“‘Tis the Time’s Plague When Madmen Lead the Blind”: How the IRS Can Prevent Pyramid-Scheme Formation (and Why It Should)

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Introduction

History has proven that pyramid schemes are tough to regulate.² Innovative schemers stay one step ahead of regulatory efforts and continuously find new applications for age-old fraud.³ But what if the IRS

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¹. WILLIAM SHAKESPEARE, KING LEAR, IN THE NORTON SHAKESPEARE, IV.1.47 (Stephen Greenblatt et al. eds., 2015).

². See JAMES WALSH, YOU CAN'T CHEAT AN HONEST MAN: HOW PONZI SCHEMES AND PYRAMID FRAUDS WORK ... AND WHY THEY'RE MORE COMMON THAN EVER 18 (1998) (quoting Larry Hodapp, a senior attorney at the Federal Trade Commission, as saying, “There’s not a lot to be done about pyramids ... People just have to be educated that the return rates these operations suggest are ridiculous”) (no relation between this author and the author of this Note).

³. See ROBERT L. FITZPATRICK & JOYCE K. REYNOLDS, FALSE PROFITS: SEEKING FINANCIAL AND SPIRITUAL DELIVERANCE IN MULTI-LEVEL MARKETING AND PYRAMID SCHEMES 12 (1997) (explaining that so many Americans are drawn to pyramid schemes because of “greed, deception,
could stop schemes before they gain traction? This Note proposes a practical solution to this dilemma by taxing right-to-recruit/right-to-sell payments ("RT payments")—which are the key feature of illegal pyramid schemes—and levying this tax against all entities that use them. There is a risk of foiling legitimate businesses that utilize RT payments as part of their business models, but this tax does not eliminate the possibility that companies could use multi-level marketing ("MLM") approaches to promote their products.4 Rather, this tax aims to imperil schemes whose business revolves around RT payments, and who use duplicitious product sales as a mere shell game to obscure their fraud.5 Further, this Note advances arguments for why it is sound public policy to require companies to surrender a significant portion of their proceeds from RT payments to the federal government.

In early 2014 at the Cleveland State University gymnasium,6 amidst a bristly pickup basketball game, a young man named "Alex," who none of the regular players has ever seen, impresses the horde of full-time economic insecurity, loss of community and [the] pervasive commercialism in our culture”).

4. For example, a legal MLM would have to be willing to pay the high marginal tax to use RT payments, but since Amway only charges “an upfront investment of about $150 [circum 1998],” the overall cost of the tax would be insignificant in the grand scheme of the enterprise. Walsh, supra note 2, at 207. Amway has since lowered the up-front cost to $67. Start Your Own Business for $67, Amway, http://www.amway.ca/start-a-business/low-cost-start-up [https://perma.cc/89BT-F529] (last visited Mar. 10, 2016).

5. See infra Part III (assuming that the IRS will identify when a scheme builds the RT payment into the price for products by marking it up a ridiculous amount). Hence, the IRS would have the power to re-characterize payments for products the same way it re-charactersizes debt vs. equity in the corporate context. Cf. 26 U.S.C. § 385 (2012).

6. This event is factually-based, but the author has changed the names and details to make them unrecognizable. For context, however, it is important to note that Cleveland State University is a large urban university that enrolls a high percentage of students from traditionally underprivileged backgrounds. See Ohio Board of Regents, Undergraduate and Graduate Student Diversity Report Fall 2010 4–5, 9 (2012), https://www.ohiohighered.org/files/uploads/data/statistical-profiles/enrollment/Diversity%20Report%20Fall%202010.0.pdf [https://perma.cc/ZQ25-2G97] (demonstrating that Cleveland State has a higher percentage of African-American students in undergraduate, graduate, and doctoral programs than every public university in Ohio, except for Central State University, which is a historically black university); see also Francine J. Lipman & Dawn Davis, Heal the Suffering Children: Fifty Years After the Declaration of War on Poverty, 34 B.C. J.L. & Soc. Just. 311, 317 (2014) (claiming that “[t]he percentage of children living in poverty soars for children of color: eleven million children of color—40% of African American children and 34% of Hispanic or Latino children—live in poverty”).
students and part-time gym-class heroes with his dynamic athleticism. Alex explains to the crowd that he follows a steady regimen of diet and exercise, but that the real secret to his success is a concoction of herbal supplements that he also sells for a living. He then discloses that the reason none of the players have ever seen him is because he is not a student at the university; he spends his days electrifying credulous gymnasium with the goal of recruiting others to his training program. Before the players can ask, “What’s the catch,” Alex wows the group of debt-ridden undergrads with a monthly income figure that halts every rehearsed dribble, reducing the gym to silence.

The above scene is a common occurrence on college campuses these days. Some may instantly praise the young entrepreneur for his “personal branding” and outspoken industry, but more than one danger lurks beneath the surface of Alex’s convincing sell. Later, Alex confides in a much smaller group that he spent the majority of his childhood in foster homes and that he never had the opportunity to


8. See Roger Parloff, The Siege of Herbalife, FORTUNE (Sept. 9, 2015, 6:30 AM), http://fortune.com/2015/09/09/the-siege-of-herbalife/ (stating that Herbalife’s “meal-replacement shake” is “remarkably successful” and that “its sales are more than double those of its three leading competitors—Ensure, Kellogg’s . . ., and Slimfast—combined”).

9. See id. (arguing that “[t]he danger with any MLM is that recruiting, not product sales, may become the raison d’etre of the enterprise, which then devolves into a thinly disguised money-transfer game”).

10. See id. (claiming that although “[t]op-tier distributors are . . . eligible for . . . lucrative . . . bonus[es] [of up to] . . . $2 million . . . only 3.7% of those pursuing the business in the U.S. grossed royalties of more than $25,000 in 2014”).


12. See Joann S. Lublin, Refreshing Your Brand Leads to Career Success, WALL ST. J. (Jan. 1, 2015, 5:02 PM), http://www.wsj.com/articles/refreshing-your-brand-leads-to-career-success-1420149760 (arguing that one’s “personal brand” is highly determinative of one’s “career success”).

13. See Parloff, supra note 8 (quoting Bill Ackman, CEO of Pershing Square Capital Management, who has overtly waged a short-sell campaign against Herbalife, as stating that the company is “fraudulently deceiving poor people into investing in a fictitious business opportunity”).
participate in organized athletics or finish high school. Alex explains that he’s wanted an opportunity like this his whole life; and that his superiors and role models in the organization are doing even better than he is. And now that he’s found his life’s work he wants the other players to join him in an opportunity that even he, sometimes, cannot believe is true.

Hopefully the risk is clear. The proposed remedy, however, is simple: Congress implements a system of taxation requiring all entities that charge RT payments to pay high marginal taxes (perhaps 75–85%) on those payments. As a practical matter, the tax works as a deterrent because: (1) direct sellers and legitimate multi-level marketing companies will toil to avoid it, which should signal to consumers that a company charging an RT payment is a scheme; and (2) it will eliminate the viability of generating income from RT payments, which should deter scheme development altogether. Since scheme formation and participant compensation both emanate from RT payments, this system of taxation discourages the payments that supply schemes. In turn, if a scheme continues to charge RT payments it will have to relinquish most of its revenue to the IRS, and the promoter who actually recruited the new participant will get the rest (if they are to have any benefit for

14. See Herb Greenberg, For Many Herbalife Recruits, Lost Money and Dashed Dreams, NBC News (Jan. 10, 2013, 8:10 AM) http://www.nbcnews.com/business/many-herbalife-recruits-lost-money-dashed-dreams-1B7899747 [https://perma.cc/R2ND-LRRQ] (interviewing Nicole Lopez, a middle-class Utah mother that lost $10,000 to Herbalife, who claims that, “[Herbalife] . . . is preying off poor and middle class families”); see also Bundy, supra note 7, at 125 (claiming that “Pyramid sales . . . are organized to attract unsophisticated investors—those lacking education and business experience”).

