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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 that 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.

(i) RELIANCE ON PROFESSIONAL ADVICE

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

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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.

(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.

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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.

(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 taxpayer'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.

2. *Melman v. R.*, [2017] FCA 83

In this Federal Court of Appeal case, the taxpayer's 2007 tax return omitted $18,850,000 in taxable dividend income with a corresponding $4,725,000 tax liability. The dividends were paid in February, 2007 through two holding companies owned and controlled by the taxpayer. The taxpayer was intimately involved with the calculation, declaration and receipt of the dividends. The taxpayer personally structured and set aside a bank reserve to meet the dividend tax liability when it became due. In April, 2007, the accountants confirmed the $4,725,000 dividend tax liability due in April, 2008. However, in April, 2008, the taxpayer's accountants made an error and informed the taxpayer of only an estimated $369,000 in personal income tax liability. The accountants then failed to include the dividends in the taxpayer's 2007 tax return. The taxpayer was a meticulous

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and sophisticated person that usually reviewed his tax return in detail with his accountants, but he did not read his 2007 tax return before signing it.

The Federal Court of Appeal found that the taxpayer was willfully blind and that he assented to, participated or acquiesced in the omission of the dividends in his tax return under circumstances amounting to gross negligence. The taxpayer's sophistication and deep knowledge of dividends far exceeded that of an average taxpayer. The size of the omitted dividends was considered objectively massive and was almost twice his other reported income. The Court found that the one-time dividend payment towards the unique life changing event of retirement increased the magnitude of the error. The Court also found that the taxpayer's trust in his longstanding accountants was not enough to excuse his departure from his usual meticulous practice of reviewing tax returns. The taxpayer's indifferent acceptance of his accountants' conduct and ignorance of warning signs in a crucial year amounted to willful blindness.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without the further consultation with professional advisers.

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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