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SUBJECT: **Third-Party Civil Penalties**

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Contents

Foreword

This information circular provides a framework for the application of third-party civil penalty provisions in section 163.2 of the Income Tax Act *and section 285.1 of the* Excise Tax Act. *The third-party civil penalty provisions evolved from a need to deter tax shelter or tax shelter-like promotions with inflated asset values and faulty assumptions. When the third-party civil penalty provisions were included in the 1999 federal budget, they also contained penalties for those persons who counsel or assist others in filing false returns or who turn a blind eye to false information submitted by taxpayers for tax purposes. Prior to the introduction of the legislative provisions, the Department of Finance stated that these penalties were intended to apply to "egregious" situations. While as much precision as possible has been included in this document, given the myriad situations that can occur, it is recognized that judgement will be needed when applying the law to the facts arising in any particular case. This circular will be refined, based on experience, to provide further clarification as necessary.*

Introduction

1. This information circular outlines guidelines and processes of the Canada Customs and Revenue Agency (CCRA) for the application of the third-party civil penalties in section 163.2 of the *Income Tax Act* (ITA) and section 285.1 of the *Excise Tax Act* (ETA). The term "taxpayer" used within this circular also applies to "registrant" under the ETA.

2. The Canadian tax system is based on the principle of self-assessment. Taxpayers are responsible for filing their tax returns accurately, truthfully, and on time. Tax legislation contains various measures to encourage compliance, including penalties for taxpayers who provide false or misleading information relating to tax matters. Until the third-party civil penalties came into force on June 29, 2000, there was no civil penalty provision that applied to those who counsel others to file their returns based on false or misleading information, or who turn a blind eye to false information provided by their clients for tax purposes.

3. The objective of the third-party civil penalties is to deter third parties from making false statements or omissions in relation to income tax or goods and services tax/harmonized sales tax (GST/HST) matters. These penalties are directed at ensuring tax compliance by deterring behaviour that results in non-compliance.

4. The Canadian tax system has benefited from a cooperative relationship between professional advisors and Canada's tax administration, the CCRA. Since that relationship is critically important to all Canadians, and to the continued health of our taxation system, the CCRA is committed to applying the penalties fairly, consistently and only when clearly justified. The CCRA recognizes that tax professionals have a responsibility to act in the best interests of their clients, and this includes the right to minimize their tax liability within the law.

The Law

5. The legislative structures under section 163.2 of the ITA and section 285.1 of the ETA are very similar. For each subsection under section 163.2 of the ITA there is a corresponding subsection under section 285.1 of the ETA. Therefore, as a general rule, this circular will refer to the relevant subsection or paragraph only. For example, subsection 163.2(2) of the ITA and subsection 285.1(2) of the ETA will be referred to as subsection (2). Where there are differences between the two Acts, a complete reference will be given and the differences will be discussed. Also, throughout the rest of the document, when the ETA is mentioned, it will refer only to the GST/HST provisions that are found in Part IX of the ETA.

6. Both section 163.2 of the ITA and section 285.1 of the ETA provide for two penalties, one directed primarily at those who prepare (or participate in), sell or promote a tax shelter or tax shelter-like arrangement, and the other directed at those who provide tax-related services to a taxpayer. The first of these two penalties will be referred to as the "planner penalty" and the latter will be referred to as the "preparer penalty" throughout the rest of this circular. Also, although mention is made in the circular of tax professionals, tax return preparers, accountants, advisors, practitioners, brokers, tax or financial planners, appraisers, valuators, and tax shelter promoters, the third-party civil penalty provisions apply to any person (defined in paragraphs 20 and 21) engaged in activities described in paragraphs 7 and 9.

"Planner Penalty"

7. Subsection (2), the "planner penalty," provides for a penalty on a person who makes, 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 for a purpose of the ITA or for a purpose of the ETA. Unlike the preparer penalty (defined in paragraph 9), the person who could use the false statement does not need to be identified in order to apply this penalty. Examples of when this subsection could be applicable are:

- 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.

"Planner Penalty" Amount

8. Subsection (3) provides that the penalty to which a person is liable under subsection (2) for a false statement is $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 or the total of the person's gross entitlements for the planning or valuation activity (calculated at the time at which the *Notice of Assessment* of the penalty is sent to the person).

"Preparer Penalty"

9. Subsection (4), the "preparer penalty," provides for a penalty on a person who makes, or participates in, assents to, or acquiesces in the making of a statement to, by or on behalf of another 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 the ITA/ETA. Despite the name "preparer penalty," it can apply to any person in the aforementioned situation and is not limited to a tax return preparer. Subsection (4) would be applicable to the tax return preparer for each investor or taxpayer that can be identified. Examples would include:

- a person preparing a tax return for a specific taxpayer;
- a person providing tax advice to a specific taxpayer; and
- an appraiser or valuator preparing a report for a specific taxpayer or a number of persons who can be identified.

"Preparer Penalty" Amount

10. For a penalty levied under the ITA, subsection 163.2(5) provides that the penalty to which a person is liable under subsection (4) in respect of a false statement is the greater of:

a) $1,000, and

b) the lesser of:

   (i) the penalty to which the other person (i.e., the person who could use the false statement for a purpose of the ITA) would be liable under subsection 163(2) if the other person made the statement in a return filed for the purposes of the ITA and knew that the statement was false; and

   (ii) the total of $100,000 and the person's gross compensation, at the time at which the *Notice of Assessment* of the penalty is sent to the person, for the false statement that could be used by or on behalf of the other person.

11. For a penalty levied under the ETA, subsection 285.1(5) provides that the penalty to which a person is liable under subsection (4) in respect of a false statement that could be used by or on behalf of the other person is the greater of:

a) $1,000, and

b) the lesser of:

   (i) the total of $100,000 and the person's gross compensation, at the time at which the *Notice of Assessment* of the penalty is sent to the person for the false statement that could be used by or on behalf of the other person; and

   (ii) 50% of the decrease in the tax liability or increase in the net refund or rebate claim caused by the reporting of a false statement by the other person, if the section 285 penalty was applied to the other person.

12. Subsections (2) and (4), concerning the planner penalty and the preparer penalty, could both apply to the same false statement. However, subsection (14) provides that a person who is liable to pay penalties under both subsections (2) and (4) for the same false statement is required to pay penalties that are not more than the greater of the penalty under subsection (2) and the penalty under subsection (4). Examples would include:

- a broker remunerated for promotional presentations of a tax shelter that is used by investors that can be identified; and
- tax planners, appraisers and/or valuators preparing a report for a proposed scheme/shelter that is used by investors who can be identified.

Application of the Legislation

13. The third-party civil penalty provisions apply to statements made after June 29, 2000. The penalties may apply to any false statement made after this date. While there is no statutory limitation regarding the time period during which an assessment of these penalties has to be issued, in practice, we do not foresee the penalty being applied in a period that is beyond the legislated record retention period of six years. However, it should be noted that there are no time restrictions for assessments in cases of fraud.

14. When two or more persons are involved in the making of a false statement, the CCRA may apply the penalties to each of the persons. See paragraphs 20 and 21 for a more detailed discussion of the term "person."

