as:

\[\text{The term “net equity” means that the dollar amounts of the account or accounts of a customer, to be determined by –} \]

\[\text{(A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customers...; minus} \]

\[\text{(B) any indebtedness of such customers to the debtor on the filing date.} \]

The statute also requires the Trustee to discharge net equity claims only “insofar as such obligations are (1) ascertainable from the books and records of the debtor or (2) are otherwise established by the satisfaction of the trustee.” (SIPA 78fff-2(b)). Interpreting these two provisions for the Madoff case and Ponzi schemes in general has been challenging.

To understand the controversies in the Madoff proceeding, it is helpful to review the background for SIPA. During the late 1960s, the rapid expansion of the securities industry led to a number of bankruptcies of securities firms. Congress enacted SIPA in 1970 to protect

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brokerage customers when a firm fails and securities were missing from customer accounts. SIPC made it easier for healthy firms to buy failing brokerage firms as the healthy firms would not be liable for missing securities. This eased the liquidation transition for failed firms.

In turn, SIPC was created and self-funded by brokerage firms to provide customer protection and return, to the extent possible, securities and cash to customers, even if those securities were missing from the brokerage accounts. SIPC designates a Trustee and counsel, who are appointed by the court to administer a special “liquidation proceeding” in which the claims of customers are satisfied to the extent possible by their net equity contributions as defined in the statute. SIPA was amended in 1978 to require that trustees “satisfy claims for securities that are missing from customer accounts with actual securities.....Both the House and Senate reports on the 1978 amendments make clear that SIPA’s protection extends to securities that are not in the account because the broker never purchased them, even though the customer ordered the purchase and the trade was confirmed by the broker.” 10 As we noted, advances up to $500,000 are available to customers with positive net equity who have claims for securities and $250,000 for claims for cash.

SIPA and SIPC were not intended to provide general insurance against loss in the market for customers of brokerage institutions—that FIDC-like role was deemed not appropriate for securities markets, which are inherently risky and investors willingly participate in these risks in return for potential gain. Rather they were designed for cases in which customers legitimately placed orders for securities and received confirmation of trades, but the securities were either stolen, disappeared or never purchased. The limited role of SIPC is also evident from the funds they have available for advances to customers. At the time of the discovery of the Madoff fraud, SIPC had approximately $1.2 billion on hand and, by statute, is authorized to borrow up to $1 billion from the U.S. Treasury. This pales in comparison to the $68 billion in the final statements of Madoff customers alone or even their estimated cash losses of $18 billion.

The SIPC definition of net equity fits comfortably within a framework of potentially missing or disappearing identifiable securities. In these cases, final customer statements would likely correspond to firm records of customer securities and credit balances (and thus

10 Op cit, p. 5.
appropriate liquidation value for an account) as they presuppose that real securities were intended for purchase. However, the net equity definition is not as helpful in other situations, including Ponzi schemes.

The major legal precedent prior to the Madoff liquidation was *In re New Time Securities, Inc.*, 371 F.3d 68 (2d Cir. 2004). Here the courts were confronted with a new situation: what happens after the brokerage fails and the securities turn out to be fictitious? Michael Conley described this situation: “The case involved a Ponzi scheme in which customers were solicited to invest in money market funds. Several of the funds (Vanguard and Putnam) were real funds, but another group of funds (the New Age funds) did not exist and were simply fabricated by the promoter. In all cases, the money was never invested, but converted by the firm’s principal, Charles Goren, for his own use.”

SIPC provided advances in both cases, but the issue that was contested was the definition of net equity. The Second Circuit treated the two classes of investors differently. For those investors whose funds were supposedly invested in real securities, their net equity was determined by their final statements. For those investors in the New Age funds, the court decided that they should be only reimbursed based on their initial cash investment. What was their rationale for treating the two customer classes differently? The court’s argument was that the former group was similarly situated to investors whose broker simply absconded with their funds. In situations like these, prior legal precedents dictated that net equity was to be determined by the final balances of customers’ statements. On the other hand, securities that were fictitious could never have been acquired, so the court used their initial cash position as a measure of their participation as investors and for defining their net equity.

The difficulty with this argument was that both groups of investors were subject to the Ponzi scheme. The unfortunate investors who were persuaded to place their funds in New Age securities rather than the Vanguard or Putnam funds were treated very differently in the restitution process—but in neither case were any funds invested. Moreover, the “reinvested proceeds” in the Vanguard and Putnam funds never really existed, because there were no true

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11 Op cit., p. 5.
earnings in investors’ accounts from these funds.\textsuperscript{12} Despite the difficulties with this judicial decision, it was the most immediate precedent for the Madoff case.

The Madoff case did not fall neatly into either of the two categories in \textit{New Times Securities}. Madoff allegedly purchased real securities or groups of securities for his customers as part of his “split-strike conversion” strategy. Madoff told his investors that during each quarter he would purchase listed stocks or groups of stocks, sell them prior to the end of the quarter, and hedge the risk of the portfolio by using options. In fact, he simply deposited money into a J.P. Morgan cash account and did not actually purchase any securities. Moreover, his staff fabricated statements for customers allegedly demonstrating that the firm bought the stocks at low prices and sold them at high prices, thereby generating high investment returns. To prepare this statement, his staff combed the historical record for each quarter and generated statements showing fictitious purchases at low prices and fictitious sales at high prices.

