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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.

(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.

(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).

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.

(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.

(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.

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***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.

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.

***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

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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.

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).

***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.

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.

E. FORFEITED ASSETS

***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

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assets remaining in the class. As such, the taxpayer's unreported income should be reduced to reflect these changes accordingly.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without the further consultation with professional advisers.

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.