15. Intuitively, recruiting new investors into a pyramid scheme involves overinflating the success of those already embroiled in the scheme. See Note, Pyramid Schemes: Dare to be Regulated, 61 Geo. L. J. 1257, 1259 (1973) [hereinafter Dare to be Regulated] (explaining that “[p]eople often are recruited for [pyramid schemes] . . . at opportunity meetings or parties where high-pressure-salesmanship, false enthusiasm of shills and organizers, and deceptive representations by promoters create the expectation of potential overwhelming financial return for a minimum of time and effort by the participant”).

16. See Bundy, supra note 7, at 126 (“[R]epresentatives tell investors how easy it will be for them to make a substantial amount of money by merely ‘sharing’ the organization’s unique concept with a few of their friends, relatives, neighbors, co-workers, and even strangers.”) (emphasis added).

17. This relies on the assumption that corporations will avoid taxes, if possible. See Jasmine M. Fisher, Note, Fairer Shores: Tax Havens, Tax Avoidance, and Corporate Social Responsibility, 94 B.U. L. Rev. 337, 338 (2014) (“[F]or today’s . . . corporations, tax avoidance and the use of tax havens have become commonplace and even an integral part of modern business practice.”).
recruiting/selling). Altogether, if the company does not sell enough products to make it profitable, the net effect of the RT payments is zero, which merely subjects MLMs and schemes to the same market risks as ordinary manufacturers, producers, and retailers.¹⁸

This proposed system corrals the economic viability of the pyramid model by obliging pyramids masking as MLM companies to actually sell products. The tax renders retail sales to actual customers the only viable means of producing income, rather than pushing valueless merchandise¹⁹ on new recruits and charging exorbitant fees for the right to sell products or recruit others.²⁰ In effect, this proposal is a “rootstriker” provision that targets the underpinnings of pyramid-scheme formation and aims to stop schemes before they start.²¹

Part I of this Note explores the historical and legal background of pyramid schemes and pyramid-scheme regulation and depicts why this is a problematic area of law. Part II closely analyzes the business models of two purportedly legitimate MLMs, Amway and Herbalife, and postulates why direct selling allows pyramid schemes an environment in which to flourish. Lastly, Part III lays out the mechanics of the proposed tax and provides policy justifications for why this tax can deter the inception of pyramid schemes.


¹⁹ This practice is known in the industry as “inventory loading.” See Aditi Jhaveri, The Telltale Signs of a Pyramid Scheme, Fed. Trade Comm’n (May 13, 2014), https://www.consumer.ftc.gov/blog/telltale-signs-pyramid-scheme [https://perma.cc/7U6S-MXEJ] (explaining that one of the signs a company is a pyramid scheme is if “you’re required to buy lots of inventory”).

²⁰ See infra Section II.B.

²¹ Cf. Lawrence Lessig, On Rootstrikers, LESEGIG BLOG, V2 (June 2015), http://lessig.tumblr.com/post/121917574292/on-rootstrikers [https://perma.cc/PLP4-J9BZ] (calling for “Rootstrikers” to fight the corrupting influence of money in politics). A rootstriker provision is one that strikes at the root of a problem. In this case, the tax cuts off the supply of capital that allows pyramid schemes to grow and develop.
I. THE HISTORICAL AND LEGAL BACKGROUND OF PYRAMID SCHEMES

The federal government has officially recognized pyramid schemes as a problem since 1967.22 Although some conflate the term “pyramid scheme” with the more widely publicized “Ponzi scheme,”23 the two are distinct, and the pyramid model has existed in some form in the United States since the early twentieth century.25 The difference between a “pyramid scheme” and a “Ponzi scheme” is that “in a Ponzi scheme money is handed over to be invested; in a pyramid scheme, money is handed over in exchange for a right to do something . . . . Ponzi schemes are always illegal; pyramid schemes are sometimes, depending upon how they are structured.”26 The most meaningful characteristic common to all illegal pyramid schemes is substantial payments made for the “right to recruit” others, or the “right to sell” products, which is also the source of compensation for scheme participants. Eventually, since pyramid-scheme logic envisions an infinite number of recruits, and since there are a finite number of people, the bottom falls out and most everyone loses.27 The theory is that if the federal government can diminish the supply of RT payments it can, in effect, eliminate the most significant means by which schemers effect pyramid frauds.

The vast majority of legal scholarship concerning pyramid-scheme regulation dates to the 1970s, which is when the FTC first targeted pyramid schemes.28 Since then, scholars have compared pyramid-
scheme tactics to other business models by grouping them into four broad economic categories: lotteries,29 securities,30 restraints of trade,31 and franchises.32 The literature has produced several interesting ways to think about how the government might intervene; but, despite this steady flow of inquiry, Sergio Pareja maintains that “legislators and legal scholars have virtually ignored the severity of [the pyramid scheme] problem.”33 One of the reasons for this is the inherent complication in defining the term “pyramid scheme.”34 Courts,35 legislators,36 and enforcement agencies have had equal difficulty in trying to define such an elusive term,37 and this Note does not presuppose a simple answer to a question that many others have found troublesome.38 Further, this Note does not categorize the indicia and nuances that render a particular business venture a pyramid scheme: many lengthy

29. Id. at 1268.
30. Bundy, supra note 7, at 128.
33. Id. at 88.
34. See, e.g., Dare to be Regulated, supra note 15, at 1290 (“One difficulty with [a] broad interpretation of profit sharing agreement is that it encompasses any arrangement which pays salesmen on a commission basis and subjects it to potential regulation.”).
35. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974). This definition, however, is largely obsolete since bad actors structure the schemes to fall outside the federal securities laws. See infra Part I.A (explaining that when participants sell their own products it largely diminishes the SEC’s role in pyramid-scheme regulation).
36. See Dare to be Regulated, supra note 15, at 1262 (listing twenty-three state statutes “dealing with pyramid schemes, endless chain sales, and referral or multilevel sales plans,” which generally “define a pyramid scheme as a plan or program in which a participant gives valuable consideration for the chance to receive compensation or something of value by procuring new participants for the program”).
37. See 15 U.S.C. § 45(a)(1) (2012) (categorizing pyramid schemes under an umbrella of “unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce”).
38. Like the distinction between personal expenses and “ordinary and necessary” business expenses, a bright line definition is not necessarily practical for identifying pyramid schemes. See Welch v. Helvering, 290 U.S. 111, 115 (1933) (explaining that “[l]ife in all its fullness must supply the answer to the riddle”). Since drawing a line between legal and illegal entities is so difficult, the proposed tax must apply to both.
studies have attempted this feat and have not prompted any cognizable systemic influence. 39

But to briefly illustrate the need for a regulatory shift, journalist Joe Nocera, in late 2015, asked FTC spokesman Frank Dorman to distinguish between illegal pyramid schemes and legal MLMs. 40 Dorman offered a peculiar response: “I have nothing for you,” he replied, “We’re not going to answer it.” 41 And so goes the belabored quest of differentiating MLMs from pyramid schemes—attempts to define this “Bermuda triangle” of fraud are scattered throughout the prior fifty years of legal scholarship. 42 Moreover, strategies that attack pyramid schemes ex post are a form of Sisyphean regulation: 43 the more resources

39. See generally WALSH, supra note 2 (describing several types of pyramid schemes); see also Eric Witiw, Selling the Right to Sell the Same Right to Sell: Applying the Consumer Fraud Act, the Uniform Securities Law and the Criminal Code to Pyramid Schemes, 26 SETON HALL L. REV. 1635, 1647 (1996) (proclaiming that “the question remains whether promoters will successfully continue to sell the same right to sell”; the answer to which, the benefit of time has indicated, is a resounding “yes”).


