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The Queen v. *Johnson*: Investigating the Tax Treatment of Ponzi Schemes

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A Ponzi scheme can be described as a scheme where a fraudster "robs Peter to pay Paul." The fraudster creates the illusion of profitable returns by shuffling money between investors and entices new investors with promises of high returns. Investors who receive returns greater than the initial investment are referred to as "up investors" whereas those who receive returns less than the initial investment are "down investors." Ponzi schemes raise two tax issues: (i) first, is an "up investor" taxable on profits as a source of income? (ii) second, is a "down investor" able to deduct losses incurred?

In *The Queen* v. *Johnson*,[1] the Federal Court of Appeal ("FCA") reversed the decision of the Tax Court of Canada ("TCC")[2] and held that Ms. Johnson's net receipts from a Ponzi scheme constituted income from a source under paragraph 3(a) of the *Income Tax Act* (Canada) (the "Act"). Justice Sharlow also noted that Ms. Johnson could be reassessed outside of the normal reassessment period under subparagraph 152(4)(a)(i), as her failure to include the "profit" in her income tax returns and to disclose the net receipts to her accountant were attributable to carelessness.

This case comment considers the differing analysis undertaken by the TCC and the FCA in *Johnson* and examines the implications to future Canadian taxpayers who may find themselves victims of Ponzi schemes.

Background

In 1997, Ms. Johnson gave $10,000 to a Mr. Andrew Lech ("Lech") to invest in a profitable options trading program (the "Investment"). By 2003, the taxpayer had earned phenomenal returns of over $1.3 million. Lech told Mrs. Johnson that any profits on the Investment were tax-free, since any tax arising from the Investment was paid by Lech's family trust which was the registered owner of the Investment. Lech signed a document for Ms. Johnson to the effect that all taxes on the income from the Investment were being paid by his family trust. In 2003, Lech's bank became suspicious of his banking activity and froze his accounts. A police investigation was commenced and in 2005, Ms. Johnson was interviewed by authorities. It was discovered that there were approximately 237 other participants investing with Lech. Of these, 32 were "up investors" like Ms. Johnson. In 2007, Lech pleaded guilty to fraud.

The Canada Revenue Agency ("CRA") reassessed Ms. Johnson for not including her net receipts from the Ponzi scheme in her income for the 2002 and 2003 taxation years. At the TCC, Justice Woods held that the net receipts did not constitute income from a source and, even if they did, Ms. Johnson could only be reassessed outside the statute-barred period in 2003 and not in 2002.

In the TCC's view, a "crucial difference" between the two years was that, in 2003, Lech's bank accounts had been frozen, police investigations and a class action lawsuit had been launched against Lech. Therefore, in the opinion of the Court, the taxpayer should have more carefully scrutinized Lech's actions and made further inquiries in 2003.

The decision was appealed to the FCA, which held that the net receipts did constitute income from a source and were taxable as income from property. Ms. Johnson had a contractual proprietary right to receive a return of payments plus a return and the fraudulent behaviour of her advisor was immaterial to the treatment of the net receipts. Furthermore, assessment outside the normal reassessment period was justified for both years because Ms. Johnson was "careless" omitting to include payments and inform her accountant of the payments.

Analysis

Income from a Source

Pursuant to paragraph 3(a), a taxpayer is subject to tax on any income "from a source" including income from "office, employment, business and property." In *The Queen* v. *Cranswick,*[3] the FCA referred to the following list of factors to assist in determining whether a particular amount is income from a source or a non-taxable receipt:

> *Did the taxpayer have an enforceable claim to the payment?*
> *Was there any organized effort on the part of the taxpayer to receive the payment?*
> *Was the payment sought after or solicited by the taxpayer in any manner?*
> *Was the payment expected by the taxpayer, either specifically or customarily?*
> *Was there any foreseeable element of recurrence with respect to the payment?*
> *Was the payor a customary source of income to the taxpayer?*
> *Was the payment in consideration for or in recognition of property, services or anything else provided or to be provided by the taxpayer? Was the payment earned by the taxpayer as a result of any activity?*

Although both the TCC and the FCA applied the *Cranswick* framework, they reached opposing results. Justice Woods of the TCC took a narrower approach to the factors set out in *Cranswick* and recharacterized the income receipts as windfalls rather than taxable income on the basis of the nature of the fraud that characterized the relationship between Lech and Ms. Johnson. On the other hand, Justice Sharlow of the FCA interpreted the factors more broadly, focusing on the actual contractual relationship that existed between the two parties while ignoring the fraud.

For example, the two courts take diverging perspectives on the first three *Cranswick* factors. With respect to the first factor, the TCC judgment notes that given the fraudulent nature of the scheme, "nothing was actually earned with the capital" and Ms. Johnson did not have an enforceable claim. Since none of the capital was actually invested by Lech, no "legal right to the net receipts" existed. Conversely, the FCA notes that Ms. Johnson <u>did</u> have an enforceable claim to the payments because she entered into a contractual agreement and received payments as consideration from Lech. In the FCA's opinion, the fact that the funds were obtained as a result of fraud is irrelevant.

