IN FACT AND IN LAW

Taxation

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Could the New Tax Penalties Apply to You?

By Stéphanie Séguin

As each April reminds us, the Canadian and Quebec income tax systems are based on the principle of self-assessment. Taxpayers assume almost complete responsibility for the information included in, or omitted from, their tax returns.

For several years, it has been possible to penalize persons who encourage taxpayers to evade taxes, but the burden of proof has been similar to the burden of proof for criminal offences, proof beyond a reasonable doubt. However, Canadian tax legislation now contains specific rules on the application of "civil" penalties to anyone who makes or counsels other persons to make false statements or omissions in relation to income tax, the goods and services tax (GST) or the harmonized sales tax (HST). Contrary to penal offences, these new civil penalties require much less constraining evidence. The concept of preponderance of probabilities applies, meaning that it is sufficient for the facts justifying the application of a penalty to outnumber those to the contrary in order for the penalties to apply.

In the 1999 federal Budget[1], Minister Paul Martin proposed the adoption of new measures relating to civil penalties for misleading information provided by third parties relating to tax matters. On June 29, 2000, Bill C-25[2], implementing these new measures in section 163.2 of the *Income Tax Act* (Canada) (the "ITA") and 285.1 of the *Excise Tax Act* (the "ETA"), came into force[3].

Very recently, the Canada Customs and Revenue Agency (the "CCRA") published a Draft Information Circular 01-1 entitled "Third-Party Civil Penalties" (the "Circular"), setting out the CCRA's guidelines and processes concerning the application of third-party civil penalties. No penalty should be imposed as long as the guidelines are not known publicly in their final form.

[1] CANADA, Department of Finance, *The 1999 Budget Plan: Additional Information*, Appendix.

[2] *Act to amend the Income Tax Act,* the *Excise Tax Act* and the *Act to implement the 1999 Budget,* Bill C-25, 2nd Session, 35th Legislature (Can.).

[3] On December 22, 2000, the Quebec Minister of Revenue tabled Bill 175 which particularly introduced sections 59.5.1 to 59.5.11 of the *Act respecting the ministère du Revenu* which, in general, goes in the same sense as the federal provisions analyzed in this article and which will apply, as they are eventually enacted, as of June 29, 2000. For a more detailed study of provincial legislative provisions, see the *Bulletin d'information de la Collection Fiscale du Québec,* volume 3, n° 2. February 2001, entitled "Faux énoncés ou omissions en matière fiscale des règles élargies aux informations fournies par des tiers", written by France Tousignant.

LAVERY, DE BILLY

BARRISTERS AND SOLICITORS

Subject Persons

The new penalties apply to any person and not only to tax advisors. "Any person" includes lawyers, notaries, accountants, promoters, financial advisors and tax return preparers. Henceforth, all of these persons will be at risk and will be a target for the tax authorities. For the purposes of this article, we will call these persons "third parties".

The main objectives of the adoption of these new penalties is to encourage compliance with the ITA and the ETA, and to discourage third parties from advising their clients to file tax returns containing false statements or omissions with the aim of reducing their tax burden, or from providing them with assistance in this sense. These new penalties also apply to third parties who intentionally disregard obvious false statements and omissions. In this regard, the failure to obtain information could constitute wilful blindness that could result in the application of penalties.

Penalties Imposed on Tax Planners and Tax Advisors Regarding Tax Returns

Two new penalties have been integrated into the ITA and the ETA. For the purposes of this section, we will only discuss the penalties prescribed under the ITA. Those stipulated under the ETA are similar.

The first penalty is codified in subsection 163.2(2)[4] of the ITA and is essentially aimed at third parties who prepare (or participate in), sell or promote tax shelters or tax shelter-like arrangements. The following are examples of situations taken from paragraph 18 of the Circular where subsection 163.2(2) of the ITA could apply, to the extent that false statements or omissions are involved:

- tax-shelter promoters holding seminars or presentations to provide information in respect of a specific tax shelter; and
- appraisers and valuators preparing a report for a proposed scheme/shelter that could be used by unidentified investors.