41. Id.


43. Cf. William Wright, The Myth of Sisyphus and the Reality of Never-ending Banking Reform, New Fin. (August 2014), http://newfinancial.eu/mythsisyphus-reality-never-ending-banking-reform/ [https://perma.cc/3L49-SEVZ] (arguing that the interpretation of international banking regulations is akin to “[a] futile task of . . . responding to relentless consultation papers on new regulations that will never be implemented, conducting continuous stress tests that are impossible to pass, and hiring infinite numbers of compliance staff whose work will never be done”).
the federal government invests in the enterprise, the less effective the regulatory scheme seems to be.44

Yet, in the age of digital commerce,45 where transactions occur at the speed of light, the need for stringent consumer protections is more compelling than ever.46 As sophisticated fraudsters discover new computerized techniques for coercing investors into forking over funds, pyramid-scheme tactics threaten the marketplace with any number of unforeseen practices.47 Some commentators argue that it is not the federal government’s role to safeguard consumers from ruinous investments, that investors should rise and fall by way of their own due diligence.48 But there is a greater public concern of consequence to any income-earning taxpayer: the amount of their hard-earned contributions submerged each fiscal year in a futile regulatory initiative.49

44. See W. Kip Viscusi & Ted Gayer, Behavioral Public Choice: The Behavioral Paradox of Government Policy, 38 Harv. J.L. & Pub. Pol’y 973, 1006 (2015) (arguing that in the context of EPA regulations, “there are real opportunity costs to wasteful expenditures. Funds that are squandered on ineffective policies could be used instead by consumers to promote their well-being”).


46. See Karen Albourek, Note, Adapting to a New World of E-Commerce: The Need for Uniform Consumer Protection in the International Electronic Marketplace, 35 Geo. Wash. Int’l. L. Rev. 425, 443 (2003) (declaring that “[t]he FTC . . . recognizes . . . that adopting a framework that subjects business only to the [consumer protections] and forums of their own country . . . has the potential of seriously undermining consumer protection and in the end consumer confidence in the global electronic marketplace”).


48. See, e.g., Tom C.W. Lin, Reasonable Investor(s), 95 B.U. L. Rev. 461, 502 (2015) (arguing that “broad-based, monolithic investor protection regulations promulgated in downtimes frequently become deregulated in boom times—creating a consequential and costly cycle of over-regulation, deregulation, and re-regulation”). Perhaps this is a given, but it is necessary to address for critics who believe any regulation of business is an unreasonable infringement by the government.

American society has decided that it will not tolerate the commission of pyramid schemes and, in this context, arguing against governmental intervention is a moot point. 50 Although criticism of policies that have the potential to suppress commercial activity is well-founded, 51 abandoning pyramid-scheme regulation altogether is ill-advised. By placing some of the regulatory burden on the IRS, Congress can impede fraudsters’ use of the most popular technique for pyramid-scheme formation: charging fees for the “right to recruit” others, or the “right to sell” products. In turn, this tax discourages entities from accepting RT payments, 52 which restricts the revenue stream and lessens reliance on the FTC’s inefficient policing—what one expert has likened to “stop[ping] one speeder while all the others race by.” 53

A. Evading the SEC’s and FTC’s Spheres of Influence

Fraudsters have toiled to evade the Securities Act of 1933 and the Securities Exchange Act of 1934, which complicates the challenges the SEC faces when combating pyramid schemes. 54 The SEC is unable to
regulate most schemes because they do not fit the U.S. Supreme Court’s interpretation of the term “investment contract,” which it established in SEC v. W. J. Howey Co.55 Schemers have found that, when inter-spersing retail products into their recruitment tactics,56 they can evade the “solely from the efforts of others” prong of the Howey test and, thus, the gambit of SEC regulation.57 This allows schemes to foist vastly overvalued retail items on unsuspecting recruits by promising them substantial bonuses either for sales (some of which are near-impossible to make),58 or for recruiting others into the scheme.59 Further, even if a venture fits the definition of “security,” it may qualify for an exemption from the registration requirement.60 Combining this fact with the explosion of cheap retail merchandise in the pyramid model has shifted most of the regulatory burden to the FTC.61

The FTC has had some success dismantling immense schemes, but only after the point when investors could recoup significant losses.62

56. See infra Part II (exploring the differences between Amway and Herbalife, the second of which operates more like a pyramid scheme because of its recruitment bonuses).
57. W. J. Howey Co., 328 U.S. at 301.
58. See Frank Partnoy, Is Herbalife a Pyramid Scheme?, THE ATLANTIC (June 2014), http://www.theatlantic.com/magazine/archive/2014/06/wall-streets-6-billion-mystery/361624/ [https://perma.cc/D23T-EF88] (claiming that critics of Herbalife “say [it] is exploiting poor people, who are tricked into paying thousands of dollars for products they will not be able to sell or want to consume”).
60. Clinton R. Black IV, The Pyramid Scheme: Don’t Be the Mortar Between the Bricks, LAW F., Fall 1981, at 10; see also Pareja, supra note 32, at 97 (explaining that “[i]n the MLM context, it is rare for the SEC to attack a company for failure to register. In fact, almost all cases involve claims of materially false or misleading statements. Thus, to determine whether an MLM is in fact a pyramid marketing scheme, the following two questions should be asked: (1) is there a security and, if so, (2) has fraud been committed?”). Undoubtedly, the answer to question (1) is usually “no.” See supra note 54 and accompanying text.
Razing a scheme is challenging, time-consuming, and expensive, and although pyramid schemes are not new, the many recent innovations have left obstinate regulators at odds. The issue with labeling a certain business a “pyramid scheme” is that even the FTC cannot decide what makes one business a proper exercise of entrepreneurial capitalism and the other a deceptive scheme advancing vicious untruths. In *Koscot Interplanetary*, the FTC appeared to have settled on the following definition: a company is a pyramid scheme if the participants pay money to “the company in return for which they receive (1) the right to sell a product and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users.” But, forty-one years later, pyramid schemes have found new ways to circumvent these regulatory measures—some for a long enough period to make millions before the FTC takes action.

The major problem with the FTC’s regulatory strategy is not that it is utterly ineffective, but that once a scheme rises to the level of


65. *See Stroud, supra note 53 (quoting Peter Vander Nat, a former senior economist with the FTC who assisted in shutting down 15 pyramid schemes, as stating that “[A] fundamental understanding of [what] a pyramid scheme [is should] be announced in a rule [by the FTC and] . . . laid down once and for all”).*


67. *Id. at 1180.*

68. *See FTC v. BurnLounge, Inc., 753 F.3d 878, 886 (9th Cir. 2014) (distinguishing BurnLounge from Amway because, unlike Amway, BurnLounge “had no rules promoting retail sales over recruitment” (emphasis in original)); see also Stroud, supra note 53 (quoting pyramid scheme expert and Dean of the College of New Jersey, Bill Keep, as stating that pyramid-scheme regulation has been largely ineffective because “[the FTC] sends confusing signals that have in no way helped us understand how to identify a multilevel marketing company that may be a pyramid scheme”).*

FTC intervention, it is too late to help injured stakeholders. The recent BurnLounge case serves as a powerful example of the FTC’s inefficient enforcement tactics because “it took [them] seven years to shut BurnLounge down [and] . . . [i]n the meantime, as many as 30,000 salespeople had been roped into the scam.” The fact that the scam attracted that many people after the FTC intervened is compelling evidence that its enforcement tactics are inadequate, at best. Perhaps the even greater concern is that the FTC’s own insiders condemn its internal enforcement actions as a feeble deterrent to scheme development. Recent cases suggest that the ex post regulation of pyramid schemes is not only disastrous for consumers but is also a significant drain on judicial and administrative resources.

In FTC v. Vemma Nutrition Company, the FTC ordered an energy drink company to temporarily shut down because it operated as an illegal pyramid scheme. There is also a pending class action suit

70. See FTC Action Leads Court to Halt Alleged Pyramid Scheme, Fed. Trade Comm’n (Jan. 28, 2013), https://www.ftc.gov/news-events/press-releases/2013/01/ftc-action-leads-court-halt-alleged-pyramid-scheme [https://perma.cc/8AYY-RW9X] (admitting that, by the time the FTC began to investigate Fortune Hi-Tech Marketing, more than 100,000 consumers had bought in to the scam, and over 90% lost their money).

71. Stroud, supra note 53.

72. See Pareja, supra note 32, at 92–93 (arguing that although “[t]he FTC has been particularly successful at stopping fraudulent ‘business opportunities’ related to the sale of vending machines and rack displays . . . enforcement under the Franchise Rule has been unsuccessful at stopping work-at-home and pyramid marketing schemes”).

