# The Application of Net Worth Assessments in Proving Tax Evasion

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## ABSTRACT

Canada has been combating tax evasion for many years. Statistics show that the Crown prefers to only accuse taxpayers of gross negligence, a civil penalty, rather than tax evasion, a crime, when net worth assessments are used. There are six court cases in which unreported income from illegal activities were found; however, the Crown only tried to impose gross negligence penalties and did not even attempt to pursue further action regarding tax evasion. There are nine cases in which the Crown actually focused specifically on tax evasion through net worth assessments, but it lost most of them. The use of a net worth assessment seems rather ineffective in proving tax evasion in Canada. By contrast, in the Unites States and other countries, the government could successfully win in a tremendous amount of such tax evasion cases with relative ease. This paper recommends that in order for the Crown to win in tax evasion cases, the standard of beyond reasonable doubt in cases regarding tax evasion must be reduced to clear and convincing evidence, and the onus should be placed on the taxpayer rather than on the Crown. This way, the loophole of net worth assessments not being able to prove tax evasion will be filled.

**KEYWORDS**: NET WORTH ASSESSMENTS, GROSS NEGLIGENCE, TAX EVASION.

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## INTRODUCTION

A net worth assessment as a good audit tool has been used frequently by the CRA in recent years. In Canada, if the CRA declared that an individual taxpayer had unreported income based on the net worth statements, the individual would have the right to object to the CRA's conclusion and appeal within a limited period. Generally speaking, there are two possible outcomes that the individual may face if she or he failed in court: the gross negligence penalty under subsection 163(2) of the Income Tax Act[1] or the consequences of tax evasion under subsection 239(1) of the Act. Data show that the number of gross negligence court cases is far beyond that of tax evasion cases. The Crown may win in gross negligence cases depending on the situation. However, the Crown failed in most of the tax evasion cases. Convictions based on net worth statements seem hard to obtain. This paper attempts to examine why the use of net worth assessments is not effective in the criminal context, explores the underlying reasons why the Crown failed in those cases, and introduces other countries' practice in proving tax evasion through net worth assessments. In the end, three recommendations are made so that the Crown may have a higher chance of winning in tax evasion cases.

The scope of this paper is limited to individual taxpayers who may be accused of gross negligence or tax evasion after a net worth assessment is used to audit his or her tax return. The other types of taxpayers, such as corporations, trusts or partnerships, are beyond this paper.

[1] Income Tax Act, RSC 1985, c.1 (5th Supp.), as amended (herein referred to as "the Act").Unless otherwise stated, statutory reference in this paper are to the Act.

# CANADIAN TAX TREATMENT OF NET WORTH ASSESSMENTS, GROSS NEGLIGENCE AND TAX EVASION

This section addresses the current tax treatment of net worth assessment, gross negligence and tax evasion from the legislation and the CRA perspectives.

## Net Worth Assessment

In Canada, a net worth assessment is also called a net worth reassessment. It is an audit tool used by the Canada Revenue Agency ("CRA") when they suspect taxpayers of having unreported income on their tax returns. It is an indirect method based on the assumption that a taxpayer's income in a given year is the increase in the taxpayer's net worth between the beginning and the end of the period, plus any expenditures and tax related adjustments.

For example, in the end of the year 2009, suppose Mr. A had an asset of a bank account with $30,000, and a liability being a student loan of $20,000. His net worth at the end of 2009 would be $10,000. By the end of 2010, let's say Mr. A had assets of a bank account with the same $30,000 and a car worth $8,000, and managed to reduce his student loan to $18,000. His net worth at the end of 2010 would be, in the same way, $20,000. The change in net worth would be $10,000. Assumed that the personal expenditure during 2010 would be $6,000, and the non-taxable gift would be $2,000 used to repay the student loan. Thus, Mr. A's 2010 taxable income based on the net worth assessment would be calculated as follows: $10,000 plus $6,000 minus $2,000, which equals $14,000.Refer to Appendix A.

Generally speaking, the CRA has the power to choose whichever it thinks is the appropriate method to assess a taxpayer's return. The specific power for the CRA to use net worth assessments is stated under section 152(7) of the Act. The CRA would use the net worth assessment when the taxpayer could not provide the proper books or record for the purpose of tax return[2]; or when the taxpayer has a lifestyle too luxurious for the CRA to think that the taxpayer has correctly reported his or her income[3]; or when the taxpayer may have untraceable cash income possibly from illegal activities such as drug dealing[4].When the CRA is preparing a net worth assessment, the taxpayer's bank accounts, brokerage and mutual fund accounts, real properties, credit card accounts and anything else that may be relevant to the taxpayer's financial position will be reviewed to determine the change in the taxpayer's net worth.

After the CRA declares that the taxpayer has unreported income based on net worth statements, the taxpayer must either accept the CRA's conclusion and pay the unpaid tax plus interest, or appeal to the courts. During the appealing process, if the taxpayers win in the court, there will be no consequences for them. However, if the taxpayers lose, there are two possible outcomes for them: gross negligence penalties or the consequences of tax evasion. This paper attempts to address the latter situation.

## Gross Negligence

The ordinary meaning of negligence is failure to exercise reasonable care[5]. Gross negligence is a conscious and voluntary disregard of the need to use reasonable care, which differs from negligence in degree of inattention[6]. It does not involve the wilful conduct that is reasonably considered to cause injury[7].

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[2] David E. Graham, "Anatomy of a Net worth Assessment," in *2007 British Columbia Tax Conference (*Toronto: Canadian Tax Foundation, 2007), page 4.
[3] Ibid
[4] Ibid
[5] It is from the Free Dictionary (http://legal-dictionary.thefreedictionary.com/Gross+negligence).
[6] Ibid
[7] Ibid

In the Act, the gross negligence penalty is a civil penalty and governed under the subsection 163(2). It is imposed on taxpayers for *"knowingly, or under circumstances amounting to gross negligence"*[8] making a *false statement or omission* in a return, form, or certificate under the *Income Tax Act* or Regulation[9].

Mr. Justice Strayer defined "gross negligence" in subsection 163(2) in *Venne*[10] as the following: (i) it involves greater neglect than failure to use reasonable care; (ii) it involves intentional acting; (iii) it is indifference no matter the law compiled or not.[11]

The CRA states that for gross negligence penalties under subsection 163(2) to apply, there must be (i) a liability for tax; (ii) a false statement or omission in a return filed as required by or under the Act or a regulation; (iii) knowledge or gross negligence by the person in the making of a false statement or omission; (iv) an understatement of income for a year, as defined by subsection 163(2.1), that is reasonably attributable to the false statement or omission.[12]. The gross negligence penalty is calculated based on the unreported income minus any deductions, which must be directly attributable to that unreported amount[13].

The consequences of gross negligence are as follows: the taxpayer is liable to pay either a penalty of at least $100 or 50% of the additional taxes payable[14]. In addition, interest will accrue on gross negligence penalties from the date the return is due.

## Tax Evasion

Tax evasion is a crime which involves deliberate criminal conduct for the purpose of not paying tax. It must be distinguished from tax avoidance, which is tax planning used to reduce the amount of tax payable within the tax law. In other words, tax avoidance is legal but tax evasion is illegal.

Under subsection 239(1) of the Act, the following activities may result in tax evasion:

> (a)"Made, or participated in, assented to or acquiesced in the making of, *false or deceptive* statements in a return, certificate, statement or answer filed or made as required by or under Income Tax Act or a regulation"[15].
>
> (b)"To evade payment of a tax imposed by the Income Tax Act, destroyed, altered, mutilated, secreted or otherwise disposed of the records or books of account of a taxpayer"[16].
>
> (c) "Made, or assented to or acquired in the making of, false or deceptive entries, or omitted, or assented to or acquiesced in the omission, to enter a material particular, in records or books of account of a taxpayer".[17]
>
> (d)"Wilfully, in any manner, evaded or attempted to evade compliance with the Income Tax Act or payment of taxes imposed by the Income Tax Act, or"[18]

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[8] ITA subsection 163(2).
[9] Ibid
[10] *Venne* v. The Queen 1984 C.T.C 223(at page 234).
[11] Ibid
[12] Ibid
[13] CRA document no. 2009-034429117, March 29, 2009
[14] Ibid
[15] Income Tax Act, subsection 239(1)
[16] Ibid
[17] Ibid

(e) "Conspired with any person to commit an offence described in (a) to (e)"[19]

The five separate offences above require an accused to have the prerequisite *mens rea* (guilty intent) before such accused can be convicted. More specifically, the guilty intent includes specific intents and general intents.[20] Paragraph 239(1) (a) and (d) define specific intents, which state that in order to be convicted of offence, the taxpayer must act knowingly with an intention to deceive or wilfully evade tax payment[21]. Paragraph 239(1) (b) and 239(1)(c) define general intents since they do not specify which books and records are being referred to[22]. The distinction between the specific intent and general intent is subtle but may be important because the specific intent implies motive of achieving illegal object[23]. Both specific intent and general intent require the Crown to prove.