In comparison to \textit{New Times Securities}, Madoff’s purchases were allegedly for real securities, similar to the fabricated investments in the Vanguard and Putnam funds. On the other hand, the trades allegedly took place at fictitious prices, a clear fabrication similar to investments in the New Age fund. The bankruptcy court and the appeals court argued that the Madoff case was closer in spirit to their ruling for the \textit{New Age} fund. Even though real securities were dangled in front of Madoff investors, they were in fact fictitious because trades could not have routinely been made at the prices that were claimed. The courts also relied heavily on the SIPA language that determinations of net equity had to be “ascertainable from the books and records of the debtor” and argued that the records of trades were totally fictitious and thus could not be relied upon by the Trustee. Indeed, as the Trustee emphasized, relying upon Madoff’s records to allocate fund to investors would have determined these allocations by the thief himself.

The bankruptcy and appeals courts also made the argument that the customers reinvested profits were “fictitious” and thus did not represent real claims for securities by

\textsuperscript{12} One rationale for the court’s decision might be that if the real securities were purchased, the investor would have earned dividends and capital gains. Allowing for fictitious gains is thus equivalent to buying “replacement” securities for the investor. However, as we argue below, this treatment is not appropriate for a Ponzi scheme.
investors. However, as we saw in *New Times Securities*, fictitious reinvested profits were allowed to count towards net equity for the alleged investments in the Vanguard and Putnam funds. But in any Ponzi scheme, these “profits” are simply funds diverted from other investors and not real earnings. The Madoff Trustee’s determination of net equity by the cash in/cash out method was one way to recognize this reality; moreover, the Trustee’s method may be one reasonable method to distribute funds to potential victims of a Ponzi scheme. But the argument that “fictitious gains” should not be recognized is simply not consistent with the outcome in the *New Times Securities* fraud with respect to the alleged Vanguard and Putnam investments.

It is difficult to draw clear distinctions in Ponzi schemes based on notions of “real” vs. “fictitious” securities. Similarly, it is also difficult to make clear distinctions between orders customers placed for specific securities that were in fact never purchased and, as in the Madoff case, purchases that customers were informed were made for them *ex post* as part of an overall investment strategy. In Ponzi schemes, all investments are fictitious.

There are two major issues in dealing with a Ponzi scheme. Are the investors eligible for SIPC advances in bankruptcy liquidation? And, if they are part of a SIPC liquidation, what is the appropriate definition of net equity? An extraordinary recent development illustrates the complications that may arise with respect to the first issue.

In an unprecedented lawsuit, the SEC has brought SIPC to court in the matter of the Ponzi scheme engineered by Robert Allen Stanford. The SEC sought to compel SIPC to initiate a SIPA liquidation proceeding. In this case, investors bought CD’s at the Stanford International Bank Ltd in Antigua. SIPC has argued that the financial institution in question was: 1) an offshore bank, not a member of SIPC, and 2) not covered under SIPC statutes or any legal precedents. On its website, SIPC stakes out a very narrow position for the agency:

- *This case is about investments in certificate of deposits ("CDs") issued by the Stanford International Bank Ltd. in Antigua. Stanford International Bank Ltd. is*

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13 See the SIPC website for background information, including the initial pleadings. [http://www.stanford-antigua-sec-lawsuit.com/](http://www.stanford-antigua-sec-lawsuit.com/)
an offshore bank: it is not a SIPC-member brokerage firm and has never been a SIPC member.

- The Securities Investor Protection Act only covers the custodial function of a SIPC-member brokerage, by offering limited protection to customers against the loss of missing cash or securities when a SIPC-member brokerage firm is holding cash or securities for an investor but fails financially.

- The Act does not authorize SIPC to protect monies invested with offshore banks or other firms that are not SIPC members. The Act also does not protect investors against a loss in value of a security, including because of mismanagement or fraud.

- In addition, this case involves CDs that were delivered, not a situation in which a SIPC-member brokerage firm had custody of securities but failed before delivery could occur.\(^{14}\)

While SIPC takes a narrow view of its role in the Stanford matter, the SEC has taken a much more expansive position. The SEC alleges that the Antigua bank was part of Robert Allen Stanford’s fraudulent empire and SIPC protection should be offered.\(^{15}\) The Stanford Group Company itself was a SIPC member and the CDs in question were sold from the U.S. offices of the Stanford Group Company. The SEC contends that the Antigua bank was effectively controlled by Allen and not truly an independent actor whose separate identify should be respected. Thus, its customers should be offered protection by SIPC, as if they were direct customers of Stanford’s U.S. brokerage operation. The SEC’s for several years did not contest that SIPC was not responsible in this case, but later changed its position after they experienced difficulties with Congress for confirmation of its Commissioners.

At stake in this case is the availability of SIPC advances to customers of Allen’s Antigua bank, not the particular definition of net equity. But it illustrates the difficulties of distinguishing between the limited role that SIPC sees for itself in terms of protecting lost or


stolen securities and the more expansive role that the SEC now advocates, which effectively provides extra protection for losses to investors not usually deemed to be covered by SIPC. Clearly, the role of SIPC is not clear even in the minds of Washington regulators.

Ultimately, only a limited amount of funds will be recovered in a SIPC liquidation proceeding and typically not enough to satisfy all the claims of investors. A definition of net equity simply allocates these funds among potential claimants. Formalistic definitions may work in some cases, but we have seen the problems that arise with formalism in recent cases. Ultimately, as the recent court decisions have noted, fairness will be an issue. As the U.S. Bankruptcy judge Burton Lifland wrote in his opinion, “While the Court recognizes that the outcome of this dispute will inevitably be unpalatable to one party or another, notions of fairness and the need for practicality also support the Net Equity method.”

