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Should Taxpayers Be Penalized for Their Accountant's¹ Lack of Due Diligence: A Criminal Lawyer and a Tax Lawyer Both Say No!

Part II²

David H. Sohmer and Suzanne Costom

Examples from the case law

The case of *Canadian Dredge & Dock Co. v. The Queen*³ stands for the principle that "in the criminal law, a natural person is responsible only for those crimes in which he is the primary actor either actually or by express or implied authorization. There is no vicarious liability in the pure sense in the case of a natural

person..."⁴ Where the accused is a corporation, since corporations must act through people, it will be held responsible for acts committed by those individuals forming the "directing minds" of such corporation. This is known as the identity doctrine and it can be distinguished somewhat from the concept of vicarious liability. Clearly, a tax preparer cannot be considered the "directing mind" of the client for whom it prepares tax returns.

Furthermore, while *Canadian Dredge & Dock Co.* dealt specifically with true crimes (*mens rea* offences), courts have held that it offends the principles of fundamental justice to impose vicarious liability even for strict liability offences. This flows clearly from the statement made by Justice Lamer in *Reference re s. 94(2) of the Motor Vehicle Act (British Columbia)* that "a law that has the potential to convict a person who has not really done anything wrong offends the principles of fundamental justice..."⁵

Some examples of the successful presentation of a "due diligence" defence include the case of *Pacifica*

1 The term "accountant" loosely refers to a third party tax preparer.
2 Part I of this article appeared in the immediate preceding issue of *The Canadian Taxpayer*.
3 [1985] 1 S.C.R. 662, 1985 CarswellOnt 96. See <http://scc.lexum.org/en/1985/1985scr1-662/1985scr1-662.html>.

4 *Ibid.*, at para. 31.
5 [1985] 2 S.C.R. 486, at para. 2. See <http://scc.lexum.org/en/1985/1985scr2-486/1985scr2-486.html>.

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Editor: Arthur B. C. Drache, C.M., Q.C.
Content Editor: Steve Hostetter
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Editorial Offices:
226 Maclaren St., Ottawa K2P 0L6
Phone: (613) 237-3300 x11
Fax: (613) 237-2786
Email: adrache@drache.ca
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One Corporate Plaza, 2075 Kennedy Road,
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conditions constituting a violation of s. 36 of the Act. The impugned act was carried out by a contractor hired by Pacifica to dig an excavation pit.

In evaluating whether or not Pacifica could benefit from the “due diligence” defence, it was not the act of the contractor that was examined, but rather the behaviour of Pacifica. The Court’s determination that Pacifica had in fact acted with due diligence was based on the fact that Pacifica “provided environmental awareness programs and insisted that its employees be kept abreast of environmental issues relating to the mill, thus establishing a proper system to prevent environmental harm and taking reasonable steps to ensure effective operation of the system”; had taken “reasonable steps to ensure that the contractor... was reputable and did good quality work before hiring them”; and had taken steps to avoid harm “by using a reliable contractor, and providing clear instructions about where the water should be pumped(...)”.⁸ Furthermore, the behaviour of the contractor’s employees “could not be reasonably anticipated by Pacifica” as their instructions were clearly ignored.⁹

In the case of *Emil K. Fishing Corp.*,¹⁰ the British Columbia Court of Appeal upheld an acquittal which had been based on a finding of due diligence. The defendant corporation was engaged in the business of commercial fishing. On the date of the commission of the alleged offence, the fish caught amounted to 37,787 pounds. This included 653 pounds of species of fish that were not authorized to be caught and ought to have been segregated and returned to the sea. This “incidental catch” was considered to be beyond acceptable limits and the defendant was charged with “unlawfully retaining and unlawfully possessing incidental catch” of prohibited species of fish.

The accused corporation had hired a skipper to operate the vessel on the date in question. The Court was called upon to assess whether or not the accused could avail itself of the due diligence defence. In doing so, it examined the behaviour of the accused corporation and concluded that it had indeed acted with due diligence and should therefore be acquitted.

*Papers Inc.*⁶ where the British Columbia Provincial Court concluded that there was evidence on which to base a finding that Pacifica was duly diligent on a balance of probabilities.⁷ This was a prosecution pursuant to the *Fisheries Act* alleging that Pacifica “deposited or permitted to be deposited, a deleterious substance” in water (count 1) and on the road surface (count 2) in

6 *R. v. Pacifica Papers Inc.*, 2002 BCPC 265, 2002 CarswellBC 1317. See <http://www.canlii.org/en/bc/bcpc/doc/2002/2002bcpc265/2002bcpc265.html>.

7 Strictly speaking, this finding was *obiter* as the Court concluded that the *actus reus* of the offence had not been made out.

