Neglect Is Not Just Unreported Income

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By virtue of subparagraph 152(4)(a)(i), when a taxpayer has made any misrepresentation that is attributable to neglect, carelessness, or wilful default in filing a return or supplying any information under the Act, a reassessment can be made notwithstanding the expiry of the normal reassessment period. There are therefore two prerequisites to the application of the subparagraph: (1) a misrepresentation and (2) neglect, carelessness, or wilful default. Early jurisprudence held that an incorrect statement is a misrepresentation (Foot, 66 DTC 5072 (SCC)). Neglect is established if the taxpayer has not exercised reasonable care, and the care exercised must be that of a "wise and prudent person" (Venne, 84 DTC 6247 (FCTD) and Regina Shoppers Mall, 90 DTC 6427 (FCTD)). Although section 11.3.7 of the CRA Audit Manual mentions the standard of a "wise and cautious taxpayer," the discussion in the manual suggests that it is the number of transactions for which income has been understated, or a single improperly recorded or omitted transaction involving a material amount of income, that is key, at least for CRA audit purposes. Three recent cases are summarized below.

It is not difficult to make a mistake in a return and thereby create a misrepresentation. But as explained above, neglect is required in order to extend the reassessment period. There is no neglect if the taxpayer acts as a "wise and prudent person." College Park Motor Products (2009 TCC 409) addresses this standard. The taxpayer was part of an associated group of corporations. Large corporations tax should have been paid, which would have eroded the taxpayer's right to the small business deduction. Questions on the inside jacket of the T2 return (for example, "Is the corporation subject to gross Part I.3 tax?") were incorrectly answered. The incorrect answers were held to be a misrepresentation. The court noted that while the owner of the taxpayer was not a lawyer or an accountant, if he had reviewed the draft return prepared by the accountant as carefully as a "wise and prudent taxpayer" would have done, then he would have read the questions on the inside jacket, seen the questions regarding the LCT, and asked his accountant about them. Although the taxpayer argued that the neglect that led to the misrepresentation was that of the accountant who prepared the return, the court did not accept that argument. On the basis of College Park Motor Products, the threshold for the application of subparagraph 152(4)(a)(i) seems low--a listed question on the return should have caused the taxpayer to ask more questions, and an incorrect answer coupled with the taxpayer's failure to inquire extended the reassessment period. The case is under appeal.

O'Dea (2009 TCC 295) involved a complicated limited partnership structure with at-risk amount and limited-recourse debt issues. A number of partners were reassessed on varying grounds, and the cases were heard together. Two of the limited partners were passive investors and had not been involved in the initial structuring details. They were reassessed to deny the deduction of partnership losses beyond the normal reassessment period on the basis of subparagraph 152(4)(a)(i). They stated that they had relied on the offering memorandum, which contained a tax opinion regarding the deductibility by the partnership of certain expenses, and on statements received from the partnership regarding deductible losses. The evidence at trial did not substantiate the full amount of the partnership expenses in the year, and accordingly the amount of the partnership losses was reduced. The court held that the individuals acted in a reasonable and prudent manner in their reliance on the tax opinion and the statements received. Thus, although there may have been a misrepresentation of the amount claimed as losses, the court found that this misrepresentation was not attributable to the individuals' neglect or carelessness.

In O'Dea, the taxpayer successfully claimed reliance on his accountant; in College Park Motor Products, a similar claim was unsuccessful. The two cases can be reconciled on the basis that the individual taxpayers in O'Dea were not the equivalent of the owner-managers who failed to make inquiry of their advisers, but were arm's-length investors who relied on tax opinions and information received. In O'Dea, the court noted that investors who rely on the professional opinions given in offering documents should not be required to personally investigate the technicalities of the structure. Thus, because the documents presumably opined on the deductibility of items at the partnership level, there was no failure to exercise reasonable care when the investor relied on the statements of loss received from the partnership in filing his return. In contrast, College Park Motor Products suggests that the owner-manager of a corporation should not assume that the corporate return is correct and must review and make inquiries of the tax preparer. The owner-manager will have access to the relevant information, whereas an investor (as in O'Dea) may not.

In Dalphond (2009 FCA 121), the FCA upheld the TCC decision that the taxpayer, by claiming the capital gains exemption on a share disposition, had made a misrepresentation in his return attributable to neglect. The taxpayer was a knowledgeable investor; he was the former manager of a pension fund with significant assets. The taxpayer claimed the capital gains exemption on the sale of shares of a corporation that was a CCPC at the time of purchase. The shares were not listed on a prescribed exchange but were traded on the Canadian Dealing Network; therefore, the corporation was not a public corporation. However, it had ceased to be a CCPC at the time of sale because of a prior merger with a subsidiary of a US corporation. The taxpayer cited a newspaper article as support for claiming the capital gains exemption. The TCC (2008 TCC 427) said, "The article said that Contour Telecom was a Canadian corporation, which made the sale eligible for a capital gains exemption of up to $500,000." However, the taxpayer disposed of shares of the merged corporation, not shares of Contour Telecom. Regarding the merger, the taxpayer acknowledged that he might have received documentation, "but he did not read everything." The TCC found that the taxpayer did not make due inquiry before claiming the exemption, and this point was affirmed on appeal. The Tax Court also had some negative comments regarding the manner in which the taxpayer prepared his tax return (some forms were missing and some calculations were incomplete), all of which may have coloured the court's decision. Dalphond, like College Park Motor Products, illustrates that the taxpayer has a duty to make inquiries in order to avoid the application of subparagraph 152(4)(a)(i).