Docket: 2001-967(GST)G

BETWEEN:

BONDFIELD CONSTRUCTION COMPANY (1983) LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on September 22, 23 and 24, 2003, October 21 and 22, 2003 and February 23, 24, 25, 26 and 27, 2004 at Toronto, Ontario,

Before: The Honourable Justice Diane Campbell

Appearances:

Counsel for the Appellant:	Timothy Danson and Robert Zigler
Counsel for the Respondent:	Margaret Nott and André LeBlanc

JUDGMENT

The appeal from the assessment made under Part IX of the *Excise Tax Act*, notice of which is dated December 22, 2000 and bears number 582 in respect to the period January 1, 1991 to November 30, 1995 is allowed and referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with the attached Reasons for Judgment on the basis that the period January 1, 1991 to June 5, 1994 is statute barred and the penalties will be deleted. The input tax credits claimed in respect to the back-charges, to the extent they are not statute barred, will be disallowed.

Two sets of costs are awarded to Appellant counsel.

Signed at Ottawa, Canada, this 18th day of May 2005.

"Diane Campbell"

Campbell J.

Citation: 2005TCC78
Date: 20050518
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BETWEEN:

BONDFIELD CONSTRUCTION COMPANY (1983) LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Campbell J.

[1] This is an appeal from a Goods and Services Tax ("GST") reassessment under Part IX of the *Excise Tax Act*, R.S.C. 1985, c.E-15, as amended (the "*Act*"), for the period of January 10, 1991 to November 30, 1995.

[2] By Notice of Assessment dated June 5, 1998, the Minister of National Revenue (the "Minister") assessed the Appellant for the period as follows:

Adjustments to GST/HST	$ 658,547.82
Adjustments to Input Tax Credits	300,433.05
Total Adjustments for Assessment Period	$ 959,007.87[1]
Penalty	417,560.26
Interest	358,564.55
Other penalty [gross negligence]	232,510.10
Amount Owing	$1,967,642.78

[1] Any discrepancies in addition are attributable to the original amounts found in Exhibit A-1, Tab 6.

[3] By Notice of Reassessment dated December 22, 2000, the Minister reversed the gross negligence penalty of $232,510.10, and made other adjustments as follows:

Period/Période 1991/01/10 to 1995/11/30	Reported Amount Montant Reporté A	Per Audit Assessed Cotisation B	Per Appeals/Selon les appels Adjustment Ajustement C	 Reassessed Nouvelle cotisation D=(A+B+C)
Net tax-Taxe nette	$543,580.94	$959,007.87	($217,483.24)	$1,285,105.57
Rebates-Remboursements	0.00	0.00	0.00	0.00
Net Interest to: - Intérêt net au:1998/06/05		358,564.55	(77.26)	$358,487.29
Penalties to: - Pénalités au:: 1998/06/05		650,070.36	(256,666.16)	$393,404.20
Refund Amount or Amount Owing- Remboursement ou Montant dû		$1,967,642.78	($474,226.66)	$1,493,416.12

[4] During the hearing the Respondent conceded that the statutory penalty and interest should be reduced as follows (Exhibit R-2):

Statutory penalty	$ 82,267.10
Interest	92,308.99
Total	$174,576.09

[5] The Appellant takes issue with the assessment of the statutory penalty and the Minister's disallowance of Input Tax Credits ("ITCs"). The ITCs at issue were related to invoices where the amount owing on the invoice, including the GST, was "back-charged" to a subcontractor. The total of the ITCs in dispute here is $153,648.88. The Appellant also argued that the Minister was statute barred from reassessing on GST returns respecting the period prior to June 5, 1994. If the Appellant is successful in arguing the statute barred period, a portion of the ITCs would also be statute barred. In other words, the Appellant takes issue with the entire amount of back-charges reassessed at $153,648.88, a portion of which may be statute barred.

[6] The Appellant does not disagree with the Minister's reassessment of the GST on PST (provincial sales tax) issue, except to the extent that a portion may be

statute barred. The Appellant submits that the following amounts are statute barred (Exhibit A-1, Tab 11):

Under-remitted GST on sales	$393,662.34
Disallowed ITCs (back-charges)	$94,777.46

Evidence

[7] The Appellant called two witnesses: Ralph Aquino, president and sole shareholder of the Appellant; and Susan Farina, a chartered accountant and partner with Goldfarb, Shulman, Patel & Co.

[8] The Respondent called four witnesses: Jin Pyeon, a technical advisor with Canada Revenue Agency ("CRA"); Chander Sudan, a chartered accountant and partner of the accounting firms which provided advice to the Appellant; Gail MacNeil, a team leader with the special investigations unit of CRA; and Lisa Kelly, an appeals officer.

The Appellant's Evidence

Ralph Aquino

[9] Ralph Aquino was born in Italy and came to Canada in 1961 at 18 years of age. He has little formal education, having completed Grade 5 in Italy. After moving to Canada he worked in the construction industry for 13 years, learning the business, gaining expertise in reading architectural plans, and tendering on large projects and concrete work. In 1974, he opened his own small business which today has grown into a company which handles approximately $300 million dollars annually in projects. In 1991, the year the GST was introduced, the Appellant company was doing approximately $100 million dollars in business. Today, the Appellant employs 35 people at its head office to track projects and an additional 15 on site in the project field. During the years 1991 to 1995, the Appellant employed 15 employees in the office and five to six in the field.

[10] The Appellant company is an institutional builder, constructing large buildings such as schools, hydro plants, municipal buildings and hospitals. The Appellant itself completes the excavation and concrete work (which comprises about 20% of each construction project) and it hires subcontractors to complete the remainder of the project. Mr. Aquino oversees each of these complicated projects

in its entirety, but his expertise is being able to envision what a building will look like from the documents containing the plan. In putting the whole package together, he spends most of his time on site at the project. He explained that a routine work day for him began very early in the morning, organizing his employees and meeting with estimators and staff. The balance of the day and the majority of his time is spent at the project site. His knowledge of and expertise in this business were obtained through hands-on experience in the first 13 years working as an employee in the industry.

[11] Mr. Aquino has had no training or knowledge respecting accounting practices for projects of this size. He recognized this weakness and hired in-house staff and off-site accountants as early as 1976. In 1985, the Appellant hired a chartered accountant named Bishwajeet Kar to act as the company's comptroller. In this capacity, Mr. Kar was in charge of and responsible for all accounting matters including the accounting staff.

[12] In March 1989, the Appellant also engaged the external accounting firm of Pannell Kerr MacGillivray to provide audited financial statements. Mr. Aquino testified that Mr. Kar was familiar with this firm and knew one of its representatives (Mr. Sudan) personally; and it was on Mr. Kar's recommendation that he chose this firm. In its engagement letter to the Appellant (Exhibit A-1, Tab 1), the firm set out its function and responsibilities and the basis of its anticipated fees. In the early 1990s, the Appellant paid between $25,000.00 and $30,000.00 per year in fees to the external accounting firm. Mr. Kar was the Appellant's principal contact with the external accounting firm. Each year an engagement letter was written to the Appellant and Mr. Kar brought the letter to Mr. Aquino's attention.

[13] On July 4, 1990 (i.e. prior to the introduction of the GST on January 1, 1991), Terry Dooley, a partner at the external accounting firm, wrote to the Appellant advising that the proposed tax would impact on the company's operations respecting its established accounting systems (Exhibit A-1, Tab 2). Mr. Dooley also advised the Appellant that his accounting firm was in the process of drafting and forwarding a GST checklist for the company's review which aimed to identify issues or potential problems regarding this new tax. Without such professional help, Mr. Aquino testified he would be absolutely unable to properly implement the new GST regime to enable his company to deal with the tax. His view of the implementation of the new tax was that it would be "...very messy and very complicated" (Transcript page 32).

[14] Mr. Aquino stated that through the years, the company's comptroller, Mr. Kar, "... became part of a family and friends" (Transcript page 31). In 1994, Mr. Aquino gave far more responsibility to Mr. Kar in order to free himself to care for his ailing wife who subsequently died in December of that year. He was comfortable giving Mr. Kar the additional responsibility as they had developed a close relationship over the years. He stated he had no reason to doubt the expertise, competence or advice he received from Mr. Kar or from the external accountants.

[15] Mr. Aquino testified that he took comfort in the fact that the company had outside accountants reviewing and monitoring his staff and their accounting activities. He explained that even if he had the education to review the GST accounting procedures, he would still have to depend on such people as it was too big a job in a company that did the volume of work that the Appellant did (e.g. during the early 1990s the Appellant paid on average half a million dollars in GST each month). Mr. Aquino testified that he did not hire an additional external accounting firm specifically to complete a GST compliance audit because he felt the firm he had hired would inform the Appellant of any GST problems. Mr. Aquino went on to state:

> …I cannot tell you what an accountant should do because I don't know, but I can tell you if somebody comes in my office and doesn't see that I pay enough GST, he should not come through that door.
>
> … If I have to hire the third person, then I will… (Transcript page 127)

[16] The company's audited statements were reviewed with Mr. Aquino each year before they were filed with Revenue Canada. During the period in issue, the external accountants never indicated to him that there were any problems with the GST procedures nor did they raise any concerns over the internal systems that the Appellant had in place to deal with and monitor the GST. Likewise, the company's comptroller, Mr. Kar, never indicated to Mr. Aquino that there was anything wrong with the company's treatment of the GST. Mr. Aquino also recalled that Revenue Canada's auditors attended the corporate premises three or four times between 1991 and 1995 to conduct audits but never indicated that there was any problem with the treatment of GST. Mr. Aquino's evidence was that the Appellant's treatment of GST was clearly recorded in the corporate books.

[17] The Appellant's year end is December 31. Every March, the external accountants attended at the Appellant's office and would take from two to three

weeks to complete the audit. The external accountants reviewed the various ongoing construction projects and asked Mr. Aquino questions relating to the jobs, such as percentage of work completed on a project and equipment details. In May, the draft audits would be presented to the Appellant for review. Mr. Kar reviewed these drafts with Mr. Aquino as Mr. Aquino did not have the expertise to personally review them. In June, the external accountants would visit the company premises again to review the final statement and returns with Mr. Aquino and Mr. Kar to advise on the amount of tax that the Appellant would owe.

[18] Mr. Aquino confirmed that in June, in each of the years from 1990 to 1994, one or two weeks prior to the date for filing and paying tax, he and Mr. Kar met with Mr. Sudan, the representative of the external accountants, to review the audited financial statements. Mr. Sudan never discussed GST issues with Mr. Aquino and he never raised the Appellant's practice of maintaining two sets of invoices for each transaction: one set that went to customers contained a higher GST amount than the set of invoices that was kept in-house. Mr. Aquino testified that he did not know, and could not have known, that Mr. Kar maintained two sets of invoices because he was unable to go into a computer to check the books. He knew nothing about bookkeeping and hired external accountants as an additional check on his business to ensure everything was done within the law.

[19] Mr. Aquino gave evidence that at no time during these meetings, or at any other time, did anyone bring to his attention any issues or problems respecting the manner in which the Appellant dealt with GST. Throughout the years in question, there was no indication from either the external accountants or Mr. Kar that there might be difficulties with the Appellant's GST reporting.

[20] Mr. Aquino confirmed that he did not ask the company's comptroller, Mr. Kar, for information regarding the financial statements or discuss the GST filings because "...the education I have I couldn't help him in the accounting" (Transcript page 92). If Mr. Kar asked Mr. Aquino anything respecting the GST filings, Mr. Aquino simply told Mr. Kar to make sure it was done properly and within the law and that if he had to employ someone else to assist him then he should do so. He gave Mr. Kar wide authority to do his job of maintaining the corporate books and records.

