

BETWEEN:

EVELYN W. CHAN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on April 2, 2012, at Ottawa, Canada

Before: The Honourable Justice Wyman W. Webb

Appearances:

For the Appellant:

The Appellant Herself

Counsel for the Respondent:

Maria Abdoullaeva (Student-at-law)

JUDGMENT

The Appellant's appeal in relation to the assessment of the penalty imposed pursuant to subsection 163(1) of the *Income Tax Act* (the "Act") in relation to the income tax return that she filed for 2008 is allowed, without costs, 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 *Act* in relation to the income tax return that she filed for 2008 is deleted.

Signed at Halifax, Nova Scotia, this 18th day of May, 2012.

"Wyman W. Webb"

Webb J.

Citation: 2012TCC168
Date: 20120518
Docket: 2011-1031(IT)I

BETWEEN:

EVELYN W. CHAN,

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 an amount that the Appellant failed to include in computing her income in her tax return that she filed for 2008 (following a previous failure to include an amount in income in filing her 2007 tax return) 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] 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 that she had failed to include amounts in her income in filing her tax returns for 2007 and 2008.

[3] In *Saunders v. The Queen*, 2006 TCC 51, 2006 DTC 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.

[4] Justice Boyle in *Dunlop v. The Queen*, 2009 TCC 177, 2009 DTC 1124, [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”.

[5] Justice Létourneau, on behalf of the Federal Court of Appeal, in *Les Résidences Majeau Inc. v. The Queen*, 2010 FCA 28, 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.

[6] Although the penalty in issue is not identified in this decision of the Federal Court of Appeal, it appears from the decision¹ of Justice Tardif 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

¹ 2009 TCC 286, [2009] G.S.T.C. 90, [2009] 2009 G.S.T.C. 118.

this penalty was also subject to the due diligence defence (see *Pillar Oilfield Projects Ltd. v. The Queen*, [1993] G.S.T.C. 49).

[7] Therefore if the Appellant can establish that she was duly diligent then the penalty will be vacated. The Appellant will need to establish either that she made a reasonable mistake of fact or that she took reasonable precautions to avoid the failure to include the omitted amounts in her income in 2007 or 2008.

[8] In 2007 the amount that the Appellant did not include in her income was \$1,156 which was comprised of the following amounts:

Taxable dividends	\$145
Other Income	\$1,010
Claim for capital gains on T3 slip	\$1
Total:	\$1,156

[9] These amounts were all related to investments that the Appellant held through TD Waterhouse. The Appellant explained that the information slips for these amounts were not received by the end of March 2008 and were only received after she had filed her income tax return for 2007.

[10] In 2008 the Appellant failed to report a portion of her investment income in her 2008 income tax return. In the Income Tax Return Information form that was filed during the hearing it is stated that the amount of the unreported income on which the penalty was assessed was \$5,226. In the Reply it was stated that this was determined as follows:

Taxable dividends	\$2,075.00
Interest	\$2,555.00
Other income	\$560.00
Other dividend income	\$89.00
Less foreign tax paid:	(\$52.35)
Total:	\$5,226.65

[11] The Appellant acknowledged that she did not include the above amounts of income in filing her tax return for 2008. The penalty imposed under subsection 163(1) of the *Act* was based on the amount of \$5,226. No explanation was provided with respect to why a deduction was made for foreign tax paid. The penalty under subsection 163(1) of the *Act* is 10% of the “amount required to be included in computing the person's income in a return filed under section 150 for a taxation year”

that the person failed to include in so computing their income. The amount paid for foreign taxes is generally deducted in computing the taxes payable, not in computing income². It also appears from the Income Tax Return Information form that was filed, that a foreign tax credit of \$165.63³ was allowed as a deduction in determining the amount of taxes payable. It is not at all clear why this was deducted in computing the amount of income that the Appellant failed to report. In any event since it reduced the amount on which the penalty was assessed and since the Minister cannot appeal his own assessment⁴, no adjustment will be made to this amount.