In Quebec, the similar tax evasion provision is provided in "An Act respecting the Minister du Revenue".[24]

In the case of R. v. Branch, the judge commented that the nature of evasion is "*deliberate attempt to escape tax* from acts of omission or commission". [25]

The CRA defines tax evasion as follows: (i) it is the commission or omission[26]; (ii) it is an act from the conspiracy[27]; (iii) this act results in a charge being laid in the Criminal Court under subsection 239(1) of the Act.[28]

Accordingly, to establish tax evasion, the taxpayer first must have intention to escape the tax *wilfully*. Second, this intention must develop to an act, and the consequence of the wilful act is to evade tax. Thus, tax evasion is determined mainly based on the result of actions. It is subtly different from tax fraud, which focuses on the conduct instead of the result.

The consequences of tax evasion could be penalties plus imprisonment. Specifically, as long as tax evasion is legally established, the taxpayer is liable, on conviction, to a fine of 50 to 200% of the federal tax evaded, or the fine and a term of imprisonment not exceeding two years.[29] In serious cases, the conviction would result in a fine of between 100% and 200% of the tax evaded and a term of imprisonment not exceeding 5 years.[30]

## Interaction between Gross Negligence and Tax Evasion

Subsection 239(3) of the Act provides that a person who is convicted under section 239 is not liable to pay a penalty imposed under subsection 162 or 163 unless the person was assessed for that penalty before the information or complaint giving rise to the conviction was laid or made. Accordingly, there are three approaches that the CRA could process the tax litigation. The first approach is that the CRA could issue civil assessments or reassessments prior to any criminal charges being laid in order to ensure that the civil penalty can be imposed. Thus, the penalty under subsection 163(2) is to be collected by the CRA first, and then the penalty under 239(1) is

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[18] Ibid
[19] Ibid
[20] Curtis. R. Stewart, "Practical Aspects of Tax Related Criminal Proceedings", in 1996 *Prairie Provinces Tax Conference*, page 2
[21] Ibid
[22] Ibid
[23] R.v. George, 128 C.C.C. 289 (S.C.C.)

[24] Quebec Act: An Act respecting the minister du Revenue, A.M.R.62, 64, 65.
[25] R.v Branch, 1975 CarswellAlta 134, [1976] C.T.C 193#2, 76 D.T.C.6112 (District Court of Alberta, Judicial District of Calgary)

[26] *Information Circular* 73-10R3, "Tax Evasion"
[27] Ibid
[28] *Ibid*

[29] ITA subsection 239(1).
[30] ITA subsection 239(2).

to be collected later if the tax evasion is established by the judge. This approach is the most beneficial to the CRA because both penalties under subsection 163(2) and subsection 239(1) could be imposed. The second approach is that the CRA could accuse the taxpayer of tax evasion directly. As a result, the penalty under subsection 163(2) would become inapplicable because subsection 239(3) does not allow the CRA to continue to accuse the taxpayer of gross negligence after the conviction was laid on the taxpayer. This approach would be disadvantageous to the CRA because fewer penalties could be imposed. The third approach is that the CRA could accuse the taxpayer of only gross negligence. This way, the penalty under subsection 163(2) can be imposed by the CRA.

Clearly, the first approach mentioned above is most advantageous to the CRA. For example, assumed that the marginal rate is 50%, a taxpayer may face more than $150,000 in tax liability if he or she is convicted of having unreported income of $100,000. It is roughly calculated as follows[31]:

| | |
|---|---:|
| Federal taxes | $33,000 |
| Provincial taxes | $17,000 |
| Federal and provincial penalties (50% of taxes owing) | $25,000 |
| Total tax and penalty liability | $75,000 |
| Interest (for, say, 5 years) | $42,000 |
| Total civil liability | $117,000 |
| Fine on prosecution (equal to 100% of federal tax evaded) Total | $33,000 |
| **Total** | **$150,000** |

It is interesting that in fact the CRA usually takes the second or the third approach rather than the first when net worth assessments are applied, knowing that that would preclude the collection of 50 percent civil penalty.

## VOLUNTARY DISCLOSURE PROGRAM

As illustrated above, the total tax liability is severe. To avoid the possible consequences of tax evasion and gross negligence, the taxpayer may get some relief from participating in the Voluntary Disclosure Program ("VDP") set out in Information Circular IC 00-IR2. The VDP program is aimed at such taxpayers who have never filed income tax returns or have given incomplete or incorrect information in previously filed income tax returns.[32]The details of VDP are beyond this paper. However, it is necessary to address the benefits, conditions and risks associated with making a voluntary disclosure.

### Benefits

The advantage of making a voluntary disclosure is obvious that the taxpayer will be required to pay only the taxes owing plus interest. Thus, no civil penalties for gross negligence under section 163(2) will be levied and there will be no criminal prosecution for tax evasion under section 239[33].

### Conditions

There are four conditions set for the purpose of the VDP. First, the taxpayer should voluntarily to make a disclosure. That means if the taxpayer has already known that the CRA has commenced an audit or investigation,

[31] Joanne E. Swystun "Voluntary Disclosures", in 1997 *Ontario Tax Conference* (Toronto: Canadian Tax Foundation 1997), page 2

[32] Joanne E. Swystun, "Voluntary Disclosures", in 1997 *Ontario Tax Conference*(Toronto: Canadian Tax Foundation 1997), page 3

[33] Information Circular IC 00-IR2

or other enforcement action, they will disqualify to participate in VDP program.[34] Secondly, the disclosure must be considered complete by the CRA. The taxpayer must provide sufficient details to allow the facts to be verified[35]. Third, the taxpayer will be liable for taxes and the applicable penalty. Even if no taxes and penalties are payable, the representative may examine further to check whether a potential penalty exists.[36]. Fourth, the disclosure must be more than one year past due. The disclosure must include information that is at least one year past due, or if it is less than one year past due, the disclosure is to correct a previously filed return[37].Given that the four conditions are met, the CRA has the discretion to waive interest and penalties under subsection 220(3.1).

### Risks

Since the four conditions above are quite strict, it is hard for the taxpayer to challenge the CRA's refusal to apply the VDP. For example, the second condition mentioned above is quite tough for the taxpayers because it is the CRA who authorizes to decide whether or not the taxpayer's disclosure is completed or not. In fact, the Tax Court of Canada does not appear to have jurisdiction to decide the issue of whether a taxpayer has met the conditions for obtaining the benefits of the VDP.[38] Thus, the taxpayer has to appeal to the Federal Court Trial Division for judicial review. However, such court cases appear to be quite limited. Consequently, the taxpayers, who participate in the VDP, still face the risks because for the most part, they have to rely on the good faith of the CRA officials.

Therefore, the goals of the taxpayer, who may try to avoid gross negligence penalties or prosecutions through the VDP, are only achievable under certain circumstances because of the strict conditions and risks addressed above.

## DATA

The number of court cases involving net worth assessments has been increasing over the past four decades. From 1971 to 2010, the total number of court cases regarding net worth assessments was 214. Seventeen of the 214 were from the Federal Court and 197 of 214 were from the Tax Court of Canada and other courts. In the first decade, from1971 to 1980, the number of cases including both federal and other courts was 20. In the second decade, from 1981 to 1990, the number of cases was 30 with the increase rate being 50%. In the third decade, from 1991 to 2000, the number of cases was 52 with the increase rate being 73%. In the fourth decade, from 2001 to 2010, the number of cases was 112 and the increase rate was 115%. Please refer to Appendix B for the details.

Appendix C shows that the number of court cases that involve gross negligence penalties has dramatically increased to 114 over the past four decades. Six of the 114 were from the Federal Court, and 108 of the 214 were from the Tax Court of Canada and other courts. In the first decade, from1971 to 1980, the number of cases including both federal and other court cases was 6. In the second decade, from 1981 to 1990, the number of cases was 16. In the third decade, from 1991 to 2000, the number of cases was 25. In the fourth decade, from 2001 to 2010, the number of cases was 67. The increase rates starting from the second decade were 167%, 56%, and 168% respectively.

However, the number of tax evasion cases through net worth assessments was only 9 over the past 40 years. None of the 9 was from the federal court. Only one case was from the Tax Court of Canada. The other 8 were from various provincial courts such as the Ontario Court of Justice. Refer to Appendix D. Moreover, the Crown failed in most of the 9 cases.

[34] Ibid
[35] Ibid
[36] Ibid
[37] Ibid
[38] *Holley* v. M.N.R 89 DTC 366(TCC) and *Mazzariol v. R.*, 2009 CarswellNat 697, 2009 TCC 169

The trend in Appendix C is similar to the trend in Appendix B, which does make sense. However, the number of tax evasion cases in Appendix D does not increase like the trend shown in Appendix B, which is odd. Moreover, the Crown only won 2 of the 9 cases. It seems that the current tax evasion law under subsection 239(1) is not easily enforceable despite that fact that net worth assessments have been used so frequently by the Crown. Data also indicate that the Crown prefers to impose civil penalties rather than pursue criminal prosecution. A few questions are raised as follows: (i) Why is the number of tax evasion cases not increasing like the trend shown in Appendix B or C? (ii) Are there cases in Appendix C where the Crown could have possibly pursued further action regarding tax evasion but in fact chose not to? (iii) What are the underlying reasons why the Crown failed in most of the tax evasion cases?

