ONUS OF PROOF

ONUS IN TAX LITIGATION: FEDERAL COURT OF APPEAL DECISION IN HOUSE V. HER MAJESTY THE QUEEN

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On August 11, 2011, the Federal Court of Appeal released its decision in *House v. Her Majesty the Queen*,[1] in which Nadon J.A., writing for the Court, provides a clear restatement of the rules respecting the taxpayer's onus in federal tax appeals.

In *House*, the Tax Court judge, Associate Chief Justice Rossiter, found that the appellant had failed to "demolish" assumptions pleaded by the Minister of Finance (the "Minister") with respect to a $305,000 asset that the Minister alleged should have been included in the appellant's income for the tax year at issue. In so doing, Rossiter, A.C.J. dismissed *viva voce* evidence from the appellant and his witnesses, and cited the appellant's failure to produce any documentary evidence in support of the testimony on this issue. In its review of the Tax Court of Canada's decision, the Federal Court of Appeal addressed the proper analysis to be conducted in determining whether a taxpayer has satisfied its onus to demolish the Minister's assumptions. The Court found that the Tax Court judge had misapplied this analysis by failing to accept the oral evidence of the appellant and his witnesses in satisfaction of the taxpayer's initial onus, where there were no credibility issues with respect to their testimony.

Background and Tax Court of Canada Decision in House

The appellant, Clyde House, and his wife, were from the island portion of Newfoundland and Labrador but settled on the mainland in Goose Bay in 1954. They operated a hunting, fishing and air charter business under the name of Hunt River Camps/Air Northland Ltd. ("Hunt River"). Both Mr. House and his wife were shareholders in Hunt River.

Hunt River operated until 1998 or 1999, when its assets were sold. Mr. House and his wife then returned to the island of Newfoundland to retire. The only remaining asset of Hunt River at that time was a $305,000 amount which is at issue in this case.

In 2004, the Canada Revenue Agency ("CRA") requested that Hunt River file tax returns for the 2001, 2002 and 2003 taxation years. The appellant's accountant, Fred Cole, duly filed the requested returns. Hunt River's income tax return for the 2003 taxation year mistakenly indicated that it had cashed in a $305,000 investment that year which led to an audit of the appellant, including a request for documents relating to the disposition of the $305,000 amount.

In the course of communications between the CRA and Mr. Cole following the CRA's request, Mr. Cole confirmed that since Hunt River had not been operating since 1999, there were no recorded transactions that would show that the appellant had cashed in $305,000 from Hunt River in 2003. Nevertheless, the CRA took the position that unless it received additional information or an acceptable explanation, it intended to include an initial amount of $305,000 in the appellant's income for 2003 taxation year and reassess him on that basis, which it proceeded to do.

The appellant objected to the reassessment, which was confirmed by the Minister. The appellant then filed a notice of appeal with the Tax Court of Canada. In his Notice of Appeal, he took the position that the $305,000 amount had not been withdrawn from Hunt River in 2003 and as a result, it should not be included in his income for that year. Specifically, he pleaded that

1 2011 FCA 234 ("*House*").

the $305,000 amount was included on the books of the company as a result of an accounting error but did not in fact exist in the year at issue.

At the hearing before the Tax Court, Mr. and Mrs. House both testified that they recalled investing the $305,000 with a credit union at a favourable rate of interest in or around 2000, when they retired and moved back to the island of Newfoundland. Since Mr. and Mrs. House both acknowledged in their testimony that their memories were not that good, the principal witness at trial for the appellant was Mr. Cole, who handled their tax affairs.

