THE FEDERAL COURT OF APPEAL AND FEDERAL COURT—TRIAL DIVISION

WHAT IS A MISREPRESENTATION? WHAT IS A MISREPRESENTATION ATTRIBUTABLE TO NEGLECT?

Nesbitt v. The Queen
96 DTC 6045 (FCTD)

Farm Business Consultants Inc. v. The Queen
96 DTC 6085 (FCA)

Two decisions handed down recently provide answers to the question: What is a misrepresentation? The question is important because, pursuant to subparagraph 152(4)(a)(i) of the Act, the minister may reassess beyond the statutory limitation period where a taxpayer makes a misrepresentation attributable to neglect, carelessness, or wilful default.

The decision in *Nesbitt v. The Queen* interprets the word "misrepresentation" broadly. In that case, the court held that an incorrect statement made in a tax return as a result of a mathematical error is a misrepresentation. In the case of *Farm Business Consultants Inc. v. The Queen*, the court looked through the taxpayer's "papering" of a transaction to the legal substance of the transaction and held that the taxpayer had made a misrepresentation when it misrepresented the true state of the facts in the financial statements and in its tax return.

In the *Nesbitt* case, the plaintiff disclosed in his 1981 tax return that the amount of a gain on the disposition of a shopping mall was $4,065,111.00 and that his interest in that gain was 17.5 percent. However, the plaintiff's accountant made a mathematical error when preparing the tax return and calculated the plaintiff's share of the capital gain as $71,139.42 instead of $711,394.25. Consequently, the amount reported on line 17 of the plaintiff's tax return was incorrect. The plaintiff signed his tax return where required after the certification "that the information given in this return and in any documents attached is true, correct and complete in every respect and fully discloses my income from all sources." The plaintiff admitted at trial that he did not carefully review the return before signing it and he did not realize that his income was underreported. He had relied on his accountant and trusted that the calculations were accurate. On October 4, 1982, the minister issued an initial notice of assessment. Approximately six years later, the minister reassessed on the basis that the plaintiff's profit was on income account. The plaintiff filed a notice of objection. On July 13, 1989, the minister reassessed the plaintiff again, this time on the basis that the correct amount of the capital gain was $711,394.25. The minister did not allege fraud.

The issue in the appeal was whether the taxpayer had made a misrepresentation attributable to neglect, carelessness, or wilful default. The minister took the position that any error on a tax return constitutes a misrepresentation, and consequently, an incorrect statement made as a result of a mathematical error is a misrepresentation.

The plaintiff's counsel took the position that Nesbitt had truthfully disclosed the relevant facts in his tax return and did not make a misrepresentation. Counsel presented definitions for the word "fact" and submitted that the product of a mathematical calculation is not a statement of a fact, a representation is a statement of fact, and consequently, an incorrect figure cannot be a misrepresentation. Counsel also argued that if the minister was correct, there would be no limitation period for mathematical errors and that, as a matter of policy, this could not be what Parliament intended when enacting subsection 152(4) of the Act.

The court acknowledged that the plaintiff's argument as to the meaning of "misrepresentation" was "ingenious" but was unpersuaded. The court stated:

> To interpret [sub]paragraph 152(4)(a)(i) [in the manner proposed by the taxpayer] would produce a result which Parliament could not possibly have intended. If the Plaintiff is correct a misstatement of a figure on a tax return could avoid the consequences of a "misrepresentation" merely because that figure was produced through an arithmetical calculation.[20]

In the court's view, any incorrect statement was a misrepresentation. The court followed the ruling in *MNR v. Foot*,[21] in which the Exchequer Court held that "any misrepresentation" was synonymous with the expression "incorrect." The court also agreed with the conclusion in *MNR v. Taylor*[22] that the words "any misrepresentation" must be construed to mean any representation that was false in substance and in fact at the material date. The court concluded that a misrepresentation is made when an incorrect figure, including one resulting from a mathematical error, is reported on a tax return.

The court confirmed that the taxation year cannot be opened unless the misrepresentation is attributable to neglect, carelessness, or wilful default. The plaintiff had conceded that the calculation error amounted to carelessness. The court, however, pointed out that the plaintiff's accountant had made the error. The court then considered whether Nesbitt had made a misrepresentation attributable to neglect, carelessness, or wilful default when his tax preparer had made the error. The court followed the leading case of *Venne v. The Queen*[23] and stated that "[i]t is no answer for a taxpayer to blame any miscalculations or errors on the preparer of his income tax return."[24] The court found that the taxpayer had been neglectful in not exercising reasonable care in reviewing his tax return and was of the view that an error of this magnitude should have been apparent.

In our view, the *Nesbitt* case is troubling. The court does not appear to consider the underlying policy for the reassessment limitation in the Act

---

[20] 96 DTC 6045, at 6049 (FCTD).

[21] 64 DTC 5196; [1964] CTC 317 (Ex. Ct.), aff'd. 66 DTC 5072 (SCC).