[21] Mr. Aquino never went through the GST documentation himself to ascertain whether GST was being properly collected, reported and remitted or if ITCs were being properly claimed. He stated that even if he had had the time to go over the massive amount of bookkeeping, given his lack of formal education, he would have been incapable of reviewing and understanding the accountants' work.

[22] Mr. Aquino was unaware of any problems until Mr. Kar's employment was terminated in late November 1995, when he was caught removing a box of documents from the head office. This was in the year following his wife's illness and death in 1994, during which time Mr. Aquino had delegated additional authority to Mr. Kar.

[23] Grant Dickinson, who replaced Mr. Kar in mid-December 1995, discovered the GST filing problems and brought them to Mr. Aquino's attention by mid-January 1996. Mr. Aquino advised him to rectify the problems immediately that same month. He stated he was "… really shocked, by having all those people around me" (Transcript page 44) and yet no one ever informed him there could be a problem. In addition to the GST reporting problems, Mr. Dickinson informed him that the corporate records disclosed that Mr. Kar had defrauded the Appellant of $940,000.00. At the suggestion of his lawyer, the Appellant hired a forensic accounting firm to investigate. The investigative report, which cost the Appellant a further $150,000.00 (Exhibit A-2), resulted in the eventual conviction of Mr. Kar for defrauding the Appellant; however, no restitution was ever paid to the Appellant.

[24] On June 5, 1998, the Appellant was reassessed in the amount of $1,967,642.78 and on June 19, 1998, the Appellant issued a cheque for payment of this amount. Although he almost lost his company, he testified that he instructed that this payment be made immediately upon reassessment because he did not want any further problems.

[25] The Appellant subsequently replaced its external accountants, initially with the accounting firm of Ernst & Young, and eventually with the firm of Goldfarb, Shulman, Patel & Co.

The Evidence of Susan Farina

[26] Susan Farina is a partner at the firm Goldfarb, Shulman, Patel & Co., the Appellant's current external accountants. She testified that her firm completes the Appellant's corporate returns and provides the Appellant with audited financial statements and advisory services. As a part of the auditing process, the firm reviews a client's GST compliance to ensure the financial statements are free of material misstatements.

[27] Ms. Farina explained that an accountant can be employed to draft financial statements at three different levels. The highest level of involvement (and most expensive) is to be engaged as an auditor. At this level, an auditor

> ...examines the evidence underlying the amounts in the financial statements, as well as the disclosures in the notes to the financial statements. The auditor considers the appropriateness of the accounting principles used and the overall presentation of the financial statement. At the conclusion of the engagement, assuming the auditor has no reservation, the auditor expresses that in its opinion the financial statements, in all material respects, are free from misstatement and are in conformance with generally accepted accounting principles. (Transcript page 151)

Ms. Farina's firm is currently engaged with the Appellant at this highest level. Similarly, during the period at issue in this appeal, the external accounting firm (Pannell Kerr MacGillivray) was appointed by the Appellant to provide a full audit. While many corporations of the Appellant's size use this audit level, there are many others that use the second highest level of engagement (the review level) and still others that use the lowest level.

[28] Ms. Farina explained the measures her firm undertakes with respect to GST when engaged at the highest level. To ensure the appropriate systems are in place and that there is compliance, a questionnaire is completed. This questionnaire addresses specific areas, where concerns could arise, and identifies on a month-to-month basis the figures reported on the GST returns, in particular, the sales, GST collected and ITC amounts reported. Total sales as reported on the GST returns are then compared to total sales in the corporate records, and where necessary, adjustments are made. She explained that these types of activities are not specifically documented in the audit engagement letter to the clients. Rather, the letter simply indicates that in making inquiries, the firm will have access to the clients' records and staff. Ms. Farina stated that the number of accounting staff employed by the Appellant during the relevant period was very similar to the number it presently employs.

[29] Ms. Farina outlined the steps the Appellant takes to ensure compliance with the law in operating its business. Firstly, the Appellant employs a comptroller to supervise its in-house accounting staff and oversee the entire accounting operation, including the filing of the monthly GST returns. The comptroller acts as a liaison between the Appellant and the external auditors and is the main contact person in the company during the audit process. To the best of her knowledge, Mr. Kar, the company's comptroller during the relevant period, had an educational background

and industry experience comparable to the individuals hired by the Appellant after he was fired. Secondly, the Appellant maintained a premier accounting software system and employed accounting procedures used by similar general contracting companies. This system and the procedures the Appellant utilized were in her words:

> …designed to ensure that all of the information that's relevant to the computation and compliance with the GST rules is captured within the books and records of the corporation. (Transcript page 165)

Finally, the company hired reputable external auditors to provide an additional level of comfort that the internal accounting activities were being appropriately applied.

[30] In addition, Ms. Farina said that the Appellant has always been co-operative and receptive to suggestions for changes to its system. She pointed out that some of the changes her firm recommended, when they took over the account, cost the Appellant additional money to implement.

[31] Ms. Farina reviewed the figures on both the assessment of June 8, 1998 and the adjustments made on the reassessment of December 22, 2000 (Exhibit A-1, Tab 9 – CRA working papers for the reassessment). In addition to penalties and interest, she identified the issues as being related to the treatment of GST, where there was a "back-charge", and to the calculation of GST on PST.

[32] Ms. Farina outlined the procedure where the problems with GST arose in applying back-charges. In any project, the Appellant hired subcontractors to complete about 80% of the work. Sometimes a subcontractor's work was deficient. If this subcontractor was unable or unwilling to rectify his work then the Appellant would engage a second subcontractor to remedy the work and this second subcontractor would invoice the Appellant. Ms. Farina gave the example of a drywall subcontractor who causes damage to the electrical work: since the drywall subcontractor has no expertise in rectifying electrical problems, a second electrical contractor is called in to correct the work. In circumstances such as these, it was the Appellant's practice to claim ITCs on the amount payable to the original subcontractor for the drywall work and also on the amount payable to the second subcontractor for the remedial electrical work.

[33] The Appellant's accounting department would then record a "back-charge", in the sub-ledger kept for the original subcontractor, equal to the amount of the invoice (including the GST). The result of the back-charge was a reduction in the amount the Appellant would pay the original subcontractor. The accounting department would

then forward the invoice along with a letter to the original subcontractor. This letter notified the subcontractor of the back-charge and requested that the subcontractor issue a credit note equal to the amount of the invoice (including the GST).

[34] The original subcontractor could either challenge the back-charge or accept it. If it is challenged successfully, the back-charge is reversed, the Appellant remains liable for the invoice and no GST issue arises with respect to the Appellant claiming the ITCs on that invoice. It is where the original subcontractor accepts the back-charge that the GST issue arises. Ms. Farina referred to the example at Exhibit A-1, Tab 15 and explained the procedure, followed by the Appellant, as follows:

> The example under Tab 15 is a situation where a back-charge was raised and was not reversed. So the procedure is that the project manager requests that the accounting department prepare the back-charge notification. The project manager signs the back-charge notification. The accounting department assigns a number to the back-charge, which is typically prefaced with B/C, denoting back-charge and then before sending the back-charge notification out to the subcontractor, the accounting department records the back-charge in the sub-ledger for the particular subcontractor.
>
> Now the sub-ledger is the document within Bondfield's books and records that tracks the contract with the subcontractor. It starts out by indicating the total contract amount. It keeps track of the payments made against the contract amount. In a separate section it keeps track of the back-charges, and then the total amount to be –- remaining to be paid under the contract. (Transcript page 186)

[35] In Ms. Farina's review of the audit working papers and other corporate documents, she found no evidence to suggest that any subcontractor ever issued a credit note in respect of any back-charge; and, apart from the letter of notification, there was no other document purporting to be a debit note. The December 22, 2000 Notice of Decision (Exhibit A-1, Tab 7) referred to these notification letters as debit notes, however Ms. Farina testified that they were not debit notes for several reasons. Firstly, the letters clearly indicated that they were simply a request to start discussions on back-charges. It is plain, she noted, from the document that the Appellant was prepared to discuss and perhaps reverse the notification of the back-charge. Secondly, the documents were in letter format and were not referred to as debit notes. Under general accounting principles, she would not classify these notification letters as debit notes for the purposes of GST. Finally, in order to be viewed as a debit note – upon which the recipient and supplier could adjust GST

pursuant to subsection 232(3) of the *Act* – the letter must contain certain prescribed information, and these letters did not contain that information.

[36] Ms. Farina reviewed the second issue respecting the calculation of GST on PST. To understand this issue, she provided an overview of how payment requests are generated in the construction industry. A contractor such as the Appellant does not produce the invoice. Rather, they are produced by the architect or engineer for the customer. The process is instituted when the general contractor (the Appellant here) on the last day of each month sends an application for payment or progress billing to the customer's architect or engineer. The architect or engineer inspects the progress of the project and, if satisfied, prepares a progress certificate (certificate of payment), certifying the approved amount of billing. Both the application for payment and the progress certificate (certificate of payment) include GST on the full contract price for the particular month. The contract price includes amounts paid for both labour and construction materials. Since the construction materials would have been subjected to PST, by charging GST on the whole contract price, GST was being charged on an inherent amount of PST.

[37] The Appellant's comptroller, Mr. Kar, devised a calculation or a formula by which GST would be adjusted in such instances. He estimated that approximately 37% of the contract revenue related to construction materials and that this 37% included PST. The accounting department would divide the 37% amount by 1.08 (to arrive at the cost before PST) and then multiply the quotient by 8% in order to determine the amount of the PST applicable to the construction materials. The result of applying this formula was that 2.7407% of all revenue was assumed to be PST on materials. To illustrate, consider the following example:

$10,000.00 contract revenue before GST
$3,700.00 assumed to be related to construction materials ($10,000.00 x 37%)
$3,425.93 cost of construction materials before PST ($3,700.00 ÷ 1.08)
$274.07 PST on the construction materials ($3,425.90 x 8%)

[38] During the period in issue, the Appellant used this formula to reduce the amount of GST collected. Mr. Kar took the position that GST respecting the PST amount did not need to be remitted. This formula was used between January 1, 1991 and November 30, 1995 and terminated in December 1995, very shortly after Mr. Kar left the Appellant's employment.

[39] The GST on PST was deleted by the Appellant's accounting department by producing a worksheet for each progress billing. The original copies of these working

papers were attached to each GST return for the month in question. Ms. Farina distinguished these working papers from invoices. Where an invoice should contain customer address information, the working papers did not contain such information; and where invoices should add PST and GST to the sales amount, the working papers used the PST to reduce the sales and GST amounts. These working papers were used to calculate the Appellant's GST reduction which led to the under-remittance of GST.

[40] In Ms. Farina's opinion, the method employed in these working papers was open and obvious. She referred to an invoice register (Exhibit R-1, Tab 5), for December 1993, where the Appellant summarized its progress billings for a particular month, setting out the sales amount, hold back amount, GST amount, and net accounts receivable. The GST amount on every progress certificate was always different than the GST amount on the sales register. From her perspective this method, used on each and every occasion, was open and obvious because:

> ... the invoice in any general contractor situation is the certificate that's issued by the customer's architect or engineer. Each and every billing amount on those progress certificates reflect a different amount than the GST that's reflected in the invoice register. If somebody was trying to conceal the method of accounting for GST, the alternative way to have accounted for this would have been to have recorded each and every sales invoice based on the architect's or engineer's certificate, do a worksheet dealing with all of the billings for the particular month and making one adjustment in respect of the GST on PST on all of the invoices, so that anybody doing a sample check of one -- of several progress certificates would be able to track them into the invoice register without exception. (Transcript page 207)

and at page 208 of the Transcript she states:

> ... So anybody looking at the invoice register and performing a very simple reasonability test would notice right away that the GST was not 7 per cent of the sales amount minus the hold-back which is what one would expect it to be.
>
> ... if any attempt was being made to conceal this issue, it would have been possible for the adjustment that we referred to not be recorded as additional revenue but to be set up in a liability account and just simply not paid.

