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Tax

Ponzi tax deduction issue still unresolved

By AdvocateDaily.com Staff

Although a recent Tax Court of Canada case attempted to deal with the question of whether Ponzi scheme losses are deductible, the issue is still not fully resolved, Toronto tax litigator Adrienne Woodyard tells *The Bottom Line*.

"This concern would not necessarily have been assuaged," she says, by the May 9 announcement of Gail Shea, the Minister of National Revenue. In that announcement, the minister reported that the U.S., Australia and the U.K. have announced that they have tax-related information involving numerous trusts and companies holding assets in jurisdictions around the world, and that she has reached out to the government of the U.K. and secured a commitment that information relevant to Canada will be shared. The minister also noted that "formal requests" have been made to the U.S. and Australian tax authorities for the same information in their possession. Read CBC

Ultimately, the results that the CRA derives from the cooperation of its international partners depends in part on how quickly and efficiently it is able to process information when it comes in, says Woodyard, a lawyer with Davis LLP.

"After all, it's one thing to receive raw data; it's quite another to locate and assign the appropriate personnel to sift through it, verify its accuracy, determine its relevance, ascertain the identity of all of the taxpayers involved and calculate the tax consequences. It's not necessarily a simple matter to turn raw data into a tax assessment or a criminal charge of tax evasion," she says.

While the government also recently announced that it has committed six to ten of its staff

and $30 million over the next five years to detecting offshore tax evasion, Woodyard asks whether that will be sufficient, or whether it is merely a first step for the government.

Woodyard also points out that some offshore tax evasion has apparently been revealed already through formal CRA channels; the CRA has reported that there has been an upswing in the number of taxpayers with unreported offshore income applying for amnesty under the voluntary disclosure program in recent years.

“It’s reasonable to assume that this has quite a lot to do with the intense media coverage that has surrounded recent information leaks from sources in offshore tax havens. But it’s very difficult, if not impossible, to determine what percentage of previously unreported offshore tax income is coming to light through the voluntary disclosure program,” she says.

While the CRA has not yet reported having convicted any Canadian taxpayers under “Project Jade,” its 2007 investigation into offshore tax evasion arising from the disclosure of information from Liechtenstein, Woodyard points out that no one outside the CRA knows how many investigations are underway, or nearing completion, or how many files are being processed. In addition, not all investigations will necessarily result in criminal prosecutions.

Where unreported offshore income is discovered but the CRA believes, for whatever reason, that a taxpayer’s conduct “falls short of the degree of culpability that would constitute the grounds for a criminal prosecution, the CRA will simply process tax reassessments, usually applying civil, but not criminal penalties,” Woodyard explains. She adds, “information about these civil proceedings will generally never be disclosed to the public, unless the taxpayer appeals the reassessment to the Tax Court, because the CRA is obliged to keep this information confidential. So it’s very difficult for members of the public to know the true scope of the problem, and to gauge how effective the CRA has been in addressing it.”

“But,” she adds, “one thing is clear: taxpayers with unreported foreign source income would certainly be wise to explore the possibility of initiating a voluntary disclosure before the CRA comes calling.”

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In Ficek v. Canada (Attorney General), taxpayer Alice Ficek asked the Federal Court to compel an examination of her 2010 tax return after an audit of registered tax shelter GLGI resulted in the denial of charitable donation claims made by taxpayers.

According to the Financial Post, in 2011, the director of the CRA's Winnipeg Tax Centre instituted a new policy that "focused on conducting the tax shelter audit before issuing a refund" – a move that affected several hundred taxpayers who had participated in GLGI in the 2010 and 2011 tax years.

This was a departure from the CRA's long-standing policy, says the decision, which is "to allow a taxpayer's claim for charitable donation tax credits made for a gifting tax shelter in the initial assessment," which would initially result in a refund to the taxpayer but might subsequently, following a reassessment, require repayment to the CRA by the taxpayer.

The Federal Court found that the delay in assessing the applicant's return was for the purpose of discouraging participation in the GLGI program and "resulted in singling out those GLGI participants under the Winnipeg Tax Centre for treatment different from those participants in other parts of the country…"

"It's not surprising that the Court took a very dim view of the CRA's Winnipeg office unilaterally developing a new policy of delaying assessments for certain taxpayers – especially one that was not consistent with the assessment policy followed by other CRA offices throughout Canada," says Woodyard, a lawyer with Davis LLP.

