Docket: 2009-3193(IT)I

BETWEEN:

NICOLE COOPER,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on July 13, 2010, at Nanaimo, British Columbia

Before: The Honourable Justice Wyman W. Webb

Appearances:

For the Appellant:	The Appellant herself
Counsel for the Respondent:	Whitney Dunn

JUDGMENT

The Appellant's appeal in relation to the assessment of the penalty imposed pursuant to subsection 163(1) of the *Income Tax Act* in relation to the income tax return that she filed for 2007 is allowed and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the penalty imposed pursuant to subsection 163(1) of the *Income Tax Act* in relation to the income tax return that she filed for 2007 is deleted.

The Respondent shall pay costs to the Appellant in the amount of $500.

Signed at Halifax, Nova Scotia, this 29th day of July, 2010.

"Wyman W. Webb"

Webb, J.

Citation: 2010TCC403
Date: 20100729
Docket: 2009-3193(IT)I

BETWEEN:

NICOLE COOPER,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Webb, J.

[1] The issue in this appeal is whether the penalty that was imposed pursuant to subsection 163(1) of the *Income Tax Act* (the "*Act*") in relation to certain income that the Appellant failed to include in her tax return that she filed for 2007 should be upheld or deleted. This subsection provides as follows:

> 163. (1) Every person who
>
> > (a) fails to report an amount required to be included in computing the person's income in a return filed under section 150 for a taxation year, and
> >
> > (b) had failed to report an amount required to be so included in any return filed under section 150 for any of the three preceding taxation years
>
> is liable to a penalty equal to 10% of the amount described in paragraph (a), except where the person is liable to a penalty under subsection (2) in respect of that amount.

[2] Subsection 163(3) of the *Act* provides that:

> 163. (3) Where, in an appeal under this Act, a penalty assessed by the Minister under this section or section 163.2 is in issue, the burden of establishing the facts justifying the assessment of the penalty is on the Minister.

[3] The penalty under subsection 163(1) of the *Act* is imposed on a person who fails to report, in that person's tax return that was filed for a particular year, an amount that is required to be included in computing that person's income and also failed to report in a tax return that was filed for any one of the three preceding taxation years an amount that was required to be included in computing that person's income for such year. The Appellant acknowledged in her Notice of Appeal that she had failed to report an amount of scholarship income in her 2004 income tax return. In 2004 the Province of British Columbia had paid a grant to a school in Nanaimo in the amount of $7,482 on behalf of the Appellant. The amount that should have been included in her income in relation to this (but which was not so included) was $4,482.

[4] In the Reply it is stated that the Appellant was reassessed for 2007 to include the following amounts of income:

(a) $7,244 of employment income from Vernon Ridge Holdings Ltd.;

(b) $13,000 of employment income from 626553 B.C. Ltd.; and

(c) Taxable dividend income of $40,000 paid by 626553 B.C. Ltd.

[5] It appears that Vernon Ridge Holdings Ltd. was a company that was owned by two holding companies – 626553 B.C. Ltd. and another company owned by the Appellant's husband's business partner. It also appears that the Appellant and her husband owned the shares of 626553 B.C. Ltd. since the dividend was paid by this company to the Appellant. The Appellant is not contesting the inclusion of these amounts in her income as she agrees that these amounts should have been included but she is contesting the assessment of the penalty imposed pursuant to subsection 163(1) of the *Act.*

[6] In the Reply the amount in relation to the dividend is referred to as the "taxable dividend income". During the hearing counsel for the Respondent and the Appellant referred to the amount as a dividend of $40,000. The T5 slip for the dividend was not introduced into evidence. Therefore it is not clear whether the amount of the dividend that was received was $40,000 or the taxable amount of the dividend (which would be the amount of the dividend that was received plus the gross-up amount prescribed by paragraph 82(1)(*b*) of the *Act*) was $40,000.