[41] Ms. Farina referred to Exhibit A-1, Tab 12 which contained summaries of each GST return, for each month filed by the Appellant, throughout the audit period. These summaries showed that the amounts reported for sales and other revenue were consistent with the amounts in the Appellant's sales register, with the exception of the GST amounts. The sales register would be approximately 2.7407% lower, reflecting the formula's application versus simply deducting 7% of the sales amount.

[42] Ms. Farina reviewed the audit working papers of the external accounting firm for the years 1991, 1992, 1993 and 1994 (Exhibit A-3). In looking at the verification processes used in each year, she confirmed that the procedures used were basically the same procedures that her firm presently employs on behalf of the Appellant. In addition, she reviewed the reasonability test, respecting GST reporting, employed in these working papers; the interim audit review checklist, which assists in doing an audit; and the management letter prepared at the end of an audit. Counsel referred Ms. Farina to a handwritten note prepared by the Appellant's accounting department (part of Exhibit A-3, Tab 2) dated December 31, 1992. This note referred to the 2.7407% reduction respecting GST and a reference to PST being approximately 37% of the total contract. Accompanying these notes in each year were working papers of the Appellant which recounted total sales and how the formula was used to reduce the tax. She testified that if the information contained in these notes and papers (which indicated an incorrect treatment of GST) raised a concern in her mind, there were procedures she would take to deal with the issue during the audit conducted for the Appellant, particularly if it had significant tax implications.

[43] Counsel also took Ms. Farina through the significant matters memo and the interim audit review checklists of the external accounting firm but none of these documents contained any reference to the use of the formula respecting GST on PST or treatment of the GST tax. On the summary of the firm's audit statements, the reference to commodity tax was marked as "low", which Ms. Farina stated meant that the external auditors were evaluating the risk for that particular client, with its treatment of tax, as low.

[44] Ms. Farina noted that there were references in the auditors' notes specifically identifying the formula devised by Mr. Kar, together with a note which stated: "Client collects GST on PST but doesn't remit it"; nevertheless, the 1993 audit checklist made no reference to GST problems. Three issues for discussion with Mr. Aquino were identified in a handwritten note dated December 30, 1993. The first two items did not deal with GST. The third item, while GST related, dealt merely with a deduction for GST that the Appellant had taken on the entire cost of a vehicle, which was beyond the maximum allowable limit. No other GST issues, particularly

the GST on PST issue, were identified in this handwritten note; yet, Ms. Farina noted, the auditors felt the vehicle issue was significant enough to be identified for discussion and remedy with Mr. Aquino.

[45] The working papers in 1993 are similar to 1992. There is again a reasonability list utilized, which compares the GST collected, by multiplying total revenue by 7% and comparing this figure to the GST amount on the client's records. The difference in 1993 was indicated to be "past trivial".

[46] For the 1994 reporting period, there was still no reference to GST problems in the year-end audit review checklist. The handwritten auditor's notes raise five issues under "Points for Discussion with Mr. Kar" but none of these related to the GST problems. The significant matters memo for 1994 appeared to make the first reference to keeping two sets of GST documents, one for customers to pay and one to record GST collected on sales. This memo contained handwritten notes at its conclusion, including a reference to discussions with Mr. Kar and Mr. Aquino during their meeting in June 1995.

[47] On cross-examination, Ms. Farina did agree that the reasonability list is a list that looks at numbers including GST to see if the figures appear reasonable. However, it is not a detailed review. She also confirmed that the three different levels of accounting review, referred to in her direct examination, were in respect to the financial statements and not the GST filings. Ms. Farina stated that the objective of her firm at the audit level is to ensure that the financial statements are free of material misstatement and that they fairly represent the financial position and operations of the corporation.

[48] On further cross-examination, Ms. Farina confirmed that she formed her conclusions, respecting Mr. Kar's development of and use of the GST on PST formula, based on CRA audit staff notes, external auditor's working papers and conversations with the Appellant's present comptroller. She agreed with Respondent counsel that it was based on her deductions after reviewing these various sources, rather than actual knowledge, because she was not engaged as the Appellant's external auditor during the period in issue. Ms. Farina also agreed that she was not a member of the Appellant's external accounting firm that was employed during the period in question and as such had no actual knowledge about the preparation of that firm's working papers which she reviewed in direct examination.

[49] Respondent counsel also reviewed Ms. Farina's conclusion that the Appellant's GST recordings were done in an open and obvious manner. Ms. Farina

confirmed that the sales figures reported on the GST returns agreed with the sales figures in the sales journal and that no adjustments were made in an attempt to conceal the fact that a portion of sales were calculated using Mr. Kar's formula. Ms. Farina did not agree with Respondent counsel's suggestion that it would be open and obvious only if one had access to both sets of documents because on its face, the GST return does not state that the GST billed was an amount slightly higher than the amount recorded on the return. Ms. Farina stated that, in her opinion, it was open and obvious because there was no attempt to alter information respecting reported sales. Ms. Farina also disagreed with the Respondent counsel's suggestion that to determine that the GST amount reported was slightly less, one would have to look at source documents and internal records. Ms. Farina stated that if the holdback amount was subtracted from the sales amount and then the resulting amount multiplied by 7%, it was evident that the result would be higher than the entry on the report.

Respondent's Evidence

The Evidence of Jin Pyeon

[50] Mr. Pyeon was an auditor for large GST files during the appeal period. He became involved in the Appellant's file in 1996, focusing on the area of ITCs only. Mr. Pyeon explained that when the Appellant employed a second subcontractor to remedy deficient work, the Appellant did not adjust for the GST reimbursed on either the original contract for work performed or the remedial work contract completed by the second subcontractor. He concluded that the Appellant over claimed ITCs in respect to the reimbursement of GST to the Appellant. Mr. Pyeon reviewed the documents (Exhibit R-1) relating to these back-charges, where he found evidence that ITCs were claimed for all of the GST charged by both subcontractors. He explained that his review included not only the sub-trade ledgers but also other documents such as the purchase journal, the general ledger GST account and the cash disbursement journal.

[51] In assessing the Appellant beyond the statutory limitation period for the period January 1, 1991 to June 5, 1994, Mr. Pyeon explained why the CRA determined that the Appellant made misrepresentations with respect to these back-charges. In making the determination he considered a variety of circumstantial factors including the following: the Appellant retained a professional accountant on staff, their accounting system was sophisticated enough to catch almost all of the numerous transactions, the accounting report made everyone in the company aware of what was happening within the company, it had external accountants, the amount was substantial and the

Appellant was reimbursed for the amounts (including GST) owed to those subcontractors that completed remedial work.

[52] On cross-examination, Mr. Pyeon admitted that it was prudent for the Appellant to have such professional staff in its employment, that the Appellant had in fact a very professional accounting staff that was sufficiently large for the size of the company, that the company had a premier computer system throughout the audit period, that outside accountants were also engaged to provide audited financial statements and that for the most part, as noted in a memo in the working papers, the Appellant's officers were co-operative. Mr. Pyeon felt it would be reasonable and prudent for the Appellant to rely on its accounting firm. He also agreed that the Appellant's method of dealing with ITCs was consistent and that it did not try to suggest in the records that ITCs had been adjusted. Mr. Pyeon agreed on further questioning that the basis of assessing the Appellant for back-charges was based on the fact that it did not make the appropriate GST adjustments. When asked if this decision was based on section 232 of the *Act*, Mr. Pyeon responded:

> Not the Section 232 we relied on. We relied on Section 169, entitlement to the ITC. Not 232, but 169… (Transcript page 441)

Mr. Pyeon acknowledged that section 232 deals with the issuance of debit notes but that it was not section 232 which he used to assess the Appellant. He did not know if section 232 was used in the reassessment of December 2000. Mr. Pyeon agreed with counsel's suggestion on cross-examination that it would not be a misrepresentation if an individual took the legitimate view that section 232 applied instead of another section of the *Act*.

[53] Although there are three types of credit return audits, he stated that on those audits where auditors attend at a taxpayer's premises, as they had done in this case, he would expect that auditors would review the ITCs and, in so doing, would review the back-charges. He was not aware that the CRA had completed several such audits respecting this Appellant prior to 1996. He also admitted that he would not expect the President of a company the size of the Appellant to be involved in the "nitty-gritty", as he put it, (Transcript page 456) of the operations.

The Evidence of Chander Sudan

[54] Mr. Sudan is currently a partner with the accounting firm Martyn, Dooley & Partners ("Martyn, Dooley"). He was working with the firm Pannell Kerr MacGillivray in 1987 or 1988 when that firm was hired by the Appellant to be its

external accountants. Pannell Kerr MacGillivray merged with Doane Raymond (to become Doane Raymond Pannell) and later with Martyn, Dooley. Throughout these changes, the Appellant remained their client and they were employed to audit the corporate financial statements. He acknowledged that the Appellant terminated the services of Martyn, Dooley in early 1996. Mr. Sudan worked in the income tax department of the firm and acted as a contact partner. Each year he took the financial statements and accompanying documents to the Appellant's office to discuss them with Mr. Kar and Mr. Aquino. Some time later he would have the tax returns signed. Mr. Sudan's primary contact person at the Appellant's office was Mr. Kar. Mr. Kar always attended any meetings where Mr. Aquino was present, and occasionally Mr. Sudan would also meet with Mr. Kar alone.

[55] Mr. Sudan was not aware of any advice given by his firm to the Appellant concerning GST. He did not know if the Appellant had asked his firm to do a GST compliance audit, but recalled that the Appellant requested a quote on an internal audit in 1994. However this was never done. Mr. Sudan thought that this audit request was made during the meeting for the 1993 reporting year in June 1994 after Martyn, Dooley pointed out to Mr. Aquino improperly claimed GST as it related to a vehicle.

[56] Mr. Sudan did not complete the Appellant's actual audit. Rather, it was the firm's audit manager for the Appellant's file, Karen Prapavessis. After Ms. Prapavessis produced the audit working papers each year, they were reviewed by the firm's audit partner, Terry Dooley. Although Mr. Sudan never personally reviewed these working papers, as the contact partner for his firm, he always met with Mr. Kar and Mr. Aquino during the last week of June to review the final statements and returns. All of the audit files including the working papers, financial statements and corporate returns accompanied him to the Appellant's offices. Even though Mr. Sudan never reviewed the working papers, he took them with him to these meetings so he could refer to them if he was asked a question. Included in the working papers were all the related documents, such as the engagement checklist and the significant matters memo. The only document he actually reviewed was this significant matters memo, together with the financial statements, so that he could discuss them with Mr. Kar and Mr. Aquino. On cross-examination, Mr. Sudan clarified that he took the firm's working papers to his meetings with Mr. Kar and Mr. Aquino to assist him in giving information to the client respecting the financial statements, but that he did not review the audit checklist with the client during these meetings.

[57] Mr. Sudan stated that although he was the contact person for his firm, he did not educate himself on GST matters. He pointed out that the firm had a separate GST department to which he deferred. He agreed with Appellant counsel's suggestion that he did not know much about GST.

