PERILS IN PRACTICE

Tales of Tax Treatment of Law Practitioner's T1 Generals

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Tax Court Decision

The decision of the Tax Court of Canada began unremarkably, if not routinely, with the result.[1] The first paragraph allowed a taxpayer's appeals from audit assessments of his 1990, 1991 and 1992 T1 General income tax returns. The assessments were ordered remitted to the Minister of National Revenue ("the Minister") for "reconsideration and reassessment" congruent with reasons for the decision.

Facially inharmonious with the substantive result, however, was the decision's second paragraph. The Minister was entitled to recover costs of the appeal from the successful appellant taxpayer. Moreover, costs were authorized on the infrequently-allowed higher solicitor-and-client scale.

What followed, in the lucid, careful judgment of Bowman T.C.J., delivered on April 14, 1998, recounts a remarkable, rancorous rumble between a taxpayer, who practises family law, and the Minister.

In determining their differences, the decision (i) affords insights on income tax law, procedure and practice treatment of tax returns of solicitors practising privately in Canada, and (ii) offers counsel about how taxpayers should *not* treat the Minister.

Practitioner Taxpayer

An "indefatigable self-promoter," the taxpayer "is, and, during the years in question, was a very successful legal practitioner" in several western Canadian provinces; "a rainmaker – a person who brought to ... [his] firm a large number of clients, and contributed significantly to the prosperity" of successive law partnerships of which he was a member. In fact, the Court found that part of its difficulty in determining the solicitor's income in the three affected years and, thus, deciding some of the appeal issues, derived from "the fact that each time a new partner joined him in the practice of law a new partnership was formed." Over those three years, the solicitor had formed five law partnerships and operated a company with links to the partnerships.

And "[w]hatever confusion may have been engendered by this proliferation of business organizations was" regretted the Court, "exacerbated by ... [the taxpayer's] stonewalling tactics vis-à-vis" the Minister, that produced a "somewhat chaotic state of affairs...."

Appeal Preliminaries (Including Disclosure and Proof)

Although the decision-producing appeal occupied seven days, the case "boiled down essentially to a number of factual issues that," the Court felt, "could and should have been resolved at the assessments level or the [administrative] appeals level." Permeating the decision was the Court's dismay at repeated failings of the taxpayer to responsibly access these extra-judicial processes.

In an aside about these processes, the Court wrote that the "system of assessment, objection and [administrative] appeals from ... assessments in Canada ... works very well"; provided "good faith and openness [is exhibited] by both sides." In Bowman T.C.J.'s experience, this system is "one of the best in the world." (This view is not universally shared in the law community. Consider a series of *Law Times* reports which began in the newspaper's 05-11 October 1998 edition, headlined "Under oath [:] Revenue Canada investigators badmouth lawyers.")

When the Minister audited the solicitor's returns for 1990 through 1992 – which yielded the impugned assessments – the solicitor was "uncooperative" to the extent that the auditor was precluded from performing the audit "in a manner that would in all probability have resolved many of the issues" ultimately presented to the Court. The taxpayer having administratively appealed from the audit assessments, by filing notices of objection to them, "refused to make any representations to the [administrative] appeals officer" on the

[1] [1998] T.C.J. (Quicklaw) No. 278: "the decision."

basis he intended to pursue his objections to Court (by a judicial appeal from rulings of the [administrative] appeals officer).

Once the solicitor lodged, in the Tax Court, his appeals from rulings of the administrative appeals officer, his behaviour in (i) pre-appeal hearing document production – document dumping "on the court's doorstep at the eleventh hour" – and (ii) examination for discovery were, the Court concluded, "a shambles" and "an exercise in gamesmanship and obfuscation"; largely the product of the taxpayer's "stonewalling tactics." These tactics, in turn, precipitated a series of motions by the Minister to obtain disclosure from the taxpayer. How successful these motions proved to be is unclear. Indeed, the Court reported, that after disposition of these motions, "documents were produced [by the taxpayer] right up to the last minute" before the appeal hearing.

