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CAN TAXPAYERS SUCCESSFULLY SUE THE CRA FOR NEGLIGENCE?

— Shaira Nanji, Tax Associate with the Toronto office of Dentons Canada LLP

Canadian taxpayers who are mistreated by the Canada Revenue Agency ("CRA") in the course of an audit are likely troubled by the noticeable absence of mechanisms in taxing statutes by which the CRA may be held accountable for its behaviour or supervision.

Canadian case law is clear that a taxpayer may not launch a "collateral attack" on a tax assessment by bringing a civil claim against the CRA.[1] However, there is no judicial authority that has yet foreclosed the possibility that a taxpayer may bring a civil claim for damages against the CRA for negligence in the course of administering or enforcing various taxing statutes.

In fact, several recent decisions have wrestled with the question of whether a negligent act or negligent supervision by the CRA in the course of administering a taxing statute can give rise to a private law remedy. The courts have determined that the answer to that question depends on whether a duty of care should be imposed on the CRA towards a taxpayer.

In three recent cases, *Leroux v. Canada Revenue Agency* ("*Leroux*"),[2] *Gordon v. R.* ("*Gordon*"),[3] and *McCreight v. Canada (Attorney General)* ("*McCreight*"),[4] the courts have opened the door (slightly) to the possibility that such a duty of care may exist at law.

In all three cases, the courts dismissed the Crown's motions to strike certain of the taxpayers' claims — including negligence — and, in doing so, demonstrated that some civil actions against the CRA may have a reasonable chance of success at trial. Although the trial judgments are yet to be rendered, the courts explored several factors which, if factually substantiated, may be persuasive in establishing that CRA officials acted negligently.

Such negligence could exist where the CRA:

- prematurely targets taxpayers without proper investigation;
- uses deceptive tactics;
- appoints an underqualified auditor;
- unnecessarily interferes with contractual relations with clients and harms the reputation of taxpayers;
- wrongfully seizes and destroys documents;
- triggers improper collection procedures; or
- acts maliciously or intends to cause loss.

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Background

The CRA has a standard response to civil lawsuits alleging negligence or other misconduct: a motion to strike the claim on the basis that it is plain and obvious the claim cannot succeed. Generally, the CRA makes the following two arguments.

Firstly, the taxpayer's negligence claim cannot be successful because no "duty of care" exists between the taxpayer and the CRA officials. Part XV of the *Income Tax Act* ("ITA")[5] outlines the administration and enforcement provisions which empower the CRA officials to review taxpayer filings and to ensure compliance in a self-assessing system. There is no provision in the ITA that creates a statutory "duty" to taxpayers.

Secondly, there is no reason to justify the creation of a novel duty of care between the CRA officials and the taxpayers under the *Anns/Cooper* test.[6] This two-step test, created in tort law to give legal recognition to a relationship not yet recognized in law, examines whether the proximity of parties is sufficient to justify the imposition of a duty of care and whether any residual policy considerations will negate or reduce the scope of this duty. Either there is insufficient proximity between the taxpayer and CRA officials or, alternatively, any duty of care found by the courts should be overruled for policy reasons.

In *Leroux*, *Gordon*, and *McCreight*, the courts did not agree with these arguments put forth by the CRA.

Leroux

Leroux has garnered significant media attention and is one of the more public cases on CRA negligence. The story has been featured in news magazines and CBC radio and even has its own Facebook account, YouTube channel, and website: lerouxed.com.[7]

In this case, the CRA conducted a prolonged income tax and GST audit on Mr. Leroux, who owned a recreational vehicle park business. In what was termed by the British Columbia Supreme Court a "series of Kafkaesque events",[8] the CRA not only seized Mr. Leroux's original documents during an initial audit without authorization and refused to return the documents when requested, but also subsequently informed Mr. Leroux that the original documents had been accidentally shredded and that it was his responsibility to provide more documents to substantiate his tax returns.

Mr. Leroux alleged that, during the audit, a Prince George auditor requested a cash bribe of $25,000 to resolve his "tax problem". When Mr. Leroux refused to pay, the auditor triggered an unjustified collection action and ignored his requests to refinance. This resulted in severe cash flow problems for Mr. Leroux's business. After 13 years of audit, assessment, reassessment, and collections activities, the taxpayer's business was financially ruined.