## CASE STUDIES

This section focuses on analysis of court cases, which include three parts. The first part includes six gross negligence cases from Appendix C, which involve illegal activities. In these six cases, the Crown could possibly have accused the taxpayer of tax evasion but in fact it did not do so. The second part contains nine of the tax evasion cases from Appendix D, in most of which the Crown failed. The third part explores the underlying reasons why the use of net worth assessments is not supported in a criminal context.

In this section, all cases of gross negligence and tax evasion are based on information gathered mostly through the use of net worth assessments.

### Selected Gross Negligence Penalties Cases

Since the total number of gross negligence cases shown in Appendix C is 114, it is not necessary to go through each of the 114 cases one by one. Therefore, only 6 of the 114 are selected. Each of the taxpayers in these six cases had unreported cash income from illegal activities. According to the current legislation under subsection 239(1), the actions of each of the six taxpayers do not simply fall into the category of "gross negligence" under subsection 163(2) as they had guilty intent; moreover, they wilfully evaded tax. However, since currently net worth assessments are not deemed sufficient evidence in a criminal context, the Crown chose not to pursue further action for tax evasion. Namely, the six cases are *Levy*[39]*, Kying*[40]*, Corriveau*[41]*,Leger*[42]*,West*[43] *and Kozar*[44]. Refer to Appendix F.

In *Kyling*, the RCMP had reasons to believe that the taxpayers, whose names were Karl Kyling, and Gary Heinz Kyling, were involved in illegal activities. The Minster imputed earnings to the taxpayers' income through net worth assessments since the taxpayers should not have been able to afford their lifestyles on incomes they reported. According to the current legislations under subsection 163(2) and tax evasion under subsection 239(1), the Minister could impose the gross negligence penalty under 163(2) first, and then pursue the taxpayers' tax evasion under subsection 239(1). In fact, only the gross negligence penalty under 163(2) was imposed even though there was evidence which indicated that the taxpayers committed offences[45].

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[39] *Levy v. crwon of National Revenue*, 1989 CarswellNat 288, [1989] 2 C.T.C. 151, 89 D.T.C. 5385, 29 F.T.R. 111 (Federal Court -- Trial Division)

[40] *Kyling v. R.*, 1998 CarswellNat 2440, [1999] 1 C.T.C. 2812, 99 D.T.C. 1060 (Tax Court of Canada)

[41] *Corriveau v. R.*, 1998 CarswellNat 2792, [1999] 2 C.T.C. 2580, 1998 CarswellNat 2602 (Tax Court of Canada)

[42] *Léger c. R.*, 2000 CarswellNat 3703, (*sub nom.* Léger v. R.) 2001 D.T.C. 471 (Fr.), [2003] 1 C.T.C. 2437, 2003 D.T.C. 36 (Eng.) (Tax Court of Canada [General Procedure])

[43] *West v. R.*, 2006 CarswellNat 3456, 2006 TCC 580, 2006 D.T.C. 7 (Eng.), [2007] 1 C.T.C. 2417 (Tax Court of Canada [Informal Procedure])

[44] *Kozar v. R.*, 2010 CarswellNat 2372, 2010 TCC 389, 2010 D.T.C. 1251 (Eng.), [2010] 6 C.T.C. 2111 (Tax Court of Canada [General Procedure])

[45] *Kyling v. R.*, 1998 CarswellNat 2440, [1999] 1 C.T.C. 2812, 99 D.T.C. 1060 (Tax Court of Canada)

In *Corriveau, West* and *Kozar*, the crown completely failed in the three cases. In *Corriveau*, the Minister conducted a net worth assessment because there were unexplained bank deposits and incomplete accounting records for property rents and business income. The taxpayer appealed and submitted that there were errors in the calculation of personal expense, and failure to consider loans owing in amount of $26,000. Even though the taxpayer was suspected to have undeclared income from illegal activities, the Crown eventually lost the case because no proof of such activities link to the taxpayer, and because of the mistakes it made in the net worth assessments. As a result, the taxpayer was freed of any penalty[46].

In *West*, the taxpayer reported nil income in his returns from 1999 to 2001.The Minister assessed gross negligence penalties for the three years through a net worth assessment. However, the taxpayer successfully challenged the Minister's assumption of his income from sales of stolen narcotics. Thus, the reassessment was referred back to the Minister for reconsideration and reassessment on the basis that the taxpayer's income for the each of the three years was nil[47].

In *Kozar,* the CRA claimed several unexplained bank deposits represented undeclared income as employee of business. The minister assessed the taxpayer's taxable income to be $220,595 for 2001 and $135,488 for 2002. Also, gross negligence penalties were imposed. However, the taxpayer successfully challenged that, saying he had received gifts from his parents, and that certain amounts of money in a joint bank account shared between the taxpayer and his mother were for the estate planning of the mother, and thus should not represent income of the taxpayer. No matter how much the Minster believed the taxpayer had income from illegal sources, eventually, the Crown failed in the case[48].

In *Levy and Leger*, the appeals were allowed in part. In *Levy*, the taxpayer, who may have had illegal income from black exchange markets before immigrating to Canada, was assessed by the Minster using the net worth method. The tax court allowed the taxpayer's appeal in respect of the penalties, but upheld the amount of income determined by the Minster for the years in question[49]. In *Leger*, the taxpayer, who engaged in drug trafficking, was assessed by the Minister. The Minster added undeclared income for each audit year as well as the gross negligence penalties, and then the taxpayer appealed. The appeal was allowed in part as the total amount of undeclared income was reduced $147,074, a reduction of 28 per cent[50].

The taxpayers in the six cases above may have had unreported income from illegal activities and evaded the payment of tax, thus the crown could have pursued both the taxpayers' gross negligence and tax evasion pursuant to subsection 163(2) and 239(1). In fact, however, they did not do so. Instead, the Crown only pursued the gross negligence penalty under subsection 163(2). Moreover, the crown only won 1 of 6 cases (see *Kyling*). The chance of the crown winning a case is as low as 16.7 %( Refer to Appendix F). This suggests that tax evasion is not being combated hard enough even in civil law. At this point, fighting tax evasion seems almost unmanageable.

Given that the six cases above  only involved gross negligence under subsection 163(2), subsection 239(3) provides that the Crown could continue to pursue tax evasion no matter whether the gross negligence penalty was successfully imposed or not. In other words, the Crown still had the chance to pursue the taxpayers for tax evasion

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[46] *Corriveau v. R.*, 1998 CarswellNat 2792, [1999] 2 C.T.C. 2580, 1998 CarswellNat 2602 (Tax Court of Canada)

[47] *West v. R.*, 2006 CarswellNat 3456, 2006 TCC 580, 2006 D.T.C. 7 (Eng.), [2007] 1 C.T.C. 2417 (Tax Court of Canada [Informal Procedure])

[48] *Kozar v. R.*, 2010 CarswellNat 2372, 2010 TCC 389, 2010 D.T.C. 1251 (Eng.), [2010] 6 C.T.C. 2111 (Tax Court of Canada [General Procedure])

[49] *Levy v. crwon of National Revenue*, 1989 CarswellNat 288, [1989] 2 C.T.C. 151, 89 D.T.C. 5385, 29 F.T.R. 111 (Federal Court -- Trial Division)

[50] *Léger c. R.*, 2000 CarswellNat 3703, (*sub nom.* Léger v. R.) 2001 D.T.C. 471 (Fr.), [2003] 1 C.T.C. 2437, 2003 D.T.C. 36 (Eng.) (Tax Court of Canada [General Procedure])

in these six cases. For example, in the case of *Leger,* there was a tremendous amount of evidence shown that the taxpayer had unreported income from drug trafficking. Even the judge Archambault said that he had no doubt that the taxpayer made an omission in filing his return, which was attributable to gross negligence "*at the very least*."[51] Unfortunately, so far there is no information found indicating that the Crown would like to further pursue tax evasion in these six cases. That would indicate that the crown has given up pursuing the six tax evasion cases.

## Tax Evasion Cases

The tax evasion cases through net worth assessments are not as common as gross negligence ones. There are only 9 of these cases from 1970 to 2010. Namely, the 9 cases are *Lowe*[52], *Garshman*[53], *Akl*[54], *Spryfield*[55], *Ross*[56], *Derose*[57], *Zuk*[58], *Hunter*[59] and *Granston*[60]. Only 1 of the 9 cases was from the Tax Court of Canada, the rest eight were from different provincial courts. Refer to Appendix G-1 & G-2.

Appendix G-1 & G-2 indicate that it is hard for the Crown to win in these cases. In fact, the Crown lost 6 of the 9 cases and won only 3 of the 9. The chance of the crown winning a tax evasion case is as low as 33%. That would explain why the selected six cases involving gross negligence in Appendix F have not been handed over to criminal courts because the Crown may face greater risk of losing, resulting in additional costs for the lawsuit. This could be also confirmed from the notes provided by the CRA official. He pointed out that the six reasons of the under-usage of net worth assessments in the criminal context are as follows:

- It takes too long[61]
- Too much paper/too messy[62]
- Too hard/too complicated to undertake[63]
- It is an estimate and is not reliable[64]
- We will never get it all[65]
- More likely to be appealed[66]

## Exploring the Three Underlying Reasons

Each case is unique, so criminal charges should be laid depending on the specific situation. However, there are still some common reasons why the Crown failed in tax evasion cases.