Because of the solicitor's reticence about disclosing information, "the case comes before the court without any of the preliminary factual determinations being made by the Minister that normally form the basis of the identification of the issues ...". The issues, in turn, usually form the starting point of an appeal to the Tax Court. Due to being required to first determine the factual underpinnings that begat the appeal issues, the Tax Court imposed, entirely on the taxpayer, the burden of "establishing all constituent elements" of facts required to justify identification and consideration of the appeal issues he raised before the Court. In deciding whether the taxpayer met that burden, the Court ruled that to "the extent ... there is any conflict between the ... [income tax auditor's] and the ... [taxpayer's] testimony in respect of the audit of the tax returns, I accept ... [the income tax auditor's] testimony."

And what of the solicitor's notices of appeal to the Court from the rulings of the administrative appeals officer who had reviewed the initial audit assessments of the three income tax returns? In theory, these notices of appeal are supposed to plead the issues for the judicial appeal hearing. At Bar, however, the Court regarded the notices of appeal as being "unhelpful." Moreover, the Court noted, at least one of the issues argued before – and determined by – the Court was not even mentioned in the appeal notices.

Appeal Record

Most of the record for the appeal to the Tax Court involved the lawyer taxpayer's records and books. Subsection 230(2.1) of the Income Tax Act[2] specifically identifies lawyers as being obligated to keep records and books. The Act does so in this way. Subsection 230(1) requires, generally, that "[e]very person carrying on business and every person who is required, by or pursuant to this Act, to pay or collect taxes or other amounts" keep records and books of account at office, home, or other place the Minister designates. Subsection 230(2) imposes a like, general, duty on "[e]very registered charity and registered Canadian amateur athletic association." Here inserted is subsection 230(2.1) which, "for greater certainty," mandates, specifically, that records and books of account "be kept by a person carrying on business as a lawyer [defined in subsection 232(1)] whether by means of a partnership or otherwise, including all accounting records of the lawyer, including supporting vouchers and cheques."

(Retention periods for such records, and others, for income tax purposes (generally: six years from when last relied on in filing a return), are prescribed, principally, in subsections 230(1), (4) and the *Income Tax Regulations*, CRC, c. 945, Part LVIII, reg. 5800; and are discussed in Revenue Canada's *Information Circular* 78-10R2. Limitation periods (generally: three years from date of mailing of a Notice of Assessment in respect of an income tax return) governing reassessment of an income tax return, either at the request of the taxpayer or the Minister, are provided for, principally, in subsection 152(3), (4); and are discussed in Revenue Canada's *Interpretation Bulletin* IT-241 and Information Circulars 75-7R3 and 84-1.)

"Why lawyers are singled out [to retain records for income tax purposes] is uncertain," remarked Bowman T.C.J. Nonetheless, she did not "regard compliance with section 230 to be a prerequisite to the deductibility of expenses if they can otherwise be proved. Failure to keep books and records carries its own sanction but had Parliament intended that sanction to include non-deductibility of

[2] RSC 1985, c. 1 (5th Supplement), as amended, (the "Act").

expenses it would have been quite capable of saying so."

Furthermore, in her view, "there is no requirement in law that expenses be supported by receipts or other corroboration if such expenses can be supported by credible *viva voce* testimony and the amounts can be identified with a reasonable degree of specificity."[3]

This, the Court qualified, by suggesting that lawyers did not enjoy *carte blanche* to forego documenting their expenses. At Bar, for example, the taxpayer and his partners were apparently in the habit of receiving expense allowances from their partnerships for which no vouchers or receipts were provided to the partnerships to account for how the allowances were spent. The Court wrote that "[e]xpenses incurred on firm business, if charged to the firm by partners or employees, should ideally be backed up by specific substantiation ... [e]ven in a busy law firm ... ."

Appeal Hearing

"A substantial part of the ... hearing was devoted to proving small expenditures" involving "the laborious proof of receipts that should have been produced at the audit or objection level."

