Docket: 2003-1672(IT)G

BETWEEN:

SANDIA MOUNTAIN HOLDINGS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on common evidence with the appeals of Elizabeth Kulla (2003-1686(IT)G)) on May 15 and 19, 2006 and August 25, 2006 and judgment with reasons delivered orally from the bench on August 28, 2006 at Toronto, Ontario

Before: The Honourable Justice J.E. Hershfield

Appearances:

Counsel for the Appellant:	Richard G. Fitzsimmons, Leigh S. Taylor, Giuseppe G.M. LoPresti
Counsel for the Respondent:	Bobby J. Sood

AMENDED JUDGMENT

The appeal from the assessment made pursuant to the *Income Tax Act* in respect of the 1993 taxation year is allowed and is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the unreported income shall be reduced by $88,677.00.

The appeals from the assessments made pursuant to the *Income Tax Act* in respect of the 1994, 1995, 1996, 1997 and 1998 taxation years are allowed and the assessments are referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the interest expenses disallowed in each of those years shall be allowed as claimed.

The **appeal** from the **assessment** in respect of the 1999 taxation **year is** dismissed.

Costs are awarded to the Respondent in the amount equal to 50% of the total tariff prescribed in respect of all the appeals heard on common evidence.

Signed at Ottawa, Canada, this 13th day of October 2006.

"J.E. Hershfield"

Hershfield J.

Docket: 2003-1686(IT)G

BETWEEN:

ELIZABETH KULLA,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on common evidence with the appeals of Sandia Mountain Holdings Inc. (2003-1672(IT)G)) on May 15 and 19, 2006 and on August 25, 2006 and judgment with reasons delivered orally from the bench on August 28, 2006 at Toronto, Ontario

Before: The Honourable Justice J.E. Hershfield

Appearances:

Counsel for the Appellant:	Richard G. Fitzsimmons, Leigh S. Taylor, Giuseppe G.M. LoPresti
Counsel for the Respondent:	Bobby J. Sood

AMENDED JUDGMENT

The appeals from the assessments made pursuant to the *Income Tax Act* for the 1991 and 1992 taxation years are allowed.

The appeal from the assessment in respect of the 1993 taxation year is allowed and the assessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the unreported income assessed as a taxable benefit shall be reduced by $88,677. The basis for confirming the balance of the amount assessed as a benefit in respect of such years shall be pursuant to subsection 15(2) of the *Act*.

The appeals in respect of the 1994, 1995, **1996**, 1997 and 1998 taxation years are allowed and the assessments are referred back to the Minister for reconsideration and reassessment on the basis that the unreported income assessed as a taxable benefit in each of those years shall be reduced by all interest amounts incurred by Sandia Mountain Holdings Inc. and attributed to the Appellant as a taxable benefit in those years. The basis for confirming the balance of the amount assessed as a benefit in each of those years shall be pursuant to subsection 15(2) of the *Act*.

The reassessment in respect of the 1999 taxation year is confirmed on the basis that the amount assessed as a benefit shall be pursuant to subsection 15(2) of the *Act*.

Each party shall bear their own costs.

Signed at Ottawa, Canada, this 13th day of October 2006.

"J.E. Hershfield"

Hershfield J.

Citation: 2006TCC348
Date: 20061013
Dockets: 2003-1672(IT)G
2003-1686(IT)G

BETWEEN:

SANDIA MOUNTAIN HOLDINGS INC.,
ELIZABETH KULLA

Appellants,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT
(Delivered from the Bench in
Toronto, Ontario on September 28, 2006.)

Hershfield J.

[1] The appeals of Ms. Kulla and Sandia Mountain Holdings Inc. ("Sandia") were heard on common evidence. Ms. Kulla was an officer and the sole shareholder of Sandia since November 1991.

[2] Ms. Kulla was reassessed for her 1991 to 1999 taxation years (inclusive). The first six of those years were reassessed beyond the normal reassessment period pursuant to subsection 152(4).

[3] Ms. Kulla was reassessed in each of the subject years on the basis that Sandia paid certain of her personal expenses in varying amounts in each of the subject years and thereby conferred benefits on her in her capacity as an officer and shareholder. The Respondent relies on subsections 6(1) and 15(1) of the *Income Tax Act* (the "*Act*"). I note however that in an Amended Reply, section 6 is relied on only in respect of Ms. Kulla's 1991 and 1992 taxation years. Further, Ms.Kulla was assessed penalties pursuant to subsection 163(2) of the *Act* for failing to include the subject benefits in computing her income in each of the subject years.