15. When considering the application of the third-party civil penalties, the CCRA will respect the intention of the legislation. Specifically, it is meant to apply to those persons who counsel and assist others in making false statements when they file their returns or who are wilfully blind to obvious "errors" when preparing, filing or assisting another person in filing a return. It also is intended to apply to arrangements and plans that contain false statements, often without the knowledge of the client. These are marketed typically as tax shelter and tax shelter-like arrangements that may be defective because of overvaluations of property, excessive or inflated costs, or lack of business activity. Tax shelter-like arrangements are those arrangements that do not fit into the definition of a "tax shelter" in subsection 237.1(1) of the ITA, but they provide similar tax benefits.

16. The legislation is not intended to apply to:

- tax-planning arrangements that comply with the law;
- honest mistakes or oversights;

- differences of interpretations or opinion where there is bona fide uncertainty (e.g., the issue is not well-settled in jurisprudence); and
- activities that are administratively acceptable to the CCRA.

17. Whether penalties will be assessed in a given situation where a false statement was made knowingly or in circumstances amounting to culpable conduct will depend upon the facts of the situation. Factors that may be relevant include:

- whether the position taken is obviously wrong, unreasonable, and/or contrary to well-established case law;
- considering the advisor's experience with the relevant subject matter and knowledge of the taxpayer's specific circumstances, the extent of knowing or deliberate participation in false statements;
- the degree to which the culpable conduct represents the most aggressive and blatantly abusive behaviour;
- the extent to which there is a pattern of repeated abuse; and
- whether the reduction of taxes is significant.

18. In the absence of repeated abusive behaviour, or widespread impact, as would be the case of a practitioner who counsels a number of clients to cheat in small amounts, the CCRA does not intend to focus on situations involving small amounts.

19. Persons who are subject to a third-party civil penalty could also be subject to criminal prosecution if the activities undertaken on behalf of their client(s) constitute tax evasion as described in section 239 of the ITA and/or section 327 of the ETA.

Interpretation and Discussion

Person

20. The term "person" is defined in subsection 248(1) of the ITA as an individual, corporation or any entity exempt from Part I tax. The term "person" is also defined in subsection 163.2(1) of the ITA to include a partnership. Furthermore, subsection 163(2.9) of the ITA provides, in part, that where a partnership is liable to a penalty under section 163.2, the assessment, payment of tax and appeal provisions apply in respect of the penalty as if the partnership were a corporation.

21. As per subsection 123(1) of the ETA, the term "person" means an individual, a partnership, a corporation, the estate of a deceased individual, a trust, or a body that is a society, union, club, association, commission, or other organization of any kind.

False Statement

22. A false statement is an incorrect statement, including a statement that is misleading because of an omission from the statement, regardless of whether the person making, participating in, or assenting to the making of, the statement has any intention to deceive. However, not every false statement would be subject to the third-party civil penalty. Example 3 at the end of the circular describes a situation in which a false statement resulted from an honest error and a penalty was not considered. In order for the third-party civil penalties to be considered, a person must know, or be reasonably expected to know, but for circumstances amounting to culpable conduct (explained in paragraph 24), that the statement is a false statement that could be used for a purpose of the ITA/ETA. The meaning of a false statement is also modified by subsection (8) to deem two or more false statements to be one false statement in cases when there is one or more planning activities that relate to a particular arrangement, entity, plan, property or scheme (such as a tax shelter, a tax shelter-like arrangement or flow-through shares) or a valuation activity that relates to a particular property or service. This deeming provision does not apply to subsections (4) and (5), the "preparer penalty."

Statement

23. "Statement" includes an oral or documentary representation including those in electronic format. Examples include information provided on tax returns, tax credit forms, election forms, correspondence, invoices, donation receipts, statements, valuation reports, certifications, professional opinions, financial statements and their notes, contracts, prospectuses, selling documents, and other publications.

Culpable Conduct

24. "Culpable conduct" must be present in the absence of actual knowledge of a false statement, in order for the third-party civil penalties to be considered. Culpable conduct refers to conduct that is not simply an honest error of judgement or failure to exercise reasonable care (i.e., ordinary negligence). As stated in the *Revised Explanatory Notes Relating to Income Tax*, issued in December 1999 by the Department of Finance, the concept "culpable conduct" is defined with reference to the types of conduct to which the courts have considered applying a civil penalty under the tax law (i.e., criteria considered for subsection 163(2) gross negligence penalty in the case of *Lucien Venne v. Her Majesty the Queen*, 84 DTC 6247 (FCTD)). "Culpable conduct" refers to conduct (an act or a failure to act) that is tantamount to intentional conduct, shows an indifference as to whether the ITA/ETA is complied with, or shows a wilful, a reckless or a wanton disregard of the law.

Tantamount to Intentional Conduct

25. The expression "tantamount to intentional conduct" in the definition of culpable conduct means conduct that is

equal, in effect, to intentional conduct, i.e., a person's conduct (an act or failure to act) shows that the person must have intended to make (or participate in or assent to the making of) a false statement.

Indifference

26. The expression "shows an indifference as to whether this Act is complied with" in the definition of culpable conduct describes the passive aspect of culpable conduct. The expression means that the person's actions or failure to act indicate that the person was wilfully blind regarding the facts or the application of the tax legislation. The person suspects that the situation demands that certain questions be asked. However, inquiries are not made because the person would then possess the knowledge of the false statement. This behaviour was addressed in *Sirois (L.C.) v. Canada*, 1995 CarswellNat 555, [1995] 2 C.T.C. 2648 (TCC) which relates to subsection 163(2) of the ITA, gross negligence on the part of the taxpayer. The court described the taxpayer's behaviour as "He buried his head in the sand."

27. The "indifference standard" is considered to be much greater than that of ordinary negligence. It is more or less equivalent to the standard used to measure the purposeful act of wilful, reckless or wanton disregard of the law. As stated in *Gerald Malleck v. Her Majesty the Queen*, 98 DTC 1019 (TCC) on page 1021, "There is, however, little, if any, difference between approaching "the willful, the reckless, the wanton," and indifference as to whether the law is complied with or not."

Wilful, Reckless, or Wanton Disregard of the Law

28. The expression "shows a wilful, reckless or wanton disregard of the law" in the definition of culpable conduct points to the situation where a reasonable, prudent person would know that it is highly likely that a false statement could be made but purposefully continues with the chosen course of action. For example, a tax return preparer decides to follow the instructions of his Canadian resident client and not report the client's foreign investment income on the tax return. The preparer is reasonably expected to know that the worldwide income of a Canadian resident is taxable in Canada. The preparer would be demonstrating wilful or wanton disregard of the law if he or she participates in a filing position that is clearly contrary to the legislation.

Participate

29. The definition of "participate" includes causing a subordinate to act or to omit information, and to know of, and to not make a reasonable attempt to prevent, the participation by a subordinate in an act or omission of information.

Subordinate

30. The definition of "subordinate" relating to a particular person includes not only employees, but also other persons over whose activities the particular person has direction, supervision or control. For example, if a particular person provides directions to, supervises or controls the activities of another person who is not an employee of the particular person or of anyone else (as in the case of a self-employed person), the other person would be considered to be a subordinate of the particular person for the purpose of determining whether the particular person participated in making a false statement. This provision may apply in a situation where a promoter, advisor or tax return preparer carves out certain activities relating to the making of a false statement and subcontracts these activities to an apparently unrelated person (in order to maintain that he or she did not participate in the making of the false statement).

