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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.

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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.

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(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.

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.

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

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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).

1. ***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

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

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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 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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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.