[12] In the Income Tax Return Information form submitted during the hearing, the unreported amount of \$2,075 was identified as “taxable dividends”. Subsection 82(1) of the *Act* in 2008 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,

² Section 126 of the *Act*.

³ The amount of \$165.63 includes the additional foreign taxes of \$52.35 paid in relation to income that was not reported. In the form the total of \$165.63 was determined as follows: Previous Amount of \$113.28 + Change of \$52.35 = \$165.63.

⁴ *Valdis v. The Queen*, [2001] 1 C.T.C. 2827.

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;

...

[13] Dividends received from corporations resident in Canada were subject to either a gross-up amount of 25% or 45%⁵ in 2008. In this case, in the Income Tax Return Information document, the unreported dividends were identified as:

Taxable dividends	\$2,075
Ineligible dividend other than eligible dividends	\$89

[14] Since dividends that were not eligible dividends were identified separately, the amount of \$2,075 must have been the taxable amount of eligible dividends. Since the gross-up amount for eligible dividends would have been 45% of the amount received this would result in a substantial difference between the amount of the dividends that were received and the taxable dividend amounts for eligible dividends. It is clear from the opening part of subsection 82(1) of the *Act*⁶ 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, in 2008, would have been 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

⁵ Decreasing after 2009.

⁶ See also paragraph 12(1)(j) of the *Act*.

computing income, that the penalty would be imposed on the grossed-up amount, which it was in this case.

[15] This result appears to be counterintuitive. For example assume that an individual received a dividend of \$10,000 in 2008. If it is an eligible dividend, an additional 45% would be included in income, or \$14,500 in total. The penalty under subsection 163(1) of the *Act* for the failure to include this amount in income would be \$1,450⁷. However, if the same individual had received \$10,000 of interest income that was not included in income, the penalty that would be imposed under subsection 163(1) of the *Act* would be \$1,000⁸. However, 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 income of \$10,000⁹. Therefore although the income taxes payable by an individual as a result of receiving a \$10,000 eligible dividend would be less than the income taxes payable by an individual as a result of receiving the same amount of interest income, the failure to include the taxable dividend amount in relation to the eligible dividend will result in larger penalties under subsection 163(1) of the *Act* than the failure to include the same amount received as interest income. This is 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 on the amount that the taxpayer received.

⁷ Assuming that this was the second time in four consecutive years that an amount was not included in income and subject to a possible due diligence defence.

⁸ Assuming that this was the second time in four consecutive years that an amount was not included in income and subject to a possible due diligence defence.

⁹ To illustrate, assume that an individual had other income in 2008 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 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

[16] In this case the taxable dividend amount of \$2,075 for 2008 is the grossed-up amount in relation to eligible dividends. Therefore the actual amount of dividends received in 2008 would have been \$1,431¹⁰. Based on the penalty as imposed by the Respondent, the failure by the Appellant to include the grossed-up amount in relation to \$1,431 of eligible dividends received will result in a penalty under subsection 163(1) of the *Act* of \$207.50. If the amount received (\$1,431) would have been interest that was not reported, the penalty would only have been \$143.10.

[17] The question in this appeal is whether the Appellant has established that she exercised the requisite level of due diligence in relation to either the failure to include an amount in income in 2007 or the failure to include an amount in income in 2008. As noted above, the penalty is imposed under subsection 163(1) of the *Act* if the conditions in both paragraphs (a) and (b) are satisfied. It seems to me that the penalty should not be imposed if the Appellant can establish that she was duly diligent in relation to either failure to include amounts in her income.

[18] In *Franck v. The Queen*, 2011 TCC 179, Justice Hogan stated as follows:

2. ... Because subsection 163(1) of the *Act* requires a failure to report in two of four consecutive years, a due diligence defence for either year will nullify the penalty.