[7] Subsection 82(1) of the *Act* in 2007 provided in part as follows:

> 82**.** (1) In computing the income of a taxpayer for a taxation year, there shall be included the total of the following amounts:
>
> (*a*) the amount, if any, by which
>
> (i) the total of all amounts, other than eligible dividends and amounts described in paragraph (*c*), (*d*) or (*e*), received by the taxpayer in the taxation year from corporations resident in Canada as, on account of, in lieu of payment of or in satisfaction of, taxable dividends,
>
> exceeds
>
> (ii) if the taxpayer is an individual, the total of all amounts paid by the taxpayer in the taxation year that are deemed by subsection 260(5) to have been received by another person as taxable dividends (other than eligible dividends);
>
> (*a.1*) the amount, if any, by which
>
> (i) the total of all amounts, other than amounts included in computing the income of the taxpayer because of paragraph (*c*), (*d*) or (*e*), received by the taxpayer in the taxation year from corporations resident in Canada as, on account of, in lieu of payment of or in satisfaction of, eligible dividends,
>
> exceeds
>
> (ii) if the taxpayer is an individual, the total of all amounts paid by the taxpayer in the taxation year that are deemed by subsection 260(5) to have been received by another person as eligible dividends;
>
> (*b*) if the taxpayer is an individual, other than a trust that is a registered charity, the total of
>
> (i) 25% of the amount determined under paragraph (*a*) in respect of the taxpayer for the taxation year, and
>
> (ii) 45% of the amount determined under paragraph (*a.1*) in respect of the taxpayer for the taxation year;

[8] Dividends received from corporations resident in Canada[1] were subject to either a gross-up amount of 25% or 45%. In this case it was not established whether the dividend was an eligible dividend. Since the gross-up amount for eligible dividends would be 45% this would result in a substantial difference between the amount of the dividend that was received and a taxable dividend amount for eligible

[1] Since 626553 B.C. Ltd. would have been incorporated under the laws of British Columbia, it would be resident in Canada (subsection 250(4) of the *Act*).

dividends. It appears clear from the opening part of subsection 82(1) of the *Act*[2] that the amount that is required to be included in computing income is both the amount of the dividend that was received and the additional amount (the gross-up) which would be 45% of the amount of the dividend that was received if the dividend was an eligible dividend. It therefore appears that since the penalty imposed pursuant to subsection 163(1) of the *Act* is 10% of the amount that is required to be included in computing income, that the penalty would be imposed on the grossed-up amount.

[9] This result appears to be counterintuitive. It appears that the failure to include a dividend of $10,000 that is received by a taxpayer, which, if it is an eligible dividend, would require an additional 45%[3] to be included in income, or $14,500 in total, would result in a penalty under subsection 163(1) of the *Act* of $1,450 but the failure to include $10,000 of interest or employment income would result in a penalty of $1,000[4] when the tax liability arising from a $10,000 eligible dividend (as a result of the dividend tax credit) would be less than the tax liability arising from interest or employment income of $10,000[5]. Therefore although the income taxes payable on eligible dividends received (or other dividends that are to be grossed up) would be less than the income taxes payable on the same amounts of interest or employment income, the failure to include eligible dividends (or other dividends that are to be grossed up) would result in larger penalties under subsection 163(1) of the *Act* than the failure to include the same amount of interest or employment income. This is

[2] See also paragraph 12(1)(*j*) of the *Act.*

[3] Decreasing after 2009.

[4] Assuming that, in each case, this was the second time in four consecutive years that an amount was not included in income.

[5] To illustrate, assume that an individual had other income in 2007 and that any additional income would be taxed at the rate of 29% under the *Act*. Assume that the dividends referred to below were received from corporations resident in Canada. The following table illustrates only the tax liability under the *Act* (and does not include any liability under any provincial income tax statute) that would be imposed on the following additional amounts of income:

	Dividend (not an eligible dividend)	Eligible dividend	Interest or employment income
A: Amount received:	$10,000	$10,000	$10,000
B: Gross-up for dividends (subs. 82(1)) (25% or 45%)	$2,500	$4,500	n/a
C: Total amount included in computing income: (A + B)	$12,500	$14,500	$10,000
D: Tax payable (s. 117) (29% of C)	$3,625	$4,205	$2,900
E: Less: Dividend Tax Credit (s. 121) (2/3 or 11/18 of B)	$1,667	$2,750	n/a
F: Net Tax Payable: (D – E)	$1,958	$1,455	$2,900

because the penalty under subsection 163(1) of the *Act* is based on the amount that was not included in computing income, not on the taxes that such amount would have generated nor is it based on the amount that the taxpayer received.