8 *Supra*, note 5 at para. 135 ff.

9 *Ibid.*, at para. 144.

10 *R. v. Emil K. Fishing Corp.*, 2008 BCCA 490, [2008] B.C.J. No. 2326. See <http://www.canlii.org/en/bc/bcca/doc/2008/2008bccca490/2008bccca490.html>.

The Court found that the accused had equipped the vessel with appropriate equipment to allow the crew to segregate fish and return them to the sea. It also determined that the company “took all reasonable steps to hire a competent crew and to instruct the crew to take due care to avoid infraction”.¹¹ These findings were sufficient to sustain the due diligence defence.

The Court explicitly rejected the argument put forward by the Crown to the effect that the accused corporation was “vicariously liable” for the negligence of its employees aboard its ship. Indeed, the Crown argued that unless the accused was able to show that its employees exercised due diligence, the corporation should be found guilty of the offence.

Quoting both the passage reproduced in Part I from *R. v. Sault Ste. Marie*,¹² as well as the case of *Canadian Dredge & Dock Co.*,¹³ the British Columbia Court of Appeal flatly rejected this submission that the accused could be convicted based on vicarious liability.¹⁴

Application of principles to tax law

As we have seen in the passage quoted from *Roberts*,¹⁵ since 1997 tax courts have evaluated the due diligence of tax return preparers, instead of that of the taxpayer, in order to determine whether the due diligence defence will be available to shield the taxpayer from the imposition of penalties. This is mistaken, for it is clear from non-tax jurisprudence that it is the behaviour of the taxpayer which must be examined.

With respect, the position set out in *Roberts* to the effect that “the accountants are after all the appellant’s agents and the appellant is responsible of what they did or failed to do...”¹⁶ erroneously imports notions of vicarious liability stemming from tort law to the realm of criminal and penal law.

It is not only principles of fundamental justice which dictate that due diligence be accepted as a defence. One of the roles of the judiciary is “to keep the common law in step with the dynamic and evolutionary fabric of our society”.¹⁷ CRA statistics demonstrate that the engagement of a tax professional is now regarded by society as the norm.

Total returns processed – from 2012-02-13 to 2012-06-11 ¹⁸		
Filing method	Number of returns	% of total
EFILE	10,989,807	45%
NETFILE	5,330,438	22%
TELEFILE	311,065	1%
Total – electronic	16,631,310	68%
Paper	7,784,744	32%
Total – all methods	24,416,054	100%

Since most e-filed returns and a portion of paper-filed returns are prepared by third parties, it is evident that a majority of Canadian taxpayers now have their returns prepared by third parties. The main purposes for so doing are to minimize tax and to minimize the risk of non-compliance, both of which are directly related to the complexity of tax law.

It is also arguable that for a substantial number of taxpayers, due diligence dictates that professional tax advice be sought. In the case of *Douglas v. R.*,¹⁹ Justice Woods implied as much when she stated:

Further, it is not reasonable to expect Mr. Douglas to have sought professional tax advice concerning the T1135 given that his income was low.²⁰

Conclusion

While each case is unique, we suggest that the following facts will be particularly relevant:

- Has the taxpayer hired a reputable and competent professional?
- What verifications did it make before hiring that person? For example, did it verify references or relevant experience?

¹¹ *Ibid.*, at para. 23.

¹² [1978] 2 S.C.R. 1299, 1978 CarswellOnt 24. See <http://scc.lexum.org/en/1978/1978scr2-1299/1978scr2-1299.html>.

¹³ *Supra*, note 2.

¹⁴ See also the case of *R. v. Mitchell*, 2011 SKPC 42, [2011] S.J. No. 139 (Sask. Prov. Ct.) which makes a statement to the same effect at para. 41. See <http://www.canlii.org/en/sk/skpc/doc/2011/2011skpc42/2011skpc42.html>.

¹⁵ *Roberts v. R.*, 1997 CarswellNat 1131, (sub nom. *Roberts v. Canada*) [1997] G.S.T.C. 58, 5 G.T.C. 1146, [1997] T.C.J. No. 771.

¹⁶ *Ibid.*, at para. 9.

¹⁷ *R. v. Salituro*, [1991] 3 S.C.R. 654, at page 670. See <http://scc.lexum.org/en/1991/1991scr3-654/1991scr3-654.html>.

¹⁸ Canada Revenue Agency, “Individual income tax return statistics for the 2012 tax-filing season”, Newsroom bulletin (Date modified: 2012-06-11), online: <http://www.cra-arc.gc.ca/nwsrm/t1stts-eng.html>.

