Docket: 2011-2466(IT)G

BETWEEN:

JOHN MORGAN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on May 17, 2013 at Calgary, Alberta

By: The Honourable Justice Judith M. Woods

Appearances:

Counsel for the Appellant: Lori G. Bokenfohr

Counsel for the Respondent: Mary Softley

JUDGMENT

The appeal with respect to an assessment made under the *Income Tax Act* for the 2009 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 penalty should not be imposed with respect to funds transferred to a registered retirement savings plan in 2009. Each party shall bear their own costs.

Signed at Toronto, Ontario this 16th day of July 2013.

"J. M. Woods"

Woods J.

Citation: 2013 TCC 232
Date: 20130716
Docket: 2011-2466(IT)G

BETWEEN:

JOHN MORGAN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Woods J.

[1] When John Morgan retired as an employee of the City of Calgary, he elected to withdraw the entirety of his pension from the employer's plan. A portion of the amount withdrawn was income to Mr. Morgan which he failed to report in his income tax return for the 2009 taxation year. Since Mr. Morgan had previous failures to report income, a penalty was assessed under subsection 163(1) of the *Income Tax Act*.

[2] The aggregate federal and provincial penalty that was assessed is approximately $36,000, which was calculated as 20 percent of the income that should have been reported. It is only the federal penalty that is at issue in this appeal.

Subsection 163(1)

[3] Subsection 163(1) of the *Act* imposes a 10 percent penalty on income that has not been reported in the income tax return if the taxpayer also has a previous failure for any of the three immediately preceding taxation years.

[4] The provision is reproduced below.

> **163. (1) Repeated failures [to report income]** - Every person who

> (a) fails to report an amount required to be included in computing the person’s income in a return filed under section 150 for a taxation year, and
>
> (b) had failed to report an amount required to be so included in any return filed under section 150 for any of the three preceding taxation years
>
> is liable to a penalty equal to 10% of the amount described in paragraph (a), except where the person is liable to a penalty under subsection (2) in respect of that amount.

[5] Although subsection 163(1) does not contain a due diligence defence, courts have recognized that the penalty should not be imposed if the taxpayer establishes that he has been diligent. The appropriate test is set out in *Les Résidences Majeau Inc v The Queen*, 2010 FCA 28.

> [8] According to *Corporation de l’école polytechnique v. Canada*, 2004 FCA 127, a defendant may rely on a defence of due diligence if either of the following can be established: that the defendant made a reasonable mistake of fact, or that the defendant took reasonable precautions to avoid the event leading to imposition of the penalty.
>
> [9] A reasonable mistake of fact requires a twofold test: subjective and objective. The subjective test is met if the defendant establishes that he or she was mistaken as to a factual situation which, if it had existed, would have made his or her act or omission innocent. In addition, for this aspect of the defence to be effective, the mistake must be reasonable, i.e. a mistake a reasonable person in the same circumstances would have made. This is the objective test.
>
> [10] As already stated, the second aspect of the defence requires that all reasonable precautions or measures be taken to avoid the event leading to imposition of the penalty.

Preliminary issue

[6] At the outset of the hearing, counsel for Mr. Morgan submitted that the Crown should bear the burden of proof of establishing that the amount on which the penalty was imposed was actually income.

[7] Mr. Morgan had not previously challenged this and I agreed with counsel for the Crown that it would be prejudicial for this issue to be raised for the first time at the hearing. I then asked counsel for Mr. Morgan whether an adjournment would be requested so that the issue could be properly put before the Court. I was informed

that Mr. Morgan did not wish to seek an adjournment and the hearing then proceeded on this basis.

Issues

[8] There are two issues to be decided:

(a) Does subsection 163(1) apply for a particular taxation year if another penalty has been imposed for one of the three preceding years?

(b) Should the penalty be vacated on grounds of due diligence?

Background

[9] Mr. Morgan was a longtime employee of the City of Calgary, first as a garbage collector and then as an inspector and foreman in the water meter department.