This ignited another stream of judicial criticism of the taxpayer, accompanied by a legal lecture; a lecture designed for the taxpayer, although beneficial to litigators at large, not least family law practitioners. The Court cited Wigmore on Evidence[4] as quoted by Wakeling J.A. in *Sunnyside Nursing Home v. Builders Contract Management Ltd. et al.*:[5]

> Where a fact could be ascertained only by the inspection of a large number of documents made up of very numerous detailed statements – as, the net balance resulting from a year's vouchers – it is obvious that it would often be practically out of the question to ... [require] production of the entire mass of documents and entries to be perused by the jury or read aloud to them. The convenience of trials demands that other evidence be allowed to be offered, in the shape of the testimony of a competent witness who has perused the entire mass and will state summarily the net result. Such a practice is well-established to be proper.

Argument at the appeal hearing, in some respects, involved taxpayer entreaties to the Court that the Court characterized as invitations "to drive a coach and four" through some Income Tax Act provisions.

The Court harboured no reservations about responsibility for this, in particular, and for shortcomings, generally, in appeal notices, appeal pre-hearing behaviour, and resulting prolix proceedings. "I imply no criticism of ... [taxpayer's counsel]," wrote the Court. He has "presented the [taxpayer's] case skillfully and professionally. However, he had an impossible client."

Rulings on Substantive Issues

Whatever may be said about his litigation conduct, the "impossible client" was substantially successful in his appellate challenge to Revenue Canada's treatment of his three income returns under scrutiny. Some of his issues were conceded by the Minister on the appeal hearing (including the Minister's denial of a $1,100 deduction for the taxpayer's home office and denial of another deduction (nature not stated) for $10,838.39). The Court allowed his appeal on other issues. They included: (i) part of a $7,860 deduction claimed by the taxpayer for entertainment expenses of a promotional nature – specifically, $6,379.46 "for a gala party [compliments of] "Your Friendly Neighborhood Solicitor"; (ii) a portion – $6,587.50 – of another group of deductions (nature not stated) that totalled $15,436; and (iii) most – $32,629.85 – of the taxpayer's deduction of $33,113.71 for interest and carrying charges.

Other taxpayer claims on appeal were disallowed. Four, in particular, moved the Court to undelicately reprove the taxpayer. (i) Omission by the taxpayer, from one of his three returns in issue, of $75,592 "plainly taxable" partnership income "was at least grossly negligent, if not deliberate"; therefore warranting the penalty imposed by the Minister which the taxpayer disputed on appeal. (ii) A deduction for $180 paid by the taxpayer to his wife for doing some filing in relation to a board on which the taxpayer sat was rejected as "ridiculous". (iii) Responding to the taxpayer's claim for a deduction, under the heading of business tax, fees, licenses and dues, of $5,059.43, the

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[3] *Weinberger v. M.N.R.*, 64 D.T.C. 5060.

[4] 3rd ed., vol. IV, s. 1230.

[5] (1990), 75 Sask. R.1, at 24.

Court wrote: "... [this included], as an example of the fatuity of the behaviour of ... [the taxpayer], $8.37 for dry-cleaning of his [court] vest and gown. To clutter up the record with this sort of thing is an insult to the court". (iv) In denying the legitimacy of the taxpayer's claim, over two tax years, of $111,672 for bad debt expense, the Court held:

> [two of the partnerships] deducted a reserve for [a portion of their] bad debts or doubtful debts. ... [Taxpayer] then claimed the balance of the debts as ... [bad debts or doubtful debts on his personal T1 returns]. I must confess I have seldom seen anything quite so far-fetched. The proposition is that one partner in a firm can, after the firm has deducted a bad or doubtful debt allowance, take the remainder of the firm's debts and personally claim a bad or doubtful debt allowance ... . The proposition needs only to be stated to be defeated by its own patent absurdity. ... The conduct is well within the type contemplated by [Income Tax Act] subsection 163(2) (which provides for imposition of a penalty on a taxpayer who, knowingly or with gross negligence, makes, participates in, assents to, or acquiesces in making of, a false statement or omission, involving a tax return or related document).

