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 losses 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 may only assess or reassess a taxpayer within the 'normal reassessment period'. Pursuant to subsection 152(3.1) of the Act, the normal reassessment period differs according to the taxpayer's category. For mutual fund trusts and corporations which 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 subsection 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 return has made a misrepresentation that is attributable to neglect, careless or wilful 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.
Since the requirements for justifying subsection 163(2) penalties and for disregarding the normal assessment period are very similar, where the Minister has justified the imposition of penalties (by proving that the taxpayer had knowledge of, or exhibited gross negligence in the making of, a false statement or omission in a tax return), such penalties will stand, even if the taxpayer was assessed by the Minister beyond the normal reassessment period.

**RECENT CASE LAW**

1. **Boucher v. The Queen, 2004 DTC 6084**

   In this recent Federal Court of Appeal case, the Minister reassessed the taxpayer, imposing penalties, after the reassessment limitation period. The taxpayer was a lawyer employed as a stockbroker who, during the course of one taxation year, misappropriated funds from the trading accounts of her clients and then failed to disclose this fraudulent income in her tax return.

   Several years later a newspaper article revealed the taxpayer's fraudulent activities, and as a result the Minister reassessed the taxpayer's tax return. The Minister found that the taxpayer understated her income by approximately $200,000 and imposed penalties. The taxpayer appealed the Minister's assessment and penalties on two grounds: (i) that the Minister erred in assessing the taxpayer after the limitation period had expired; and (ii) taxpayer's understatement of income was completely offset by the taxpayer's pre-existing non-capital losses (resulting in no taxes for the taxpayer), no penalties should be imposed.

   The Federal Court of Appeal dismissed the taxpayer's appeal. On the first issue, the Court declared that the limitation period *does not apply* when there is (i) an assessment or reassessment based upon a misrepresentation by the taxpayer and (ii) the misrepresentation is attributable to neglect, careless or willful default. By looking at the evidence which clearly indicated that there was a misrepresentation attributed to the willful default of the taxpayer given that the taxpayer, a lawyer by profession who was well versed in tax law, not only failed to disclose her fraudulent income in the initial tax return but continually refused to disclose such income in her communications with the Minister, the Court found that the normal limitation period did not apply in this case. As such, the Court found that the Minister did not error in assessing the taxpayer beyond the normal reassessment period.
2. **Lloyd v. The Queen, 2002 DTC 1493**

In this Tax Court of Canada case, the taxpayer, a professional engineer, was assessed by the Minister for the taxation years 1989 to 1993, several years after the reassessment limitation period. The Minister found that the taxpayer had failed to report (i) receipt of interest income in regards to the sale of a certain property and (ii) certain shareholder benefits he obtained. As such the Minister assessed penalties pursuant to subsection 163(2) of the Act. The taxpayer appealed the penalties imposed.

The taxpayer’s appeal was allowed in part. In regards to the unreported interest income, the taxpayer argued that he was not grossly negligent as he was simply unaware there was a clause in the sales agreement that imposed interest on the installments paid by the purchaser of the taxpayer's property. The taxpayer claimed that did not know that such interest income was even received during the years in question. The Court found the taxpayer's argument highly implausible given that the taxpayer was an educated man familiar with legal and accounting matters. Finding the taxpayer grossly negligent, the Court imposed penalties on the taxpayer for the years in which he received the interest income, except a year in which the taxpayer seemed to have accidentally included the interest income under the wrong heading.

In regards to the undisclosed shareholder benefits, the taxpayer argued that he was not grossly negligent in failing to report such benefits, as the Minister attributed the benefits on him only because certain expenses were disallowed to his company. The Court, followed Robson et al. v. The Queen, 2001 DTC 1039 and shunned the departmental mindset which says when a corporation is disallowed an expense, then a matching tax consequence, such as a shareholder or employee benefit under subsection 15(1) of the Act, must be imposed upon the shareholders of the company as a kind of punishment for allowing their corporation to incur disallowable expenses. As such, the Court disallowed the imposition of penalties against the taxpayer for failing to report such 'income'.

