Net Worth Assessments

By Vern Krishna, CM, QC

Approximately 27.5 million individuals file tax returns every year. One-third of the returns filed are non-taxable and are filed to claim tax benefits. The remaining two-thirds pay about $196 billion in tax annually. Most taxpayers file their returns without complications and the Canada Revenue Agency (CRA) assesses them quite quickly. However, some taxpayers choose not to file their returns even when they have taxable income, or misrepresent their income in their filings. The sanctions for failing to file and filing false returns are severe, but different, for the two groups.

Although taxpayers are required to voluntarily file their tax returns, the CRA is not bound by the tax return or any information filed. The CRA may "arbitrarily" assess the taxpayer using any appropriate method for determining the tax payable by the taxpayer.[1] Where the taxpayer does not file a proper tax return, has insufficient records, or provides inaccurate information in his return, the Minister of National Revenue (the "Minister") can issue a "net worth" or arbitrary assessment of the tax payable. The consequences of a net worth assessment and any penalties depend on the nature of the taxpayer's delinquencies in filing or non-filing.

A net worth assessment estimates a taxpayer's income for a year by valuing the appreciation in her wealth (adjusted for consumption) between two time periods. For example, if the taxpayer had net assets of $100,000 on January 1 and $400,000 of net assets on December 31, the increase is $300,000. If the taxpayer consumed $150,000 during that year, her income would increase to $450,000 for the year. The Minister typically overestimates the taxpayer's income and leaves it to the taxpayer to establish whether any of the receipts are from non-taxable sources.

By its very nature, a net worth assessment is prone to errors of classifying the various sources of income. Inaccuracy is inherent in the method of calculation. It is a blunt instrument at best and the Minister is prone to maximize the taxpayer's income. However, the taxpayer is the architect of his or her own misfortune by not maintaining proper bookkeeping records.

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[1] § 152(7); See, *Hsu v Canada* 2001 FCA 240 leave to SCC refused.

A net worth assessment is valid and binding notwithstanding any error, defect, or omission in the assessment.[2] The CRA needs only to demonstrate that the taxpayer's net worth (adjusted for consumption) increased in the taxation year. It is not required to prove the taxpayer's particular sources of income. Once the CRA demonstrates a net increase in wealth, the taxpayer has the onus to separate his or her taxable income from other various sources, such as, for example, business income, capital gains, or non-taxable sources receipts.[3]

The explanation that taxpayers most often provide for undisclosed increases in net worth are that they had windfall gambling gains, or received a substantial bequest from an elderly aunt (since deceased) in a distant land. The reason those explanations corroborate their claims is that gambling gains are usually not taxable to amateurs, and gifts are never taxable.

Given the frequency of the "generosity of elderly aunts" explanation, the CRA has a jaundiced view of such theories, and will require substantiating evidence in support of the assertions. However, it is usually difficult to provide such evidence because it is the very absence of adequate records that led to the assessment in the first place.

Where the assessment is outside the normal assessment period the onus is on the Minister to prove, on a balance of probabilities, that the taxpayer made misrepresentations that were attributable to neglect, carelessness or willful default for the relevant year.[4] The normal assessment period is three years for individuals and generally four years from the date of the initial assessment for corporations (other than a Canadian-controlled private corporation).

There is no assessment deadline if the taxpayer does not file a return and the Minister has not issued an initial assessment. In a net worth assessment, the clock begins to run from the date of the assessment and, absent willful misrepresentation, the Minister can reassess within the three or four year period. However, the CRA interprets the tax statute liberally and says that failure to file a

[2] § 152(8).
[3] *Gentile v R*, [1988] 1 CTC 253 (FCTD), at 256.
[4] § 152(4)(a); *Kozar v Canada*, 2010 TCC 389, 2010 DTC 1251 at para. 7.

return when tax is payable may be willful misrepresentation that there is no tax payable. In other words, in the CRA's view a non-statement is a statement!

A special rule applies when a taxpayer does not report his or her disposition of real or immovable property. In such a case, there is no limitation period.[5] The purpose of this recently enacted rule is to discourage taxpayers from not declaring taxable gains on speculative real estate flips.

The Minister may discharge her burden of proof of establishing misrepresentation by making assumptions based on reliable information. The Minister only needs to show that there is a discrepancy between a taxpayer's assets and expenses, and that the discrepancy is unexplained and inexplicable.[6] At that point, the onus shifts to the taxpayer to identify and explain the sources of income, and why they should not be taxable based on the assumptions.

The consequences are more severe where the taxpayer files a tax return, but the Minister issues a net worth assessment because of the inadequacy of the information filed. In these circumstances, the Minister can also impose gross negligence penalties, which will add an additional 50% tax on the undeclared income. The penalty will apply even if the taxpayer could, but did not, claim discretionary deductions that would have reduced the tax payable.

However, the penalty applies only to a misrepresentation in a return, and not to the lack of filing of a return[7]. The sanctions for failure to file and filing false returns are anomalous. The *Income Tax Act* imposes a penalty for misrepresenting a return, but not for failing to file a return that falsely implies that there is no tax payable for the year. Hence, in some situations, the taxpayer is better off not filing a return at all rather than filing a false return!

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[5] § 152(4)(b.3).
[6] *Molenaar v Canada*, 2004 FCA 349 at para. 4.
[7] See *Lee*, [2010] GSTC 114 (TCC), para. 61 and *Calandra*, [2011] GSTC 3 (TCC), para. 20.