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NET WORTH OR ARBITRARY ASSESSMENTS - PART II

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on net worth assessments under the Income Tax Act (Canada) and the possible challenges to such assessments. Alpert Law Firm is experienced in providing legal services to its clients relating to challenges to net worth or arbitrary assessments.

A. ADDITIONAL DEFENCES TO NET WORTH ASSESSMENTS

In addition to the defences set out in "Net Worth or Arbitrary Assessments- Part I", there are various other defences that a taxpayer can employ to successfully challenge all or a portion of the net worth assessment.

(i) DAMAGES RECEIVED BY TAXPAYER ON ACCOUNT OF PERSONAL INJURY

A net worth assessment can also be challenged on the grounds that an increase in net worth is attributed to receipt of damages on account of a personal injury settlement, which are non-taxable. If a taxpayer can show that an increase in the taxpayer's income is attributed to receipt of such damages, then the Minister's assessment will be reduced accordingly.

1. *Bigayan v. The Queen,* 2000 DTC 1619

In this case, in which the facts were previously set out in "Net Worth or Arbitrary Assessments-Part I", the taxpayer appealed the Minister's net worth assessment on the basis that it incorrectly included settlement funds obtained by the taxpayer as a result of a personal injury claim.

The taxpayer also claimed that the Minister's assessment should be reduced to take into account these settlement funds he received. The taxpayer presented documentary evidence that he received such funds and the Court reduced the appellant's net worth assessment to account for this non-taxable gain.

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(ii) MONEY NOT BELONGING TO THE TAXPAYER

A net worth assessment can also be successfully challenged on the grounds that an increase in net worth is attributed to money not belonging to the taxpayer. Case law has indicated that if the taxpayer can establish that the Minister's assessment erroneously included money the taxpayer held in trust for someone else or money simply not belonging to the taxpayer, the assessment will be reduced accordingly.

1. *Lee v. M.N.R., 53 DTC 331*

In this influential Tax Appeal Board case, the taxpayer was arbitrarily assessed for three consecutive years. The Minister calculated an increase in net worth for these years. The taxpayer appealed the Minister's assessment on the grounds that it erroneously included monies and securities that the taxpayer held in trust for various other people in accordance with the traditional Chinese practice of holding valuables for others for safekeeping.

The taxpayer gave testimony that he held in trust monies, amounting to $10,000, and securities, amounting to $3,000. The taxpayer also claimed that he had opened various bank accounts in which the trust monies had been deposited.

Various friends and relatives of the taxpayer gave verbal testimony that they had each given the taxpayer, in trust, monies and/or securities during the three year taxation period. In addition, a special representative of the Bank of Montreal testified that it is a very common practice among the Chinese community to leave cash, securities, jewellery, and so on in trust with certain friends in whom they have confidence.

The Court gave considerable weight to the testimony of the taxpayer and the corroborating witnesses. As such, the Court found that the Minister's net worth Assessment should be reduced to take into account the capital assets the taxpayer held in trust for other people.

2. *No. 356 v. M.N.R., 56 DTC 460*

In this Tax Appeal Board case, the taxpayer, a scrap dealer by trade, was assessed for a three year tax period. The Minister calculated an increase in the net worth for these years. The taxpayer challenged the Minister's assessment for one of these years, on the grounds that the assessment included money that did not belong to the taxpayer. Specifically, the taxpayer claimed that the assessment included $10,000 that belonged to his wife.

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In the absence of documentary evidence, the taxpayer testified that for several years his wife had been saving sums of money that the taxpayer had given her from time to time. Her money was kept in the cedar chest at home which had accumulated to approximately $10,000 by the taxation year in question. He claimed that during the taxation year the couple decided to buy a house, and it was at this time that the taxpayer's wife deposited the $10,000 in the taxpayer's bank account for the purpose of purchasing the house.

The taxpayer's testimony was corroborated by his wife. The taxpayer's wife stated that she saved her money in this way so that she would be able to surprise her husband when it came time to buy a house.