73. See Stroud, supra note 53 (quoting Vander Nat as saying that “[the FTC’s] process [is one] in which the prosecution takes so long that the deterrent effect is insufficient”).

74. Cf. Laura L. Arbeiter, A Waste of Judicial and Agency Resources—The FAA’s Painstaking Compliance with Regulations Governing the Hangar 24 Project, 78 J. Air L. & Com. 173, 178 (2013) (arguing that “the FAA appears to have gone above and beyond what is required by the review process” and “judicial resources are squandered by such an extensive review of the administrative record”).


against Vemma Nutrition in the District of Arizona in which the plaintiffs raise similar allegations.\(^77\) One challenge in the FTC/Vemma case was over the so-called “51% Rule,” which, after the temporary shutdown, Vemma proposed as a compliance measure.\(^78\) Under this rule, “full bonuses are paid to an Affiliate if 51% of the sales of the Affiliate’s organization are to Customers. When less than 51% of sales are to Customers, an Affiliate is still paid a bonus, but the portion . . . may not exceed the bonus resulting from sales to Customers.”\(^79\) First, we must consider whether it is the business of courts, rather than legislators, to affix proper sales percentages to private sales arrangements. Second, is it sound economic policy to allow a company to survive if it does not make a majority of its sales to actual customers? Clearly, the “Affiliates” who are the furthest downstream bear the brunt of the losses. The lack of bright-line rules in pyramid-scheme regulation—and regulators’ hesitancy to implement formal boundaries—is chaos for the novice scholar, but imagine how overwhelming it must be to consumers thinking of pursuing one of these business opportunities.\(^80\)

The FTC did, however, object to Vemma’s proposed arrangement, and the Court agreed on the grounds that “the 51% Rule can provide significant compensation to an Affiliate whose sales are principally to downstream Affiliates . . . and . . . the . . . plan does not include other anti-inventory loading safeguards or otherwise incentivize sales to Customers rather than Affiliates.”\(^81\) The Court, therefore, denied Vemma’s Motion to Approve Revised Compensation Plan.\(^82\) Critics who are cautious of paternalistic courts managing business decisions may shake their heads at such intricate judicial analysis—especially since


\(^{79}\) See id. (defining “Affiliate” as “a participant who ‘intends to participate and earn rewards under Vemma’s Marketing Plan,’ and a Customer [as] a participant who ‘is interested in purchasing and using’ Vemma products”).

\(^{80}\) See Partnoy, supra note 58 (quoting Herbalife President, Des Walsh (no relation), as saying “[w]e don’t track [the] number” of sales made outside the company’s network “and do not believe it is relevant”).

\(^{81}\) FTC v. Vemma, 2015 WL 9694632 at *2.

\(^{82}\) Id.

\(^{83}\) See, e.g., Lyman Johnson, Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose, 38 Del. J. Corp. L. 405, 410 (2013) (comparing a re-examination of the business judgment rule in Delaware to “visiting the Vatican with the intention of giving the Pope a copy of Luther’s small catechism, or Calvin’s Institutes of the Christian Religion”).
this ruling merely dealt with an amendment to an earlier preliminary injunction. But this weighty judicial inquiry is a byproduct of the natural adversities that come from distinguishing pyramid schemes from MLMs.\textsuperscript{84}

In \textit{FTC v. BurnLounge}, the Ninth Circuit affirmed a district court ruling that held that BurnLounge was an illegal pyramid scheme because recruitment of new members was at the heart of both its business plan and its bonus structure.\textsuperscript{85} BurnLounge participants did actually sell retail merchandise in the form of online media, but the Ninth Circuit held that the principal purpose was not actual sales, but was recruiting new members.\textsuperscript{86} The Ninth Circuit found that BurnLounge was a pyramid scheme because: “Moguls were required to recruit new members in order to become eligible for all three types of cash bonuses . . . and . . . BurnLounge’s sales plummeted after the Mogul program was enjoined.”\textsuperscript{87} Even though this was, unquestionably, the correct determination, one cannot help but think that the Ninth Circuit has more urgent judicial duties than investigating the snares of BurnLounge’s fatefully titled “Mogul Program.”\textsuperscript{88} A key inefficiency in pyramid-scheme regulation is requiring courts to undergo lengthy and complicated factual analyses that use balancing tests, percentages, and somewhat arbitrary ratios.\textsuperscript{89} Revisiting the FTC’s recent investigations into

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\item \textsuperscript{84} See, e.g., Bill Schuette, \textit{Multi-Level Marketing or Illegal Pyramid Scheme? What is the Difference?}, MICH. ATT’Y GEN. CONSUMER ALERTS, https://www.michigan.gov/ag/0,4534,7-164-17337_20942-208400--00.html [https://perma.cc/VG9V-QULT] (last visited Mar. 12, 2016) (“It is understandable that consumers often have difficulty telling the difference between an illegal pyramid scheme and a legitimate multi-level marketing opportunity. Governmental regulators and the industry continue to debate where the legal lines are drawn.”).
\item \textsuperscript{85} FTC v. BurnLounge, Inc., 753 F.3d 878, 881 (9th Cir. 2014).
\item \textsuperscript{86} \textit{Id.} at 884.
\item \textsuperscript{87} \textit{Id.} To become a part of BurnLounge’s program, “Independent Retailers could earn points redeemable for music or merchandise, or they could pay an additional fee to become ‘Moguls’ and earn cash rewards.” \textit{Id.} at 880 (emphasis added).
\item \textsuperscript{88} See Jennifer Bendery, \textit{Federal Judges Are Burned Out, Overworked and Wondering Where Congress Is}, HUFFINGTON POST (Sept. 30, 2015, 2:15 PM), http://www.huffingtonpost.com/entry/judge-federal-courts-vacancies_us_55d77721e4b0a40aa3af14b [https://perma.cc/GE3W-UF6W] (“\textit{T}he Huffington Post talked to half a dozen federal judges about how court vacancies and the lack of new judgeships affect their workloads. All of them said they feel like they’re underwater and desperately need more judges.”).
\item \textsuperscript{89} See \textit{BurnLounge}, 753 F.3d at 883 (“The district court described BurnLounge’s bonus system as ‘a labyrinth of obsfuscation.’ It found there was a 93.84% failure rate for all Moguls, meaning 93.84% of Moguls never recouped their investment.”).
\end{itemize}
\end{footnotesize}
BurnLounge and Vemma Nutrition helps one grasp the ex post inefficiency of its regulatory strategy—by the time the FTC intervened, the vast majority of participants in BurnLounge and Vemma Nutrition had lost their original investment. For example, in the BurnLounge case, the court awarded $16.2 million to injured stakeholders, but BurnLounge only paid $1.9 million in refund checks. If the purpose is to deter schemes from developing, it is clear that the FTC’s existing strategy is not working—BurnLounge profited over $28.3 million, and Vemma Nutrition a whopping $400 million, before the FTC intervened.

B. Difficulties with the FTC’s “Business Opportunity Rule”

It is necessary to note that “a franchise is a business opportunity, but not all business opportunities are franchises.” The FTC’s current version of the “business opportunity rule” includes three requirements: (1) the Seller has to give Buyer a one-page disclosure document, which it must provide seven days before Buyer signs a contract or pays any money for the business opportunity; (2) if Seller makes an earnings claim it must give Buyer a separate document that includes several sub-requirements; and (3) the Seller must comply with general truth-in-advertising principles that are spelled out in the rule. The FTC promulgated this rule because pyramid schemes usually fit the exceptions to the FTC’s “franchise rule.”

90. Id.; see also Kurt Orzech, Vemma Temporarily Shut Down Amid Pyramid Scheme Claims, LAW360 (Aug. 26, 2015, 9:45 PM), http://www.law360.com/articles/695548/vemma-temporarily-shut-down-amid-pyramid-scheme-claims [https://perma.cc/2PQ4-K9DH] (explaining that “most of the independent distributors, or ‘affiliates’—who were told they could make up to $50,000 a week—actually lost money, the [FTC] said”).


