

Docket: 2006-3100(IT)I

BETWEEN:

JACEK MILKOWSKI,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on July 25, 2007, at Toronto, Ontario
By: The Honourable Justice Campbell J. Miller

Appearances:

Agent for the Appellant: Costa A. Abinajem
Counsel for the Respondent: Brandon Siegal

JUDGMENT

The income tax appeal for the 2001 taxation year is allowed and the assessment is vacated.

The income tax appeals for the 2002 and 2003 taxation years are allowed and the matter is referred back to the Minister on the basis that that Mr. Milkowski's underreported income in 2002 was \$7,068 and in 2003 was \$8,017 and that there are no section 163(2) gross negligence penalties.

Signed at Ottawa, Canada, this 7th day of November, 2007.

“Campbell J. Miller”

C. Miller J.

Docket: 2006-3099(GST)I

BETWEEN:

JACEK MILKOWSKI,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on July 25, 2007, at Toronto, Ontario
By: The Honourable Justice Campbell J. Miller

Appearances:

Agent for the Appellant: Costa A. Abinajem
Counsel for the Respondent: Brandon Siegal

JUDGMENT

The GST appeal is allowed and referred back to the Minister on the basis that there is no underreported income in 2001, but \$9,424 and \$10,690 of unreported income in 2002 and 2003 respectively: there are no section 285 gross negligence penalties.

Signed at Ottawa, Canada, this 7th day of November, 2007.

“Campbell J. Miller”

C. Miller J.

Citation: 2007TCC680
Date: 200711
Docket: 2006-3099(GST)I
2006-3100(IT)I

BETWEEN:

JACEK MILKOWSKI,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Miller J.

[1] This is a net worth assessment case. The use of the net worth assessment has been described as the use of a blunt instrument, yet that bluntness can be sharpened by reasonable, respectful dialogue between the parties outside the trial setting. That did not happen in this case. That is regrettable.

[2] Mr. Milkowski appeals by way of the informal procedure assessments under both the *Income Tax Act* and the *Excise Tax Act* for the three-year period of 2001, 2002 and 2003. The Minister of National Revenue has also assessed penalties and interest.

[3] Mr. Milkowski is a painter by trade. During the relevant period, he carried on his painting business in partnership with his wife on a 75-25% split. Most of Mr. Milkowski's work was in commercial premises (about 90%) with the balance on residential. He testified that he always received payment by cheque from the general contractors for whom he worked. Seventy to 80% of his work was for one general contractor: the balance of his work came from two or three other general contractors. Occasionally, Mr. Milkowski had to hire subcontractors to get a job

finished. Most jobs were remunerated on the basis of so much per square foot: 22¢ was an amount Mr. Milkowski suggested was common.

[4] Mr. Milkowski filed his income tax returns for the 2001, 2002 and 2003 taxation years, reporting gross income from the business of \$59,260, \$45,930 and \$48,735, respectively, and net income of \$18,871, \$10,754 and \$7,781, respectively. He reported his personal total income as \$10,626, \$6,278 and a loss of (\$3,175) in 2001, 2002 and 2003, respectively.

[5] In 2005, Canada Revenue Agency (“CRA”) conducted an audit. They received from Mr. Milkowski business bank statements, invoices and certain other records. Due to a belief that the income reported could not support the lifestyle of a family of five, CRA proceeded to conduct a net worth assessment. When the Appellant, and more particularly his accountant, were made aware of the net worth approach, they provided no further information to CRA. The auditor suggested there were two financial tests that supported the notion of underreported income: the bank deposit analysis and the source and application of funds analysis. The bank deposit analysis consisted of totalling all the bank deposits for 2001 and noting that the total of \$64,470 was \$7,280 greater than Mr. Milkowski’s gross income reported. The source and application of funds analysis for 2003 noted that there were funds applied of \$346,302 with a source of only \$294,861. This was in large measure due to purchasing a home, for which Mr. Milkowski relied on savings, a line of credit and a mortgage. He was first refused a mortgage by TD Canada Trust, as his down payment was too small, so he had to go through a broker to get a mortgage.