31. An exception lies within the definition of "subordinate." Specifically, if a particular person is a member of a partnership, a person reporting to (i.e., activities of the person being directed, supervised or controlled by) the particular person is not a subordinate of another partner solely because the other partner is a member of the partnership. In other words, a person who reports to a particular partner is a subordinate of that particular partner and not of any other partner unless that person also reports to that other partner.

Clerical or Secretarial Services

32. Subsection (9) provides that a person is not considered to have made or furnished, or participated in, assented to or acquiesced in the making of, a false statement solely because the person provided clerical services (other than bookkeeping services) or secretarial services relating to the statement.

33. For the purposes of the third-party civil penalties, clerical and secretarial duties do not include any involvement in the preparation of financial accounts. Clerical and secretarial duties are considered to be of an administrative nature, such as typing or formatting, without having any regard to content other than the accurate reproduction of originals that are prepared by others. Bookkeeping services would include recording business accounts and transactions and could lead to penalties.

Good Faith Reliance

34. Subsection (6) provides for an exception to culpable conduct (rather than actual knowledge). This exception provides that an advisor who acts on behalf of the other person (i.e., the person who could use the false statement for a purpose of the ITA/ETA) is not considered to have acted in circumstances amounting to culpable conduct relating to a false statement solely because the person (referred to as the advisor) relied, in good faith, on information provided to the advisor by, or on behalf of, the other person, or because of

such reliance, failed to verify, investigate, or correct the information (i.e., did not look into the accuracy of the information).

35. Good faith is described as “honesty of intention, and freedom from knowledge of circumstances which ought to put the holder on inquiry.” The good faith reliance exception is available when the information used by the advisor or tax return preparer is not on its face, clearly false, or obviously unreasonable to a prudent person or does not raise obvious questions in the mind of the advisor or tax return preparer. In other words, a person may rely on information in good faith in the absence of a reason that could cause a reasonable and prudent person to believe that the information could be incorrect. There may be situations when additional questions will have to be asked before the person can satisfy himself or herself that the information is credible (i.e., consistent with the person’s knowledge). A person may wish to document this supplementary information if it needs to be referred to at a later date. The good faith reliance exception is restricted to a person who acts on behalf of the other person who could use the false statement for a purpose of the ITA/ETA.

36. As per subsection (7), the reliance in the good faith exception does not apply to a statement that a person makes, participates in or assents to in the course of an “excluded activity,” as defined in paragraph 37. As a result, the good faith reliance exception is not applicable to a person who is selling or promoting, or accepting consideration for the promotion or sale of a flow through share, a tax shelter or a tax shelter-like arrangement.

Excluded Activity

37. The term “excluded activity”means the activity of promoting or selling (whether as a principal or agent, or directly or indirectly) an arrangement where it can reasonably be considered that the arrangement concerns a flow-through share, a tax shelter, or an arrangement where one of the main purposes for participation in the arrangement is to obtain a tax benefit (a tax shelter-like arrangement). It also includes accepting (whether as a principal or agent, or directly or indirectly) consideration for the sale or promotion of such an arrangement. Since tax shelters and flow through shares are not relevant for the purposes of GST/HST, these terms are not included in the definition of “excluded activity” in subsection 285.1(1) of the ETA. Only a tax shelter-like arrangement would be considered an “excluded activity” for GST/HST purposes.

38. Generally, the use of rollover provisions, estate freezes and other conventional tax-planning techniques are not considered excluded activities when the activity is carried on for a fee for a specific client. The client receives advice that is tailored to the client’s facts, circumstances and needs. However, if a tax plan is prepared for a specific client and is subsequently promoted or sold to other clients, it may fall within the ambit of excluded activity since it would no longer be client-specific advice.

39. As stated in paragraph 36, when an activity is an excluded activity the good faith reliance exception is not applicable. However, determination of whether the civil penalties would apply would still depend on the existence of a false statement and the knowledge thereof, or the reasonable expectation of such knowledge but for circumstances amounting to culpable conduct.

Gross Entitlements

40. “Gross entitlements” means all the amounts to which the person, or another person not dealing at arm’s length with the person, is entitled in respect of a planning activity or a valuation activity. The amounts included are amounts that are receivable or received, either absolutely or contingently, either before or after that time of the planning or valuation activity.

Two or More False Statements

41. Subsection (8) treats two or more false statements made or furnished by a person in the course of one or more planning activities (or a valuation activity) as one false statement for the purpose of applying the planner penalty relating to the person's false statements. This is the case when a person made or furnished false statements in the course of one or more planning activities that are for a particular arrangement, entity, plan, property, or scheme or in the course of a valuation activity that is in respect of a particular property or service. For example, a tax-planning scheme could include two false statements: the over-valuation of property, and the overstatement of expenses. These two statements would be deemed to be one false statement for the purposes of applying the planner penalty. However, in the case of the preparer penalty, one false statement used in a number of returns would be considered multiple false statements.

Special Rules for Valuation Activities

42. Subsection (10) provides a special rule that applies to a statement made by a person who expresses an opinion on the value of a property or service (referred to as the “stated value”) or by a person who uses that stated value in the course of an excluded activity. A statement as to the stated value is deemed to be a false statement that the person would reasonably be expected to know, but for circumstances amounting to culpable conduct, if the stated value is outside (either higher or lower than) a range of values. This is called the “reverse onus rule,” which is more fully described in paragraph 48. However, if the “stated value” is different from the fair market value but is within the range, it may still be a false statement.

43. The bottom of this range corresponds to the results of multiplying the prescribed percentage referred to in paragraph (10)*(a)* by the fair market value (as determined by the CCRA, subject to variation by a court on an appeal) of the property or service. The top of this range corresponds to the results of multiplying the prescribed percentage referred

to in paragraph (10)*(b)* by the fair market value of the property or service.

44. At the time of publication of this document, the regulations prescribing percentages have not yet been issued. When they are issued, we will provide further information as to how they apply. In the meantime, a false statement in respect of valuation of property or service will be treated like any other false statement, since the reverse onus rule will not be applicable. Specifically, the onus is on the CCRA to prove the existence of a false statement made with knowledge or in circumstances amounting to culpable conduct. Factors to be considered in determining whether penalties would be assessed include factors such as those listed in paragraph 17.

45. The CCRA has well-established Real Estate Appraisal and Business Equity Valuation programs. The objective of the Real Estate Appraisal Program is to provide an effective and efficient appraisal service involving fair market value determinations of real estate and other tangible property. The CCRA appraisers follow professional standards as set out by the Appraisal Institute of Canada and l'Ordre des évaluateurs agréés du Québec.

46. The Business Equity Valuation Program is responsible for advising as to the fair market value determinations of private and public securities, partnerships, proprietorships, copyrights, royalties, patents, goodwill, financial instruments and other business equities for tax purposes. It provides expert opinions on technical valuation and related issues, prepared in accordance with current professional standards and ethics, as set out by the Canadian Institute of Chartered Business Valuators.

47. The standards followed by each group promote and maintain a high level of public trust in professional valuation and appraisal practices by establishing requirements for various types of assignments. These standards cover ethical issues, which set out the requirements for integrity, impartiality, objectivity, independent judgement and ethical conduct. The reverse onus rule, once in effect, would only be invoked after the CCRA had used the above principles and methodology in arriving at a fair market value.