[19] The due diligence defence arises as a result of the classification of the offence as a strict liability offence. In *The Queen v. The Corporation of The City of Sault Ste. Marie*, [1978] 2 S.C.R. 1299, Justice Dickson (as he then was) writing on behalf of the Supreme Court of Canada stated that:

I conclude, for the reasons which I have sought to express, that there are compelling grounds for the recognition of three categories of offences rather than the traditional two:

1. Offences in which *mens rea*, consisting of some positive state of mind such as intent, knowledge, or recklessness, must be proved by the prosecution either as an inference from the nature of the act committed, or by additional evidence.
2. Offences in which there is no necessity for the prosecution to prove the existence of *mens rea*; the doing of the prohibited act *prima facie* imports the offence, leaving it open to the accused to avoid liability by proving that he took all reasonable care. This involves consideration of what a reasonable man would have done in the circumstances. The defence will be available if the accused

¹⁰ \$1,431 + 45% of \$1,431 = \$2,075.

reasonably believed in a mistaken set of facts which, if true, would render the act or omission innocent, or if he took all reasonable steps to avoid the particular event. These offences may properly be called offences of strict liability. Mr. Justice Estey so referred to them in Hickey's case.

3. Offences of absolute liability where it is not open to the accused to exculpate himself by showing that he was free of fault.

[20] There are numerous cases that have held that a defence of due diligence, if established, may be relied upon by a taxpayer to avoid a penalty imposed under subsection 163(1) of the *Act*. The penalty can only be imposed under this subsection of the *Act* if a particular taxpayer fails to include an amount in income in two different years. Therefore, the "prohibited act" consists of two failures - one is the failure to include an amount in income in one year and the second is the failure to include an amount in income in another year that is within three years following the first failure.

[21] Therefore if a taxpayer, as stated by Justice Hogan, can establish that he or she (or in the case of a corporation, it) exercised due diligence in relation to either the first failure to include an amount in income or the second failure to include an amount in income, then that taxpayer will be successful in relation to the assessment of a penalty under subsection 163(1) of the *Act*. Even though the calculation of the amount of the penalty is only based on the second amount that the person failed to include in computing income, in order for the penalty to be imposed the person must have failed to include amounts in computing income in two different years and the two failures to include amounts in computing income would be part of the "prohibited act". In this case the Appellant will be successful if she can establish that she exercised due diligence in relation to either her failure to include \$1,156 in her income for 2007 or her failure to include \$5,226 in her income for 2008.

[22] The amount that the Appellant did not include in her income for 2007 was \$1,156. Included in this amount are taxable dividends of \$145. There was no indication whether these are eligible dividends. Assuming that these dividends are eligible dividends, the amount that the Appellant actually received was \$100. Her total income for 2007 (including these unreported amounts) was \$109,123. Therefore the unreported amount (including the taxable dividend amount) was 1.06% of her total income for 2007. The Appellant explained that TD Waterhouse (who held the investments that generated the income) did not send her the necessary information slips by the end of March. The T3 and T5 slips for 2007 were to have been completed and sent by:

T5 (for dividends, interest, other income)

February 29, 2008¹¹

T3 (for trusts)

March 31, 2008¹²

[23] The Appellant's mistake of fact in 2007 was that she had mistakenly believed that she had all of the information slips that were to be sent to her by the end of March by TD Waterhouse and therefore that she was reporting all of her income when she completed her tax return in early April. It seems to me that this mistake was reasonable. The amount that she omitted from her income was only 1.06% of her total income in 2007. Her mistake in not including this amount in her income was innocent. It also seems reasonable to believe that a large financial institution such as TD Waterhouse would have complied with its obligations under the *Income Tax Regulations* to forward the necessary tax slips by the deadlines as set out in these *Regulations*. It seems to me that a reasonable person could have made the same error and mistakenly omitted such a small portion of his or her income in the same circumstances. As a result, the Appellant has established that she was duly diligent in relation to the failure to include the amount of \$1,156 in her income for 2007.

