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PENALTIES FOR FALSE STATEMENTS OR OMISSIONS - PART I

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on penalties under the Income Tax Act (Canada) and the possible challenges to such assessments. Alpert Law Firm is experienced in providing legal services to its clients in tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions and estate administration.

A. SUBSECTION 163(2) PENALTIES

Pursuant to the provisions of subsection 163(2) of the Income Tax Act (the "Act'), the Minister of National Revenue (the "Minister") may impose penalties on taxpayers who *knowingly* or under circumstances amounting to *gross negligence* make, participate in, assent to, or acquiesce in the making of a false statement or omission in a tax return, form, certificate, statement or answer filed or made in respect to a taxation year.

It is important to note, that the imposition of such a penalty requires either one of the following constituent elements to be proven: (i) the taxpayer had *knowledge* of the omission or false statement; or (ii) the taxpayer was *grossly negligent* in regards to the omission or false statement.

Pursuant to subsection 163(3) of the Act, the Minister has the onus of proving, on a balance of probabilities, the facts indicate that either of these elements exist. If the Minister fails to establish that the facts of the case justify the assessment of the penalty, then the penalty cannot be imposed. While the Minister has the burden of justifying the imposition of the penalty, the taxpayer still has the usual burden of challenging the Minister's assessment.

The penalties imposed under subsection 163(2) can be substantial. The taxpayer will be liable for a penalty of the greater of $100 and 50% of the tax payable on the taxpayer's understatement of income (i.e. 50% of the amount by which the tax, which would have been payable by the taxpayer if the false statement had not been made in the taxation year, exceeds the amount of tax which would have been payable if the return was accepted as filed).

In addition, pursuant to subsection 163(1) of the Act, the Minister may impose penalties on taxpayers who repeatedly fail to report income in their tax returns. The penalty under subsection 163(1) is 10% of the amount which was not reported in the tax return. Under this penalty there is no requirement for the Minister to prove intent or negligence on the part of the re-offending taxpayer.

Also, a taxpayer who entirely fails to file a tax return, or files a tax return after the required time, can be subject to a penalty of 5% of the unpaid tax, pursuant to subsection 162(1) of the Act. There is also a similar penalty for repeated failures to file a tax return pursuant to subsection 162(2) of the Act.

The taxpayer could also be charged criminally with income tax evasion pursuant to the provisions of subsection 239(1) of the Act. However, a person who is criminally convicted under subsection 239(1) cannot be held liable to pay a penalty imposed under sections 162 or 163 for the same evasion, unless the person was assessed for that penalty under section 162 or 163 before the information or complaint giving rise to the criminal conviction was laid or made.

If the Department of Justice decides to prosecute a taxpayer for tax evasion, it can elect to proceed summarily or by indictment. Subsection 239(1) of the Act states that upon summary conviction for tax evasion, fines ranging from 50% to 200% of the amount sought to be evaded could be levied, as well as a possible imprisonment term of not more than two years. If the Department of Justice elects to proceed by indictment, upon conviction the offending taxpayer could pay fines ranging from 100% to 200% of the amount sought to be evaded, as well as face a maximum imprisonment term of five years, pursuant to subsection 239(2) of the Act.

In addition, third parties who advise or participate in the making of a false statement or omission in a tax return can also be held liable for civil penalties, pursuant to the provisions of subsection 163.2 of the Act. However, these penalties are limited to persons who either: (i) knew such statements or omissions were false; or (ii) should be reasonably expected to know that such statements or omissions were false.

B. DEFENCES AGAINST IMPOSITION OF PENALTIES

Where penalties under subsection 163(2) of the Act have been assessed, the Minister has the burden of justifying their imposition. The Minister must prove, on a balance of probabilities, that the taxpayer had knowledge of, or exhibited gross negligence in the making of, the false statement or omission. An attack upon any of these constituent elements amounts to a defence against the imposition of penalties.

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(i) <u>RELIANCE ON PROFESSIONAL ADVICE</u>

Penalties under subsection 163(2) of the Act can be challenged by the taxpayer on the basis that the taxpayer relied upon the professional services of an accountant to prepare the income tax return, and as such the taxpayer did not have *knowledge* of, or was not *grossly negligent* in the making of, the false statement or omission.

In general, the Courts have said that where errors or omissions have been made in a tax return and there has been gross negligence on the part of the accountant who prepared the tax return, the accountant's gross negligence cannot be automatically attributed to the taxpayer. Rather, it is up to the Minister to prove that the taxpayer is indeed liable for the accountant's gross negligence by proving either that the taxpayer had knowledge of the mistakes, or that the taxpayer was grossly negligent himself for failing to notice the accountant's mistakes.

To ascertain whether the taxpayer's reliance on professional advice provides an adequate defence against the imposition of penalties, the Courts look at a variety of factors including:

(i) whether the taxpayer was actually privy to the omission or error of the accountant;

(ii) the taxpayer's level of participation in the preparation of the tax return by the accountant;

(iii) the taxpayer's business expertise or knowledge of income tax and accounting principles that would have made it likely that the taxpayer actually knew of the errors or omissions made by the accountant;

(iv) whether the taxpayer had reason to believe that the accountant would make errors or omissions in the tax return (i.e. the qualifications and experience of the accountant; the duration of the taxpayer's reliance on professional advice without any income tax problems arising); and

(v) whether the amount of the error or omission was such that the taxpayer would have reasonably been aware of it.

