Citation: 2011 TCC 14
Date: 20110110
Docket: 2006-2873(IT)G

BETWEEN:

SERGUEI VATCHIANTS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

REASONS FOR JUDGMENT

Jorré J.

I. Introduction

[1] This is an appeal from assessments dated March 17, 2004, in respect of the 1997, 1998, 1999 and 2001 taxation years.[1]

[2] The assessments result from an estimate of the appellant's income by the Canada Revenue Agency (CRA); the so-called net worth method was used.

[3] The CRA added the following amounts to the income that the appellant had previously reported, and assessed penalties under subsection 163(2) of the *Income Tax Act*:

Year	Income added	Penalties assessed
1997	$345,308.25	$45,209.66
1998	$242,475.36	$30,402.98
1999	$640,054.30	$80,518.69

[1] The parties agree that there is no dispute regarding the 2001 taxation year, but that the decision concerning the years 1997 to 1999 will have an impact on the year 2001.

[4] The issues are as follows:

1. Was the CRA right to add the amounts to the appellant's income? The appellant contends that there are several mistakes in the calculation of net worth.

2. Was the CRA right to assess penalties under subsection 163(2) of the ITA?

3. Was the CRA right to make assessments beyond the normal three-year period?

[5] In very large part, these issues are questions of fact.

[6] Sonia Sariboyajian of the CRA testified and explained the net worth calculation that she prepared. The appellant also testified.

[7] Since the appellant is not challenging the entire net worth assessment, but, rather, has limited his challenge to certain factual aspects and some of the methodology, I will proceed by examining the appellant's criticisms. The respondent has already made certain concessions at the close of the case, and I will simply list those concessions, without examining the dispute surrounding the facts that led to them.

II. Background

[8] The appellant is a civil engineer by training.

[9] The appellant was a senior state employee in the former Soviet Union. Among other things, he was the chief executive of a company that built hospitals and clinics for the Ministry of Health. He spent part of his career in government working abroad in Algeria and Iran.

[10] In 1988, shortly after the economic liberalization of the Soviet Union began, the appellant created a first business called Drevo.[2]

[2] Although the appellant referred to a cooperative at one point in his testimony, that testimony, and notably the fact that he described himself as a sole shareholder at the beginning, leads me to believe that it is indeed a company and not a cooperative.

[11] Later, he gave 10% of the shares of Drevo to his wife, 10% to Albert Diakonov, and 4% to his accountant Ms. Taraskula.

[12] Around 1990, the appellant created another company called Drevco, which he described as a joint venture.[3] Drevo owned 51% of the shares of Drevco.[4]

[13] Initially, the other 49% of Drevco belonged to a Swedish business and a Dutch business, but these businesses did not make the investments they were supposed to make, and were replaced by a British business called Cosmos Trading and an Egyptian business called Banna Wood.

[14] Drevco operated a lumber and transportation business.

[15] The foreign (British and Egyptian) businesses, like the two businesses that preceded them, did not meet their obligations toward Drevco and, in early 1994, everyone agreed that they would withdraw from Drevco.[5]

[16] It is from this point onward that certain events related to Drevco become relevant to this litigation.

[17] Before examining these events, in order to complete the context, it must be noted that the appellant arrived in Canada as an investor immigrant in 1996 after obtaining his visa earlier that year.[6]

[18] For the purposes of his visa application, he prepared a personal balance sheet, which indicated a significant net worth: approximately C$7,000,000.[7]

[19] It is worth recalling that the late 1980s and the 1990s were a turbulent period in Russia, marked by an extremely rapid transition from a centrally planned economy to a form of market economy, and by the end of the Soviet Union. It is widely known that there were major economic difficulties during these transitions.[8]

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[3] When, for example, the English translation of the documents at tab 5 of Exhibit A-2 is examined, there is no doubt that it is a company, not a contractual relationship.
[4] There were several businesses called Drevco. See below.
[5] As described in paragraph 1 of the minutes of January 25, 1994 (Exhibit A-2, tab 3). For the purposes of the appeal, the manner in which these companies "withdrew" is entirely unimportant, but we will see that the relevant company, Drevco, is a new company.
[6] Exhibit I-2, tab 7, last page.
[7] *Ibid.*, first page.
[8] Such transitions also call for significant legal changes.

[20] The CRA used the net worth method because it considered that the incomes reported by the appellant and his wife were modest (slightly below $90,000 in total for the 1997, 1998 and 1999 taxation years) compared to the appellant's lifestyle.

[21] The documents obtained by the CRA include two letters addressed to General Trust of Canada in support of a credit application. The first letter, dated October 28, 1996, and signed by the appellant, asserts that he owns two large companies in Russia and receives a stable income of $5,000 to $8,000 per month from those companies. The letter is written on Drevco letterhead.[9]

[22] A second letter to General Trust, this one unsigned, is from Drevco's head accountant. This letter, dated November 11, 1996, is also written on Drevco letterhead, and states that Drevco's annual sales exceed US$15,000,000, and that the appellant's income is US$10,000 per month.

[23] The CRA also obtained notes taken by an employee of the financial institution on November 18, 1996, with respect to a conversation that she had with the appellant. The employee's notes say that the appellant's income was US$10,000 per month.

[24] These documents undoubtedly influenced the CRA's decision to make the assessments.

III. The appellant's criticisms regarding net worth[10]

[25] Firstly, the appellant submits that the net worth does not take into account a major loan which he made, and which was partially repaid in several stages.

[26] Secondly, the appellant is making certain criticisms of the estimation method.

[27] Thirdly, he has specific criticisms apart from the first, though only one of these remains in dispute.

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[9] See Exhibit I-3, which contains a credit application evaluation form, as well as the two letters, and notes on conversations.

[10] I will not be following the order in which the appellant presented these criticisms.