The Court gave considerable weight to the testimony of the taxpayer and his wife, deeming them to be very reliable. Accordingly, the Court found that although the $10,000 was deposited into the taxpayer's account, it was actually his wife's savings, and as such should not be included in the Minister's net worth assessment as the taxpayer's income.

3. *Werry v. The Queen*, 74 DTC 6214

In this Federal Court case, the taxpayer appealed net worth assessments covering a six year period during which the taxpayer failed to file income tax returns. The taxpayer challenged the Minister's assessment for these years on the ground that the assessments included money that did not belong to him. Specifically, the taxpayer claimed that the assessment erroneously included a mortgage receivable that was in fact owned by his wife.

The taxpayer's claim was substantiated by the fact that the mortgage was assigned by the taxpayer to his wife before the taxation years in question. The Court found that the deed of assignment of mortgage was genuine and was registered as a public document in the Registry Office. Therefore, the Federal Court held the mortgage receivable should not be included in the Minister's net worth assessment.

4. *McLeod v. Canada*, 2013 DTC 1219

In this Tax Court of Canada case, the taxpayer appealed the Minister’s use of the net worth method on the grounds that it did not take into account loans given to the taxpayer and an adjustment made to the taxpayer’s shareholder loan account.

The taxpayer owned a Mongolian food restaurant "Mongos" in Kelowna. In 2006 he was audited with respect to 2003 and 2004. The auditor found a considerable discrepancy between the restaurant's bank deposits and the reported sales, and thereby determined that the restaurant's account books were unreliable. Based on this finding, the auditor proceeded to conduct a net worth assessment, pursuant to which he (i) found substantial unreported income of $83,089 in 2003 and $164,749 in 2004; and (ii) imposed penalities.

The Court explained that the outcome of the case depended on whether the taxpayer's claim that he had received loans for $155,000 and $30,000 was credible. As the taxpayer's evidence was minimal and in some instances suspect, the Court held that only a portion of the loans should be considered in a recalculation of the unreported income. In addition, given that the amount of the unreported income was substantial, the Court upheld the penalties.

(iii) TAXPAYER'S NET WORTH AT THE BEGINNING OF THE TAXATION PERIOD

As the Minister's net worth assessment involves a comparison of the taxpayer's net worth at the beginning of the taxation period with the taxpayer's net worth at the end of the taxation period, the Minister's net worth assessment can be successfully challenged and reduced on the grounds that the taxpayer's net worth at the beginning of the taxation period was actually higher than the figure indicated by the Minister.

There are several ways the taxpayer can challenge the opening balance. One method is to challenge the figure on the grounds that the taxpayer had loans owing to him at the beginning of the taxation period. Another common method is to prove that the taxpayer had a large amount of cash on hand or had significant bank or term deposits at the beginning of the net worth period that the Minister did not take into account.

(iv) LOANS OWED TO THE TAXPAYER AT THE BEGINNING OF THE TAXATION PERIOD

Case law has indicated that if a taxpayer has loans or debts owing to him at the beginning of the taxation period then such assets should be included in the Minister's determination of the net worth figure for the beginning of the taxation period. This inclusion would in effect reduce the taxpayer's net worth assessment for the period in question (i.e. the period for which the Minister is performing a net worth assessment to ascertain the taxpayer's income).

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In the absence of documentation that proves that the taxpayer has loans owning to him, the Courts may give considerable weight to the testimony of the taxpayer and other witnesses who have personal knowledge of the taxpayer's loans, such as individuals indebted to the taxpayer.

1. *Tremblay v. M.N.R.*, 54 DTC 132

In this influential Tax Appeal Board case, the taxpayer failed to file his tax returns for five consecutive years, 1942-1946. The Minister performed a net worth assessment in order to ascertain the taxpayer's income for these years. The Minister determined that the taxpayer's net worth at the beginning of this five year taxation period was $4,500 and that the taxpayer's net worth at the end of this five year period was approximately $46,500. The Minister then added $11,500 for the taxpayer's personal and living expenses during the five years. Consequently, the Minister determined that the taxpayer's income for the five year taxation period, in which the taxpayer failed to file his tax returns, was approximately $53,500.