While the Appeals Court agreed with the Trustee that the cash in/cash out method was appropriate for the Madoff liquidation, in other circumstances the final statement method may be appropriate. As Judge Jacobs wrote, “...we expressly do not hold that such a method of calculating ‘net equity’ is inherently impermissible.” Since one method does not clearly dominate the other, could the rules adopted by the IRS help clarify the choice of method?

III. How did the Madoff Courts Treat Taxes?

Despite the emphasis placed on taxation by the appellants in their pleadings, the Courts paid little attention to these arguments. In his bankruptcy court ruling, Judge Liflin devoted just one paragraph to this issue and the appeals court ruling did not mention tax issues at all. As we noted above, the IRS restitution process did take into consideration the final balances in customer accounts or, in the court’s term “fictitious profits.” Judge Liflin simply argued that this was irrelevant, “as the IRS and SIPC are governed by disparate statutory schemes with different purposes.” In addition, he noted that the IRS treatment of Madoff losses was “temporal” (coming after the fact) rather than part of a prior statutory scheme. By this

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16 Bankruptcy ruling at 31.
17 Appeals ruling at 24.
18 Bankruptcy ruling at 25
comment he was referring to the Revenue Ruling and Revenue Procedure which were issued after the Madoff fraud came to light.\textsuperscript{19}

Neither of these arguments is persuasive. While it is true the IRS and SIPC are governed by different statutory schemes, they are both informed by notions of restitution. Why would the IRS adopt an apparently contrary approach to the Trustee? Could not there be some similar underlying factors that could influence the Court’s reasoning, particularly in interpreting the ambiguities in the Madoff case and its relationship to past precedents?

Judge Lifland’s dismissal of the Revenue Ruling and Revenue Procedure was also facile. The IRS issues revenue rulings and procedures to interpret existing statutes and regulations when they deem that additional clarity is required. These are not meant to promulgate new law or regulations, but to interpret existing law and regulations. Indeed, Revenue Rulings and Revenue Procedures might be particularly informative for a court to help disentangle the complexities of financial failure or fraud. Why did the IRS base its restitution method on final customer balances?

\textbf{IV. The Logic of the IRS Treatment of Ponzi Losses}\textsuperscript{20}

While the “net winners” were displeased with the Trustee’s position and the courts’ rulings on their reimbursement, they were quite pleased with their treatment by the Internal Revenue Service. The IRS issued Revenue Ruling 2009-09 and Revenue Procedure 2009-20 to clarify rules on losses from Ponzi schemes and provide both guidance and safe-harbors for Madoff investors. The IRS procedures took into account the final statement balances of investors. Indeed, Commissioner Doug Shulman even used the term “fictitious income” in his press release describing the Revenue Ruling and Revenue Procedure.\textsuperscript{21}

The Revenue Ruling begins with a hypothetical situation, similar to the Madoff case. An investor, entering into a transaction for profit, deposits funds with a broker and agrees to

\begin{itemize}
\item \textsuperscript{19} Revenue Rulings 2000-09 and Revenue Procedure 2000-20.
\item \textsuperscript{20} I focus in this discussion on direct investors in a Ponzi scheme. Many investors did so through partnerships and would have theft deductions through their partnerships reported on their individual returns.
\item \textsuperscript{21} Prepared Testimony of Douglas Shulman, Commissioner, Internal Revenue Service, Before the Senate Finance Committee on Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation. Available at: \url{http://www.irs.gov/newsroom/article/0,,id=205374,00.html}
\end{itemize}
reinvest any returns on her investment with him. The broker sends yearly statements to the investor and the investor includes the reported investment returns in gross income for her federal taxes. At some point, the investor withdrew a portion (but not all) of the funds from her account. At a later point, it is discovered that the broker is running a Ponzi scheme, which constituted criminal fraud or embezzlement in that jurisdiction.

The Revenue Ruling then takes us on a tour of the pertinent IRS code sections and regulations to outline the proper treatment of the loss suffered by the investor. The keys to the IRS’s treatment for Madoff-like Ponzi scheme are: 1) the taxpayer’s loss is characterized as a theft loss, not a capital loss, and 2) the theft loss that was incurred was characterized as a transaction entered into for profit. These two conclusions are very favorable to the taxpayers. First, a capital loss would be subject to the general restrictions on capital losses and would not generally be desirable for a taxpayer. Second, theft losses for individuals in profit-seeking transactions, IRC 165(c)(2)), are not subject to the limitations on other casualty or theft losses in 165(h) nor the overall limitations on itemized deductions in IRC 86(c)(3).

Theft losses can be taken in the year that the theft was discovered; however, if there is a possible claim of reimbursement, the taxpayer must wait until the year in which it the amount of the recovery can be reasonably ascertained to take the loss. This creates some potential difficulties for compliance.

Importantly, theft losses arising from profit-seeking transactions can be taken as net operating losses as if they were business deductions IRC 174(d)(4)(C). Essentially, the taxpayer is treated as if she were a sole proprietorship for this investment and allowed both a carryback and carryforward (if necessary) of net operating losses. As a special bonus to Madoff victims, the American Recovery and Reinvestment Act of 2009 (the “stimulus” bill) had extended the carryback provisions to 3-5 years, depending on the size of the business.