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1. *Udell v. M.N.R.,* 70 DTC 6019

In this leading Exchequer Court of Canada case, penalties were assessed against the taxpayer for three taxation years under what is now subsection 163(2) of the Act. For the years in question, the taxpayer, who was a farmer, followed his usual practice of providing his accountant with meticulously maintained accurate records of all of his business transactions at the close of each taxation year. Despite receiving accurate records, the accountant made a number of substantial errors and omissions in the taxpayer's tax returns. These errors had the effect of understating the taxpayer's income during the three years in question.

The Minister performed a net worth assessment for these years and found that the taxpayer had underreported his income. The Minister also assessed penalties for these three taxation years on the grounds that the taxpayer was guilty of *gross negligence* in that the taxpayer was not alerted to obvious mistakes made by the accountant.

While the taxpayer did not challenge the Minister's assessment of his taxable income, the taxpayer disputed the penalties assessed against him. The taxpayer argued that while the accountant was grossly negligent in his preparation of the tax returns, the accountant's gross negligence should not be attributed to the taxpayer since: (i) the taxpayer provided the accountant with accurate records; and (ii) the taxpayer had no reason to believe that the accountant would make such errors since the accountant was highly qualified (even had extensive experience as an assessor for the Department of National Revenue) and the taxpayer had relied upon the accountant for many years to prepare his tax returns with no problems; and (iii) the taxpayer was not privy to the accountant's gross negligence, nor did he authorize it.

The fact that the taxpayer gave accurate records to the accountant and had no reason to doubt the correctness of the accountant's services led the Court to find that the taxpayer was not grossly negligent and as such could not be held liable for penalties. In finding that the taxpayer could not be held liable for penalties, the Court established that subsection 163(2) of the Act indicates that gross negligence on the part of the taxpayer's accountant cannot be attributed to the taxpayer. Instead, gross negligence of the taxpayer himself needs to be proven in order to justify the imposition of such penalties.

2. *Thibault v. M.N.R.*, 78 DTC 1641

In this Tax Review Board case, subsection 163(2) penalties were assessed against the taxpayer for three consecutive taxation years. The Minister conducted an audit on the taxpayer, who was a sole proprietor of a garage, and found that the taxpayer severely understated his income for three consecutive years, failing to disclose 80%, 50% and 30% of his income in each of the three years. The Minister also found that the taxpayer kept very poor and inaccurate accounting records, as many important documents, such as sales invoices and accounts payable and receivable books were simply missing. As a result, the taxpayer was assessed penalties on the grounds that the taxpayer had been grossly negligent in reporting his income in each of the years in question.

While the taxpayer accepted the Minister's assessment of additional income, he appealed against the imposition of penalties arguing that he was not grossly negligent claiming he entrusted an expert accountant with the preparation of his tax returns and did not contribute or participate in any wilful failure to report income.

The Court found the taxpayer to be grossly negligent, given that the massive amounts of undisclosed income were just too large to escape the taxpayer's notice, and the taxpayer failed to keep all the documents necessary for the accurate preparation of his tax returns. As such, the Court found the imposition of penalties to be justified. Thus, the defence of reliance of professional advice may not be successful if either: (i) the amount of the error in the tax return was extremely high; or (ii) the taxpayer did not actually provide the tax professional with accurate information.

3. *Venne v. Canada,* 84 DTC 6247

In this Federal Court case, the taxpayer was reassessed for seven consecutive taxation years and assessed penalties under subsection 163(2). In reassessing the taxpayer, the Minister added over $348,000 of undisclosed interest income from mortgage investments for the seven year period. The taxpayer admitted that over $283,000 of income was unreported.

During most of this period, the taxpayer and his wife operated a service station and marine business. The other important source of income for the taxpayer during this period was mortgage interest. The taxpayer's tax returns had been prepared by a succession of bookkeepers or accountants. The taxpayer had only a grade 5 education and used a relatively simple method of record keeping. Each month he took copies of all

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receipts, cheque stubs, and other documents to the bookkeeper. At the end of the year, the taxpayer would provide the inventory information to the bookkeeper, who would prepare the tax return, which the taxpayer would sign. The taxpayer admitted that he did not read his tax returns before signing them, testifying that he found tax returns almost entirely incomprehensible, even though successive bookkeepers tried to explain these matters to him.

The Federal Court held that the Minister was justified in reassessing the taxpayer beyond the normal reassessment period, since the taxpayer's negligence resulted in misrepresentations being made in his returns. First, the taxpayer did not exercise reasonable care when he failed to read his returns before signing them. Second, because of the magnitude of the unreported income, the errors in the return should have been sufficiently obvious that a reasonable man of even limited education and experience, especially one who was apparently a very successful businessman and investor, should have noticed them.

However, the Federal Court disallowed the imposition of subsection 163(2) penalties. The Court held that gross negligence must be taken to involve greater neglect than simply a failure to use reasonable care. It must involve a high degree of negligence tantamount to intentional acting, indifference as to whether the law is complied with or not. In this case, it was quite conceivable that the taxpayer did not notice the errors in the returns and his neglect in not noticing them fell short of constituting gross negligence. Moreover, it was not improbable for the taxpayer to believe that only the amounts of interest income shown on the T-5 slips were taxable.

