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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. *Mompérousse 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

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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 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.

(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.

(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.

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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.

This case is the leading Tax Court of Canada case regarding a claim by a taxpayer of a mental illness defence to the assessment of penalties. 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. *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.

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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 dismissed the appeal and upheld the penalty assessment. The Court distinguished this case from ***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.

(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.

This case is the leading Tax Court of Canada case regarding a taxpayer challenge to the Minister's expense estimates based on StatsCan norms. 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. *Wang v. R.*, 2008 TCC 308

In this Tax Court of Canada case, the Minister increased the taxpayer's net business income by $37,234 and $34,055 for the 2002 and 2003 taxation years, respectively, using the net worth method of assessment. The Minister also imposed a gross negligence penalty for both years.

The taxpayer argued that the difference in his net worth was attributable to cash gifts received from family members in China. Further, he argued the CRA's assessment was unreasonable because it was based on unreliable StatsCan figures. The taxpayer

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argued that a downward adjustment of 53% should be made to the StatsCan figure to reflect his living standards.

The Tax Court of Canada distinguished the ruling in ***Cox v. The Queen*** and found that there was a lack of evidence to suggest the 53% downward adjustment would be appropriate. Further, the Court found that the taxpayer provided contradictory evidence and his claims regarding expenses were unrealistic. The taxpayer claimed no expenses for health care, despite having his mother-in-law living with him and having a small baby. Additionally, his evidence that his clothing expense was zero because his mother-in-law brought all his clothes from China was not credible. The Court determined that although the net worth method of assessment is considered a last resort, it can be used when the taxpayer has no records, inadequate records, inconsistent records or where there is a cash business. The Court found the net worth method to be appropriate in this case because of inadequate records and dismissed the taxpayer's appeal.

3. *Lee v. R.*, [2017] TCC 74

The taxpayer's retail flower business in this Tax Court of Canada case was assessed by the Minister to have unreported income totaling $440,249 within the 2002-2006 taxation years. The taxpayer's business records were given to her accountant and later substantially destroyed in a flood. Due to the lack of records, the Minister used the net worth method of assessment. The taxpayer argued the relevant years were statute-barred and that she had fully disclosed her income.

The Tax Court found that the auditor erred in her assessment of investment accounts, accounts receivable and inventory, among others. In assessing personal expenditures, the Court relied on ***Cox v. The Queen*** to make a downward adjustment to the StatsCan figures due to evidence that the taxpayer lived frugally. After the Court's adjustments, the cumulative unreported income was reduced to $109,951.

Having determined that a discrepancy remained between the income reported by the taxpayer and the income calculated using the net worth method, the Court concluded that the Minister discharged the burden of proof in re-opening the statute-barred years.

However, the gross negligence penalties were struck out by the Tax Court. The Court emphasized that while the taxpayer's records were lacking, she nevertheless maintained them and hired an accountant to help her with her tax filings. After considering the significant reduction in the magnitude of her unreported income, the Court rejected that the misstatements in her tax filings were tantamount to intentional acts that reached a level of reprehensible recklessness.

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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.