[24] Although this is sufficient to dispose of the appeal, the Appellant also explained how the amount was missed for 2008. During 2008 the Appellant transferred some investments that she had with National Bank to TD Waterhouse (where she already had an account). To keep the two groups of investments separate until the transfer was completed, the Appellant opened a separate account at TD Waterhouse. Once the Appellant was satisfied that all of the investments were transferred from National Bank, she asked TD Waterhouse to transfer all of the investments from the temporary account to her other TD Waterhouse account.

[25] While TD Waterhouse did transfer the investments, for some unexplained reason, the investment income earned on the investments held in the temporary account did not get added to the investment income reported on her main TD Waterhouse account nor was a separate T5 or T3 slip sent to the Appellant for this investment income.

[26] The amount that was missed for 2008 (using the taxable dividend amount) was \$5,226 and her total income for 2008 was \$111,768. Therefore the missed amounts

¹¹ Subsections 201(1) and 205(1) and section 209 of the *Income Tax Regulations*.

¹² Subsection 204(2) and section 209 of the *Income Tax Regulations* and section 26 and the definition of "holiday" in subsection 35(1) of the *Interpretation Act*. March 30, 2008 was a Sunday.

were 4.7% of her total income. While the amounts that were missed were less than 5% of her total income they were a significant percentage of her investment income. The amounts that she failed to include in her income and upon which the penalty was calculated and the total amounts of each type of income were as follows:

Type of Income	Amount Reported	Amount Not Reported	Total Amount	% of Total not Reported
Taxable dividends	\$3,041	\$2,075	\$5,116	41%
Interest and investment income	\$14,940	\$2,555	\$17,495	15%
Other income	\$2,343	\$560	\$2,903	19%
Ineligible dividend	\$43	\$89	\$132	67%

[27] The percentage of her total amount that should have been reported for each type of income is significant - ranging from 15% of her total interest and investment income to 67% of her ineligible dividends, although the actual amount of ineligible dividends that were not reported is small (\$89). If the Appellant would have been as diligent about ensuring that all of her income had been reported by TD Waterhouse as she was about ensuring that all of her investments had been transferred from National Bank, she would have noticed the missing income. As well, since the year before TD Waterhouse had been late in sending the information slips, a reasonable person would have taken further steps to ensure that all amounts were accurately reported in 2008 by TD Waterhouse. Her mistake of fact for 2008 was not reasonable and she did not take reasonable steps to ensure that she did not fail to include all of her investment income in her income in 2008. Therefore, it seems to me that the Appellant did not exercise the requisite due diligence for 2008. However, since she only needs to establish that she exercised the requisite due diligence for one of the years for which an amount was not included in her income and since she has established that she exercised the requisite due diligence in relation to the failure to include an amount in income in 2007, the Appellant's appeal will be allowed.

[28] As a result the appeal is allowed, without costs, 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 *Act* in relation to the income tax return that the Appellant filed for 2008 is deleted.

Signed at Halifax, Nova Scotia, this 18th day of May, 2012.

“Wyman W. Webb”

Webb J.

CITATION: 2012TCC168

COURT FILE NO.: 2011-1031(IT)I

STYLE OF CAUSE: EVELYN W. CHAN AND HER MAJESTY
THE QUEEN

PLACE OF HEARING: Ottawa, Canada

DATE OF HEARING: April 2, 2012

REASONS FOR JUDGMENT BY: The Honourable Justice Wyman W. Webb

DATE OF JUDGMENT: May 18, 2012

APPEARANCES:

For the Appellant: The Appellant Herself
Counsel for the Respondent: Maria Abdoullaeva (Student-at-law)

COUNSEL OF RECORD:

For the Appellant:

Name:

Firm:

For the Respondent:

Myles J. Kirvan
Deputy Attorney General of Canada
Ottawa, Canada