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PENALTIES FOR FALSE STATEMENTS OR OMISSIONS – PART III

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. RECENT DEVELOPMENTS IN THE AREA OF PENALTIES

This memorandum deals with certain important developments in the assessment of penalties. Specifically, the Courts have dealt with the assessment of penalties as they relate to: (i) the reassessment limitation period; (ii) non-capital loss carry forwards; (iii) carry back of losses; and (iv) the capital gains exemption.

(i) LIMITATION PERIOD FOR MINISTER'S ASSESSMENTS & REASSESSMENTS

As a general rule, the Minister of National Revenue (the "Minister") may only assess or reassess a taxpayer within the "normal reassessment period." Pursuant to subsection 152(3.1) of the *Income Tax Act* (the "Act"), the normal reassessment period differs according to the taxpayer's category. For mutual fund trusts and corporations that are non-Canadian controlled private corporations, the limitation period for reassessments is four years from the earlier of: (i) the date of mailing of a notice of original assessment; and (ii) the date of mailing the original notification that no tax is payable for the taxation year. For all other taxpayers, the reassessment period is three years from the earlier of the two dates stated above.

However, pursuant to paragraph 152(4)(a) of the Act, this limitation period does not apply when the following two factors are present: (i) there is an assessment or reassessment based upon a misrepresentation by the taxpayer; and (ii) the taxpayer or the person filing the return has made a misrepresentation that is attributable to neglect, carelessness or willful default, or has committed any fraud in filing the return or in the supplying of information. Where the Minister has performed an assessment or reassessment beyond the normal limitation period, the Minister has the burden of proving, on a balance of probabilities, misrepresentation or fraud on the part of the taxpayer.

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Although the requirements for justifying subsection 163(2) penalties and for disregarding the normal assessment period are very similar, the Minister nevertheless must prove more in order to impose penalties. To assess a taxpayer beyond the normal reassessment period, it is sufficient to prove a failure to use reasonable care, while penalties will only be justified if the Minister can prove gross negligence on the part of the taxpayer.

(ii) <u>THE TREATMENT OF NON-CAPITAL LOSS CARRY-FORWARDS IN THE CALCULATION OF PENALTIES</u>

Penalties under subsection 163(2) of the Act are calculated, on a percentage basis, according to the amount of tax payable on the taxpayer's understatement of income. Specifically, 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. Case law has indicated that once penalties are imposed, taxpayers very often attempt to show the existence of legitimate previous non-capital losses or expenses that could be attributed to the tax period in question, in the hopes that such losses would reduce the amount of understatement of income that their penalties will be calculated on.

Until recently, the law has been vague as to whether such losses or expenses should be used in the calculation of income for the purposes of calculating penalties (and in effect reducing or obliterating the amount of penalties to be paid), or whether previous losses should be ignored in penalty calculation. Recent case law has illuminated this ambiguous area. The Courts have said that in calculating penalties, previous losses or expenses can be used only if such losses or expenses *are wholly applicable* to the unreported income (i.e. the non-capital expenses originate from the same source as the unreported income).

Recently the Court has found that by the combined operation of subparagraph 163(2)(a)(i) and paragraph 163(2.1)(a) of the Act, previous losses that not applicable to the unreported income should be ignored for the purposes of penalty calculation. As such, a penalty may arise even in a year when unreported income is offset by previous losses leaving no taxes to be paid by the taxpayer.

(iii) <u>THE TREATMENT OF LOSS-CARRYBACKS IN THE CALCULATION OF PENALTIES</u>

As previously set out in this issue of Legal Business Report, penalties under subsection 163(2) of the Act are calculated, on a percentage basis, according to the

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amount of tax payable on the taxpayer's understatement of income. Also, a taxpayer who entirely fails to file a tax return, or who 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.

However, loss-carrybacks cannot be used in determining understatement of income for the purpose of penalty calculation. Subsection 162(11) of the Act clearly indicates that for the purpose of computing late-filing penalties under subsections 162(1) and 162(2), the person's tax payable shall be determined *before* taking into consideration items such as loss-carrybacks, foreign tax credits and investment tax credits from subsequent years.

Recent Court decisions have also been very clear in reiterating that while subsequent losses and expenses can be used in the calculation of taxable income, such loss-carrybacks cannot be used in determining income tax owing for the purpose of calculating penalties.

(iv) THE TREATMENT OF THE CAPITAL GAINS EXEMPTION

Capital gains arising on dispositions of qualifying shares of small business corporations, as well as dispositions of qualified farm property, are eligible for a lifetime capital gains exemption of $800,000.00 pursuant to section 110.6 of the Act. The capital gains exemption applies to Canadian resident individuals other than trusts.

In recent cases, taxpayers who have been assessed for penalties have claimed that they are entitled to the capital gains exemption, in the hopes that such a deduction would reduce the income upon which their taxes and penalties are calculated. However, the Courts, pursuant to subsection 110.6(6) of the Act, have denied such a claim, stating that if an individual fails to report a capital gain knowingly or under circumstances amounting to gross negligence, as proven by the Minister, then the individual will lose the right to claim the exemption for the gain in the year of disposition or any subsequent taxation year. As such, individuals are prevented from: (i) claiming that the exemption can work to reduce their understatement of income; and (ii) arguing that any applicable penalties should be based on a tax liability which has been reduced by the capital gains exemption.

As a result, the taxpayer will lose the benefit of the capital gains exemption, both in the calculation of income and as a deduction in the calculation of penalties.

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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.