Federal Court of Appeal  Cour d'appel fédérale

Date: 20121004

Docket: A-491-11

Citation: 2012 FCA 253

CORAM: **BLAIS C.J.**
SHARLOW J.A.
TRUDEL J.A.

BETWEEN:

HER MAJESTY THE QUEEN

Appellant

and

DONNA M. JOHNSON

Respondent

Heard at Toronto, Ontario, on September 13, 2012.

Judgment delivered at Ottawa, Ontario, on October 4, 2012.

REASONS FOR JUDGMENT BY: SHARLOW J.A.

CONCURRED IN BY: BLAIS C.J.
TRUDEL J.A.

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REASONS FOR JUDGMENT

SHARLOW J.A.

[1] The respondent Donna M. Johnson appealed successfully to the Tax Court of Canada for an order vacating reassessments under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) for 2002 and 2003 (2011 TCC 540). The Crown has appealed to this Court to restore the reassessments.

[2] The main issue in the appeal is whether Ms. Johnson is required to pay income tax on certain payments she received in 2002 and 2003 (net of related outlays) from Andrew Lech. When Ms. Johnson received the payments, she believed that they represented her share of the after-tax

profit derived from option trading transactions engaged in by a trust managed by Mr. Lech. In fact, and unknown to Ms. Johnson, Mr. Lech was paying her from money he had obtained fraudulently from the victims of a Ponzi scheme he was operating. Ms. Johnson argued successfully in the Tax Court that the payments were not taxable in her hands because the Ponzi scheme could not be a source of income to her. For the reasons that follow, I have concluded that Ms. Johnson's argument is wrong in law.

[3] If the payments in issue were properly included in Ms. Johnson's income for 2002 and 2003, an issue arises as to whether the reassessments are invalid because they were made outside the "normal reassessment period", defined in the *Income Tax Act* as three years after the date of initial assessment. The judge held that the reassessment for 2003 was valid, but not the reassessment for 2002. The Crown argues that the judge misapplied the applicable legal test for 2002 but not 2003. Ms. Johnson argues the contrary. For the reasons that follow, I agree with the Crown that the reassessments for both years were valid.

Facts

[4] The facts as found by the judge are not in dispute. Ms. Johnson worked as a registered nurse until the 1990s. She assisted her husband with a church they began in Peterborough in 1974, and from 1982 worked with him in a travelling ministry. Although Ms. Johnson has no formal training in business or finance, the judge found her to be astute in business matters. In connection with the transactions that are the subject of this case, Ms. Johnson drafted two documents that the

judge characterized as "relatively sophisticated" (see paragraph 59 of the judge's reasons; the two documents are described in the discussion below).

[5] In the late 1990s, Ms. Johnson was introduced to Andrew Lech by her friend Liz Wakeford. Ms. Wakeford is a bookkeeper who also files income tax returns and has some real estate experience. She told Ms. Johnson that she had invested successfully with Mr. Lech.

[6] From approximately 1997 until April of 2003, Ms. Johnson entered into numerous transactions with Mr. Lech, at first through Ms. Wakeford as an intermediary, and later directly with Mr. Lech. In each transaction, Ms. Johnson would give Mr. Lech a cheque and at the same time, he would give her a number of cheques, postdated to provide her with payments over eight to ten weeks in amounts that in total exceeded her payment to him. Typically, the last postdated cheque for each transaction represented the excess, or profit. It is not clear how many of these transactions occurred, but Ms. Johnson testified that there were approximately 70 in 2002 and 2003.

[7] Mr. Lech told Ms. Johnson that he was combining her money with money held in a family trust that he managed, and that he was using the money in option trading to generate profits. He assured her that she had no risk of loss. He also assured her that the family trust paid tax on the profits, and that the money he paid to Ms. Johnson was "after tax profits" that she was not obliged to report in her income tax returns. Ms. Johnson believed everything Mr. Lech told her.

[8] Ms. Johnson did not seek professional investment or tax advice before entering into the transactions with Mr. Lech, or at any time. Her own research consisted of seeking and obtaining an assurance from her banker that large profits could be made from option trading by someone who knew what they were doing. As to the tax consequences of her investments, she consulted only her friend Ms. Wakeford, who as indicated above was also an investor with Mr. Lech. Ms. Wakeford did not testify in the Tax Court. Ms. Johnson testified that Ms. Wakeford assured her that the amounts received from Mr. Lech should not be reported as income because the tax on the profits was paid by the trust.

[9] The transactions between Ms. Johnson and Mr. Lech were not fully documented. Ms. Johnson kept her own notes of the transactions. She also drafted two documents that she asked Mr. Lech to sign. He did so in March of 2000. Those two documents read as follows:

> **AGREEMENT BETWEEN ANDREW LECH & DONNA M. JOHNSON FOR INVESTMENT FUNDS AND INCOME TAX PURPOSES**
>
> I, **Andrew Lech**, declare and certify that all taxes payable for income tax purposes, for all the investments funded by Donna M. Johnson, have and are being paid through the Lech family trust account over which I am the financial manager. It is not necessary for Donna M. Johnson or her immediate family to report and declare investment income to be taxed again.