Mr. Leroux brought an action against the CRA for negligent behaviour during the audit, reassessment, and collection process. The British Columbia Supreme Court dismissed the CRA's motion to strike portions of the claim. The British Columbia Court of Appeal confirmed the lower court decision that it was not plain and obvious that the claims of negligence would fail. It held that whether a duty of care was owed by the CRA to the taxpayer is an issue that should be decided by the trial court when a full matrix of facts was available.

The British Columbia courts' refusals to strike actions of negligence indicates that wrongful seizure and destruction of documents, improper collection procedures, abusive behaviour of audit officials, and actions by the CRA done for malicious purposes with intent to cause loss or harm to the taxpayer are factors that may form the basis of a successful negligence claim against the CRA.

McCreight

In *McCreight*, the CRA audited two accountants, their accounting firm, and some of the firm's corporate clients. The CRA alleged that the accountants helped their clients apply for fraudulent research and development tax credits. During the investigation, the CRA investigators obtained warrants for and seized over 60 boxes of documents from the corporate clients and the accountants. The CRA was authorized to retain these documents until July 1999 but failed to complete its investigation on time and requested a judicial extension of the warrants. The Ontario Superior Court of Justice denied the request and ordered the return of the documents. Two weeks later, the CRA investigator charged various individuals with fraud and conspiracy under the ITA and the *Criminal Code*.[9] In subsequent court proceedings, it

was determined that there was no legitimate basis for the criminal charges and the primary purpose of those charges was to retain the seized documents and circumvent the judicial order.

The plaintiffs brought an action against the CRA for, among other matters, claims of negligence, misfeasance in public office, and abuse of process. The Ontario Superior Court of Justice allowed the CRA's motion to strike portions of the claim but this was overturned in part on appeal. The Ontario Court of Appeal noted that it was not plain and obvious that CRA officials who operated under provisions in the ITA that attract criminal sanction did not owe a duty of care to the taxpayers who were the subject of investigations.[10]

The *McCreight* decision suggests that the premature targeting of taxpayers with criminal charges without proper investigation or for deceptive purposes (such as surreptitiously circumventing judicial orders) could provide a basis for a negligence claim against the CRA.

Gordon

In *Gordon*, the CRA laid fraud-related criminal charges against two accountants and their accounting firm with respect to SR&ED claims. The case continued for seven years until the charges were stayed at the request of the Crown.

The accountants and their firm brought claims against the CRA for misfeasance, abuse of authority, negligence, and engaging in a fraudulent scheme against them.[11] They sought compensation for loss of income, loss of clients, and general and punitive damages. The taxpayers alleged that, during the audit, the CRA threatened existing and potential customers with criminal charges and read the accountants their rights in front of clients. Consequently, the company lost significant potential earnings and business opportunities. In addition, they alleged that the CRA was negligent in assigning and failing to supervise an unqualified auditor.

The Crown brought a motion to strike substantial portions of the claims. The Prothonotary struck out a number of claims with the exception of two, namely, intentional interference with contractual relations and negligence. The Crown appealed to a judge of the Federal Court. The Crown's appeal was dismissed.

The Federal Court refused to strike the claims for intentional interference with contractual relations and negligence. Importantly, the Court held that the Prothonotary had correctly concluded that it was not plain and obvious there was no duty of care owed by the CRA to the taxpayers. The Court stated, "The case law is clearly evolving in this area, and the last word has yet to be written by an appellate court. The continuation of this claim at this stage of the proceedings is not unduly burdensome. The matter is proceeding in any event, and the relevant facts will have to be established and considered in dealing with the other claims. I decline to strike this claim at this stage of the actions".[12]

The *Gordon* decision suggests that a negligence claim may be well-founded where the CRA unnecessarily interferes with contractual relations with clients to the extent that the taxpayer's reputation is harmed or where the CRA appoints an underqualified auditor without adequate supervision.

Conclusion

The litigation in this area has not yet progressed beyond preliminary motions. The taxpayers, however, have been successful in fighting the CRA's repeated attempts to dismiss civil claims on the basis that it is plain and obvious that the claims must fail. The three decisions seem to foreshadow a new tort. A court determination that the CRA owes a duty of care to taxpayers would undoubtedly provide a helpful deterrent mechanism against potentially negligent administration and enforcement actions by the CRA.

A number of tax lawyers from Dentons Canada LLP write commentary for CCH's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for CCH's Canadian* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for CCH's* Federal Tax Practice *reporter and the summaries for CCH's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by CCH:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy Under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Denton's Canada LLP and a member of the Editorial Board of CCH's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

For more insight from the tax practitioners at Dentons Canada LLP on the latest developments in tax litigation, visit the firm's Tax Litigation blog at http://www.canadiantaxlitigation.com/.