[58] On cross-examination, Appellant counsel took Mr. Sudan through each year of the firm's working papers to determine if the firm raised any issues with the manner in which the Appellant calculated GST after removing PST. Although Mr. Sudan acknowledged that the working papers contained references to the Appellant utilizing a formula to remove PST before calculating GST, his response generally was to the effect that he had not reviewed these documents and that he had no knowledge of the GST issue until June 1995. He confirmed that unless a problem was raised in the significant matters memo he would not discuss it with Mr. Kar or Mr. Aquino. Mr. Sudan agreed that none of the significant matters memos in the years preceding 1994 raised or made any reference to a problem respecting the GST formulation, even though the accountants in their working papers were describing the system of calculating GST after removing PST and actually making the calculation based on the formula.

[59] The 1993 working papers contained a document entitled "audit program commodity taxes". Mr. Sudan confirmed that this document did not raise any GST problems or question the appropriateness of how GST had been charged on taxable sales and revenues. Mr. Sudan acknowledged the statement on this document that concluded: "I am satisfied that the results of the above procedures provide reasonable assurance that commodity taxes are not materially misstated". The next document Mr. Sudan reviewed was the reconciliation schedule. He agreed that the formula was again referenced and recognized by the external accountants but that no problems were noted. Counsel attempted to have Mr. Sudan go through the calculations contained in these papers but Mr. Sudan was simply unable to follow the calculations or adjustments completed by his firm. Counsel also referred Mr. Sudan to a letter on the Appellant's letterhead (Exhibit A-3, Tab 3) concerning the Municipality of Muskoka which contained a handwritten note referencing that the GST remittance was reduced by a PST portion. Mr. Sudan again agreed that Martyn, Dooley had fully recognized the collection procedures that the Appellant had employed in not remitting GST on the PST.

[60] Appellant counsel then took Mr. Sudan through the 1994 working papers (Exhibit A-3, Tab 4), which he discussed with Mr. Kar and Mr. Aquino during their June 1995 meeting. Mr. Sudan acknowledged that the audit checklist did not identify any contentious accounting audit problems. Counsel also referred

Mr. Sudan to a handwritten memo entitled “Points for Discussion with Mr. Kar”; Mr. Sudan agreed that the only problem referenced here was a query as to whether Mr. Aquino had a will. As well, counsel referred Mr. Sudan to an earlier letter dated July 8, 1992, which was included in the 1994 working papers. In this letter, Mr. Sudan wrote to Mr. Kar advising him of a potential problem concerning withholding taxes in 1992 that might expose the Appellant to liability. Mr. Sudan testified he did not know what prompted him to write this letter: that is, whether he recognized the problem himself and wrote the letter or if the Appellant requested that he write it. He also testified that he was not sure whether he would write a letter similar to this to notify the Appellant of a problem of a much more serious nature, such as the problem that is at the centre of this appeal.

[61] Appellant counsel then reviewed the 1994 significant matters memo with Mr. Sudan. This significant matters memo, for the first time, contained references with respect to commodity taxes: that the procedures were “consistent with last year” and that the Appellant maintained two sets of invoices. Although the system of calculating GST after removing PST had been described by the accountants in their working papers, this was the first time the issue was referred to in the significant matters memo. Mr. Sudan could not explain why this issue was not brought to the Appellant’s attention in a letter as other matters had been. The 1994 significant matters memo contained a further reference, under items to be discussed with Mr. Aquino, to an issue with respect to a GST deduction related to a shareholder acquired vehicle. Mr. Sudan did not know why the more serious GST issue referenced under the heading “Commodity Taxes” was not listed for discussion with the Appellant except that when he discussed it with Mr. Aquino he thought this might be sufficient communication to the Appellant. He did agree that he never advised Mr. Aquino of the consequences of this issue – just simply that he advised that it was a problem that should be fixed. He did no further follow-up with the Appellant.

[62] On direct examination, Respondent counsel had referred Mr. Sudan to the 1994 significant matters memo (which was also contained in Exhibit R-1, Tab 11). Under the heading “Commodity Taxes” on page one, the significant matters memo states:

> Consistent with last year – client maintains two sets of invoices
>
> one for customers to pay
> and one to record GST collected on sales

> the difference between the two – is on the invoice for GST remittance purposes, break down the PST portion included in the sales, so that the GST amount is less – the excess GST collected is recorded by the client as miscellaneous revenue

Mr. Sudan testified that he was not aware of this issue before the June 1995 meeting. He stated that he raised the point with Mr. Kar and Mr. Aquino and advised them that they were collecting GST on PST but not remitting it and that it should be remitted; he said he thought Mr. Kar or Mr. Aquino said they would fix it. He was not aware of anything that his firm did after that to address or correct this matter.

[63] Mr. Sudan testified that the significant matters memo would have been prepared by Ms. Prapavessis and reviewed by Mr. Dooley. In addition to the typed text, several handwritten notes appeared on pages one and two of the memo. Mr. Sudan identified one of the handwritten notes on page two (the one entitled "Related Party Disclosure") as belonging to Ms. Prapavessis and the remaining notes as belonging to Mr. Dooley.

[64] On cross-examination, Appellant counsel referred Mr. Sudan to the handwritten notes beside the heading "Commodity Taxes" on page one, which read:

> What? (N)
> not Kosher

Mr. Sudan identified this writing as belonging to Mr. Dooley. He stated that the letter N which was circled meant that "the explanation was on the next page". The second page of the memo contained Mr. Dooley's handwritten explanation of the three word note on page one. The portion of the explanation that Mr. Sudan was able to decipher read:

> checked with KP [Karen Prapavessis]
> this discussed with Kar and Ralph [Mr. Aquino]
> both aware of these …

[65] On direct examination by Respondent counsel, Mr. Sudan had initially stated that the handwritten notes were not on the document at the time of the June 1995 meeting. On further questioning he clarified that the notes written by Mr. Dooley were not present at the time of this meeting, but he was not sure whether the note written by Ms. Prapavessis (which is not relevant to the issues in this case) was present at that time. On cross-examination by Appellant counsel, Mr. Sudan

testified that Mr. Dooley's handwritten notes on page 2 (the explanation) were definitely not present at the time of the meeting but that Mr. Dooley's note on page one ("What? not Kosher") was "probably" present (Transcript page 529). He explained that Mr. Dooley's handwritten note, "What? not Kosher", could have been on the significant matters memo when he took it to this meeting because Mr. Dooley had to make an evaluation of materiality before the statements were issued. However, on further questioning by Appellant counsel, Mr. Sudan admitted that he was just guessing; that he was not sure whether the note, "What? not Kosher", was present at the time of the meeting. At Transcript page 534, Appellant counsel asked Mr. Sudan:

> ...You're certain that that was there?

and he responded:

> I said it looks to me this was – this may have been there. I'm not sure.
>
> ...
>
> Well, I don't remember if it was there or not, so I don't know. I'm guessing it was.

The Evidence of Gail MacNeil

[66] Ms. MacNeil, a team leader with the CRA investigations, focused her review on how the Appellant calculated and remitted GST. She became involved when the file was referred from audit to investigations in May 1996. According to Ms. MacNeil, the problem was that on the invoices provided to the auditor, the consideration for a particular progress billing had been reduced by 2.7407%, which was allegedly for PST buried in the invoice, before applying the 7% GST.

[67] In completing her work for the years 1991 to 1993, she did not review every source document because she did not have all the records for those years. Instead, she used an arithmetical calculation based on the general ledgers and the sales ledgers. However, for 1994 and 1995 she was able to review all of the source documents for each transaction. She testified that for both 1994 and 1995 she conducted third party checks whereby each sales invoice received by the third party was compared to the sales invoice that was kept by the Appellant and provided to the auditors. This third party check by Ms. MacNeil revealed that the GST on the customers' invoices had been calculated on the full consideration of the contract. In contrast, on the invoices provided to the auditor, the consideration

had been reduced by 2.7407% before the GST was calculated. The result was that a higher amount of GST was charged to, and paid by, the customer than was remitted by the Appellant.

[68] Ms. MacNeil stated that the invoices, containing the lower amounts of GST, were seized in binders labeled “GST 94” and “GST 95” and that invoices identical to those provided to the customers were also located on the premises. She referred to Exhibit R-1, Tab 4, which was a spreadsheet she prepared of the invoices completed by the Appellant in respect to one project that contained six progress billings or invoices. She reviewed a set of documents, including the architect’s certificate of payment, which is provided to the customer, advising that a certain amount is owing to the Appellant; the sales invoice or progress billing that is sent from the Appellant to the customer; and a cheque from the customer to the Appellant. All three documents show the same amount of GST. The final document in the set was the invoice provided to the auditors but never given to the customer. This last document contained the same total sales price as the first three documents, but it was subjected to a lesser amount of GST. She stated this was typical of every transaction she reviewed. The difference between the amount of GST on the customer invoices and the invoices provided to the auditors established the basis for the assessment.

[69] She decided that in the circumstances of the case, the Appellant should be assessed beyond the statutory limitation period because the GST amounts were substantial and because the company had an internal auditor

> ...who stated that he did it knowingly and because if he’s guilty of doing this so therefore is the company, ... and he didn’t inform the auditors of the two different sales invoices ... And Bondfield had two individuals from CCRA go to their business premises and explain GST, and no one questioned if the method was correct. And no one at Bondfield questioned if it should be done this way or a different way. (Transcript pages 658-659)

[70] On cross-examination, Ms. MacNeil was referred to a memorandum from the audit notes (Exhibit A-4) which indicated that all sales and purchase invoices were provided to the auditors on request on the occasions during this period when they visited the Appellant’s premises. In this memo the auditor indicated that there was a 2.7407% deduction for PST from the contracts before calculating GST and that the contracts which showed the removal of the PST from the sale price were also being provided to the auditor.

[71] Ms. MacNeil stated that, in her opinion, she would characterize the application for payment to a payment certifier in the construction industry as an invoice that would attract GST.

[72] She stated that the Appellant recorded all of its transactions in the general ledger and the sales ledger.

[73] She agreed that the system was changed as soon as a new internal auditor, Mr. Dickinson, was hired in December 1995. She recalled that an individual with the Appellant informed her that the GST on PST system was developed by Mr. Kar, its internal auditor at the time, and that most of the GST returns were signed by him.

[74] Ms. MacNeil confirmed that she attended at the Martyn, Dooley offices and that she took certified copies of their working papers (Exhibit A-3). Appellant counsel referred Ms. MacNeil to the handwritten notes dated December 31, 1992 (Tab 2 at page 32), which set out in detail how the GST on PST was being calculated. It was her understanding that the difference between the GST on the progress certificate and the GST calculated by the Appellant was added to the Appellant's income. From her review of the documents of Martyn, Dooley and her discussions with them, she determined that Martyn, Dooley was aware that this amount was being added to the Appellant's income. She stated that Martyn, Dooley advised her that they had informed Mr. Aquino and Mr. Kar that the method used for calculating GST on PST was incorrect. Ms. MacNeil thought that Martyn, Dooley gave her this information around the time that the Appellant sued Martyn, Dooley for what had occurred.

[75] She confirmed that there was no indication in any of the documents contained in the extract from the CRA auditor's contact and review file folder (Exhibit A-5) that the CRA auditor, Phil Soosaithasan, did not receive the Appellant's co-operation when he requested documents.