[10] In penalty cases it is important that the Respondent establish the amount that the taxpayer failed to include in income. In this case, counsel for the Respondent referred to both a dividend of $40,000 and total unreported income of $60,000. The unreported income amount is only $60,000 if the taxable dividend amount (including the gross-up) is $40,000. The references to the dividend during the testimony of the Appellant (who was the only witness) suggested that the amount of the dividend that was received was $40,000. When dealing with dividend income it is very important (especially with a possible gross-up amount of 45%) to distinguish between the amount of the dividend that was received and the taxable amount of the dividend.

[11] This failure to distinguish between the amount of the dividend that was received and the taxable amount of the dividend does not mean that penalties could not be imposed. The result is that the $40,000 amount will be considered to be the taxable amount of the dividend.

[12] In *Saunders* v. *The Queen*, 2006 TCC 51, 2006 D.T.C. 2267, [2006] 2 C.T.C. 2255, Justice Woods stated that:

> 12 The penalty in subsection 163(1) is one of strict liability, although this Court has held that it can be vacated if the taxpayer can establish due diligence.

[13] Justice Boyle in *Dunlop* v. *The Queen*, 2009 TCC 177, 2009 D.T.C. 650, [2009] 6 C.T.C. 2223 reiterated that the penalty will not apply if the taxpayer “can demonstrate he exercised a requisite degree of due diligence”.

[14] In the recent decision of the Federal Court of Appeal in *Les Résidences Majeau Inc.* v. *The Queen*, 2010 FCA 28, Justice Létourneau, on behalf of the Federal Court of Appeal, stated as follows:

> 7 As far as the penalty is concerned, we are satisfied that the judge did not make any mistake in upholding it. To avoid this penalty, the appellant had to establish that it was duly diligent.
>
> 8 According to *Corporation de l'école polytechnique* v. *Canada*, 2004 FCA 127, a defendant may rely on a defence of due diligence if either of the following can be established: that the defendant made a reasonable mistake of fact, or that the

> defendant took reasonable precautions to avoid the event leading to imposition of the penalty.
>
> 9 A reasonable mistake of fact requires a twofold test: subjective and objective. The subjective test is met if the defendant establishes that he or she was mistaken as to a factual situation which, if it had existed, would have made his or her act or omission innocent. In addition, for this aspect of the defence to be effective, the mistake must be reasonable, i.e. a mistake a reasonable person in the same circumstances would have made. This is the objective test.
>
> 10 As already stated, the second aspect of the defence requires that all reasonable precautions or measures be taken to avoid the event leading to imposition of the penalty.

[15] Although the penalty in issue is not identified in the decision of the Federal Court of Appeal, it appears from the decision[6] which was appealed to the Federal Court of Appeal that the penalty in issue is the penalty that was, prior to April 1, 2007, imposed under section 280 of the *Excise Tax Act*. The imposition of this penalty was also subject to the due diligence defence (see *Pillar Oilfield Projects Ltd.* v. *The Queen*, [1993] G.S.T.C. 49).

[16] In this case the Appellant (prior to 2007) had her tax returns prepared by the same accounting firm that did the accounting work for Vernon Ridge Holdings Ltd. and 626553 B.C. Ltd. In 2007 the Appellant's daughter had been sick for approximately four years. Her illness required her to be hospitalized from time to time. In 2007 the Appellant decided to have H & R Block prepare hers (and her husband's) income tax returns since they were closer than the accounting firm and her husband was working away from home. She contacted the accounting firm for the companies and asked them to fax the necessary tax information to H & R Block. This was the day before the tax returns were signed and filed. The accounting firm faxed this information to H & R Block but it appears that for some unexplained reason, the income amounts referred to above were not included by H & R Block in her tax return.

[17] The reasonable mistake of fact that the Appellant has alleged is the mistake with respect to whether all of the income that she had earned in 2007 was included by H & R Block in her tax return. She has satisfied the subjective element of this test as clearly she believed that following her phone call to the accounting firm and the accounting firm faxing the information to H & R Block, that her tax return then did include all of her income amounts for 2007.

[6] 2009 TCC 286, [2009] G.S.T.C. 90, [2009] 2009 G.S.T.C. 118.