[6] The auditor proceeded to conduct the net worth assessment based on information already provided by the Appellant including income tax returns filed, and also based on Statscan’s statistics. CRA concluded that the Appellant had underreported income by \$14,205, \$18,298 and \$35,337 in 2001, 2002 and 2003, respectively, and assessed accordingly under both the *Income Tax Act* and the *Excise Tax Act*. In a proposal letter dated April 25, 2005, CRA stated:

After conducting a factual audit of your business, we have determined that your revenues and expenses matched the documentation provided. However, we believe that your net income is too low to support your lifestyle. In order to determine your correct income we have employed an indirect audit technique for the three-year period. The additional income was calculated using the net worth method of assessment. Calculating the change in net worth from year to year and then making adjustments for personal expenditures and non-taxable income sources, have determined your minimum income requirements.

So, following that approach, the auditor calculated assets and liabilities, both personal and business, acknowledging that he only had personal banking information for one year and no information with respect to mortgage principal reduction, which he assumed was \$6,300 in 2001, \$4,200 in 2002 and \$4,200 in 2003. He also calculated a summary of personal expenditures under the following 14 headings:

- 1) Food
- 2) Shelter
- 3) Household operations
- 4) Clothing
- 5) Transportation
- 6) Health care
- 7) Personal care
- 8) Recreation
- 9) Reading material and other printed matter
- 10) Education
- 11) Tobacco and alcohol
- 12) Security
- 13) Gifts and contributions
- 14) Miscellaneous

For the purposes of determining the shelter, transportation and health care expenses, the auditor relied on information received from the Appellant. For everything else he relied on Statscan's statistics. Notices of Reassessment for the 2001, 2002 and 2003 taxation years were received on July 21, 2005 and confirmed on July 25, 2006.

[7] Mrs. Milkowski testified as to the household expenditures. Her evidence was that the family lived at a very low standard as they had little money. She discussed their food requirements and needs including household maintenance needs, and estimated about \$150 a week in 2003. She outlined the clothing requirements and suggested approximately \$2,400 a year was accurate. She similarly went through their social, recreational and educational needs setting costs significantly less than CRA's estimates based on Statscan. It also came to light that one of the Milkowski's children had income of \$4,800 in 2003.

[8] Issues

- (i) Is CRA statute-barred from reassessing 2001 under the *Income Tax Act*?
- (ii) If not, are the net worth assessments correct for purposes of both the *Income Tax Act* and GST liability for 2001, and also for 2002 and 2003?

Analysis

[9] Mr. Abinajem, the Appellant's agent, made two major submissions regarding the net worth assessment:

1. First, it is unwarranted;
2. Second, it is incorrect.

[10] With respect to his position that it is unwarranted, Mr. Abinajem argued that as a method of last resort, an arbitrary net worth assessment should not be relied upon when there are books and records in place. In this case he maintained the Appellant had proper accounts and records and that the auditor even acknowledged by letter that "after conducting a factual audit of your business, we have determined that your revenue and expenses match the documentation provided". CRA's letter identifies the reason for the audit was a belief that income was too low to support the Milkowski's lifestyle. Mr. Abinajem argues this approach would open the floodgate to abusive and unnecessary audits.

[11] The authority for the net worth assessment is found in subsection 152(7) which reads:

The Minister is not bound by a return or information supplied by or on behalf of a taxpayer and, in making an assessment, may, notwithstanding a return or information so supplied or if no return has been filed, assess the tax payable under this Part.

[12] This section has been relied upon by CRA to assess on whatever basis it determines is appropriate, including an arbitrary or net worth assessment. These assessments are used in many cases where the taxpayer refuses to file a return, files a return that is grossly inaccurate or does not furnish any evidentiary support or documentation to allow CRA to verify the return. Mr. Abinajem maintains none of these circumstances exist in this case. Mr. Siegal, for the Respondent, argues that

Mr. Milkowski's declared net income was grossly inaccurate justifying the net worth assessment.