The final issue, being the issue of the Minister's reassessment beyond the limitation period, was also decided upon by the Court. The Court found that since there was clear evidence that the taxpayer received unreported interest income and the failure to report income was attributed to the taxpayer's neglect, the Minister was permitted to reassess beyond the normal reassessment period.
(ii) THE TREATMENT OF NON-CAPITAL LOSS CARRY-FORWARDS IN THE CALCULATION OF PENALTIES

Penalties under subsection 163(2) of the Act are calculated, on a percentage basis, according 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 very 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 subparagraphs 163(2)(a)(i) and 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.

1. Boucher v. The Queen, 2004 DTC 6084

In this Federal Court of Appeal case, in which the facts were previously set out in this issue of Legal Business Report, the Minister assessed the taxpayer and found the taxpayer had undisclosed income and assessed penalties against her. The taxpayer appealed the minister's assessment of penalties. The taxpayer argued that no penalties should be imposed because she was not liable to pay any taxes during this year despite her understatement of income as previous non-capital trading losses worked to offset the understatement of income.

The Court agreed that the taxpayer owed no taxes, on account of previous losses, but imposed penalties regardless. The Court stated that a penalty may be
assessed under subsection 163(2) of the Act in respect to unreported income for a particular year even if the unreported income is offset by pre-existing losses arising in the same year, as pre-existing losses which are *not wholly applicable* to the unreported income (i.e. does not come from the same source as the unreported income), should be ignored in the calculation of penalties.

The Court found that by the combined operation of subparagraphs 163(2)(a)(i) and 163(2.1)(a) of the Act non-applicable previously recognized losses, should be ignored for the purposes of penalty calculation. As a consequence, a penalty may arise even in a year when unreported income is offset by previous losses. As such, in this case since taxpayer's losses were trading losses, and were not from the same source as the unreported income, the losses could not directly offset the taxpayer's unreported income for the purposes of penalties.

**iii) THE TREATMENT OF LOSS-CARRYBACKS IN THE CALCULATION OF PENALTIES**

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 amount of tax payable on the taxpayer's understatement of income. 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.

However, loss-carrybacks can not 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 subsection 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.
1. **Yang v. The Queen, 2004 DTC 2579**

The taxpayer carried on a real estate development business through two wholly owned corporations. The taxpayer did not file income tax returns for five consecutive years beginning in 1996. The Minister assessed the taxpayer for 1996 and 1997 and discovered that i) rental income from both corporations was deposited into the taxpayer’s personal bank account and ii) that the taxpayer also had unreported income from two houses he personally owned. However, in calculating the income tax owing by the taxpayer, the Minister allowed the deduction of significant loss-carrybacks from 1998, a subsequent year. This resulted in no income tax owing for the years under assessment. The Minister also assessed i) late-filing penalties and ii) interest on arrears against the taxpayer, but did not include the 1998 loss-carrybacks in the calculation of either.

The taxpayer appealed to the Tax Court of Canada. He asked the Court to either reduce the interest and penalties or to waive both completely, arguing that his loss-carrybacks should be factored into the calculation of income for the purpose of determining penalties and interest. The taxpayer submitted that no interest or late filing penalties should be assessed against him as there was no need for him to file income tax returns for both taxation years in question since there was no income to declare initially and later, even though there was income, the taxes owed became nil by applying the loss-carrybacks.

The Court dismissed the taxpayer’s appeal. The Court held that in computing penalties and interest, there is no place in the legislative scheme for taking into account non-capital losses arising after the time when the return is required to be filed. In coming to the conclusion that loss-carrybacks should not be used in the calculation of penalties, the Court referred to: (i) subsection 162(11) of the Act which indicates that penalties are to be computed on the appellant’s tax payable for the year, before taking into consideration the carry-back of losses from subsequent years.

The Court also gave significant detail as to the reasons why in this case the 1998 loss-carrybacks were not to be taken into account in the calculation of interest. The Court referred to subsection 161(7) of the Act. This subsection indicated that carryback deductions used to reduce income tax of a preceding taxation year will not affect the calculation of interest, until 30 days after the latest of four possible days: (i) the first day following that subsequent taxation year; (ii) the day the taxpayer’s income tax return for that subsequent taxation year was filed; (iii) where an amended return or prescribed form for the year was filed in accordance with subsection 49(4), 152(6) or paragraph 164(6)(e), the day on which it was titled; and (iv) where a written request was made.
which resulted in the Minister reassessing the taxpayer's tax for the year to take into account the deduction or exclusion, the day on which the request was made. Up until that day, the interest is calculated under subsections 161(1) and 161(2) as it would have been calculated if there had been no reduction in the taxpayer's tax liability as a result of any such deduction or exclusion claim arising in a subsequent year.