A. Truck purchase financing

[28] The evidence on this issue was not ideal. Additional documentation on certain points would normally be expected, even considering the amount of time between the events of 1994 and the beginning of the audit.[11] The appellant's answers were not always easy to follow,[12] though I find that this was partly because the appellant testified in a language that is not his mother tongue.[13] Consequently, I can understand why the dispute about this aspect of the assessment has made it to this stage.

[29] Nonetheless, as I will explain below, I accept a very large part of the appellant's testimony on this aspect of the instant dispute.

[30] As we shall see, part of the problem stems from the fact that, in the Russian legal context of 1994, the appellant could only accomplish all his objectives if the amount of US$1,000,000 that he was to provide for the purchase of the trucks by Drevco was simultaneously a loan and an investment toward the purchase of shares.

Did the appellant make a US$1,000,000 loan in 1994?

[31] In 1994, according to the appellant, it was decided that he would invest the equivalent of US$1,000,000,[14] which he held outside Russia, to finance the purchase of ten tractors and ten trailers (hereinafter, "the trucks") that would be used in Drevco's transportation business.

[32] The appellant had several objectives: he wanted to finance the purchase of the tractors and trailers, ensure that he could take the US$1,000,000 outside Russia once Drevco had "paid" for the trucks, and prevent Drevco from paying 25% in customs duties upon importing the tractors and trailers.[15]

[33] At the time, Russian law offered several advantages to foreign companies that invested in companies and joint ventures in Russia. Among other things, they could remove capital from the country under circumstances in which Russians could not.

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[11] The audit began in July 2000. In September 2001, the file was transferred to special investigations, and in April 2003, it was returned to the audit branch (Exhibit I-2, tab 33, page 2).
[12] For example, see transcript, March 3, 2009, questions 571 to 576.
[13] The appellant learned Armenian and Russian before learning other languages; see Exhibit A-2, tab 2, and Exhibit I-2, tab 7, box 17 of the visa.
[14] The price of the trucks was in Deutschmarks.
[15] Transcript, March 3, 2009, question 156.

[34] Moreover, foreign companies that made investments in the form of property benefited from an import tax exemption.[16]

[35] To take advantage of these benefits, the appellant incorporated Paron Transport in England in November 1994 and became the sole shareholder of that company by purchasing one share for one pound sterling.[17]

[36] I accept the appellant's testimony that he loaned US$1,000,000 to Paron.[18]

[37] However, for the following reasons, I do not find that Paron or the appellant made a loan to Drevco.

[38] The appellant's testimony and his other evidence on this question are in conflict. At times, the appellant testified that a loan was involved, but his documentary evidence shows that Paron paid for its majority interest in Drevco by contributing the trucks purchased for the equivalent of US$1,000,000. (This was a new company called "Drevco".)

[39] There cannot be an acquisition of Drevco shares by Paron in consideration for the contribution of tractors and trailers, and, simultaneously, a US$1,000,000 loan from Paron to Drevco.

[40] I have no doubt that the appellant's objective was to lend his funds to Drevco in order to enable Drevco to purchase the trucks. I have no doubt that the appellant feels, from both an economic and practical perspective, that he made a "loan" in the sense that he took personal money, that this money enabled Drevco to obtain the new trucks, and that he expected to recover the entire amount of US$1,000,000.

[41] There is no loan contract with Drevco for US$1,000,000.

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[16] Tax or customs duties.

[17] Exhibit A-2, tab 4, pages 1 to 3; Exhibit A-4, folder no. 4.

[18] Not only did he testify to this effect, there was also some indirect corroboration:

(i) the Russian customs declaration and the value declared on the form, both of which support the fact that Paron acquired the trucks (Exhibit A-2, tab 7);

(ii) the Drevco meeting minutes of January 25 and December 23, 1994 (Exhibit A-2, tabs 3 and 6);

(iii) the fact that the share capital of Paron was only one pound sterling, which means that Paron had to obtain the funds elsewhere.

Moreover, there was no advantage for the appellant to purchase shares at a price of US$1,000,000 instead of making a loan to Paron. As for the absence of financial statements for Paron, the appellant's testimony was that Paron existed solely to finance the purchase of the trucks and that he wanted to minimize Paron's expenses (transcript, March 3, 2009, questions 552 to 558). Although a company normally prepares financial statements, I accept the appellant's testimony that, in order to save money, he decided not to have any financial statements prepared.

[42] There are references to a loan in Drevco's minutes of January 25, 1994, at paragraphs 2 to 5, and its minutes of December 23, 1994, at paragraphs 1 to 5.[19] Among other things, it stated:

> [Translation from the original Russian of the minutes of January 25, 1994, tendered in evidence.]
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> 5. The shareholders understand that S.G. Vatchiants invests his personal money to purchase the trucks and trailers, since currently all the funds of the Joint Venture are involved in the business activity of the company. The shareholders agree to regard the money that S.G. Vatchiants will pay for the trucks and trailers as well as the expenses incurred by opening and maintaining a European company, as a loan to the Drevco company, obtained through the new European company. The loan must be repaid to S.G. Vatchiants as per a separate agreement or Minutes, which shall be drawn later, when the parties will know the exact amount spent by S.G. Vatchiants on the purchase of the trucks and trailers, as well as the maintenance of the new company.[20]
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> [Emphasis added.]

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[19] The Drevco in question in the minutes of January 25, 1994, is the "Soviet-English-Egyptian Joint Venture Drevco", a different company from the "Drevco Joint-Stock Company" referred to in the minutes of December 23, 1994. Paron is the majority shareholder of the latter company. A reading of clause 8 of Drevco's articles of incorporation clearly shows that the founding shareholders created a new company, the "Drevco Joint-Stock Company" (Exhibit A-2, tab 5). The minutes quoted are at tabs 3 and 6 of the same exhibit.

