

Docket: 2012-1830(IT)G

BETWEEN:

ANTTI J. KOTILAINEN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on November 28 and 29, 2016, at Toronto, Ontario

Before: The Honourable Justice Robert J. Hogan

Appearances:

For the Appellant: The Appellant himself
Counsel for the Respondent: Tony Cheung

JUDGMENT

The appeal from the reassessments made under the *Income Tax Act* for the 2003 and 2004 taxation years is allowed and the reassessments are vacated in accordance with the attached reasons for judgment. The parties are each to bear their own costs.

Signed at Ottawa, Canada, this 17th day of January 2017.

“Robert J. Hogan”

Hogan J.

Citation: 2017 TCC 7
Date: 20170117
Docket: 2012-1830(IT)G

BETWEEN:

ANTTI J. KOTILAINEN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Hogan J.

I. INTRODUCTION

[1] By concurrent notices of reassessment dated April 12, 2011, the Minister of National Revenue (the “Minister”) increased the income tax liability of Antti J. Kotilainen (the “Appellant”) for his 2003 and 2004 taxation years. The Appellant was assessed with respect to shareholder benefits in the amount of \$96,451 for the 2003 taxation year and \$70,701 for the 2004 taxation year which benefits were traceable to funds withdrawn by the Appellant from 933093 Ontario Ltd. (the “Corporation”). The Appellant was, at all material times, the sole shareholder of the Corporation.

[2] The Minister also imposed gross negligence penalties under subsection 163(2) of the *Income Tax Act* (Canada) (the “Act”). The reassessments were issued beyond the normal three-year limitation period.

[3] The Appellant acknowledges that he received the funds assessed to him as shareholder benefits. He also acknowledges that the Corporation paid \$50,000.00 to his former wife so that he could acquire full title to their principal residence.

[4] The Appellant argues that the Corporation simply repaid part of the shareholder loans owed to him. The Appellant alleges that the Corporation’s motel business was unprofitable throughout the period that the Corporation carried on

that business. He was required to loan funds to the Corporation so that it could continue in business and/or revitalize the property it owned.

[5] I commended the Respondent's counsel for his assistance in ensuring that the Appellant's documentary evidence and his case in general were properly presented to the Court. The Appellant was under the mistaken belief that his documentary evidence would be entered into the Court's record by the Respondent. The Appellant was self-represented and, as is often the case, unfamiliar with how to present his case to the Court.

[6] At trial, after the evidence was closed, the Respondent's counsel conceded that the Appellant had loaned some funds to the Corporation in the 2002 taxation year. This concession was based on documentary evidence submitted by the Appellant and entered into the record by the Respondent. These documents had previously been shown to the Canada Revenue Agency (the "CRA") auditor during the audit of the taxpayer. The CRA auditor assigned to complete the audit of the taxpayer did not accept the Appellant's explanation that the Corporation owed him the money he withdrew, because the loans were not disclosed on the Corporation's balance sheets. He also found unreliable the documentary evidence presented by the Appellant to prove the amount of his shareholder loans.

[7] The Minister now says that the Appellant received shareholder benefits in the amounts of \$50,000 (an amount paid to the Appellant's wife at his direction) and \$44,637 for the 2003 and 2004 taxation years respectively (collectively "the Revised Amounts"). The Respondent also agrees that the Appellant is not liable to gross negligence penalties. The Respondent defended the balance of the assessments.

II. ISSUES TO BE DECIDED

[8] The issues to be decided are:

- (a) Has the Respondent discharged the onus to be met by her in order to reassess the Appellant for the 2003 and 2004 taxation years beyond the normal reassessment period?
- (b) If yes, were the Revised Amounts properly included in the Appellant's income for the taxation years under appeal?

III. BACKGROUND

[9] The Appellant, Antti J. Kotilainen is an architect who operates under the business name Antti Kotilainen Architect.