[76] Ms. MacNeil stated that she used subsection 298(4) to assess beyond the statutory limitation period because:

1) the amount was significant as it totalled over $600,000.00;

2) the Appellant employed an internal accountant (Mr. Kar) for the period of the assessments;

3) the internal accountant stated that he knowingly did not adjust GST on back-charges and adjusted GST on PST;

4) the internal accountant made a misrepresentation attributable to negligence, carelessness or wilful default and therefore the Appellant has misrepresented these amounts;

5) Mr. Dickinson, the internal accountant hired to replace Mr. Kar, did not inform the auditors of the two different sales invoices when the auditors attended at the Appellant's offices in January 1996 and was therefore not co-operative;

6) there were two different and completely separate sales invoices, those shown to the auditors and the invoices issued to the third parties and this second set to the third parties was not shown to the auditors; and

7) two individuals from the CRA attended at the Appellant's premises to explain GST and no one questioned the CRA officials as to whether the method used by the Appellant was correct.

[77] Ms. MacNeil agreed on cross-examination that there was nothing in Mr. Soosaithasan's notes, from his meetings with Mr. Dickinson, that would indicate that Mr. Dickinson did not inform the CRA auditor of the two sets of sales invoices or show the CRA auditor those invoices. She stated she was not aware that Mr. Dickinson was at this time also dealing with a million dollar fraud perpetrated against the Appellant by Mr. Kar, which he had just discovered. She admitted that she relied on Mr. Kar for information as to what the Appellant was doing with respect to the issues. She agreed on cross-examination that she relied on Mr. Kar's honesty and the accuracy of his statements to her with respect to gathering information on the issues. Although she knew he had been dismissed from employment with the Appellant, she did not recall if he had been charged with fraud at that time. She did not consider this relevant to her investigations.

[78] On further cross-examination, Ms. MacNeil also agreed that the Appellant kept all of the payment certificates and progress certificates in its files and that to the best of her knowledge kept adequate and complete books and records. She also agreed that the Appellant dealt with the GST on PST issue, in calculating how much GST the company owed in those four years, in a consistent manner throughout the books.

The Evidence of Lisa Kelly

[79] Respondent counsel took Ms. Kelly, the appeals officer, through a schedule prepared by Ms. Farina (Exhibit A-1, Tab 17), which contained the CRA's calculations of refund interest and penalty from the December 2000 reassessment and proposed calculations showing how the Appellant thinks the interest and penalty ought to have been calculated. Ms. Kelly stated that she agreed with Ms. Farina's recalculations of interest and penalty "...give or take a few dollars" (Transcript page 848). In referring to the Recalculation of Reassessment (Exhibit R-2), Ms. Kelly explained that the documentation showed the interest and penalty refund amounts owing to the Appellant as of June 5, 1998, the date of the original assessment. As of December 22, 2000, the date of the reassessment, the amounts would be the same but the Appellant would receive credits on those amounts.

[80] On cross-examination, she stated that it was section 232 of the *Act* that was used in completing the December 2000 reassessment. She also explained that misrepresentation occurred, with respect to the back-charges, when amounts were charged back to subcontractors, whose work was remedied, that included the consideration plus GST but no adjustment was made to the GST component in this respect.

The Issues:

[81] The issues are:

(1) Whether the period from January 1, 1991 to June 5, 1994 is statute barred within the meaning of subsection 298(1) of the *Act*.

(2) Whether the Appellant is liable for the penalties assessed under section 280 of the *Act*.

(3) Whether the Appellant is entitled to the ITCs.

The Appellant's Position

[82] The period under appeal is from January 10, 1991 to November 30, 1995. The assessment is dated June 5, 1998. The Appellant contends that the Minister is barred from reassessing the Appellant on GST returns filed prior to June 5, 1994. The audit started in January 1996 with the matter being discussed with special investigations as early as January 25, 1996 and formally referred to that department

in May 1996. No assessment took place until June 1998. A waiver was not requested. Eventually the amount of back-charges was reduced by $120,000.00 and the allegation of gross negligence was not pursued. The Minister is now "...scrambling to come up with ... misrepresentation" (Transcript page 1022). The Appellant argues that the Respondent should not have the advantage of reassessing outside the normal reassessment period on the basis of misrepresentation simply because it disagrees with the taxpayer's filing position. The Appellant had a *bona fide* filing position respecting the back-charges as well as the calculation of GST on PST. This is a difference of opinion which does not equal misrepresentation. There is no calculation error respecting back-charges and the Appellant's interpretation of the applicable provisions in the *Act* are correct. Even if that interpretation is wrong, it was *bona fide* and reasonable and therefore not a misrepresentation.

[83] The Appellant submits that GST is a small administrative portion of its business, that the back-charges make up a miniscule portion of the ITCs it claims and that the back-charges at issue are an even smaller portion of that amount. The approach taken by the Appellant on the back-charges is correct but in the alternative a *bona fide* filing position cannot amount to a misrepresentation.

[84] The Appellant asserts that where a back-charge is made, the provision that applies is section 232. Subsection 232(2) allows the parties to adjust GST in the event, that the consideration upon which it was based, is subsequently reduced. The Appellant argues, that since section 232 is an optional provision, one does not have to adjust unless there is some other specific section that requires a taxpayer to adjust. Moreover, this is so even if section 232 does not apply. The Minister's interpretation that a taxpayer must adjust GST and the related ITCs under other provisions of the *Act*, even if section 232 does not apply, cannot be correct. If the Minister's interpretation is correct, then the option provided pursuant to section 232 is illusory. The Appellant submits that if a taxpayer exercises an option not to adjust pursuant to section 232, then he should not be asked to adjust under another section of the *Act*.

[85] Finally, the Appellant argues that the penalties should be deleted because subsection 280(1) cannot apply where the Appellant has exercised reasonable care and due diligence. Since the Appellant took all reasonable precautions and had all necessary systems in place, it should not be responsible for the acts of its comptroller, who was criminally convicted of defrauding the Appellant of close to one million dollars, or for the acts of the external accounting firm.

The Respondent's Position

[86] The Respondent submits that the Appellant made a misrepresentation that is attributable to neglect, carelessness or wilful default, and thus, subsection 298(4) applies. The Appellant should have adjusted the original invoices from the subcontractors to reflect the appropriate GST adjustment, and in failing to adjust, the Appellant made a misrepresentation. Since the Appellant passed on approximately $153,000.00 in GST to the original subcontractors where no supply was provided by the Appellant, that amount must be taken into consideration when the Appellant claims its refund by way of ITCs. If there was no supply, no GST should have been charged. Only the principal consideration should have been charged to the original subcontractor. In over-claiming ITCs and in under-remitting GST on the PST portion of the subcontractor's invoices, the Appellant made a misrepresentation on its GST returns that is attributable to neglect, carelessness or wilful default. The Appellant did not exercise due diligence and is liable to pay penalties pursuant to subsection 280(1) together with interest at the prescribed rate.

[87] The Respondent contends that the Appellant relied on its internal and external accountants and that, since they were both agents of the Appellant, their actions and intent were the very actions and intent of the Appellant itself. Therefore negligence of the internal and external accountants is in essence negligence attributable to the Appellant.

[88] The Respondent submits that section 232 does not apply as there was no decision by the parties to adjust under this provision and in any event Respondent counsel abandoned reliance on this section during the hearing. However, the Appellant must adjust GST and related ITCs under other relevant sections of the *Act* when section 232 is not being applied.

Analysis

Issues # 1 and # 2

[89] I will address the issues of the statute barred period and penalties together as they tend to overlap in the evidence.

[90] Subsection 298(1) provides a time limit of four years for the CRA to issue an assessment. However, under subsection 298(4), if certain conditions are met, an assessment can be made at any time beyond the four year limitation period set down

in the *Act*. Since a waiver was never requested and fraud is not alleged, we are dealing with paragraph 298(4)(a) which states:

> An assessment in respect of any matter may be made at any time where the person to be assessed has, in respect of that matter,
>
> (a) made a misrepresentation that is attributable to the person's neglect, carelessness or wilful default;

The onus is on the Minister to establish the existence of misrepresentation that is attributable to neglect, carelessness or wilful default. To succeed, the Minister must first establish that there was a misrepresentation made by or on behalf of the Appellant, and second, that the misrepresentation is attributable to neglect, carelessness or wilful default.

[91] Penalties and interest are imposed pursuant to section 280 of the *Act* where a taxpayer fails to remit or pay an amount as required. In assessing the Appellant for penalties, the Minister relied on subsection 280(1) which states:

> Subject to this section and section 281, where a person fails to remit or pay an amount to the Receiver General when required under this Part, the person shall pay on the amount not remitted or paid
>
> (a) a penalty of 6% per year, and
>
> (b) interest at the prescribed rate,
>
> computed for the period beginning on the first day following the day on or before which the amount was required to be remitted or paid and ending on the day the amount is remitted or paid.

Penalties assessed pursuant to this provision, are of course susceptible to the Appellant raising the implied defence of due diligence. A taxpayer will not be penalized under this section if due diligence was exercised in attempting to comply with the legislation (*Canada (A.G.) v. Consolidated Canadian Contractors Inc.*, [1999] 1 F.C. 209 (F.C.A.), explaining Bowman J.'s widely approved of decision in *Pillar Oilfield Projects Ltd. v. Canada*, [1993] G.S.T.C. 49 (T.C.C.)). This provides registrants the opportunity to exculpate themselves in respect to the penalties if they can demonstrate that they "exercised reasonable care in attempting to ascertain the correct amount of GST owing" (*Consolidated Canadian Contractors* at paragraph 52).

[92] In essence then, the issue of misrepresentation as it applies to both sections 298 and 280 turns on whether the Appellant exercised reasonable care in respect to the two transactions (the GST on PST and the back-charges). Under section 298, the statute barred years may be re-opened only if the Minister can establish that the Appellant, in failing to exercise reasonable care, committed a misrepresentation due to neglect, carelessness or wilful default. Under section 280, the Appellant may escape the penalties if it can show that it exercised reasonable care in dealing with these transactions.

[93] The Federal Court (Trial Division) in *Venne v. The Queen*, 84 DTC 6247 at 6251 discussed the standard of care required of a taxpayer under sub-paragraph 152(4)(a)(i) of the *Income Tax Act*, the equivalent of subsection 298(4) of the *Excise Tax Act* and containing much the same wording:

> I am satisfied that it is sufficient for the Minister, in order to invoke the power under subparagraph 152(4)(a)(i) of the Act to show that, with respect to any one or more aspects of his income tax return for a given year, a taxpayer has been negligent. Such negligence is established if it is shown that the taxpayer has not exercised reasonable care. This is surely what the words "misrepresentation that is attributable to neglect" must mean, particularly when combined with other grounds such as "carelessness" or "wilful default" which refer to a higher degree of negligence or to intentional misconduct. Unless these words are superfluous in the section, which I am not able to assume, the term "neglect" involves a lesser standard of deficiency akin to that used in other fields of law such as the law of tort.

[94] Due diligence in the context of section 280 was discussed in *Pillar Oilfield*, *supra*. At pages 49-4 and 49-7, Justice Bowman wrote:

> … It is, I think, contrary to ordinary concepts of fairness that a taxpayer should be penalized for a failure to observe a statutory provision or to calculate tax correctly if that taxpayer demonstrates that even with the exercise of due diligence the mistake was unavoidable. …
>
> Innocent good faith does not, however, amount to due diligence.

[95] The term due diligence was again described by Justice Bowman in *Wong (E) v. Canada*, [1996] G.S.T.C. 73-1 (T.C.C.) at 73-5, as follows:

> ... Due diligence is nothing more than the degree [of] care that a reasonable person would take to ensure compliance with the Act. It does not require perfection or infallibility. It does, however, require more than a casual inquiry of an official in the Tax Department. (Emphasis mine.)