4. ***Findlay v. Canada*** **[2000] F.C.J. No. 731**

In this recent Federal Court of Appeal case, penalties under subsection 163(2) of the Act were assessed against the taxpayer for one taxation year. The taxpayer, who was a sole proprietor of three video stores, decided to incorporate his businesses in the year in question. During the incorporation process, the taxpayer rolled over his assets into the corporation, thereby generating large capital gains of $135,000. The taxpayer hired a tax-preparing company to prepare his tax returns, as he had done for several years with no income tax problems. In reviewing the taxpayer's personal tax return, the Minister noticed that the $135,000 of capital gains generated from the rollover had been omitted. As a result, the Minister assessed penalties on the grounds that the taxpayer was grossly negligent in omitting these capital gains.

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The taxpayer challenged the penalties assessed against him. The taxpayer maintained that while the professional tax preparer may have been grossly negligent, the taxpayer himself was not since: (i) the taxpayer was not actually privy to the tax preparer's omission; and (ii) the taxpayer provided accurate records of the capital gains to the professional tax preparer. A representative of the tax-preparing company corroborated the taxpayer's claim. He testified that it was not unreasonable for the taxpayer to overlook the fact that the capital gains was not declared in his personal return, given that the tax return was extremely complex and the taxpayer was under the false impression that very little tax would result from the rollover on account of faulty advice from his tax-preparing company.

On account of the testimony of the taxpayer and the representative of the tax-preparing company, the Court found that the taxpayer was not grossly negligent. In finding that the taxpayer could not be held liable for penalties, the Court reiterated the *Udell* principle: that gross negligence on the part on the taxpayer's agent should not be attributed to the taxpayer.

5. *LaPlante v. The Queen*, 2008 DTC 4294

The taxpayer was assessed for a period of three consecutive years for overstating deductions for expenses with respect to a rental property he owned and claiming a medical expense tax credit for one of the tax years based on expenses that he did not actually incur. The Minister assessed gross negligence penalties pursuant to subsection 163(2) of the Act. The taxpayer appealed the imposition of the penalties.

The Tax Court dismissed the taxpayer's appeal. For the taxation years at issue, the taxpayer used the services of a chartered accountant to prepare his returns. The Tax Court held that that the taxpayer should have noticed the significant discrepancy between the net rental revenues for the years under appeal and the two preceding years, for which the taxpayer's returns had been prepared by another person. Failure to question the accountant about this discrepancy amounted to wilful blindness on the part of the taxpayer.

Moreover, the Tax Court found that the taxpayer showed gross negligence by not reviewing his tax returns before signing them. The taxpayer testified that if he had reviewed the returns, he would have noticed the misrepresentations regarding his medical expenses, car rental expenses, and the distance driven for the purpose of earning income. The Tax Court found that the taxpayer's cavalier attitude amounted to total indifference as to whether the law was complied with or not.

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(ii) MATERIALITY OF UNREPORTED INCOME

Where the Minister assesses penalties on the basis of gross negligence, a taxpayer can raise the defence that the size of the unreported amount was not substantial or material given the facts of the case. Case law has indicated when evaluating this defence, the Courts may take into account facts which indicate: (i) sizeable complexity of the taxpayer's business transactions; and (ii) the overall size of the unreported income is inconsequential given the taxpayer's total taxable income.

The Courts have also cancelled penalties where the discrepancy between the Minister's net worth assessment and the taxpayer's own figures are judged to not be significantly different. The Courts have also found the net worth assessment method to be imprecise and the taxpayer may be given the benefit of the doubt in the above mentioned circumstances.

1. *Mark v. M.N.R.,* 78 DTC 1205

In this Tax Review Board case, the Minister assessed penalties on the taxpayer for failing to report certain income in his tax return for one taxation year. In his defence, the taxpayer successfully claimed that the amount of unreported income was not substantial and material enough to support a finding of gross negligence and impose penalties.

The taxpayer was a businessman, whose business interests were very wide and varied. In the year in question, the taxpayer was paid a management fee of $17,500 for acting as the secretary-treasurer of an investment company of which he owned fifty percent. However, the taxpayer's accountant failed to include this payment as income in the taxpayer's personal tax return.

The Minister assessed a penalty on the taxpayer, finding that the taxpayer was grossly negligent in understating his income by the $17,500. The Minister argued that the amount could not have escaped the taxpayer's purview, as the amount would have arisen several times when the taxpayer was conducting the company's affairs. To support this argument, the Minister provided documentary evidence that the taxpayer was indeed responsible for all the banking transactions of the investment company, indicating that the $17,500 must have come to his attention during his functions as a secretary-treasurer of the company.

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The taxpayer appealed the Minister's assessment of the penalty. The taxpayer claimed that the amount of unreported income was immaterial given the taxpayer's much larger total income in the year in question, which was shown to be approximately $90,000. Furthermore, the taxpayer provided documentary evidence that his business affairs were extremely complex: the taxpayer's income was derived from a variety of sources and the amounts of payments, receipts and expenses likely amounted to one or even two million dollars during the year in question. This complexity was further reiterated by the taxpayer's sizeable fifty-three-page tax return.

The Court found that the taxpayer was not grossly negligent on the basis that the unreported amount was immaterial as: (i) the unreported amount was small in comparison to the taxpayer's more significant total taxable income; and (ii) the taxpayer's business affairs were extremely complex, such that the error was inconsequential considering the taxpayer's overall business complexity.