The taxpayer challenged the Minister's assessment on the basis that his net worth at the beginning of this five year period was actually substantially higher than the amount determined by the Minister and as such the net worth assessment for the five-year period should be reduced. More specifically, the taxpayer claimed that the Minister had failed to take into account various debts owed to him at the beginning of the five-year taxation period.

The taxpayer was an expert gambler who had won many thousands of dollars. His luck was well known in the gaming community. The taxpayer was employed in a large gaming house. As a result of this position, the taxpayer posted a $10,000 personal bond, prior to the commencement of five year taxation period, with his own funds to prove his good faith as he was in charge of cash. In addition to the bond, the taxpayer testified that by beginning of the taxation period several regular customers owed him money that amounted to $8,500.

Several witnesses, including the gaming house owner and those customers indebted to the taxpayer testified that the taxpayer did indeed have such debts owed to him at the beginning of the five year taxation period. The Board found these witnesses credible, and found that taxpayer's net worth at beginning of the taxation period should be increased from $4,500 to $23,000 to reflect these loans. As such, on account of the taxpayer's increased beginning net worth, his income for the following five years, as determined by the Minister's net worth assessment, was reduced accordingly from

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$53,500 to $34,500. Thus, the Board held that if it can be determined that the taxpayer had loans owed to him at the beginning of the taxation period, which the Minister's net worth assessment did not take into account, the assessment should be reduced accordingly.

(v) CASH ON HAND AT THE BEGINNING OF THE TAXATION PERIOD

Another way in which a taxpayer can challenge the Minister's opening balance is through establishing that the taxpayer had a large amount of cash on hand or bank or term deposits at the beginning of the taxation period that the Minister did not take into account.

Case law has indicated that taxpayers can show that they had significant cash on hand at the beginning of the taxation period in various ways such as: (i) evidencing that they were the recipients of capital assets which were transferred into Canada from foreign jurisdictions; or (ii) by proving that such savings existed.

Note, the burden is on the taxpayer to present adequate evidence of cash on hand. If the taxpayer fails to discharge this burden, then the Minister's opening balance will not be amended and the net worth assessment will stand.

1. ***Rawsthorne v. M.N.R.*, 81 DTC 116**

In this Tax Appeal Board case, the taxpayer was assessed for a tax year shortly after he immigrated to Canada from England. The Minister's net worth assessment added an amount of $9,000 to the income reported by the taxpayer for the year in question.

The taxpayer appealed the Minister's assessment on the basis that the opening balance did not take into account the $33,000 of cash he had on hand at the beginning of the taxation period. The taxpayer claimed that he had such cash on hand as he brought it into Canada when he immigrated before the taxation period.

In the absence of documentation, the taxpayer gave verbal testimony that he brought two separate sums of money ($16,000 and $17,000) into Canada, which he later deposited into a Canadian bank. Two of the taxpayer's friends, who housed the taxpayer for three weeks after his arrival, also offered their testimony to support the taxpayer's assertion that he brought $33,000 into Canada.

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However, the Court did not find the testimony of the taxpayer and the two witnesses credible, as they gave evidence which directly contrasted each other on important points such as date, time, and place. Furthermore, the Court found that there was no clear evidence that anyone actually counted the money in an organized manner so as to determine the amount that was actually brought into Canada. Thus, in the absence of documentary evidence and credible witnesses the Court found that the Minister's net worth assessment should stand.

While the Court decided against the taxpayer, this case indicates that if a taxpayer can provide sufficient evidence that he had considerable cash on hand as a result of receipt of foreign monies, the Court may reduce the Minister's net worth assessment.

2. *Nesrallah v. The Queen*, 85 DTC 5585

In this Federal Court case, the taxpayer was assessed for three taxation years in which he filed tax returns that were deemed inaccurate by the Minister. The taxpayer appealed the Minister's assessment on the basis that the opening balance did not take into account the $25,000 in savings he had on hand at the beginning of the taxation period.