92. Mullin, supra note 47.

93. Orzech, supra note 90.


96. 16 C.F.R. § 436 (2007); see also Pareja, supra note 32, at 92 (explaining that the “franchise rule” does not apply when “the purchaser does not need to make a payment of more than $500 or more within six months of purchase
The only law review article written in the last ten years specifically devoted to pyramid-scheme regulation examined the FTC’s application of this “business opportunity rule.” Pareja argues that ideal FTC intervention would take place on two fronts: one, prospective purchasers could bring private actions against the scheme for failure to disclose material information; and, two, schemes would have to comply with an “anti-pyramid marketing scheme rule” that would require schemes to divulge their business practices to the government. Pareja’s suggestions are commendable and seem to correspond well with the Commission’s stated purpose, but these recommendations would hamstring participants with the same inefficient remedy the FTC pursues—a lengthy and costly litigation process.

Further, in light of the complex disclosure requirements, Pareja’s proposal would force the FTC to operate like the de facto SEC for “business opportunities.” The prospect of this regulatory burden is daunting, and one has trouble imagining a scenario in which every business opportunity in the nation would have to comply with baseline federal disclosure requirements. This is either too heavy a burden on . . . 

. . . [and] voluntary purchases of reasonable amounts of inventory at wholesale prices does not count toward this $500 threshold.” Lastly, the rule “does not apply if the purchaser is merely paying for training or if the buyer and seller agree that the seller will buy back and resell goods assembled by the buyer.”

97. See generally id. (proposing a two-fold approach to pyramid scheme regulation in which the FTC would require schemes to make material disclosures to both potential investors and enforcement agencies).

98. Id. at 129.

99. See About the FTC, Fed. Trade Comm’n, https://www.ftc.gov/about-ftc [https://perma.cc/RK6R-J5GZ] (last visited Nov. 10, 2015) (stating that the FTC’s mission is “[t]o prevent business practices that are anticompetitive or deceptive or unfair to consumers; to enhance informed consumer choice and public understanding of the competitive process; and to accomplish this without unduly burdening legitimate business activity”).

100. See AG Announces FTC Settlement Regarding Fortune Hi-Tech Marketing, Lane Rep. (May 13, 2014), http://www.lanereport.com/31757/2014/05/ag-announces-ftc-settlement-regarding-fortune-hi-tech-marketing/ [https://perma.cc/Y29U-3BUS] (reporting that the Attorneys General of North Dakota, Illinois, and Kentucky all began investigating the company in 2010 or before, and that the FTC did not reach a settlement with the company until 2014). Although the order imposed a judgment of $169 million, investors only recovered $7.75 million. Id.

the FTC, or on the businesses, or both.102 Although Pareja seems to agree that regulators must confront a scheme before it starts, the FTC has had this disclosure requirement for almost a decade and the news headlines and federal court dockets suggest that it has not prevented much of anything.103

II. Case Study: Amway v. Herbalife

The goal of this Section is to deconstruct two MLMs to demonstrate reasons why federal regulators have not successfully distinguished MLMs from pyramid schemes.104 As a matter of first principle, the inherent challenges in making this distinction support the argument that the solution to the pyramid-scheme problem, insofar as there is a solution,105 is taxing all entities that charge RT payments. The concern is that since MLMs and pyramid schemes have similar tactics,106 the

imposing costly reporting, and record-keeping requirements”) (emphasis added).

102. Which is why a federal tax is the answer to this regulatory snafu—companies already have to file yearly tax returns with the IRS.


104. See Herbalife Will Restructure Its Multi-Level Marketing Operations and Pay $200 Million for Consumer Redress to Settle FTC Charges, Fed. Trade Comm’n, https://www.ftc.gov/news-events/press-releases/2016/07/herbalife-will-restructure-its-multi-level-marketing-operations [https://perma.cc/5TMG-5JYH] (last visited Sept. 2, 2016) (explaining, several months after the author drafted the bulk of this Note, that “this settlement will require Herbalife to fundamentally restructure its business so that participants are rewarded for what they sell, not how many people they recruit,” and “Herbalife is going to have to start operating legitimately . . . and it will have to compensate consumers for the losses they have suffered as a result of what we charge are unfair and deceptive practices”).

105. Since MLM companies and pyramid schemes are so difficult to distinguish, some regulators think it is impossible. See Herb Greenberg & Karina Frayter, Why Spotting a Pyramid Scheme Isn’t So Easy, CNBC (Jan. 9, 2013, 3:19 PM), http://www.cnbc.com/id/100364484 [https://perma.cc/T7KE-4SZ7] (arguing that the problem with spotting a pyramid scheme is that “so many of these businesses, legal or not, are simply too complicated”).

106. See Jayne O’Donnell, Multilevel Marketing or ‘Pyramid’? Sales People Find it Hard to Earn Much, USA Today (Feb. 10, 2011, 1:36:04 PM) http://usatoday30.usatoday.com/money/industries/retail/2011-02-07-multilevelmarketing03_CV_N.htm [https://perma.cc/K4MV-MV9Q] (explaining that multi-level marketing companies are similar to pyramid schemes because they pay “commissions to salespeople for the products they
proposed tax may thwart some of the legitimate business practices of MLMs. But, after scrutinizing the business practices of MLMs, one doubts that it is sound policy to protect these quasi-legitimate entities, especially if the cost is allowing pyramid schemes a fruitful environment in which to thrive. This Section, therefore, appraises the thin line between these two types of entities to support the argument that it is not an unreasonable infringement on business to expose MLMs to this tax, as well.

A. The Multi-Level Marketing Model

According to the World Federation of Direct Selling Associations, the unique feature of MLMs is that direct salespersons “forge strong personal relationships with prospective customers, primarily through face-to-face discussions and demonstrations.” But the actual key feature of MLMs is that “when you work for an MLM, you’re compensated for your own product sales as well as the sales of your recruits and your recruits’ recruits.”

The Direct Selling Association (“DSA”) argues that, despite the above compensation structure, MLMs are distinguishable from pyramid sell, on products sold by others they recruit, and often bonuses when their teams reach a certain level of sales”).


108. But see id. (reporting that “MLMs will suggest the difference in earnings” between the top and the bottom distributors “stems from a difference in effort” but “critics say high earners are part of a deception and contribute to the lottery mindset of sellers”).

109. See O’Donnell, supra note 103 (“Even proponents of multilevel marketing say the cases and probes underscore one of the growing problems in the industry: it can be very difficult, if not impossible, for most individuals to make a lot of money through the direct sale of products to consumers.”).

110. Fearing that this proposal might suggest otherwise, the author would like to clearly state his belief that it is sound public policy to lower taxes on legitimate businesses if it results in economic growth and job creation.


schemes; namely because MLMs provide accurate information, charge nominal start-up fees, sell products that end users ultimately purchase, require sellers to hold little or no inventory, honor buyback policies, base compensation on sale of products to end users, and give potential sellers time to make a decision on whether to join the company. 113 In contrast, the DSA argues that pyramid schemes vow large earnings from recruiting but may not even sell products, or convince sellers to buy large amounts of inventory, charge large start-up fees, and compensate primarily from recruiting fees.114 It is usually difficult to tell the difference between a pyramid scheme and an MLM without an in-depth examination of the company’s compensation structure, and that is a lot to ask of an unsophisticated investor. For that reason, this Section begins with an analysis of Amway, which is known worldwide as the “poster-child” for the MLM model.115

Amway was formed in Ada, Michigan in the 1950s, and its name is an abbreviation for “American Way.”116 The company manufactures, distributes, and sells “more than 150 kinds of homecare, car-care and personal-care products, as well as vitamins and food supplements . . . [and] sells over 300 products . . . of other manufacturers . . . including clothing, household appliances, furnishings, tools, luggage, watches, cameras and other items.”117 Clearly Amway is diversified, but its stock in trade is not what captivates confused regulators. Many schemes have attempted to emulate the Amway model, which requires “distributors . . . to resell at least 70 percent of the products they purchased each month.”118 Courts have found that Amway’s amalgamation of recruiting and retail sales is legal since “distributorships were not for sale and sponsoring distributors received no profit from the act of sponsoring.”119

114. Id.
118. WALSH, supra note 2, at 209.
119. Id.
Opinions on Amway are all over the map, but they range from profitable\(^{120}\) to educational\(^{121}\) to utterly corrupt\(^{122}\).