[4] Sandia was reassessed for its 1993 to 1999 taxation years (inclusive) ending July 31. The first of these years was reassessed beyond the normal assessment period pursuant to subsection 152(4).

[5] Sandia was reassessed under section 9 of the *Act* in each of the subject years on the basis that it misrepresented rental income amounts paid to it by a related (sister) company – The Shield & Sword Inns Limited ("S & S").[1] Penalties were assessed under subsection 163(2) in respect of the understated rental income for each of the subject years. Penalties were also assessed under subsection 162(1) for the late filing of returns for the 1994 to 1999 taxation years (inclusive). Further, certain interest expenses claimed were denied pursuant to paragraphs 18(1)(a) and 20(1)(c) of the *Act* in respect of the 1994 through 1998 taxation years (inclusive).

[6] The trial of the subject appeals involved the testimony of five witnesses including one expert and a number of read-ins from examinations for discovery and a read-in of a second expert witness's affidavit along with a transcript of his examination, all taking place over a six day period. While some challenges were presented in respect of findings of facts relating to reassessments beyond the normal assessment period and penalties under subsection 163(2) in respect of which the Respondent has the burden of proof, the taxation issues *per se* in my view are straightforward.

Sandia Reassessments

[7] Dealing first with the Sandia reassessments the question is whether certain amounts received from S & S were on account of rent.

[8] Sandia and S & S entered into a rental agreement for the occupation and use of a 50-room motel/tavern which included an adult entertainment lounge. The property had been owned by S & S until 1987 when it was transferred to Sandia. The reason for the sale was to help creditor proof against liabilities that might arise in the course of operations. At the time the motel was leased for use as a detention centre. This was felt to present unusual liability risks as did its bar and lounge business in respect of which liability for impaired driving had become an issue.

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[1] It was not asserted that Ms. Kulla was the controlling shareholder of S & S, however it was not disputed that the control of S & S rested with a related group of which she was a member.

[9] The lease agreement made in 1987 with Sandia specified a fixed monthly rent of $15,000. There was one formal adjustment to the rent in 1992 allowing Sandia as tenant to defer its obligations ostensibly indefinitely at its choice which, for tax purposes, does not in my view create in the years in question an obligation to pay more than $10,000 a month as rent. As well I note that S & S rent expense claims never exceeded $120,000 per year. The accountant for Sandia, S & S and Ms. Kulla testified that he believed the rental charges were intended to be and did reflect the market value of the property. However he also testified that rent adjustments were required to eliminate income in Sandia. Sandia had few deductions and as a result had too much income by virtue of the rental receipts under the lease agreement even at the reduced rent of $10,000 per month. To flatten its income, posted rental amounts received were adjusted downward after the end of the year and the excess receipts were treated as an advance from S & S. These adjustments were shown on Sandia's statements as "unrealized income" or "economic recoveries".

[10] Accordingly, in the subject years, the amounts Sandia reported as rental income were significantly less than the stipulated, paid and received payments from S & S. Sandia's posted rent receipts were as follows:

	1993	1994	1995	1996	1997	1998	1999
Posted Rent Receipts	$190,667	107,000	103,200	104,000	120,000	120,000	120,000
Unrealized Income/Economic Recovery (treated as loans)	$152,000	87,000	57,000	93,000	92,000	89,000	99,000

After taking out amounts treated as loans from S & S, the reported rent was as follows:

	1993	1994	1995	1996	1997	1998	1999
Income Reported	$38,667	33,333	31,200	23,000	28,000	31,000	21,611

[11] The unrealized income/economic recovery amounts were added back to income under the reassessments so that the assessed amounts were as follows:

	1993	1994	1995	1996	1997	1998	1999
Additional Rent	$152,000	87,000	57,000	93,000	92,000	89,000	99,000

[12] 1993 is the only year where amounts brought into income as rent exceeded the amount payable under the lease. Indeed it is higher than the unadjusted rent of $15,000 per month, further supporting the idea that not all payments received by Sandia and posted as rent could in fact be rent. Payments beyond rental amounts owing were credibly advanced as loans. Accordingly for 1993 the rental inclusion should be reduced by $70,677.[2] However, having concluded that it is not unreasonable to regard some part of the posted rent payments as a loan it is helpful to refer to the amounts claimed as rental expense in S & S. In 1993 the amount claimed as rental expense was $102,000. Although S & S had a different year-end (December 31), the reassessments and Reply treat S & S's filed rent expense amount as Sandia's rent receipts for all years except 1993 notwithstanding year-end differences. On that basis I find that the same treatment should be applied in 1993 so that the assessed rent should be reduced by $88,677 as opposed to the $70,677 referred to above.[3]

