CANADIAN TAX Highlights

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T1135 Penalty Relief

On March 28, 2018, in *Takenaka* (2018 FC 347), the FC quashed a CRA decision to maintain a late-filing penalty for a foreign income verification statement (the T1135 form), filed by a taxpayer with no income. *Takenaka* raises important procedural questions concerning the TCC's and the FC's roles in resolving penalty disputes and the challenges that their overlapping jurisdictions cause taxpayers. The case also spotlights the lengths to which the CRA will go to avoid granting penalty relief that is clearly warranted.

Yoshimi Takenaka, an immigrant homemaker, jointly owned US rental property with her husband, who dutifully reported the rental income from the property on his 2011 and 2012 tax returns and declared the property on his annual T1135 form. Ms Takenaka, however, did not file her own T1135 form in those years because she had no income of her own and thus no obligation to file a tax return.

In 2014, however, she voluntarily late-filed her 2011 and 2012 returns (showing nil income) in order to claim the Canadian child tax benefit (CCTB), a monthly benefit formerly available for low- and middle-income families. She attached to the returns a T1135 form disclosing the US rental property and was assessed late-filing penalties (paragraph 162(7)(a)) ($2,500 for each year) plus interest.

Section 233.3 requires the annual filing of a T1135 form if a taxpayer owns more than $100,000 of foreign assets, even if a tax return is not otherwise required. Before 2013, however, CRA instructions incorrectly suggested that a T1135 form was required only if a taxpayer filed a tax return. The CRA amended its instructions in 2013 due to widespread misunderstanding by taxpayers of their obligation to file a T1135 form. The court noted:

> I agree with Ms. Takenaka that the pre-2013 T1135 form's instructions are unclear, confusing, and border on misleading. It is likely because of this that the CRA saw fit to change its form in 2013. Ms. Takenaka is not the first person to have made this mistake.

Ms Takenaka applied to the CRA under subsection 220(3.1) (the fairness provisions) for discretionary cancellation of the late-filing penalties and related interest, on two grounds: (1) she made an honest mistake attributable to erroneous CRA guidance, and (2) financial hardship. Initially, the CRA denied her application, but on a second-order review arbitrarily decided to cancel the penalty for 2012 only. Ms Takenaka sought an FC judicial review of the CRA decision and represented herself.

On its initial review, the CRA refused relief to Ms Takenaka on the grounds that the late-filing penalty was a tax balance that she "knowingly allowed . . . to exist." The FC described this reasoning as "circular and perverse" because the "balance" "allowed to exist" was the same balance that Ms Takenaka sought to cancel. The FC also found the CRA's position factually unreasonable, given that all the evidence showed that Ms Takenaka did not, in fact, know about her obligation to file a T1135 form.

During the second-order review, the CRA developed a slightly different theory: Ms Takenaka was obliged to file a tax return to claim the CCTB, and thus her retroactive CCTB claim made her non-compliant with her T1135 filing requirements and justified the late-filing penalty. The court said that this was also "a form of circular and erroneous reasoning" and thus that the CRA decision "lack[ed] justification and [was] not intelligible." The court also found it unreasonable that the CRA delegate did not seem to consider any of Ms Takenaka's hardship submissions. Ultimately, the court quashed the decision not to cancel the 2011 penalty and remitted the matter for reconsideration.

The judgment does not explain why Ms Takenaka chose to challenge the penalty through a fairness application instead of an objection or appeal to the TCC based on due diligence. The TCC has repeatedly vacated late-filing penalties for T1135 forms attached to tax returns in which no tax was payable, such as *Douglas* (2012 TCC 73) and *Fiset* (2017 TCC 63). One might speculate that Ms Takenaka was advised (correctly) that the TCC would not have had jurisdiction to consider her alternative arguments about hardship. With the benefit of hindsight, however, Ms Takenaka might have avoided litigation and achieved a faster resolution via an objection based purely on due-diligence grounds, perhaps keeping her hardship arguments in reserve for a fairness application if the objection failed.

The CRA officials involved in the fairness application were aware of *Douglas*, but gave it no weight: it was "not binding precedent," and "[t]he CRA assesses each case on its own merit." Before the FC, the CRA continued to argue that it should not follow *Douglas*. The court rejected this argument: the FC may not be bound by TCC case law, but it can "take some guidance from the views expressed by the Tax Court, which is much more knowledgeable and experienced in interpreting the Act than this Court."

Perhaps the more disturbing question raised by *Takenaka* is how the case got litigated to judgment in the first place. Ms Takenaka made a very common mistake induced by the CRA's own misleading instructions that caused no prejudice

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to the Canadian taxpaying public and only came to light when she sought to apply for a tax benefit available to low- and middle-income families. The penalty imposed automatically by the Act was disproportionate to the gravity of the mistake, and the TCC had repeatedly held that such penalties in such circumstances can and should be vacated. Nevertheless, in defiance of the courts and common sense, the CRA doggedly refused to grant interest relief and ultimately obliged Ms Takenaka—a low- or middle-income, immigrant homemaker not speaking English or French as her first language—to initiate and prosecute FC proceedings without the assistance of counsel to judgment, all to obtain the cancellation of a $2,500 penalty that could and should have been waived by the CRA at the pre-assessment review stage. One hopes that *Takenaka* will prompt a reflection by the CRA on how it assesses applications to cancel late-filing penalties, but also on what cases it decides to litigate.

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