A critical issue is the amount of loss deduction that is allowed. The IRS interprets its regulation Section 1.165-8(c) as allowing an amount deductible equal to the basis of the property that was lost, less any reimbursements or claims to which there is a reasonable prospect of recovery. The calculation for the basis of the property for the Madoff victims begins with the initial investment amount less any cash withdrawal. But the Revenue Ruling
also adds that “If an amount is reported to the investor as income in years prior to the year of
the discovery of the theft, the investor includes the amount in gross income, and the investor
reinvests the amount in the arrangement, the amount increases the deductible theft loss.”22
Thus, the basis includes “fictitious income.” Similar to the treatment of reinvested earnings in
taxable mutual funds, the basis in the Ponzi investment is increased by the amount of income
previously included in gross income and subject to tax. Thus, the tax basis for Madoff investors
is finally determined as: \[
\text{[cash in]} - \text{[cash out]} + \text{[reinvested earnings that were included in}
gross income]\
\]

With the combination of liberal carryback rules and with the amount allowable for a loss
defined as the tax basis, the IRS reaches an outcome similar to: 1) allowing a refund for taxes
paid on the fictitious income, plus 2) a deduction for the net amount (cash in minus cash out)
invested in the fund. We can illustrate this with point with a simple example. Consider an
investor A who initially puts $100x into the fund in year 1, withdrew $20x in year 3 and
reported gross income of $60x for the entire investment period before the theft was reported
in year 8. Under these rules investor A would be allowed a theft deduction in year 8 of $100x-$20x +$60x = $140x. This is equivalent to allowing a deduction of $60x in year 8 (effectively
allowing a refund on taxes paid) as well as a deduction for the net investment of $80x in the
scheme. In practice, these outcomes might not be identical as tax rates may change over time
and there may not be sufficient income to immediately carryback all the loss (thereby requiring
it to be carried forward). Despite these possible differences, the underlying logic is that the
taxpayer is allowed a deduction for taxes paid on fictitious income plus the net investment (if
positive) in the fund.23

Though this ruling, the IRS reaches an outcome remarkably similar to the Trustee’s
methodology for determining net equity in the Madoff case. First, the IRS simply concedes
that it should not have taxed the $60x of fictitious income to begin with and provides a
mechanism similar to a refund to address this problem. It then allows an additional theft

22 Revenue Ruling 2009-09, p. 8.
23 The Revenue Ruling did not preclude filing an amended return for any open period, although that would not be
allowed under the safe harbors in the Revenue Procedure discussed below. In addition, the Revenue Ruling did
not allow a claim of right under Section 1341 so there would be no mechanism to address the fact that current tax
rates (perhaps stemming from the loss) might be lower than past tax rates.
deduction equal to the net investment in the scheme, identical to the cash in/cash out method proposed by the Trustee and adopted by the courts. Indeed, if we start with the tax basis for the theft loss and subtract the deduction-equivalent refund for taxes paid on fictitious income, we arrive at the Trustee’s definition of net equity, cash in minus cash out. The IRS first undoes its own damage from taxing fictitious income and then allows a theft loss deduction for net investment. Even though they allow a deduction for “fictitious income” for taxpayers, the IRS ends up at the same place as the Madoff Trustee in terms of its view of the damage actually incurred by the taxpayer in the fraud. Ironically, the IRS procedures reinforce the Trustee’s solution; the IRS procedures do not provide the analytical support that Chaitman and others contended for their position that net equity should be determined by final statement balances.24

To understand the implications of the IRS solution more fully, consider the case of a “net winner.” Investor B is a net winner who initially invests $100x, withdraws $120x from the fund and pays federal income taxes on $60x. His tax basis is $40x [100-120+60] for which he is allowed a theft deduction. We can think of this as the IRS effectively allowing him a deduction of $60x, which compensates him for taxes paid on fictitious income, less the $20x on the net cash withdrawn from the Ponzi scheme. The reason that the initial deduction was reduced was that not all of the $60x gain was fictitious. For this investor, $20x was real as he took it from the Ponzi enterprise. Therefore, the IRS just limits its refund to the portion of fictitious gains that were truly fictitious. We can calculate net equity by starting with the tax basis of $40x and subtracting the income on which investor B paid taxes, $60x, for a result of -$20. This is precisely the same level of negative net equity in the Ponzi scheme as determined by the Trustee.

Now consider the case of an investor who deposited $100x, earned $100x that was included in gross income and withdrew $40x to pay taxes (40% tax rate). That investor would have a tax basis of $160x for the theft loss. This can be decomposed as having the IRS allow a deduction of $100x, which compensates for taxes paid on fictitious income, plus an additional theft deduction of $60x (100-40) for net investment in the fund. This latter deduction

24 One difference is that the US tax system operates on a worldwide basis, so foreign Ponzi schemes clearly not covered under SIPC, would be eligible from relief under the IRS theft provisions.
incorporates the fact that the individual did not actually bear the burden of the taxes paid (other investors did) and his net investment is reduced accordingly. Picard’s measure of net equity in this situation is also $60x; starting with the tax basis of $160x we reach this result by subtracting the deduction for fictitious gains included in gross income.

Our approach also extends to the treatment of both traditional and Roth IRAs. For both types of IRAs, no investment gains are included in gross income so there is no added tax basis from gains. Assuming no withdrawals, the tax basis of a Roth IRA is thus the original investment. Since the original investment in a Roth IRA is its tax basis, the IRS does allow a theft loss deduction for that amount. Starting with this tax basis and noting that no gains were subject to tax (and need to be subtracted), we arrive at what was, in fact, the Trustee’s determination of net equity—the initial investment level in the Roth IRA.