[13] The Appellants' position was that I should go further and treat the rent adjustments as loans and reduce rent receipts accordingly. The argument is that the intentions of the parties as ultimately shown on financial statements were to amend the written lease and charge a floating rent. The Appellant presented two expert opinions to support this method of accounting, in particular Derek Rostant, who testified that it would be acceptable to reduce recorded rent as being a liability from Sandia back to S & S. Rostant's expert report described the proper journal entries to be Debit Cash $120,000, Credit Rental Income $120,000; Debit "Unrealized Revenue" $90,000, Credit Loan from Shield $90,000. That this was not done in the case at bar does not advance the Appellant's argument.

[14] Indeed, the expert evidence relied on by the Appellants is of no assistance. Notwithstanding that GAAP allows for or requires adjusting entries to reflect actual realizations of items such as rent, it is a legal question as to what those realizations are. The expert opinions were based on assumed facts that did not give the full picture and were given on the basis that the statements in respect of which the opinion was applicable were subject to GAAP with Notes to the Statements

[2] Rent received under lease $120,000 less reported amount $38,667 leaves unreported income at $81,333; i.e. $70,677 less than the assessed amount of $152,000.

[3] Rent received under lease $102,000 less reported amount $38,677 leaves unreported income at $63,333; i.e. $88,667 less than the assessed amount of $152,000.

regarding related party transactions. Since these were Notice to Reader Statements the reporting format was different than the format contemplated by the opinion.

[15] I also point out in respect of this issue that if there were loans in such substantial amounts made each year, the payable should increase. In fact, as pointed out by Respondent's counsel, they decreased which is hard to explain when income was flattened every year and no other sources of funds are apparent.

[16] I have noted and indeed relied on S & S's posted treatment of its rent expenses. I have done so contrary to the Appellant's own assertion that S & S adjusted its rent expense claims to match the rent reduction amounts claimed by Sandia. Indeed the manner in which the accountant said S & S treated the rent adjustments only enhances the Respondent's position and further supports my impression that the recasting of the rents was nothing more than a covert unscrupulous attempt to avoid taxation. That is, contrary to Sandia's assertion that S & S ultimately claimed lower rent payments than shown on its statements is a dubious one. On that point I simply note that the accounting for such purported reduction is so wanting in transparency and the accountant's explanation so inadequate that I am unconvinced that there were genuine and timely adjustments to the expense claims made by S & S. The accountant said he decreased the cost of sales in S & S to account for the rent adjustments but reconciliations of such covert adjustments required reconciliation with further adjustments all serving to totally obscure the true financial picture of S & S. If S & S had the burden to establish that the rent expenses claimed were adjusted downward by the unrealized income amounts shown on Sandia's statements, it would have failed to meet that burden.

[17] Accordingly, subject to my consideration of the statute barred years issue, I find that the reassessments adding rental income to Sandia's income must stand with an adjustment being allowed in respect of 1993 as noted above.

[18] As to interest expenses denied Sandia, I am satisfied on the evidence that same were incurred all or substantially all for the purposes of gaining and producing income. National Bank mortgage documents refer to the refinancing and renovation of the hotel. I have the testimony of two witnesses, Ms. Kulla and her son-in-law (who managed the hotel and assisted Ms. Kulla in dealing with the bank in regard to this mortgage) that the borrowed funds in respect of which interest was denied were used in part for refinancing the hotel and in part for renovations to it. While further documentary evidence would have been better evidence and while their testimony was self-serving and admitted to the hypothetical possibility of personal interest expenses being incurred and while on a number of other points their testimony was

not always credible, I am satisfied as to the probability that the borrowed funds giving rise to the interest expense in issue were expended on the hotel as asserted by the Appellants. The Respondent's theory as to the funds being used to finance lands owned by Ms. Kulla was not admitted and is so speculative that it does little to discredit the witnesses on this point.

