

NET WORTH OR ARBITRARY ASSESSMENTS - PART I

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. NET WORTH ASSESSMENTS

Pursuant to the provisions of subsection 152(7) of the Income Tax Act (the "Act"), the Minister of National Revenue (the "Minister") is not bound by the information contained in the return or the information supplied by the taxpayer, and may use what is known as a Net Worth Assessment (also known as an arbitrary assessment) as a method of estimating an individual's annual income where: (i) no tax return has been filed; (ii) the Minister considers that the tax return which has been filed is inaccurate; or (iii) the taxpayer has not maintained adequate records of the taxpayer's income.

Specifically, the calculation of the net worth assessment consists of two steps: (i) in the first step, there is a comparison of the taxpayer's net worth (i.e. the taxpayer's assets less liabilities) at the beginning of the taxation year with the taxpayer's net worth at the end of the taxation year; and (ii) in the second step, the taxpayer's estimated cost of living expenses for the taxation year is added to the difference in net worth calculated in step one. The resulting figure is assumed to be the taxpayer's income unless the taxpayer establishes that there is an error, defect or omission in the assessment. The taxpayer is bound by the net worth assessment, unless the taxpayer files a notice of objection within 90 days from the date of mailing of the assessment as provided in section 165 of the Act.

When calculating the cost of living expenses of the taxpayer, the Minister can use the information provided by the taxpayer and/or national averages provided in Statistics Canada ("StatsCan") expenditure figures.

In general, the Courts have found that the net worth assessment is an unsatisfactory and imprecise method of determining a taxpayer's income and should only be used as a last resort when all else fails. Although the net worth assessment is viewed to be an imprecise method, the burden of proof remains on the taxpayer to rebut the assessment. If the taxpayer is unsuccessful in rebutting all or a part of the assessment, then the portion of the net worth assessment that was not successfully rebutted will stand pursuant to subsection 152(8) of the Act.

In addition, penalties are often assessed against the taxpayer alleging that the taxpayer knowingly, or in circumstances amounting to gross negligence neglected to report income. Where penalties are assessed, the burden of proof is on the Minister to justify their imposition. It is also possible that the taxpayer could be charged criminally with income tax evasion pursuant to the provisions of subsection 239(1) of the Act.

B. DEFENCES TO NET WORTH ASSESSMENTS

There are various defences that a taxpayer can employ to successfully challenge all or a portion of the net worth assessment.

(i) GIFTS AND INHERITANCES

A net worth assessment can be challenged on the basis that the increase in net worth is attributed in whole or in part to receipt of gifts or inheritances, since a taxpayer can receive a gift or inheritance on a tax-free basis pursuant to the Act.

In the absence of documentation that proves receipt of gifts, the Courts may give considerable weight to testimony provided by the taxpayer and witnesses who are able to offer corroboration, such as the donor, friends, relatives, and the donor's accountant. In general, the Courts will consider all reasonable explanations for the accumulation of wealth before giving considerable weight to the explanation of receipt of gifts.

Cox v. The Queen, 2002 DTC 1515

The taxpayer, who was represented by Alpert Law Firm, was assessed for a total of seven years. In three of these years, the taxpayer had amassed a substantial fortune in mutual funds, but had altogether failed to file tax returns. In the remaining four years, the taxpayer, upon request from the Minister, had filed tax returns that were prepared by "volunteers" for Revenue Canada.

The Minister employed the net worth assessment method to discern the taxpayer's income for these seven years and used figures from StatsCan to estimate the taxpayer's cost of living expenses. The taxpayer appealed to the Tax Court of Canada challenging the Minister's net worth assessment and the penalties imposed. The taxpayer raised three main defences: (i) receipt of gifts and inheritances; (ii) challenging the estimation of cost of living expenses; and (iii) challenging the assessment of penalties on the basis of his mental condition.

The taxpayer asserted that some of his assets were attributed to the gifts his girlfriend gave to him over the years in question. He claimed he received approximately \$9,360 to \$10,800 a year from his girlfriend. His girlfriend was also a schizophrenic, who, in addition to receiving a disability pension, received a monthly income of \$700 to \$1,200 from her wealthy family.

There was no documentation to support the taxpayer's testimony about secondary gifts, however the taxpayer's brother corroborated the taxpayer's claim by testifying that the taxpayer received approximately \$10,000 a year from his girlfriend. The Court accepted the verbal testimony, but opted for the lower amount of \$7,000 a year for each of the seven years. As such, the net worth assessment was reduced by a total of \$49,000 to take into account the monetary gifts the taxpayer received.

The taxpayer also asserted that his increase in net worth was partly a result of being paid \$21,600 for his share of an inheritance resulting from the sale of the family home. This claim was corroborated by the taxpayer's brother. The Court found this inheritance payment was a partial explanation for the increase in net worth, and reduced the net worth assessment accordingly.

(ii) PROCEEDS FROM GAMBLING

A net worth assessment can also be successfully challenged on the grounds that the increase in net worth is attributed to non-taxable casual gambling gains. Note that net worth assessment will only be reduced on account of non-taxable gambling gains if such gambling or betting activities can be shown to be a casual form of amusement (i.e. a hobby). If, however, such gambling gains amount to the carrying on of a business activity by the taxpayer, then the profits are taxable.

To ascertain whether gambling proceeds are the result of a business activity and are thus taxable, the Court will look at whether the gambling proceeds are the product of an organized system of winning akin to a business. If, on the other hand, the taxpayer's wins are the result of luck then the Court will find that the gambling proceeds are not taxable, even if it is shown that the taxpayer is a frequent gambler and has won large sums of money. In the absence of satisfactory documentation, the Court may give weight to the testimony of the taxpayer and other witnesses who have personal knowledge of the taxpayer's gambling activities.

(iii) COST OF LIVING DEFENCE

The personal expenditures that are factored into the net worth assessment are estimated on the basis of StatsCan expenditure figures (consumer price index). In

general, the Courts have indicated that the method of using StatsCan figures is unsatisfactory, as these figures are simply national averages and do not accurately reflect the precise cost of living for every taxpayer. Thus, the taxpayer has the ability to disprove the estimate by presenting evidence to the contrary.

The amounts that the Minister allocate to personal and living expenses will be reduced if the taxpayer can provide satisfactory evidence that the taxpayer's living expenses were lower than the Minister's estimate.

Cox v. The Queen, 2002 DTC 1515

In this case, in which the facts were previously set out in this issue of Legal Business Report, the taxpayer, who was a diagnosed paranoid schizophrenic, raised the cost of living defence. The taxpayer, who was represented by Alpert Law Firm, claimed that the Minister's estimate of his cost of living was too high.

In the absence of documentation that contradicted the cost of living estimate in the Minister's net worth assessment, the taxpayer produced evidence that his lifestyle was extremely meagre and did not conform to the average StatsCan norm that the Minister used. The judge considered the taxpayer's unkempt appearance and psychiatric problems in deciding that the taxpayer's personal expenses were considerably lower than the StatsCan norm used in the assessment.

As a result, the Court lowered the net worth assessment to account for the taxpayer's reduced cost of living expenses for food, clothing, household operations, personal care, recreation, reading materials and gifts.

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Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

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