[10] Upon taking early retirement around the age of 55, Mr. Morgan had the option of withdrawing his pension funds from the employer's pension plan. Pursuant to a Benefits Option Package (Ex. A-1), Mr. Morgan was informed that if he elected to withdraw the entire amount, a portion, $268,466, had to be transferred to a locked-in retirement account (LIRA) and the balance, $179,612, could be paid to him directly or transferred to a registered retirement savings plan (RRSP).

[11] On February 18, 2009, Mr. Morgan elected to withdraw the full pension entitlement. With respect to funds that were not locked-in, Mr. Morgan elected to have a portion, $143,510, paid directly to him and the balance, $36,102, transferred to an RRSP.

[12] Payments were made in accordance with the election a short time later. The RRSP amount, $36,102, was transferred to an RRSP of which Mr. Morgan's spouse was the annuitant. The amount that was paid directly to Mr. Morgan was $144,757 less source deductions in the amount of $43,427 (Ex. A-4).

[13] Mr. Morgan arranged with the Bank of Nova Scotia to look after the funds. He testified that the Bank assured him that tax would be taken care of and he did not think that he had to report it.

[14] A T4A slip was issued to Mr. Morgan with respect to the amount paid directly to him ($144,757) (Ex. A-4). The slip reflected that tax was deducted at source.

[15] In addition, the Bank of Nova Scotia issued to Mr. Morgan a receipt for the spousal RRSP contribution in the amount of $36,102. The receipt that was entered into evidence indicated that it should be attached to the provincial income tax return. Based on the RRSP receipt, I have concluded that no source deductions were made with respect to the transfer to the RRSP in the amount of $36,102.

[16] Mr. Morgan prepared his own income tax return for the 2009 taxation year, as he always had done. None of the pension funds were reported as income. Mr. Morgan testified that he did not realize the pension monies were income and that he was concerned about double tax because he knew that tax had been taken at source. He also testified that his spouse just put the tax slips into a file without opening the envelopes.

[17] In calculating the penalty under subsection 163(1), the Minister of National Revenue considered that the amount paid directly to Mr. Morgan and the amount paid to the spousal RRSP were income to Mr. Morgan and that the locked-in amount transferred to the LIRA was not. The aggregate amount that was considered to be taxable is $180,859.

[18] As mentioned earlier, the penalty under subsection 163(1) requires repeated failures to report income. With respect to the immediately preceding three taxation years, Mr. Morgan failed to report the following amounts of income in his income tax returns.

(a) For the 2006 taxation year, Mr. Morgan failed to report income from two sources, a $10,000 withdrawal from an RRSP and a receipt of $12,500 from The John C. Morgan Family Trust, which was established by Mr. Morgan's father.

(b) For the 2007 taxation year, Mr. Morgan failed to report income from The John C. Morgan Family Trust in the amount of $11,250.

[19] Mr. Morgan testified that he thought the amounts from his father's trust were a gift which he assumed were not taxable. As for the RRSP withdrawal in 2006, he stated that he did not receive the tax slip and assumed that the omission would be picked up by the Canada Revenue Agency (CRA).

[20] Mr. Morgan was assessed a penalty under subsection 163(1) for the 2007 taxation year.

Discussion

Effect of multiple penalties

[21] The first issue is whether subsection 163(1) applies to multiple taxation years. Mr. Morgan submits that the application of the penalty for the 2009 taxation year results in double jeopardy because the penalty was also imposed for the 2007 taxation year. In effect, it is submitted that s. 163(1) only applies once during a four year period.

[22] I disagree with this submission. A purposive interpretation of subsection 163(1) suggests that the penalty is imposed on a year by year basis. The target of the assessment for the 2009 taxation year is the failure to report income for that year. The assessment for the 2007 taxation year targeted a failure to report income for that year. There is no double jeopardy even though a previous failure to report income is a condition that must be satisfied.

Has due diligence been established?