In the absence of documentation, the taxpayer gave verbal testimony that he had lived very frugally during the years prior to the taxation period and had managed to save a considerable sum of money. The taxpayer claimed that at the beginning of the taxation period this money was kept at home and not in a bank because of his religious conviction that charging interest is unethical. However, as a result of the taxpayer's growing concern over theft, the taxpayer began depositing his money on a gradual basis into a bank account during the course of the taxation period. The taxpayer claimed that he deposited the monies gradually in order to avoid embarrassment as the bank tellers tended to count his deposits five or six times since the bills were very old and in small denominations.

The taxpayer's wife also gave verbal testimony to this effect. However, the Court did not find her testimony particularly reliable as she had never actually counted the money and did not know exactly where the money was kept in her house.

A teller at the taxpayer's bank also provided verbal testimony. The teller testified that the taxpayer made frequent deposits of money during the years in question. The teller claimed that she distinctly remembered such deposits as the money was

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extremely old and so musty smelling that the tellers had to wash their hands after each transaction with the taxpayer.

While, the Court found the testimony of the taxpayer and his wife unreliable in many respects, including that the taxpayer gave conflicting evidence about the amount of money he kept, the Court found the bank teller extremely credible. In weighing the evidence, the Court found that although there were no records of the cash on hand prior to the tax period, the testimonial evidence of the gradual deposits established that the Minister's opening balance should be increased to include the $25,000 of cash the taxpayer had on hand at the beginning of the tax period.

3. *Houle v. The Queen,* 2008 DTC 3764

The taxpayer appealed the Minister's net worth assessment, claiming that the assessment did not take into account certain amounts of cash that he withdrew from his safety deposit box. The taxpayer told the Minister that he accessed his safety deposit box on two particular days. He produced bank slips showing that he made several cash deposits into the bank accounts of his businesses on the same date that he accessed the safety deposit box. The Minister agreed to subtract the amounts deposited on the same day.

The Tax Court held that other cash deposits made by the taxpayer within one to two business days of accessing the safety deposit box should also be subtracted from the net worth totals: the short period between the time that the safety deposit box was accessed and the time that the cash was deposited into the bank accounts did not make it implausible that the cash may have come from the safety deposit box.

However, the Tax Court refused to allow the taxpayer to subtract any amounts for which deposit slips could not be obtained showing that cash deposits had been made. The Tax Court also held that the penalties were properly imposed since the taxpayer deliberately failed to keep adequate books of account so that the tax authorities would be confused and repeatedly failed to report all his income.

4. *Hedzic v Canada* 2013 DTC 1242

In this Tax Court of Canada case, the taxpayers (“Mr. Hedzic” and “Mrs. Hedzic”) appealed the Minister’s (i) addition of $15,790 and $25,651 of undeclared income, and (ii) imposition of penalities. During an audit, the Canada Revenue Agency determined that the taxpayer’s reported income was low, and proceeded to use the net worth assessment method to determine the taxpayer’s tax liability.

The taxpayers, who were married, came to Canada from Bosnia. Initially, Mr. Hedzic worked on a berry farm and as a delivery person at a pizzeria. Subsequently he bought a share in a restaurant, a grocery store, and together with Mrs. Hedzic opened a pizzeria. Mr Hedzic claimed that at the beginning of the assessment period he and his wife had $76,305.97 cash on hand, and that he kept the money in a safety deposit box because he did not trust banks. He claimed that this money came from the sales of the restaurant share and the grocery store.

The Court largely upheld the reassessment. The Court found that the records from the bank showed that the amounts from the sale of the restaurant share and grocery store were deposited in the taxpayer's bank accounts and then used to pay bills. In addition, the bank statements indicated that the records of entries and exits for the safety deposit box did not correspond to the days when Mr. Hedzic withdrew money from his account. This led to the conclusion that, contrary to the taxpayer's testimony, money from the sale of the restaurant share and the grocery store was not being transferred from the bank account to the safety deposit box. With regard to the issue of cash on hand at the beginning of the taxation period, the Court accepted that the taxpayers had $10,000 in their safety deposit box at the beginning of the taxation period. However, due to inconsistencies in Mr. Hedzic's testimony the Court rejected the claim that there had been $76,305.97 of cash on hand.