The Court found that, given the facts of the case, the latest day applicable under subsection 161(7) of the Act was the day the taxpayer filed his income tax return for the subsequent taxation year in which the loss was incurred. As a result, given that the taxpayer in this case did not file his income tax return for 1998 (i.e. the year in which the subsequent losses were incurred) the until March 2002, no losses incurred before 30 days after March 2002 could be carried backwards in the calculation of interest. The Court found that the Minister correctly calculated the interest payments by not allowing the 1998 losses incurred to be carried back and factored into the calculation of interest owing. The Court also indicated that while the Minister has discretion under the fairness rules to waive interest and penalties, the Tax Court has no jurisdiction to do so.

(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 gain exemption of $500,000.00 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 on. 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 (i) prevented from claiming that the exemption can work to reduce their understatement of income and (ii) are prevented from 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.
RELEVANT CASE LAW

1. **Malleck v. The Queen, 98 DTC 1019**

   In this Tax Court of Canada case, the taxpayer was assessed penalties for failing to report capital gains in his income tax return. The Taxpayer was a partner of a business whose sole business was to own and operate a building. In the year in question, the partnership's building was sold, at a gain of $75,000, with each partner receiving an equal share. Contrary to advice of his partner, the taxpayer did not inform the person preparing his tax return of the capital gains he received and as such his tax return erroneously omitted the capital gains he received from the sale of the building.

   The Minister reassessed the taxpayer and imposed penalties on the basis that the taxpayer was grossly negligent in not reporting the income. The taxpayer appealed the Minister’s assessment of penalties on the basis that (i) he could not be required to know all of the reporting requirements of the act and its operation and (ii) that the amount of the penalties, if imposed, would be considerably reduced given the operation of the capital gains exemption.

   Given the evidence which pointed out that the taxpayer was actually advised by his partner to disclose his capital gains in his tax return, but simply failed to do so, the Court found that the taxpayer was grossly negligent in not reporting his capital gains. As for the amount of the penalties, the Court reiterated the general principle espoused in subparagraph 110.6(6)(b) of the Act: where the Minister has proven that an individual has knowingly or on account of gross negligence failed to report a capital gain, no amount may be deducted in respect to the capital gains exemption in computing the taxpayer income for the purposes of calculating penalties to be paid.

2. **Sidhu v. The Queen, 2004 DTC 2540**

   In this Tax Court of Canada case, the taxpayer was assessed by the Minister for a period comprising of six consecutive years. The Minister found issue with the taxpayer's treatment of a capital gain realized on the disposition of a residential property in 1993. The Minister claimed: (i) the taxpayer was not entitled to the principal residence exemption in regards to the property as the property was simply not a ‘principal residence’ at the time of the sale; and (ii) the taxpayer was not entitled to a section 110.6 lifetime capital gains deduction on the sale of the property as the taxpayer failed to report the gain realized on disposition of the property which disentitled him to a
capital gains deduction. The Minister did not, however assess penalties against the taxpayer. The taxpayer appealed the assessment.

The Court found that the taxpayer had sold rental property and not his principal residence and as such the principal residence exemption did not apply.

The taxpayer also asserted that he was entitled to claim the capital gains exemption in respect of the unreported gain on the 1993 disposition of the property in question. The Minister disagreed with the taxpayer's position claiming that the deduction should not be granted if the taxpayer knowingly or under circumstances amounting to gross negligence failed to report the gain.

The Tax Court held that the taxpayer's non-reporting of the gain from the disposition of the property, was tantamount to intentional, which meant the taxpayer knowingly or under circumstances amounting to gross negligence failed to report a gain. This disentitled the taxpayer from using the capital gains deduction under subsection 110.6 of the Act. Interestingly, the Court also noted, that absolutely no negative inference was to be drawn from the fact that the Minister did not decide to assess penalties against the taxpayer. The fact that penalties were not assessed, was not a consideration in deciding that the capital gains deduction was not available for the taxpayer.