[96] For the Minister to be successful in re-opening the statute barred years respecting the back-charge transactions, it must be shown that the Appellant committed a misrepresentation in completing its returns and that the mistake was the result of neglect, carelessness or wilful default. The processes, which led to the establishment of the back-charges and the calculation of the GST on PST, are clearly outlined in the evidence. Basically, when a subcontractor was responsible for deficient work the Appellant hired a second subcontractor to correct it and this second subcontractor charged the Appellant for the remedial work together with GST, for which the Appellant claimed an ITC. The entire amount paid to this second subcontractor, including the GST portion, was back-charged to the original subcontractor, who was asked to pay the amount or alternatively have his progress payments on the original contract reduced by that amount. Ms. Farina in giving her evidence explained that a notification letter was generated by the Appellant's accounts department and then forwarded to the original subcontractor whose work had been remedied. The documents in support of Ms. Farina's explanation of the procedure were taken primarily from the working papers of the external accountants. The same procedure was followed each and every time; if there were exceptions, none were picked up. Although this notification letter talks about a credit note, the evidence of both Ms. Farina (the Appellant's current external accountant) and Mr. Pyeon (a CRA technical advisor) confirmed that no debit notes were ever processed. It was the Appellant's contention that no debit notes were generated because in reducing the contract consideration, neither party was making an adjustment of tax. According to the Appellant's argument, the parties did not exercise the option to adjust under section 232 and therefore no credit note or debit note had to be generated. Under subsection 232(2) no adjustment of tax was therefore required and there is no other specific section that requires the parties to adjust. I do not agree with the Appellant's interpretation here. First of all, the Respondent abandoned section 232 during the hearing and agreed that it did not apply in the circumstances of this appeal, even though the Reply initially indicated that it was section 232 that required the adjustment. There was certainly confusion as to which section of the *Act* should be applied. Ms. Kelly, the appeals officer,

testified that she relied on section 232 to assess the Appellant for the over-claimed ITCs where there was a back-charge. Mr. Pyeon's evidence was that he used a completely different section, section 169 (entitlement to ITCs), when he completed his audit. He stated that in his opinion section 232 did not apply.

[97] I do not agree with the Appellant's interpretation of the provisions of the *Act*, however I believe that the Appellant's interpretation, although wrong, may be *bona fide* and reasonable particularly where CRA officials could not agree on which provisions should govern the back-charge transactions. But does the Appellant's interpretation amount to a misrepresentation? None of the Appellant's records suggest that the company was covertly adjusting the ITCs. Everything was open and obvious. During cross-examination, Mr. Pyeon agreed that a difference of opinion as to which section of the *Act* may apply to a transaction does not amount to a misrepresentation. On cross-examination, he also agreed that the Appellant's records were consistent in not adjusting tax. There was no evidence to suggest that the Appellant ever attempted to adjust for ITCs where there was a back-charge. Mr. Pyeon, when asked if the Appellant had tried to misrepresent the ITC adjustments, replied that he could not tell and that he simply did not know.

[98] Respecting the calculation of GST on PST, Ms. Farina testified that it was also recorded in an open fashion and that each transaction was dealt with consistently by the Appellant. The evidence established that the Appellant did not hide, or attempt to hide, the fact that adjustments were made. The Appellant conceded the amounts respecting these transactions and thus they are not at issue.

[99] I agree with the Appellant's contention that a *bona fide* approach to adjusting the tax cannot, in these circumstances, constitute a misrepresentation, particularly where Agency officials cannot agree on the appropriate sections of the *Act* that govern the transactions.

[100] So, in the final result, do I have any evidence before me establishing that the Appellant made a misrepresentation to the Minister? There was no such evidence provided to me. Although the Appellant's approach, I believe, was incorrect, I do not believe it amounted to a misrepresentation to the Minister. I appreciate that this Appellant has been put in a difficult position, not only because of the passage of time, but also because the principal players that have so affected this outcome have either been found criminally liable for fraud and jailed (the Appellant's comptroller, Mr. Kar) or are being sued by the Appellant (the external accountants, Martyn, Dooley & Partners). The Respondent did not specifically refer to a single GST return that contained a misrepresentation. When Ms. MacNeil was questioned

respecting her determination to assess beyond the statutory limitation period, she stated that one of her reasons was "... because the amount was significant for GST purposes ..." (Transcript page 658). Quantum is certainly not sufficient for the Minister to find a misrepresentation; and even if by some stretch I could find that it was, the amount was relatively miniscule when viewed in the context of the overall business revenue of the Appellant, where hundreds of millions of dollars in transactions took place over a five-year period. Ms. MacNeil then went on to state some of her other reasons, which were "... because the company had an internal accountant for the majority of the time of the assessment who stated that he did it knowingly and because if he's guilty of doing this so therefore is the company ..." (Transcript pages 658 – 659). On cross-examination, she admitted that her perception was based on conversations she had with Mr. Kar. Given Mr. Kar's conviction on charges of defrauding the Appellant of close to one million dollars, I would not accept as credible or remotely reliable any such representations he is alleged to have made, even if they were admissible. In the next portion of Ms. MacNeil's response, she stated that a further reason was "... because they hired another internal accountant who was also a C.A., and he didn't inform the auditors of the two different sales invoices when the auditors went out there; there were two different and complete separate sales invoices and the third party – the ones provided to the third parties were never shown to the auditors" (Transcript page 659). Although there were no specifics in the Reply to the Notice of Appeal respecting this allegation, Ms. MacNeil is stating that Mr. Dickinson, the internal accountant hired to replace Mr. Kar, did not give copies of the progress certificates to the auditors and that this supported a misrepresentation. First, as rightly pointed out by Appellant counsel, even if there was such a misrepresentation by Mr. Dickinson to the auditor, Phil Soosaithasan, the proper way to prove such an allegation is by calling Mr. Soosaithasan. Ms. MacNeil admits she was not present; and because of the number of intervening years, even if I were to disregard evidentiary rules and give some sort of credence to this allegation, I could not give it any weight. The audit file contained notes belonging to Mr. Soosaithasan (filed on consent as Exhibit A-4) which indicate that he reviewed many invoices and documents. He went to a third party to obtain a progress certificate which he then checked against the worksheet that the Appellant (according to Ms. Farina's evidence) used to calculate the GST. Since Mr. Soosaithasan did not testify, I can only speculate that on comparison of these documents, being the progress certificate and the worksheet, he would see a discrepancy. I assume this to be the case because at the third page of Exhibit A-4 it was noted that the Appellant's officers were co-operative in providing other necessary documents when requested. His notes confirm that he requested further records and that he received them. These notes contradict the evidence provided by Ms. MacNeil in Court, who

in any event was not present with Mr. Soosaithasan at the Appellant's offices. It is clear that Mr. Soosaithasan knew that the Appellant was openly making a reduction for PST and then applying GST on the reduced amount because the Appellant kept the calculations on a worksheet with the GST filings to show exactly how the calculations were being made. This is not the method the Appellant would employ if it were intent on misrepresenting those calculations and concealing them. There was no such attempt here. Contained in the special investigations' file (Exhibit A-5) were two memoranda from Ms. MacNeil that outlined her conversations with the CRA audit team: one on January 25, 1996 and one prior to the referral to special investigations on May 24, 1996. There is no reference of a specific misrepresentation made to the Minister or that the Appellant's officers were not being co-operative. Her notes merely document her discussions with Mr. Soosaithasan and in those notes she summarized the tax adjustments made by the Appellant. In fact, in her January 25, 1996 notes, Ms. MacNeil stated that she advised Mr. Soosaithasan that the Appellant "could have reasons" for adjusting the tax.

[101] Now, with respect to the GST on PST adjustments, as they relate to the statute barred issue, the Appellant utilized the 2.7407% formula to calculate the GST on a reduced contract price, and as a result it under-remitted GST. Since the introduction of GST, it has become a recognized principle that general retail sales tax is to be excluded from GST calculations. I do not believe it is such a giant leap to expect that the Appellant would accept that it was reasonable to not charge GST on PST. Devising a formula to accomplish this, however, does not amount to a misrepresentation. Certainly the Appellant under remitted GST and should have dealt with it differently. It was the responsibility of Martyn, Dooley to detect this error and inform the Appellant. The Appellant did not take the position that the correct procedures were instituted in respect to the GST on PST issue but that the evidence does not support a conclusion that the Appellant made a misrepresentation to the Minister. If the Appellant concluded that it was correct to back out the GST on the PST, is it a misrepresentation to the Minister to include it in income where the internal chartered accountant devised the formula and the external accounting firm sanctioned it but never advised the Appellant to change its procedures? In addition can there be a misrepresentation when the records were open and obvious for anyone viewing them, with the worksheets attached to the GST filings and returns? I do not believe so, particularly when one looks at the period under appeal. It was during the inception of the GST tax, when confusion existed respecting its implementation. The Appellant made no attempt to conceal the GST it under-remitted either in books, records or accounts. It was simply viewed as not owing to the Minister and therefore it was included in income and

taxes paid on it. I do not believe this means the Appellant was negligent or careless and certainly it is not evidence of wilful default. The crux of the problem here is with accountants. It is unfortunate when transactions such as these are not recognized as problematic by an internal accountant, who appears to have had his own agenda respecting the Appellant's revenue, but it is tragic when first rate external accountants examine these records year after year and place their seal of approval on those procedures utilized by the Appellant. There was no reason for the Appellant to hide anything from the CRA auditors. All the professionals, whom the Appellant hired and paid, told the Appellant everything was fine. The Respondent argued that the Appellant relied solely on its own viewpoint and did not seek advice regarding the specific method it adopted for the GST on PST adjustments and the back-charges. This is simply not correct. The Appellant formulated the calculations but all adjustments were in plain view for the external accountants to review and take issue with, if they felt there were potential problems.

[102] Ms. MacNeil testified that the Appellant created two sets of invoices (being the customer invoices and the invoices shown to the auditor). However this is not quite accurate. Firstly, regarding the supposed 'customer invoices', Ms. Farina explained that in the construction industry no one gets paid based on an invoice and, in fact, invoices are generally not forwarded to the customer. Rather, parties are paid pursuant to a certificate of payment. In the present case, the Appellant received payment based on the certificates of payment and the evidence does not suggest that they were altered in any way to support some elaborate scheme to collect GST but not remit it.

[103] Secondly, the worksheets created by the Appellant (the supposed 'invoices' shown to the auditor) would not be considered invoices in the construction industry and the Appellant did not receive payment based on them. Accordingly, I find that these worksheets were not invoices as suggested by Ms. MacNeil. They were simply the means used to document and track all of the adjustments because everyone believed they were acceptable. There is no misrepresentation here. Everything was in full view for anyone perusing the books to see and the Appellant utilized the same tracking method for every transaction involving huge amounts of money over a period of years.