[20] The French translation of the excerpt in question is as follows:

[TRADUCTION]

5. Les actionnaires conviennent que S.G. Vatchiants investit ses fonds personnels dans l'achat des camions et des remorques, puisque tous les fonds de la coentreprise sont présentement consacrés à l'exploitation de la société. Les actionnaires acceptent de considérer les sommes que S.G. Vatchiants versera pour les camions et les remorques, ainsi que les coûts liés à la constitution et au maintien d'une société européenne, comme un prêt à la société Drevco obtenu par l'entremise de la nouvelle société européenne. Le prêt sera remboursé à S.G. Vatchiants conformément à une entente ou à un procès-verbal distinct, rédigé ultérieurement lorsque les parties connaîtront le montant précis que S.G. Vatchiants aura versé pour l'achat des camions et des remorques et pour le maintien de la nouvelle société. [Je souligne.]

> [Translation from the original Russian of the minutes of December 23, 1994, tendered in evidence.]
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> 1. The shareholders of the company understand and agree that Mr. S.G. Vatchiants is the sole owner of PARON TRANSPORT LIMITED, and that the 10 Mercedes Benz trucks as well as 10 Crona trailers, for the total amount of DM 1,710,000, placed by PARON company as its share in the capital fund of Drevco Joint Venture, were purchased by Mr. Vatchiants with his own money, and that the parties consider it a loan to the Joint Venture Drevco.[21]
>
> [Emphasis added.]

[43] The fact that the parties say that they "agree to regard the money . . . as a loan to the Drevco company" cannot, in and of itself, create a loan in the absence of an advance of funds or property constituting the subject matter of a loan.[22]

[44] An examination of clause 8 of Drevco's articles of incorporation[23] reveals that Paron contributed the tractors and trailers in consideration for the shares that it received.

[45] Since Paron acquired a majority of the shares in consideration for the trucks purchased for the sum of US$1,000,000, it is impossible for Paron to have loaned US$1,000,000 or its equivalent to Drevco.

[46] Thus, the appellant loaned US$1,000,000 to Paron, which purchased the trucks, and Paron acquired the majority of Drevco’s shares in consideration for the trucks. There was no loan to Drevco.

The amounts owed to Drevco which were paid to the appellant

[47] Various amounts that were owed to Drevco were paid to the appellant.

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[21] The French translation of the excerpt in question is as follows:
[TRADUCTION]
1. Les actionnaires de la société reconnaissent et conviennent que M. S.G. Vatchiants est l'unique propriétaire de PARON TRANSPORT LIMITED et qu'il a acheté avec ses fonds personnels les 10 camions de marque Mercedes Benz et les 10 remorques de marque Crona, dont le coût total est de 1 710 000 marks allemands, que la société PARON a affectés à titre de sa part des capitaux propres de la coentreprise Drevco. Les parties considèrent qu'il s'agit d'un prêt à la coentreprise Drevco. [Je souligne.]

[22] We can also wonder about the effect of the agreement of the January 25, 1994 meeting of the "Soviet-English-Egyptian Joint Venture Drevco" on the new Drevco company, a distinct company, created in December 1994. An agreement between Cosmos Trading, Banna Wood and Drevo could not be binding on Paron and Drevo.

[23] Exhibit A-2, tab 5.

[48] The respondent's position is that even if the appellant made a loan, there was an appropriation, and the amounts paid to the appellant must be included in income under subsection 15(1) or 246(1) of the ITA.

The sale of the trucks to Hilton Construction

[49] The largest amount is from the sale of the trucks by Drevco to Hilton Construction for US$400,000 in 1999.[24]

[50] Further to Drevco's instructions,[25] this amount was transferred directly from Hilton Construction to the appellant's bank account in Montréal in 1999.[26]

[51] Since there was no loan by the appellant to Drevco or from Paron to Drevco, and this was not a dividend,[27] this was an appropriation by Drevco.

[52] At the time, the appellant was the sole shareholder of Paron, and held at least 76% of the shares of Drevo, which means that he indirectly controlled Drevco. He also chaired Drevco's board of directors.[28] Therefore, he controlled all of Drevco's decisions.

[53] Was this an appropriation by Drevco in favour of the appellant, or an appropriation by Drevco in favour of Paron?

[54] Given the minutes of December 23, 1994,[29] which reveal an intent to treat Paron's investment as a loan, and given the minutes of November 28, 1998,[30] which state, among other things, at the bottom of the first page, that the proceeds of the sale of the trucks [TRANSLATION] "shall be used to offset the debt to PARON"[31] and the

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[24] I accept the appellant's testimony that this sale took place. See transcript, March 3, 2009, questions 357 to 372. In addition, see Exhibit A-2, at tabs 23 to 28, and Exhibit I-2, at tab 14, which show a U.S. dollar deposit in May into the appellant's account at the National Bank.

In coming to this conclusion, I have taken into account the fact that, according to the Russian tax authorities, Hilton Construction was not registered with the Moscow tax authorities. I did not accord much importance to this, given the other documents in evidence. See Exhibit I-8.

[25] Exhibit A-2, tab 25.

[26] There was a transfer of US$49,995.12 and a transfer of US$349,990.23 (Exhibit A-2, tabs 26 and 27).

[27] Nor was this a benefit conferred on a shareholder within the meaning of paragraphs 15(1)(*a*) to (*d*) of the ITA.

[28] See the attendances noted at the beginning of the minutes of April 10, 1999, and June 26, 1999 (Exhibit A-2, tabs 24 and 28).

[29] Exhibit A-2, tab 6, paragraphs 1 to 4.

[30] The minutes contain the decision to sell the trucks and states that, due to the economic difficulties that started in August 1998, the transportation business experienced losses, and that Drevco therefore decided to cease its transportation activities (Exhibit A-2, tab 23).