The third party is liable to a fine of $1,000. However, when a false statement is made in the course of a planning activity or a valuation activity, the penalty amount is the greater of $1,000 and 100% of the gross revenue that the

[4] Subsection 163.2(2) of the ITA reads as follows: "Every person who makes or furnishes, participates in the making of or causes another person to make or furnish a statement that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by another person (in subsections (6) and (15) referred to as the "other person") for a purpose of this Act is liable to a penalty in respect of the false statement."

third party has derived or was entitled to derived from the planning or valuation activity specified in subsection 163.2(3) of the ITA.

The second penalty is prescribed in subsection 163.2(4)[5] of the ITA and is aimed at third parties who provide tax-related services to taxpayers. Examples of cases are set forth in paragraph 20 of the Circular where this penalty could apply, again to the extent that the third party has engaged in reprehensible conduct:

. a tax preparer preparing a tax return for a specific taxpayer;

. a tax advisor providing tax advice to a specific taxpayer;

. an appraiser or valuator of movable or immovable property preparing a report for a specific taxpayer or a number of persons who can be identified.

The penalty applicable to the third parties in respect of tax return preparation is prescribed in subsection 163.2(5) of the ITA and corresponds to the greater of:

a) $1,000; and

b) the lesser of:

   i) the penalty to which the other person who can use the false statement would be liable under subsection 163.2(2) of the ITA, if the other person made the statement in a return filed for the purposes of this Act and knew that the statement was false; and

   ii) the total of $100,000 and the third party's gross compensation at the time at which the notice of assessment of the penalty is sent to the person.

The application of the new penalties will depend on the specific facts of each case and the CCRA will assume the burden of proof under subsection 163.2(3) of the ITA. The burden of proof will correspond to the normal civil burden according to the rule of the preponderance of probabilities and not proof beyond a reasonable doubt, as it is required particularly in criminal matters.

Meaning of False Statement

Subsection 163.2(1) of the ITA contains numerous definitions, including that of what constitutes a false statement. A false statement is an incorrect statement, including a statement that is misleading because of an omission from the statement, regardless of whether the

[5] Subsection 163.2(4) of the ITA reads as follows: "Every person who makes or participates in, assents to or acquiesces in the making of, a statement to, or by or on behalf, of another person (in this subsection, subsection (5) and (6), paragraph (12) (c) and subsection (15) referred to as the "other person") that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by or on behalf of the other person, for a purpose of this Act is liable to a penalty in respect of the false statement."

person making, participating in, or assenting to the making of, the statement has any intention to deceive.

Under the new penalties, the third party could be liable for a penalty when he intentionally or in full knowledge of the circumstances makes a false statement or an omission, particularly in an income tax return, a statement, financial statements, a prospectus, a form, a receipt for donations, a document of sale or an invoice.

The CCRA, before imposing a third-party penalty, will have to ascertain that the person knew or would have been reasonably expected to know, but for circumstances amounting to culpable conduct, that the statement in question was a false statement that a third party could use for a purpose of the ITA.

Meaning of Culpable Conduct

The notion of culpable conduct is also defined in subsection 163.2(1) of the ITA. In the absence of knowledge of a false statement, the CCRA will have the burden of proving culpable conduct in order to impose any third-party penalty. Culpable conduct may constitute an act or a failure to act that is tantamount to intentional conduct, shows an indifference as to whether the ITA is complied with or a wilful, reckless or wanton disregard of the ITA. The latter expression refer to a situation where a reasonable, prudent person would know that his actions would result in a false statement but purposely continues with the chosen course of action.

A third-party penalty cannot be imposed when the fault is the consequence of a simple omission that is easily explainable or a simple lack of reasonable prudence. For a penalty to be imposed, there must be a substantial degree of fault or negligence and the third party must show indifference or wilful disregard for the observance of the ITA.