Reverse Onus Rule

48. As stated in paragraph 42, if the stated value of a property or service lies outside the range, a reverse onus rule will apply, which means the person who made the false statement must establish that the valuation was reasonable in the circumstances, made in good faith, and not based on unreasonable or misleading assumptions.

49. Until the percentages are prescribed in the regulations, the deeming provision is not effective. This means the CCRA will have to demonstrate that a false statement was made either knowingly, or in circumstances amounting to culpable conduct.

Multiple Assessments

50. Subsection (12) provides rules for the purpose of applying, to a person, the third-party civil penalties in section 163.2 of the ITA or section 285.1 of the ETA.

51. Paragraph (12)(*a*) applies to cases in which a person is assessed a planner penalty at a particular time regarding a specific planning or valuation activity, and another assessment of the penalty is made at a later time regarding the same activity. If the penalty is reassessed because the gross entitlements of the person are greater at the subsequent time, then under subparagraph (12)*(a)*(i), the reassessment of the penalty at that later time, which will amount to the net increase, is considered to be a separate penalty (for an example see paragraph 53). In any other case (i.e., the gross entitlements of the person are lesser at the subsequent time), the *Notice of Assessment* of the earlier penalty is deemed not to have been sent.

52. Paragraph (12)(*b*) excludes certain amounts from a person's gross entitlements (in respect of a planning or a valuation activity in which there is a false statement made or furnished by the person). In general, this rule operates to base each assessment of a penalty under the planner penalty for a false statement on the increase in gross entitlements of the person not counted in calculating the amount of the person's penalty previously assessed for the false statement. However, when the first *Notice of Assessment* is deemed not to have been sent by virtue of subparagraph (12)*(a)*(ii), paragraph (12)(*b*) does not apply to reduce the amount of the second assessment, since the original *Notice of Assessment* is deemed not to have been sent. As a result, the penalty amount on the second assessment in that case is based on the person's total gross entitlements at the time that *Notice of Assessment* is sent.

53. As an example, suppose that a person is assessed a planner penalty at a particular time in the amount of $10,000, which represents the amount of the person's gross entitlements from a planning activity at that time. At a later time, it is discovered that the person's gross entitlements from the same planning activity have increased to $25,000 and another assessment of a penalty is made at that later time, under subsection (2) against the person. The effect of subparagraph (12)(*a*)(i) in these circumstances is to deem the second assessment to be the assessment of a second penalty, and the effect of paragraph (12)(*b*) is to reduce the person's gross entitlements at the later time to $15,000, in order to take into account the previous assessment of $10,000. Thus, the end result is that the person is liable to pay two penalties: one of $10,000 as of the particular time, and another of $15,000 as of the later time.

54. As another example, suppose that the facts are the same as in paragraph 53, except that at the time of the first assessment the person's gross entitlements were $700. In that case, the person would have been assessed $1,000 under paragraph (3)(*a*) at that time (i.e., the minimum amount of the penalty). When the person is assessed at the later time,

paragraph (12)(*b*) reduces the person's gross entitlements at that later time by $1,000, the amount of the previous assessment of the penalty. As well, subparagraph (12)(*a*)(i) deems the second assessment to be the assessment of a second penalty. In these circumstances, the person would be liable to pay a penalty of $1,000 as of the time of the first assessment and would be liable to pay a second penalty of $24,000 (gross entitlements of $25,000 minus initial assessment of $1,000) at the later time.

55. In short, the amount of the gross entitlements used for the calculation of the second assessment is calculated by totaling the gross entitlements to date and reducing that amount by the penalty already assessed.

56. Subsection (12)*(c)* deals with the calculation of a preparer penalty. The amount of the gross compensation relating to the false statement is the total of the gross compensation to date less the amount of the preparer penalty already assessed.

Exemption for Employees

57. Subsection (15) provides that the third-party civil penalty provisions do not apply to an employee of the "other person" (i.e., the person who could use the false statement) referred to in the "planner penalty" or "preparer penalty." That is, an employee is protected by this exemption only for his employer's tax returns or information. It would not apply to the employees of the advisor or the tax return preparer. The exemption in subsection (15) also does not extend to employees who are engaged in excluded activities or who are specified employees (see paragraph 58). Under subparagraph (15)*(b)*, the conduct of the employee is attributed to the employer for the purpose of applying subsection 163(2) of the ITA or section 285 of the ETA (the gross negligence penalties) to the employer.

58. A "specified employee" of a person is defined in subsection 248(1) of the ITA to mean an employee of the person (the other person as described in paragraph 57) who is a specified shareholder of the person, or who does not deal at arm's length with the person. Essentially, a specified shareholder of a corporation is a person who owns, directly or indirectly, 10% or more of the issued shares of any class of the capital stock of the corporation or a related corporation. This definition applies to section 163.2 of the *Income Tax Act* and section 285.1 of the *Excise Tax Act*.

59. For certain corporate groups, employees of one corporation maintain the accounting records and do tax planning and tax return preparation for the entire corporate group. Such employees are not technically covered by the exemption provided in subsection (15) for their work related to other members of the corporate group. However, in such a situation, the CCRA would assess the preparer penalty against the employer (whether a resident or non-resident of Canada), and not the employee, since the employee would be considered to have engaged in conduct that resulted in a penalty situation in the course of the employee's employment duties. This policy will also apply to other groups of organizations that have consolidated their accounting or tax functions in one of the member organizations. The policy will not apply in either of the situations described above if the consolidation was done, or an employee was placed in the consolidated function, to avoid the third-party penalty or as part of a tax avoidance arrangement.

Burden of Proof

60. Under subsection 163(3) of the ITA and subsection 285.1(16) of the ETA, and aside from the reverse onus rule, once in effect, applicable to valuation activities, the burden of proof of the applicability of the third-party civil penalties will lie with the CCRA. The standard of evidence used for these third-party penalties is the balance of probabilities with the benefit of the doubt going to the third party (see paragraph 64 for additional comments).

Other Issues

Professional Standards and Terms of Engagement

61. The accountants' Notice to Reader communication, as described in the Canadian Institute of Chartered Accountants Handbook, is not considered to be an admission of indifference as to whether there is compliance with the ITA/ETA. In order for the civil penalties to apply, there must be a false statement made knowingly, or in circumstances amounting to culpable conduct, i.e., there are obvious inconsistencies, or the information supplied is obviously incorrect, incomplete, or otherwise unsatisfactory, with the result that the financial statements may be false or misleading. This determination would be made based on the facts.

62. A disclaimer of the tax return preparer's responsibility for information received from the client does not absolve the preparer from the penalties if the conditions for applying the penalties exist (described in paragraphs 7 and 9).

63. Failure to meet professional standards that give rise to sanctions by professional bodies or financial liabilities to a client because of negligence or malpractice would not necessarily result in the application of the third-party civil penalties. Each situation will have to be considered individually before any penalty assessment occurs. The CCRA would still have to prove that the person knew, or would reasonably be expected to know, but for circumstances amounting to culpable conduct, that there is a false statement that can be used for a purpose of the ITA/ETA.

64. As stated in paragraph 60, the burden of proof lies with the CCRA. The CCRA has to prove, on the balance of probabilities, that an advisor or tax return preparer knew of the false statement or that culpable conduct existed in a given situation. This can only be established by reviewing the facts of the situation.