2. ***Vigeant v. Canada*, 2009 DTC 1332**

In this case, the taxpayer appealed the assessment and penalties in respect of the 1998, 1999 and 2000 taxation years. The Minister added $6,512 for 1998, $74,548 for 1999 and $41,043 for 2000 as unreported business income, using the net worth assessment method. Because the Minister’s assessments were made beyond the normal reassessment period, the Minister was required to show the taxpayer made a misrepresentation that was attributable to neglect, carelessness or wilful default in addition to bearing the burden of establishing the facts justifying the penalties.

The Tax Court of Canada held that the Minister was justified in making the assessments outside the normal period. There was evidence that the taxpayer had made misrepresentations with respect to capital gains, capital cost allowances and income from an estate. The Tax Court of Canada ruled that: (i) the taxpayer was not justified in asking that only the errors in the assessment to his disadvantage be corrected, especially since the taxpayer did not provide evidence to establish his true cost of living; and (ii) the taxpayer had not adduced credible evidence regarding supposed gifts and expenses.

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(iii) SINGLE OMISSION TO REPORT INCOME

1. *Snelgrove v. Canada*, 79 DTC 780

In this Tax Review Board case, the taxpayer appealed against the penalty portion of an income tax assessment for one tax year. The taxpayer was a businessman with income from salary, commissions, dividends and interest. In January 1976, the taxpayer cashed Canada Savings Bond Coupons in the amount of $22,540.00 and received a T-600 form issued by the bank. However, when the taxpayer filed his income tax return in April 1977 in respect of his 1976 taxation year, he did not report this income.

The taxpayer claimed that he misplaced the T-600 and forgot about it when giving all his 1976 income tax information to his accountants. He testified that this was the only experience he could recall with the T-600 form, and that if the bank had instead issued the T-5 form, with which he was familiar, the result might have been different.

The Tax Review Board allowed the taxpayer's appeal. It held that when dealing with a taxpayer who is normally careful and diligent about his affairs, the "gross negligence" in an instance of a single transgression must be virtually indistinguishable from "knowingly." The Board also noted that the fact that the omitted amount was substantial, both in itself and as a portion of the appellant's total income, was not determinative: it was the taxpayer's conduct, rather than the amount at issue, that established gross negligence. In this case, the single omission in an otherwise acceptable and appropriate record by the taxpayer fell considerably short of gross negligence.

(iv) MAINTAINING ADEQUATE BOOKS AND RECORDS

Penalties under subsection 163(2) of the Act can be imposed if the taxpayer had *knowledge* of, or was *grossly negligent* in the making of, a false statement or omission. One way in which the Minister can establish that a taxpayer was grossly negligent is if he proves, on a balance of probabilities, the taxpayer failed to keep proper and accurate records. On the other hand, where such a justification for penalties is raised by the Minister, a taxpayer can successfully challenge the penalties by providing evidence that proves that the taxpayer did indeed keep adequate records and as such was not grossly negligent in the making errors in the tax return.

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1. *Sandhu v. M.N.R.*, 83 DTC 500

In this Tax Review Board case, the Minister assessed penalties against the taxpayer on the grounds that the taxpayer exhibited gross negligence in keeping inadequate books and records that resulted in the errors in his tax return. The taxpayer successfully appealed the Minister's assessment by proving that he did indeed keep adequate records.

The taxpayer was an owner of a small ladies-wear boutique, who filed his tax return regularly. The Minister conducted an assessment for a period of four consecutive years and found that the taxpayer's bank statements and cheques demonstrated higher deposits than what the taxpayer had reported as his sales. The Minister imposed penalties on the taxpayer on the grounds that the errors in the tax returns were a result of the taxpayer's gross negligence as he failed to keep adequate books and records of his business activities.

The taxpayer challenged the Minister's claim, testifying that he did keep accurate records of his sales. The taxpayer claimed that the increase in his income was not the result of sales he failed to report; rather the increased income was attributed to monies he received from his father totalling $58,000 during these four taxation years. The taxpayer's testimony was corroborated by the testimony of an individual who was both the taxpayer's bank manager and bookkeeper. This individual testified that he prepared the taxpayer's books every three months during the four years in question, even making some spot checks, and had never discovered any unreported sales.

The Court found that the Minister had failed to prove that taxpayer did not keep adequate records. The Court found it to be inconceivable that such large amounts could have been earned from the taxpayer's small business; thus, the only plausible explanation was that the $58,000 was actually received as gifts from the taxpayer's father and was not derived from sales that the taxpayer negligently failed to report.

This case indicates that if the Minister attempts to justify penalties on the basis that the taxpayer exhibited gross negligence by keeping inadequate books and records, penalties may not be imposed if the taxpayer produces corroborated verbal testimony that demonstrates that the taxpayer kept adequate records.

2. *Stirton v. M.N.R.*, 88 DTC 1205

In this Tax Court of Canada case, the Minister assessed the taxpayer for penalties on the grounds that the taxpayer was grossly negligent in the making of false statements in seven consecutive tax returns as seen by the taxpayer's improper record keeping.

The taxpayer in this case was the owner of a successful business which trained racehorses. However, the taxpayer was in the habit of filing late and imprecise tax returns, which caused the Minister to audit the taxpayer for a seven-year period. In his audit, the Minister found that the taxpayer had underreported his income in several of these years (in one year underreported by as much as 32%). The Minister assessed penalties on the taxpayer on the grounds that the taxpayer's was grossly negligent given that the taxpayer maintained inaccurate business books and records.