> **AGREEMENT BETWEEN ANDREW LECH & DONNA JOHNSON FOR INVESTMENTS**
>
> I, **Andrew Lech**, am acting as a trustee of investment funds for Donna M. Johnson, [……..address omitted……..……]. All cheques, whether current or post-dated payable to Mrs. Donna Johnson and bearing my signature are to be honoured from the proceeds of my estate in the event of my death.

[10] Ms. Johnson testified that she did not require any documentation of the transactions with Mr. Lech because she believed and trusted him. She also testified that she believed it would be unreasonable of her to request disclosure of what she assumed would be private information relating to Mr. Lech's family trust. The first document quoted above was intended only to provide documentary evidence in the event of enquiries from the tax authorities, and the second was intended to protect the position of Ms. Johnson in the event of the death of Mr. Lech.

[11] The last transaction between Ms. Johnson and Mr. Lech occurred in April of 2003. In that month Ms. Johnson gave Mr. Lech what would prove to be her last cheque to him, which was cashed. However, Mr. Lech's bank accounts were frozen shortly afterward, and she could no longer cash his cheques. At about this time, a class action was commenced against Mr. Lech by others who had invested with him, and Ms. Johnson joined them. She testified that she did so in order to recover the money represented by the cheques that she was unable to cash. She was interviewed by the lawyer for the class action in December of 2003.

[12] The freezing of Mr. Lech's bank account was part of or led to a police investigation that lasted approximately three years. Ms. Johnson was interviewed by the police in 2005. She testified that it was only at this point that she began to have doubts about the trustworthiness of Mr. Lech. Criminal charges were brought and Mr. Lech was convicted in 2007, receiving a sentence of imprisonment for six years.

[13] After 2003, Ms. Johnson embarked on a strategy of option trading on her own account because she believed that she had learned enough from Mr. Lech to do so successfully. She was initially successful, but the success did not last. By 2008, Ms. Johnson's savings were gone.

[14] None of what Mr. Lech told Ms. Johnson was true. In fact, Mr. Lech and some other individuals were operating a Ponzi scheme. Ms. Johnson was not being paid a share of the profits from investments or option trading. Rather, unknown to her, she was being paid from money that Mr. Lech had received from other people through the operation of his Ponzi scheme.

[15] When the Ponzi scheme operated by Mr. Lech collapsed in 2003, many people in Canada and the United States lost significant sums of money. The Canada Revenue Agency audited 132 of the participants, and concluded that 32 of them had profited from their dealings with Mr. Lech. Ms. Johnson was one of them. Although she lost the value of the last cheque she gave him in 2003, she received $614,000 in 2002 and $702,000 in 2003 in excess of the amounts she paid to him.

[16] The judge commented at paragraph 28 of her reasons that those who lost money on Mr. Lech's Ponzi scheme may have been able to assert a claim against Ms. Johnson for restitution (*Re Titan Investments Ltd. Partnership*, 2005 ABQB 637; *Den Haag Capital, LLC v. Correia*, 2010 ONSC 5339). However, as of the date of the Tax Court hearing in 2011, no such claim had been made.

[17] Ms. Johnson prepared her own income tax return for 2002, and had an accountant prepare her income tax return for 2003 because she did not know how to report the result of her own option trading. None of the payments received from Mr. Lech were included in her income for either year. Ms. Johnson testified that she believed Mr. Lech when he said that these payments were not taxable in her hands because the tax had been paid by the family trust, and for that reason she did not report the payments as income when she filed her income tax return for 2002, and did not disclose her transactions with Mr. Lech to the accountant who filed her income tax return for 2003.

[18] Ms. Johnson's income tax returns for 2002 and 2003 were reassessed on November 20, 2007 to include in her income the net amounts she received in those years, $614,000 and $702,000 respectively. Ms. Johnson objected to the reassessments and then appealed to the Tax Court of Canada, on the basis that the 2007 reassessments were time barred, and alternatively that the amounts included in income were not taxable.

[19] The judge agreed with Ms. Johnson that the amounts included in her income were not taxable, and allowed her appeal from the reassessments on that basis.

[20] The judge went on to consider, in the alternative, the merits of Ms. Johnson's argument that the reassessments were invalid because they were time barred. The judge held that the misrepresentations in Ms. Johnson's 2002 income tax return were not attributable to any neglect, carelessness, wilful default, or fraud on her part because when she filed her 2002 return, she had no reason to doubt the truth of what Mr. Lech had been telling her. However, by the time Ms. Johnson

filed her 2003 return, she had knowledge of facts that should have put her on notice that he had been misleading her, and her failure to inform her accountant about the transactions was careless. On that basis, the judge concluded that the reassessment for 2002 was time barred, but the reassessment for 2003 was not.