Ms. Kulla

[19] Turning now to the issues pertaining to Ms. Kulla, I note that the asserted benefits relate to three shareholder loan accounts. One such account was maintained for each of three categories of personal benefit. Firstly there was a horse racing stable; secondly there was a farm property which was rented out; and thirdly, there were payments for Ms. Kulla's personal use automobile.

[20] I am satisfied that the entries that were made by Sandia's full-time bookkeeper in respect of these personal items, and accounted for by Sandia on behalf of Ms. Kulla, were likely accurate. Nothing in this case suggests otherwise in my view. Speculation and innuendo as to that not being the case is based on the Respondent's position that the Appellant's assertions, and bookkeeping and accounting records, must be regarded as unreliable. The Respondent adds to this some credibility issues with which I do not disagree. However, I do not embrace the Respondent's position in regard to the record keeping of personal expenditures. While original receipts and similar records were not available, it seems apparent that daily or regular postings or notations were in fact made by the full-time bookkeeper of all transactions relating to these personal accounts. This is not a case of a total absence of business records. The accountant recorded these postings in three separate accounts and then consolidated them in a shareholders loan account. Perhaps this approach made things harder to track but certainly there was nothing sinister about it, so far at least.

[21] What happens next however is that payments against balances due by Ms. Kulla are credited so as to eliminate any such balance due by her. The timing of applying the credits is such to ensure no taxable benefit is created. The method employed to do this was to have S & S clear the account with Sandia and then make corresponding adjustments to its shareholder loan account maintained for Ms. Kulla. Since each company had a different year-end, loan balances could be effectively shifted between the two companies so that there was always a timely repayment of the balance payable by Ms. Kulla to each of the companies so as to avoid a taxable benefit under subsection 15(2) of the *Act*.

[22] The application of subsection 15(2) is alleviated by subsection 15(2.6) subject to an express anti-avoidance provision set out in that subsection. Subsection 15(2) includes in income, loans to shareholders and subsection 15(2.6) eliminates the income inclusion if the loan is repaid within a year *unless the repayment is part of a series of loans and repayments*. That is, the manipulation employed to avoid the application of a taxable benefit provision was not at the stage of posting outlays for Ms. Kulla's benefit, but rather was focused on the repayment of the loan accounts. The Sandia shareholder loans were made to disappear on a timely basis so as to avoid application of 15(2). Returns were filed on the basis that 15(2) did not apply regardless that 15(2.6) required that loans repaid in the manner employed by the parties were subject to the income inclusion provided for in 15(2).

[23] In short then, what was done and continued to be done throughout the subject period was to create a series of loans and repayments amongst Sandia, S & S and Ms. Kulla so as to avoid liability for tax under subsection 15(2) of the *Act*. The accountant for the Appellant admitted to this at the hearing.

[24] However, the auditor for the Canada Revenue Agency ("CRA"), who testified at the hearing as well, admitted that he did not fully understand what had happened until sitting through the hearing. He was not as sophisticated in covert accounting as the Appellant's advisor. Further, there is no doubt that the auditor was being stalled and misled prior to the reassessment being issued. For example, at the time of the objection the unrealized rent amounts were argued to be uncollected bad debts. As well, Ms. Kulla was unresponsive. In the circumstances, faced with taxpayers doing little to assist the audit and not being forthright (or as it turns out honest) about the actual goings on in respect of shareholder benefits, I find no fault on the auditor's part in proceeding as he did. The reassessment and confirmation assumed the operative provisions were subsection 15(1). The auditor understandably took the view that Sandia had paid the subject amounts for the personal benefit of Ms. Kulla without the proper accounting for the expenditure as a shareholder loan. There were no loans outstanding as shown on the statements.

[25] However what emerges is a fresh issue; namely whether the reassessment under subsection 15(1) can stand in light of the more specific assessing provision contained in subsection 15(2) and if not, whether the basis for the reassessment can

be changed to take into account facts as revealed at trial.[4] Principles of statutory construction generally prefer application of the more specific provision and in this case that affords Ms. Kulla a better result. Assessing under subsection 15(2) entitles her to a deduction of the income inclusion when the loan amount is repaid. This may have occurred in 2003 according to her testimony. Assessing under subsection 15(1) affords no such benefit. I note here as well that there is some older authority for applying similar specific loan benefit provisions over general benefit provisions. *Vallée Estate v. M.N.R.*[5] and *Herbacz v. M.N.R.*[6]

[26] The Respondent relies on 15(1) as the primary assessing position. One premise on which the Respondent seems to rely is that since they were not assessed as loans – 15(2) does not apply. Along the same lines the Respondent argues that book entry credits do not constitute payments. While I do not agree that the credits in this case are not payments and would distinguish authorities cited by the Respondent, and while I do not agree that the chosen assessing section determines its correctness, I am not satisfied that 15(1) cannot apply if for any reason 15(2) cannot apply. This would include applying 15(1) should the application of 15(2) be barred by virtue of it being raised too late even where the reason it is raised late is due to the Appellant's own covert dealings.