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[51] Léger c. R., 2000 CarswellNat 3703, (sub nom. Léger v. R.) 2001 D.T.C. 471 (Fr.), [2003] 1 C.T.C. 2437, 2003 D.T.C. 36 (Eng.) (Tax Court of Canada [General Procedure])
[52] *R. v. Lowe*, 1975 CarswellOnt 1064, 26 C.C.C. (2d) 345 (Ontario Provincial Court)
[53] *R. v. Garshman*, 1976 CarswellAlta 154, [1976] C.T.C. 197, 76 D.T.C. 6103 (District Court of Alberta, Judicial District of Calgary)
[54] *Akl (N.T.), Canada v.*, 1992 CarswellOnt 932, [1992] 2 C.T.C. 145 (Ontario Court of Justice (Provincial Division))
[55] *R. v. Spryfield Bingo & Amusement Centre Ltd.*, 1997 CarswellNS 359, 162 N.S.R. (2d) 1, 485 A.P.R. 1, [1998] 1 C.T.C. 158 (Nova Scotia Provincial Court)

[56] *R. v. Ross*, 1998 CarswellNS 115, 166 N.S.R. (2d) 366, 498 A.P.R. 366, [1998] 3 C.T.C. 159 (Nova Scotia Supreme Court)
[57] *R. v. Derose*, 2001 CarswellAlta 1163, 2001 ABPC 146, [2001] A.J. No. 1117, [2003] 1 C.T.C. 378, 297 A.R. 51 (Alberta Provincial Court)
[58] *R. v. Zuk*, 2005 CarswellOnt 5031, 2005 ONCJ 428, [2005] 5 C.T.C. 177, 2005 D.T.C. 5628 (Eng.) (Ontario Court of Justice)
[59] *R. v. Hunter*, 2006 CarswellOnt 7727, 84 O.R. (3d) 34 (Ontario Superior Court of Justice)
[60] *Crownnston v. R.*, 2010 CarswellNat 2608, 2010 TCC 414, 2010 D.T.C. 1280 (Eng.), [2011] 1 C.T.C. 2275 (Tax Court of Canada [General Procedure])
[61] CRA official, March 14, 2011
[62] Ibid
[63] Ibid
[64] Ibid
[65] Ibid
[66] Ibid

***First, a net worth assessment itself is not impeccable enough.***

If done properly by the Crown, a net worth assessment is a very good audit tool. However, a net worth assessment has its imperfections since it is an imprecise approximation method as addressed in the case of Hsu[67]. It was said that the nature of a net worth assessment is an "arbitrary and imprecise approximation"[68], and the factual basis of the Minster's estimation is "inaccurate".[69]

In addition, the Judge Bowman said in the case of Bigayan[70] the following:

> "It is a *blunt instrument*, accurate *within a range of indeterminate magnitude*. It is based on an *assumption* that if one subtracts a taxpayer's net worth at the beginning of a year from that at the end, adds the taxpayer's expenditure in the year, deletes non-taxable receipts and accretions to value of existing assets, the net result, less any amount declared by the taxpayer, must be attributable to unreported income earned in the year, unless the taxpayer can demonstrate otherwise. It is at best an *unsatisfactory method, arbitrary and inaccurate* but sometimes it is *the only means of approximating the income* of a taxpayer".

In fact, there are many aspects from which the taxpayer could attack the net worth assessment method, e.g. in cases involving cash on hand (see *Derose*), joint owned assets (see *Ross*), or overstated inventory. The unreported cash declared by the taxpayer is probably the most often used to attack net worth assessments. The taxpayer could claim that he had a large amount of cash at hand from the start, and that the Crown failed to give him credit for it. Especially when the taxpayer engages in illegal activities such as drug dealing, a net worth assessment could not catch the unreported source of cash income[71]. For example, in the case of *Léger,* there is evidence which showed that the taxpayer did indeed have cash revenue from drug dealing without keeping any receipts, and if he expended the cash directly, then his transactions would never touch any of the four items of a net worth assessment statement. In this case, inaccurate calculations of this taxpayer's income may result.

There is a loophole in such cases like *Leger*. When the taxpayers could not provide the proper books or records, the Crown would have to use a net worth assessment to audit them as it is the last resort adopted by the Crown as it is said in case of Bigayan[72] the following:

> "The net worth method, as observed in Ramey v. The Queen, 93 DTC 791, is a *last resort to be used* when all else fails. Frequently, it is used when a tax payer has failed to file income tax returns or has kept no records."

However, it may have little effect because the taxpayer's cash transactions from illegal activities may not be shown on the net worth statement. As a result, the Crown cannot obtain how much income the taxpayer did not report based on a net worth method.

Given the imperfections of net worth assessments, the standard of proof and who has the onus are equally important aspects in proving tax evasion.

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[67] *Hsu v. The Queen* 2001 DTC 5459(FCA), paragraph 30
[68] Ibid
[69] Ibid
[70] *Bigayan v. The Queen* 2000 DTC 1619(TCC)
[71] David E. Graham, "Anatomy of a Net worth Assessment," in *2007 British Columbia Tax Conference (*Toronto: Canadian Tax Foundation, 2007), page 18.
[72] *Bigayan v.The Queen* 2000 DTC 1619(TCC)

***Second, the standard of beyond reasonable doubt is too high.***

The standard of proof is the amount of evidence which the taxpayer or the Crown must present in a trial in order to win. In Canada, the standards of proof include a balance of probabilities and beyond a reasonable doubt. A balance of probabilities is the lower standard of proof, which means that a judge or jury must believe that there is a greater than *50 percent* chance that the accused has committed a crime. Beyond a reasonable doubt is the highest standard in Canada, and it means for a criminal defendant to be convicted of a crime, the prosecutor must prove her case to the point where the jurors are *reasonably sure* that the defendant did whatever he or she is charged with having done.

In Canada, a balance of probabilities is used in civil law and beyond a reasonable doubt is used in criminal law. Since gross negligence belongs to civil law, the standard of proof used is a balance of probabilities. As tax evasion is a crime, the standard of proof used in proving tax evasion is therefore beyond a reasonable doubt.

The higher the standard of proof is, the lower the chances that the Crown will win. The Crown failed in the tax evasion cases because the standard of proof of beyond reasonable doubt could not be met. (See Appendix G)

***Third, the onus is not placed on the taxpayer but on the Crown, which reduces the chances of the Crown winning***

In the Latin language, the word "onus" means "burden". The onus of proof represents the side that has the responsibility to prove either the innocence of the defendant or the guilt of the accused.

Originally, it is the Crown who accuses the taxpayer of gross negligence or tax evasion. Also, it is the Crown that has the onus to prove either the gross negligence or tax evasion. Thus, the Crown runs the higher risk of losing its case. If the onus was on the taxpayer, the risk would shift from the Crown to the taxpayers, which would increase the chances for the Crown to win in tax evasion cases.

For example, if a taxpayer was accused by the CRA of having unreported income, the CRA would use the net worth assessment to audit his returns and possibly impose gross negligence penalties accordingly under subsection 163(2). The taxpayer would of course appeal. If the onus of proof was placed on the taxpayer and not the Minster, as long as the taxpayer could not explain the discrepancy between the net worth statements and his regular tax return, he would be still imposed the penalty based on the tax law. As a result, the Minster would have a significantly greater chance of winning while the taxpayer may be more likely to lose. However, if the onus was on the Minster, as it is in subsection 163(2) of Income Tax Act, it would be difficult for the minster to prove each item on the net worth statement as some numbers are based on assumptions. Therefore, the penalty may not be imposed successfully because the minster could not discharge his burden of proof. Simply put, the minister will have a much greater chance of winning if the onus was on the taxpayer.

In fact, this shifting seems to have happened in gross negligence cases. Even though this paper focuses on tax evasion rather than gross negligence, the shifting of the onus in gross negligence cases could be extended to tax evasion cases. Thus, it is necessary to address how the shifting occurred in gross negligence cases.

The onus of proof in gross negligence lawsuits is governed under subsection 163(3), which has been changed over past decades. Previously, the onus was laid on the taxpayer[73]. Now subsection 163(2) clearly indicates that the onus of proof is on the minster. Thus, it is the minster who must establish that the taxpayer had "knowingly, or under circumstances amounting to gross negligence" avoided the full payment of tax. However, the minster could discharge its burden of proof if the taxpayer had unreported

[73] *Pashovitz*. V MNR 1961 C.T.C.288

income but could not provide a credible explanation. The following three cases showed that the onus of proof had been shifted from the minster to the taxpayer.[74]

In *Lacroi*x, the minster assessed tax on about $560,000 of unreported income following a net worth audit. The Federal Court of Appeal ("FCA") concluded that the minster had met the burden of proof necessary to reopen a statue-barred year and to impose the gross negligence penalty without the minster presenting definitive evidence of gross negligence. It said as follows:

> "Insofar as the TCC is satisfied that the taxpayer earned unreported income and did not provide a credible explanation for the discrepancy between…reported income and …net worth, *the minster has discharged his burden of proof."*[75]

The Federal Court of Appeal concluded that the minster need only make assumption of the fact in the course of an audit that leads to a further assumption of unreported income[76]. If the taxpayer cannot explain the discrepancy between the reported income and net worth, the minster may impose the gross negligence penalty[77].

