Tax for the Owner-Manager

Editor: Thomas E. McDonnell, QC

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Ponzi Schemes and Bad or Doubtful Debts

In *Delle Donne v. The Queen* (2015 TCC 150), the issue in dispute was whether $137,500 of interest was properly included in the appellant's income and was deductible by virtue of subparagraph 20(1)(l)(i) or 20(1)(p)(i).

On December 11, 2008, January 26, 2009, and February 27, 2009, the appellant loaned $900,000 to SA, a corporation incorporated by the appellant's brother-in-law, pursuant to three loan agreements: each was for a three-year term and bore simple interest at 25 percent per year. Interest was to be paid on the first and second anniversary dates of the loan agreements, but only if the lender requested payment in writing. (If no request was made, interest would be added to the principal amount owing.) SA also borrowed funds from other individuals, and from May 2008 onward SA loaned funds exclusively to EMB, a corporation owned by Mr. M, who claimed that he was a "super trader" with a specialized trading strategy.

In December 2009, the appellant was made aware that EMB was in financial difficulty. In January 2010, SA made an application to place EMB in receivership. A hearing was scheduled for March 17, 2010. Mr. M did not attend the meeting, and the parties received notice that he had been found dead in his home. Media reports indicated that Mr. M had defrauded many investors across southern Ontario and that a receiver had been appointed in relation to the remaining assets.

A signed statement of affairs dated April 23, 2010 indicated that SA's liabilities exceeded its assets by $17,030,103. On April 6, 2010, SA filed a notice of intention to make a proposal under the Bankruptcy and Insolvency Act, which was accepted by SA's creditors and by the Superior Court of Ontario.

SA issued the appellant a T5 slip for his 2009 taxation year in respect of the interest. The T5 slip was followed by a letter from SA dated March 29, 2010 indicating that SA was unsure whether the amount identified on the slip would actually be paid and that the payment would depend on the court-ordered receiver's investigation.

The appellant's T1 income tax return was prepared and filed by his accountant, who decided not to include the interest but provided a letter to the CRA dated April 21, 2010 with an explanation of the omission—namely, that the amount of the interest was "never earned, payable or collectible." The TCC held that "[t]he interest may not have been payable until a written demand was made . . . or the loan matured, but it was nevertheless owed by SA to the Appellant as it accrued," and it was therefore a debt.

The TCC said that subparagraph 20(1)(l)(i) required the taxpayer to establish three things: (1) that the deduction being claimed in respect of the debt had been included in income, (2) that the debt was doubtful, and (3) that the amount being claimed as a deduction from income was reasonable.

With respect to the first requirement, the Crown asserted that because the appellant had not recorded the amount of the interest as income on his T1 income tax return, the amount had not been included in income and consequently was not deductible. The court rejected this argument and said that the amount was to be included in the appellant's income by virtue of the application of the Act's provisions to the facts, regardless of what had been recorded on the relevant tax return.

With respect to the second requirement, the court concluded that the appellant must show that the debt had become doubtful at the end of the relevant taxation year; in making this determination, he could take into account all relevant information available up to the filing-due date. Relying on *Coppley Noyes & Randall Limited v. The Queen* (91 DTC 5291 (FCTD)) (which held that for a debt to be doubtful it is sufficient that there be reasonable doubt about the collectibility of it), the court concluded that on the basis of the information available to the appellant by April 30, 2010, there was serious doubt about the collectibility of the interest. Consequently, the second requirement of subparagraph 20(1)(l)(i) was met.

With respect to the third requirement, the court concluded that because the appellant was very likely a victim of a Ponzi scheme, it was reasonable for him to claim a deduction for the full amount of the interest.

The court then ruled that subparagraph 20(1)(p)(i) required the taxpayer to establish two things: "First, the debt in issue must have been included in the taxpayer's income for the year the deduction is claimed or for a previous year. . . . Second, the taxpayer must establish that the debt has become a bad debt in the year." On the basis of its prior reasoning, the court found that the first requirement had been met.

Citing *Flexi-Coil Ltd. v. The Queen* (96 DTC 6350 (FCA)), the court held that a debt is a bad debt when the taxpayer determines that the debt is uncollectible and in making that determination has "acted reasonably and in a pragmatic business-like manner, applying the proper factors." The court further ruled that subsequent events do not alter a taxpayer's properly made determination. The court then said that "[t]he information

available to the Appellant as at April 30, 2010 indicated that as of December 31, 2009 SA had no resources to pay its debts other than what it might collect from EMB under the receivership." Therefore, although the appellant might not have known the amount that might be recovered by SA, it was reasonable for him to conclude that only a portion of the principal owed was likely to be recovered and that the interest itself was illusory and would not be recovered. Consequently, the interest was a bad debt as of the end of 2009.

The court rejected the Crown's argument that in order to claim a deduction under either subparagraph 20(1)(l)(i) or 20(1)(p)(i), the appellant should have recorded the interest as income on his income tax return and then claimed the appropriate deduction. Citing *The Queen v. Imperial Oil Ltd.* (2003 FCA 289), the court found that it is open to a taxpayer to amend the return through the appeal process: the appellant used the appeal process to claim a deduction under subparagraph 20(1)(l)(i) or 20(1)(p)(i) and in doing so clarified the filing position taken in his 2009 T1 income tax return. The TCC therefore allowed the appeal and referred the matter back to the CRA for reconsideration and reassessment on the basis that the interest was deductible under subparagraph 20(1)(p)(i).

This decision comes on the heels of a number of other cases dealing with Ponzi schemes. From a practitioner's perspective, it is interesting to consider whether the situation in *Delle Donne* could have been more simply addressed on the basis of the holding in *Roszko v. The Queen* (2014 TCC 59). In *Roszko*, Miller J held that proceeds of an illegal activity in and of themselves can give rise to a taxable source of income, but if the investment itself is fraudulent, the return of funds to the extent of the original investment cannot. It is unclear from the facts in *Delle Donne* whether the holding in *Roszko* is applicable, especially because the relevant fraud occurred between SA and EMB. However, if *Roszko* had been applicable it would have obviated the need for the *Delle Donne* court's extensive inquiry into the applicability of subparagraph 20(1)(l)(i) or 20(1)(p)(i).

Philip Friedlan and Adam Friedlan
Friedlan Law
Richmond Hill, ON