[27] I note here as well that the Respondent argues that there were no loans. My findings are otherwise. I am satisfied the payments made by Sandia on Ms. Kulla's behalf were not recorded without purpose. I accept the probability that amounts were paid by Sandia for Ms. Kulla's benefit as advances to be accounted for, repaid by her, at some point in the future. As noted, the problem is the series of loans and repayments.

[28] This takes me to consider the statutory provisions relating to late reliance on a different charging provision of the *Act* to confirm an assessment on appeal. The provision of the *Act* that has application is subsection 152(9). There are recent authorities dealing with this provision.

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[4] I note that the Reply makes reference to a series of loans and repayments. This raises some question as to whether the CRA intentionally seized upon the harsher assessing provision. Based on the auditor's testimony, however, I do not believe this to be the case. His view was that loan account entries were after the fact creations. Based on my acceptance of bookkeeping entries I have found the question of when the accountant recorded them to be irrelevant.

[5] 57 DTC 38 (T.A.B.)

[6] 56 DTC 34 (T.A.B.)

[29] The Respondent argues that 152(9) permits alternative arguments at any time and that there is no distinction between an alternative argument and an alternative basis for assessment which is to say an alternative basis for assessment is permitted at any time. The Respondent relies on *The Queen v. Anchor Pointe Energy.*[7]

[30] As well the Respondent relies on *G.M.A.C. v. The Queen.*[8] In this case Justice Rip noted that facts are known to the taxpayers and as additional facts are made known additional assessing sections may become apparent. As well the correctness of the reasons for making an assessment is not the issue. The Court is concerned with the validity of the assessment which is a dollar amount.

[31] The Appellant argues that the Respondent cannot now raise 15(2) as it not only changes the statutory basis for the assessment but involves different transactions. It is argued that *Anchor* only allows a new basis for assessing where such new basis did not involve different transactions such as in *Pedwell v. The Queen.*[9]

[32] I do not agree with the Appellant's construction of 152(9) and the authorities relied on do not support the Appellant's arguments. There are no new transactions in my view of the type considered in *Pedwell* that must be considered in the application of 15(2) versus 15(1). We are concerned here with payments made for the benefit of a shareholder – that is the relevant transaction. Taken together or one at a time they are the identical transactions that give rise to the question of which taxing provision to apply. That the Appellants and their advisers have obscured the records so as to frustrate the Respondent's ability to apply the right basis of assessment surely cannot be used to shield the Appellants from the application of the correct assessment provision. As alluded to in *G.M.A.C.* this Court determines the correctness of the amount assessed in the year assessed and in this case the amount assessed in the years assessed is the same whether 15(1) or 15(2) is applied. The more specific section should apply. However as stated, this is not to suggest that but for the application of 15(2) I would not apply 15(1).

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[7] 2003 DTC 5512 (F.C.A.)

[8] 2000 DTC 1844 (T.C.C.)

[9] 2000 DTC 6405 (F.C.A.)

[33] At this point I note that the Respondent did not assess the actual payments it determined that Sandia had paid on Ms. Kulla's behalf. The Respondent capped the reassessments at the amount each year that equalled the unrealized income that Sandia did not report as rental income. The theory of this approach seems to be that this was unreported profit that disappeared from Sandia's coffers. It was, in a manner of speaking, the unreported income that was bonused out to Ms. Kulla without Ms. Kulla reporting the income. The reassessments then effectively tax the bonus in Ms. Kulla's hands without a deduction to Sandia. While I have accepted the accounting for the payments made by Sandia on Ms. Kulla's behalf I am not prepared to penalize Ms. Kulla further by refusing to allow her the benefit of the assessing approach taken by the CRA. If that approach caps her benefit at amounts equal to the missing unreported income in Sandia, her benefit must be reduced by the $88,677 referred to earlier in these Reasons.[10]

[34] Before looking at the next set of issues affecting both Ms. Kulla and Sandia, namely barred assessment years and penalties, there is one last benefit issue to be dealt with. Ms. Kulla was reassessed as having received a benefit for the interest amounts Sandia was reassessed as having paid on her behalf and for her benefit. Having found these interest amounts to have been paid on account of Sandia's own debt incurred for income producing purposes, the related reassessments adding these interest amounts to Ms. Kulla's income must be vacated.