Guidance to Practitioners

65. During consultations with practitioners, the CCRA was asked to provide guidance regarding best practices to minimize the risk of a penalty being applied. In response, and recognizing audits generally occur after the fact and the CCRA's attendant reliance on documentation, the following suggestions are offered:

- Record any information supplied by the client.
- Document any concerns about the truthfulness, accuracy, or inconsistency in the information supplied.
- Record questions asked about those concerns.
- Record the client's responses.
- Record any further discussions to clarify inconsistencies or contradictions.
- Document any research conducted and the results of such research.
- Record any assumptions made.
- Question the reasonableness of statements and assumptions.
- Record why the assumptions are reasonable.

66. On rare occasions, where a practitioner believes that he/she is being asked to use a statement that is clearly false or highly suspicious, and the client is rejecting the practitioner's advice, the practitioner should consider withdrawing from the engagement if he or she wishes to eliminate any possibility of the third-party penalty.

False Statements in Prior Years

67. If an advisor or tax return preparer finds himself or herself in a situation where he or she discovers that another person had made a false statement for tax purposes (e.g., he or she obtains a new client and finds that the previous accountant has made a false statement), the new advisor or tax return preparer would be expected to rectify the situation to the extent that the false statement affects the tax return of the current year. If the advisor or preparer advises his or her client to make a voluntary disclosure as described in Information Circular 00-1, *Voluntary Disclosures Program*, for the prior years, and the client does not follow this advice, the advisor or preparer is not exposed to the third-party civil penalties in respect of prior years. If the current-year return does not reflect the corrections (for example, an incorrect balance of an undepreciated capital cost schedule) because the taxpayer did not agree to it, and the advisor or preparer prepared the return knowing of the false statement, the advisor or preparer as well as the taxpayer may be subject to penalties. The advisor could be subject to the third-party civil penalties, and the person to whom the tax return belongs could be subject to a gross negligence penalty (subsection 163(2) of the ITA and section 285 of the ETA).

Persons Subject to Penalties

68. A corporation acts through its officers (i.e., employees including members of the board of directors); if an officer knew of the false statement, or was reasonably expected to know but for culpable conduct, both the officer and the corporation might be exposed to the penalties. For example, where a corporation may be engaged in planning and/or promoting or selling an abusive tax shelter with over-valuations or inflated costs, both the officers and the corporation could be exposed to the third-party civil penalties. Where the facts show that an employee had engaged in a situation subject to third-party penalties without the knowledge of the employer, only the employee will be subject to the penalties.

69. As stated in paragraphs 20 and 21, a partnership is a "person," therefore, the comments in paragraph 68 apply to a partnership and its partners. Hence, the third-party civil penalties may be assessed on a partnership as well as its partners and employees (i.e., of the advisor or the tax return preparer).

Price Adjustment Clause

70. Interpretation Bulletin IT-169, *Price Adjustment Clauses,* states that when a property is transferred in a non-arm's length transaction, the parties often include a price adjustment clause in the covering agreement under which the parties may agree that if the CCRA determines that the fair market value of the property is greater or less than the price otherwise determined in the agreement, that price will be adjusted to take into account the excess or the shortfall, provided that all of the following conditions are met:

- The agreement reflects a bona fide intention of the parties to transfer the property at fair market value and arrives at that value for the purposes of the agreement by a fair and reasonable method.
- Each of the parties to the agreement notifies the CCRA by a letter attached to the return for the year in which the property was transferred
  - •that he or she is prepared to have the price in the agreement reviewed by the CCRA according to the price adjustment clause,
  - •that he or she will take the necessary steps to settle any resulting excess or shortfall in the price, and
  - •that a copy of the agreement will be filed with the CCRA if and when required.
- The excess or shortfall in price is actually refunded or paid, or a legal liability therefore is adjusted.

71. The condition to file a letter attached to the return, as stated above, can be substituted. Administratively, the CCRA does accept a rollover form such as T2057, T2058 or T2059, filed with a "yes" answer to the question concerning the existence of a price adjustment clause as sufficient notice. Also, in circumstances where no form is required (e.g., section 86 or 51 of the ITA), the CCRA has stated that simply not notifying the CCRA does not prevent Interpretation Bulletin IT-169 from being applied if all of the other conditions are met.

72. If all the above conditions in paragraph 70 were met, there would not be a false statement made with actual knowledge or in circumstances amounting to culpable conduct since the parties (i.e., the vendor, the buyer, and the CCRA) have agreed to agree on a revised value of the property transferred. Hence, the third-party civil penalties under the ITA would not be applicable.

73. If the parties (i.e., the vendor, the buyer, and the CCRA) do not agree on a revised value of the property transferred, the price adjustment clause cannot be applied and there will be a false statement due to the difference between the stated value and the fair market value determined by the CCRA. However, in order for the third-party civil penalties to apply subject to the reverse onus rule described in paragraph 48, the CCRA must prove that the false statement was made knowingly or in circumstances amounting to culpable conduct.

Notices of Objection and Appeals to the Court

74. If after careful consideration of the representations made by the third party, it is decided that a third-party penalty is warranted and an assessment against the third party is issued, the normal objection and appeal procedures will apply.

75. The role of the Appeals Branch is to carry out fair and impartial reviews of objections to the CCRA's assessments. In the event that an objection in respect of the third-party penalty is not resolved at this stage, the third party has the option of appealing to the Tax Court of Canada and, as applicable, to higher courts.

76. There is no third-party penalty in the absence of a false statement. Where a taxpayer has filed a Notice of Objection relating to an assessment arising from a false statement (for which the planner or preparer has been penalized), it is the Appeals Branch's policy to hold the planner's or preparer's Notice of Objection in abeyance pending the outcome of the taxpayer's objection or appeal.

The General Anti-Avoidance Rule

77. The penalties are not intended to apply to arrangements by reason only of a determination that they are subject to the application of the general anti-avoidance rule (GAAR). The GAAR applies only if an arrangement is otherwise technically effective. This means that the particular filing position is based on true statements rather than false statements. Thus, the penalties cannot apply. However, if a person takes a filing position contrary to well-settled jurisprudence on an identical issue, the third-party civil penalties would be considered.

Non-Residents

78. The third-party civil penalty provisions apply to non-resident persons. For example, where an employee of a non-resident parent caused a Canadian company to file a return containing a false statement, the non-resident parent will be subject to the penalties as discussed in paragraphs 57 to 59.

Process

79. The CCRA intends to strictly control the application of the penalties. Procedural checks and balances are in place to ensure that no one person can direct the application of the penalties or otherwise inappropriately apply the penalties. In addition, the CCRA will establish a Headquarters review committee, the Third-Party Penalty Review Committee (TPPRC). It will include, for the foreseeable future, senior representatives from the CCRA's Compliance Programs Branch and Policy and Legislation Branch, and representatives from the Departments of Finance and Justice.

80. During the course of a regular audit, an auditor may discover circumstances that prompt consideration of the penalties. In such a situation, the auditor must first consult a manager or a senior member designated by management of the field office before a penalty audit is initiated.

81. When the management of the field office determines that it is appropriate to conduct an audit of the third party, it will consult orally or in writing with a member of the technical section in Headquarters that supports the TPPRC.