Conventional IRAs are a more interesting example. The tax basis of a conventional IRA is zero—the original investment is counterbalanced by a deduction from gross income, and no tax basis is added from any investment gains. Consistent with this principle, the IRS does not allow a theft loss deduction for a conventional IRA; to permit one would be to allow a taxpayer to receive two deductions for the same investment. Following our approach to determine net equity from the tax basis, we start with the zero tax basis and now add an increase in gross income for the individual to offset the initial tax deduction for the IRA. Once this transaction has been deemed to occur, we are left with the original investment in the IRA as the determination of net equity. In fact, the Trustee treated conventional IRAs as having net equity equal to their original level of investment.

At the end, the net equity for Ponzi scheme recovery of both a Roth and conventional IRA are equal to the initial investment level. For tax purposes, the Roth IRA receives a theft loss of that amount. The conventional IRA does not, but it already received an equivalent deduction from the initial investment. The effective equivalence for tax purposes for the two types of IRAs is mirrored in the determination of net equity for the Ponzi scheme recovery.

26 See, for example, the complaint file by Diane and Roger Peskin and Maureen Ebel in re: Bernard L. Madoff Investment Securities LLC, United States Bankruptcy Court Southern District of New York, filed June 10, 2009. Ebel had an IRA investment for which the Trustee determined its net equity to be the initial investment level.
A key part of our interpretation of the IRS procedure is that the IRS recognized that it was not legitimate to collect taxes on fictitious income; these taxes needed to be refunded through some mechanism to taxpayers, otherwise the IRS would be causing additional harm. This is a natural position for the IRS that is consistent with other provisions of the tax code; note that if taxpayers had open years, they could have “undone” the taxes they paid on their fictitious income by filing an amended return and reducing their gross income by the amount of the fictitious income.

There is also direct evidence through the IRS’s own actions that it does not believe it should benefit from taxing fictitious profits. Bernie Madoff’s firm collected $330 million in withholding taxes on the fictitious profits allegedly earned by nonresident aliens and foreign corporations which it paid to the IRS. Ostensibly, Madoff’s firm took this action so as to not attract undue attention to it by following the well established procedures of the tax laws. In a legal settlement with the Trustee, the IRS refunded $326 million they had previously collected from the withholding taxes.\(^\text{27}\) Returning these funds to the Trustee is similar to returning (to the taxpayer) the taxes the IRS erroneously collected from them.

Aside from the effective refund of taxes paid on fictitious income, a taxpayer also reduces his or her total taxes by \(t \times (\text{net investment})\) where \(t\) is the current tax rate. This tax benefit is increasing in the tax rate, so higher tax bracket investors gain more from the theft loss deduction. A striking example of this phenomenon occurs if individuals (as some did) invested with Madoff through a personal account as well as through a non-taxable foundation.\(^\text{28}\) The tax benefit for net investment only accrues to the funds in a personal account but not on funds invested through a non-taxable foundation.\(^\text{29}\)

Here the IRS restitution differs in effect from the Trustee’s methodology. The IRS makes a refund to the taxable investor, but the Trustee would make similar payouts to both the taxable and non-taxable accounts on a cash in/cash out determination of net equity. Why is there this difference? The logic here is that a taxpayer has the government as a silent partner,


\(^\text{28}\) This was allegedly the situation with Elie Wiesel.

\(^\text{29}\) The non-taxable foundation, of course, does not pay taxes on fictitious income so the only issue here is the treatment for net investment.
sharing in the gains or losses from investments at risk. The sharing fraction is determined by the tax rate. The non-taxable foundation, although it also suffered a loss, did not have the government as its silent partner. Is this outcome fair? Perhaps, as the non-taxable foundation will have had other advantages from the tax code such as benefiting from the charitable contribution deduction and paying no taxes on the earnings from its investments. However, even in this case, the calculation of net equity for the Trustee and the IRS is the same—the only difference is that only taxable entities receive a deduction for their loss of net principal.\(^{30}\)

The Revenue Procedure was more specifically geared to the Madoff case than the Revenue Ruling and made life even easier for some investors, particularly with regard to difficult question of the timing of their theft loss claim. The Revenue Procedure distinguished between two classes of investors: those who were not seeking potential third-party recovery (aside from SIPC advances) and those were seeking third-party recovery. For the former group, the IRS allowed them a safe-harbor of 95% of their potential claims as outlined in the Revenue Ruling; for the latter group, the corresponding figure was 75%. Potential claims are determined by the basis rules outlined above, less actual recoveries as well as potential SIPC advances and other insurance coverage. Any amount not taken initially (the 5% or 25%) can be taken once the uncertainty with regard to actual reimbursements has been resolved. Similarly, any net unexpected recoveries would be added to gross income at the time of recovery. To qualify for the safe-harbor, the taxpayer must claim only the allowable deduction; not file an amended return for open years; and follow the guidance of the Revenue Ruling with respect to other tax issues that could potentially be raised.\(^{31}\) Investors following these rules may then claim their theft loss in the year the theft was reported (2008 for the Madoff investors) and not wait until the uncertainty with respect to any reimbursements claims have been resolved.

\(^{30}\) By “taxable entities” I include IRAs in which the effective tax rate on the particular investment may be below the tax rate on other income. For a conventional IRA, gains and losses are shared ex post as the tax is prepaid, although the ex-ante tax rate is zero. For Roth IRAs, there is no “sharing” mechanism based on the tax rate, but the initial deposit is made with after-tax income.

\(^{31}\) Specifically, the taxpayer cannot apply for claim of right (Section 1341) or equitable recoupment for errors (Sections 1311-1314).
The IRS Revenue Procedure for Ponzi theft losses also outlines the specific preconditions for investors to claim losses. These guidelines go beyond the Revenue Ruling, which merely described the proper tax treatment under a hypothetical Ponzi scheme.