Statute Barred Years & Penalties

[35] I turn now to the question of the statute barred years and the penalties.

[36] In regard to penalties, Appellants' counsel has argued that the Minister has not brought proper evidence of the calculation of the penalties and accordingly they should be struck down. He cites the decision in *Hans v. The Queen*,[11] of Justice Bowie at paragraph 20 where relying on a comment made by the then Associate Chief Justice Bowman in *Urpesz v. The Queen*,[12] that the Minister can only sustain the penalties if he proves the correctness of the amount of the penalty.

[10] The last two sentences of this paragraph were omitted in the Reasons delivered from the bench on September 28, 2006. The Judgments signed on September 21, 2006 included this allowance in respect of Ms. Kulla's appeals but omitted it in respect of Sandia's appeals. The omissions were unintentional and Amended Judgments have been signed accordingly.

[11] 2003 DTC 1065 (T.C.C.)

[12] [2001] 3 C.T.C. 2256 (T.C.C.)

Appellants' counsel argues the Minister has not done so in this case because he did not bring evidence at the trial as to the calculation. Indeed the auditor testified that he did not check the calculations.

[37] While the Judge's comment in *Urpesz*, an appeal under the informal procedure, does not elaborate as to what is meant by, or what it might take to prove, the correctness of the amount of the penalty, the suggestion of Appellants' counsel that it requires evidence of the correctness of the calculation to be brought at trial does not follow and Justice Bowie's observations in *Hans*, an appeal under the general procedure, do not go that far either. In *Hans* Justice Bowie stated that in that case the Minister had not discharged his burden of showing that the precise penalties imposed were justified. He added and I quote: "Neither the Reply nor the evidence reveals how the Minister computed the penalties that he imposed."

[38] The question then arises as to what is meant by "how the Minister computed the penalties that he imposed". For one, it might mean that the Reply must set out the exact calculation of the income subject to the penalty and the percentage applied. If the Reply sets out the penalty amount that is shown clearly as 50% of the income shown as subject to the penalty, then the Reply in my view has met the test set out by Justice Bowie in cases such as the one at bar where identifying the amount that the penalty is assessed against and the applicable percentage are clearly the only relevant amounts needed to establish the correctness of the penalty assessed.

[39] The importance of the Reply dealing adequately with the calculation of penalties is also shown in *Francavilla v. The Queen*[13] where the Minister's Reply did not refer to the penalties and on that basis Justice Rip deleted the penalties. That is clearly not the case in respect of the appeals at bar.

[40] Accordingly, Appellants' counsel's submission that in order for a penalty to be assessed properly the Minister must call an auditor to the stand and have them testify as the calculation of the penalties is one with which I cannot agree. Unlike the case of *Hans* and *Francavilla*, the Replies in the subject appeals sufficiently address the 163(2) penalties. Furthermore, Respondent's counsel presented documentary evidence (exhibit R-15) to demonstrate the income upon which the 163(2) taxes would be based. There is no possible debate as to the correctness of the calculations of the penalties in respect of either appeal. They are fixed and afford no discretion or

[13] 2005 DTC 811 (T.C.C.)

variation even by this Court once the income amounts properly subject to penalty have been proven.

Are the Requirements for Imposing Penalties and Assessing Beyond the Normal Period Met?

[41] I turn now to the tests and analysis for assessing beyond the normal assessment period in subsection 152(4) and for assessing penalties under subsection 163(2).

[42] The relevant provisions of the *Act* provide that in the case of assessing beyond the normal reassessment period, the Minister can only do so if :

> (a) the taxpayer or person filing the return
>
> > (i) has made any misrepresentation that is attributable to neglect, carelessness or wilful default or has committed any fraud in filing the return or in supplying any information under this *Act*.