82. The member of the technical support section of the TPPRC will inform the field office whether the situation indicates an egregious circumstance that warrants further consideration.

83. Should Headquarters agree that the situation warrants audit, the field office must then inform the advisor/preparer that he or she will be audited for a possible penalty application.

84. At completion of the field work of the audit, and after consideration of the representations of the advisor/preparer, the field office will prepare a recommendation report as to whether penalties are appropriate in the situation. If the recommendation is to propose the penalty, this action must be supported by the management of the field office before being referred to the TPPRC. On the other hand, if the field office decides not to recommend a penalty, it must inform the advisor/preparer in writing and close the audit.

85. Headquarters will review the facts of each case including the representations of the third party before a penalty proposal is made to the third party. To this end, the members of the TPPRC will meet as necessary to consider penalty referrals.

86. If the recommendation by the field office is not endorsed by the TPPRC, it will notify the field office in writing. If, after review of the facts, the Committee does endorse the recommendation report, the field office will then send a proposal letter to the advisor/preparer regarding the

application of a penalty. The advisor/preparer then has 30 days to submit his or her response.

87. After the expiration of the 30-day period, the field office will send any representations received, in their entirety, along with the comments of the field office to the TPPRC.

88. Upon review of the complete representations and the penalty recommendation report, the TPPRC will either seek additional information or provide its decision to support or reject the recommendation of the field office.

89. The advisor/preparer will be informed, in writing, of the final decision. If the TPPRC decides not to support the application of the penalty, the advisor/preparer will be advised in writing. Otherwise, an assessment pertaining to the penalty will be issued.

90. Where an auditor envisages the application of section 239 of the ITA or section 327 of the ETA, the case would be referred to the Investigation Division of the local tax services office and the above process would be replaced by the investigation process. If circumstances warrant the application of the penalty, the Investigations Division will make the referral to the TPPRC in a manner and timing that is appropriate in the context of the investigation.

91. The CCRA is prohibited by section 241 of the ITA and section 295 of the ETA from disclosing to the taxpayer any information relating to the advisor or tax return preparer. Consequently, at no time will the taxpayer be informed that the CCRA is gathering information to determine whether the taxpayer's advisor or tax return preparer could be subject to the penalty.

Periodic Update

92. The CCRA is committed to providing the tax community with periodic updates on the CCRA's experience in applying the penalties either directly at practitioner events, or through information provided to various groups in writing.

APPENDIX – EXAMPLES

The following examples consider only the possible application of the third-party penalties. As a result, the CCRA is limiting its comments to civil penalties that could be assessed. Any other tax issues that may arise out of these examples are not considered.

Situations Where the Penalty Would Generally Not Apply

Example 1: Good Faith Reliance on Client's Information

A newly acquired client, who is self-employed, brings to his accountant a listing of his business expenses. The client also provides the accountant with a figure for his total revenue. He instructs his accountant to prepare an income statement and his tax return based on this information. The accountant has a quick look at the expenses. The expenses seem to be related to the type of business of the client and nothing stands out as obviously unreasonable. After the client's income statement is prepared, it reflects $80,000 of revenue and $55,000 of expenses and the income tax return is filed on that basis.

Upon audit, the CCRA finds a large proportion of the expenses claimed cannot be substantiated by adequate documentation and may not have been incurred. Furthermore, the reported revenue is only half of actual revenue.

Comments

In view of the business that the taxpayer is in, there was nothing in the income statement that would have made the accountant question the validity of the information provided to him. Therefore, he could rely on the good faith reliance exception and would not be subject to the preparer penalty.

Example 2: Reliance on Information Provided by Another Professional

An accountant relies on the financial statements prepared by another professional accountant to report his client's self-employment income. The statements did not look obviously unreasonable. The CCRA conducts an audit and discovers that the income statement contained material misrepresentations.

Comments

Although the tax return contains one or more false statements, the accountant would be entitled to the good faith defense since he relied, in good faith, on information (the financial statements) provided by another professional on behalf of the client that was not obviously unreasonable. Therefore, he would not be subject to the preparer penalty.

The third-party penalties may be applied to the other accountant if he knew or would be expected to know, but for circumstances amounting to culpable conduct, that the financial statements contained a false statement.

Example 3: Honest Error

Near the midnight deadline on April 30, a T1 is prepared and filed. Due to the hurry in meeting the statutory deadline, and confidence in the qualifications of the senior personnel who prepared the return, the return is filed without normal review. During an audit, it is discovered that carrying charges were misstated because of an apparent recording error. The actual amount of $1,098 was claimed as $10,098.

Comments

This situation would not warrant the application of the third-party civil penalties. While the preparer might have been negligent in making the error, his actions were, in the circumstances, neither tantamount to intentional conduct nor was he showing an indifference as to whether there was compliance with the law.

Example 4: Reconciling Inconsistent Information

An accountant who lives in an expensive neighbourhood notices that the house next door has just been sold. It was listed for $1 million. The accountant introduces himself to the new neighbour and they become friends. At tax time the friend hires the accountant to prepare his return. The accountant is given a T4 with $25,000 in income reported. Thinking that the gross income is on the low side, the accountant asks if this is all the income he has and the friend replies that it is so. The accountant is still not satisfied with the answer as the income seems to be out of proportion with the living standard of the friend, so he then asks him if he has received money from any source other than his employment and the friend replies that he received an inheritance from his mother last year. The accountant does not ask any further questions but prepares and files the return. When the taxpayer is audited it is discovered that he has over $200,000 in income.

Comments

The accountant would not be subject to the penalties for participating or acquiescing in the understatement of a tax liability. The facts were highly suspect until the accountant asked questions to clear up the doubt in his mind that the client was not presenting him with implausible information. The response addressed the concern and was not inconsistent with the knowledge he possessed.

Example 5: Following CCRA Administrative Policy

Xco is a small business, usually with less than $200,000 annual income. When preparing financial statements after the year-end of the business, the external accountant determines taxable income to be $250,000, and books a bonus payable of $50,000 to be paid to the principal shareholder-manager. The tax return is prepared and filed on this basis since the general practice of the corporation is to distribute the profits in the form of bonuses.

Comments

In general, the CCRA does not challenge the reasonableness of salaries and bonuses paid to the principal shareholder-managers of a corporation when:

(a) the general practice of the corporation is to distribute the profits of the company to its shareholder-managers in the form of bonuses or additional salaries; or

(b) the company has adopted a policy of declaring bonuses to the shareholders to remunerate them for the profits the company has earned that are, in fact, attributable to the special know-how, connections, or entrepreneurial skills of the shareholders.

The above-mentioned policy also applies to the first year of operations of a business.

Bonuses paid to shareholders other than principal shareholder-managers will be subject to the normal test of reasonableness.

In view of the above, the preparer penalty would not apply.

Example 6: Making Sufficient Inquiries

A tax advisor is a partner in a firm that has a particular corporate client. The client has recently increased the royalty payments to its non-resident parent company as instructed by its parent company. The tax advisor suspects that the deduction of royalties might be unreasonable because of the large increase over the previous year. The advisor reviews the client's records and discusses the issue with the client. Based on the review and the discussion, the advisor is satisfied that the deduction is reasonable and files the corporate tax return on that basis.