The Minister provided documentary evidence that the taxpayer was not precise in his bookkeeping in that he used estimates rather than accurate figures in all of his records and did not itemize his income sources. In his defence, the taxpayer simply claimed that while he did indeed maintain poor records his improper record keeping did not amount to gross negligence. However, the taxpayer brought forth no evidence to prove this claim.

The Court found, in view of the largely uncontradicted evidence the Minister put forth, the imposition of penalties under subsection 163(2) of the Act were justified. While the taxpayer in this case was unsuccessful in his defence of penalties, the Court makes it clear that in order to launch a successful defence, the taxpayer must present evidence, whether it is documentary or verbal, which would contradict the Minister's assertion that the taxpayer was grossly negligent on account of keeping adequate books and records.

3. *Deschênes v. The Queen*, 2009 DTC 1210

In this case, the Minister assessed the taxpayer for the 2001, 2002 and 2003 taxation years using the net worth method. The taxpayer operated a business involving surfacing driveways with asphalt. He did not have an account book, invoices, records of his transactions and the taxpayer conducted his business largely in cash. The taxpayer was only able to provide the auditor with a barely legible notebook containing the names, contact information and rough estimates for the work to be done. The taxpayer appealed the assessments on the basis that (i) it was impossible for him working alone

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to earn the net income corresponding to that suggested by the CRA; (ii) it was possible for the auditor to use the notebooks for the assessments instead of the net worth method; and (iii) the taxpayer had a low level of schooling which contributed to his failure to keep accounting records.

The Tax Court of Canada dismissed the taxpayer's appeal. The Court determined that: (i) it was impossible for the auditor to draw any kind of conclusion based upon the notebook; (ii) the taxpayer failed to meet his duty to keep proper accounting records; and (iii) he did not seek help from a tax professional or accountant to fix his financial records. The Court upheld the gross negligence penalties as the taxpayer had failed to adduce credible evidence that explained the difference between his reported income and what the auditor found. The Court also found that the onus was on the taxpayer to have adequate bookkeeping. It was not the responsibility of the auditor or the CRA to determine a taxpayer's net income based upon improper or poor documentation.

(v) CO-OPERATION WITH THE MINISTER

Where the Minister assesses penalties on the grounds that the taxpayer's actions or omissions constituted gross negligence, a taxpayer can challenge such an assessment on the basis that the taxpayer was not grossly negligent as the taxpayer had supplied the Minister with all the necessary and relevant information during the course of Minister's investigation. Conversely, the Courts have justified the imposition of penalties on the grounds that a taxpayer has exhibited a notable lack of co-operation with the Minister.

1. *Le Centre de Quilles Laurentien Ltée v. M.N.R.,* 68 DTC 570

In this Tax Appeal Board case, the Minister assessed penalties against the taxpayer on the basis that the taxpayer was grossly negligent which resulted in an erroneous tax return. The taxpayer successfully utilized the defence of co-operation with the Minister in challenging the imposition of penalties.

The taxpayer was a corporation that owned a bowling alley that had been severely damaged in a fire. As a result of the fire, the corporation received certain monies from an insurance settlement as compensation for loss of profits and damages to capital assets. However, since neither the corporation's accountant nor president were able to establish what part of the settlement monies specifically pertained to loss

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of profits, the corporation's accountant entered the whole amount as non-taxable capital profit on the tax return.

The Minister performed a reassessment and found that $66,000 of the settlement monies was not capital profits, but was rather compensation for loss of profits and as such should have been included as taxable income in the tax return. The Minister imposed penalties claiming that the taxpayer acted grossly negligent resulting in the error in the tax return. The taxpayer challenged the imposition of penalties and claimed that it was not grossly negligent because included in the tax return were financial statements, which made no omissions, and showed in detail all the amounts received as compensation for the losses incurred from the fire.

In weighing the both sides, the Court found that the taxpayer's conduct was not grossly negligent, as the taxpayer did make full disclosure of the entire settlement in the tax return, but simply allotted the amount incorrectly because they themselves were unsure as to what the correct amount was. As such, this case indicates that a taxpayer can challenge the imposition of penalties on the basis that the taxpayer was not grossly negligent given that the taxpayer had supplied the Minister with all the necessary and relevant information in the tax return.

2. *Easton v. M.N.R.,* 71 DTC 731

In this Tax Appeal Board case, the taxpayer was the owner of an aluminium contracting company, who failed to include considerable amounts of monies he received from interest and dividends on investments. The Minister reassessed the taxpayer and imposed penalties on the basis of gross negligence. The Minister maintained that the taxpayer was grossly negligent as the taxpayer did not fully co-operate with the Minister during in his reassessment.

The taxpayer appealed the penalties simply claiming that his failure to report investment income was not gross negligence but rather an oversight which resulted from the pressure of being very busy and working long hours in his business. The Board found that the imposition of penalties was justified as the taxpayer's behaviour indicated gross negligence. The Board found the taxpayer's uncooperative behaviour of: (i) only disclosing information to the Minister when he was pressured; and (ii) maintaining a generally disobliging demeanour before the Board, particularly determinative in coming to their conclusion to impose penalties.

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Thus, while the Courts have found that co-operation with the Minister could be a successful defence against penalties, case law has also indicated that the Minister can justify the imposition of penalties on the grounds that the taxpayer exhibited a notable lack of co-operation with the Minister.