[43] Respondent's counsel advanced two preliminary arguments in respect of this provision. Firstly he suggested that the person filing the return was the accountant since he prepared it or, alternatively, he argued that the tax preparer should be regarded as the filer for the purposes of this provision. I reject these submissions. The Respondent has not established that the person who signed the return was other than the respective Appellants. Indeed, evidence supports the contrary. The Appellants were the persons filing the returns, and there are no authorities warranting a construction of the subject section that suggests that the preparer should be regarded as the filer. Indeed, the authorities suggest otherwise when they deal with attributing knowledge to the taxpayer who signs and files returns. Further, tax preparer penalties now in the *Act* suggest that they are dealt with separately.

[44] The second preliminary argument made by the Respondent refers to the Federal Court of Appeal decision in *Nesbit v. The Queen*[14] he argued that any incorrect statement on a return is a misstatement. While that is true the provision does not open assessment periods beyond the normal periods if the

[14] 96 DTC 6588

misrepresentation is, for example, innocent. The easiest test for the Minister to meet is establishing on a balance of probability that the taxpayer was neglectful or careless. In *Nesbit,* for example, a missed decimal point creating a $700,000 under-reporting was found at least to be careless – the taxpayer signing should be careful to pick-up such obvious mistakes. In the case at bar the under-reporting was anything but obvious in respect of both Appellants. Indeed the manner by which income was under-reported was not even apparent to the auditor who may have had more information at his disposal than Ms. Kulla. The Respondent's counsel still argues that it should have been obvious, regardless of the methods employed, to anyone who has ever filed a tax return, as Ms. Kulla had done for years, that showing no income on tax returns warranted enquiry when it would have been clear to her that there was money being made and she was benefiting personally.

[45] Ms. Kulla's testimony was to plead innocence in respect of having any knowledge of what her accountant was doing even though it appears she signed both personal returns and corporate returns. The accountant testified as well that he didn't discuss these matters with her.

[46] Some background is now required.

[47] Ms. Kulla had nothing to do with Sandia, S & S, horses and farms until her husband died in November of 1991. The stable and farm were owned by her husband, not her. That she became actively involved at some point following her husband's death, is clear from the evidence. However the death of her husband and her first arrival on the scene in late 1991 is a circumstance that merits consideration. She was 52 years old and not involved in the business. Indeed, although for a very brief period on the incorporation of Sandia she held some shares, she was not a shareholder or employee at the end of *its* 1991 taxation year (July 31). To assess her benefits in respect of *her* 1991 year which ended less than two months after her husband died, defies logic. Clearly I can attribute no neglect or carelessness to Ms. Kulla in these circumstances.

[48] Further, I note that under her husband's control, the profits of Sandia were being expensed as management fees. It is these fees that are being added to Ms. Kulla's income as a benefit. Presumably if the fees were not paid in any other way except as benefits re the farms, stable and vehicle, they should be included as benefits but how would this be apparent to a widow new on the scene even in her 1992 taxation year? When she filed the return for that year she would have been a widow for some 16 months – barely time for probate of some estates. The Minister bears the burden of proof. I see no satisfactory evidence that establishes when she

became the recipient of benefits and even if there was, I see no carelessness or neglect on her part in signing returns that show no income at this point.

[49] Accordingly, I find that the reassessments of Ms. Kulla for 1991 and 1992 are beyond the reassessment period allowed for under 152(4) and her appeals for those years are allowed.

[50] As to future years however the situation changes in my view. By early 1994 when she would be looking at her 1993 tax return she had to be a party to the unscrupulous goings on. At that time Sandia had filed its 1993 return. While I acknowledge the likelihood that there were games being played with the management fees employed during her husband's tenure that continued after his death, most likely in my view without Ms. Kulla's knowledge or acquiescence, that scheme was less covert than the one I have described above in relation to the deceitful way in which rent adjustments were being made. That repugnant scheme was first employed in Sandia's 1993 year and it is not a bit credible to me that by that time Ms. Kulla was not a party to such new scheme. While I have allowed a 52 year-old widow the benefit of common sense regarding the passing of an estate, that is not to say that I see her as a shrinking violet. She is the one signing the cheques – the signing officer – attending at the hotel premises regularly and meticulously watching the books. This is a family business and there is another similar establishment owned by immediate family members. Ms. Kulla did not strike me as an idle owner and the testimony of the witnesses that suggest that she never asked the accountant what was going on is neither reliable nor credible. Even if she did not make enquires there is a compelling line of cases that establishes gross negligence where a taxpayer simply turns a blind eye in circumstances warranting enquiry. This was a situation warranting enquiry. I will say more of gross negligence in the context of penalties.