As we know, many have tried, and failed, to analytically distinguish MLMs from pyramid schemes\(^{123}\). But in a landmark administrative case involving Amway, the FTC recognized three company practices that signaled legitimacy: (1) a ten retail customer policy requiring ongoing sales to retail customers; (2) a 70 percent rule requiring distributors to have sold 70 percent of previously purchased products before reordering; and (3) a buyback policy for the inventory of terminating distributors\(^{124}\). Collectively, these became known as the “Amway Safeguards Rule,” which serve as the closest resemblance of a distinction between a legal MLM and an illegal pyramid scheme\(^{125}\).

Whatever one thinks about the MLM model, the Amway enterprise has allowed some to profit handsomely\(^{126}\). Nevertheless, Amway’s busi-
ness practices are similar enough to the pyramid model that the company faced a class action lawsuit in November 2010 alleging that it “is a ‘pyramid scheme.”’ Nevertheless, it is important to accept that there are fair reasons why regulators have been reluctant to scrutinize the MLM business model too closely, especially in light of the fact that Amway has been successful in certain contexts. The distinctions between Amway and Herbalife are subtle, but they illustrate why the “pyramid-scheme tax” can obstruct the development of illegal schemes without unjustly encroaching on MLMs.

B. The Pitfalls of Incorporating Sham Products

On the surface, Herbalife is an above-average MLM; it is publicly traded with a market capitalization value of $5.28 billion, and earnings of nearly $4.5 billion in 2015. But the company and its critics disagree on one major characterization issue: Herbalife argues that “a substantial majority (73%)” of its members join “primarily to receive a discounted price on products,” whereas critics bemoan that Herbalife is “a criminal enterprise that preys on the poor.” The fact that the incomes of less than $115. The remaining third vary wildly. The upper income range, $45,000 to $700,000, accounts for only .6% of the sales force.”

127. O’Donnell, supra note 106. Amway settled the case and agreed to pay $55 million to former distributors, strengthen refund policies, and make other changes estimated to cost the company an additional $100 million. Id.

128. In theory, the direct selling model sounds fair, and even a bit egalitarian. See Direct Selling Retail Channel, DIRECT SELLING ASSOC., http://www.dsa.org/about (last visited Oct. 24, 2016) (“The direct selling channel differs from broader retail in an important way. It isn’t only about getting great products and services into consumers’ hands. It’s also an avenue where entrepreneurial-minded Americans can work independently to build a business with low start-up and overhead costs.”).

129. MLMs, however, will almost certainly have to change their business models to remain profitable.


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company openly admits that only twenty-seven percent of its distributors sign up to earn income is intriguing, but at first glance this proportionality does not resemble legitimate multi-level marketing. The FTC, directly on the agency website, proclaims that “one sign of a pyramid scheme is if distributors sell more product to other distributors than to the public.”\textsuperscript{134} Legitimate or not, it is important to consider the threat that a company like Herbalife poses to disadvantaged individuals and communities.\textsuperscript{135}

The current price to start a full distributorship is $94.10,\textsuperscript{136} and a mini-distributorship is $60.70,\textsuperscript{137} but one slighted distributor, David Furniss, said that “after paying $79 for an introductory packet that came in the mail . . . he paid $1,500 for lists of phone numbers he could use to recruit new distributors.”\textsuperscript{138} The small start-up fees make Herbalife appear legitimate (like Amway), but dozens of news stories tell tales of a company that pressures distributors into investing thousands, only to ultimately lose it all.\textsuperscript{139} Herein lies the grave danger of the modern pyramid scheme: companies like Herbalife lure investors in with small start-up fees that disguise them as legitimate MLMs, but then mark up the price of their products to the point where they are impossible to sell.\textsuperscript{140} This allows the company to avoid excessive upfront


\textsuperscript{137} Id.

\textsuperscript{138} Hartley, supra note 135.

\textsuperscript{139} See, e.g., Brent A. Wilkes, Herbalife: A Pyramid Scheme Disguised as a Business Opportunity, HUFFINGTON POST (Nov. 11, 2013, 5:13 PM), http://www.huffingtonpost.com/brent-a-wilkes/herbalife-a-pyramid-scheme-b_4220426.html [https://perma.cc/43XL-6BHB] (“Herbalife claims it only costs $59 to get started with the company,” but “distributors . . . typically [spend] $4,000” to start “at the supervisor level . . . Yet to stay at the supervisor level the new distributor must continue to purchase $2,500 worth of product every month.”).

recruitment fees, which have evolved into an industry taboo, while enjoying the same windfall that comes from bilking unsophisticated investors. Bill Ackman, whose company, Pershing Square Capital Management, publicly announced a short position on Herbalife’s common stock, calls Herbalife’s “Formula 1” the company’s $2 billion brand “nobody’s ever heard of.” Ackman explains how Herbalife has surreptitiously become one of America’s largest consumer-product companies, but that its gross margin is nearly double those of similarly sized companies that actually have recognizable brands, such as Arm & Hammer Baking Soda, Energizer Batteries, and Clorox Bleach.

Ackman exhibits how Herbalife’s shakes cost almost double the price of every competitor in the field, and its multivitamins cost triple. And although the company claims that “everyone in the world knows Herbalife,” its 2004 SEC filings explain that its advertising expenditures are “de minimis.” Perhaps what is most alarming for a company that does not have to advertise its products is that, per the company’s 2011 Annual Report, “research and development costs . . . [are] not material.” The company also owns only one U.S. patent, which undercuts the notion that its products are somehow too unique for the traditional marketplace. So how is Herbalife making so much money? An impassioned Ackman, who runs a lucrative hedge fund, queries, “What company’s goal is to recruit as many inexperienced salespeople as possible (on full commission with limited oversight) without regard for the ultimate demand for its products?”

Consider one Herbalife recruit, Maria, who claims that she “worked hard to move forward because” she doesn’t “know how to read or

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142. Id. at 10–11.

143. Id. at 16.

144. Id. at 18.

145. Id. at 23.

146. Id. at 24. Most of Herbalife’s limited advertising focuses on the company and not on any of its products. Id. at 25.

147. Id. at 30.

148. Id. at 38.

149. Id. at 80.
write,”150 but that she ultimately lost $35,000 investing in the company.151 Although those who invest in pyramid schemes are culpable to a degree, since their own desire to “get rich quick” blinds them to the evils of pyramid schemes,152 the American economy has always embraced entrepreneurship. Although the “get rich quick” model is a farce to the majority of sophisticated investors,153 the pervasive mythos of upward mobility primarily harms those that lack the proper training or experience to decipher a real investment from a scam.154 What appears to be a way out of poverty is actually a hook that claps benighted investors deeper into its grips. Pyramid schemes are one of the few business opportunities that the working poor are likely to encounter, but these are not real opportunities at all. When applied to the proper context, the “power to tax” can work as “the power to destroy.”155

III. Proposed Amendments to the Tax Code

A working definition of entities subject to this tax, for these purposes, would be any business entity or individual that accepts payments for the “right to recruit” or the “right to sell” products (the aforementioned “RT payments”).156 At first glance, this bright-line definition would seem to cast Amway, Avon, and other legitimate MLMs on the wrong side of the fence. But legal MLMs, like Amway, do not generate significant income from RT payments, which is the foremost distinction between legal MLMs and illegal pyramid schemes.157 Companies like


151. Id.

152. See generally Fitzpatrick & Reynolds, supra note 3 (arguing that “many Americans are drawn to these enterprises” due to greed, deception, and economic insecurity among other things).


154. See Fitzpatrick & Reynolds, supra note 3, at 30 (“In this modern American Dream, wealth comes not from frugality, hard work or ingenuity but from being at the right place at the right time.”).