[13] Can the Court find the subsection 152(7) assessment is invalid due to the circumstances surrounding its instigation, and proceed to vacate the assessment on that basis? No.

[14] There are no limitations written into subsection 152(7) that serve as preconditions subject to review by this Court. This is not a two step process of first determining whether CRA can make an assessment, and only then determining the correctness of that assessment. If a taxpayer believes CRA is acting abusively in invoking subsection 152(7), then the remedy may be found in an action for abuse of process. But once the assessment is issued, subsection 152(8) deems that assessment to be correct and it is the correctness of the assessment at issue before this Court.

[15] I will turn therefore to the assessment itself. The parties spent all day on the evidence of the Milkowskis and the CRA auditor, to the point that there was no time at the end of the day for oral argument. The parties provided me with over 60 pages of written argument. The Respondent conceded certain points in the net worth assessment. The Appellant emphasized the auditor's errors and inappropriate motivation for conducting a net worth in the first place, which I have addressed. I have seen no better example than this case for insisting that parties involved in a net worth assessment meet long before trial with each other and their respective financial advisors to work through the numbers. They have not done so.

[16] I find that parts of the net worth assessment are inaccurate. The following is my summary of the adjustments to be made to the net worth assessment, based on the testimony I have heard from the Milkowskis and a review of the Government's Statscan's statistics. I have related my adjustments to the CRA's audit schedules:

- Schedule I – Assets
- Schedule II – Liabilities
- Schedule III – Adjustments
- Schedule IV – Personal Expenditures

Deductions from Underreported Income

2001 2002 2003

From Schedule I

Value of vehicle	-\$1,200 ¹	-\$900	-\$8,459 ²
<u>From Schedule II</u>			
Difference in net worth arising from accurate mortgage balances (see Appendix A)	-\$3,281	\$308	\$19
<u>From Schedule III</u>			
Ontario supplement	-\$1,100	-\$1,100	-\$308
Additional family income			-\$4,800
<u>From Schedule IV</u>			
Food	-\$2,000	-\$2,000	-\$2,000
Shelter (agreed)		-\$1,800	-\$11,544
Household	-\$1,000	-\$1,000	-\$1,000
Clothing	-\$1,250	-\$1,250	-\$1,250
Personal care	-\$500	-\$500	-\$500
Recreation	-\$1,500	-\$1,500	-\$1,500
Education	-\$500	-\$500	-\$500
Tobacco and alcohol	-\$500	-\$500	-\$500
Security (agreed) ³	-\$2,745	-\$3,293	-\$3,660
Gifts	-\$500	-\$500	-\$500
Transportation (agreed)	-\$1,654	-\$167	\$355
Other (agreed)	<u>-\$266</u>	<u>-\$272</u>	<u>-\$280</u>
Total	<u>-\$17,996</u>	<u>-\$14,974</u>	<u>-36,427</u>
Government underreported income	\$18,940	\$24,398	\$47,117
Actual underreported income	\$944	\$9,424	\$10,690

[17] The Appellant argued that adjustments should also have been made in the following areas:

¹ Value overstated.

² No longer owned vehicle.

³ The parties agreed on expenses for security, though these included RRSP contributions, which had already been included in Schedule I so these amounts have also been backed out of this category.

1. RRSPs – I find the auditor correctly listed the contributions to RRSPs as assets, and not as security, which is where the Appellant showed the contribution. This has the effect of reducing the security amount in Schedule IV, otherwise there would be a doubling-up.
2. Credit card liability – There was insufficient evidence to indicate changes from one year to the next to make any adjustments in this category.
3. Capital cost allowance – The Appellant argued that the non-cash CCA on fixed assets should be deducted from the increase in net worth. This would be acceptable had the fixed assets remained constant from year to year. However, CRA reduced the asset value of the fixed assets by taking into account the CCA; therefore no further deduction is in order.

[18] I conclude from this review that Mr. Milkowski's 2001 tax return was accurate: he made no misrepresentation justifying the application of subsection 152(4) which would allow the Respondent to assess Mr. Milkowski's 2001 taxation year beyond the normal reassessment. The appeal from the 2001 taxation year is therefore allowed and the assessment is vacated.

