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 relating to challenging the imposition of penalties.

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, 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, which 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.

In addition, it is also possible that the taxpayer also could 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 could be imposed, 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 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);

(v) whether the amount of the error or omission was such that the taxpayer would have reasonably been aware of it.
RELEVANT CASE LAW

1. **Udell v. M.N.R. 70 DTC 6019**

   In this leading Exchequer Court of Canada case, penalties, under what is now subsection 163(2) of the Act, were assessed against the taxpayer for three taxation years. For the years in question, the taxpayer, who was a farmer, did as he always had done and provided his accountant with meticulously maintained accurate records of all of his business transactions at the close of each taxation year. Despite receiving accurate records, the accountant made a number of substantial errors and omissions in the taxpayer's tax returns. These errors had the effect of understating the correct taxpayer's income during the three years in question.

   The Minister performed a net worth assessment for these years and found that the taxpayer had underreported his income. The Minister also assessed penalties for these three taxation years on the grounds that the taxpayer was guilty of gross negligence in that the taxpayer was not alerted to obvious mistakes made by the accountant.

   While the taxpayer did not challenge the Minister's assessment of his taxable income, the taxpayer disputed the penalties assessed against him. The taxpayer argued that while the accountant was grossly negligent in his preparation of the tax returns, the accountant's gross negligence should not be attributed to the taxpayer since: (i) the taxpayer provided the accountant with accurate records; (ii) the taxpayer had no reason to believe that the accountant would make such errors since the accountant was highly qualified (even had extensive experience as an assessor for the Department of National Revenue) and the taxpayer had relied upon the accountant for many years to prepare his tax returns with no problems; and (iii) the taxpayer was not privy to the accountant's gross negligence, nor did he authorize it.

   The fact that the taxpayer gave accurate records to the accountant and had no reason to doubt the correctness of the accountant's services led the Court to find that the taxpayer was not grossly negligent and as such could not be held liable for penalties. In finding that the taxpayer could not be held liable for penalties, the Court established that subsection 163(2) of the Act indicates that gross negligence on the part of the taxpayer's accountant cannot be attributed to the taxpayer. Instead, gross negligence of the taxpayer himself needs to be proven in order to justify the imposition of such penalties.

In this recent Federal Court of Appeal case, penalties under subsection 163(2) of the Act were assessed against the taxpayer for one taxation year. The taxpayer, a sole proprietor of three video stores, who in the year in question decided to incorporate his businesses. During the incorporation process, the taxpayer rolled over his assets into the corporation which generated large capital gains of $135,000. The taxpayer, as he had done for several years with no income tax problems, hired a tax-preparing company to prepare his tax returns. In reviewing the taxpayer's personal tax return, the Minister noticed that the $135,000 of capital gains generated from the rollover had been omitted. As a result, the Minister assessed penalties on the grounds that the taxpayer was grossly negligent in omitting these capital gains.

The taxpayer challenged the penalties assessed against him. The taxpayer maintained that while the professional tax preparer may have been grossly negligent, the taxpayer himself was not since (i) the taxpayer was not actually privy to the tax preparer's omission and (ii) the taxpayer provided accurate records of the capital gains to the professional tax preparer. A representative of the tax-preparing company further corroborated the taxpayer's claim. He testified that it was not unreasonable for the taxpayer to overlook the fact that the capital gains was not declared in his personal return given that the tax return was extremely complex and the taxpayer was under the false impression that very little tax would result from the rollover on account of faulty advice from his tax-preparing company.

On account of the testimony of the taxpayer and the representative of the tax-preparing company, the Court found that the taxpayer was not grossly negligent and as such could not be held liable for penalties. In finding that the taxpayer could not be held liable for penalties, the Court reiterated the *Udell* principle: that gross negligence on the part on the taxpayer's agent should not be attributed to the taxpayer.

3. **Thibault v. M.N.R. 78 DTC 1641**

In this Tax Review Board case, penalties, under subsection 163(2) of the Act, were assessed against the taxpayer for three consecutive taxation years. The taxpayer was a sole proprietor of a garage. The Minister conducted an audit on the taxpayer and found that the taxpayer severely understated his income for three consecutive years. Specifically, the Minister found that the taxpayer failed to disclose 80%, 50% and 30% of his income in each of these consecutive years. The Minister also found that the taxpayer kept very poor and inaccurate accounting records as many important
documents, such as sales invoices, and accounts payable and receivable books were simply missing. As a result, the taxpayer was assessed penalties on the grounds that the taxpayer had been grossly negligent in reporting his income in each of the years in question.