156. This would include any unreasonable markup in product prices, which the IRS could re-characterize on audit. Supra note 5 and accompanying text.

157. See Walsh, supra note 2, at 209 (explaining that Amway, amidst FTC charges, stated that “its distributorships were not for sale and sponsoring distributors received no profit from the act of sponsoring”). In other words,
Amway and Avon may have to change their business models to avoid this tax, but large companies are all too familiar with altering their business models to find the most favorable tax treatment in the Internal Revenue Code.

The thrust of the argument is that the IRS can relieve the FTC’s regulatory burden, which arises out of inefficient execution by regulators and deliberate avoidance on the part of schemes, by imposing a tax on payments similar to all pyramid schemes—even though the tax also touches legitimate businesses.\textsuperscript{158} Since it is mathematically certain that pyramid schemes will fail,\textsuperscript{159} the federal government ought to recoup some of the tax revenue spent, both in the form of human capital and actual expenditures, on costly agency enforcement actions.\textsuperscript{160} Imposing tax liability on these potentially fraudulent entities ex ante is one way of creating the revenue necessary to investigate and prosecute these entities ex post. The ensuing sections clarify why it is sound policy to adopt this tax, which provides the FTC with much needed ex ante assistance.

A. Mechanics of the Proposal

Prior to enactment of the “pyramid-scheme tax”: Assume Schemer A convinces New Recruit B to pay $500 to join the scheme. A then tells B that for each new recruit that B signs up, B will earn 50% of A’s profit, or $250 out of the $500. This is an appealing proposition for B, but notice the difference when we apply the basic “pyramid-scheme tax.”

After enactment of the “pyramid-scheme tax”: Say Schemer A convinces New Recruit B to pay $500 to join the scheme. A then tells B that for each new recruit B signs up, B will earn 50% of A’s profit, or $62.50 of the $500, a significant decrease from before since $375 (75%)...
goes to the IRS, and $62.50 goes to A. Obviously, this is not nearly as appealing to either A or B as receiving $250 from the transaction.

These basic amendments and additions to the Internal Revenue Code encompass the “pyramid-scheme tax” (discussion follows): 161

§ 61 Gross income defined (amendment): 162

(16) Gross income derived from payments received by any business entity or individual taxpayer for the “right to recruit” or the “right to sell products” (excluding franchising fees subject to the provisions of the FTC’s franchise rule contained in 16 C.F.R. pt. 436 and 437).

§ 1224 Pyramid-scheme tax (proposed new provision):

(a) All income derived from § 61(16) shall be computed and taxed separately from all other income, but shall be declared on the same reporting document of the individual or business entity, and shall be taxed at a marginal rate not below 75%.

(b) Income subject to the tax described in subsection (a) shall not be reduced by any losses, credits, or exclusions contained herein, or in any other provision in this article.

(c) Markup of any inventory sold by any business entity or any individual taxpayer that is essentially equivalent to a payment described in § 61(16), 163 to the extent determined by the Secretary, 164 is subject to re-characterization and imputation of income to the seller under subsection (a), but subject to the limitations described in subsection (e). 165

(d) Subject to the limitations in subsection (e), the Secretary shall impute current tax liability under subsection (a) to any entity who accepts payments for products described in subsection (c) in any of the previous 10 taxable years. 166

161. These provisions are specifically drafted broadly to allow the Department of the Treasury wide latitude to adopt regulations that will address the issue.

162. 26 U.S.C. § 61 (2012) (currently provisions (1)–(15)).

163. This would not have to be a bright-line rule, but to avoid the same difficulties in distinguishing MLMs from pyramid-schemes any markup greater than fifteen percent of the company’s original purchase price would be imputed income and taxed according to subsection (a) of the proposed provision.

164. In conjunction with the Department of Treasury.


(e) subsection (a) applies to payments between individual taxpayers and business entities, or individual taxpayers and other individual taxpayers, unless:  

(i) An individual taxpayer, as part of a step transaction, is required to form or join a business entity in order to make a payment of the type described in § 61(16). In this scenario, the entity receiving the payment is still liable for the tax described in subsection (a).

(ii) The parties to the transaction enter a franchise agreement that is consistent with the laws of the United States.

(f) To the extent possible, the Commissioner shall refund all individual taxpayers who made payments to any of the entities taxed under this section (provided that the individuals declare these payments on their individual tax returns),

(i) the full amount of any payment or payments (if enough revenue is collected from the payor entity in a given taxable year), but subject to the limitation in (f)(iii), or;

(ii) a pro rata amount in proportion to the amount of revenue collected from the payor entity in a given taxable year, but subject to the limitation in (f)(iii).

(iii) less any amount, pro rata, for the costs of investigation, prosecution, and administration.

(g) Any business entity, including the officers, board members, partners, and members thereof, or any individual taxpayer, caught evading the “pyramid-scheme tax” is liable for tax evasion and is subject to the penalties under 26 U.S.C. § 7201.

These provisions, in order of appearance, achieve the following goals:

167. This provision prevents the application of this tax to existing business entities in supplier/customer relationships and the like.

168. This provision prevents pyramid schemes from requiring participants to form an LLC or sole-proprietorship, or join a partnership or corporation, in order to avoid the tax and buy into the scheme.

169. This prevents the imposition of tax liability to franchisors under this section, but forces a pyramid scheme to subject itself to the tighter restrictions of franchise law if it wants to sidestep this tax.

170. 26 U.S.C. § 7201 (2012) (“Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.”).
• § 61(16), like capital gains,\(^{171}\) creates a separate class of income for RT payments, except unlike capital gains, which are treated preferentially, income under this section is treated adversely. This provision also declares that this tax does not apply to franchising fees, which are subject to more stringent regulations than “business opportunities.”

• § 1224(a) spells out this adverse treatment of RT payments, but requires taxpayers to declare this income on the same reporting document to discourage fraudulent concealment.

• § 1224(b) creates a disfavored “basket analysis,” meaning gains from this type of income can only be offset by losses from this type of income, but since it is impossible to sustain losses from RT payments there is no way to lower the associated tax liability with losses, credits, or exclusions.

• § 1224(c) prevents a business from building the price of RT payments into the sale price of its products by granting the IRS the power to re-characterize payments received for products as disguised RT payments, and to impute tax liability under subsection (a).

• § 1224(d) grants the IRS a 10-year “lookback” to determine if companies owe tax liability under (c).

• § 1224(e) prevents this tax from applying to business-to-business sales unless an individual is required to form or join a business entity as part of a step transaction to execute one of these payments. Again, this provision also explicitly excludes franchises.

• § 1224(f) instructs the Commissioner to refund all individual taxpayers who made payments to entities subject to this tax since the purpose of this provision is to protect consumers from predatory business opportunities.

• And, finally, § 1224(g) subjects individuals and leaders of businesses who evade this tax to the penalties associated with criminal and civil tax evasion.

### B. Tax as Deterrence

Perhaps we can take it as given that taxes impact the way businesses behave. After all, scholars continue to observe that taxes directly influence economic behavior,\(^ {172}\) and Congress has creatively engineered


172. See David Gamage, A Way Forward for Tax Law and Economics? A Response to Osofsky’s “Frictions, Screening, and Tax Law Design,” 61 BUFF. L. REV. 189, 190 (2014) (“The recent empirical literature suggests that taxpayers primarily respond to taxation through a variety of responses that we might collectively refer to as ‘tax planning’ or ‘tax gaming.’”).
its Article I Section 8 taxing power since the earliest days of the Republic. Tax policy influences supply and demand, which marks the cornerstone of this Note: the IRS, through the “pyramid-scheme tax,” can lessen the supply of money going to pyramid schemes and lessen the likelihood that a pyramid scheme will develop.

Taxes provide incentives and disincentives for myriad forms of economic behavior, which often creates inefficiency, but is actually desirable when the aim is to prevent fraudulent transfers. Prominent tax incentives are for research and innovation, real estate development, renewable energy, and historic preservation, while some of the more glaring disincentives are those targeting secondary income earners.

