BUDGET 2015: PENALTIES FOR TAX REPORTING FAILURES MODIFIED

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Budget 2015 announced the Government's intention to more narrowly define the circumstances under which a taxpayer may be liable for a penalty in respect of repeated failures to report income.

Subsection 163(1) of the *Income Tax Act* (Canada) (the "**Tax Act**") currently imposes an onerous penalty on taxpayers that repeatedly fail to report amounts in their tax returns that are required to be included in their income. While this penalty provision is designed to provide a strong incentive for taxpayers to ensure that their tax filings are accurate and complete, the scope and consequences of contravening subsection 163(1) often catch taxpayers by surprise and have been the subject of much criticism.

Subsection 163(1): The Basics

In highly simplified terms, subsection 163(1) of the Tax Act currently provides that, where a taxpayer fails to report an amount required to be included in computing his/her income twice within a four-year period, the taxpayer is generally liable to a penalty equal to 10% of the amount that the taxpayer failed to report in the latter year (the "**163(1) Penalty**").[1]

Current subsection 163(1) may apply, irrespective of the size of, or circumstances surrounding, the amounts not reported by a taxpayer, and is frequently applied in a seemingly incongruous manner. For instance, a taxpayer who fails to report a small amount of income one year and then a larger amount two years later may be assessed a penalty equal to 10% of the *larger* amount. In a recent case before the Tax Court of Canada (*Galachiuk v. The Queen*), a taxpayer failed to report $683 of investment income in 2008 and then subsequently failed to report $436,890 of income relating to a pension payment in 2009. Such repeated reporting failures led the Canada Revenue Agency to assess the taxpayer a 163(1) Penalty of $43,690. (By contrast, the applicable penalty would presumably have amounted to only $68.30 if the instances of non-reporting had been reversed.)

A survey of the historical case law reveals that taxpayers have been assessed a 163(1) Penalty even in circumstances where:

- sufficient income tax was withheld from the taxpayer at source and no additional taxes were owing by the taxpayer;
- the taxpayer did not receive the appropriate tax slip (e.g., a T4, T5, T4A) before filing his/her tax return;
- the taxpayer relied on an accountant to prepare her returns; or
- the amount of the penalty was grossly disproportionate to the amount of unpaid tax.

Relative Severity of the 163(1) Penalty

Section 163 of the Tax Act provides for the imposition of a number of different types of penalties, depending on the circumstances. In addition to the broad penalty imposed under subsection 163(1), a special penalty is imposed under subsection 163(2) of the Tax Act on persons who knowingly, or under circumstances amounting to gross negligence, have made or have participated in, assented to or acquiesced in the making of, a false statement or omission in a tax filing. The penalty that may be levied under subsection 163(2) is generally equal to the greater of $100 and 50% of the total amount of additional tax that is payable after accounting for the false statement or omission at issue.

One might expect that the size of the penalty imposed under subsection 163(2) would be commensurate with the higher level of taxpayer culpability that is required for the subsection to apply. However, in many circumstances, the 163(1) Penalty could be close to, and often exceed, the penalty that would have been imposed under subsection 163(2) if the latter provision had instead applied in respect of the amounts that had not been reported by the applicable taxpayer.

This counter-intuitive result arises largely because the two penalties are computed on the basis of different reference points. The penalty levied under subsection 163(1) is generally computed on the basis of the gross amount of unreported income of a taxpayer, irrespective of the underlying tax payable (if any). By contrast, the gross negligence penalty levied under subsection 163(2) is generally computed on the basis of the incremental tax payable by a taxpayer that is attributable to the false statement or omission in question.

Budget 2015: Reducing the Inequities

Budget 2015 proposes to address certain of the foregoing deficiencies inherent in the current drafting of subsection 163(1) of the Tax Act. In particular, Budget 2015 announced the Government's intention to modify subsection 163(1) of the Tax Act in the following respects:

1. A 163(1) Penalty will only potentially apply where a taxpayer has failed to report an amount required to be included in computing income, which is equal to or greater than $500, in tax returns filed in respect of both (i) the current taxation year, and (ii) any of the three preceding taxation years.
2. The amount of a 163(1) Penalty will generally be limited to the lesser of:]

(i) 10% of the amount that was not reported in the current taxation year (the "unreported amount"); and

(ii) an amount equal to 50% of the difference between

a. the under-statement of tax payable (or the over-statement of tax credits) related to the current year omission, and

b. the amount of tax deducted or withheld by third parties pursuant to certain provisions of the Tax Act that may reasonably be considered to be in respect of the unreported amount (e.g., withholdings by an employer where the unreported amount relates to wages paid by the employer) (such net amount being the "**Understated Net Tax**").

The amendments to subsection 163(1) of the Tax Act proposed in Budget 2015 are positive in several respects.

Historically, a small, inadvertent failure to report amounts required to be included in income in a previous taxation year could result in a taxpayer becoming liable for a significant 163(1) Penalty where the taxpayer inadvertently fails to report a more material amount in the current taxation year. The establishment of a de *minimis* threshold, which requires non-reported amounts to exceed $500 prior to such non-reporting becoming relevant to the determination of whether a 163(1) Penalty may apply, reflects the Government's attempt to preclude a 163(1) Penalty from arising where non-reporting in an earlier year was immaterial. While this proposed amendment is welcome, it will not entirely preclude subsection 163(1) from applying under seemingly unbalanced circumstances, including where a historical failure to report income slightly exceeds the new $500 de *minimis* threshold.

The proposal to limit the 163(1) Penalty to the lesser of 10% of an unreported amount and an amount equal to 50% of the Understated Net Tax reflects the Government's desire to ensure that penalties levied under subsection 163(1) on account of inadvertent non-reporting do not exceed the penalties that would have applied if such non-reporting was made knowingly, or arose under circumstances amounting to gross negligence. While this proposal is again a welcome statutory change, it does not fully address the concerns previously voiced that the quantum of a penalty levied under subsection 163(1) could be close to, or equal, the amount of the penalty that would have arisen if the non-reporting was attributable to more blameworthy conduct.

Finally, the Government's recognition that it is unjust to levy a penalty for non-reporting where the tax that would have applied in respect of the non-reported amount has already been remitted to the Government (in the form of previously remitted source withholdings) represents a commendable effort to properly temper the application of subsection 163(1) of the Tax Act.

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Ultimately, the proposals contained in Budget 2015 with respect to the 163(1) Penalty represent constructive amendments to the Tax Act. When enacted, the amended statutory language will apply in respect of the 2014 and later taxation years.

The Government has indicated that the proposed amendments to subsection 163(1) are expected to result in a reduction of Government revenues of approximately $45 million over the coming five years. The Government should be recognized for paying heed to the concerns expressed by both taxpayers and the Courts, and for taking positive steps to make the provisions of the Tax Act more equitable and proportional.

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1 Many provincial income tax statutes levy an equivalent provincial penalty in respect of such reporting failures.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.