(vi) ASSUMPTIONS BY THE MINISTER THAT ARE FAVOURABLE TO THE TAXPAYER

If Reply to a Notice of Appeal made by the Minister initially makes an assumption which is favourable to the taxpayer, then the Minister has the burden of establishing that this assumption is wrong.

1. *Seto et al. v. The Queen*, 2007 DTC 1647

The taxpayer and his wife worked long hours in a restaurant for 364 days of the year. The taxpayer's parents resided in the same household with the taxpayer, his wife, and their children; they shopped for groceries and clothing, looked after the taxpayer's children and contributed all of their combined incomes to the family unit. The taxpayer's parents had also provided the down payment for the house in which they all resided and eventually helped to pay off the mortgage.

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The Minister's Reply to the Notice of Appeal contained several relevant assumptions of fact upon which the Minister relied in reassessing the taxpayer's tax liability. These assumptions related specifically to the importance of the role of the taxpayer's parents in calculating the net worth assessment. In reassessing the taxpayer, the Minister made assumptions that the taxpayer, his spouse and parents should be considered as part of a family unit, because their financial affairs were intertwined.

The audit calculation of personal expenditures contemplated the expenses of the taxpayers' parents as well as those of the taxpayer and his wife. However, the audit calculation failed to include the parents' income in computing the total family income.

The Tax Court held that after initially making an assumption which was favourable to the taxpayer, the Minister had the burden of establishing that the assumption was wrong. Since the Minister failed to discharge this burden, the parents' income had to be accounted for in computing the total family income.

B. ASSESSMENT OF A CORPORATION

Since it is not possible to determine the net worth of a corporation, the Minister may make a net worth assessment of the corporation's shareholder in order to determine the corporation's unreported or underreported income.

1. *Poopathie Company Ltd. v. The Queen*, 2006 DTC 2935

The taxpayer corporation was operated by its sole shareholder and his wife. In reassessing the taxpayer corporation, the Minister used a net worth assessment of the shareholder to determine underreported corporate income. The increase in the shareholder's net worth was added to the income reported on the corporate tax return.

The Tax Court agreed with the Minister's approach of using a net worth assessment of the shareholder, because it is not possible to determine a net worth of the corporation. Since the corporation's taxation year commenced on March 1, the Minister determined the shareholder's increase in net worth for the calendar years and then pro-rated the results to determine a net worth for periods coinciding with the corporation's taxation year. The Tax Court stated that it would have been more appropriate for the Minister to instead compute the shareholder's net worth for 12 month periods commencing March 1. However, because the taxpayer did not establish that his income was overstated as a result, this calculation was accepted.

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In the corporate return, the taxpayer claimed CCA for a vehicle owned by the shareholder. Although the registration was in the name of the shareholder, the financing documents were in the name of the corporation and the sale agreement was in the joint names of the corporation and the shareholder. The Tax Court held that this was indicative of the intention of the parties; thus the corporation was the beneficial owner of the vehicle. The payments for the vehicle by the shareholder were not determinative because he often used his personal bank account for business matters. Thus, the corporation was allowed to deduct CCA for the vehicle, and the amounts related to the vehicle's financing were removed from the shareholder's net worth assessment.

C. ASSESSMENT OF PENALTIES

In addition, due to the nature of the allegations, penalties are often assessed against the taxpayer if the taxpayer knowingly, or in circumstances amounting to gross negligence makes a false statement or omission in a tax return, pursuant to subsection 163(2) of the Act.

Where penalties are sought, the burden of proof is on the Minister. The Minister must establish, on a balance of probabilities, that the omission or false statement was made knowingly or as a result of gross negligence, or at the very least to the Court's satisfaction that simple neglect does not fit the facts. Case law has also indicated that penalties can only be imposed against taxpayers who possess the requisite mental capacity, of being capable of actually understanding his actions.