[18] However as noted by the Federal Court of Appeal there is also an objective component to this test. Would a reasonable person have made the same mistake? In this case in order to test the reasonableness of the mistake, it would be important to review what income she did report for 2007. Were there other amounts of employment income and dividends that were reported that would make the failure to include these amounts innocent? Would a reasonable person not notice that approximately $20,000 of employment income and a $40,000 taxable dividend amount (which would include the amount of the dividend that was received plus the appropriate gross-up amount) had not been included?

[19] Neither party introduced a copy of the Appellant’s income tax return for 2007. It is not clear whether the Appellant has a copy of her 2007 income tax return. It was not established whether she has a copy or not. It is clear however that since the Appellant filed her tax return for 2007 that the Respondent would have the income tax return that was filed by the Appellant.

[20] In the *Law of Evidence in Canada*, third edition, by Justice Lederman, Justice Bryant and Justice Fuerst of the Superior Court of Justice for Ontario, it is stated at p. 377 that:

> **§6.449** In civil cases, an unfavourable inference can be drawn when, in the absence of an explanation, a party litigant does not testify, or fails to provide affidavit evidence on an application, or fails to call a witness who would have knowledge of the facts and would be assumed to be willing to assist that party. In the same vein, an adverse inference may be drawn against a party who does not call a material witness over whom he or she has exclusive control and does not explain it away. Such failure amounts to an implied admission that the evidence of the absent witness would be contrary to the party’s case, or at least would not support it.*
>
> **§6.450** An adverse inference should be drawn only after a *prima facie* case has been established by the party bearing the burden of proof.*
>
> (* denotes a footnote reference that is in the original text but which has not been included.)

[21] It seems to me that this can also apply to a failure to produce a document that is within the exclusive control of a party. In this case that document is the income tax return of the Appellant. While the Appellant may have retained a copy, the original return would have been filed with the Canada Revenue Agency and therefore the Respondent would have exclusive control over the tax return that was filed by the

Appellant for 2007. No satisfactory explanation was provided for the failure to introduce the Appellant's income tax return for 2007.

[22] In this case the Respondent has the burden of establishing the facts justifying the assessment of the penalty and the Appellant has the burden of establishing the facts that would support a due diligence defence. In my opinion the Appellant did establish a *prima facie* case for a due diligence defence. She established that she had contacted the accounting firm for the companies before the tax returns were filed and asked them to fax the necessary tax information to H & R Block (which they did). She stated that she had reviewed her tax return before it was filed but did not notice that her tax return did not contain the missing income. She stated that she did not understand her tax return in any event and since the end result of how much she had to pay or was to receive as a refund matched what she was expecting, she did not think that anything was missing.

[23] It should also be noted that the Respondent was represented by counsel and the Appellant represented herself. It seems to me that an unfavourable inference can be drawn from the failure of the Respondent to introduce the income tax return that the Appellant filed for 2007. The negative inference is that the return would have disclosed such other employment income and dividend income that a reasonable person would have made the same mistake as the Appellant did in these circumstances.

[24] As a result the appeal is allowed and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the penalty imposed pursuant to subsection 163(1) of the *Income Tax Act* in relation to the income tax return that she filed for 2007 is deleted.

[25] The Respondent shall pay costs to the Appellant in the amount of $500.

Signed at Halifax, Nova Scotia, this 29th day of July 2010.

"Wyman W. Webb"

Webb, J.

CITATION:	2010TCC403
COURT FILE NO.:	2009-3193(IT)I
STYLE OF CAUSE:	NICOLE COOPER AND HER MAJESTY THE QUEEN
PLACE OF HEARING:	Nanaimo, British Columbia
DATE OF HEARING:	July 13, 2010
REASONS FOR JUDGMENT BY:	The Honourable Justice Wyman W. Webb
DATE OF JUDGMENT:	July 29, 2010
APPEARANCES:	
For the Appellant:	The Appellant herself
Counsel for the Respondent:	Whitney Dunn
COUNSEL OF RECORD:	
For the Appellant:	
Name:	
Firm:	
For the Respondent:	Myles J. Kirvan Deputy Attorney General of Canada Nanaimo, British Columbia