According to *Lacroix,* the Crown imposed gross negligence penalties after the taxpayer failed to provide corroborative documentations to dislodge the Crown's assumptions in the case of *Szlavy*[78]. The taxpayer in *Szlavy* was found to have fabricated evidence while deliberately failing to report…income.[79]

In addition, in the case of *Ohayon*[80], the taxpayer was a career gambler who later opened a jewellery business. The minster conducted a net worth assessment after the normal reassessment. The TCC cited *Lacroix* and focused on the lack of a credible explanation from the taxpayer rather than requiring the minster to present further evidence beyond the assumptions made in the course of a net worth audit. Thus, the gross negligence penalty was imposed.[81]

This onus shifting from taxpayers to the Crown has proven to increase the likelihood of the Crown winning. However, in tax evasion cases, the onus is still on the Crown to prove the guilt of the accused.

To summarize, the reason why the Crown failed in most tax evasion cases is that the standard of beyond reasonable doubt for the Crown is too high to meet when imperfect net worth assessments are used, especially if illegal activities were involved. Specifically, on one hand, the CRA has to choose net worth assessments as a last resort when taxpayer could not provide the adequate books or records; but on the other hand, in a criminal case to prove tax evasion, net worth assessments could not provide precise calculations to meet the standard of proof of beyond a reasonable doubt. In addition, the onus is placed on the Crown, which makes things even more difficult for the Crown to win because the Crown has the burden of proving its case.

Consequently, if the Crown used net worth assessments in proving tax evasion cases, there is little chance for it to win. A taxpayer, who specifically engages in a cash business, possibly involving illegal activities such as drug

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[74] Kim M. Ho, "Reverse Onus" (2010) 18:4 *Canadia*n *Tax Highlights*.

[75] Lbid

[76] Kim M. Ho, "Reverse Onus" (2010) 18:4 *Canadia*n *Tax Highlight*
[77] Ibid
[78] *Martin Szlavy v. The Queen* 2009 DTC 1293(TCC)
[79] Ibid
[80] *Edmond Ohayon v. The Queen* 2010 DTC 1050(TCC)
[81] Ibid

dealing, may take advantage of the current law and intentionally evade the payment of tax because although he risks civil penalties, it would be very difficult to convict him criminally. That would contradict the Crown's goal of combating tax evasion in Canada.

# COMPARISON WITH OTHER COUNTRIES

## United States

### *Legislation*

In the United States, the net worth assessment is referred to as the net worth method. The basic concept and calculation of net worth method in US is as same as it is in Canada. There is no statutory provision defining the net worth method and specifically authorizing its use by the Commissioner. However, every judicial circuit has endorsed the net worth method as proof and the Supreme Court has approved its use in a number of investigations such as *Holland v. United States, 348 US 121(1954), Friedberg v. United States, 348 US 142(1954) and Smith v. United States, 348 US 147(1954).*

Tax evasion in the United States is defined as follows:

> "Any person who wilfully makes and subscribes any return, statement, or other document which contains or is verifies by a written declaration that is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter…shall be guilty of felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in cases of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution."[82]

In addition, convictions under the above section are explained further in the case of *Powell*[83] and *Presbitero*[84] as follows: in order to make a conviction, (i) the person must have made or subscribed to a federal tax return which he verified as true[85]; (ii) the return was false as to a material matter; (iii) the defendant signed the return wilfully and knowing it was false[86]; and (iv), the return contained a written declaration that it was made under the penalty of perjury.[87]

It is worthy to note that in the United States, there are two levels of tax fraud lawsuits existing in courts. In one level, the civil tax fraud penalty, which is equal to 75% of the tax owed, plus interest may be imposed.[88] This civil penalty is similar to the gross negligence penalty in Canada. The other level is about tax crimes including tax evasion when filing a false tax return. The penalty for criminal tax fraud is up to 5 years in jail, plus fines of up to $100,000.[89]

### *How to Prove Tax Evasion*

There are three levels of standards of proof in the US, which include guilty beyond a reasonable doubt in most criminal cases, clear and convincing evidence in both civil and criminal cases, and preponderance of the evidence in most civil cases. The highest standard is beyond a reasonable doubt, which is the same as it is in Canada. The

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[82] US code § 7206.
[83] *United States v. Powell*, 576 F.3d 482, 495 (7th Cir. 2009)
[84] *United States v. Presbitero,* 569 F.3d 691, 700 (7th Cir. 2009)
[85] Ibid
[86] Ibid
[87] Ibid.
[88] IRS Code Section 6663
[89] IRS Code Section 7201

lowest standard is a preponderance of the evidence, which is equal to a balance of probabilities in Canada. The intermediate standard is clear and convincing evidence, which means that for a party to prove its case under this standard, it must show something that is more likely than not, but not as much as beyond a reasonable doubt.

In the Rules of Practice and Procedure United States Tax Court, it clearly indicates the following:

> "In any case involving the issue of fraud with intent to evade tax, the burden of proof in respect of that issue in on the respondent, and the burden of proof is to be carried by clear and convincing evidence."[90]

As indicated in Rule 142(b) above, in terms of proving tax evasion in the US, the standard of proof is clear and convincing evidence,[91] and the burden of proof is on the taxpayer and not the Crown.

Compared to Canada, when a net worth assessment is used to prove tax evasion, the United States adopts the standard of clear and convincing evidence, which is lower than the standard of beyond a reasonable doubt used in Canada. In addition, the US adopts the legal system of presumption of guilt for tax evasion cases so that the onus is placed on the taxpayer, whereas Canada still adopts the system of presumption of innocence in tax evasion cases, which places the onus on the Crown. As a result, the US government could successfully win the cases in proving tax evasion through a net worth assessment with relative ease whereas the Canadian government could not nearly as easily.

### *US Court Cases*

There are numerous court cases that the US government won in proving tax evasion through net worth methods.

As mentioned before, the taxpayers are most likely to challenge the opening balance of a net worth or claim to have untraceable cash income since those figures may not appear in net worth statements.

In the case of *Holland*, the taxpayers were convicted under the Internal Revenue Code of a wilful attempt to evade their income taxes. The taxpayers claimed that the prosecution did not include in its opening net worth a figure of $104,000 accumulated before the year 1933. However, the prosecution introduced no direct evidence to dispute this claim, but instead relied on the inference that anyone who had $104,000 in cash would not have undergone the hardships shown to have been endured by the taxpayer from 1926 to 1940. The judge accepted the inference and concluded that the taxpayers were guilty of tax evasion rather than that the prosecution had made a mistake in the opening net worth. If the similar cases were incurred in Canada, the result may be quite different. In Canada, when taxpayers challenged the opening net worth, the court just focused on how to prove the opening figures directly rather than using indirect evidences to prove it (See *Ross, Zuk*). More likely than not, the court will be stuck with proving the opening figures given that the net worth assessment is not precise enough.

Since there is no requirement that the likely source of income should be a legal source, an illegal source of income could as well be the likely source of income. For example, drug sales frequently provide a possible source of income. Moreover, the evidence must not be introduced in a manner calculated to inflame the jury. Drug sales frequently provide a possible source of income. In the case of *Heyward*[92] the taxpayer claimed that any increase in net worth was due to a $175,000 loan he received from a man named Robert Horan, who died before the taxpayer was prosecuted. The judge declined his claim and did not further investigate to verify each figure of the taxpayer's net worth statement. Instead, the court found that there was evidence shown that the taxpayer engaged in drug smuggling. As a result, the taxpayer was convicted of evading taxes. Except *Heyward*, the US government

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[90] Rules of Practice &Procedure, United States Tax Court (Effective January 2010), rule 142(b)
[91]Ibid
[92] *United States v. Heyward*, 729 F.2D 297(1984)

successfully convicted taxpayers' tax evasion in cases of *Enstam*[93]and *Lewis*[94]. The similar case in Canada is *Leger*. As mentioned before, the taxpayer in *Leger* was only imposed the gross negligence penalty and the Canadian government seems to have given up pursing the taxpayer's tax evasion.

The latest court case of *Perez*[95] seems to show that the US government is now fighting tax evasion more severely. That means the taxpayers will face more risks of being caught. In *Perez,* the taxpayer who was found to have unreported income on his returns and was charged with filing false tax returns. He challenged the US government, saying that (i) the IRS's net worth method was not sufficient to support his conviction because there are some flaws on the net worth statement[96]; and (ii) the evidence is insufficient to measure his wilfulness[97]. For the taxpayer's first argument, the US government did not need to prove the exact amount of such unreported income or the existence of a tax deficiency to establish the falsity of the tax return.[98]Instead, it was only necessary to show there was unreported income.[99] For the taxpayer's second argument, the judge quoted the definition of wilfulness held by the Supreme Court as follows:

> "Wilfulness, as construed by our prior decisions in criminal tax cases, required the government to prove that the tax imposed a duty on the defendant, the defendant knew of this duty, and he voluntarily and intentionally violated that duty…"[100]

In this case, the taxpayer knew he had a duty to report all income from his various drywall jobs. The evidence showed that the taxpayer received cash payments from customers and did not inform his wife of all those payments, and his wife was the one who provided the financial information to the tax preparer. Thus, the taxpayer's wilfulness did exist. The taxpayer was sentenced to 30 months with the appealing costs.