[51] I make these findings in spite of Appellant's counsel's argument that the subject misrepresentations were made solely by Ms. Kulla's accountant and without her knowledge. While it is not necessary for me to make a finding on the point, it is a fine line between authorities that suggest one can attribute the negligence or gross negligence of the accountant and authorities that refer to turning a blind eye to the negligence of one's agents. Whether Ms. Kulla knew exactly what the accountant was doing is irrelevant. He was her authorized agent. He was Sandia's authorized agent. Whether or not she had a proper understanding of the accounting methods used in the reporting of her income and that of Sandia in 1993 and subsequent years, she must have been aware not only that income was not declared but that the books were being manipulated to achieve this result.

Indeed I have little doubt she was likely an active player in the covert structuring of or restructuring of the transactions in issue in respect of calculating and reporting both her income and that of Sandia.

[52] Further, I make these findings in spite of arguments that Ms. Kulla was just carrying on what her husband set up. Her husband trusted the accountant for 25 years without problems – why should she be expected to question his methods? Well, his methods did change under her watch so even if following someone you thought you can trust were a determinative factor in this case, which it is not, the facts do not support the argument. Examples of changes under her watch are the creation of rent adjustments and not filing returns on time. Returns for 1994, 1995, 1996 and 1997 were not filed until roughly the time that 1997 returns were required to be filed. This was due to waiting to see if a loss acquisition could be used to save taxes. Ms. Kulla had to know tax returns were to be filed annually. She had to know this was *not* done for at least three years. She had to know that they were not filed because there were reorganization and take-over plans being considered to utilize another company's losses. She had to know that despite S & S being profitable, neither S & S, Sandia or her personal return allowed for that income to be taxed. This speaks to her credibility that she knew nothing.

[53] Accordingly, I find the assessment of Ms. Kulla's 1993 and subsequent years, 1994 through 1996, were assessed within the time permitted under section 152(4).

[54] The basis of such finding also supports a finding of gross negligence which is the threshold test for imposing penalties under 163(2). That subsection imposes the penalties assessed on every person who, knowingly, or under circumstances amounting to gross negligence, has made or has participated in, assented to or acquiesced in the making of a false statement or omission in a return, form, certificate, statement or answer filed or made in respect of a taxation year. Applying the test for what constitutes gross negligence as set out in *Venne v. The Queen*[15] warrants finding that there has been gross negligence in this case. The test there sets out that gross negligence must be taken to involve greater neglect than simply a failure to use reasonable care. It must involve a high degree of negligence tantamount to intentional acting or indifference as to whether the law is complied with or not. I have little doubt that Ms. Kulla knew of and approved of or concurred with the accountant's attempts to avoid the application of applicable taxing

[15] 84 DTC 6247 (F.C.T.D.)

provisions by failing to report income required to be reported. Even if she was not directly involved there was a knowing concurrence that satisfies the test in *Venne*. Accordingly, the application of 163(2) penalties is affirmed for Ms. Kulla's years 1993 through 1999 inclusive.

[55] Similarly in respect of Sandia, Ms. Kulla was the directing mind behind the company. Her gross negligence constitutes the gross negligence of the company. The 1993 financial statements for Sandia, approved by Ms. Kulla, were dated January 1994. That is, even though 1993 returns for Sandia would have been filed earlier than when Ms. Kulla filed her 1993 return, I do not see that the difference of those few months as assisting Sandia. Accordingly, Sandia's 1993 taxation year was assessed within the time permitted under subsection 152(4) and the application of 163(2) penalties is affirmed in respect of all years assessed – 1993-1999 inclusive.

[56] Lastly, I note that the late filing penalties assessed against Sandia have not been challenged and will stand.

Signed at Ottawa, Canada, this 13th day of October 2006.

"J.E. Hershfield"

Hershfield J.

CITATION:	2006TCC348
COURT FILE NO.:	2003-1672(IT)G
STYLE OF CAUSE:	Sandia Mountain Holdings Inc. and Her Majesty the Queen
PLACE OF HEARING:	Toronto, Ontario
DATE OF HEARING:	May 15-19, 2006
REASONS FOR JUDGMENT BY:	The Honourable Justice J.E. Hershfield
DATE OF JUDGMENT:	October 13, 2006

APPEARANCES:

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STYLE OF CAUSE:	Elizabeth Kulla and Her Majesty the Queen
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