

## **PENALTIES FOR FALSE STATEMENTS OR OMISSIONS - PART II**

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.

### **C. ADDITIONAL 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.

#### **(i) 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.

#### **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 ladieswear 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 that 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, income was underreported by as much as 32%). The Minister assessed penalties on the taxpayer on the grounds that the taxpayer 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, 2008 TCC 655**

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 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.

#### 4. **Mompérouse v. Canada, 2010 TCC 172**

In this Tax Court of Canada case, penalties under subsection 163(2) of the Act were imposed for the 2003, 2004, 2005 taxation years. In addition, the Minister revised the taxpayer's business income figures, and applied subsection 152(4) of the Act to reassess statute barred taxation years. A determining factor in this case was that the taxpayer had not kept adequate records of his income.

The taxpayer, a taxi driver who owned both his taxi and his taxi permit declared the amounts of \$1,095, \$2,321 and \$5,072 respectively as business income. This income was used to support the taxpayer, his spouse and their four children. The evidence showed that the taxpayer did not maintain adequate books and accounting records. He kept notes in an agenda which marked the total for one week's work based on approximate gross receipts. He did not account for (i) the number of trips with or without passengers; (ii) the distance; or (iii) the revenue earned for each trip. The auditor used the taxi maintenance records to establish the kilometers traveled by the taxpayer and then applied the projection method to determine the existence of undeclared income. Based on the auditor's calculation, the Minister revised the net business income to the amounts \$14,374, \$19,704 and \$17,366.

Subsection 152(4) of the Act, allows the Minister to reassess statute barred taxation years when the taxpayer has made any misrepresentation that is attributable to neglect, carelessness or wilful deceit. Case law establishes that the Minister bears the burden of proof in establishing such a misrepresentation. In this case, the Tax Court held that the Minister met his burden by revealing gaps between the gross business income declared and the net business income calculated using the projection method. While, the taxpayer objected to the auditor's use of the projection method, his inadequate accounts did not offer an alternative method.

Subsection 163(2) of the Act penalizes a taxpayer who knowingly or in gross negligence makes a false statement or omission in a return. In this case, the Tax Court followed the Federal Court of Appeal decision in *Lacroix v Canada* 2008 FCA 241 and held that the taxpayer had committed gross negligence because he could not provide a credible explanation for the misrepresentation of his income. The taxpayer did not keep

adequate books or accounting registers and was therefore incapable of specifying how many paid trips he made and the corresponding income. Moreover, he could not offer a credible explanation for the gap between the cost of living for his family and the modest net income he declared.

The Tax Court also found that the auditor's projection method calculation made an error in not including the travel distance to and from the taxpayer's home as a business expense. Hence, the Court accepted the reassessment of statute barred years, the application of penalties, and the general use of the projection method, though sent the reassessments back to the Minister for revision. This case stands for the proposition that inadequate records in combination with a gap between reported income and cost of living can be sufficient to justify a reassessment of past years and the imposition of penalties.

#### 5. **Schafer v. Canada, 2013 TCC 382**

In this Tax Court of Canada case, the taxpayer and the corporation Amisk Investment Limited ("Amisk") both appealed their reassessments of the 2005 taxation year regarding \$214,770 of unreported income and gross negligence penalties.

The taxpayer was a lawyer, with his practice incorporated as Amisk. The taxpayer and his spouse were the sole shareholders of Amisk. The taxpayer offered explanations for the unreported income, claiming that most of it derived from a shareholder loan, cash gifts, and money set aside for his son's university education. He admitted that individual amounts of \$4,100, \$2,000, \$560 and \$1,000 were unreported dividend income, but argued that his failure to report these amounts was inadvertent and that the amounts themselves were nominal. In addition, the taxpayer alleged that all accounting and administrative aspects of his business were managed by his spouse, and that a deferred payment arrangement employed for some clients was the cause of accounting oversights and errors.

The court found the taxpayer's evidence inadequate, and found him to lack credibility. In his oral testimony he offered no plausible explanation as to why he had not called his spouse or his accountant to support his claims. In addition, he did not provide documentation to support his claims. The Court did not accept the taxpayer's explanations with respect to the undeclared income.

The Tax Court held the penalties were justified, on the basis that the taxpayer was well-educated with extensive experience in corporate and commercial law. The

taxpayer's claim that his failure to report income was an unintended consequence of sloppy business practices was implausible. This case indicates that the court is unwilling to accept a defence based on inadequate record keeping in cases where the taxpayer shows general business sense or prowess.