As indicated before, a net worth assessment has its imperfections resulting in the challenge of sufficiency of evidence in proving tax evasion cases. It seems that the Canadian government has been stuck with the issue. However, the US government could be relieved from the challenge as provided in the case of *Seymour*[101]*:*

> "In considering a sufficiency of the evidence challenge, this court considers the evidence in the light most favourable to the Government, defers to the credibility determination of the jury, and overturns a verdict only when the record contains no evidence, regardless of how it is weighed, from which the jury could find guilt beyond a reasonable doubt".

In addition, the US government may use more than one method of proof. In *Abodeely*[102], a tax evasion prosecution where the taxpayer received unreported income from gambling, the court discussed the net worth, cash expenditures, and bank deposit method of proof and stated:

[93] *United States v. Enstam*, 622 F.2d 857, 860 (5th Cir. 1980)
[94] *United States v. Lewis*,759 F.2d 1316, 1328, 1336 (8th Cir.
[95] U.S. Court of Appeals, 7th Circuit; 08-2566, July 6, 2010
[96] Ibid
[97] Ibid
[98] *United States v. Pree* [ 2005-2 USTC ¶50,480],
408 F.3d 855, 867 (7th Cir. 2005)
[99] *Leeby v. United States* [ 51-2 USTC ¶9497], 192 F.2d 331, 334 (8th Cir. 1951)
[100] *Cheek v. United States* [ 91-1 USTC ¶50,012], 498 U.S. 192, 201 (1991)
[101] *United States v. Seymour*, 519 F.3d 700,714 (7th Cir. 2008)
[102] *United States v. Abodeely*, 801 F.2d 1020, 1023 (8th Cir. 1986)

> "The government may choose to proceed under any single theory of proof or a combination method, including a combination of circumstantial and direct proofs."[103]

The expenditures method of proof measures spending that exceeds the reported income in a given year. In contrast with the net worth method, the taxpayer is not accumulating assets, but is spending money on items such as clothing, travel, meals and so on. It is similar to the net worth method but the number of cases using the expenditures method has outgrown that of the net worth method.[104]

Evidently, in the US, the tax law is more favourable to the government's side rather than the taxpayers', who may not have even engaged in any other illegal activities but were nonetheless convicted as long as the conditions for tax evasion were met. The application of the net worth method/assessment in proving tax evasion in the US is more enforceable when compared to Canada. As a result, taxpayers in the US may be more easily proven guilty of tax evasion.

## Australian

In Australia, a net worth assessment is called an "*asset betterment statement*". From 1970 to 2010, there were 92 court cases regarding asset betterment statements. Fifty-six of the 92 were from the Administrative Appeals Tribunal. Twenty-eight of the 92 were from the Federal Court. Two of the 92 were from the High court. Eight of the 92 were from the Supreme Court. Refer to Appendix E.

There is no similar trend found in Appendix E as there is was in Appendix B & C. In fact, starting from 1997, the use of asset betterments in Australia seems to have been reduced. Moreover, all of the 92 cases involve administrative penalties, which is a civil penalty similar to the gross negligence penalty in Canada.

An asset betterment investigation is done through the authority given by the section 167 of the Income Tax Assessment Act 1936**.** The onus is specifically placed on the taxpayer by legislations[105]. In the latest case of *Day*[106], the burden of proof on taxpayers was confirmed.

However, it is difficult to find court cases, in which prove tax evasion through asset betterment for an individual taxpayer.

## New Zealand

In New Zealand, the net worth assessment is called "*asset accretion"*. The onus is placed on the taxpayer[107].The standard of proof is beyond a reasonable doubt in criminal law.[108] It is hard to find cases in proving tax evasion through asset accretion.

To summarize the three foreign countries' practice, it can be concluded that the country the most comparable to Canada is the US because both Canada and the US have accepted that net worth methods could prove tax evasion in courts. However, the result in the two countries is quite different. The US could quite successfully prove tax evasion through the net worth method at the criminal law level while Canada

[103] Ibid
[104] 2008 Criminal Tax Manual (http://www.justice.gov/tax/readingroom/2008ctm/CTM%20TOC.htm).
[105] Tax Administration Act 1953(Australian), section 14ZZK

[106] DAY v FC of T, 2010 ATC 10-1133

[107] Inland Revenue Department Amendment ACT 1960 section 20
[108] Hall V. Commission of Inland Revenue [1965] nzlr 184

seems to have lagged far behind the US. Compared to Canada, the US takes the lower standard of proof and the onus is clearly placed on the taxpayer rather than the Crown. Moreover, the net worth method combined with other methods such as expenditures method of proof could be used in the US in proving tax evasion. To compare the onus and standards of the three countries with those of Canada, refer to Appendix H.

## RECOMMENDATIONS

Even though subsection 239(1) clearly provides the law of tax evasion, the application of net worth assessments in proving tax evasion seems to have taken little effects because of the three underlying reasons explored. In order for the Crown to more effectively deal with tax evasion in Canada and to solve the problem of having to prove tax evasion beyond a reasonable doubt when a net worth assessment is used by the Crown, three recommendations are raised.

First, the standard of proof should be set lower than the current standard of beyond a reasonable doubt. Canada should borrow the US's standard of proof, which is clear and convincing evidence in proving tax evasion when net worth assessments are applied. Moreover, the standard of proof of clear and convincing evidence should be written in tax law, which is separately from other crimes.

Second, the onus should be placed on the taxpayer instead of the Crown when net worth assessments are used. The onus shifting has been proven to be beneficial for the Crown in gross negligence lawsuits. The Crown will obtain the same benefits if the onus shifting could also transpire in tax evasion cases.

Third, the Crown should be able to choose the net worth assessments combined with other methods such as the expenditure method of proof rather than just one single method of the net worth assessment to prove tax evasion, for the sake of the imperfections of net worth assessments.

The impacts of the three recommendations above are profound. The first recommendation will affect the Canadian criminal law system. Currently there is only one standard of proof of beyond a reasonable doubt used in all the criminal cases in Canada. Canada is not like the United States where a different standard is set for the purpose of proving tax evasion. Moreover, the separate standard has been written as a law in the US. The huge success in the US has proved that the separate standard is plausible. As Canada is more of a conservative country, whether or not the separate standard could be set up and separated from other criminal laws depends on how much determination the Canadian government has in terms of attacking tax evasion. It is known that combating tax evasion has become a growing concern worldwide. Canada should follow the trend. Specifically, the effective measurements used to attack tax evasion should not only stay at the administration level but also at the criminal law level. For example, the Canadian government should change its angle to rethink the tax evasion issue in Canada. A separate standard for proving tax evasion as it is similar in the US could be set up to prove tax evasion more effectively when a net worth assessment is used.

The second recommendation will impact the principle Canadian justice system, but it is achievable. A few other countries, like China for example, have taken the assumption of guilt system where the onus is placed on the taxpayer. Most western countries including Canada adopt the system of assumption of innocence where the onus is on the Crown. Even though the onus shifting could not deny the whole system of assumption of innocence, the impact is inevitable. In fact, it is interesting that in the Canadian justice history, the onus has been changed over decades. In the earlier part of this century, the onus seemed to be on the Crown in a tax case. From 1946 to 1994, the onus was on the taxpayer. After 1994, the onus was back on the Crown[109]. Recently, the onus seems to be on the taxpayer again as it is in the case of *Lacroix*. Therefore, for the purpose of attacking tax evasion, the second

[109] Joel A. Nitikman, "The onus of proof in tax litigation and other litigation matters affecting GAAR", in 1997 *Conference Report*, page 26-27

recommendation of how the onus should be placed on the taxpayer could be achievable regardless of its impact on the current system of assumption of innocence.

The third recommendation would impact the Crown's administrations system. Because of the imperfections of net worth assessments, the Crown should use net worth assessments combined with other methods in proving tax evasion cases because the combined methods would be stronger than a single net worth assessment in courts.

If the three recommendations could be implemented, the biggest beneficiary would be the Minister, who would have a much higher chance of winning with relatively lower cost in tax evasion cases. On the contrary, the taxpayers who attempt to evade tax and possibly engage in other illegal activities would face much more risk because not only might the gross negligence penalty be imposed, but also convictions could now be laid on them. As a result, more money will be put into the government's account and Canada will be a step forward in the fight against tax evasion.

## CONCLUSION

When net worth assessments are applied in appealing process, the Canadian income tax law currently contains the gross negligence penalty, which is a civil penalty for taxpayers who makes false statements under subsection 163(2), and criminal penalties under subsection 239(1) for taxpayers whose actions are held to constitute tax evasion with intent. The CRA found that it was virtually impossible to prove tax evasion because the current standard of proof is too high to meet. In fact, the CRA prefers to impose only gross negligence penalties even in the many cases where tax evasion could possibly be pursued (see Appendix F). In some cases, the CRA actually focused specifically on tax evasion through net worth assessments, but it lost most of them (see Appendix G). Consequently, the provision of tax evasion under subsection 239(1) may seem meaningless for taxpayers when net worth assessments are applied.