Issues

[21] The main question in this appeal is whether Ms. Johnson's net receipts in 2002 and 2003 from her transactions with Mr. Lech were income from a source. If the answer is no, the Crown's appeal cannot succeed.

[22] If the answer is yes, it will be necessary to consider whether the Minister had the legal authority to reassess Ms. Johnson after the normal reassessment period for 2002 and 2003.

The income inclusions

[23] The Minister relies on section 3 of the *Income Tax Act*, and in particular paragraph 3(*a*), to justify the income inclusions in the reassessments under appeal. Section 3 sets out the rules for determining a taxpayer's "income" for a taxation year for income tax purposes. The first component of the computation, as set out in paragraph 3(*a*), is the total of all income from all sources. By virtue of the computational steps in the remainder of section 3, the amount determined under paragraph 3(*a*) is included in income for income tax purposes. Section 3 reads as follows (my emphasis):

3. The income of a taxpayer for a taxation year for the purposes of this	3. Pour déterminer le revenu d'un contribuable pour une année

Part is the taxpayer's income for the year determined by the following rules:

(*a*) determine the total of all amounts each of which is the taxpayer's income for the year (other than a taxable capital gain from the disposition of a property) from a source inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer's income for the year from each office, employment, business and property,

(*b*) determine the amount, if any, by which

(i) the total of

(A) all of the taxpayer's taxable capital gains for the year from dispositions of property other than listed personal property, and

(B) the taxpayer's taxable net gain for the year from dispositions of listed personal property,

exceeds

(ii) the amount, if any, by which the taxpayer's allowable capital losses for the year from dispositions of property other than listed personal property exceed the taxpayer's allowable business investment losses for the year,

d'imposition, pour l'application de la présente partie, les calculs suivants sont à effectuer :

a) le calcul du total des sommes qui constituent chacune le revenu du contribuable pour l'année (autre qu'un gain en capital imposable résultant de la disposition d'un bien) dont la source se situe au Canada ou à l'étranger, y compris, sans que soit limitée la portée générale de ce qui précède, le revenu tiré de chaque charge, emploi, entreprise et bien;

b) le calcul de l'excédent éventuel du montant visé au sous-alinéa (i) sur le montant visé au sous-alinéa (ii):

(i) le total des montants suivants :

(A) ses gains en capital imposables pour l'année tirés de la disposition de biens, autres que des biens meubles déterminés,

(B) son gain net imposable pour l'année tiré de la disposition de biens meubles déterminés,

(ii) l'excédent éventuel de ses pertes en capital déductibles pour l'année, résultant de la disposition de biens autres que des biens meubles déterminés sur les pertes déductibles au titre d'un placement d'entreprise pour l'année, subies par le contribuable;

(*c*) determine the amount, if any, by which the total determined under paragraph (*a*) plus the amount determined under paragraph (*b*) exceeds the total of the deductions permitted by subdivision e in computing the taxpayer's income for the year (except to the extent that those deductions, if any, have been taken into account in determining the total referred to in paragraph (*a*), and	*c*) le calcul de l'excédent éventuel du total établi selon l'alinéa *a*) plus le montant établi selon l'alinéa *b*) sur le total des déductions permises par la sous-section e dans le calcul du revenu du contribuable pour l'année (sauf dans la mesure où il a été tenu compte de ces déductions dans le calcul du total visé à l'alinéa *a*));
(*d*) determine the amount, if any, by which the amount determined under paragraph (*c*) exceeds the total of all amounts each of which is the taxpayer's loss for the year from an office, employment, business or property or the taxpayer's allowable business investment loss for the year,	*d*) le calcul de l'excédent éventuel de l'excédent calculé selon l'alinéa *c*) sur le total des pertes subies par le contribuable pour l'année qui résultent d'une charge, d'un emploi, d'une entreprise ou d'un bien et des pertes déductibles au titre d'un placement d'entreprise subies par le contribuable pour l'année;
and for the purposes of this Part,	Pour l'application de la présente partie, les règles suivantes s'appliquent :
(*e*) where an amount is determined under paragraph (*d*) for the year in respect of the taxpayer, the taxpayer's income for the year is the amount so determined, and	*e*) si un montant est calculé selon l'alinéa *d*) à l'égard du contribuable pour l'année, le revenu du contribuable pour l'année correspond à ce montant;
(*f*) in any other case, the taxpayer shall be deemed to have income for the year in an amount equal to zero.	*f*) sinon, le revenu du contribuable pour l'année est réputé égal à zéro.

[24] Many provisions in the *Income Tax Act*, including paragraph 3(*a*), use the word "source" in phrases such as "source of income" and "income from a source". These words and phrases are not defined in the *Income Tax Act*. However, their meaning is sufficiently clear from the context in which they are used. Paragraph 3(*a*) lists four sources of income – office, employment, property and

business. The use of the word "including" in paragraph 3(*a*) indicates that there may be sources of income apart from those listed. Section 56 of the *Income Tax Act*, for example, lists other amounts that are treated as income for income tax purposes, including pension payments, and various kinds of government and other benefits. (Section 56 is part of subdivision d (entitled "*Other Sources of Income"*) of division B (entitled "*Computation of Income*") of Part I of the *Income Tax Act* (entitled "*Income Tax*"); Part I of the *Income Tax Act* includes sections 3 and 56).