While the taxpayer accepted the Minister's assessment of additional income, he appealed against the imposition of penalties arguing that he was not grossly negligent claiming he entrusted an expert accountant with the preparation of his tax returns and did not contribute or participate in any wilful failure to report income.

The Court found the taxpayer to be grossly negligent given that the massive amounts of undisclosed income was just too large to escape the taxpayer's notice and the taxpayer failed to keep all the documents necessary for the accurate preparation of his tax returns. As such the Court found the imposition of penalties to be justified. Thus, the defence of reliance of professional advice may not be successful if either (i) the amount of the error in the tax return was extremely high or (ii) the taxpayer did not actually provide the tax professional with accurate information.

(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.

RELEVANT CASE LAW

Mark v. M.N.R. 78 DTC 1205

In this Tax Review Board case, the Minister assessed penalties on the taxpayer for failing to report certain income in his tax return for one taxation year. In his defence, the taxpayer successfully claimed that amount unreported income was not substantial and material enough to support a finding of gross negligence and impose penalties.
The taxpayer was a businessman, whose business interests were very wide and varied. In the year in question, the taxpayer was paid a management fee of $17,500 for acting as the secretary-treasurer of an investment company of which he owned fifty percent. However, the taxpayer's accountant failed to include this payment as income in the taxpayer's personal tax return.

The Minister assessed the taxpayer and found that the taxpayer was grossly negligent in understating his income by the $17,500 and assessed a penalty on the taxpayer. The Minister argued that the taxpayer was negligent claiming there was no possibility the amount could have escaped the taxpayer's purview, as the amount would have arisen several times when the taxpayer was conducting the company's affairs. To support this argument, the Minister provided documentary evidence that the taxpayer was indeed responsible for all the banking transactions of the investment company, indicating that the $17,500 must have come to his attention during his functions as a secretary-treasurer of the company.

The taxpayer appealed the Minister's assessment of the penalty. The taxpayer claimed that the amount of unreported income was immaterial given the taxpayer's much larger total income in the year in question. The taxpayer provided documentary evidence that showed his income was approximately $90,000 in the year in question. Furthermore, the taxpayer provided documentary evidence that his business affairs were extremely complex, such that the error seemed even more inconsequential considering the complexity of the taxpayer's affairs. Evidence was provided that indicated that the taxpayer's income was derived for a variety of sources and the taxpayer's business enterprises were so complex that the amounts of payments, receipts and expenses, likely amounted to one or even two million dollars during the year in question. This complexity was further reiterated by the taxpayer's sizeable fifty-three-page tax return.

The Court found that the taxpayer was not grossly negligent on the basis that the unreported amount was immaterial as (i) the unreported amount was small in comparison to the taxpayer's more significant total taxable income and (ii) the taxpayer's business affairs were extremely complex, such that the error was inconsequential considering the taxpayer's overall business complexity.
(iii) 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, that 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.

RELEVANT CASE LAW

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 ladies-wear 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 weighed the evidence and found that the Minister had failed to prove his assertion that taxpayer did not keep adequate records which amounted to gross negligence. This finding was reached as 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, as the Court found it to be inconceivable that such large amounts of monies could have been earned from the taxpayer's small business. As such, this case indicates that if the Minister's 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 which 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 underreported by as much as 32%). The Minister assessed penalties on the taxpayer on the grounds that the taxpayer's 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 162(3) 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 be documentary or verbal, which would contradict the Minister's
assertion that the taxpayer was grossly negligent on account of keeping adequate books and records.

(iv) **CO-OPERATION 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 co-operation with the Minister.

**RELEVANT CASELAW**

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 co-operation 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 compensate 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 acted 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 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 co-operate 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 co-operation with the Minister could 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 co-operation with the Minister.

(v) **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 DTC 1515**

   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, inability to retain information, very disorganized, and very forgetful. The taxpayer's doctor and psychiatrist provided letters that collaborated the taxpayer's brother's testimony. They also indicated that the disease, for which the taxpayer was at the time of hearing taking several medications for, was left untreated during the taxation years in question.

   The Court in this case 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 the taxpayer lacked the requisite mental state to be penalized as a result of his psychological illness which divorced him from reality. 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.
(vi) **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, 98 DTC 1607**

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 level education. The wife, completed grade eight in Canada and shortly thereafter opened her own hairstylist salon. While she ran her salon for more than 25 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 or not. 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 the taxpayers minds to consider the idea that they should be concerned about the Income Tax 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 unsophistication or inexperience in tax matters.

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If you require assistance with penalties for false statements or omissions or need other tax, corporate and estate planning advice, please contact Howard Alpert directly at (416) 923-0809.

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