[104] Assuming I had found a misrepresentation here, which I have not, there is no evidence of neglect, carelessness or wilful default on the part of the Appellant. Therefore, the Minister could not satisfy the second part of the test even if I found a misrepresentation. The Appellant implemented many systems to ensure proper

compliance with this new legislation. It retained a full-time internal auditor who was a chartered accountant, accounting staff typical of a business the size of the Appellant, and a top rated external accounting firm. A premier accounting and software system was maintained and the highest level of audit was employed. Both Ms. Farina and Mr. Pyeon testified that the Appellant fully employed these systems and that every transaction was recorded in a consistent manner throughout the books. The Appellant was never told to change anything. There was no hint that something might be amiss. Large sums of money were expended to implement an elaborate system of checks and balances. The Appellant provided the CRA auditors with full access to all of its documents and the evidence would suggest that it did so co-operatively. It is simply not possible for me to conclude that this taxpayer was guilty of neglect or carelessness and certainly not wilful default. Martyn, Dooley had access to all of the Appellant's records. The evidence is that this accounting firm knew full well from the worksheets that the GST on PST was being adjusted using a formula of 2.7407%. The worksheets and other documentation paint a full picture of what the Appellant was doing. Yet none of the GST reasonability tests or the significant matters memos raise any concerns respecting this calculation in any of the years. In fact, evidence that Martyn, Dooley considered these adjustments appropriate and proper is indicated at Exhibit A-3, where at page 70, under the heading "Following to be reviewed with Ralph Aquino", only a very minor GST matter involving a vehicle was raised, for which Martyn, Dooley thought Revenue Canada might take exception. If Martyn, Dooley saw the calculations and did not know they were incorrect, how can it be said that the Appellant should have known and that there was some neglect, carelessness or wilful default here of which the Appellant is guilty?

[105]The Respondent argued that Mr. Sudan of Martyn, Dooley discussed the GST on PST issue during the meeting in June 1995 with Mr. Kar and Mr. Aquino. I was also referred to the 1994 significant matters memo (Exhibit A-3) containing the handwritten notes. Respondent argued that the evidence suggests that the matter of having two sets of invoices – of collecting GST and remitting less than collected – was discussed with the Appellant during that meeting as evidenced by these notes, and yet despite this knowledge, the Appellant decided to continue with the practice for several months after the meeting until November 1995. Although I intend to address this item in my analysis of the penalty issue, I cannot conclude that the evidence supports the Respondent's characterization of these events. The Appellant's principal contact person at Martyn, Dooley was Mr. Sudan. I reject Mr. Sudan's testimony in its entirety. He was the most unreliable witness I have ever had before me. I view anything he said under oath as totally self-serving and

suspicious. I reject his entire evidence with respect to this significant matters memo and the handwritten notes appearing on its face.

[106] Martyn, Dooley, according to Ms. Farina's evidence, was employed at the highest level of engagement and one of the crucial aspects of such an engagement is to identify potential issues and problems for the taxpayer that is employing them. It must be one of the important reasons a taxpayer would decide to pay huge sums of money for the highest level of accounting advice. Certainly if Martyn, Dooley felt a minor GST issue involving a vehicle was important enough to reference for discussions with Mr. Aquino, then the open, obvious and problematic GST calculations at issue here should have reduced them to shell shock. Yes, Martyn, Dooley should have known, but a reasonably prudent taxpayer such as the Appellant would not and could not be expected to. There is no negligence or carelessness on the part of the Appellant and certainly no evidence of wilful default.

[107] But can negligence be attributed to the Appellant because it hired internal and external accountants so that the resulting relationship makes the actions of the servants/employees that of the master/employer? Although I believe that my finding (that the Appellant made no misrepresentations to the Minster) ends the matter, both Respondent and Appellant counsel spent considerable time addressing this issue and, for this reason, I wish to make the following comments. Agency principles propose that if an agent can be said to be the directing mind and a vital organ of the corporate entity, then his actions and intent, within the sphere of his assigned duties and responsibilities, become the very action and intent of the corporation itself. This renders the corporation liable for the agents' actions. However, this principle applies only to the extent that the agent was acting within the scope of his authority, either express or implied. Mr. Aquino did not have the education or knowledge to deal directly with GST matters and even if he did, in a company that size, he would, out of necessity, have to delegate those matters. Mr. Kar was certainly the main man in respect to GST matters within the corporation. While many of the systems put in place may have been at the request of Mr. Kar, I do not believe for one second that he would have implemented any of these elaborate mechanisms unless Mr. Aquino acquiesced. Mr. Aquino presented as an individual who was a "hands on" owner. He testified he spent many hours in the field overseeing the projects. He is a self-educated man and this is where his expertise lies. I think the only time he may have given Mr. Kar more reign was during the period in 1994 when his wife was ill and subsequently died. Before Mr. Kar perpetrated the fraud, Mr. Aquino trusted his judgment and suggestions respecting tax matters, but Mr. Aquino had no choice. It is interesting to note that

on the significant matters memo, it was Mr. Aquino's name, not Mr. Kar's, that Martyn, Dooley referenced, for discussion of issues raised. Mr. Aquino testified that he was always present when Mr. Sudan attended at the Appellant's offices to review its statements and returns. Mr. Aquino did not abdicate his authority by delegating certain office responsibilities to Mr. Kar. Even if I found Mr. Kar to be the directing mind, there is no doubt on the evidence before me that he was acting outside the scope of his authority, and therefore, the Appellant would not be responsible for his acts. This would also apply to the actions of Martyn, Dooley if in fact the principles of agency could be extended that far. Mr. Aquino retained ultimate control. It was his corporation and he worked hard through the years to make it what it is today. Even if agency laws apply here, Mr. Kar was not its directing mind.

[108] As much as Mr. Aquino was able to understand, he attended the year end meetings and discussions with Martyn, Dooley and attended to the final review and signing of the returns. He is not someone who hired an incompetent bookkeeper to look after tax matters and then ignored what was happening over a period of time. Mr. Kar was a chartered accountant. He could never be characterized as patently inadequate because he was so adept as a scoundrel that he swindled almost a million dollars from the Appellant.

[109] In respect to the external accounting firm, they were hired at the highest level of engagement to review all records, audit financial statements and report on issues and problems; however, this did not make the firm a directing mind of the Appellant in respect to GST matters. They were negligent, careless, inadequate and inept but they were not, perhaps thankfully, the directing mind of corporate affairs for the Appellant. They were the last notch in a system of checks and balances that the Appellant put in place and the Appellant paid huge sums of money for their services. Regrettably for the Appellant, all of these elaborate systems failed miserably.

[110] In summary, I conclude that the Minister has not met the onus of establishing that the Appellant made a misrepresentation to the Minister that was attributable to the Appellant's neglect, carelessness or wilful default. As a result, the period from January 1, 1991 to June 5, 1994 is statute barred within the meaning of subsection 298(1) of the *Act* and may not be re-opened.

[111] The second issue involves the imposition of penalties pursuant to section 280 of the *Act*.

[112] Because of my conclusion on the first issue (that the period January 1, 1991 to June 5, 1994 is statute barred), some of the penalties will be reduced accordingly. However, the latter portion of the period under appeal does not fall within the statute barred years and thus may be subject to penalties. The onus is on the Appellant to convince me that I should reverse the penalties. To do so I must be convinced that the Appellant exercised due diligence. Based on my analysis of the statute barred issue, it almost necessarily follows that I find that the Appellant was duly diligent for the purposes of the section 280 penalty. Each case must turn on its own unique set of facts and certainly this case is in ample supply of those. The evidence has clearly established that Mr. Aquino, the sole shareholder, President and directing mind of the Appellant company, had neither the education nor the knowledge in tax matters to deal “hands on” with this particular aspect of his business. He knew his limitations and ensured the proper systems were in place to deal with the complexity of this legislation. An internal accountant and staff were hired to ensure compliance. A sophisticated computer system and premier accounting software system were installed. A reputable external accounting firm was engaged to complete the highest level of accounting advice and he personally attended the meetings with the representative of the external accounting firm.

[113] Ms. Farina explained that the obligations of the external accountants would include making sure that the appropriate procedures were in place to ensure GST compliance. She testified that this would be a standard practice when paying for the highest level of accounting or audited statements. Although engagement letters do not specifically cover this, I accept Ms. Farina’s evidence that this is standard practice. Ms. Farina presented herself as a highly professional, competent and reliable witness who was knowledgeable and skilled in accounting matters. I was very impressed with her testimony. I have no reason not to accept all of her evidence. The Appellant engaged every possible internal and external control to ensure compliance and there was nothing that would have alerted him to the fact that his company was not in compliance. This was certainly an erroneous assumption on his part, but one for which he cannot be deemed negligent. The wording of the engagement letter from the external accountants (Exhibit A-1, Tab 1), although pre-GST, provides the breadth of the types of professional accounting services the Appellant engaged. Mr. Aquino testified that he took a level of comfort and reliance on the accounting services he was paying for. When the GST was introduced, the external accountants forwarded a letter to the Appellant (Exhibit A-1, Tab 2) in which they referred to formulating a future planning checklist to identify any GST planning opportunities, issues or potential problems. This was forwarded to the Appellant, with eventual contact and follow-up. In another letter from Mr. Dooley, on behalf of his firm (Doane Raymond Pannell at

the time), dated May 13, 1991 (Exhibit A-1, Tab 3), the Appellant was advised that the external accountants would ascertain whether the financial statements were free of material misstatement and that they would assess the accounting principles being used. I believe that these statements imply that GST compliance will be part of their audit. In addition, I have Ms. Farina's unchallenged evidence that, although engagement letters do not normally refer specifically to GST, it is clearly included when they agree to provide and receive payment for a full service audit. The working papers of the external accountants identified the GST calculations in issue but then failed to identify them as problems. It is in fact quite remarkable and telling that, in Exhibit A-3, Tab 4, under the heading "commodity taxes", the firm wrote:

> Consistent with last year – client maintains two sets of invoices one for customers to pay and one to record GST collected on sales.

Mr. Kar's calculations were open and obvious throughout but Martyn, Dooley failed to identify them as problems on any of the significant matters memos. According to Mr. Sudan's evidence, he brought these problems to the Appellant's attention in June 1995. However, I have rejected all of Mr. Sudan's evidence; and even if I accepted his evidence on this one point, it was clear that it was beyond his ability to convey or explain the serious nature of those problems to Mr. Kar and Mr. Aquino. I base this conclusion on the fact that Mr. Sudan was unable to follow a fairly simple GST calculation that Appellant counsel attempted to take him through on cross-examination. There was nothing that was hidden or disguised in Mr. Kar's calculations and in fact Mr. Dickinson, who replaced Mr. Kar, was able to identify these calculations as problematic very shortly after he started working for the Appellant.

[114] The handwritten notes of the external accountants in each of the reports on the working papers contain no references to these GST issues to be discussed with Mr. Aquino. A note to discuss GST on a vehicle can hardly compare to the magnitude of the problem with Mr. Kar's GST calculations. Mr. Aquino testified that none of the accountants ever indicated any difficulties with GST or concerns with the way his company was dealing with and reporting GST. If he had been so advised, he stated that he would have acted immediately to correct these problems as he did when he paid the amount owed to the CRA as soon as Mr. Dickinson informed him of the problems. In addition, CRA officials had attended at the premises several times to complete audits and he was not advised of any GST problems. So what other reasonable actions could the Appellant have taken to ensure compliance? I know of no other steps that the company could have taken

except to proceed into the realm of the ridiculous by speculating that the company should have also paid for a second firm of external accountants to check on the work of the first. This is just not a step that could be deemed reasonable in the every day business world. If the Appellant had been suspect of Martyn, Dooley's work, then it could be said that it might be responsible and reasonable to have a second accounting firm review the work. The Appellant however had no reason to be suspicious.

[115] In addition, although these GST amounts may seem large on their face, the shortfall on a month-by-month basis was small in comparison to the total revenues generated by the Appellant. The Appellant had to pay a significant amount of GST but the difference between what was remitted and what should have been remitted is small and certainly not significant enough that Mr. Aquino, or anyone else signing the cheques and seeing the GST returns, should have caught or be reasonably expected to have caught.