First, the Revenue Procedure defines a “specified fraudulent arrangement” as one “in which a party (the lead figure) receives cash or property from investors; reports income amounts that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from other investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors’ cash or property.”32 Note that while this definition would certainly include the Madoff scheme, it would not necessarily cover other investment operations in which misdeeds were alleged. In particular, there could be other actions (reckless speculation or misrepresentations, for example) that rendered a security worthless that would not be characterized under this definition as a Ponzi scheme.

To qualify for a theft loss from a “specified fraudulent arrangement,” one of two criteria must be met, either: (1) The lead figure must be “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” or (2) the lead figure was the subject of a state or federal complaint on similar grounds and either a) the complaint alleged an admission of the crime by the lead figure or b) a receiver or trustee was appointed for the case.

While the first criteria—an actual indictment— is reasonably stringent, the second criteria is more vague and may be difficult to interpret for an average taxpayer. An aggressive state attorney general may file many different types of complaints about brokers or managers of investment funds; for example, charges could be filed for misappropriation of funds, misleading investment advice, violations of fiduciary duties as well as for theft or embezzlement. Taxpayers may naturally have difficulties distinguishing among these varying complaints. And even if there are allegations of fraudulent behavior, these may be the type of actions that result in a capital loss for an existing security, rather than a true theft loss, as

32 Revenue Procedure 09-20 at 3.
determined either under the Revenue Procedure or for SIPC. Moreover, determining what constitutes an “admission” by a lead figure will also be challenging. A lead figure could, for example, take “responsibility” for poor communication to investors or maybe even for providing misleading advice, but deny explicit fraud or embezzlement. How can an average investor decide how to file a tax return in this environment?

Concerns about excessive claims for theft losses, in fact, led the Treasury Inspector General for Tax Administration to conduct an investigation. The title of his report summarizes the main finding: “Many Investment Theft Loss Deductions Appear to Be Erroneous.”\textsuperscript{33} We should note that the law in this area is complex—so complex, that even this report misstates the Revenue Procedure. A summary table in the Inspector General’s report incorrectly reports that to utilize the safe-harbor procedures in the Revenue Procedure the lead figure must be criminally charged.\textsuperscript{34} As we described above, a criminal charge is not necessary to utilize the safe-harbor.

The Inspector General’s study analyzed electronically filed returns for tax year 2008. In that year, for electronically filed returns, 1,967 reported theft deductions totaling $780 million. The investigators took a sample of 140 returns and examined them closely. Overall, they concluded that 82% of these returns either did not appear to meet the qualifications for theft losses (58% of the total returns) or the IRS and the Inspector General could not determine whether or not they met the qualifications from the information provided on the return (24% of the total returns).

For the group that did not meet the qualifications for a theft loss, 62% of the total returns had no matching documentation connecting them to a loss. For example, in some cases there were neither matching Schedule K-1 or Form1099-B forms associated with the individual taxpayer—thus no evidence of current investments—and no evidence of either gains or losses reported in prior years from these investments. Another 11% of the total returns took theft losses that were actually capital losses. For example, a stock would be sold for a capital loss but

\textsuperscript{34} Ibid, Figure 1, p. 3. Under the category of Criminal Act, the table states that for the Safe-Harbor Method “Lead Figure is Criminally Charged.”
reported as a theft loss. Finally, 3% of the total returns claimed to be victims of Madoff, but these taxpayers failed to appear in any records associated with the fraud.

For the group where it was impossible to determine whether or not they met the theft loss criteria, 18% of all returns claimed partnership losses but the partnerships returns (which in this case were matched to the individual taxpayer) did not file the required Form 4684 necessary to report the theft loss. Another 5% of all the returns claimed the theft deduction in the year the theft was reported (with claims still unresolved), but not make the required safe-harbor election.

In addition to their study of individual returns, the report also notes that IRS audit results from the Tax Preparer Projects revealed that “96 percent of the 1,761 investment theft loss claims associated with tax returns under examination were erroneous.”\(^{35}\) The two most common reasons for these erroneous returns were that taxpayers converted capital losses to theft losses and taxpayers chose the safe harbor when they were not the victim of a Ponzi scheme or other investment loss. The 96% figure may not generalize. As the IRS notes in their management response to the audit, the IRS sought out clients of promoters they thought to be abusive theft loss clients; thus, the underling sample was far from random.\(^ {36}\) Nonetheless, the direct examination of electronically filed returns reveals the untidy world of actual filings for loss, despite the elegant guidance from the Revenue Rulings and Revenue Procedures.

\section*{V. Evaluating Alternative Methods for Determining Net Equity}\(^ {37}\)

While we have shown that the IRS treatment for victims of Ponzi schemes is broadly consistent with cash in/cash out method used by the Trustee and the Courts, it is not clear that this method is the most fair. Once the Trustee has recovered as much as possible through avoidance actions and other legal measures, the only remaining issue is how to divide a fixed sum among investors. In addition to the cash in/cash out method used by the Trustee, there are a number of other possible alternatives. These include the “final statement” method

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\[35\] Ibid, p.12.
\[36\] Ibid, Appendix VI, pp. 23-25.
\[37\] The calculations described in this section were performed by Minzala Mvula.
advocated by Helen Chaitman; an inflation-adjusted cash in/cash out method as proposed by the SEC (inflation-adjusted method); and a method which would attribute a low, safe interest rate to the investors (interest-adjusted method). All of these alternative methods would provide higher returns to earlier investors in a Ponzi scheme. This could be justified on a number of different grounds. But how would they differ in practice, say, over the same time frame as the Madoff scheme? And, specifically, how would the Chaitman final statement rule compare to other alternatives?