3. *Black v. The Queen*, 2008 DTC 2025

In this Tax Court of Canada case, the taxpayer appealed from a net worth assessment for several taxation years and penalties for gross negligence. During the investigation, the taxpayer ignored the Minister's requests for information and documentation. The Tax Court found that the method used by the Minister to determine the taxpayer's net worth was reasonable, although arbitrary, since it was a direct result of the taxpayer's refusal to disclose financial information and documentation. The Tax Court found the taxpayer's evidence to be self-serving and his attitude that of avoidance at all costs. Because of the taxpayer's cavalier attitude and lack of cooperation in the investigation, the Tax Court upheld the imposition of the penalties.

4. *Charron v. Canada*, 2009 DTC 1257

In this Tax Court of Canada case, the taxpayer was an experienced, professional investment advisor, who was selected for a tax audit for the 2000, 2001 and 2002 taxation years. The taxpayer provided the auditor with all the documents pertaining to 2000 and 2001 and suggested that 2002 not be audited if the other two years were fine. An analysis of 2000 and 2001 showed that everything was in order. The auditor however still maintained his request for the documents for 2002.

The taxpayer was reluctant to provide the documents, and submitted incomplete, unreliable or misleading documents. When the appropriate documents were finally submitted, they revealed that the taxpayer had overvalued his capital losses by $402,255. The taxpayer then attempted to blame his accountant, the auditor or to claim that he did not have the expertise to calculate his losses accurately.

The Tax Court of Canada dismissed the taxpayer’s appeal. The Court did not find any of the taxpayer's excuses to be credible, given the circumstances and his behaviour preceding the discovery of the overvalued losses. The taxpayer had attempted to mislead or dissuade the audit in several different ways. Much time had passed between the first meeting with the auditor and his discovery of the loss and the taxpayer did not attempt to correct the error or cooperate with the auditor during this

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time. The Court found that the penalty was completely warranted, given that the evidence showed the taxpayer deliberately made false and misleading statements about the loss on his return.

(vi) THE TAXPAYER LACKED THE REQUISITE MENTAL STATE

Recent case law has demonstrated that in order for penalties to be imposed against the taxpayer, it is essential that the taxpayer possess the *requisite mental state* to be penalized. Thus, where the Minister assesses penalties, if the taxpayer can prove that he does not possess the requisite mental state to be penalized, then the Courts will not impose penalties against him.

1. *Cox v. The Queen,* 2002 DTC 1515

In this case, the taxpayer, who was represented by Alpert Law Firm, was assessed for a total of seven years. In three of these years, the taxpayer had amassed a substantial fortune in mutual funds, but had altogether failed to file tax returns. In the remaining four years, the taxpayer, upon request from the Minister, had filed tax returns that were prepared by "volunteers" for Revenue Canada.

The Minister assessed the taxpayer and imposed penalties. The taxpayer appealed to the Tax Court of Canada, challenging the Minister's net worth assessment and the penalties imposed. The taxpayer challenged the imposition of penalties on the basis that his mental condition, paranoid schizophrenia, denied him of the requisite mental state required for the imposition of penalties. Evidence was provided by the taxpayer's brother, a psychologist, who testified that the taxpayer had for many years displayed all the classic signs traditionally associated with schizophrenia including: learning disability, anxiety disorder, inability to retain information, hallucinations and delusions, and being very disorganized and very forgetful.

The Court in this case stated that in order for a penalty to be imposed under subsection 163(2) of the Act, two elements must be present: (i) a misstatement or omission in a tax return; and (ii) the requisite mental state. The Court found that the first element was evident, as the taxpayer clearly omitted to file his tax returns for three consecutive years. However, the second element was not present: as a result of his psychological illness, which divorced him from reality, the taxpayer lacked the requisite mental state to be penalized. Consequently, the Court disallowed the imposition of

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penalties on the taxpayer. As such, this case has opened the doors to the defence of lack of requisite mental state.

2. ***Bashir v. The Queen*, 2008 GTC 645**

In this case, the taxpayer, who was a self-employed electrical engineer and software safety specialist, was assessed for a period of three consecutive years for unremitted GST, interest, and penalties pursuant to sections 285 and 280 of the Excise Tax Act. The taxpayer appealed to the Tax Court of Canada, asking that the amounts be waived on compassionate grounds.

The Tax Court allowed the taxpayer's appeal in part, holding that while it had no jurisdiction to waive the GST not remitted or the interest, it would not be just to allow the penalties to stand. The taxpayer had been suffering from bipolar disorder for many years. During the years under appeal, he experienced psychotic episodes, had poor and impaired judgment, and was incapable of managing his own affairs. The Tax Court found that the taxpayer exercised due diligence as he was neither reckless nor careless. The section 280 penalty was therefore deleted.

The Tax Court also deleted the section 285 penalty, holding that the Minister failed to prove that the taxpayer demonstrated a high degree of negligence tantamount to intentional acting.

3. ***Pontarini v. Canada*, 2009 DTC 1268**

In this Tax Court of Canada case, the taxpayer, who was a medical physician, was assessed for the 1997, 1998, 1999, 2000 and 2001 taxation years for significant underreporting of income and overstating of expenses. By the time the trial commenced, the substantive issues were resolved and the taxpayer was appealing the penalties for gross negligence. The taxpayer challenged the penalties on the basis that his mental health issues and the stressors in his life made it reasonable for him to think he filed his return correctly.