[31] Translation from the original Russian of the minutes of November 28, 1998, tendered in evidence.

fact that Paron, represented by the appellant, had already received certain amounts, I find that the appropriation was made by Drevco in favour of Paron.[32]

[55] The appellant had kept these amounts given the loan of US$1,000,000, so there was a partial setoff between the appellant and Paron.

[56] Under these circumstances, there cannot have been an appropriation by Paron in favour of the appellant.

[57] Consequently, subsection 15(1) of the ITA cannot apply to the appellant.

[58] The respondent also relied on subsection 246(1)[33] of the ITA. One of the conditions that must be met for that subsection to apply is that the amount of the benefit must be an amount that would be included in the taxpayer's income only "if the amount…were a payment made directly by the person to the taxpayer."

[59] Even if it is assumed that all the other conditions of subsection 246(1) are met, the fact is that if Paron had paid the amount directly to the appellant, the US$400,000 would be a repayment, and the amount would not be taxable.

[60] I therefore accept the appellant's argument that the amount must not be included in income, and the Canadian dollar equivalent of US$400,000[34] (namely C$580,458.74)[35] must be subtracted from the appellant's 1999 income.[36]

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[32] Although other minutes, subsequent to those of November 28, 1998, refer solely to the debt to the appellant and not to Paron, they refer to the minutes of November 28, 1998, and December 23, 1994. Consequently, upon reading everything as a whole, I find that the payments were received by the appellant for Paron.

[33] Subsection 246(1) reads:

> **246. (1) Benefit conferred on a person** — Where at any time a person confers a benefit, either directly or indirectly, by any means whatever, on a taxpayer, the amount of the benefit shall, to the extent that it is not otherwise included in the taxpayer's income or taxable income earned in Canada under Part I and would be included in the taxpayer's income if the amount of the benefit were a payment made directly by the person to the taxpayer and if the taxpayer were resident in Canada, be
>
> (*a*) included in computing the taxpayer's income or taxable income earned in Canada under Part I for the taxation year that includes that time;
>
> . . .

[34] US$349,990.23 + US$49,995.12 = US$399,985.35, to be more precise.

[35] The appellant provided the Bank of Canada exchange rates on the date of the two transfers. Since the respondent did not object, I used this information for the conversion into Canadian dollars. The Bank of Canada provides a minimum and maximum rate for each day. I used the average of the two, that is to say, (US$349,990.23 X 1.45125) + (US$49,995.12 X 1.45125) = C$580,458.74.

[36] Strictly speaking, the assets for the base year would have to be increased by the amount of the US$1,000,000 loan to Paron and reduced in 1999, and the entire net worth calculation would have to be redone. However, the practical effect once all of this is done is to reduce the 1999 income estimate by C$580,458.74.

The other amounts owed to Drevco and paid to the appellant

[61] Other amounts were owed to Drevco and paid to the appellant with a view to "repaying" the "loan" that he had made.[37]

Sale of equipment in 1997

[62] Before examining the other amounts, it is important to point out that, in his testimony, the appellant stated that certain amounts that he was paid were not sent to Canada.

[63] According to Drevco's minutes of June 26, 1999,[38] an amount of US$260,000 was paid to the appellant following an equipment sale that took place in 1997.

[64] In his testimony, the appellant said that part of this amount came to Canada, but that another part remained in his bank account in Russia, where he used it, among other things, to make a gift to two of his children in Russia and to make a very large advance support payment to his first wife in Russia.[39]

[65] The entire amount that remained in Russia consists of expenses, or increased assets in Russia, which the CRA did not take into account in estimating income. These Russian expenses, or increases in Russian assets, result in an increase of the appellant's income,[40] but are offset by the fact that the loan repayment is capital in nature. The net result is nil, and any repayment that remained in Russia has no effect on the income estimate.

[66] The repayment in the nature of capital can only reduce the estimated taxable income to the extent that the repayment came to Canada.

[67] If I understand the appellant's argument correctly, he is not submitting that the "repayment" of US$260,000 should reduce his taxable income. Consequently, I am not taking it into account.[41]

Loan to Andrey N. Skibinsky

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[37] A first sum of US$78,000 appears to have been paid to the appellant in 1996. This amount has no impact on the end result, because the effect is to reduce the assets for the base year and for all subsequent years by that amount.
[38] Exhibit A-2, tab 28, point 3.
[39] Transcript, March 3, 2009, questions 614 to 617.
[40] Since these Russian expenses do not appear in the net worth.
[41] I would add that if this was not the appellant's position, then, on the basis of the evidence before me, I find that the appellant has not shown that part of the US$260,000 left Russia and came to Canada.

[68] Apart from the payment from Hilton Construction, the repayments that the appellant claims to have received include an amount of C$29,914.21[42] in 1997. The appellant testified that Drevco loaned Mr. Skibinsky the equivalent of US$21,700 in roubles for a ten-year term, without interest. He also testified that Mr. Skibinsky repaid that amount by sending him the payment in accordance with Drevco's instructions. I accept that evidence.[43]

[69] As a result, the appellant's income must be reduced by $29,914.21 in 1997.[44]

Payment from LAG Holding

[70] Lastly, I accept the appellant's evidence that LAG Holding had, among other debts, a US$70,000 debt to Drevco, and that Drevco instructed LAG Holding to pay this amount into the appellant's bank account in Montréal.[45] This payment, which came out to C$96,257,[46] was received in 1997.

[71] Consequently, the appellant's income for the 1997 year must be reduced by $96,257.[47]

B. The amounts conceded by the respondent

[72] The respondent conceded that the following changes need to be made[48]:

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[42] Exhibit A-2, tab 18, first page.