[10] In the late 1980s the Appellant became a co-investor in a 14-room motel located in Parry Sound, Ontario (the "Property"). At that time, the motel was run-down and unprofitable. However, the Appellant and his co-investors believed that the Property was strategically located as it was in Parry Sound, a deep freshwater port on Georgian Bay, a popular tourist destination forming part of Lake Huron. The co-investors planned to revitalize the motel through capital improvements.

[11] The initial project was unsuccessful. The Appellant arranged to purchase the interests of his co-investors. He established the Corporation for this purpose and became its sole shareholder. The Corporation assumed the existing mortgage on the Property and paid nominal consideration to the co-investors.

[12] The evidence shows that starting around 1991 the Appellant devoted a significant portion of his time to the redevelopment of the Property. As a result, he let his architect's practice wind down. Notwithstanding the Appellant's best efforts, the business remained unprofitable throughout the period from 1991 to 2002. The Corporation declared tax losses amounting to approximately \$425,000 in its tax returns for that period. The Appellant claims that he had to fund these losses to avoid foreclosure on the Property and that he used his personal funds to do so. It appears, from the evidence that the Corporation's large loss carryovers weighed heavily in the Minister's decision not to conduct an audit of the Corporation's activities.

[13] The evidence shows that in 2002 the Appellant refinanced the mortgage on his principal residence located in Toronto. The Appellant received net loan proceeds of approximately \$70,000 which were deposited in his personal account at the Royal Bank of Canada. As alluded to above, the Respondent's counsel conceded that the Appellant had used more than 50% of the loan proceeds to fund the Corporation's operations in 2002. I observe that the Appellant's loan to the Corporation was not recorded as a liability on its balance sheet for the fiscal period ending December 31, 2002.

[14] The facts and circumstances surrounding the audit are noteworthy. The audit began on November 20, 2008 and was terminated on April 12, 2011 when the Minister issued the concurrent notices of reassessment.

[15] Initially, the audit was conducted by Rajini Masilamany. It appears that Ms. Masilamany left government service in the spring of 2009, prior to completing her audit. The Appellant alleges that he interacted with Ms. Masilamany and provided her with the documents in his possession at the time. The normal three-year limitation period expired without a waiver request by the CRA.

[16] The Appellant's testimony suggests that he believed that Ms. Masilamany was satisfied with his responses to her initial audit inquiries. He was surprised to learn in the fall of 2010 that the audit was still ongoing. Mr. Gajewski was assigned to complete the audit commenced by Ms. Masilamany. It appears from the audit record that he began his audit work on October 7, 2010. His audit notes reveal that he was being pressed to complete the audit. He was the sole witness to appear on behalf of the Respondent.

[17] Mr. Gajewski met with the Appellant on November 22, 2010 to explain his audit findings. In summary, he observed that the Corporation had remortgaged the Property on October 28, 2003. It received net loan proceeds of approximately \$235,000. Mr. Gajewski's audit revealed that the Appellant withdrew \$96,451 in 2003 and \$70,701 in 2004 out of these funds.¹

[18] Mr. Gajewski told the Appellant that these amounts would be assessed as shareholder benefits under subsection 15(1) of the Act unless the Appellant could establish that the withdrawn amounts were not taxable. Ultimately, he did not accept the Appellant's explanation that the Corporation was simply repaying loans that were owed to him.

[19] Mr. Gajewski was very responsive to the Court's questions on his audit work. I asked him why he did not use the combined net worth method to determine whether the Appellant had undeclared income under subsection 15(1). He indicated that he was fairly confident that the Corporation did not have undeclared income. I surmise that the Corporation's long history of reporting annual losses provided the CRA with the necessary comfort in this regard.

[20] I questioned Mr. Gajewski on why he did not accept the Appellant's explanation that he had loaned money to the Corporation to fund its accumulated operating losses. There is no evidence in the record to suggest that prior to 2003 the Corporation had access to additional third party loans or to capital injections to fund its losses. This suggests to me that the Appellant's explanation is true.