[25] It is an open question whether any source of income exists that is not listed in paragraph 3(*a*) or section 56. However, it is not necessary to answer that question in this case. Indeed, it may never be necessary to determine that question because the words "business" and "property" are so broadly defined for income tax purposes that they may capture anything from which income is or may be derived (other than an office or employment). Those definitions appear in subsection 248(1) of the *Income Tax Act* and read as follows (my emphasis):

"business" includes a profession, calling, trade, manufacture or undertaking of any kind whatever and, except for the purposes of paragraph 18(2)(*c*), section 54.2, subsection 95(1) and paragraph 110.6(14)(*f*), an adventure or concern in the nature of trade but does not include an office or employment;	« entreprise » Sont compris parmi les entreprises les professions, métiers, commerces, industries ou activités de quelque genre que ce soit et, sauf pour l'application de l'alinéa 18(2)*c*), de l'article 54.2, du paragraphe 95(1) et de l'alinéa 110.6(14)*f*), les projets comportant un risque ou les affaires de caractère commercial, à l'exclusion toutefois d'une charge ou d'un emploi.
"property" means property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes	« biens » Biens de toute nature, meubles ou immeubles, corporels ou incorporels, y compris, sans préjudice de la portée générale de ce qui précède :

(*a*) a right of any kind whatever, a share or a chose in action,	*a*) les droits de quelque nature qu'ils soient, les actions ou parts;
(*b*) unless a contrary intention is evident, money,	*b*) à moins d'une intention contraire évidente, l'argent;
(*c*) a timber resource property, and	*c*) les avoirs forestiers;
(*d*) the work in progress of a business that is a profession;	*d*) les travaux en cours d'une entreprise qui est une profession libérale.

[26] The other statutory provision cited by the Crown is subsection 9(1), which reads as follows:

9. (1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.	**9.** (1) Sous réserve des autres dispositions de la présente partie, le revenu qu'un contribuable tire d'une entreprise ou d'un bien pour une année d'imposition est le bénéfice qu'il en tire pour cette année.

[27] No controversy arises in this case in connection with subsection 9(1). It equates the profit from a business or property with the income from that business or property for income tax purposes, subject to numerous positive and negative adjustments required or permitted by other provisions in Part I of the *Income Tax Act*, none of which are relevant in this case. Ms. Johnson does not dispute that if her net receipts from her transactions with Mr. Lech are income from property as the Crown contends, then the amount of the income for 2002 is $614,000 and for 2003 is $702,000.

[28] I summarize as follows the reasoning behind the Crown's position that Ms. Johnson's net receipts are taxable in her hands. Over several years, including 2002 and 2003, Ms. Johnson entered into a number of similar transactions with Mr. Lech under which she invested money with Mr. Lech in consideration of payments to be received in the amounts and on the dates evidenced by the postdated cheques that Mr. Lech gave her at the time of each investment. Each contract between Ms. Johnson and Mr. Lech was performed except the last one. A right under a contract is a chose in action, which is "property" according to the statutory definition quoted above. It follows that Ms. Johnson's profit from the contracts falls within the scope of paragraph 3(*a*) as income from a source. 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.

[29] In support of its position, the Crown cites the decision of the Supreme Court of Canada in *Stewart v. Canada*, 2002 SCC 46. That case involved a challenge to reassessments that disallowed rental losses on the basis that he had no reasonable expectation of profit from the rental properties in issue. The main proposition determined in *Stewart* is captured in paragraph 4 of the reasons written by Justice Iacobucci and Justice Bastarache:

> In our view, the reasonable expectation of profit analysis cannot be maintained as an independent source test. To do so would run contrary to the principle that courts should avoid judicial innovation and rule-making in tax law. Although the phrase "reasonable expectation of profit" is found in the *Income Tax Act*, S.C. 1970-71-72, c. 63 (the "Act"), its statutory use does not support the broad judicial application to which the phrase has been subjected. In addition, the reasonable expectation of profit test is imprecise, causing an unfortunate degree of uncertainty for taxpayers. As well, the nature of the test has encouraged a hindsight assessment of the business

> judgment of taxpayers in order to deny losses incurred in *bona fide*, albeit unsuccessful, commercial ventures.

[30] Paragraph 50 of *Stewart* explains how to determine whether a source of business or property income exists:

> It is clear that in order to apply s. 9, the taxpayer must first determine whether he or she has a source of either business or property income. As has been pointed out, a commercial activity which falls short of being a business, may nevertheless be a source of property income. As well, it is clear that some taxpayer endeavours are neither businesses, nor sources of property income, but are mere personal activities. As such, the following two-stage approach with respect to the source question can be employed:
>
> > (i) Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour?
> >
> > (ii) If it is not a personal endeavour, is the source of the income a business or property?
>
> The first stage of the test assesses the general question of whether or not a source of income exists; the second stage categorizes the source as either business or property.