The Federal Court of Appeal took note of the following points of evidence from Mr. House, his wife and Mr. Cole that were introduced at the Tax Court hearing:

- Mr. House testified that Hunt River did not hold the $305,000 investment in 2003 but could not remember precisely in what year it had been held. Mr. House further testified that the $305,000 amount was transferred out of Hunt River to his wife's account at a Labrador credit union.
- Mrs. House corroborated her husband's testimony with respect to the $305,000 amount being taken out of Hunt River and put into her account at the Labrador credit union. Mrs. House further testified that she believed that it had been cashed out around 2000.
- Mr. Cole stated that in the course of that of the balance of probabilities. reviewing Hunt River's tax returns during the CRA's investigation, he discovered that the $305,000 investment did not exist in the company's name for the 2003 taxation year and that an accounting error was at the root of the $305,000 entry in the 2003 tax return. Mr. Cole further testified that the investment had been cashed out in the year 2000 and that he was satisfied that the amount had been paid to Mrs. House and that she had bought the additional GIC's at the Labrador credit union with the money.[2]

Evidence was also heard from the CRA's auditor, Ms. Brophy, who explained the basis for the Minister's reassessment. Ms. Brophy testified that she had not received source documents from Mr. Cole or the appellant with respect to the disposition of the $305,000 amount and had not been made aware that the amount had been paid out in 2000. The Minister led no evidence in support of its assumption that the appellant had received the $305,000 amount in 2003.

Rossiter, A.C.J. decided that this evidence was insufficient to demolish the Minister's assumptions and in so doing, placed weight on the fact that neither the Houses nor Mr. Cole had adduced any documents in support of their explanation for what they say happened to the $305,000 amount. At the same time, he made no findings against their credibility. In support of his reasons, he also relied upon earlier jurisprudence in regards to a taxpayer's obligation to keep proper records. Accordingly, the appellant's appeal before the Tax Court was dismissed.

2 Mrs. House was owed in excess of $305,000 by Hunt River. The $305,000 distribution simply paid down a portion of the amount of her outstanding loan balance, which would not result in any taxable income to her on the distribution.

The Federal Court of Appeal Decision in House

The Federal Court of Appeal began its analysis of the principles governing the burden of proof in taxation cases by considering the judgment of the Supreme Court of Canada in *Hickman Motors Ltd. v. Canada*,[3] which may be summarized as follows:

1. The burden of proof in taxation cases is that of the balance of probabilities.
2. With regard to the assumptions on which the Minister relies for his assessment, the taxpayer has the initial onus to "demolish" the assumptions.
3. The taxpayer will have met his initial onus when he or she has made a *prima facie* case.
4. Once the taxpayer has established a prima facie case, the burden than shifts to the Minister, who must rebut the taxpayer's prima facie case by proving, on a balance of probabilities, his assumptions (in this case, that Hunt River held at the end of taxation year 2002 a long-term investment of $305,000, which was transferred to the appellant in 2003).
5. If the Minister fails to produce satisfactory evidence, the taxpayer will succeed.

The Federal Court of Appeal cited the following comments made by Madame Justice L'Heureux-Dubé in *Hickman* on what exactly the taxpayer's initial burden/onus is:

> The initial burden is only to "demolish" the exact assumptions made by the Minister but no more: *First Fund Genesis Corp. v. The Queen,* 90 D.T.C. 6337 (F.C.T.D.), at p. 6340.
>
> This initial onus of "demolishing" the Minister's exact assumptions is met where the appellant makes out at least a *prima facie* case: *Kamin v. M.N.R.*, 93 D.T.C. 62 (T.C.C.); *Goodwin v. M.N.R.*, 82 D.T.C. 1679 (T.R.B.).[4]

Applying the principles established in *Hickman*, the Federal Court of Appeal found that the Tax Court judge had "erred in law in concluding that the Appellant had not met his burden of demolishing the assumptions made by the Minister … that Hunt River had, at the end of 2002, an investment of $305,000 which it transferred to the appellant in 2003." Specifically, the Court found that the trial judge had confused the appellant's initial burden to simply make out a *prima facie* case on the evidence in satisfaction of his onus, with the overall burden to prove that the investment had not been paid to the appellant in 2003. The overall burden need not be addressed if a *prima facie* case is made and the Crown leads no evidence in support of its assumptions.