Since the "net worth [assessment] is a tool that has been available and used by in criminal investigations in the past, is used currently and will be utilized more and more as the CRA goes forward"[110], the loophole of the application of net worth assessments in proving tax evasion must be filled. The current standard of proof of beyond a reasonable doubt should be lowered to clear and convincing evidence as adopted in the US when net worth assessments have to be used to against taxpayers in the courts. In addition, the onus of proof is better placed on the taxpayer instead of the Crown. Moreover, the use of net worth assessments combined with other methods should be accepted for the Crown in proving tax evasion. The court cases in Appendix F & G should be revisited. If so, then, subsection 239(1) could truly take effect when the net worth assessment is applied in proving tax evasion and Canada could therefore better tackle tax evasion as the US did.

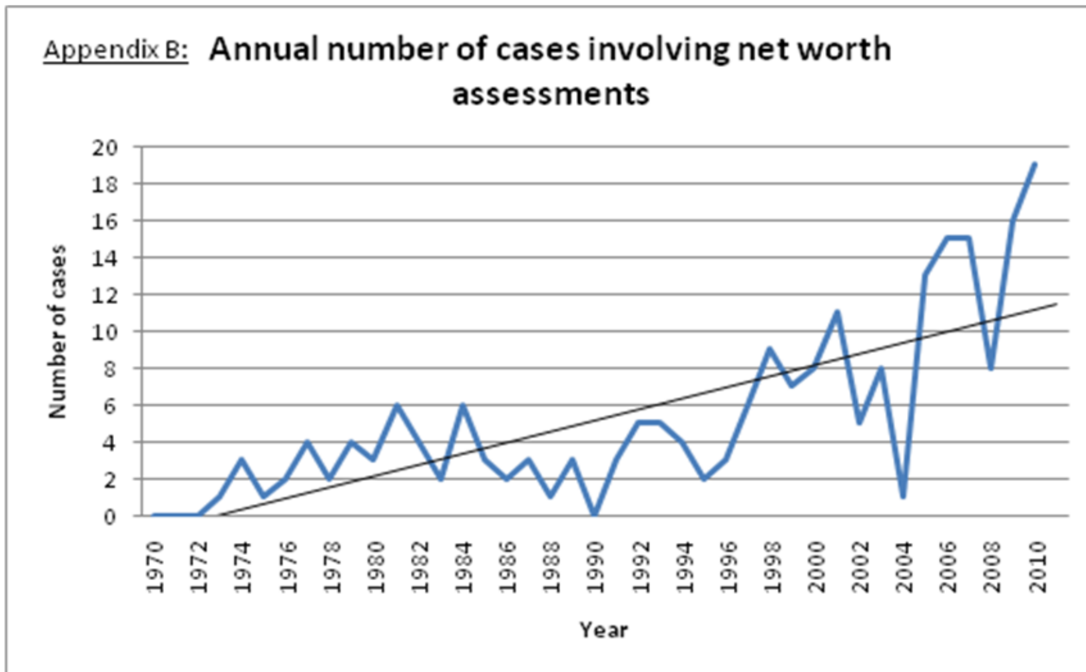
[110] CRA official, March 14, 2011

# APPENDIXES:

## Appendix A: Net Worth Assessments

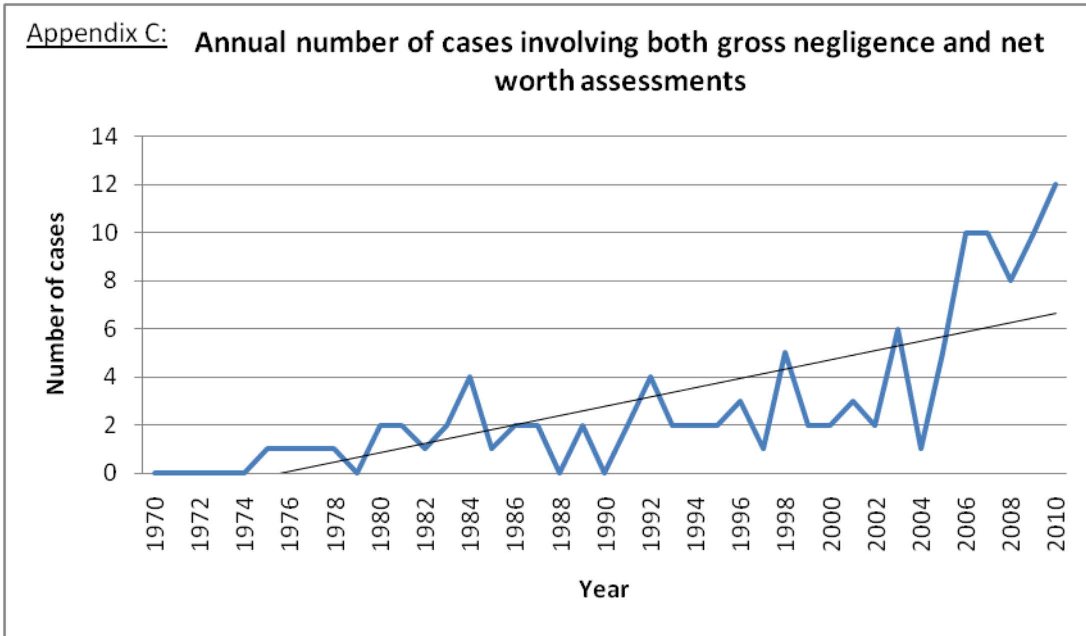
| Appendix A: **Net Worth Assessments** | | | | |
|---|---|---|---|---|
| Years | | 2009 | | 2010 |
| | | | | |
| **Assets** | | | | |
| Bank accounts | | 30,000 | | 30000 |
| car | | | | 8000 |
| **Liabilities** | | | | |
| Student loan | | -20000 | | -18000 |
| | | | | |
| **net worth** | | 10,000 | | 20,000 |
| | | | | |
| **Change in net worth** | | | | 10,000 |
| **Personal expenditures** | | | | 6000 |
| **Tax related adjustment** | | | | -2000 |
| **Income** | | | | 14,000 |