What was particularly interesting about the case, she says, was the abundance of evidence, in the form of correspondence from the Winnipeg TSO, "explaining quite candidly the ultimate motivation behind the new policy, which was to discourage taxpayers from participating in certain charitable donation programs."

The statutory rule, says Woodyard, is that the Minister of National Revenue, through its agent, the CRA, must review tax returns and issue assessments "with all due dispatch."

However, she says, “the CRA has traditionally been given a great deal of leeway in terms of meeting the ‘due dispatch’ requirement, because the courts have recognized that, if there are complex issues involved, it may not always possible to do the work necessary to verify taxpayers’ returns within a few months of filing,” she says.

But Woodyard says there are compelling reasons for the “due dispatch” rule.

“The issuing of a notice of assessment is what starts the normal reassessment period running for individuals – the three-year period in which the CRA can come back and reassess the taxpayer for additional amounts. Once the three-year rule expires, the CRA cannot reassess (in most cases) unless it can prove that there has been a misrepresentation by the taxpayer that is attributable to carelessness, neglect, wilful default or fraud,” she says.

“Without the assessment, that three-year deadline cannot start to run,” she adds.

In addition, Woodyard explains, a taxpayer may be entitled to other, completely non-controversial refunds, credits and benefits, such as refunds arising from RRSP contributions, GST/HST credits for those with low to modest incomes, and the Child Tax Benefit. The receipt of all of these will be delayed if the assessment is delayed, she says.

While the decision may put pressure on the CRA to be more prompt in assessing charitable donors, Woodyard says that the government has announced other changes in the March 21, 2013 federal budget which may give the CRA more time to assess and increase its collection powers.

“One amendment could extend the ‘normal reassessment period’ in certain cases where a charitable donation tax shelter promoted is late in filing (or has failed to file) an information return as required by the Income Tax Act. In those cases, the “normal reassessment period” is extended for up to three years after the information return is filed, so it will no longer be based on the date the individual taxpayer is assessed,” she says.

Also, says Woodyard, there will be a change to the normal rule that prevents the CRA from collecting tax, interest and penalties from a taxpayer if the taxpayer has filed an objection to a tax assessment.

"If the tax assessment relates to charitable donations that the CRA has challenged, the CRA may be able to collect 50 per cent of the tax, interest and penalty, even when the amount is in dispute. This change may have been prompted by taxpayers who objected to tax assessments and, by the time the dispute was resolved and the tax liability was ultimately determined, were unable to pay the tax owing. This change to the suspension-of-collection rules will be effective for taxation years beginning in 2013," she adds.

Perhaps to counter-balance these measures, says Woodyard, the government also proposed a "first time donor's super credit" in the same budget for people making charitable donations for the first time.

"It won't help anyone who was involved in charitable donation programs in the past, as it will only apply to donations made starting in 2013, but it does represent a carrot among the sticks," she says.

In *Roszko v. The Queen*, says the article, the court considered whether $156,000 that a duped investor provided to a Ponzi scheme was taxable as interest or simply a partial return of a larger amount he provided the scheme. The court ruled that it was the latter, finding that the scheme did not use Roszko's money "as it had contracted to" – a critical element required to consider the amount as interest, says the article.

"One of the most important elements of the taxpayer's case was the fact that he never derived any profits from his investment," says Woodyard, a lawyer with Davis LLP.

In the 2005 case of *Hammill v. Canada*, says the article, the Federal Court of Appeal ruled that losses incurred by a Ponzi scheme victim were not tax deductible, as the taxpayer "had been the subject of a fraud from beginning to end," and that no business could be said to exist.

"This comment also suggested that any profits that a successful participant might earn from a Ponzi scheme also might not be subject to tax," Woodyard tells *The Bottom Line.*

In another Federal Court case, *Johnson v. Canada*, the article says the court found profits derived from a Ponzi scheme were taxable, as the taxpayer "received exactly what she had contracted for."

"Roszko appears to stand for the principle that amounts paid out of a Ponzi scheme may be taxable, but only where they constitute profits. This is consistent with *Johnson,"* says Woodyard.

"Of course, given the nature of Ponzi schemes, the distinction between operators and participants is not always clear. Roszko and its predecessors make it clear that the courts view the degree of knowledge the participant possesses about the nature of the scheme as a persuasive, if not a determinative, factor."