If the Minister fails to establish that the facts of the case justify the assessment of the penalty, then the penalty cannot be imposed.

Note that while the Minister has the burden of justifying the imposition of the penalty, the taxpayer still has the usual burden of challenging the Minister’s net worth assessment, given that the penalty will not be imposed if the taxpayer can prove that no omissions or false statements were actually made.

The penalties imposed under subsection 163(2) can be substantial. The taxpayer will be liable for a penalty of the greater of $100 and 50% of the tax payable on the taxpayer’s understatement of income (i.e. 50% of the amount by which the tax, which would have been payable by the taxpayer if the false statement had not been made in the taxation year, exceeds the amount of tax which would have been payable if the return was accepted as filed).

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1. *Bigayan v. The Queen,* 2000 DTC 1619

In this case, in which the facts were previously set out in "Net Worth or Arbitrary Assessments-Part I", the Court reinforced that the onus is on the Minister to justify the imposition of penalties by proving the taxpayer was grossly negligent. In weighing the evidence, the Court found that the Minister failed to establish gross negligence on the part of the taxpayer and thus imposed no penalties.

2. *Cox v. The Queen,* 2002 DTC 1515

The Court in this case, in which the facts were previously set out in "Net Worth or Arbitrary Assessments-Part I", stated that in order for a penalty to be imposed under subsection 163(2) of the Act, two elements must be present: (i) a misstatement or omission in a tax return; and (ii) the requisite mental state.

The Court found that the first element was evident as the taxpayer, who was represented by Alpert Law Firm, clearly omitted to file his tax returns for three consecutive years. However, the second element was not present, as the taxpayer lacked the requisite mental state to be penalized as a result of his psychological illness, paranoid schizophrenia, which divorced him from reality. Consequently, the Court disallowed the imposition of penalties on the taxpayer.

3. *Seto et al. v. The Queen,* 2007 DTC 1647

In this Tax Court of Canada case, the Court held that the Minister properly assessed the taxpayer beyond the normal reassessment period. The taxpayer's lack of record keeping, as required under the Act, indicated that he and his company acted with neglect or carelessness which resulted in income not being reported. Although there were no intentional actions taken to mislead or to portray a picture different from what existed, the taxpayer did not exercise reasonable care in the completion of his returns, pursuant to the provisions in paragraph 152(4)(a) of the Act.

The Tax Court disallowed the imposition of penalties pursuant to subsection 163(2) of the Act, even though the net worth assessment showed that the taxpayer underreported his income. The Court held that in addition to the difference resulting from the net worth assessment, the Minister must show that the penalties are justified by pointing to specific evidence or circumstances that amounted to gross negligence. While the negligence sufficient to trigger paragraph 152(4)(a) of the Act is a failure to use reasonable care, subsection 163(2) of the Act requires more: it requires gross

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negligence. In addition, the Court held that the difference between the net worth assessment and the net amount actually reported on the returns was not substantial.

4. *Wasserman v. The Queen*, 2010 DTC 1246

In this Tax Court of Canada case, the taxpayer inherited from his parents a pet shop, which he had successfully operated for over 20 years. Despite the fact that the taxpayer had taken a bookkeeping course, his business records were seriously inadequate as he did not retain cash register receipts or any other records of transactions, and also failed to keep his personal bank account separate from that of his business. The Canada Revenue Agency noticed that bank deposits were being made by the taxpayer on a regular basis and consisted of cash deposits of a large number of 20, 50 and 100 dollar bills. Consequently, the Minister assessed the taxpayer's unreported income as approximately $74,000 in 2003 and $47,000 in 2004. Penalties for gross negligence were also imposed under subsection 163(2) of the Act.

