

Ponzi Schemes and Taxation

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In the flurry of economy-related stories over the past few years, perhaps one of the saddest items is the current situation of Earl Jones's victims. Earl Jones, as most will recall, was a financial "adviser" in Montreal who swindled hundreds of victims over the past 20 or so years. For most of those years, the main swindle involved a Ponzi scheme — although in later years Jones convinced people (mostly elderly) to sell or mortgage their homes (and other property) and give him the proceeds to lend out at higher interest rates than they would pay on their mortgage.

In running his Ponzi scheme, every year Jones would allocate to a client some amount of fictitious income and ostensibly reinvest this amount to the client's account. The client would then pay tax on this fictional income. Once the scheme became known, these individuals were in the terrible position of not only having lost their initial investment, realizing that all gains were fictional, but also that they paid tax on income they never earned!

Predictably, and justifiably, the victims turned to the government to seek return of tax paid on income that was never earned. Those in the tax community know that the CRA's ability to reassess returns depends mostly on the year in which the return was originally filed. So victims who had paid tax on fictitious income within the previous three years could simply file a T1 adjustment request and expect the CRA to agree to the request (although, the CRA could later reassess to assume a different position). However, for time periods between three and 10 years previous, the CRA retains the discretion as to whether or not to honour the adjustment request. This discretion is exercised where the CRA believes that if the request had been made within the allowable time it would not have objected to the filing position of the taxpayer. And for time periods over 10 years previous the CRA has no discretion to amend filed returns.

Complicating matters for the victims in this case was that most of them were based in Quebec and so there were two taxing authorities to convince of the relative merits of returning the income. Revenue Quebec has already stated publicly that it will not return the tax paid on fictitious income. We were retained to act on behalf of the victims in their negotiations with the CRA and were encouraged by the Victims of Earl Jones Organizing Committee to publicize the results of our discussions with the CRA, hence this article which is being run with permission of the clients. Perhaps because of the publicity the victims received in this case, but no doubt also because of the large number of victims and the far too frequent occurrences of Ponzi schemes, the Minister of National Revenue and his office took an active interest in the speedy disposition of this matter.

In the event, the CRA basically accepted the legal position we advocated on behalf of the victims. Factually, it seems obvious that the victims each entered into one or more investment contracts with Earl Jones (or his corporation) which were based on fraudulent misrepresentations. Under both civil and common law, contracts based on a fraudulent misrepresentation can be declared *void ab initio*. So, if a court declares that a particular contract was never valid, the CRA is prepared to return the tax paid on the fictional income allocated by Jones. They are not, however, prepared to allow the individual to deduct as a capital loss the initial investment. On the other hand, if a court does not have the contract declared void, he or she would be entitled to a deduction in the current year equal to the amount of the initial investment and any unpaid (fictional) income.

In general, the CRA's position is a fair one and it adopts a fairly merciful attitude to people, including many seniors, who are otherwise facing utter ruin. However, there are some

unanswered questions. For example, what about situations where the taxpayer passed away some years ago, and perhaps the estate has received a clearance certificate? How does having the contract declared void make the initial loss a loss under the *Income Tax Act*? And on what moral basis can the government keep what amounts to proceeds of crime that occurred more than 10 years ago?

It is as yet unknown if the CRA will publicize the position it took in respect of the victims in this case and apply it more generally to victims of fraud. However, we remain available to discuss any aspects of this case with the tax community.