[19] With respect to the 2002 and 2003 taxation years, the underreported income is to be adjusted downwards to \$9,424 and \$10,690 respectively, Mr. Milkowski's portion being 75% of those amounts.

[20] There remains the issue of penalties for the 2002 and 2003 taxation years. Subsection 163(2) of the *Act* stipulates that a taxpayer is liable for penalties where he has knowingly or under circumstances amounting to gross negligence made or participated in the making of the false statement or omission in a return. The parallel provision is found in section 285 of the *Excise Tax Act*. When a gross negligence penalty is imposed, the onus is on the Minister on a balance of probabilities to prove the gross negligence. It does not follow that just because there is an underreported income there has been gross negligence on the part of the taxpayer. The Respondent acknowledges there must be other factors and suggests the following in this case: magnitude of the unreported income, percent of unreported income to the amount which should have been reported and the lack of credibility of the Appellant with respect to mortgage and other borrowings.

[21] With respect to the magnitude of the underreported income, while there is no hard and fast measure, I find that underreported income of approximately \$10,000 given the numerous areas of possible dispute and the range of alternative estimates is not so significant as to render it a certainty that Mr. Milkowski knew or ought to have known he was underreporting. The shortfall of \$10,000 does, however, represent a significant proportion of what should have been reported in 2002 and 2003. With respect to the mortgage, the Respondent argues that the size of the mortgage and the rate obtained do not suggest a high-risk loan and therefore Mr. Milkowski must have shown the lender more assets and income than he reported. The Respondent also referred to Mr. Milkowski's line of credit to suggest this position. This is only conjecture on the Minister's part, and certainly not sufficient proof to meet the onus of proving gross negligence.

[22] Finally, I am swayed by the fact that Mr. Milkowski did provide books and records of which CRA wrote "we have determined that your revenue and expenses match the documentation provided". While the Appellant has been unable to satisfy me, on balance, that the income he reported is accurate, the Minister has likewise not satisfied me that the inaccuracy of the Appellant's underreporting arises from gross negligence.

[23] The income tax appeal for 2001 is allowed and the assessment is vacated on the basis that the Minister simply assessed too late. The income tax appeals for the 2002 and 2003 taxation years are allowed and the matter is referred back to the Minister on the basis that that Mr. Milkowski's underreported income in 2002 was \$7,068 and in 2003 was \$8,017 and that there are no subsection 163(2) gross negligence penalties. The GST appeal is allowed and referred back to the Minister on the basis that there is no underreported income in 2001, but \$9,424 and \$10,690 of unreported income in 2002 and 2003, respectively. Again, there are no section 285 gross negligence penalties.

[24] I make no award of costs.

Signed at Ottawa, Canada, this 7th day of November, 2007.

“Campbell J. Miller”

C. Miller J.

Appendix "A"

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
CRA Net Worth	\$45,276	\$53,988	\$53,934	\$50,268
Increase in mortgage*	\$12,728	\$16,009	\$15,513	\$15,493
Revised Net Worth	\$32,548	\$37,979	\$38,421	\$34,725
Less Prior Year		\$32,548	\$37,979	\$38,421
Increase (decrease) in Net Worth		\$5,431	\$442	(\$3,646)
CRA's Increase in Net Worth		\$8,712	(\$54)	(\$3,665)
Deduction from Net Worth		\$3,281	(\$388)	(\$19)

* As agreed by parties.

CITATION: 2007TCC680
COURT FILE NO.: 2006-3099(GST)I. 2006-3100(IT)I
STYLE OF CAUSE: JACEK MILKOWSKI AND HER
MAJESTY THE QUEEN

PLACE OF HEARING: Toronto, Ontario

DATE OF HEARING: July 25, 2007

REASONS FOR JUDGMENT BY: Campbell J. Miller

DATE OF JUDGMENT: November, 2007

APPEARANCES:

Agent for the Appellant: Costa A. Abinajem
Counsel for the Respondent: Brandon Siegal

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