[22] 61 DTC 1139; [1961] CTC 211 (Ex. Ct.).

[23] 84 DTC 6247; [1984] CTC 223 (FCTD).

[24] Supra footnote 20, at 6049.

and, with respect, creates an imbalance by allowing the minister too much latitude to reassess at the expense of taxpayer's need for finality. The reassessment provisions in the Act are a compromise between two important objectives. On one side of the scale, the minister of national revenue must have the power to enforce the Act and a reasonable time period in which to review and reassess. On the other side of the scale, taxpayers need certainty and finality.

The word "misrepresentation" has been judicially interpreted to mean an incorrect statement. While this interpretation may be considered by many to be too broad, in our view, it is the requirement that the misrepresentation be "attributable to neglect, carelessness or wilful default" that is key to correctly balancing the underlying policy objectives. The courts have held that a misrepresentation attributable to neglect is the least serious infraction.[25] The phrase "attributable to neglect" has been judicially interpreted to mean that a taxpayer who has not exercised reasonable care is neglectful for the purposes of subparagraph 152(4)(a)(i) of the Act.[26]

What constitutes reasonable care must be determined on the facts on a case-by-case basis. In the *Nesbitt* case, the taxpayer hired an experienced accountant to prepare his tax return. Nesbitt reviewed his tax return and would have seen that all of the appropriate lines had been filled in. What Nesbitt did not do was verify each of his accountant's calculations, but is it reasonable to expect a taxpayer to do this when the accountant has a better understanding of the Act? Nesbitt also did not recognize that his capital gains were understated on line 17 by approximately $300,000, but neither did his accountant. Further, it is not clear from the facts of the case whether Revenue Canada noticed the mathematical error at the time of the initial assessment in 1982. In addition, there is no suggestion in the facts that the taxpayer had known that his capital gains should have been in the vicinity of $495,000. There is also no suggestion that the taxpayer was aware of his windfall before he was reassessed in 1989.

With respect, on the basis of the facts, Nesbitt has been held to a standard of care inconsistent with the underlying policy objectives of the reassessment provisions. If a statute-barred year may be opened for the simple reason that the information given in the taxpayer's return is incorrect because of a mathematical error, without anything more, there is no certainty or finality for a disproportionate number of taxpayers.

In the *Farm Business Consultants* case, the appellant was a wholly owned subsidiary of Datatax Business Services Limited ("Datatax") involved in the business of providing financial, accounting, and tax services to farmers. In 1982, the appellant and Datatax purchased the assets of Agricultural Tax Service Limited and Agricultural Tax Service (Canada)

---

[25] *Venne*, supra footnote 23, at 6251; 228. See also *Farm Business Consultants Inc. v. The Queen*, 95 DTC 200, at 204; [1994] 2 CTC 2450, at 2456 (TCC); and *MNR v. Bisson*, 72 DTC 6374; [1972] CTC 446 (FCTD).

[26] *Venne*, supra footnote 23, at 6251; 228.

Limited (collectively "Agricultural"). The only asset of significant value was goodwill. In the agreement of purchase and sale, the value allocated to goodwill was $1.00. The appellant and Datatax entered into a separate consulting agreement in which they agreed to pay the individual shareholder of Agricultural $86,580.00 per year for seven years. However, before closing, the parties amended the consulting agreement so as to restrict the consulting commitment to a maximum of five days of service per year.

In each year, the appellant deducted the consulting fees in calculating its tax. In 1990, the minister reassessed the appellant for the taxation years ending April 30, 1983 to April 30, 1987 and August 31, 1987 to August 31, 1989, and disallowed the deduction of the amounts paid under the consulting agreement.

The appellant's first argument before the Tax Court was a procedural one. The appellant argued that the minister has the onus of demonstrating the validity of the assessment relating to statute-barred years before the merits of the case may be determined. The appellant further argued that the minister must lead in the presentation of facts and argument on the issue whether the taxpayer had made a misrepresentation attributable to neglect, carelessness, or wilful default. It was the appellant's position that it was only after the minister had proved that the taxpayer had made a misrepresentation attributable to neglect, carelessness, or wilful default that the merits of the case could be put to the court.

The appellant referred to the *Taylor* case, where the court held that

> the burden of proof lies on the Minister to *first* establish to the satisfaction of the Court that the taxpayer (or person filing the return) has "made any misrepresentation or committed any fraud in filing the return or supplying information under this Act" unless the taxpayer in the pleadings or in his Notice of Appeal (or, if he be a respondent in this Court, in his reply to the Notice of Appeal) or at the hearing of the appeal has admitted such misrepresentation or fraud [emphasis added].[27]

The minister took the position that *Taylor* was distinguishable, arguing that Taylor had not disputed the correctness of the reassessments apart from their timeliness. The minister then argued that where a taxpayer disputes a reassessment, the onus is on the taxpayer to prove that the minister's assumptions are incorrect. The minister submitted that the onus should remain with the taxpayer where the taxpayer also disputes the validity of a reassessment. It was submitted that the minister should lead only where the merits of the reassessment are not in dispute.