Notes:

[1] See *Main Rehabilitation Co. v. R.*, 2004 DTC 6762 (FCA) and *Ereiser v. Canada*, 2013 DTC 5036 (FCA).

[2] 2012 DTC 5050 (BCCA).

[3] 2013 DTC 5112 (FC).

[4] 2013 ONCA 483.

[5] R.S.C. 1985, c.1 (5th Supp.), as amended.

[6] A cause of action in respect of negligence is to be examined using the *Anns/Cooper* test. This test originated in the House of Lords decision *Anns v. Merton London Borough Council*, [1978] AC 728 (UK HL) and was further developed by the Supreme Court of Canada in *Cooper v. Hobart*, [2001] 3 SCR 537.

[7] See, for example, the *National Post* article entitled "I want my life back: After more than a decade, B.C. man still fighting to right damages wrought by tax agency", April 26, 2013, http://news.nationalpost.com/2013/04/26/irvin-leroux-still-fighting-to-right-damages-wrought-by-canada-revenue-agency/.

[8] *Leroux v. Canada Revenue Agency*, 2010 DTC 5123 (BCSC).

[9] R.S.C., 1985, c. C-46.

[10] The Court of Appeal found that the duty owed by police officers to criminal suspects could be analogous to the CRA and certain taxpayers. See *Hill v. Hamilton-Wentworth Police Services Board*, 2007 SCC 41.

[11] The claims in *Gordon* were brought via the Federal Court, which shares concurrent jurisdiction with the provincial superior courts with respect to claims by and against the federal Crown.

[12] *Supra* note 3, paragraph 39.

RECENT CASES

Bad debts deduction disallowed since amount of debts not previously included in taxpayer's income

The Minister disallowed the taxpayer's deduction of bad debts for 2008 on the ground that the amount of the debts had not previously been included in his income. In dismissing the taxpayer's appeal, the Tax Court of Canada rejected his argument that the amount of the debts had been included at some point in his income, since he had made the underlying loans out of tax-paid income (2012 DTC 1263). The taxpayer appealed to the Federal Court of Appeal, repeating the argument that he had put before the Tax Court.

The taxpayer's appeal was dismissed. For purposes of subparagraph 20(1)(*p*)(i), a debt owed to a taxpayer can only be said to have been previously included in his or her income when it represents unpaid revenue earned by the taxpayer in connection with a business or property that has already been included in his or her income. The argument raised by the taxpayer in the Tax Court and again in the Federal Court of Appeal was therefore untenable. In addition, subparagraph 20(1)(*p*)(ii) was of no assistance to the taxpayer since his ordinary business did not include the lending of money. The Minister's reassessment was affirmed accordingly.

¶48,522, *Brake*, 2013 DTC 5127

Documents respecting sale of property were not subject to solicitor-client privilege

The Minister was seeking a court order requiring the respondent, Jakabfy (the "solicitor"), to provide documents and information respecting his clients D and N's sale of property. The Minister requested details regarding the distribution of the proceeds of disposition to determine if a transfer was made to non-arm's length persons who could be subject to an assessment under section 160 of the *Income Tax Act*. D had unpaid personal taxes of approximately $62,000 and $59,000 of unpaid GST. The solicitor was served with a requirement for information and documents, but his clients instructed him to refuse to produce the requested information on the grounds of solicitor-client privilege.

An order was issued requiring the solicitor to provide documents and information respecting his clients' sale of a property. The Minister was seeking the information for purposes related to the administration and enforcement of the *Income Tax Act*. Solicitor-client privilege can be claimed for documents respecting the seeking and providing of legal advice, but it does not include accounting records and documents that are evidence of transactions. The documents requested were: (a) trust ledgers showing the names and amounts of transactions where distributions were made to, or on behalf of, the clients or a corporation that they controlled (the "Parties"); (b) trust accounts or cheque journals

displaying names and amounts for transactions where money was received and paid on behalf of the Parties; (c) copies of cancelled cheques; (d) a copy of the statement of adjustments or a disbursement statement for all transactions and copies of all invoices or receipts for payments made on behalf of the Parties. None of these documents were subject to solicitor-client privilege. The solicitor acted appropriately and no costs were to be awarded against him.