[43] See the second page at tab 17 of Exhibit A-2 for the English translation of the loan contract, and the fourth page, for a copy of the Russian-language original. The amount of $29, 914.21 roughly matches the amount of US$21,700; see the Bank of Canada exchange rate (Exhibit A-2, tab 18, second page) and the minutes of June 26, 1999, which refer to this "repayment" to Paron (Exhibit A-2, tab 28), except that, for unknown reasons, the amount indicated is US$30,000.

[44] Strictly speaking, it would be necessary to redo the entire net worth calculation by including the1996 loan, and then reduce the appellant's assets by the amount of the loan to Paron in 1997 and subsequent years. The result, as with the payment from Hilton Construction, is to reduce the appellant's income by the amount of the payment ($29,914.21 in this instance) in the year of the payment (1997).

As to the question of whether subsection 15(1) or 246(1) of the ITA applies, my reasoning is the same as with respect to the payment from Hilton Construction. See above.

[45] See transcript, March 3, 2009, questions 348 to 356; in addition, see Exhibit A-2, tabs 19 and 20 and tab 28 (item 2 in the second paragraph of the minutes of June 26, 1999). In these minutes, a total of US$120,000, including the amount of US$70,000, is mentioned. Since there is no evidence that the other US$50,000 was transferred to Canada, for reasons similar to those I explained in relation to the amount of US$260,000 for the sale of equipment discussed in item 3 of the minutes, I find that only the US$70,000 transferred to Canada can reduce the appellant's income.

[46] The conversion is done in the same manner as with the payments from Hilton Construction.

[47] I am setting out the result without redoing the entire net worth calculation. As to the question of whether subsection 15(1) or 246(1) of the ITA applies, my reasoning is the same as with respect to the payment from Hilton Construction. See above.

[48] Transcript, March 4, 2009, pages 3 to 7.

(a) The Cadillac car was sold in 1998 in Canada and must therefore be removed from the appellant's assets at the end of 1998 and in 1999. The effect of this change is to reduce the increase in net worth by $65,000 in 1998, thereby reducing the appellant's 1998 income by the same amount. There is no effect on the appellant's 1999 income, because the net worth at the beginning and end of the year are reduced by an equal amount.
(b) The appellant's cars in Russia were sold in 1997, thereby reducing his net worth by US$59,983.20 at the end of 1997 and in each subsequent year. The effect is to reduce the appellant's 1997 income by US$59,983.20 (C$83,388.64). There is no effect on the years 1998 and 1999.[49]
(c) The appellant's 1998 income must be reduced by $251.50, and his 1999 income by $405.50, on account of input tax credits not deducted.
(d) The appellant's 1999 income must be reduced by $5,584 on account of cheques to his wife.

[73] The changes to net worth listed above can be summarized, by taxation year, as follows (in Canadian dollars):

(a) The appellant's 1997 income must be reduced by $209,559.85.[50]
(b) The appellant's 1998 income must be reduced by $65,251.50.[51]
(c) The appellant's 1999 income must be reduced by $586,448.24.[52]

C. The critique of the methodology

[74] The first criticism is about the determination of the assets for the base year, 1996, in the net worth calculation, and the fact that no value was given to certain commercial property in Russia.

[75] The personal balance sheet that the appellant provided with his immigration application states that his commercial property, his companies, had a value of $4,300,000.

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[49] The respondent's concession was $57,000. However, upon examining tabs 21 and 22 of Exhibit A-2, it is clear that the amount is US$59,983.20, or C$83,388.64.
[50] $209,559.85 = ($29,914.21 — payment by Mr. Skibinsky) + ($96,257 — payment by LAG Holding) + ($83,388.64 — sale of cars in Russia).
[51] $65,251.50 = ($65,000 — sale of Cadillac) + ($251.50 — input tax credits).
[52] $586,448.24 = ($580,458.74 — payment of Hilton Construction) + ($405.50 — input tax credits) + ($5,584 — cheques to appellant's wife).

[76] The CRA excluded these amounts on the basis that the situation prevented the appellant from recovering this property.

[77] Obviously, the commercial property in Russia has value. However, the evidence clearly shows that there were restrictions on moving capital out of the country.[53]

[78] It should also be recalled that it is the changes in assets— the increases and decreases — that are important. It must also be remembered that it is a principle of our tax system that changes in the fair market value of property are only taken into account when the property is realized.

[79] Consequently, an item of property that is held during the entire period covered by the net worth analysis has no impact on the result, because the item does not contribute to the change in the individual's net worth.

[80] The result is that the shares that the appellant held in the two companies, namely, Drevco and Drevo, have no effect on net worth, since he owned the shares for the entire period.

[81] The appellant also complains that, in the calculation of net worth, certain amounts in Russia or derived from Russia that were part of his personal assets were not tracked. These amounts total $1,401,250 at the end of the 1996 base year.[54]

[82] As I have explained, the important thing for the purpose of the estimate is the fluctuation in net worth. If a particular asset is kept for the entire period during which net worth is being analyzed, that asset creates no fluctuation in net worth and has no effect on the income calculation.

[83] The amounts totalling $1,401,250 are found in the personal balance sheet prepared by the appellant for his immigrant visa application.[55]

[84] The appellant is in a very good position to show whether there are changes in his assets.[56]

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[53] To cite just one example, see transcript, March 3, 2009, paragraphs 331 to 338. The restrictions on the movements of capital undoubtedly explain the complexity of the movements of funds.

[54] They consist of furniture and accessories ($250,000), an automobile in Russia ($57,500), other property ($187,500) and real estate in Russia ($906,250); see Exhibit I-2, tab 1, page 6.

[55] Exhibit A-2, tab 9, pages 1 and 2.

[85] That is what the appellant has done in relation to the automobiles in Russia, and, as a result, the respondent has conceded an adjustment for the automobiles after the evidence was submitted.

[86] These first two criticisms of the methodology give me no reason to conclude that the use of the net worth method should be completely rejected.

[87] The appellant also criticizes the unidentified cheques or withdrawals that were included in personal expenses.