Here is an example:

. a tax preparer, rushing to produce a tax return before midnight on April 30, makes a transcription error by overestimating certain expenses. An audit by the tax authorities uncovers this false statement. The specialist, in general, would not be liable for a penalty since this error is attributable to negligence but is not evidence of indifference to the observance of the ITA.

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Exception to the Application of Penalties

Subsection 163.2(6) of the ITA provides for an exception in the application of penalties for reliance in good faith on the information provided. This exception provides that the third party will not be considered to have acted in circumstances amounting to culpable conduct solely because he relied, in good faith, on information provided to him by the client and, because of such reliance, failed to verify, correct or investigate the information.

Here are two examples where the defence based on third-party good faith could be invoked:

- a lawyer who uses information obtained from his client for personal planning purposes and who has no reason or no grounds to doubt his veracity cannot be deemed to have acted in circumstances amounting to culpable conduct.
- an accountant uses the financial statements established by another accountant and they seem reasonable. After audit, the CCRA finds that the income statement contains several items of false information. Despite the presence of the false statements in the income statement, the accountant could defend himself by pointing out that he used the information obtained in good faith because it did not seem erroneous. However, a penalty could be applied against the accountant who prepared the financial statements if he knew that the financial statements contained false statements.

Valuation Activities

A special rule is provided in subsection 163.2(10) of the ITA concerning a statement made on the value of a property or service by a third party. A penalty could be imposed when a third party makes a false statement as to the value of a property or service and the stated value represents a percentage of the fair market value of the said good or service that is outside of a range, the lower and upper limits of which will be set by regulation. We should note that these limits have not yet been determined by the Department of Finance.

An exception to this special rule is set forth in subsection 163.2(11) of the ITA and provides that no penalty will be imposed if the third party has established that the valuation was reasonable, had been produced in good faith and was not based on assumptions that he knew or should have known were unreasonable or misleading.

Principles of Application of the New Penalties

We should point out that the CCRA sets forth several principles of application in the Circular, including the one whereby no penalty applies in case of a difference of opinion on the following questions:

- capital expenses as opposed to current expenses (deductible);
- capital gains as opposed to business income; and
- personal expenses as opposed to business expenses.

Moreover, the Circular specifies that the application of these new penalties is not meant to impede tax planning on issues such as estate freezes, rollovers, reorganizations, amalgamations and owner/manager remuneration. These activities will not be impeded as long as they do not contain a false statement made knowingly or with culpable conduct.

Process of Application of the New Penalties

The CCRA plans to impose a penalty only to the extent that an interpretation is manifestly contrary to its policy. The CCRA is attempting to reassure third parties, by informing them that the framework for application of the penalties will be rigorously controlled. An audit process, controls, procedures and balancing measures have been put in place so that the penalties are applied appropriately.

The Circular contains many examples of situations where the new penalties could be imposed on a third party.

Any third party must show prudence and diligence, particularly if he is involved in one of the following situations:

- a third party who is well informed of his client's personal position should be capable of detecting incompatible information that the clients provides to him in the preparation of his tax returns and should not intentionally omit to ask him questions;
- a promoter who designs a tax shelter like arrangement while knowing that it is based on a false statement relating to the value of a property;
- when preparing a tax return, the accountant includes an expense incurred for a family vacation when he is well aware that this is a personal expense;
- salaries are paid by a company to the members of a family, some of whom have provided no service to the company. The accountant is informed of the situation but completes the financial statements and the tax returns of all of the family's members.

The CCRA has undertaken, through its Circular, to provide tax specialists with periodic updates concerning the penalties applied, either directly within the context of events organized for tax specialists, or within the context of information provided to various groups in writing.

In the meantime, it is particularly recommended that third parties:

- show greater prudence in clients' tax files;
- verify the information transmitted to ensure that it does not constitute a false statement;
- oppose a false statement made by a client or a another third party, or both;
- make disclosures to the tax authorities that do not contain any omissions;
- have the clients sign letters of declaration concerning the veracity of the information they provide.

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