The taxpayer was negatively affected by the new OHIP changes that reduced his revenue by approximately 25%. His medical license was also suspended for a criminal conviction for trafficking in narcotics. He had additional financial difficulties due to some reassessed tax shelters, legal proceedings and the loss of his home. The taxpayer had also pled guilty to tax evasion and was fined a significant amount. He was asked by his

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hospital to resign for having an extra-marital affair with another colleague; he also separated from his wife for a period of half a year.

Evidence was provided by the taxpayer's own psychiatrist. The psychiatrist stated that the taxpayer was not clinically ill and his mental health was not significantly impaired aside from having reactive depression to stressful events. The only medication used by the taxpayer was a small dose of a tranquilizer. The psychiatrist also testified that the taxpayer had an odd and troubled personality with difficulty in making good judgments.

The Tax Court referred to *Cox v. The Queen* in their analysis, finding that unlike in *Cox*, the taxpayer in this case did not suffer from a mental health illness in such a way that interfered with his ability to comprehend his actions or to form the requisite intention as required by subsection 163(2). The Court found that the stressors in the taxpayer's life were not debilitating and incapacitating. He was able to continue his medical practice and salvage his family relationships. The Court concluded that the taxpayer chose not to focus any effort on tax compliance and intentionally filed an incorrect return.

(vii) TAXPAYER LACKED SOPHISTICATION

Where the Minister assesses penalties on the grounds that a taxpayer's actions or omissions constituted gross negligence, the taxpayer can challenge such an assessment on the basis that the taxpayer was inexperienced in tax matters and as such was not grossly negligent in failing to detect the errors or omissions. Recent case law has demonstrated that if a taxpayer is able to prove that he lacked sophistication in tax matters, the Court may hold that penalties are unjustified.

1. *Estate of Colangelo et al. v. The Queen*, 98 DTC 1607

In this Tax Court of Canada case, the taxpayers were a married couple who had omitted from their tax returns a large amount of taxable capital gains they had received from a sale of property. The Minister reassessed the couple's income accordingly and imposed penalties against them on the basis of gross negligence.

While the taxpayers assented to the Minister's reassessment of their taxable income, they challenged the imposition of penalties. The taxpayers asserted that given their inexperience in tax matters, they were not grossly negligent in failing to notice the omission; rather they simply did not know that an error, such as the one they committed,

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existed. Both of the taxpayers immigrated to Canada from Italy as children. The husband, who had since died, was a line worker in a bakery and had a grade two level education. The wife completed grade eight in Canada and shortly thereafter opened her own hairstylist salon. While she ran her salon for more than 25 years, documentary evidence showed she had minimal bookkeeping knowledge.

In coming to its finding, the Court said that in order to find *gross negligence,* there must be a greater degree of neglect than simple failure to use reasonable care; rather *gross negligence* must involve a high degree of negligence tantamount to acting intentionally or being indifferent as to whether the law is complied with or not. The Court found that the penalties were not justified in this case, as the taxpayers were not grossly negligent or indifferent to whether they complied with the law. The Court based this finding on evidence which indicated that the taxpayers had limited education, had very minimal bookkeeping knowledge, and led relatively simple unsophisticated lives. The Court found that, at the very most, the taxpayers were simply negligent in that it had not crossed their minds to consider that they should be concerned about the Income Tax Act in the context of the property sale, but they were not wilfully blind or indifferent to complying with the law. Thus, this case indicates that a taxpayer can successfully challenge an assessment of penalties on the basis of a lack of sophistication or inexperience in tax matters.

2. ***Panini et al. v. The Queen*, 2006 DTC 6450**

In this case, the Federal Court of Appeal affirmed the Tax Court decision upholding the imposition of penalties for gross negligence. The taxpayers were employees who failed to include the taxable benefit arising from the exercise of their stock options in their income tax returns. The taxpayers argued that although the form for exercising their stock options advised employees to consult a tax/financial advisor, since the employer did not include the amount of the benefit in their T4 slips, they honestly believed that the income resulting from the exercise of their stock options did not have to be reported in their income tax returns.

The Tax Court held that the taxpayers were senior employees and intelligent individuals, so the standard of care in their case was greater than for a taxpayer of marginal intelligence. They should have made an inquiry with respect to the tax consequences of the exercise of the stock options. Their indifference as to whether the law was complied with amounted to wilful blindness and gross negligence. The penalties were therefore justified.

3. *Spunt v. The Queen*, 2007 DTC 1568

In this Tax Court of Canada case, the taxpayer appealed from a penalty assessment for failure to include capital gains from dispositions of shares and mutual funds in his income for 2000. The taxpayer's returns had always been prepared by his accountant, to whom the taxpayer merely delivered all related documents. After the accountant prepared the return, the taxpayer scanned it very briefly, only to check the amount from the T4, which reflected most of his income, the amount payable, and his RRSP contribution room.

The Tax Court held that the taxpayer was grossly negligent in not verifying that the capital gains from the dispositions were included in his income. The taxpayer was well-educated and experienced, and he had made similar dispositions in prior years, so he should have known that the amounts must be included. His attitude in not examining his return more carefully was so "cavalier" that it amounted to gross negligence.

The Tax Court also held that the taxpayer was grossly negligent in not notifying the Minister after being reassessed by Revenue Québec. The taxpayer merely faxed the reassessment to his accountant, without inquiring about the federal tax consequences of his omission. The Tax Court stated that the taxpayer's act of blindly entrusting his tax affairs to his accountant went beyond simple carelessness.

