Tax Treatment Of Ponzi Scheme Investments



We have previously written about court decisions on the tax results arising from taxpayers' (failed) investments in Ponzi schemes (see our posts on *Roszko v. The Queen* (2014 TCC 59), *Johnson v. The Queen* (2011 TCC 54) and (2012 FCA 253), *Hammill v. The Queen* (2005 FCA 252) and *Orman v. Marnat* (2012 ONSC 549)).

These decisions raise questions as to how the CRA may assess all aspects of the income earned and losses suffered by the duped investors. For example, while the cases focused on whether the taxpayer was required to report some of the returned funds as income, the tax treatment of losses after the collapse of the fraudulent scheme has not been considered.

The CRA has now provided some guidance on how it will administer the *Income Tax Act* (Canada) in respect of the income and losses arising from Ponzi schemes. In CRA Document No. 2014-0531171M6 "Fraudulent Investment Schemes" (July 3, 2014), the CRA stated:

- **Income inclusion** – Amounts paid to a taxpayer that are returns on their investment should be included in the taxpayer's income. The fact that the funds were not invested on behalf of the taxpayer does not change the nature of the transaction for the taxpayer.
- **Bad debt** – If the investment was a fraudulent scheme, the taxpayer may be able to claim a bad debt under paragraph 20(1)(p) of the Act in respect of the lost investment funds. The amount of the bad debt claim will be subject to certain adjustments. The bad debt should be claimed in the year the fraud is discovered (*i.e.*, the year in which fraud charges are laid by the Crown against the perpetrator, or at such earlier time as the debt is established to have become bad).
- **Losses** – The taxpayer may be able to claim a capital loss or business investment loss:
    - **Capital loss** – The taxpayer may be able to claim a capital loss under paragraph 39(1)(b) of the Act, which may be carried back three years or forward indefinitely. A net capital loss may only be applied against a taxable capital gain.
    - **Business investment loss** – Under paragraph 39(1)(c), a business investment loss is a capital loss from a disposition of a share of a small business corporation or a debt owing to the taxpayer by a Canadian-controlled private corporation that was a small business corporation. Under paragraph 38(c) of the Act, one-half of a business investment loss is an allowable business investment loss, which may be deducted against all sources of

income.

- **Other deductions** – The taxpayer may be able to claim interest expenses or other carrying charges not previously claimed by filing a T1 Adjustment Request form.
- **Recovered amounts** – Where the taxpayer recovers funds from a scheme (*i.e.*, through a legal settlement or otherwise), these recovered amounts may be taxable as recovery of a previously deducted bad debt, recovery of a previously deducted business loss, or recovery of a previously deducted capital loss.
- **Taxpayer relief** – The CRA will consider requests for taxpayer relief on a case-by-case basis.

This guidance is helpful, but there are many technical requirements for the operation of these provisions, and further it is not clear how the CRA's administrative views accord with the case law. For example, at least three cases (*Roszko*, *Orman*and *Hammill*) have held that amounts paid out a fraudulent scheme are **not** income to the duped investor. In future cases, we expect the courts will continue to clarify the tax treatment of income and losses arising from failed Ponzi schemes.

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