¹ This amount includes the amount paid to the Appellant's wife at his direction.

[21] I noted other deficiencies when reviewing the Corporation's balance sheets. Operating losses were not reflected on those balance sheets. I surmise that the Appellant's shareholder loans could not be properly accounted for on the Corporation's balance sheets without taking into account the impact of the operating losses on the corporation's shareholder equity account.

[22] On this point, the Appellant explained that his stepson prepared the Corporation's financial statements and tax returns. The Corporation had limited resources to pay for professionally prepared financial statements. The Appellant's stepson did the best he could in the circumstances. I accept this explanation.

IV. ANALYSIS

[23] It is important to recall that the onus lies with the Respondent to show that the Appellant misrepresented his income by failing, in circumstances amounting to neglect, carelessness or wilful default, to properly account for shareholder benefits in the Revised Amounts for each of the 2003 and 2004 taxation years.

[24] The fact that the Minister relied on the deposit method to reassess the Appellant has a direct bearing on the Court's determination as to whether or not the Respondent has discharged her burden under subparagraph 152(4)(a)(i) of the Act. This method was chosen over the more accurate combined net worth method typically used by the CRA to assess undeclared income.

[25] The outcome of this matter may well have been different had the combined net worth method been used to determine whether the Appellant failed to report income in 2003 and 2004 and had the analysis covered a period longer than just two years. That net worth method accounts for variations in net assets that are not traceable to non-taxable sources. The deposit method does not. Moreover, the taxpayer's combined family income and expenditures are accounted for under the former method and not the latter.

[26] In the instant case, the Respondent alleged facts that she was unable to prove. For example, in paragraph 11 of the Reply, the Respondent alleged that the Appellant had high expenditures. No evidence was led on this point because the deposit method does not take into account a taxpayer's lifestyle. The Respondent also alleged that the Appellant failed to account for personal income other than the

shareholder benefits for which he was assessed.² No evidence was presented by the Respondent to prove this allegation.

[27] As noted earlier, the Corporation reported significant tax losses. From the evidence, I conclude that the Corporation's expenses significantly exceeded its revenue. This buttresses the Appellant's claim that he loaned funds to the Corporation to cover the Corporation's cash shortfalls and to avoid foreclosure on the Property.

[28] I would have liked to have seen documentary evidence that would have fully corroborated the Appellant's testimony on this point. However, I take comfort from the fact that the Appellant presented documentary evidence that confirmed that he did loan funds to the Corporation in 2002. As noted above, this loan was not recorded on the Corporation's balance sheets, which was consistent with the Appellant's testimony regarding the Corporation's past accounting practices. The Appellant's evidence was nonetheless accepted as reliable by the Respondent at the termination of the hearing. It had previously been determined to be unreliable by the auditor.

[29] The Appellant presented an additional document that buttresses his claim. Exhibit A-16 appears to be a copy of the Corporation's ledger summary showing shareholder loans for the period from 1991 to 1995. The Corporation is shown as owing its shareholder \$122,000 at the end of 1995.

[30] The Appellant produced a second document³ to illustrate that the Corporation's operations produced negative cash flow. That document tabulates the operating losses incurred and capital improvements made by the Corporation throughout the relevant period. It appears to have been prepared by the Appellant's stepson to substantiate the Appellant's claim that he loaned significant funds to the Corporation. At the end of 1995, negative cash flow from operating losses and capital improvements alone is shown to be \$98,613. This is not that far off the amount shown in the shareholder loan account ledger as the shareholder loan amount at the end of 1995.⁴ The Corporation's cumulative negative cash flow,

² The Appellant's failure to report personal income is alleged in paragraph 11(k) of the Reply. The Appellant's failure to report shareholder benefits is specifically dealt with in paragraph 11(l).

³ Exhibit A-9.