The Tax Court ruled that the minister should lead in the presentation of evidence and argument to establish that the minister had the right to reassess beyond the three-year limitation period. His Honour Judge Bowman commented that switching the order of presentation should not make

---

[27] Supra footnote 22, at 1141; 214.

any difference because the minister may call the taxpayer (or an officer or director, as the case may be) as a witness. The Tax Court then held:

> Before the court can consider whether a reassessment is correct it must first decide that it was validly made. . . . Until the validity of the reassessment that is otherwise statute-barred is established by the Minister under subparagraph 152(4)(a)(i) the taxpayer's only onus is to show that the reassessment was made out of the normal reassessment period.[28]

Argument then turned to a question of fact. The minister presented the facts on which the reassessments were based. The minister treated the transaction between the appellant, Datatax, Agricultural, and the shareholder as a sale of goodwill. The appellant argued that the transaction was a consulting agreement.

The Tax Court found that, as a matter of fact, the agreements between the parties did not reflect the legal reality of the relationship. The arrangement was, in reality, a sale of a business. Agricultural and the shareholder did not provide any consulting services over the seven years of the consulting agreement. The $86,580 per annum payable to Agricultural and the shareholder was not for services; it was for the sale of the customer list, and the scheme was blatant. His Honour Judge Bowman suggested that had the taxpayer spoken "to a moderately competent tax lawyer or accountant he would unquestionably have been told that the scheme did not work."[29] In his view, the case law held that "[t]he essential nature of a transaction cannot be altered for income tax purposes by calling by it a different name."[30]

On this basis, the court concluded that there had been a misrepresentation in the financial statements because consulting fees were not paid to Agricultural and the shareholder. The payments were for goodwill and therefore were not currently deductible expenses, but were eligible capital expenditures deductible over time. It did not matter that the financial statements of the taxpayer were audited and that the deduction for fees was in accordance with generally accepted accounting principles, since the financial statements were based on the inaccurate assumption that consulting services had been performed.

In the Tax Court's view, the misrepresentation was attributable to neglect, carelessness, or wilful default. It was not necessary to decide into which category the misrepresentation fell because it was clear that the misrepresentation fit within the broad range covered by the three words. However, the court characterized the misrepresentation as wilful and stated, "The appellant either knew what it was doing or was reckless as to the legal efficacy of the arrangement."[31]

---

[28] *Farm Business Consultants*, supra footnote 25, at 202; 2452-53.

[29] Ibid., at 204; 2456.

[30] Ibid., at 203; 2454.

[31] Ibid., at 205; 2456.

The taxpayer appealed the decision; however, the Federal Court of Appeal, without reasons, dismissed the appeal. The court simply stated that the Tax Court had applied the proper principles of law to the facts and did not err in concluding that there had been a misrepresentation attributable to neglect, carelessness, or wilful default.

In our view, the *Farm Business Consultants* case is correctly decided and is consistent with the underlying policy objectives of the reassessment provisions. A taxpayer may be found to have made a misrepresentation where the characterization adopted is contrary to the legal substance of the transaction. Statute-barred years should be opened where a taxpayer has misled Revenue Canada as to the true state of the facts in order to gain a tax advantage.

The procedural requirement set out in *Farm Business Consultants*, that the court determine whether a reassessment is validly made before consideration of the merits of the case, may be used to balance the underlying policy objectives. It is consistent with the objective of finality that a statute-barred year not be opened where a taxpayer may have innocently misapplied or misinterpreted an unclear provision of the Act. If it is not clear to the court that the taxpayer has misapplied or misinterpreted a provision of the Act, without getting into the merits of the case and whether or not the minister would be successful if the merits were considered, the taxpayer cannot be said to have made an error. Even if it is assumed that the taxpayer's application or interpretation of a provision is wrong, the error is not attributable to neglect and the year should therefore remain statute-barred.

This is not a new idea. The Tax Review Board in *M.D. Glazier Ltd. v. MNR*[32] held that the taxpayer has not made a misrepresentation where it is not clear, without getting into the merits of the case, that the taxpayer has made an incorrect statement. In that case, the taxpayer realized an amount from the sale of an option on land, included that amount in his income, and reported a non-capital loss, claiming part of the loss in that year and part in the following year. Whether Glazier's treatment was incorrect could not be determined without looking at the merits of the case. The board held that it could not open the statute-barred year to do so.

It will be interesting to see if courts in the future will be guided by *Farm Business Consultants* in limiting the minister's ability to reopen statute-barred years. If courts do not make a move toward finality, there appears to be no limitation on murder and the reassessment of taxes.

Cyndee B. Todgham

[32] 83 DTC 48; [1983] CTC 2061 (TRB).