[31] The *Stewart* approach to the identification of a source of income was developed in a factual context quite unlike this case. In *Stewart*, the question was whether Mr. Stewart's investment in rental properties could be considered a source of income even though the objective evidence indicated no reasonable expectation of profit for the years under appeal. The answer was yes, because Mr. Stewart's investment in the rental properties was essentially commercial in nature and there was no personal element. Looking no further than *Stewart*, it would appear that the Crown is entitled to succeed in this appeal.

[32] However, it is necessary to go further and consider the position of Ms. Johnson, which is that the net receipts of her arrangements with Mr. Lech are not taxable because, unknown to her, the money came from an unlawful Ponzi scheme rather than the lawful option trading that she believed Mr. Lech would undertake on her behalf.

[33] The most frequently cited case in which an amount was found not to be income from a source is *R. v. Cranswick*, [1982] 1 F.C. 813 (C.A.). In that case, an amount paid to a minority shareholder of a corporation by the majority shareholder was held not to be taxable. The majority shareholder had arranged for the sale of the corporation's assets for less than their book value. In the hope of avoiding controversy and potential litigation, the majority shareholder offered to purchase the shares of all minority shareholders for an amount exceeding their fair market value. A minority shareholder could choose instead to receive a cash payment, which is what Mr. Cranswick chose.

[34] The Crown took the position that the payment was taxable to Mr. Cranswick, because it was income from property (the shares). Justice Le Dain, writing for the Federal Court of Appeal, disagreed. He referred to the following list of factors, derived in part from *Federal Farms Ltd. v. Minister of National Revenue*, [1959] Ex. C.R. 91, to assist in determining whether a particular amount is income from a source or a non-taxable receipt (sometimes referred to in tax cases as a "windfall"):

(a) The recipient had no enforceable claim to the payment.

(b) There was no organized effort on the part of the recipient to receive the payment.

(c) The payment was not sought after or solicited by the recipient in any manner.

(d) The payment was not expected by the recipient, either specifically or customarily.

(e) The payment had no foreseeable element of recurrence.

(f) The payer was not a customary source of income to the recipient.

(g) The payment was not in consideration for or in recognition of property, services or anything else provided or to be provided by the recipient; it was not earned by the recipient, either as a result of any activity or pursuit of gain carried on by the recipient.

[35] The *Cranswick* factors have proved to be a useful analytical framework in many cases where it is alleged that an amount received by a taxpayer is not income from a source.

[36] In this case, the judge considered the *Cranswick* factors. While she acknowledged that Ms. Johnson's net receipts have some characteristics of income from a source, in that she provided capital to Mr. Lech and received something in return, the judge found very little factual connection between Ms. Johnson's capital and the payments she received. The judge noted that there was no evidence that Mr. Lech actually used Ms. Johnson's money to obtain the amounts he paid her, and concluded that the payments were not in satisfaction of her agreement with Lech. It was essentially on that basis that the judge held that the *Cranswick* factors favoured the position of Ms. Johnson.

[37] The judge's analysis flows from a particular construction of the agreement between Ms. Johnson and Mr. Lech, as set out in paragraph 39 of the judge's reasons. Essentially, the judge concluded that Mr. Lech was obliged to invest the money Ms. Johnson paid him and to pay her the earnings from that investment activity. I respectfully disagree with that construction of the agreement.

[38] The agreement between Ms. Johnson and Mr. Lech was never reduced to writing and is evidenced only by Ms. Johnson's testimony about what she was told by Mr. Lech, and her subjective belief that he was telling the truth. In my view, her evidence establishes no more than the existence of an agreement that Mr. Lech would repay Ms. Johnson any money she gave him, with a return, in instalments in the amounts and on the dates indicated by the postdated cheques he gave her in exchange.

[39] Ms. Johnson may well have believed that Mr. Lech was going to use the money to earn profits by option trading, because that is what he told her he would do. However, the record discloses no evidence upon which the judge could reasonably conclude that Mr. Lech was under a contractual obligation to Ms. Johnson to generate profits in that manner, or in any particular manner.

[40] The Crown suggested an apt analogy. A person who deposits money with a bank in an interest bearing account is entitled to receive interest from the bank in accordance with terms governing the deposit, and is subject to income tax on the interest received. The depositor may be told, or may reasonably assume, that the bank will generate the money required to pay interest on the deposit by conducting a lawful banking business. But the depositor is not relieved of the obligation to pay tax on the interest on the deposit merely because the bank, unknown to the depositor, generates the required funds through unlawful activities.