The Federal Court of Appeal further found that Rossiter, A.C.J. erred in not accepting the oral evidence of the appellant and his witnesses towards satisfaction of his initial onus in demonstrating a *prima facie* case that the $305,000 amount had not been paid to him in 2003. Given that there were no credibility issues noted by the trial judge in his reasons with regard to

3 [1997] 2 S.C.R. 336

4 Ibid. at paragraphs 92 and 93

this testimony, and the Crown led no evidence rebutting it, the Federal Court of Appeal found that there ought not to have been any requirement for corroborating source documents in order to satisfy this initial onus.

The Federal Court of Appeal restated what exactly a taxpayer must do to make out a *prima facie* case in order to demolish the Minister's assumptions. In so doing, the Court, at paragraph 57, cited the following statement from its earlier decision in *Amiante Spec Inc. v. Canada*:[5]

> A *prima facie* case is one supported by evidence which raises such degree of probability in its favour that it must be accepted if believed by the Court unless it is rebutted or the contrary is proved. It may be contrasted with conclusive evidence which excludes the possibility of the truth of any other conclusion than the one established by that evidence.[6]

This explanation is appealing. It justifies the Court's view that the evidence of the appellant and his witnesses should have been accepted by Rossiter, A.C.J. in satisfaction of the appellant's initial burden. As the Court noted, the trial judge did not find any credibility issues with respect to the appellant's or his witnesses' evidence, so it can be reasonably inferred that this evidence was believable; accordingly, it must be accepted towards establishing a *prima facie* case without any need for corroboration that "excludes the possibility of truth of any other conclusion."

The Court went on to explain that the appellant's burden was to demonstrate that the Minister's assumptions were incorrect, not to establish that he had not received $350,000 in 2003. In its assessment of the trial judge's reasons, the Court found that the trial judge erroneously believed that the appellant had to demonstrate on a balance of probabilities that he had not received the $305,000 in 2003, which was too high a burden at that stage of the analysis. In this regard, the Court remarked, at paragraph 62:

> Had the [trial judge] properly understood and applied the correct burden, he would not have been looking for positive evidence establishing that the appellant had not received $305,000 in 2003 but, rather, for evidence establishing that the Minister's assumptions were incorrect … the appellant had offered evidence which, unless disbelieved or rebutted, was capable of establishing a *prima facie* case "demolishing" the Minister's assumptions.

The Court also addressed the trial judge's second error, being his mistaken view that Mr. Cole's testimony, without the support of source documents, could not assist the appellant in satisfying his initial onus. The Court correctly noted that the Income Tax Act[7] did not require the appellant to produce source documents and since no credibility findings had been made against him, his wife or Mr. Cole, source documents were not necessarily required. The Court further stated that

5 2009 FCA 139.
6 2009 FCA 139, at paragraph 23.
7 R.S.C. 1985, c. 1 (5th Supplement), as amended.

a determination of whether corroborating documents were required to establish a point depended on the particular circumstances of the case. In this case, the Court was critical of the trial judge for not assessing the credibility of the witnesses' oral evidence, which would have allowed for an assessment to have been made on the need for corroborating documents.

The Court considered the jurisprudence relied upon by the trial judge in deciding that source documents were necessary, but pointed out that all of them involved the Tax Court having made findings with respect to the quality of the oral evidence, which did not occur in Mr. House's case. The Federal Court of Appeal's decision in *House* states with clarity the proper analysis to be applied with respect to onus in federal tax appeals and provides a practical, commonsense approach to the business of tax litigation. The Court's decision sends a strong message that oral evidence should not be dismissed without careful assessment being made as to the quality of that evidence, which should then be reflected in the trial judge's reasons. Failure of the trial judge to do so could lead to reversal on appeal to relieve the taxpayer from harsh results.