175. See, e.g., 26 U.S.C. § 5881 (2012) (imposing a prohibitive excise tax on “greenmail,” i.e. when a shareholder feigns a hostile takeover attempt and the company pays them to go away; profits from this activity now carry a fifty percent tax which has all but eliminated the practice).
176. See Edward A. Zelinsky, Efficiency and Income Taxes: The Rehabilitation of Tax Incentives, 64 TEX. L. REV. 973, 974 (1986) (“Most legal commentators concerned about the economic aspects of tax incentives apparently believe there is little to discuss: the inefficiency of tax incentives is, by and large, treated as obvious and well established.”).
177. See generally Shaun P. Mahaffy, Note, The Case for Tax: A Comparative Approach to Innovation Policy, 123 YALE L. J. 812 (2013) (“Tax credits could be used to ameliorate a number of inefficiencies that arise from the failures of patent law.”).
178. See Jeffrey A. Markowitz & Rebecca G. del Carmen, Real Estate Tax Incentives, 39 MD. B.J. 49 (2006) (outlining the federal rehabilitation, low-income housing, and new markets tax credits, which are designed to promote various types of real estate development).
181. See Margaret Ryznar, To Work, or Not To Work? The Immortal Tax Disincentives for Married Women, 13 LEWIS & CLARK L. REV. 921 (2009) (arguing that there are disincentives for married women to participate in the workforce embedded in the federal tax code).
and “sin taxes,” which target consumers of cigarettes, alcohol, and other socially adverse behaviors.\textsuperscript{182} Although the goal of this proposal is to deter RT payments and, thus, the formation of pyramid schemes, the danger is that fraudsters will discover ways to dodge this tax since they have found ways to dodge all other forms of pyramid-scheme regulation. The risk of the tax, however, is greater since fraudsters expose themselves to the civil and criminal penalties associated with tax evasion and the taboo of putting others at risk for tax fraud.

At the later stages of scheme development, regulators have found it near impossible to differentiate between MLMs and pyramid schemes, but this proposal contemplates a ferreting-out process where the IRS detects glaring inconsistencies in the early stages of scheme formation.\textsuperscript{183} Justifying the decision to delegate even greater duties to the already overburdened IRS is a challenge,\textsuperscript{184} but pressuring would-be pyramids to the additional self-disclosure required on annual tax returns should serve as a considerable secondary deterrent to scheme formation. Although we charge the overburdened IRS with a truly astonishing number of complicated tasks, sensing incongruities in these types of transactions is its bread-and-butter, and we should be confident in its ability to sniff out sham attempts to evade this tax.\textsuperscript{185} Besides, the fact that a particular federal agency does not currently possess the capabilities to carry out its congressionally-delegated duties is not an excuse for letting innovative ideas go to the wayside.

\textsuperscript{182} See Rachelle Holmes Perkins, \textit{Salience and Sin: Designing Taxes in the New Sin Era}, 2014 BYU L. Rev. 143 (2014) (“Legislators are also turning to sin taxes in hopes of modifying undesirable taxpayer behaviors on the basis of theories advanced by the new surge of behavioral economists.”).

\textsuperscript{183} Cf. Robert W. Wood, \textit{What Every Lawyer Should Know about IRS Audits}, 65 Wash. St. B. News 32 (“One of the primary messages of the IRS audit guide for law practices is that the IRS expects lawyers to have good internal accounting and a good system of recording costs and expenses . . . The IRS expects billing software, of course, and will want to examine it and its results. The IRS is particularly interested in seeing the adjustment log that reconciles the output of the time and billing system to the appropriate accounts in the general ledger . . . The IRS will want the accounting and general ledger to tie together. If it does not, the IRS may want to go through bank records in excruciating detail.”). There is no reason the IRS could not perform a similar analysis on would-be pyramid schemes in hopes of stopping them in their tracks.

\textsuperscript{184} See Martin Vaughan, \textit{Watchdog Warns IRS Is Overburdened}, WALL ST. J. (Jan. 6, 2010, 10:50 AM), http://www.wsj.com/articles/SB126279262905118009 [https://perma.cc/5PYS-VA52] (“An expanding slate of duties is stretching the Internal Revenue Service too thin, leading to poor customer service and undermining its ability to collect taxes owed.”).

\textsuperscript{185} Congress charges the IRS with making complicated fact discoveries in a great number of Code provisions.
Kathleen Delaney Thomas convincingly argues that “the government should raise the psychic cost of tax evasion by employing subtle behavioral ‘nudges’ that encourage taxpayers to be more honest.”\textsuperscript{186} Specifically, Thomas suggests that “the IRS might incorporate brief statements on income tax returns that are designed to call attention to the taxpayer’s moral standards.”\textsuperscript{187} Further, Thomas argues that “adopting measures to increase the psychic cost of tax evasion should impose a relatively small administrative cost to the government.”\textsuperscript{188} The pyramid-scheme tax comports with the spirit of Thomas’s argument in the sense that the IRS has yearly contact with every income-earning citizen, which means it has more everyday influence and exposure in American communities than other federal agencies. In theory, citizens are less likely to launch or continue a scheme if they learn Congress passed a new “pyramid-scheme tax.” Although they cannot know with certainty that the IRS will catch them, the threat of an audit is sure to lead to some second guessing.

Another happy consequence of this proposal is that it might expand the tax base, however minutely. But since the tax’s major purpose is to serve as a deterrent to funding with RT payments, it is unlikely that anyone would ever pay it. Nevertheless, the deterrent effect has powerful capabilities because schemes will have to build the earnings traditionally received from RT payments into the price of their already overvalued retail products; and if market efficiency is a reality, the marketplace will likely reject such disproportionate pricing mechanisms. Further, if schemes markup the price too high, this proposal grants the IRS authority to impute tax liability. Of late, win-win regulatory solutions at the federal level are few and far between, and adopting a simple pyramid-scheme deterrence program should serve as a potent reminder of the American pragmatism that made this nation the keystone of global commerce.\textsuperscript{189}

If the record has proven anything, it is that commercial fraud is not something that society can completely rid itself of—fraud adapts to economic and social changes as quickly as anything else. But setting up obstacles in the fraudsters’ path makes the schemes less attractive to unsophisticated investors and, therefore, less likely to materialize.


\textsuperscript{187} Id.

\textsuperscript{188} Id.

\textsuperscript{189} See Oliver W. Holmes Jr., \textit{The Path of the Law}, 10 Harv. L. Rev. 457, 474 (1897) (“Instead of ingenious research [lawyers] shall spend [their] energy on a study of the ends sought to be attained and the reasons for desiring them. As a step toward that ideal it seems . . . that every lawyer ought to seek an understanding of economics.”).
Conclusion

The art of money flowing from those who have it to those who need it has led to a staggering amount of innovation and economic development. Unfortunately, as a counterpoint, it has led to an indelible amount of fraud committed against innocent investors and entrepreneurs (think of all the economic waste resulting from fake investments and business opportunities). Any proposal like this runs the risk of being labeled “economic paternalism” and “overreaching regulation;” but the fact remains that when fraud surfaces, the United States Government usually bears the responsibility of bringing the bad actors to justice—many times at great expense to taxpayers. Although it is difficult to put a specific dollar amount on the costs of such an enterprise, the human capital spent investigating and prosecuting a single case is enough to raise the eyebrows of those fiscal classicists who yearn for the days of a balanced budget.

This proposal imagines a system where the federal government protects consumers by the most cost-effective means possible—not ex post, but ex ante. This is not to say that there won’t be unanticipated hiccoughs—any time Congress imposes a new tax there are unforeseen consequences, not to mention political backlash, which is a likely impediment to such a proposal ever emerging. But political obstacles alone are not enough to deter lawmakers from achieving a solution. The integrity of the marketplace is a common goal that should benefit all, and we should constantly strive to preserve the freedom to invest in newfound opportunities. Although investing fundamentally entails a degree of risk, the freedom to invest should not include the risk of falling into an avoidable trap. Freedom without opportunity for growth is not freedom at all, and tolerating fraud in the marketplace without ample precautions is none other than institutionalized bondage by another name.

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