To address this question, we conducted a small simulation exercise. We populated a Ponzi world with 25 different types of investors, each of whom invested an identical sum into the scheme. Each investor earned a constant 11% rate of return on their investments. The investors differed along two dimensions: the percent they annually withdrew from their accounts and the year in which they made their initial investment. The withdrawal rates for investors A, B, C, D, and E were 2, 4, 6, 8, and 10% respectively. Initial investments could be made in one of five years: 1989, 1994, 1999, 2004, and 2007. The Ponzi scheme was uncovered in 2008. For later reference, an investor denoted C1999 joined the Ponzi scheme in 1999 and withdrew 6% per year annually from the fund.

For each representative investor, we calculated their initial and yearly balances, their withdrawals, and their final balance at the end of the Ponzi scheme. We then looked at the world in 2008 when the Ponzi scheme collapsed. As a benchmark for the simulations, we began with the Trustee method and assumed that the Trustee was able to recover 30% of the total of all claims with positive net equity. We then used this same dollar amount to allocate the funds according to all four of our alternatives. For the final statement rule, we used the 2008 balances to allocate the funds across investors. For the inflation-adjusted method, we used the annual CPI index from 1998 to 2008 to convert both the cash in and cash out from the Ponzi scheme to constant dollars. Finally, for the interest-adjusted method, we used the 3-month Treasury bill rate to effectively calculate the present value of payments and withdrawals.

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38 By favoring early investors, one creates incentives for longer term investments by funds which may be more profitable and lead to more stable markets.
39 In practice, for a Ponzi scheme to persist the number of investors would need to increase over time. In the results reported below we simply look at representative individuals of differing vintages.
from the fund.\textsuperscript{40} The rationale for an interest adjustment is that investors perhaps should earn a low, safe return from entrusting their funds into firms that were supposedly registered and monitored by the government. Note that the inflation-adjusted calculation could be seen as providing a zero real interest rate adjustment.

We then explored how the 25 different representative investors would fare under the alternative reimbursement schemes. In Table 1, we rank the investors in terms of their share (if any) of net equity. These are simply numerical rankings by the amount they receive after the liquidation and distribution of funds recovered from the Ponzi scheme. Only investors with positive net equity received funds. Investors with negative net entry are shaded in the table.

A few lessons quickly emerge from Table 1. First, as expected, more recent entrants to the Ponzi scheme and those with lower withdrawal rates benefit the most from the Trustee scheme. Since all investors in our simulation invested the same dollar amount, long term investors had more time to withdraw funds, reducing their net equity. Those with the higher withdrawal rates received the least. Of the 25 investors, 7 in this case did not receive any funds.

In contrast, the final balance rule was very heavily tilted towards earlier investors, whose deposited funds grew at rates exceeding investors’ withdraw rates in all cases. Under this scheme, all investors shared in payouts from the liquidation. Again, this is not particularly surprising.

The rankings for both the inflation and interest-adjusted payouts differ from both the Trustee and final statement rankings, but are considerably closer to the Trustee rankings. Consider, for example, those investors who have negative net equity and would not receive payouts. Of the 7 and 5 investors with negative net equity under the inflation and interest-adjusted methods respectively, all are either 1990 or 1995 investors. Moreover, very few of the top final statement investors rank near the top of the list for these other two methods.

Another way to demonstrate that the final statement method differs substantially from the other methods is to compute the correlations among actual payouts to investors, conditional on those investors receiving payouts. This latter condition requires removing the 7 investors who did not receive payouts under at least one scenario, and then calculating the

\textsuperscript{40} The interest factor, the value of a dollar invested in 3 month Treasury bills in 1989, reached 2.09 by 2008.
correlation matrix of the actual payouts from the liquidation for the remaining investors under the alternative scenarios.\textsuperscript{41}

Table 1

\textbf{Ranking of Investors by Alternative Net Equity Methods}

\textbf{Shaded Areas are Negative Net Equity Investors}

<table>
<thead>
<tr>
<th>Trustee</th>
<th>Inflation-Adjusted</th>
<th>Interest-Adjusted</th>
<th>Final Statement</th>
</tr>
</thead>
</table>

\textsuperscript{41} Since only positive payouts were allowed, we avoided the discontinuity at zero. This makes the correlation coefficients more meaningful. The results are similar, however, when all investors—including those with zero payouts—are considered.
The results of this calculation appear in Table 2. The inflation-adjusted method recommended by the SEC is closest to the original Trustee method. However, the interest-adjusted method is also quite similar. On the other hand, the final statement method is totally at odds with the other methods. Payoffs from this method are negatively correlated with the Trustee and inflation-adjusted methods and virtually uncorrelated with the interest-adjusted method.

As a final measure, we calculated several indices of social welfare. We took the payouts from the various methods and computed a measure of social welfare across representative individuals. For each representative individual, we calculated the squared deviation of their payouts (either inflation-adjusted or interest-adjusted) from the mean payout. Treating all representative individuals equally, we then summed these squared deviations as our measure of social welfare. A higher value of this index meant more inequality (either in inflation adjusted or present value terms) and less social welfare.

With the exception of the final balance method, the other numerical welfare measures were all quite similar to one another. The Trustee method, inflation-adjusted method, and interest-adjusted method all delivered higher indices of social welfare than the final balance measure. The final balance method was clearly inferior under this measure. Although justice cannot always be determined by a majority vote, this calculation along with the results in
Tables 1 and 2 all suggest that the final statement method does appear to be an outlier for Ponzi restitution.