The taxpayer appealed to the Tax Court of Canada and contested the amounts of unreported income that the Minister had assessed for the 2003 and 2004 taxation years. He argued that the amounts were not unreported income but, rather, reported income from previous years which he had held onto as cash. He agreed that he should have kept better records, but explained that, since he was a sole proprietor, he did not think that he would have to account for his sales to anyone else. Furthermore, the Minister conceded that the taxpayer did not act deceitfully, but had merely adopted a system from his parents that did not conform to the Income Tax Act.

The Tax Court of Canada held that all of the penalties for gross negligence were unjustified, and had to be vacated. The Court found that the Minister had not met the burden of proof in establishing gross negligence, as the taxpayer was credible and did not intentionally fail to maintain records in an effort to avoid paying taxes. The taxpayer's failure to maintain adequate records was careless and negligent, but it did not rise to the level of "gross negligence" that would be required to attract penalties pursuant to subsection 163(2) of the Act.

5. *Omer O/A Kabul Auto Sell v. The Queen*, 2009 DTC 1118

In this Tax Court of Canada case, the taxpayer operated a used car dealership and was reassessed on a net worth basis by the Minister for unreported income of around $20,000 and $15,700 in the 2004 and 2005 taxation years respectively. Penalties for gross negligence were also imposed under subsection 163(2) of the Act. The taxpayer appealed to the Tax Court of Canada, contending that certain adjustments

should be made to the amount of unreported business income alleged by the Minister. The Court took into account adjustments agreed upon by both parties, and made further adjustments to the taxpayer's unreported income to more accurately reflect the taxpayer's actual personal expenditure amounts. Due to the adjustments, the Court arrived at a revised unreported business income of approximately $8,700 and $6,700 for the 2004 and 2005 taxation years respectively.

The Court held that the gross penalties should be vacated as the Minister had not met the burden of proving that the taxpayer knowingly, or under circumstances amounting to gross negligence, made false statements when filing his returns. Gross negligence involves a greater level of neglect than a simple failure to use reasonable care. It involves a high degree of negligence tantamount to an intentional act or indifference as to whether or not the law was complied with. Although the taxpayer's receipts and records were disorganized and incomplete, the failure to maintain proper records was insufficient to justify the imposition of penalties. The Minister was also unable to point to specific evidence that amounted to gross negligence on the part of the taxpayer other than the discrepancy between the net worth assessment and the amount reported on the taxpayer's returns. Furthermore, the revised amount of unreported business income was no longer a substantial amount relative to the taxpayer's gross income. The unreported amount was only 14% of the revised gross income in 2004, and a mere 4% in 2005.

D. INCOME TAX EVASION

Where a taxpayer has been charged with income tax evasion, a net worth assessment may be used as a basis for obtaining a conviction of the taxpayer. Even if the Minister cannot prove the exact amount of tax owing based upon a net worth assessment, a taxpayer may still be found guilty of tax evasion if it can be proved beyond a reasonable doubt that the taxpayer wilfully evaded or attempted to evade compliance with the Act or payment of taxes imposed by the Act.

1. *R. v. Hunter*, [2008] O.J. No. 467

The taxpayer was charged pursuant to subsection 239(1) of the Act for tax evasion and making false or deceptive statements on his income tax returns in 1996 and 1997. The taxpayer was involved in high volume stock trading. On his income tax returns, the taxpayer declared "nil" income for the years in question but had spent hundreds of thousands of dollars. The Minister produced a net worth assessment to determine the tax owing as the taxpayer had not kept the necessary records.

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The Ontario Superior Court of Justice acquitted the taxpayer on both charges. The Court held that the evidence in this case indicated beyond a reasonable doubt that the taxpayer was guilty of both tax evasion and making false or deceptive statements on his income tax returns. However, the opening net worth statement could not be established with reasonable certainty. As a result, the estimated increase in net worth by the Minister was not reliable. The taxpayer was acquitted on the basis that it was not possible to determine the amount of tax owing.