[88] These amounts account for the majority of personal expenses because they range between 55% and 80% of personal expenses, depending on the year. Some of the withdrawals in question are quite large (e.g. $10,000, $13,000, and $16,000).

[89] According to the net worth, the personal expenses range from roughly $200,000 to roughly $300,000, depending on the year.

[90] The appellant says that the inclusion of these unidentified cheques or withdrawals in personal expenses poses too great a risk of mistakes.

[91] Unidentified cheques or withdrawals could constitute expenses[57] or could be used for the acquisition of an asset[58] or the repayment of a debt.[59]

[92] Their use for the acquisition of an asset (or the repayment of a debt) would not reduce the appellant's income unless the acquisition or repayment was already taken into account in the net worth.

[93] If a given asset acquisition or debt repayment has already been taken into account, the appellant is in the best position to show that the unidentified cheque or withdrawal that served to acquire the asset or repay the debt has already been taken into account.

[94] This is especially true when the amount is large. For example, on October 30, 1997, the appellant withdrew $16,000 from his bank account.[60]

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[56] With respect to furniture, the respondent's documents show the changes in this amount over the years in issue; see tabs 8, 9 (page 2), 10 (page 2), 11 (page 2), and 18 to 21 of Exhibit I-2. This is another instance in which the appellant is in a good position to verify what was done and point out any errors.

[57] Including a gift.

[58] Including a loan to someone.

[59] Which results in an increase of a person's net worth.

One would normally expect it to be easier to remember what such an amount was used for, and to trace the documentation pertaining to its use.

[95] It is also important to note that the total of these unidentified cheques or withdrawals is very large in both relative and absolute terms.[61]

[96] The appellant further submits that there could be mistakes due to movements between the appellant's various accounts, or between the appellant and his company in Canada. However, upon examining the auditor's work sheets, we can see that she factored in movements between accounts and between the appellant and his company.

[97] Once again, the appellant is in the best position to point out mistakes. The auditor's work in connection with the withdrawals and cheques was done on the basis of the appellant's records.

[98] Consequently, I am not satisfied that an assumption that unexplained cheques or withdrawals were used for personal expenses creates inherent methodological flaws to such an extent that it should automatically be ruled out.[62] Moreover, I am not satisfied that there are reasons to completely rule out such an assumption in this particular case.[63]

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[60] Exhibit A-1, tab 4, last page.

[61] For example, roughly US$78,000 plus C$67,000 in 1999 (see Exhibit I-2, at tabs 14 and 10 respectively).

[62] The appellant argued that he had no obligation to keep his books before arriving in Canada, but this cannot affect the years 1997, 1998 and 1999. Under subsection 230(4) of the ITA, a taxpayer must keep books for six years beyond the end of a taxation year. The 1997 audit began well before the end of that period (see note 11 above).

[63] The appellant brought certain cases to my attention in support of his argument that no assumption can be made that unexplained cheques or withdrawals were used for personal expenses.

The case law in question does not stand for an absolute prohibition. However, one must be very careful in applying such a presumption, a caution that also applies to the use of the net worth method in general.

The appellant placed particular emphasis on the comments of Justice Archambault in *Léger v. Canada*, [2000] T.C.J. No. 911 (QL), particularly at paragraphs 41 and 43.

However, these comments must be read in their context, which includes the specific problems of double inclusion that arose in *Léger* and are discussed at paragraphs 41 and 42 thereof.

However, the evidence in the instant case does not show that the amounts were already included as specific personal expenses listed by the auditor, because an examination of the auditor's work sheets shows that all the other expenses (the expenses other than unidentified cheques or withdrawals) are expenses specifically identified on the basis of bank or MasterCard accounts.

The work sheets also show that the auditor identified the movements between accounts, as well as the funds that the appellant advanced to his company, AGS Taron.

The situation in this case does not pose the risks that existed in *Léger*.

The appellant also stressed *Valentini v. Québec*, 2006 QCCQ 409, aff'd 2007 QCCA 886. Once again, the situation there was quite different. First of all, at first instance, the Court of Québec concluded that the appellant had succeeded in showing that there were so many errors that the very foundation of the estimate should be rejected.

In the instant case, the foundation of the calculation has not been shaken to such a degree, because:

(i) even with the corrections that are required, the income that the taxpayer has failed to report remains significant,

D. Loan to AGS Taron (December 1997)

[99] Lastly, the appellant raised a specific question regarding the amount that he loaned to AGS Taron, his company in Canada.

[100] In view of errors in the company's accounts, the auditor did a complete recalculation of the amounts that the appellant loaned to AGS Taron.

[101] This recalculation by the auditor was to the appellant's advantage, because, on the basis of the financial statements, the appellant's loan to AGS went from $0 at the end of base year 1996, to $1,002,159 at the end of 1999.[64] However, according to the auditor's calculation, the appellant's loan went from $0 to $712,287.[65] This difference of roughly $280,000 is to the appellant's advantage.

(ii) the changes that need to be made (due to the appellant's evidence that I accept, or due to the respondent's concessions) are all attributable to the fact that the appellant showed that there were non-taxable sources of funds that could have covered the expenses. The appellant's evidence did not cast doubt on the expense estimates themselves.

Secondly, with respect to *Valentini*, I would note that the Quebec Court of Appeal stated, in the last sentence of paragraph 24, that the method was not [TRANSLATION] "inadequate *per se*".

Lastly, it should be noted that the method used in *Valentini* was the unexplained deposits method.

I also to wish to recall what I said earlier: If the unexplained cheque or withdrawal was used for the acquisition of an asset or the reduction of a debt, this increases the appellant's income accordingly, unless the Minister already took the asset or the debt reduction into account. The appellant is in a very good position to show that the withdrawals or cheques were used for the acquisition of an asset, or the reduction of a debt already taken into account.