¶48,523, *Jakabfy*, 2013 DTC 5128

Whether income was earned on reserve requires more than listing the factors and must include proper weight and relevance

The taxpayer appealed the Tax Court of Canada's decision regarding the years 1994 to 2003, where it was held that his business income for those years was not "personal property situated on a reserve" under section 87 of the *Indian Act* and therefore was not exempt from taxation (2009 DTC 1126). The lower court did not have the benefit of two recent Supreme Court decisions concerning section 87. Those decisions restated and consolidated the analysis in applying section 87. The taxpayer had argued that his business income was strongly tied to the reserve with a view to his work as an adviser and consultant for strategic planning and traditional Aboriginal governance matters. The Minister argued that the taxpayer spent significant time off-reserve and his business income was not tied adequately to on-reserve activities.

The taxpayer's appeal was allowed and the matter was referred back to the Tax Court for redetermination. Correctness of law was the proper standard of review in this case. The Supreme Court affirmed that non-physical property, such as benefits or income, can qualify as property for purposes of section 87. In all, a more comprehensive review of the connecting factors was required with a view to the purpose of the exemption, type of property, and nature of the taxation. The collective factors should not be listed and evaluated without proper consideration to the weight and relevance of each factor. The question was whether the property (i.e., business income) was situated on a reserve, not whether the taxpayer was situated on a reserve.

¶48,524, *Kelly*, 2013 DTC 5129

Interest amounts deducted on account of term deposits placed as security with bank lender were non-deductible

The corporate taxpayer was required to post securities to cover potential liabilities owing to US trade authorities. The arrangement involved the Royal Bank of Canada ("RBC") and an insurance company. The term deposits were held by RBC and were then hypothecated in its favour as security for obligations undertaken by the bank in favour of the insurance company. In 2001, the taxpayer deducted $3,576,088 on account of the term deposits as a deductible outlay or expense. In 2002, the taxpayer included in its income the term deposit amounts as they were discharged. The Minister disallowed the taxpayer's deduction of the amounts in 2001. At the Tax Court of Canada, the issue was whether the term deposits were an outlay or expense made or incurred for the purposes of gaining or producing income from business under paragraph 18(1)(*a*). More specifically, the issue was whether amounts deducted were in connection with a reserve or contingent liability under paragraph 18(1)(*h*) or permissible under paragraph 20(1)(*vv*) (2012 DTC 1072). The Tax Court held that the $3,576,088 constituted a non-deductible reserve under paragraph 18(1)(*e*). The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was dismissed with costs. The amounts deposited with the bank were not expenses that were "once and for all, without recourse" and in fact always remained an asset to the taxpayer with a contingent liability element. Accordingly, the amounts were non-deductible under paragraph 18(1)(*e*). Further, amounts held by the bank on account of potential liabilities were not deductible under paragraph 20(1)(*vv*).

¶48,525, *Industries Perron Inc.*, 2013 DTC 5131

Taxpayer trust ceased to exist, but appeal permitted to continue if suitably funded new appellant could be found

During the course of the taxpayer trust's appeal to the Tax Court of Canada, it ceased to exist when it transferred all of its property to another trust (the "Fund"). The same property was then transferred by the Fund to a corporation (the

"Corporation"). The taxpayer moved for an order under rule 29 of the *Tax Court of Canada Rules (General Procedure)* permitting the Corporation to become the named appellant before the Tax Court. In dismissing the taxpayer's motion, the Tax Court concluded that the circumstances of the case were not within the scope of rule 29 (2012 DTC 1177). The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was allowed. The Tax Court had interpreted rule 29 too narrowly. As a result of the taxpayer's transfer of its property, if its appeal to the Tax Court were not to succeed, the Corporation would become liable under subsection 160(1) for any of the taxpayer's tax found to be owing, and the trustees of the taxpayer would themselves also become liable for that same tax under subsection 159(3). These concerns clearly fell within the language and intended purpose of rule 29, despite the Tax Court judge's findings to the contrary. The Tax Court judge's order should therefore be set aside, and the matter should be returned to the Tax Court for redetermination on the basis that the appeal before the Tax Court should be allowed to continue if an appropriate properly funded appellant could be found. At the redetermination hearing, moreover, fresh evidence from the parties should be permitted to be adduced at their request.

¶48,526, *Clearwater Seafoods Holdings Trust*, 2013 DTC 5132

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For CCH Canadian Limited

Robin Mackie, Director of Editorial
Tax, Accounting, and Financial Planning
(416) 228-6135
email: Robin.Mackie@wolterskluwer.com

Natasha Menon, Content Product Manager
Tax, Accounting, and Financial Planning
(416) 224-2224, ext. 6360
email: Natasha.Menon@wolterskluwer.com

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CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.cch.ca

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