⁴ Exhibit A-9 fails to account for a number of items that affect cash flow, such as principal repayments on debt owed. For this reason, I place very little weight on this document because it does not accurately measure changes in cash flow.

consisting solely of operating losses and capital improvements, is shown to be at least \$25,805.80 at the end of 2002.

[31] When a business fails or its owner faces insolvency or bankruptcy it is not uncommon to find that bookkeeping has suffered. In such cases, the Court can rely on testimonial evidence that it finds credible and coherent to fill in the gaps. The events that are relevant to the reassessments herein occurred a long time ago. I am not surprised that the Appellant did not keep copies of his personal bank records dating back to 1991. Those years were long statute-barred.

[32] Finally I take comfort from the fact that the Appellant's evidence is consistent with his subsequent actions. The Appellant remortgaged his personal residence in 2009, using the remaining equity in that property to fund, *inter alia*, the Corporation's mortgage arrears and back taxes.⁵ He had little choice but to do so because he had guaranteed the Corporation's mortgage borrowing in 2003. Thereafter, the Corporation continued to lose money. Unfortunately, the Appellant exhausted all of his personal wealth on the venture and was unable to provide further assistance to the Corporation. His home was foreclosed in 2012. He now lives temporarily in a seniors' home. The Corporation's lenders also foreclosed on the Property in 2012.

[33] The explanations offered by the Appellant justifying tax-free withdrawals from the Corporation distinguish this case from *Lacroix*, a case in which the taxpayer was found to have made a misrepresentation of facts.⁶ There, the Appellant was not able to provide a credible explanation for the discrepancy that the CRA auditor found in carrying out a net worth assessment, and so the Minister was found to have discharged the burden of proof placed upon him by subparagraph 152(4)(a)(i) of the Act. In the case at bar, there is a credible explanation as to why the funds withdrawn from the Corporation are not taxable in the Appellant's hands.

[34] Considering all of the above, I conclude that the Respondent failed to establish that the Appellant understated his income for 2003 and 2004 in

⁵ The Appellant added a second mortgage on his principal residence in the amount of \$100,000.00. The mortgage loan was provided by the same lenders as the Corporation's. The net loan proceeds after expenses were \$93,226. The mortgage lenders applied \$53,274 of the net proceeds to payment of the arrears owed by the Corporation to the lenders and to payment of back taxes. An amount of \$11,356 was applied to pay the arrears owed by the Appellant on the first mortgage on his principal residence and \$14,299 was used to pay the back taxes on that residence. Interest was also prepaid on the Corporation's mortgage loan and the Appellant's second mortgage. The Appellant received only \$3,482 directly from this new borrowing.

⁶ *Lacroix v The Queen*, 2008 FCA 241, 2009 DTC 5029 at para. 30.

circumstances amounting to neglect, carelessness or wilful default. Accordingly, the 2003 and 2004 taxation years remain statute-barred. For these reasons, the appeals are allowed and the assessments are vacated.

[35] While costs normally follow the cause, I find that the Appellant greatly benefited from the assistance provided to him by the Respondent in presenting his case. This allowed the Court to have a clearer record on which to base its judgment. In these circumstances, it is fair that each party bear its own costs.

Signed at Ottawa, Canada, this 17th day of January 2017.

“Robert J. Hogan”

Hogan J.

CITATION: 2017 TCC 7

COURT FILE NO.: 2012-1830(IT)G

STYLE OF CAUSE: ANTTI J. KOTILAINEN v. HER
MAJESTY THE QUEEN

PLACE OF HEARING: Toronto, Ontario

DATE OF HEARING: November 28 and 29, 2016

REASONS FOR JUDGMENT BY: The Honourable Justice Robert J. Hogan

DATE OF JUDGMENT: January 17, 2017

APPEARANCES:

For the Appellant: The Appellant himself
Counsel for the Respondent: Tony Cheung

COUNSEL OF RECORD:

For the Appellant:

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