Moreover, although not all the auditor's work sheets have been offered in evidence, the ones that are can be used to trace the identified funds that account for the largest increase in assets, namely, the category that includes advances by the appellant to AGS Taron (see Exhibit I-2, tab 1, page 7, tab 22 and the work sheets cited at tab 22, which can be found at tabs 9 to 11). It is also possible to trace the identified funds that account for the increase in assets, "Total Personal Property", an increase that is entirely due to the increase of the subcategory "Furniture and accessories" (see Exhibit I-2, tab 1, page 6, and tabs 32, 9 to 11 and 16 to 21). Lastly, it is possible to trace identified sources of the mortgage debt reduction (see Exhibit I-2, tab 1, page 3, and tabs 31, 9 to 11, 15 to 17 and 28 to 30. There seems to be a small time lag for the mortgage repayments between 1997 and 1998, in the order of a few thousand dollars, as they appear in the financial statements at tabs 28 and 29 and at tabs 9, 11, 15 and 16, respectively. However, if the years 1997 and 1998 are considered together, the total is almost identical.)

Not only has the appellant not shown that unexplained cheques or withdrawals were used for the acquisition of an asset or the reduction of a debt that the respondent had already taken into account, but given the increases in assets or debt reductions resulting from the identified funds which I have just described, the possibility that unexplained cheques or withdrawals were used for the purchase of an asset or reduction of a debt that the respondent has already taken into account is greatly diminished.

In particular, I note that in 1997, almost all the asset increases or debt decreases derive from identified sources of funds. This can be seen in the change in assets between 1996 year-end and 1997 year-end (Exhibit I-2, tab 1, pages 3 to 7). Consequently, in 1997, it is mathematically impossible for unidentified cheques and withdrawals totalling $233,000 (Exhibit I-2, tabs 11 and 15) to correspond to asset acquisitions or debt reductions of more than a few thousand dollars, which appear in the net worth.

[64] Exhibit I-2, tab 22, second page.

[65] *Ibid.*, first page.

[102] One of the amounts that the auditor included in the appellant's advances to AGS Taron is a $90,000 amount from December 1997.[66]

[103] According to the appellant, two unidentified deposits of $45,000 into his account in 1997 are in repayment of a $90,000 loan he made to AGS, and consequently, his loan to AGS Taron should be reduced by $90,000 at the end of 1997, thereby reducing his income by the same amount in 1997.[67]

[104] The appellant submits that this is a repayment because the company Trident Educational Services (also known as Techtran) allegedly issued an invoice for $90,000 to AGS Taron on October 31, 1997. Then, on December 10, 1997, the appellant purportedly advanced $90,000 to AGS Taron. On the same day, AGS Taron issued a $90,000 cheque to Trident, and Trident issued a $55,000 cheque to the appellant's wife and a $45,000 cheque to Mr. Zaplatine, an employee of AGS Taron. On that same December 10, there was also an unidentified deposit of $45,000 into the appellant's account, which the auditor thought was probably from Mr. Zaplatine, but she had no proof to that effect. Lastly, on December 9, 1997, one day before the other cheques, there was another unidentified deposit of $45,000 into the appellant's bank account, which the auditor thought was probably from the appellant's wife, although, once again, the auditor did not have any proof to that effect.[68]

[105] Even if it is assumed that the unidentified deposits made into the appellant's account on December 9 and December 10, 1997, emanated from his wife and Mr. Zaplatine, I do not see how this series of movements of funds could constitute a $90,000 repayment by AGS Taron to the appellant. There is no evidence to explain how these amounts might have taken on the nature of repayments, or why it was necessary for the two amounts of $45,000 to travel such a circuitous route to get from AGS Taron to the appellant.[69]

[106] Consequently, it is not warranted to change this amount of $90,000 which the appellant loaned to AGS Taron in December 1997.

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[66] *Ibid.*, tab 11, page 1, row "AGS Taron", column "DEC."

[67] The net worth would be reduced by the same amount in subsequent years, but this would have no effect on the appellant's 1998 and 1999 income.

[68] Exhibit A-1, tab 2, second page. The appellant's testimony shed no light on these transactions.

[69] Unlike the amounts from Russia, there was no obstacle to a direct payment by AGS Taron to the appellant. I also note that the auditor reconciled her calculation of the appellant's loan to AGS Taron with the amounts in the financial statements, and, that, apart from a $1,785 discrepancy, she explained the difference. With respect to 1997, she explained the difference — with the exception of an amount of $355 — by a completely different transaction (see Exhibit I-2, tab 22, third page, and Exhibit A-1, tab 2, item "#2" at the bottom of the first page).

[107] In conclusion, apart from the changes set out above at paragraph 73, there is no evidence warranting additional changes.

IV. The penalties under subsection 163(2) of the ITA

[108] Subsection 163(2) of the ITA applies to

> [e]very person who, knowingly, or under circumstances amounting to gross negligence, has made…a false statement or omission in a return . . .

[109] In *Venne v. Canada*,[70] Justice Strayer stated as follows:

> Gross negligence must be taken to involve greater neglect than simply a failure to use reasonable care. It must involve a high degree of negligence tantamount to intentional acting and indifference as to whether the law is complied with or not.