VI. Challenges for a Restitution Policy

This paper has identified several challenges to restitution policies for Ponzi schemes. Although it is not the primary focus of this paper, the recent Stanford Ponzi scheme raised the issue of what types of financial collapses are covered by SIPC and eligible for advances. Aside from their argument that the Antigua bank was not covered under the statute, SIPC made the claim that the CDs that were purchased were “delivered” either physically or electronically, meaning there was no longer a custodial issue with regard to securities. While the Stanford CDs were nearly worthless, they were not “missing.” In their view, this is a case of a security becoming worthless (through fraud and mismanagement) which is unfortunate for investors, but not covered by the SIPC statute and eligible for SIPC advances.

But suppose that Madoff had issued a “certificate of participation in a profit-sharing agreement” to his investors. These instruments, along with certificates of deposits and many other financial instruments are included under the definition of “securities” in the SIPC statute. Madoff could have informed his investors that he was following a “split-strike conversion” strategy and even provided information to them as to his purchases and sales of securities for the fund. Nonetheless, the investors would only own a share of the profit from these trades as evidenced by their certificates. Would the certificates be deemed worthless securities in this case? Would the fact that investors had the certificates in their possession (either physically or electronically) make them ineligible for SIPC advances?

One difficulty here is distinguishing between fraud in failing to purchase a security—even a fictitious one—and fraud committed in part by the issuance of certificates. The former is covered under SIPC, the latter may not be. The courts have and will struggle with this distinction.

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42 SIPC 78//II(14)
Given SIPC’s very limited financial reserves and its clear desire not to be perceived as an insurer for investors comparable to the FDIC, some changes in the law may be necessary. One alternative legislative approach would be to limit SIPC exposure by partly basing potential reimbursements on the timing of investments.

Consider this proposal: Investors could be eligible for SIPC advances only if: 1) an actual security was purchased by a covered broker at any time prior to a SIPC liquidation or, 2) in the event of a fraud or bankruptcy, any investor would be eligible for all funds deposited with a covered broker for up to one year from the time of the deposit.

This proposal would protect investors for whom actual securities had been purchased but stolen or misappropriated, consistent with SIPC’s historical custodial role. In addition, this proposal also would protect all investors for one year from any funds misappropriated from their accounts or from fraudulent actions, including the purchase of fictitious securities, or participation in a Ponzi scheme in which CDs were issued. This places investors who held CDs or certificates of profit-sharing on the same plane as investors who were tricked into placing funds in fictitious securities. It would not, however, provide protection beyond that one year time frame. All cases after that time would be viewed as “worthless” securities cases. After one year, Madoff investors would not have been covered under this proposal, but they would nonetheless be eligible for their share of the recovered proceeds based on their net equity.

Turning to the determination of net equity, the inflation-adjusted method may be the most fair of the alternatives. It would be easy to administer, similar to the cash in/cash out method, but provide purchasing power restitution to individuals. Our simulation indicated that it had similar properties to the current method, but would provide an extra degree of protection to long term investors. While the interest-adjusted method also yielded similar results, there is no compelling justification why some investors should earn a rate of return equal to the Treasury bill rate (an ex ante option to them) when they chose to invest in risky securities. The final balance method has the least to recommend itself for Ponzi scheme restitution. As we noted, it allows the thief to determine the distribution of funds. Our

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43 This would cause a divergence with the IRS treatment, as the tax system is not generally indexed.
simulation also indicated how sharply it differed from other reasonable method and appeared clearly inferior on welfare grounds.

Finally, the IRS needs to provide more guidance to investors as to when they can claim a loss deduction from a Ponzi scheme or whether any financial loss incurred should be considered a capital loss. This is not an easy determination: in the Stanford case, SIPC effectively characterizes the worthless CDs as subject to capital losses, while the SEC views the same facts as constituting a theft. The definition of “specified fraudulent arrangement” in the IRS Revenue Procedure does appear to fit the facts of the Stanford case. The CDs were a mechanism to run a Ponzi scheme. If that is indeed the case, the IRS would treat this as a theft loss for tax purposes, whereas SIPC (not the SEC) has characterized this as a capital loss from a “worthless security.”

The current Revenue Procedure is simply too ambiguous for the average taxpayer to make this determination. It requires the taxpayers to determine if the lead figure would be charged with theft, embezzlement or “a similar crime.”44 The IRS could perhaps cooperate with other agencies to publish a list of “officially determined Ponzi schemes” on the Web. To take advantage of the safe harbor provisions in the Revenue Procedure, taxpayers would then be required to reference a listed Ponzi scheme on their return to qualify for the theft deduction. Taxpayer not wishing to utilize the safe harbor can file a return consistent with their understanding of the existing Revenue Ruling. There need not be full consistency between the IRS and the SEC or SIPC for these determinations. Theft losses can be taken independently of SIPC advances. But, at the least, taxpayers should be given better guidance.

This paper has shown that the Trustee’s definition of net equity is broadly consistent with the tax law and recent IRS rulings, despite the surface treatment of fictitious gains. The IRS approach, however, has a broader range. It applies to foreign Ponzi schemes entered into by US taxpayers and most likely applies to a broader range of frauds than may be covered by SIPC.45

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44 Revenue Procedure 09-20 at 3.
45 The range of SIPC coverage going forward will depend significantly on the resolution of the legal proceedings between the SEC and SIPC in the Stanford matter.