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Issues in Law You Need To Know

Net Worth Assessment - Avoid It At All Costs

A net worth audit is one of the most powerful techniques available to the Canada Revenue Agency (CRA) to unilaterally deem a taxpayer to have a certain amount of unreported income. The net worth audit is a method which, on its premise, assumes the taxpayer has hidden or failed to disclose annual income, and as a result CRA is not able to rely on the accuracy of the amount of taxpayer income from tax returns filed. Subsequently, CRA will use the results of a net worth audit to deem a taxpayer to have unreported income, resulting in allegations of tax evasion or civil fraud against the taxpayer.

In recent years tax professionals have noticed an increase in CRA's use of net worth audits against taxpayers. The CRA appears to be targeting their net worth audits to cash-based businesses, owner-manager businesses and illegal businesses (such as drug dealers).

The following will attempt to answer two primary questions, first, what is a net worth audit and second, what is the burden on a taxpayer faced with a net worth audit.

What is a Net Worth Audit?

A net worth audit is a two-step audit by the CRA. First, the Agency will look at the taxpayer's assets and liabilities at the beginning and end of the tax year and determine the increase and/or decrease in the taxpayer's net worth. Second, the CRA will review the taxpayer's expenditures for that same tax year and compare them with standards of expenditures according to Statistics Canada.

The net worth method relies on the concept that when a taxpayer accumulates wealth during a tax year, he shall either invest it or spend it. For an auditor conducting a net worth audit, they will consider an increase in the taxpayer's net worth throughout the year as taxable income. From that starting point, the auditor will add all non-deductible expenditures to the taxpayer's net worth and then compare the taxpayer's net worth at the beginning of the taxation year and the taxpayer's net worth at the end of the taxation year. Any increase in the taxpayer's net worth will be considered income for tax purposes.

Interestingly, at the audit stage, the CRA has essentially free reign in their assessment and interpretation of the taxpayer's net worth. Indeed, CRA



may assume facts or use general statistics from Statistic Canada in their assessment; in most instances, to the taxpayer's detriment.

Burden is on the Taxpayer

It is important to understand that because the Canadian tax system is a self-assessing system, the onus is on the taxpayer to rebut all of the Minister's assumptions and findings.

The Courts have consistently taken the view that once CRA issues a reas-

assessment based on a net worth audit, the taxpayer must rebut all of CRA's assumptions and findings by either:

1. Challenging whether the net worth assessment is needed or is the most appropriate method of computing the taxpayer's income; or
2. Challenging every specific aspect of the net worth assessment calculations.

In the context of a net worth audit, the taxpayer's onus of proof is a considerable one. Indeed, in most net worth audits, the auditor will have requested all available taxpayer records including, but not limited to, a list of all inventories, physical assets, debts to creditors, bank records, securities, and any other statements of assets.

From the documentation provided, the auditor may have interpreted some book entries and assume facts that may not be accurate, however, the onus is on the taxpayer to provide proof to clarify, explain and rebut all of the auditor's assumptions and interpretation of facts.

When combating a net worth audit, the devil is in the details. Every item, interpretation and assumption of the auditor must be analyzed in great detail and dissected for correctness.

Indeed, with every error found, the trustworthiness of this inherently untrustworthy method is called further into question.

If the matter is to proceed before the Tax Court of Canada, pointing out the auditor's errors in their interpretation shall contribute to discrediting the auditor's findings and tilt the judge's opinion in favor of the taxpayer. However, the taxpayer will also need to provide evidence explaining and clarifying the increase in his net worth over the year.

A valid explanation, such as the receipt of an inheritance, will undoubtedly favor the taxpayer in his pursuit of rebutting the auditor's finding. However, if the taxpayer lacks any evidentiary documentation attesting his point then the matter becomes one of credibility; something a taxpayer should always avoid.

Conclusion

Maintaining well-organized documents and financial records is truly the sole solution for succeeding over a net worth audit. Indeed, documenting all receipts of significant funds received during the taxation year, especially any foreign funds, is the very best way to beat a net worth audit.

My former colleague Arthur Drache once wrote: "good paper almost always will prevail, but in a contest of your unsupported word against CRA, you'll almost always lose." This remains the gold standard in a net worth audit.

If you are the subject of a net worth audit, we highly recommend you consult with your accountant and lawyer.

Tierney Stauffer LLP would be glad to assist and advise you. If you have any questions, please do not hesitate to contact us.

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PRACTICE SUMMARY:

Sébastien joined Tierney Stauffer LLP as an Associate in the Wills, Estates & Trusts Planning & Administrative Practice Group in 2009. His practise focuses on estate planning, will drafting and personal and corporate taxation. Sébastien has experience in resolving disputes with the Canada Revenue Agency (CRA), filing voluntary disclosures, assisting individuals with their tax related issues and tax planning for families and businesses. Sébastien is bilingual and practices in both official languages.

He has spoken at various seminars on estate, trust and tax matters. Sébastien has also appeared on radio and television discussing legal issues. He is a tutor for the Law Society of Upper Canada for the Estate Practice section.

Prior to joining Tierney Stauffer LLP, Sébastien practiced with another Ottawa law firm where he gained experience in tax law, charity law, estate planning and will drafting.