## Appendix B: Annual Number of Cases Involving Net Worth Assessments



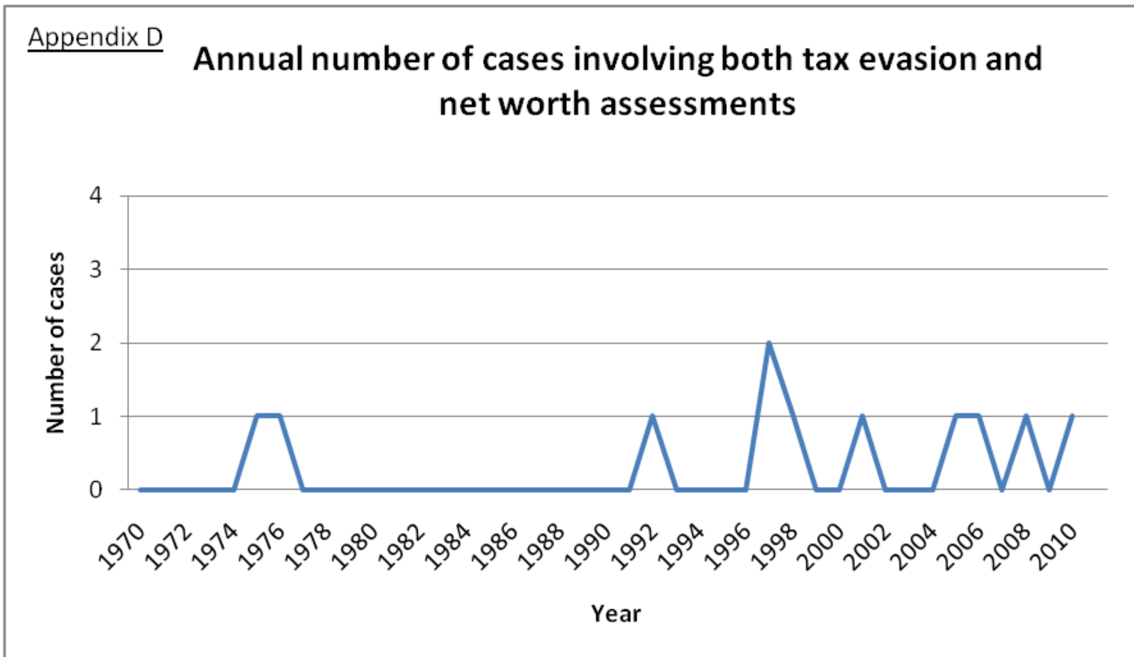

Source: Knotia.ca

## Appendix C: Annual Number of Cases Involving both Gross Negligence and Net Worth Assessments



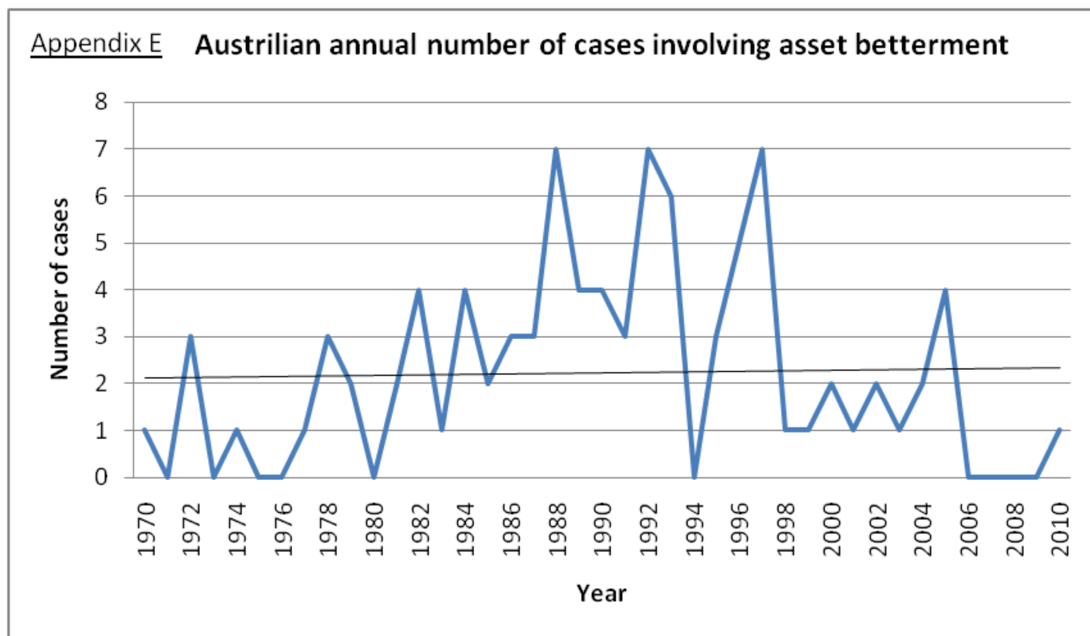

Source: Knotia.ca

## Appendix D: Annual Number of Cases Involving both Tax Evasion and Net Worth Assessments




Source: Knotia.ca

## Appendix E: Australian Annual Number of Cases Involving Asset Betterment




Source: Australian Government Legal Database Web (http://law.ato.gov.au/atolaw/results_java.htm?rank=find&cat=C&criteria=AND~'asset~basic~exact:::AND~betterment%22%22~basic~exact&target=C&style=java&recStart=81&PiT=999912312359

## Appendix F: Selected Six Cases Involving Illegal Activities

| **Appendix F: Selected Six Cases Involving Illegal Activites** | | | | | |
|---|---|---|---|---|---|
| **The name of the case** | **Year** | **The name of the court** | **Type of illegal activity involved** | **The reasons why net worth assessments were used** | **Was the taxpayer imposed the gross negligence penalty under subsection 163(2)?** |
| **1. Levy** | 1989 | Federal Court-Trial Division | The taxpayer brought money from Israel. The money was from illegal activities when he was in Israel. | not mentioned | allowed in part |
| **2. Kyling** | 1998 | Tax Court of Canada | The RCMP believed that the taxpayer was involved in illegal activities but it was not specifically named in the case. | Taxpayers could not have been able to afford assets on incomes they reported. | yes |
| **3. Corriveau** | 1998 | Tax Court of Canada | It was possible that undeclared amounts were from illegal activities but there is no proof of such activities. | The minister contended that there were unexplained bank deposits, numerous deposits in small denominations over three months totalling $10,000, and incomplete accounting records for property rentals and business income. | no |
| **4. Leger** | 2000 | Tax Court of Canada | Drug trafficking | The crown obtained information from the RCMP concerning the taxpayer's involvement in drug trafficking | allowed in part |
| **5. West** | 2006 | Tax Court of Canada | The sale of illegal narcotics.The assumptions with respect to the Appellant's illegal activities stemmed from information from Mr. McCabe, the auditor in charge of the Appellant's file, who had received the information from the Integrated Proceeds of Crime ("IPOC") after the Appellant and two companions had been found in possession of some $60,000 in cash at the Toronto airport. | The taxpayer kept no records because he had no income. His lifestyle is far more modest than that of the Statistics Canada model upon which the net worth template is based. | no |
| **6. Kozar** | 2010 | Tax Court of Canada | The auditor received information from various other enforcement agencies (RCMP, OPP, Windsor Police, CBSA) that Sang Nguyen [the taxpayer's fiancé] was involved in the illegal satellite business and other various illegal activities (alien smuggling, money laundering and in the production and trafficking of drugs). | There were several unexplained bank deposits representing undeclared income. | no |
| Source : Taxnet pro. Search Terms"net worth assessment" and "gross negligence""illegal activities" | | | | | |

## Appendix G: Tax Evasion Cases

Appendix G-1: **Tax Evasion Cases**

| **The name of the case** | **Year** | **The name of the court** | **Type of activities** | **The reasons why net worth assessments were used** | **Was the taxpayer guilty or not?** |
|---|---|---|---|---|---|
| **1. Lowe** | 1975 | Ontario Court of Justice | The taxpayer had lucrative business activities | The evidence of unreported income for the period mentioned is circumstantial. | Yes.The prosecution did not prove each figure on the net worth assesssment directly, but the judge was satisfied beyond a reasonable doubt that the accused evaded tax. The crown did not discharge its onus of proof. |
| **2. Garshman** | 1976 | Alberta Provincial Court | The taxpayer controlled a number of corporations, and conducted his affairs carelessly. | No books or records were kept. | No. Evidence showed that the taxpayer was extremely careless in keeping records, but the evidence failed to establish the presence of mens rea. |
| **3. Akl** | 1992 | Ontario Court of Justice | (not mentioned) | The taxpayer had unreported income. | No.The accused's opening personal net worth had not been satisfactorily proved. |
| **4.R.v.Spryfield Bingo** | 1997 | Nova Scotia Country Court | The taxpayer operated a commercial bingo hall. | The taxpayer made false or deceptive statements in income tax returns by failing to report income in the years 1983 to 1986, contrary to section 239(1 )(d) and 239(1 )(a) respectively of the *Income Tax Act* . | No. Even though the crown's evidence indicated on the balance of probabilities that the taxpayer did not report all his revenue, it was however insufficient to prove beyond a reasonable doubt the tax evasion. Net worth assessments are useful for civil penalties, but they are not supported in proceedings of a quasi-criminal nature. As a result, the accused was acquitted. |

Appendix G-2: **Tax Evasion Cases**

| The name of the case | Year | The name of the court | Type of activities | The reasons why net worth assessments were used | Was the taxpayer guilty or not? |
|---|---|---|---|---|---|
| **5. Ross** | 1997/ 1998 | Nova Scotia Prinvical Court/Supreme Court | The taxpayer engaged in smuggling operations based on R.C.M.P's information. | Many of the records were destroyed in a fire. | No. The crown's net worth assessment was incomplete and flawed as the crown did not calculate the separate net worth statements for the taxpayer and his wife, so the standard of proof of beyond reasonable in proving tax evasion was not met. |
| **6.Derose** | 2001 | Alberta Provincial Court | Running a cash business. | Taxpayers pocketed or diverted cash from their restaurant and retail businesses which were cash businesses operated through closely held personal corporations | No. The crown could not prove accuracy of the calculations in the net worth assessments or negate all possible sources of nontaxable income. |
| **7.Zuk** | 2005 | Ontario Court of Justice | The taxpayer was a self-employed stock promoter who promoted and traded stocks. | The taxpayer misrepresented income for the 1997 taxation year contrary to ss. 239(1 )(a) and (d) of Income Tax Act. Allegations were derived from a net worth assessment of the accused's assets and liabilities from December 31, 1996 to December 31, 1997 | No, even though common sense would dictate that the taxpayer must have had unreported income. However, common sense is not proof beyond a reasonable doubt. The jurisprudence requires that the crown prove beyond a reasonable doubt either a likely source of the alleged unreported income or disprove beyond a reasonable doubt all non-taxable sources. In this case, the crown has not met its onus on either of the required tests. |
| **8.Hunter** | 2006/ 2008 | Ontario Superior Court/Ontario Court of Appeal | The taxpayer was in the business of trading shares. | No records | Yes.In 2006 at the Ontario Superior Court, the taxpayer was found not guilty because the judge was unable to calculate the amount of unpaid income tax.Later, the crown appealed to the Ontario Court of Appeal where the taxpayer was convicted as there was no evidence that net worth statement was grossly inaccurate. |
| **9.Granston** | 2010 | Tax Court of Canada | (not mentioned) | No records | Yes. The judge confirmed the decision made by the Ontario Court of Justice and Ontario Supreme Court. In addition, the judge thought that the Crown had proved beyond a reasonable doubt the precise amount of unreported income. |

Source: Taxnet pro. Search Terms"net worth" and "239(1)"

## Appendix H: Comparison of the Standard of Proof and Onus

Appendix H: **Compare the Standard of Proof and the Onus**

| **Country** | **Standard of proof** | **Who has the onus** |
|---|---|---|
| | | |
| **Canada** | Beyond reasonable doubt | crown |
| | | |
| **US** | Clear and convincing evidences | taxpayer |
| | | |
| **Australian** | Beyond reasonable doubt | taxpayer |
| | | |
| **New Zealand** | Beyond reasonable doubt | taxpayer |

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