## (ii) **COOPERATION 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 cooperation 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 cooperation 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 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 was 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 cooperate 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.

Thus, while the Courts have found that cooperation with the Minister can 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 cooperation with the Minister.

## 3. **Black v. The Queen, 2007 TCC 679**

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 TCC 290**

In this 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 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.

The case then went to the Federal Court of Appeal. The court dismissed the taxpayers appeal on the grounds that evidence regarding the taxpayer's level of education and professional experience showed that on a balance of probabilities the taxpayer had deliberately and knowingly decided to report losses that were greatly overstated.

## 5. *Walker v. Canada, 2011 TCC 10*

In this case, the taxpayers who were equal partners in a business, which specialized in selling customized orthotic products internationally, were reassessed for the 2003 and 2004 taxation years. The Minister added amounts of \$120,086.35 and \$130,508.58 to their partnership income, denied deduction of various expenses and imposed gross negligence penalties. The taxpayers appealed to the Tax Court of Canada, asking that some of the added partnership income be reconsidered, that the business deductions be reconsidered and that the gross negligence penalties be cancelled.

The Court agreed to reduce the partnership income for 2004 by \$10,000, and to allow for additional deductions for business expenses. Additionally, the court held that the gross negligence penalties should be cancelled. In reaching its conclusion regarding the penalties, the court underscored that the test for a subsection 163(2) penalty is distinct from the test that applies to subsection 152(4)(c)(i) of the Act. The court emphasized that in the case of gross negligence penalties the Minister has a duty to justify his decision, and doing so requires more than the subsection 152(4) test, which only requires showing that the taxpayer has unreported income and lacks a credible explanation.

Based on this understanding of the test for gross negligence penalties, the Court held that in this case the penalties were not warranted. In particular, the Court found that the taxpayers had been honest and had made errors only because they had failed to appreciate that the records they relied on were complex and inadequate. The Court thus determined that the taxpayers did not act intentionally in misrepresenting their income, and therefore the Minister had not met the onus to justify the imposition of penalties.

## 6. *Lenneville v Canada 2013 DTC 1196*

In this Tax Court of Canada case the Minister reassessed the taxpayers in 2010 with respect to the 2004, 2005, and 2006 taxation years. Using the net worth method the Minister found a discrepancy between the taxpayers' reported income and their actual net worth, and therefore imposed penalties pursuant to subsection 163(2) of the Act. The key issues in this case were the reassessment of statute barred years pursuant to subsection 152(4)(c) of the Act and the imposition of gross negligence penalties.

The taxpayers were spouses who operated a fishing business. Their customers often paid in cash and sometimes did not pay immediately, creating confusion in the business's accounting records. Every month invoices, accounts, statements and the cash register tapes were given to the taxpayers's accountant. Upon being audited the taxpayers fully cooperated with the auditor, supplying all accounting documents and records. The Tax Court found the taxpayers to be credible hard-working individuals.

On the question of reassessment of statute barred years, The Tax Court of Canada held that mere existence of significant discrepancies between reported income and net worth is insufficient to meet the Minister's burden of proof with regards to subsection 152(4) of the Act. As a result, the reassessment with respect to the 2004 taxation year was statute-barred.

On the question of the imposition of penalties under subsection 163(4) of the Act, the Tax Court noted that the taxpayers had cooperated fully, answering all questions without any attempt to evade a single one, supplying the auditor with all the documentation they had, and allowing their accountant to collaborate with the auditor. On this basis, the Tax Court held that the Minister had not met his burden of proof, and that there was no gross negligence.

The Tax Court of Canada ordered that (i) the 2004 assessment be vacated and the related penalty canceled; (ii) the penalties relating to 2005 and 2006 be cancelled, and (iii) the net worth calculations for 2005 and 2006 be revised to more accurately reflect the taxpayer's expenses.

### **(iii) 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] TCJ No 139**

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 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 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 TCC 356**

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 TCC 395**

In this Tax Court of Canada case, the taxpayer, who was a 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 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 its 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.

**(iv) 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, [1998] TCJ No 187**

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, 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 education. The wife completed grade eight in Canada and shortly thereafter opened her own hairstylist salon. While she ran her salon for more than twenty-five 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 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 FCA 224***

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 TCC 571***

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 taxpayer's education, experience and intellect should have noticed it. Consequently, the Court upheld the penalties imposed by the Minister.

#### 4. **Anjaria v. The Queen, 2007 TCC 746**

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, 2008 TCC 572**

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.

#### (v) **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 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] TCJ No 139**

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 TCC 158*

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. 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.**

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