[41] In my respectful view, the judge's overly narrow construction of the agreement between Ms. Johnson and Mr. Lech led to incorrect conclusions in respect of the *Cranswick* factors. If those

factors are considered in light of what I have concluded is the correct construction of the agreement, the *Cranswick* factors favour the position of the Crown:

(a) *Did Ms. Johnson have an enforceable claim to the payments in issue?* Yes. Ms. Johnson entered into an agreement with Mr. Lech under which she would receive payments in the amounts and on the dates indicated by the postdated cheques she received from Mr. Lech when she invested her money with him. There is no basis for concluding that the agreement was unenforceable as a matter of law.

(b) *Was there an organized effort by Ms. Johnson to receive the payments?* Yes. Ms. Johnson engaged in a consistent pattern of investments in which she received postdated cheques simultaneously with each investment.

(c) *Did Ms. Johnson seek or solicit the payments?* Yes.

(d) *Were the payments expected by Ms. Johnson, either specifically or customarily?* Yes.

(e) *Did the payments have a foreseeable element of recurrence?* Yes.

(f) *Did the payments in issue come from a customary source of income?* Yes. The general nature of the agreement between Ms. Johnson and Mr. Lech – a contract of investment – is a common commercial transaction, and Mr. Lech became a customary source of income to Ms. Johnson.

(g) *Were the payments in consideration for something provided by Ms. Johnson?* Yes. Each series of payments, represented by the postdated cheques, was consideration for a payment made by Ms. Johnson to Mr. Lech.

[42] It is submitted for Ms. Johnson (and here I quote from paragraph 23 of her memorandum of fact and law) that "A Ponzi scheme cannot be considered to be a source of income

for innocent participants because it only involves the reshuffling of money, not the creation of new wealth, and Ponzi schemes are, by their very nature, doomed to collapse."

[43] I do not quarrel with the proposition that a Ponzi scheme involves the shuffling of money and that it will collapse at some point. However, for income tax purposes, income is calculated on an annual basis, not over the entire life of an enterprise. A Ponzi scheme may well be a source of income for some participants during some part of its existence. This case suggests how that could be so. Hypothetically, if Ms. Johnson had made her payments to Mr. Lech knowing that he would use the money to operate a Ponzi scheme, she would have profited exactly as she did in the years in issue in this case, 2002 and 2003.

[44] Ms. Johnson relied on some evidence from a tax official to the effect that those who lost money because of the Ponzi scheme in this case were reassessed to disallow the losses on the basis that the Ponzi scheme was not and could not be a source of income to them. There is a document on the record that indicates that at least one tax official believed that this would be a valid basis for disallowing the deduction of losses suffered by victims of Mr. Lech's Ponzi scheme although the record contains no specific information about any such reassessments. The Crown pointed out, correctly in my view, that the tax official's belief is not binding on the Crown and does not reflect the Crown's position in this case.

[45] Nevertheless, Ms. Johnson relies on this document as the basis for her argument if a Ponzi scheme cannot be a source of income to a victim who loses money, it must follow that it

cannot be a source of income to an innocent participant who happens to profit from it. Ms. Johnson also argues that there is a substantial injustice in taxing persons who innocently profit from a Ponzi scheme while denying the losses incurred by innocent victims of the same scheme.

[46] There are two difficulties with Ms. Johnson's position. The first difficulty is that it is based on a mischaracterization of the basis upon which Ms. Johnson is being taxed. She is not being taxed because she profited innocently from a Ponzi scheme. She is being taxed because she entered into a series of agreements with Mr. Lech to receive a profit on her investments with him, and she received what she bargained for. The fact that Mr. Lech funded her payments with the proceeds of a Ponzi scheme is irrelevant.

[47] The second difficulty with Ms. Johnson's argument is that it is based on an incorrect understanding of the statutory scheme for determining income for income tax purposes. The question as to whether a Ponzi scheme is a source of income to a particular person, whether innocent or not, is a question that must be answered on the basis of the facts relating to that person. In principle, a person who participates in a Ponzi scheme, either as the main operator or in association with others, may be engaged in an undertaking that would be recognized for income tax purposes as a business, even if the business is unlawful. Such a person is taxable on any profits derived from the Ponzi scheme and, depending upon the specific circumstances, may be permitted to deduct any related losses.

[48] It may well be that a victim of a Ponzi scheme is unable to claim any tax relief for the resulting loss. That would be the case if, for example, the circumstances are analogous to those in *Hammill v. Canada*, 2005 FCA 252. Mr. Hammill was induced to purchase gems for eventual resale, and accumulated a significant inventory. When he decided it was time to sell the gems, he paid a substantial sum of money to a person who promised to facilitate the sale. The promises were never kept, and the gems were stolen. Mr. Hammill claimed a deduction for the amounts paid to facilitate the sale, on the basis that the purpose of the expenditures had been to sell his gems at a profit. It was determined at trial, however, that Mr. Hammill was the victim of a fraud that commenced when he was contacted about the profits to be made from buying and selling gems, and continued with the purported efforts of the perpetrators to sell the gems. This Court confirmed that his expenditures were not deductible because they were not connected to any source of income – or in other words, there was in fact no business even though Mr. Hammill honestly believed that there was. Justice Noël, writing for the Court, summarized this conclusion as follows at paragraph 28 of the reasons:

> A fraudulent scheme from beginning to end or a sting operation, if that be the case, cannot give rise to a source of income from the victim's point of view and hence cannot be considered as a business under any definition.