Subsequently, an audit of the corporation determines that the company did not satisfy the requirements of subsection 247(4) of the ITA, as it failed to establish that reasonable efforts were made to determine and use arm's length transfer prices on the royalties. The royalties adjustments for the year are in excess of 10% of the company's gross revenues.

Comments

The tax advisor was suspicious of the information provided by the client. Therefore, he reviewed the client's records and had a discussion with the client. The advisor was satisfied with the inquiries. Although the CCRA came to a different conclusion in a subsequent audit, it was satisfied that the false statement was not made knowingly or in circumstances amounting to culpable conduct. The tax advisor had made sufficient enquiries. Furthermore, his response to the answers provided by the corporate client did not show an indifference to compliance with the ITA.

The corporate client may be subject to the transfer-pricing penalty under subsection 247(3), since he failed to make reasonable efforts to determine and use arm's length transfer prices on the royalties. Before the transfer-pricing penalty can be proposed, the matter must be approved by the Transfer Pricing Review Committee.

Example 7: Discussion Regarding Voluntary Disclosure

An advisor is asked by a new client to discuss a potential voluntary disclosure with the CCRA on a no-name basis, to determine the implications of making a voluntary disclosure with respect to prior year income omissions. The advisor is informed of the implications of making the disclosure, including the estimated income tax and related interest liability, by a Voluntary Disclosure Program officer. The client is informed by the advisor and decides not to proceed with the voluntary disclosure.

Comments

In this situation, the advisor would not be subject to the third-party penalty. The advisor is not responsible for the omissions in the prior year income tax returns, notwithstanding that the advisor is aware of the omissions and may have advised the client to proceed with the voluntary disclosure. However, as stated in paragraph 67, the advisor would be expected to rectify the situation to the extent that the false statement affects the tax return of the current year.

Situations Where the Penalty Could Apply

Conduct That Is Tantamount to Intentional Conduct

Example 8: Deliberate Over-Valuation in a Tax Shelter-Like Arrangement

A promoter sells a tax shelter-like arrangement to individual taxpayers involving 10,000 pieces of art.

Each taxpayer acquires one piece of art for its fair market value of $100. The valuator is aware of this information but agrees to appraise each art piece at $1,000.

Concurrently, the promoter solicits a registered charity that agrees to accept the art as a charitable donation and issue a charitable donation receipt in the amount of the appraised value ($1,000 per art piece). This charity immediately auctions off the art to the highest bidder, and the price paid reflects the $100 value per piece.

A tax return preparer, who does not have any direct knowledge of the false statement, prepares the income tax return of his client, who had acquired and donated art making use of the above-mentioned arrangement.

The CCRA conducts a review of the client's return and determines that it contains a false statement (the over-valuation of the property donated).

Comments

The promoter organized an arrangement that he or she knew included a false statement (i.e., about the discrepancy between $100 value of the art and the issuance of $1,000 charitable donation receipts), so the CCRA would consider assessing the promoter with the planner penalty.

The valuator has furnished false statements knowingly relating to the arrangement and is liable to the penalties unless he can prove the stated value was reasonable in the circumstances, and that the statement was made in good faith.

If the charity knew, or would have reasonably been expected to know but for circumstances amounting to culpable conduct, that the valuations were incorrect, it would be liable for the penalties for issuing false receipts.

Although the tax return did contain a false statement, the tax return preparer did not know of the false statement, nor would he reasonably be expected to know but for circumstances amounting to culpable conduct. As a result, the preparer would not be assessed a third-party civil penalty.

Example 9: Deliberate Over-Valuation in an Abusive Tax Shelter

A company is selling units in a limited partnership tax shelter. The company had acquired software for $50,000 on the open market and transferred it to the limited partnership on the same day for $10,000,000. The prospectus prepared by the company states that the fair market value of the software is $10,000,000 and is supported by an appraisal. The tax shelter is registered with the CCRA and is available as an investment opportunity in the current year. The company's gross entitlements are $2,000,000.

The CCRA reviews the tax shelter and determines that the fair market value of the software on the day of transfer into the limited partnership is $50,000. The appraisal supporting the $10,000,000 value was prepared by an independent appraiser. However, it was not prepared using normal valuation principles. The appraiser informed the CCRA that all his calculations were based on the assumptions and other relevant facts provided to him by the company. The appraiser was paid $75,000 for the appraisal.

Comments

The prospectus prepared by the company contains a false statement (overstated fair market value of the software) that could be used for tax purposes. The company knew or would reasonably be expected to know, but for culpable conduct, that the fair market value of the software was a false statement. Since the company is engaged in an excluded activity, it cannot rely on the good faith reliance exception with respect to the valuation. The CCRA would consider assessing the company with third-party penalties in the amount of $2,000,000 (i.e., the gross entitlements). The CCRA would also consider assessing the appraiser with third-party civil penalties. The amount of the penalty would be his gross entitlements from the valuation activity, which is $75,000.

Example 10: Promotion Involving a False Statement

A person is selling GST/HST exemption cards to consumers. For a payment of a certain amount, a consumer would receive a card that states the cardholder is entitled to purchase goods and services free of GST/HST.

Comments

The person selling the GST/HST exemption cards is reasonably expected to know that the GST/HST exemption card does not entitle the consumers to purchase goods and services free of tax. In providing such assurance and issuing the card, the person is making a false statement either knowingly or in circumstances amounting to culpable conduct. Consequently, the CCRA would consider assessing the person with the third-party civil penalties such as the planner penalty. The person's gross entitlements for the purposes of calculating the planner penalty are the total of all amounts he is entitled to collect from the sale of the GST/HST exemption cards.

Example 11: Promoting Non-Compliance With the ETA

An organization is advocating the position that the GST/HST is unconstitutional, and, therefore, people should not pay, collect, or remit the GST/HST. The organization makes presentations and publishes a number of publications containing statements of that nature.

Comments

The statement that the GST/HST is unconstitutional is clearly a false statement. This matter has been considered in a number of court cases including *Winterhaven Stables Ltd. v. Attorney General of Canada* [1988] 53 D.L.R. (4th) 413 (Alta. C.A.*), Jean-Maurice Charbonneau v. Minister of National Revenue*, 96 DTC 6058 (FC-TD), *and Jean-Luc St-Laurent v. Her Majesty the Queen*, 97 DTC 532. A person would know, or would reasonably be expected to know, that the statement is a false statement. The CCRA would consider assessing the person who has made the false statement with the third-party civil penalty. In the absence of gross entitlements (e.g., revenues from the sale of publications containing false statements), the minimum penalty amount of $1,000 would apply.

Conduct Which Describes an Indifference as to Whether There Is Compliance With the Legislation

Example 12: Indifference When There Is a Lack of Information Submitted

A taxpayer approaches a tax return preparer to prepare and e-file his tax return. Prior to this, the tax return preparer and his firm did not provide any services to the taxpayer and they did not know each other.

The taxpayer provides the tax return preparer with a T4 slip indicating that the taxpayer has $32,000 of employment income, which represents his sole source of income.

The taxpayer tells the tax return preparer that he made a charitable donation of $20,000 but forgot the receipt at home. The taxpayer asks that the tax return preparer immediately prepare and e-file the tax return without obtaining the receipt.