¹⁹ 2012 CarswellNat 479, 2012 TCC 73 (T.C.C. [Informal Procedure]). See <http://www.canlii.org/en/ca/tcc/doc/2012/2012tcc73/2012tcc73.html>.

²⁰ *Ibid.*, at para. 16.

- Did the taxpayer provide the professional with all appropriate and necessary information? Was the information that was provided clear and unambiguous?
- Did the taxpayer have the opportunity to correct the mistake? Did they review the tax return with appropriate attention?
 - In this regard, the particular characteristics of the taxpayer may be relevant. A sophisticated taxpayer with training or knowledge in tax or finance would be expected to catch errors that an “ordinary” taxpayer would not.
 - The nature of the mistake will also become relevant in this regard. For example, the failure to include a multimillion dollar asset or revenue source on a tax return will be more readily ascertainable than a more minor, technical error.
- Did the taxpayer rely on the tax preparer’s expertise in good faith?

Since principles of fundamental justice are universal, it is of more than passing interest that these guidelines conform to the American position as reflected in the case of *Petitioners v. Commissioner of Internal Revenue*,²¹ where the United States Tax Court stated:

As we stated in *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43, 99 (2000), affd. 229 F.3d 221 (3d Cir. 2002):

“for a taxpayer to rely reasonably upon advice so as possibly to negate a section 6662(a) accuracy-related penalty determined by the Commissioner, the taxpayer must prove by a preponderance of the evidence that the taxpayer meets each requirement of the following three-prong test: (1) The adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser’s judgment.”

It is hoped that the following statement by Justice Bell in *Morrison v. R.*²² is retrieved from tax jurisprudence wilderness and is given the weight it deserves:

21 *Stephen G. Woodsum and Anne R. Lovett v. Commissioner of Internal Revenue*, 136 T.C. No. 29. See <http://www.ustaxcourt.gov/InOpHistoric/woodsum.TC.WPD.pdf>.

22 [2003] 2 C.T.C. 2076, at para. 21, 2003 D.T.C. 166 (T.C.C. [General Procedure]). See <http://www.canlii.org/en/ca/tcc/doc/2002/2002canlii1147/2002canlii1147.html>. See also the case comment in the current volume of *The Canadian Taxpayer* at page 96.

I do not subscribe to the notion that a taxpayer, in circumstances such as those of the Appellant, cannot be said to have exercised due diligence for the purpose of avoiding a penalty under subsection 163(1) of the *Act*. He, in the preparation of his 1995 taxation year income tax return engaged the services of the chartered accountant who had assisted him for years and to whom he had given all relevant information, all in respect of a formula concept contained in the *Income Tax Act* which is not easily understood. The suggestion by Respondent’s counsel that he should have read the Interpretation Bulletin or read the *Income Tax Act* cannot have been seriously advanced by Respondent’s counsel.²³

The standard of review of the Minister’s decision to deny relief under subsection 220(3.1) of the *Income Tax Act* is reasonableness. Since the Federal Court of Appeal in *Stemijon*²⁴ held that it would be reasonable for the Minister to reject an application for penalty relief on the basis of a lack of due diligence by a tax return preparer, taxpayers should argue their own due diligence in a notice of objection followed by an appeal to the Tax Court of Canada. Particular note should be taken of the observations by Justice Hershfield in the case of *Bateman v. R.*:²⁵

As noted, this Court has jurisdiction to consider questions of due diligence in relation to the imposition of penalties. Exercising that jurisdiction, I am allowing the appeal. Unlike the Minister’s rigid pigeonhole approach to determine the application of fairness relief, this Court looks at the facts and circumstances of each case.²⁶

David H. Sohmer, a frequent contributor to The Canadian Taxpayer, is a shareholder of Spiegel Sohmer Inc., a Montreal law firm, and can be reached at dhsohmer@spiegelsohmer.com.

Suzanne Costom is a partner at Shadley Battista where she practises criminal and penal law and can be reached at scostom@shadleybattista.com.

Daniel Bornstein contributed to this article and is an articling student with Spiegel Sohmer Inc. in Montreal. He can be reached at dbornstein@spiegelsohmer.com.

23 *Ibid.*, at para. 21.

24 *Stemijon Investments Ltd. v. Canada (Attorney General)*, 2011 CarswellNat 4372, 2011 FCA 299, [2012] 1 C.T.C. 207, 2011 D.T.C. 5169 (Eng.), 341 D.L.R. (4th) 710, 425 N.R. 341.

25 2006 CarswellNat 3877, 2006 TCC 635, [2007] 2 C.T.C. 2020, 2007 D.T.C. 156 (T.C.C. [Informal Procedure]).

26 *Supra*, note 24 at para. 12.