[49] However, the principle upon which Mr. Hammill was precluded from claiming tax relief for his losses is not applicable to Ms. Johnson. Their circumstances are entirely different, not because she profited from her transactions with Mr. Lech, but because her contractual rights were respected. As a matter of law, the fact that Mr. Lech used the proceeds of his unlawful Ponzi

scheme to fund the profits he was contractually obliged to pay to Ms. Johnson is not relevant in determining the income tax consequences to Ms. Johnson of her transactions with Mr. Lech.

Time limitations for the reassessments

[50] Having concluded that Ms. Johnson was required by paragraph 3(*a*) of the *Income Tax Act* to report her net receipts from Mr. Lech in 2002 and 2003 in her income tax returns for those years, it is necessary to consider whether the reassessments that included those amounts in her income for those years were made within the statutory time limits.

[51] For individuals, the normal reassessment period is three years from the date of initial assessment. The Minister has the legal authority to reassess at any time within that three year period. However, the reassessments in issue in this case were made after that three year period. The Crown argues that the Minister had the legal authority to make the late reassessments because of subparagraph 152(4)(*a*)(i), which reads as follows:

152. (4) The Minister may at any time make an assessment, reassessment or additional assessment of tax for a taxation year, interest or penalties, if any, payable under this Part by a taxpayer or notify in writing any person by whom a return of income for a taxation year has been filed that no tax is payable for the year, except that an assessment, reassessment or additional assessment may be made after the taxpayer's normal reassessment period in respect of the year only if	**152**. (4) Le ministre peut établir une cotisation, une nouvelle cotisation ou une cotisation supplémentaire concernant l'impôt pour une année d'imposition, ainsi que les intérêts ou les pénalités, qui sont payables par un contribuable en vertu de la présente partie ou donner avis par écrit qu'aucun impôt n'est payable pour l'année à toute personne qui a produit une déclaration de revenu pour une année d'imposition. Pareille cotisation ne peut être établie après l'expiration de la période normale de nouvelle cotisation

applicable au contribuable pour l'année que dans les cas suivants :

(*a*) the taxpayer or person filing the return

(i) has made any misrepresentation that is attributable to neglect, carelessness or wilful default or has committed any fraud in filing the return or in supplying any information under this Act …

a) le contribuable ou la personne produisant la déclaration :

(i) soit a fait une présentation erronée des faits, par négligence, inattention ou omission volontaire, ou a commis quelque fraude en produisant la déclaration ou en fournissant quelque renseignement sous le régime de la présente loi […]

[52] Generally, an income tax return that omits income from a particular source contains a misrepresentation. If such a misrepresentation is attributable to neglect, carelessness, wilful default, or any fraud by the person filing the return or supplying any information under the *Income Tax Act*, paragraph 152(4)(*a*)(i) authorizes the Minister to reassess the return outside the normal reassessment period.

[53] In this case the key question is whether Ms. Johnson was careless in failing to include in her 2002 and 2003 income tax returns the payments she received from Mr. Lech in those years. The judge reasoned that the key factual question was whether Ms. Johnson was careless in relying on Mr. Lech's assurances that tax had been paid on the profits and that she was not required to include them in her income.

[54] The judge held that, because Mr. Lech's bank accounts had not been frozen by the time Ms. Johnson's 2002 income tax return was due, it was reasonable for her to continue to rely on his

assurances, combined with those of her fellow investors who all believed the same thing. However, by the time Ms. Johnson's 2003 income tax return was due, the fact that Mr. Lech's bank accounts were frozen and the class action commenced should have alerted her to the need to investigate further the truth of what he had told her, and her failure to do so was careless. On that basis, the judge concluded that the reassessments for 2002 were statute barred, but the reassessments for 2003 were not.

[55] The Crown argues that in respect of 2002, the judge erred in failing to consider whether Ms. Johnson met the requisite standard of care – that of a wise and prudent person who has considered the matter thoughtfully, deliberately and carefully. That legal test is based on the following passage from the decision of Justice Addy in *Regina Shoppers Mall Ltd. v. Canada* (1990), 90 D.T.C. 6427 (F.C.T.D.), adopted by Justice MacGuigan, writing for this Court in *Regina Shoppers Mall Ltd. v. Canada* (1991), 91 D.T.C. 5101, at page 5013:

> Where a taxpayer thoughtfully, deliberately and carefully assesses the situation and files on what he believes *bona fide* to be the proper method there can be no misrepresentation as contemplated by section 152 [*1056 Enterprises Ltd v. The Queen*, [1989] 2 C.T.C. 1]. In *Joseph Levy v. The Queen*, [1989] C.T.C. 151 at 176, Teitelbaum J. quotes with approval the following statement by Muldoon J. in the above case:
>
> > Subsection 152(4) protects such conduct, and perhaps only such conduct, where the taxpayer thoughtfully, deliberately and carefully assesses the situation as being one in which the law does not exact the reporting of that which the taxpayer *bona fide* believes does not exist.
>
> It has also been established that the care exercised must be that of a wise and prudent person and that the report must be made in a manner that the taxpayer truly believes to be correct. In another decision by Mr. Justice Muldoon, namely *Iris M. Reilly, Executrix and Trustee of the Estate of Cleo E. Reilly*,

[1984] C.T.C. 21, in which he dealt again with the subject, we find the following statement at p. 38:

> In order to make any determination of making "any misrepresentation that is attributable to neglect, carelessness or wilful default . . . in filing the return or in supplying any information under the Act" it is necessary to have direct evidence of the state of mind and intention of "the taxpayer or person filing the return" or other evidence upon which reasonable inferences can be drawn in regard to the taxpayer's or other person's state of mind and intention.

And at p. 40:

> The issue is not whether Mr. Tetz, in forming his opinion at the material time was wrong, but whether his not reporting the disposition was attributable to neglect, carelessness or wilful default.

Finally, at p. 42:

> So, when it is now said that the standard of care is that of a wise and prudent person, it must be understood that wisdom is not infallibility and prudence is not perfection.

[56] The Crown argues that for 2002, Ms. Johnson did not meet the standard of a wise and prudent person, nor did she consider the matter thoughtfully, deliberately and carefully, when she accepted the assurances of Mr. Lech that the payments she received were free of tax. Her carelessness is proved by the fact that she failed to consult a knowledgeable adviser, simply taking comfort in the beliefs of others who had entered into similar arrangements with Mr. Lech.

[57] Ms. Johnson does not take issue with the authority of *Regina Shoppers Mall*, but argues that she acted reasonably in relying on Mr. Lech’s assurances, since he would have had no

motivation to mislead her about the tax treatment of the payments, and other people that she knew and trusted had also relied on him.

[58] I am unable to accept the submissions of Ms. Johnson on this point. In early 2003 when Ms. Johnson would have been preparing to file her 2002 income tax return, she would have known that her net receipts from Mr. Lech for 2002 were substantial – over $600,000. She had Mr. Lech's assurance that the net receipts were not taxable in her hands. However, she had no factual basis for assessing the reliability of those assurances, and she failed to do what any reasonable person in her position would have done, which was to seek independent advice (and here I agree with the Crown that seeking assurances from a fellow investor, even one who is a bookkeeper, is not the kind of independent advice that would demonstrate reasonable care). Having failed to take that obvious and simple step, she cannot claim to have considered the matter thoughtfully, deliberately and carefully as a wise and prudent person would have done. I agree with the Crown that the only reasonable conclusion on the evidence is that Ms. Johnson was careless in omitting to include the payments in her income for 2002.

[59] By the time Ms. Johnson's 2003 income tax return was due, it was even more apparent that the reliability of Mr. Lech's assurances were seriously in doubt. In respect of 2003, I agree with the judge that Ms. Johnson was careless in omitting to inform the accountant who prepared her 2003 return about the payments from Mr. Lech.

[60] Ms. Johnson argues that even if she had sought independent advice about the taxability of the payments from Mr. Lech in 2003, any investigation by an adviser at that time would have disclosed the fraud, and the adviser probably would have advised Ms. Johnson that she had a reasonable basis for excluding the payments from her income for 2003. This argument is interesting but entirely speculative. The fact is that Ms. Johnson chose not to seek independent advice, and there is nothing in the record from which it is possible to determine what an independent adviser would have discovered or advised at the time Ms. Johnson's 2003 income tax return was due. The Crown has the onus of justifying a late reassessment by proving that the conditions in subparagraph 152(4)(*a*)(i) are met, but that does not require the Court to give weight to arguments made by the taxpayer that have no evidentiary foundation.

Conclusion

[61] For these reasons I would allow the appeal, set aside the judgment of the Tax Court of Canada, and dismiss Ms. Johnson's income tax appeal for 2002 and 2003. The Crown is entitled to its costs in this Court and in the Tax Court.

"K. Sharlow"

J.A.

"I agree
Pierre Blais, Chief Justice"

"I agree
Johanne Trudel J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-491-11
(APPEAL OF THE JUDGMENT RENDERED BY THE HONOURABLE MADAM JUSTICE WOODS OF THE TAX COURT OF CANADA, DATED NOVEMBER 24, 2011, DOCKET NUMBER 2009-3460(IT)G)	
STYLE OF CAUSE:	Her Majesty the Queen v. Donna M. Johnson
PLACE OF HEARING:	Toronto, Ontario
DATE OF HEARING:	September 13, 2012
REASONS FOR JUDGMENT BY:	SHARLOW J.A.
CONCURRED IN BY:	BLAIS C.J. TRUDEL J.A.
DATED:	October 4 2012

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