[110] It must also be borne in mind that the burden of proof is on the Minister. In *Lacroix v. Canada*,[71] Justice Pelletier stated:

> 26 Although the Minister has the benefit of the assumptions of fact underlying the reassessment, he does not enjoy any similar advantage with regard to proving the facts justifying a reassessment beyond the statutory period, or those facts justifying the assessment of a penalty for the taxpayer's misconduct in filing his tax return. The Minister is undeniably required to adduce facts justifying these exceptional measures.
>
> 27 In *Richard Boileau v. M.N.R.*, 89 D.T.C. 247, Judge Lamarre Proulx stated as follows, at page 250:
>
> > Indeed, the Appellant was unable to contradict the basic elements of the net worth assessments. However, in my view, this is not sufficient for discharging the burden of proof which lies on the Minister. To decide otherwise would be to remove any purpose to subsection 163(3) by reverting the Minister's burden of proof back onto the Appellant.
>
> 28 In a similar vein, in *Farm Business Consultants Inc. v. Her Majesty the Queen*, [1994] 2 C.T.C. 2450, 95 D.T.C. 200, Judge Bowman wrote the following at paragraph 27:

[70] [1984] F.C.J. No. 314 (QL).
[71] 2008 FCA 241.

> 27 A court must be extremely cautious in sanctioning the imposition of penalties under subsection 163(2). Conduct that warrants reopening a statute-barred year does not automatically justify a penalty and the routine imposition of penalties by the Minister is to be discouraged . . . . Moreover, where a penalty is imposed under subsection 163(2) although a civil standard of proof is required, if a taxpayer's conduct is consistent with two viable and reasonable hypotheses, one justifying the penalty and one not, the benefit of the doubt must be given to the taxpayer and the penalty must be deleted . . .

29 This last passage highlights the dialectic specific to certain reassessments made using the net worth method. In the case at bar, the Minister found undeclared income and asked the taxpayer to justify it. The taxpayer provided an explanation that neither the Minister nor the Tax Court of Canada found to be credible. Accordingly, there is no viable and reasonable hypothesis that could lead the decision-maker to give the taxpayer the benefit of the doubt. The only hypothesis offered was deemed not to be credible.

30 The facts in evidence in this case are such that the taxpayer's tax return made a misrepresentation of facts, and the only explanation offered by the taxpayer was found not to be credible. Clearly, there must be some other explanation for this income. It must therefore be concluded that the taxpayer had an unreported source of income, was aware of this source and refused to disclose it, since the explanations he gave were found not to be credible. In my view, given such circumstances, one must come to the inevitable conclusion that the false tax return was filed knowingly, or under circumstances amounting to gross negligence. This justifies not only a penalty, but also a reassessment beyond the statutory period.

. . .

32 What, then, of the burden of proof on the Minister? How does he discharge this burden? There may be circumstances where the Minister would be able to show direct evidence of the taxpayer's state of mind at the time the tax return was filed. However, in the vast majority of cases, the Minister will be limited to undermining the taxpayer's credibility by either adducing evidence or cross-examining the taxpayer. Insofar as the Tax Court of Canada is satisfied that the taxpayer earned unreported income and did not provide a credible explanation for the discrepancy between his or her reported income and his or her net worth, the Minister has discharged the burden of proof on him . . . .

33 As Justice Létourneau so aptly put it in *Molenaar v. Canada*, 2004 FCA 349, 2004 D.T.C. 6688, at paragraph 4:

> 4 Once the Ministère establishes on the basis of reliable information that there is a discrepancy, and a substantial one in the

> case at bar, between a taxpayer's assets and his expenses, and that discrepancy continues to be unexplained and inexplicable, the Ministère has discharged its burden of proof. It is then for the taxpayer to identify the source of his income and show that it is not taxable.

[111] The respondent adduced the net worth that formed the basis of the assessments under appeal. The appellant's evidence that I have accepted explains a significant portion of the assessments:

	1997	1998	1999
Additional income assessed	$345,308.25	$242,475.36	$640,054.30
Reductions of additional income by virtue of these reasons for judgment	$209,559.85	$65,251.50	$586,448.24
Additional income remaining	$135,748.40	$177,223.86	$53,606.06
Income reported by taxpayer[72]	$28,202.07	$18,903.59	$41,089.00

[112] However, the appellant has not shown that the respondent erred about the remaining additional income. The total additional income remaining in the table hereinabove for the three taxation years is more than $360,000, and the total income reported by the taxpayer is less than $90,000. The income omitted is four times greater than the income reported. Therefore, there has been a significant omission of income.

[113] Under such circumstances, I cannot avoid the conclusion that the omission of the additional income is the result of gross negligence.[73]

[114] Consequently, the penalties under subsection 163(2) will be maintained, but only on the remaining additional income amounts.[74]

V. The assessment made beyond the normal period

[72] Exhibit I-2, tab 1, page 2.
[73] Given the difference between the appellant's income and the reported income, it is difficult not to conclude that there was wilful blindness at the least. See *Panini v. Canada*, 2006 FCA 224, at paragraph 43.
[74] That is, $135,748.40 for 1997, $177, 223.86 for 1998 and $53,606.06 for 1999. The practical consequence is a major reduction in penalties.

[115] Since subparagraph 152(4)(*a*)(i) of the ITA provides that an assessment may be made beyond the normal period if there has been a misrepresentation[75] attributable to neglect or carelessness, and since there is necessarily neglect in cases of gross negligence, the Minister was clearly entitled to make the assessments beyond the normal period.

VI. Conclusion

[116] For these reasons, the appeal will be allowed, and the matter will be referred back to the Minister for reconsideration and reassessment on the basis that

(a) the appellant's income must be reduced by

(i) $209,559.85 for the 1997 taxation year,
(ii) $65,251.50 for the 1998 taxation year, and
(iii) $586,448.24for the 1999 taxation year; and

(b) the interest and penalties must be adjusted accordingly.

[117] Before signing the judgment, I will ask the registrar to contact the parties in order to seek their comments regarding the form of the judgment in relation to the 2001 taxation year, and to ask them whether they wish to make representations concerning costs.

Signed at Ottawa, Ontario, this 10th day of January 2011.

"Gaston Jorré"

Jorré J.

Translation certified true
on this 14th day of November 2011

François Brunet, Revisor

[75] Given the omission of $360,000 for the three taxation years, there can be no doubt that there was a misrepresentation.

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