Comments

On these facts, if the tax return preparer were to prepare and e-file the taxpayer's return without obtaining the charitable donation receipt, the CCRA would consider assessing the tax return preparer with the preparer penalty. Given that the quantum of the deduction is so disproportionate to the taxpayer's apparent resources as to defy credibility, to proceed unquestioningly in this situation would show wilful blindness and thus an indifference as to whether the ITA is complied with.

Example 13: Information a Tax Preparer Is Reasonably Expected to Know

An annual GST/HST return filer informs her accountant that she has not kept records of the GST/HST paid or payable on her business purchases for the year. The accountant informs her that he would make an input tax credit (ITC) claim based on the financial statements of her business.

The accountant applies a factor of 7/107 (as the filer is located in a non HST-participating province) to all expenses shown in the income statement. This includes the cost of sales and all acquisitions shown in the balance sheet. The amounts are reasonable and have been incurred. The income statement includes a large amount of payroll expenses (incurred in the non HST-participating province) and interest expense on which GST/HST is not paid or payable.

The cost of sales includes a large proportion of purchases that are zero-rated. The accountant applies the 7/107 factor to payroll, interest, and zero-rated purchases. This results in an overstatement of input tax credits reported on the GST/HST return.

Comments

The factors in paragraph 17 would be considered in determining whether the preparer penalty would be applied. The accountant is expected to know that GST is not payable on most of payroll expenses, interest expenses, and zero-rated purchases. In filing a claim that includes the above items, the accountant made a false statement, either knowingly, or in circumstances amounting to culpable conduct. Consequently, the CCRA would consider assessing the accountant with the third-party civil penalty, specifically, the preparer penalty.

Example 14: Deliberately Overstated Tax Credits

An experienced tax practitioner prepares a Scientific Research and Experimental Development (SR&ED) claim on behalf of a client. The practitioner's fee is based on the total investment tax credit claimed by the claimant. The work claimed is properly defined and therefore eligible as a SR&ED activity; however, the allocation of the company's expenses to the subsection 37(1) of the ITA SR&ED expenditures is obviously inflated and is material in nature. Although the costs were incurred, most of the costs are not attributable to SR&ED activities.

Comments

The SR&ED claim contains a false statement (inflated allocation of SR&ED expenditures). If the tax practitioner knew or would reasonably be expected to know, but for culpable conduct, that the claim contains a false statement, the CCRA would consider assessing the tax practitioner with the preparer penalty.

Conduct Demonstrating a Wilful, Reckless, or Wanton Disregard of the Law

Example 15: Ignoring a Court Decision

An accountant has several clients who have been reassessed for a tax shelter. The accountant knows that the CCRA is challenging the tax benefits claimed for the tax shelter on the basis that the shelter is not a business, is based on a significant over-valuation of the related property and, alternatively, is technically deficient.

The Tax Court of Canada, in a test case (general procedure), denies deductions claimed for the tax shelter in a previous year by a client of the accountant (i.e., the client's appeal is dismissed). The case is not appealed and the accountant is aware of the Court's decision.

The accountant prepares and files a tax return on behalf of a different client that includes a claim for the same tax shelter that the Tax Court determined was ineffective.

Comments

On these facts, the CCRA would consider assessing the accountant with the preparer penalty. However, if the accountant had determined, and was able to demonstrate that the fact situation was different or there was a reasonable basis upon which the Tax Court decision could be overturned by a higher court, the penalty would not apply.

Example 16: Indifference Regarding Personal Expenses Claimed as Business Expenses

An accountant receives a box of personal and business receipts from his client and agrees to prepare a business expense statement for him. The accountant includes the $10,000 cost of the client's family vacation (which he knew to be a non-deductible personal expense) as a business expense in the client's tax return.

The accountant prepares and finalizes the client's tax return and advises the client that he will be receiving a $5,000 tax refund. The client signs and files the tax return.

The CCRA conducts an audit and discovers the $10,000 of personal expenses deducted in the client's tax return. The auditor also discovers that the families of the accountant and the client vacationed together. Therefore, the accountant knew the expense was personal at the time he included it in the business expenses.

Comments

The CCRA would consider assessing the accountant with the preparer penalty because the return was prepared and filed despite his knowledge of the false statement. Also, the CCRA would consider applying the gross negligence penalty (subsection 163(2) of the ITA) to the client in whose tax return the false statement was made.

Example 17: Income Splitting When Services Are Not Rendered

Financial statements and tax returns for Familyco are prepared by an accountant. Familyco pays salaries to all family members, two of whom are in university and one of whom lives outside Canada. The taxpayer informs the accountant that the family meets a few times a year to discuss company business.

Comments

Generally, reasonableness of salaries to family members who provide services in the course of the business is not an issue that would be subject to the third-party civil penalties. In extreme situations these penalties may apply. Where family members have provided no services and the accountant knows this fact, the preparer penalty would be considered.

If the accountant did not know, but would be reasonably expected to know of the false statement, one needs to determine if the accountant's action resulted in culpable conduct. Facts to be considered with regard to whether the penalties would be applied include those listed in paragraph 17.

Example 18: Possible Wilful Blindness

An advisor is responsible for the filing of returns of a group of related subsidiary companies. He is employed by one of the companies in the group. The transfer prices used have been provided by the foreign parent and the advisor does not know they are appropriate for Canadian income tax purposes. He makes a request of each Canadian company to provide details of their pricing decisions. Some companies respond that the documents and records they maintain for transfer pricing purposes satisfy the requirements of subsection 247(4) of the ITA. Others, whose transfer prices had increased significantly from prior years, indicate that although they do not maintain documents and records in accordance with the requirements of subsection 247(4), they believe they would be able to justify the transfer prices.

An audit of one of the subsidiaries (the advisor is not employed by the subsidiary audited) results in net transfer pricing adjustments for the year in excess of 10% of the company's gross revenue. It is further determined that the company did not satisfy the requirements of subsection 247(4), as it failed to establish that reasonable efforts were made to determine and use arm's length transfer prices or allocations.

Comments

Whether the penalties are applied would depend on whether there is culpable conduct. The criteria stated in paragraph 17 would be used to determine if the penalties are applicable. In the situation at hand, the advisor knew that certain members of the related group were not complying with the documentation requirements of subsection 247(4). The advisor also knew that the transfer prices of the goods and services supplied by these companies to their Canadian subsidiaries had significantly increased from prior years. In view of these facts, it appears that the advisor might have been wilfully blind in not pursuing the matter further. The employer of the internal advisor is at risk if his employee (the internal advisor) was wilfully blind to the fact that the transfer prices might be incorrect and the return was filed notwithstanding that knowledge.

Regarding the applicability of the employee exemption, the internal advisor is not an employee of the company that was reassessed. Therefore, in law, the subsection 163.2(15) exemption would not be available to the internal advisor. However, if a penalty were to be applied, it would not be applied to the internal advisor but to his employer as per paragraph 59. The non-resident parent participated in the making of the false statement (as it initiated it), and therefore, it may also be subject to the third-party civil penalty. Employees of the non-resident parent would have the same protection as the internal advisor.

The corporate client may also be subject to the transfer-pricing penalty under subsection 247(3), since it failed to make reasonable efforts to determine and use arm's length transfer prices on the goods and services. Before the transfer-pricing penalty can be proposed, the matter must be approved by the Transfer Pricing Review Committee.

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