[116] Mr. Aquino placed great reliance on Mr. Kar, his comptroller. He placed him in a greater position of trust in 1994 when his wife was ill. It was at this time that Mr. Kar perpetrated the fraud of almost one million dollars against the company. However throughout the entire period, the Appellant maintained its supporting systems of software package, computer system, inside accounting staff and professional external accountants as the ultimate system of checks and balances.

[117] And finally we have Mr. Sudan who was the only partner of the external accounting firm, Martyn, Dooley, and its predecessor firms, to have direct contact throughout this period with Mr. Aquino. As the representative of the external accounting firm, he had been involved with the Appellant since 1987 or 1988. He was the individual that reviewed the audited statements and accounting practices with Mr. Aquino. And yet it was Mr. Sudan's testimony that he neither reviewed nor, more importantly, even understood the working papers. Mr. Sudan holds himself out as a professional chartered accountant, but one who admittedly could not have recognized and identified this problem as a significant one for the Appellant. He testified that he looked only at the significant matters memo and if no GST issue was identified there, it would never be brought to Mr. Aquino's attention. Ms. Prapavessis did the actual audit and her work was reviewed by Mr. Dooley, the audit partner. We know from the working papers that Martyn, Dooley was aware of the GST calculations, and yet year after year the firm never informed Mr. Aquino. Suddenly in June 1995, according to Mr. Sudan, while he was finalizing the statements, he presented the problem to Mr. Aquino, just a day

or two before the returns were due for filing. Mr. Sudan suggested during his testimony that Mr. Aquino just did nothing. Yet Mr. Aquino's own evidence is that when Mr. Dickinson discovered the problem, he (Mr. Aquino) was absolutely shocked; he corrected the problem immediately and wrote a cheque to the CRA for almost two million dollars that nearly bankrupt his company. I do not know how Mr. Sudan could have identified it as a problem, when according to his evidence, he did not even know that this could be a problem. Quite an admission from the individual who was Mr. Aquino's principal contact person at Martyn, Dooley and the person ultimately responsible for bringing such problems to Mr. Aquino's attention. This was astonishing but perhaps not surprising considering that this same witness, a chartered accountant and the contact person for the Appellant, could not follow Appellant counsel through a simple GST calculation on cross-examination. I have rejected Mr. Sudan's evidence in totality and I certainly did not believe him when he told me that he informed Mr. Aquino about this problem in June 1995. However if I were to believe anything that he did tell me, it would be his initial assertion that the handwriting on the significant matters memo was *not* present when he met with Mr. Aquino in June 1995. On direct examination by Respondent counsel, Mr. Sudan testified that this handwriting came after June 1995; however on cross-examination, he changed his evidence. Eventually, after see-sawing back and forth, he settled on a statement that the handwritten notes "could have been there" in June 1995. I do not believe that those marginal handwritten notes were present when Mr. Sudan met with Mr. Aquino in June 1995. How or why they magically appeared after this date is best left for another court at another time. All of this amounts to stunning incompetence and is not the type of conduct for which the Appellant can be held responsible. There was simply no amount of due diligence that could have alerted the Appellant to this problem. He hired the right people, put the right systems in place and expended huge sums of money to ensure compliance. Unfortunately the Appellant ended up surrounded by amazingly incompetent individuals, one of whom was also a crook. Under reasonable circumstances, all of these systems should have worked for the Appellant. If the external accountants had completed their audits to the level of competency for which they were hired and paid, the improper GST calculations would have been earmarked early on and rectified. But the evidence here clearly establishes that the Appellant has acted reasonably and prudently and cannot be punished for the conduct of its external accountants where their level of incompetence and negligence was so great that no amount of due diligence beyond that demonstrated by the Appellant would have avoided the problem. It is totally unreasonable to suggest that the Appellant somehow should have been alerted to the problem through the exercise of due diligence when professional people hired

and paid to do this very thing, identified the problematic GST calculations but failed to recognize that they were problems.

[118] I am satisfied on the evidence that the Appellant did everything that it could be reasonably expected to do in order to comply with the *Act*. The Appellant was duly diligent in that it exercised the degree of care that a reasonable person would take to ensure such compliance. Any penalties assessed in respect to the period not statute barred will be deleted.

Issue #3

[119] It is best to address this issue, from the perspective of the following question: *who* is entitled to claim the ITCs? To answer this question, it is necessary to review the relevant provisions of the *Excise Tax Act*, namely the former subsection 123(1), the present subsection 123(1) and subsection 169(1).

[120] Initially, the *Excise Tax Act* defined "recipient" as follows:[2]

> 123.(1) "recipient", in respect of a supply, means the person who pays or agrees to pay consideration for the supply or, if no consideration is or is to be paid for the supply, the person to whom the supply is made;

In 1993, an amended definition was introduced and made effective retroactive to December 17, 1990. The new definition, which is still in force today, appears in the present subsection 123(1):[3]

> 123.(1) "recipient" of a supply of property or a service means
>
> (a) where consideration for the supply is payable under an agreement for the supply, the person who is liable under the agreement to pay that consideration,
>
> (b) where paragraph (a) does not apply and consideration is payable for the supply, the person who is liable to pay that consideration ...

[2] Definition as added by S.C. 1990, c. 45, subsection 12(1).
[3] Definition as amended by S.C. 1993, c. 27, subsection 10(1), deemed to be in force on December 17, 1990.

> and any reference to a person to whom a supply is made shall be read as a reference to the recipient of the supply.

The general rule for determining ITCs is contained in subsection 169(1), which during the relevant period read as follows:

> 169.(1) Subject to this Part, where property or a service is supplied to or imported by a person and, … tax in respect of the supply or importation becomes payable by the person or is paid by the person without having become payable, the input tax credit of the person in respect of the property or service … is the amount determined by the formula
>
> A x B
>
> where
>
> A is the total of all tax in respect of the supply or importation that becomes payable … or that is paid by the person during the period without having become payable; and
>
> B is
>
> […]
>
> (c) … the extent (expressed as a percentage) to which the person acquired or imported the property or service for consumption, use or supply in the course of commercial activities of the person.

[121] Under subsection 169(1), the person entitled to claim the ITC is the person to whom the supply is made; and under subsection 123(1) that person is deemed to be the "recipient". Accordingly, for the purposes of the *Excise Tax Act*, it is the recipient of the supply who is entitled to claim the ITC. Who, then, was the recipient in the present case? In both subsections 123(1) and 169(1) the focus is on: who is liable to pay for the supply (and thus the tax on that supply)? The language of these provisions and just simple logic dictate that the intent of subsections 123(1) and 169(1) is to allocate the ITC to the person who actually paid the GST on the supply.

[122] The evidence shows that there were agreements in the form of invoices between the Appellant and the subcontractors hired to do the remedial work. Does it follow that paragraph 123(1)(a) applies such that the Appellant (being the person liable on the face of the agreement) becomes the "recipient"? Not necessarily. Subsection 123(1), and in particular, the relationship between paragraphs 123(1)(a) and (b), was considered by this Court in *Immeubles Sansfaçon Inc. v. Canada*, [2000] TCJ No. 603. In that case, Tardif J. determined that:

> [33] … in a case where consideration has to be paid, the recipient is the one who, ultimately, under an agreement for a supply [according to paragraph (a)] or otherwise [according to paragraph (b)], is liable to pay that consideration.
>
> [34] The situations provided for by paragraphs (a) and (b) are mutually exclusive in the sense that there cannot be two separate recipients, one under paragraph (a), the other under paragraph (b). This does not mean, however, that if there is an agreement for a supply, paragraph (a) cannot apply. Paragraph (b) could apply despite the existence of an agreement for a supply in a case where the person liable to pay under that agreement is not required to pay anything at all. [Note 5: Judge Dussault's finding in *163410 Canada Inc. v. Canada*, T.C.C., No. 97-1752-GST-G, September 24, 1998 ([1998] G.S.T.C. 116) appears to be consistent with this interpretation. In that case, the existence of an agreement between the supplier and a third party intermediary did not seem to pose an obstacle to the possibility of the appellant having a legal obligation towards the supplier under paragraph (b) of the definition of "recipient" in section 123 of the Act.]
>
> [Emphasis added.]

[123] Thus, we must determine who was "ultimately" liable to pay for the supply. In the present case, where a subcontractor's work was deficient, it was common practice for the Appellant to hire a second subcontractor to remedy the work. The Appellant would then attempt to recover its costs for this remedial work from the original subcontractor through a back-charge, that is, by seeking a price reduction on the original contract equal to the amount paid to the second subcontractor (including the GST paid). By accepting this back-charge, the original subcontractor acknowledged its responsibility for the work deficiencies and assumed liability for the invoice. Although the Appellant's name appeared on the face of the invoice, it was the original subcontractor, not the Appellant, that accepted ultimate liability for the invoice including the GST on that invoice.

[124] There was also evidence that it was open to a subcontractor to contest the back-charge, and in some instances, the Appellant would reverse the back-charge. However, those cases are not at issue in the present case. Rather, what is at issue are those cases were the Appellant claimed ITCs on remedial work invoices even though its liability for those invoices was successfully transferred to a subcontractor. In these latter instances, I find that this subcontractor is the recipient and, accordingly, the Appellant is not entitled to claim the ITCs. Although this sufficiently disposes of this issue, I would like to briefly address the Appellant's arguments.

[125] The Appellant claimed that a back-charge was intended to amend the original contract with a subcontractor and that this is supported by the back-charge notification letter in which the Appellant requested a credit note from the subcontractor. I do not agree. Had the Appellant intended to reduce the original contract (and the related GST), it could have either sent a debit note with the prescribed information or insisted on receiving a credit note with the prescribed information; however, the Appellant did neither. The notification letters do not amount to debit notes and there was no evidence that any credit notes were ever issued to the Appellant. It seems that the Appellant, rather than insisting on an adjustment of the original contract, was content to let the subcontractor adopt responsibility for the remedial work invoice by accepting the back-charge. Thus, while a back-charge does *offset* the amount the Appellant owes the original subcontractor under the original contract, it does not *reduce* the original contract.

[126] The Appellant argued in the alternative that the back-charge was an amount paid by the subcontractor to cover a loss suffered by the Appellant (see Transcript at page 1314), which is not a taxable supply and hence not subject to GST. I do not accept this argument. Where a subcontractor receives a notification letter (including the invoice) and elects to accept the back-charge without amending the original contract (through the issuance of a credit note), it is clear that the subcontractor is accepting liability for that particular invoice.

Conclusion

[127] In summary, the period from January 1, 1991 to June 5, 1994 is statute barred, the penalties will be deleted and the ITCs claimed in respect to the back-charges, to the extent they are not statute barred, will be disallowed. Since the Appellant has been successful for the most part, I am awarding the Appellant two sets of counsel costs.

Signed at Ottawa, Canada, this 18th day of May 2005.

"Diane Campbell"

Campbell, J.

CITATION:	2005TCC78
COURT FILE NO.:	2001-967(GST)G
STYLE OF CAUSE:	Bondfield Construction Company (1983) Limited and Her Majesty the Queen
PLACE OF HEARING:	Toronto, Ontario
DATES OF HEARING:	September 22, 23 and 24, 2003, October 21 and 22, 2003 and February 23, 24, 25, 26 and 27, 2004
REASONS FOR JUDGMENT BY:	The Honourable Justice Diane Campbell
DATE OF JUDGMENT:	May 18, 2005

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