Costs

In adjudicating substantive issues raised on the appeal, Bowman T.C.J. maintained that she "ignored," as being irrelevant, the taxpayer's "unacceptable behaviour and focused solely on the legal and factual issues." She noted, though, that "it is not inconceivable that had he behaved less outrageously at the audit, objection and appeals level [all of which preceded the appeal] he might have obtained further relief [in those processes] that I am not, on the evidence, prepared to give him."

As for "unacceptable conduct" on the appeal, the Judge concluded, the appropriate response is to consider whether and what costs to award.

At Bar, she wrote, the taxpayer "has been given all that he could reasonably expect in respect of the substantive issues. Moreover, he has been given great leeway in respect of the production of documents and the raising of issues. He has, however, treated this court, its rules, the orders of the court and counsel for the ... [Minister], who is an officer of the court, with disdain."

A further concern, the judge wrote, was that the taxpayer engaged in "a dangerous and risky game" in treating the court as a forum for a tax audit and foisting that function on a judge. "[A]s will be apparent from my award of costs," the judge promised, that type of gamesmanship will prove "expensive" to the taxpayer.

Her analysis of legal and factual considerations in, consequently, awarding solicitor and client costs against the taxpayer speaks for itself:

> It is unusual to award costs against a party who has been partially successful, and in particular solicitor and client costs. The matter is discussed in *Young v. Young*, [1993] 4 S.C.R. 3. The general rule is that a successful litigant is entitled to party and party costs. Where success is divided it is not unusual for no order to be made for costs. To depart from the usual rule requires unusual circumstances. For a successful or partially successful litigant (a) to be deprived of costs, (b) to be ordered to pay party and party costs, [or] (c) to be ordered to pay costs to the other party on a solicitor and client ... [basis], requires a measure of reprehensibility. To award solicitor and client costs against a litigant who has achieved the degree of success that ... [the taxpayer] has [,] requires a high degree of reprehensible conduct. There must, to use the words of McLachlin J. in *Young* (supra) at p. 134, be "reprehensible, scandalous or outrageous conduct on the part of one of the parties.

After citing Sarchuk J. in *Bruhm v. The Queen*[6] on the same issue, Bowman J. concludes, as to principle, that "to award solicitor and client costs against a partially successful party is rare and should be done only in exceptional circumstances."

She then refers to section 147 of the General Procedure Rules governing appeals to the Tax Court of Canada (addressed in detail in McMechan & Bourgard, *Tax Court Practice* (Carswell, looseleaf). That provision of the Rules affords the Court "wide discretionary power in respect of the awarding of costs."

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[6] 94 D.T.C. 1400 (T.C.C.).

Turning to the appeal at Bar, she concludes that this "is a case for ordering ... [the taxpayer] to pay the Crown's costs on a solicitor and client basis" and to do so on the appeal hearing and on all preceding motions.

Her reasons:

> From the outset ... [the taxpayer] has done everything possible to obstruct the Crown in its attempt to put its case forward in an orderly way. He has produced documents up to the last minute. He has rendered impossible the conduct of the discovery. The abuse of the assessor, who acted properly throughout, is intolerable. Generally speaking, conduct prior to the commencement of the ... [appeal] is not relevant to the award of costs. The rule is not invariable. Here, ... [the taxpayer] has deliberately frustrated the audit process and the objection process with a view to having matters dealt with by the court that should never have had to come before it. His conduct prior to commencement of the appeal [to the administrative officer] and prior to ... [the appeal hearing] has had a direct impact upon the manner in which ... [this appeal] proceeded. He has caused a ... [hearing] that should have lasted no more than one day to last seven days. Moreover such success as he has achieved ... [as a result of the appeal hearing] is no more than he could have achieved at the audit, objection or [appeal] discovery level had he not seen fit to obstruct the orderly process of assessment and objection laid down in the Income Tax Act and the procedures set out in the rules of this court.

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