[23] The second issue is whether Mr. Morgan has established a due diligence defence.

[24] I would first comment that the amount of the penalty imposed in this case is very harsh.

[25] As mentioned in previous cases, the penalty can be particularly harsh if source deductions have been taken because there is often no intent to avoid the payment of tax. Counsel for Mr. Morgan suggested in argument that the source deductions in this case were sufficient to pay the entire tax owing. This is certainly plausible since Mr. Morgan apparently had no other income in 2009.

[26] In circumstances such as this, where there is no apparent intent to avoid the payment of tax, it seems excessive to impose a 20 percent penalty on top of Part I tax. Mr. Morgan’s counsel also noted that the amount of the penalty is very large for someone in Mr. Morgan’s financial circumstances.

[27] Despite the harshness, it is not up to courts to rewrite the law. Parliament has seen fit to enact the penalty under subsection 163(1) and it is the duty of the courts to apply it.

[28] I now turn to the due diligence defence.

[29] The defence can apply to mistakes of fact or if all reasonable measures have been taken to prevent the failure. In this case, there is not sufficient evidence of a mistake of fact and therefore the issue is whether Mr. Morgan has taken all reasonable measures to prevent the failure. A review of the case law referred to me suggests that each case depends on its own particular facts.

[30] Did Mr. Morgan take all reasonable measures to prevent the failure to report income in the income tax return? In my view, he did not.

[31] First, Mr. Morgan acknowledges that he was aware of the obligation to report all income in the income tax return as a result of receiving the previous penalty under subsection 163(1).

[32] Mr. Morgan testified that he satisfied the obligation to report by putting the matter in the hands of the Bank of Nova Scotia and that they informed him that the tax would be taken care of. This is not a satisfactory explanation.

[33] It appears that the conversation with the Bank was quite general and was not specific with respect to completing the income tax return. If Mr. Morgan was diligent with respect to his obligation to report income in the income tax return, he would have made specific enquiries of the Bank or someone else about how to complete the income tax return.

[34] I would also note that Mr. Morgan received a document from the employer which indicated that funds paid directly to him are “taken as a taxable cash refund” (Ex. A-1). In addition, the employer issued a T4A for the amount paid directly to him. In these circumstances, Mr. Morgan did not take sufficient steps to determine his reporting obligations with respect to this amount.

[35] I would take a different view of the $36,102 that was transferred to the RRSP. The tax disclosure provided by the employer indicated that “amounts transferred that are higher than allowed under the *Income Tax Act* will be considered as income in the year they are transferred.” In this case no source deductions were taken and it appears that a T4A may not have been issued.

[36] I would have preferred to have more detailed evidence as to whether Mr. Morgan received any tax advice at the time of the election and as to why he

decided to transfer $36,102 to an RRSP. It is not likely that this amount was pulled out of the air.

[37] Although the lack of evidence is troubling, it is appropriate in my view to apply the due diligence defence to the pension funds that were transferred directly to the RRSP. They came from one tax-exempt vehicle to another and there was no indication that Mr. Morgan was advised that this amount would be taxable at the time of transfer. If this is a generous interpretation of the facts in Mr. Morgan's favour, the circumstances as a whole justify that result in my view.

[38] The appeal will be allowed to reduce the federal penalty so that it is not applied with respect to the amount transferred to the RRSP.

[39] Each party shall bear their own costs.

Signed at Toronto, Ontario this 16th day of July 2013.

"J. M. Woods"

Woods J.

CITATION:	2013 TCC 232
COURT FILE NO.:	2011-2466(IT)G
STYLE OF CAUSE:	JOHN MORGAN and HER MAJESTY THE QUEEN
PLACE OF HEARING:	Calgary, Alberta
DATE OF HEARING:	May 17, 2013
REASONS FOR JUDGMENT BY:	The Honourable Justice J.M. Woods
DATE OF JUDGMENT:	July 16, 2013

APPEARANCES:

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Counsel for the Respondent:	Mary Softley

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