The Ontario Court of Appeal overturned the acquittal and convicted the taxpayer. The Court stated that while the burden of proof remained on the Crown, the taxpayer was required to keep proper books and records. The Crown tendered evidence that the taxpayer had a certain amount of assets as of a particular date and had increased his net worth as a result of taxable income that had not been disclosed. The taxpayer offered no evidence by way of explanation. Since the opening net worth statement of his assets and the value of the shares he owned at the time were peculiarly within the knowledge of the taxpayer, the Court held that the Crown was not required to negate every possibility respecting the amounts put forward.

2. *R v Zuk* 2012 ONSC 2235

In this Ontario Superior Court of Justice case, the taxpayer appealed convictions for tax evasion and for failures to file tax returns. The taxpayer was a business man, involved in various commercial endeavours, including stock promotion. In his dealings, the taxpayer failed to pay taxes related to dealings with a company purchased by the taxpayer, which was then sold to another corporation in consideration for which the taxpayer received shares in the purchaser.

At trial, the Crown attempted to prove that the taxpayer was guilty of tax evasion by using the direct method and the net worth assessment method. The trial judge found that the direct method suceeded in determining liability but that the net worth method did not. The taxpayer appealed arguing that the trial finding demonstrated an internal inconsistency in the Crown’s argument.

On appeal, the Court held that both the direct method and the net worth method of determining taxable income were legitimate, and that the trial judge’s dissatisfaction with the net worth method did not discount the applicability of the direct method. The appeal was dismissed.

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E. FORFEITED ASSETS

1. *Chronis v. The Queen*, 2010 DTC 1188

Following a conviction for engaging in an illegal Satellite Piracy Business, where most of the taxpayer's business assets were seized and destroyed by the RCMP, the taxpayer was reassessed on a net worth method for unreported income of approximately $46,000, $114,300 and $12,000 for the 2001, 2002 and 2003 taxation years respectively. The taxpayer appealed to the Tax Court of Canada, arguing that the cost of the forfeited assets from his business should be deducted when calculating his net worth.

The Tax Court of Canada allowed the appeal and held that expenses incurred in order to generate business income, even if the business is illegal in nature, are deductible. Since most of the forfeited assets were not returned to the taxpayer, and the assets were not seized as a result of the imposition of a penalty or fine pursuant to subsection 67.6 of the Act, the taxpayer is entitled to deduct the cost of these assets from his net worth. The taxpayer should be also be entitled to a terminal loss with respect to the capital cost of any depreciable assets that were destroyed or forfeited where there are no depreciable assets remaining in the class. As such, the taxpayer's unreported income should be reduced to reflect these changes accordingly.

2. *Chow v. The Queen*, 2011 DTC 1196

In 2006, the taxpayer pleaded guilty to drug trafficking and for being in possession of proceeds from criminal activities. Following a police seizure of $106,000 in cash from the taxpayer's possessions, and under a direction from the Minister, the taxpayer had his accountant prepare net worth statements for 2001 to 2004. These statements were signed and acknowledged by the taxpayer, but was later claimed to contain errors. Based on the net worth statements prepared by the taxpayer's accountant, the Minister reassessed the taxpayer for unreported income of around $22,000, $23,000, $55,200 and $31,400 for the 2001, 2002, 2003 and 2004 taxation years respectively. The taxpayer claimed that: (i) the $106,000 seized by the police were not proceeds from criminal activity but, rather, constituted savings from prior years and; (ii) that the amount forfeited to the Crown should be deductible.

The Tax Court of Canada rejected the taxpayer's evidence that the $106,000 was cash on hand at the beginning of the taxation period as no documents were presented to support this position. It was also held that amounts forfeited as proceeds of crime were not deductible. Firstly, as the $106,000 was not incurred to gain or produce

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income from his business, it is not deductible under subsection 18(1)(a) of the Act. Secondly, pursuant to subsection 67.6 of the Act, no deduction shall be made in respect of any amount that is a fine or penalty imposed after March 22, 2004. Since the forfeited amount is a penalty for illegal activities, it is not deductible. Gross negligence penalties were also upheld under subsection 163(2) of the Act. The taxpayer's failure to report all of his income involved a high degree of negligence tantamount to intentional acting and, at the very least, indicated an indifference as to whether the law is complied with or not.

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