The taxpayer had a history of over forty years of compliance with his tax obligations. He had a degree in political science a post-graduate diploma in management. During the 2000 taxation year, he was operating a business whose core activity was solving marketing and sales problems of pharmaceutical companies. The Tax Court noted that the omission in his 2000 tax return should have been sufficiently obvious that a man of the appellant's education, experience and intellect should have noticed it. Consequently, the Court upheld the penalties imposed by the Minister.

4. *Anjaria v. The Queen*, 2008 DTC 2306

In this Tax Court of Canada case, the taxpayer appealed from a reassessment for 2000, in which the Minister included $33,974 in his income and assessed subsection 163(2) penalties. In either 2000 or 2001, the taxpayer was convicted of “possession for the purposes of trafficking” and “conspiracy to traffic” in an illegal substance. On the date of his conviction, the amount of $33,974 was forfeited to the Crown as proceeds of crime, whereas the taxpayer's tax return for the year was nil.

The Tax Court agreed with the inclusion of the forfeited amount in the taxpayer's income. However, the Tax Court deleted the penalty, stating that the Minister failed to prove gross negligence on the part of the taxpayer. The only evidence tendered by the Minister to support the penalties was that the taxpayer had filed his 2000 tax return reporting nil income. The taxpayer stated that his tax returns had always been prepared by his father. The taxpayer was not aware that income from an illegal business was taxable and did not tell his father that he earned income in that year.

5. *Agregan v. Canada*, 2009 DTC 1005

In this Tax Court of Canada case, the taxpayer appealed an assessment and penalties for the 2000 and 2001 taxation years for underreporting her income. The taxpayer was the sole proprietor of a drywalling business. She stated that she did not understand bookkeeping and accepted and signed the returns that had been prepared for her without verifying the information.

The Tax Court of Canada allowed the taxpayer's appeal and the reassessments were remitted for reconsideration. The Court found that while the taxpayer was responsible for confirming the accuracy of her returns and for keeping proper financial records, she was also unsophisticated and very naïve. The Court noted that her common law spouse was the person who usually negotiated the work contracts and prepared the invoices, leading them to question who was actually running the business. The Court also found that the taxpayer did not attempt to deliberately conceal her income, and the unreported amounts were immaterial when compared to the gross income actually reported. The unreported amounts represented 18% and 11% of the gross income reported and the Court ruled that this amount was not so substantial that the taxpayer could have or ought to have known that she had failed to report it. Thus, the penalties under subsection 163(2) were deleted.

(viii) STATISTICS CANADA AVERAGE EXPENSES

Where a taxpayer has failed to file an income tax return or has kept inadequate records, the Minister can assess the tax using the net worth method. This method involves subtracting the taxpayer's net worth at the beginning of the year from the worth at the end and also taking into account personal expenditures on an annual basis. The difference, less any amount declared by the taxpayer, is attributed to unreported income earned in the year unless it is demonstrated otherwise. Personal expenses are often

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based upon Statistics Canada's ("StatsCan") estimates of how much it costs for the average, normal Canadian to live. This method has been described as a last resort method that can produce inaccurate results.

The taxpayer may be able to challenge the estimates and the method of assessment if they can show their own lifestyle differed from the assumptions made based upon the StatsCan figures. By challenging the estimates, the taxpayer may be able to decrease the amount of unreported income, reduce the penalty or have the penalty deleted completely because the difference between the unreported income and the reported income was insubstantial.

1. *Cox v. The Queen*, 2002 DTC 1515

In this Tax Court of Canada case, the taxpayer, who was represented by Alpert Law Firm, was assessed for a total of seven taxation years. The taxpayer appealed to the Tax Court of Canada, challenging the Minister's expense estimates based upon StatsCan norms. He suffered from paranoid schizophrenia and his lifestyle was meagre and did not conform to that of the average Canadian.

The Tax Court of Canada allowed the appeal in part. The Court reduced the total annual personal expenses, based upon the judge's own observations of the taxpayer and the taxpayer's known mental health condition. For example, the judge noted that the taxpayer appeared in court on both days in the same dirty outfit and thus reduced the amount spent on clothing and dry cleaning significantly. The judge also noted that the taxpayer appeared unkempt and reduced the amount allotted for personal care. The judge also reduced the amount spent on recreation as he noted it was unlikely that a person with severe psychiatric problem would participate in these activities. The taxpayer did not fit into the StatsCan norms.

2. *Omer v. The Queen*, 2009 DTC 1118

The taxpayer owned a used car dealership. He was reassessed for his 2004 and 2005 taxation years by an auditor using the net worth method. The taxpayer challenged the amount of unreported income found by the auditor based upon the amounts determined for personal expenditures using StatsCan estimates.

The Tax Court of Canada allowed the appeal in part. The Court made a few adjustments. The taxpayer’s wife’s income was also included in the net worth analysis,

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however she did not testify and as a result, the Court was not able to accept all of the adjustments proposed by the taxpayer. For example, the taxpayer said he had no restaurant expenditures for the two years in question but no evidence was put forward with respect to his wife's restaurant expenses. The Court applied similar reasoning for expenses related to cleaning supplies, women's clothing, reading material, toys, and personal care supplies.

The Court found after the series of adjustments that the unreported income amount, as a percentage of the total gross income, amounted to only 4% in 2005. The Court ruled that the Minister failed to prove that the taxpayer was knowingly making a false statement or was grossly negligent with his return and thus deleted the penalties pursuant to subsection 163(2).

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Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.