Similarly, with respect to the second factor, the TCC found that there was no "organized effort" since the taxpayer wanted "investment returns" not "fraudulently obtained returns." At the FCA,

it was held that, regardless of the fraud, there was still an "organized effort by Ms. Johnson to receive the payments" as she consistently received post-dated cheques for each investment. Her contractual rights were respected.

As a final example, when considering the third factor, the TCC determined the appellant did not expect "fraudulently obtained funds" but expected legally obtained funds. The FCA, on the other hand, noted that the payments were sought after by Ms. Johnson and ultimately "*she received what she bargained for*. The fact that Lech funded her payments with the proceeds of a Ponzi scheme is irrelevant" [my emphasis].

The TCC's narrow analysis does not accurately encapsulate the legal arrangement between Ms. Johnson and Lech and implies that fraud alters the relationship and what Ms. Johnson "bargained" for. The FCA's contractual approach reflects what actually transpired between the two parties. At paragraph 28 of the FCA decision the Court reiterates "the fact that Mr. Lech lied to Ms. Johnson about the manner in which the profits were derived does not detract from the conclusion that she received what she bargained for, which was a profit on her investment." Justice Sharlow critically observes that there is no evidence that Lech had a "contractual obligation" to Ms. Johnson to generate profits in "any particular manner."

This contractual approach taken by the FCA raises additional questions. If, as the Court reasons, the net receipts constitute income from a source because fraud does not alter the underlying contract that existed between Ms. Johnson and Lech, then query what would happen if the contract explicitly stated the invested funds could only be used in a legal manner. If a contractual arrangement is established, following this analysis, Ms. Johnson could claim that funds used in a fraudulent scheme ignored her contractual rights and the profits are not income "from a source." The Court does not reference how this contractual analysis affects the deduction of losses for "down investors."

Recently, in *Alan Orman and Gerald L. Freed* v. *Marnat Inc. et. al.,*[4] the applicants paid significant amounts of income taxes on Ponzi scheme distributions. The Ontario Superior Court held that the distributions were a return of capital and not investment income but refrained from ruling on the treatment of the distributions for tax purposes, deferring to the Tax Courts and tax authorities. The CRA has refused to reassess the taxpayers. If the contractual approach of the FCA in *Johnson* were followed in the *Orman* case, it is unlikely the distributions in *Orman* would be treated as a non-taxable return of capital in the Tax Court.

Another crucial question is why the FCA judge did not consider the legal investment of funds as an implied term of the contract. The TCC specifically makes note of Ms. Johnson's "sophistication" in making Lech sign agreements declaring that the money was being "held in trust" and that it was unnecessary for her to "report or declare investment income." The FCA overlooks the fact that it could have been an implicit term of the contract that the funds Ms. Johnson provided to Lech were to be invested legally. These unanswered questions complicate the contract-focused analysis undertaken by the FCA.

Carelessness

The second issue the TCC and FCA disagreed on is whether the Minister had the legal authority to reassess Ms. Johnson or whether the reassessments were statute-barred for 2002 and 2003 taxation years. For individuals, the normal reassessment period is three years from the date of

initial assessment. However, under paragraph 152(4), the Minister may reassess after the normal three-year period if the taxpayer makes any "misrepresentation" that is "attributable to neglect, carelessness or wilful default."

For 2002, the TCC found that Ms. Johnson was entitled to rely on Lech when he told her that profit from the Investment did not have to be reported for tax purposes. Justice Woods believed Ms. Johnson when she testified that "she trusted Lech" and followed other investors who also did not declare net receipts as income. However, for 2003, the TCC held Ms. Johnson to a higher standard because investigations had been initiated into Lech's business practices and thus she should have at least made inquiries and notified the accountant that prepared her income tax returns.

The FCA took a stricter approach and determined that Ms. Johnson should be reassessed for both the 2002 and 2003 taxation years because "seeking assurances from a fellow investor, even one who is a bookkeeper is not the kind of independent advice that would demonstrate reasonable care." The fact that Ms. Johnson did not seek "professional investment or tax advice" at any time and relied on Lech's advice was also problematic. Unlike the TCC, the FCA ignored the change in external circumstances in 2003 and focused on the actions of the taxpayer and what she did or did not do.

The FCA decision makes it clear that taxpayers cannot sit back and rely on the opinion of fellow investors, accountant or advisors. Taxpayers bear a great degree of responsibility and must conduct their own due diligence by consulting with a professional advisor if unsure about the implications of their investments.

Concluding Remarks

The *Johnson* case suggests contractual principles will govern the tax treatment of fraudulent payments received under Ponzi schemes. The FCA's contract-focused analysis is an interesting approach to the tax treatment of "up investors." As long as investors' contractual rights are respected, it is the opinion of the FCA that the net receipts will constitute income from a source for tax purposes. This raises important practical questions about what clauses investors should include in their contract with investment advisors and what influence these clauses will have in the Courts. In addition, the judgment also shows that taxpayers are held to a high standard to demonstrate to the court that they are exercising proper care in managing their investments.

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[1] 2012 FCA 253 (hereinafter "*Johnson*").
[2] *Johnson* v. *The Queen* (2011 TCC 540).
[3] 82 DTC 6073(FCA) *(*hereinafter *"Cranswick"*).
[4] 2012 ONSC 549 (hereinafter "*Orman"*).