

Docket: 2010-2575(IT)G

BETWEEN:

GREGORY GEORGE SCHMIDT,

appellant,

and

HER MAJESTY THE QUEEN,

respondent.

Appeal heard on November 8, 2012, at Regina, Saskatchewan.

Before: The Honourable Justice Robert J. Hogan

Appearances:

Counsel for the appellant: Kenneth J. Brodt

Counsel for the respondent: Bryn Frape

JUDGMENT

The appeals from the reassessments made under the Income Tax Act for the 2003 and 2004 taxation years are allowed and the reassessments are vacated in accordance with the attached reasons for judgment.

Each party is to pay their own costs.

Signed at Ottawa, Canada, this 11th day of February.

“Robert J. Hogan”

Hogan J.

Citation: 2013 TCC 11
Date: 20130211
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BETWEEN:

GREGORY GEORGE SCHMIDT,

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REASONS FOR JUDGMENT

Hogan J.

Introduction

[1] By notices of reassessment dated October 14, 2008 and varied on May 5, 2010, the Minister of National Revenue increased the income tax liability of Gregory George Schmidt, the appellant, for his 2003 and 2004 taxation years. The Minister used the deposit method to add \$49,499 and \$38,901 to the appellant's income for the 2003 and 2004 taxation years. The Minister also imposed gross negligence penalties under subsection 163(2) of the *Income Tax Act*, Canada (the "Act"). The reassessments were issued beyond the normal 3-year limitation period.

Issues to Be Decided

[2] The issues to be determined in this appeal are:

- (a) Whether the Minister properly revised the appellant's taxable income for the 2003 and 2004 taxation years;

- (b) Whether the Minister properly reassessed the appellant beyond the normal reassessment period under subsection 152(4) of the Act; and
- (c) Whether the Minister properly assessed penalties pursuant to subsection 163(2) of the Act.

Background

[3] The appellant is a contractor who is engaged in road building, demolition and snow removal. He is married with three children. He and his family live in a modest 800-square-foot, two-bedroom house in Regina. According to the appellant, his home is situated in a tough neighbourhood in that city.

[4] The appellant filed for bankruptcy in 2001. He transferred certain of his road-building equipment into a new company, 101050094 Saskatchewan Ltd., which was used to do contracting work.

[5] The appellant reported \$4,325.00 of income on his 2003 personal tax return. It came from a project he had completed that year. According to the appellant he worked very little in 2003 and spent most of his time looking after his two little girls, who were age three and five at the time. His wife worked full-time in 2003, earning \$21,419.16. For 2004 the appellant reported income of \$12,000.00.

[6] The CRA concluded that most deposits made in the appellant's bank account in 2003 and 2004 constituted unreported business income from his snow removal and road-building activities.

[7] The appellant provided three explanations for the deposits into his bank account.

[8] First, the appellant's brother would loan him money from time to time. This explanation applies to the 2003 period.

[9] Second, the appellant would cash cheques for his brother, Bernard Schmidt, on whose account there was a hold and who was thus unable to immediately withdraw from his account funds from cheques that he (Bernard Schmidt) received from customers of his (Bernard Schmidt's) business.

[10] There was not a similar hold on the appellant's bank account. He could withdraw up to \$500 for each cheque he deposited to his account. As the appellant could access funds quicker, he was able to assist his brother's company by providing

access to the cash flow needed in that business. The speedier access to cash allowed his brother's company to continue to operate. The appellant did not work for his brother's company during the periods in question. In cross-examination, the appellant said that he had explained the above-described practice to the CRA auditor "12 ways to Sunday".

[11] The appellant's brother corroborated the appellant's evidence. He explained the hold on his account: whenever he deposited a cheque in his account, it would take five to ten business days before he could withdraw the cash. He also explained that, as brothers, they exchanged money back and forth and that there were never any terms of repayment.

[12] The auditor, Mr. Michael Dean Curley, testified that the appellant did not provide him with any explanations for the deposits. The auditor also testified that he did not conduct a net worth assessment in conjunction with the deposit method because he did not think there would be enough asset information to justify the use of that method.

[13] On cross-examination, the auditor admitted he had had little contact with the taxpayer.

Appellant's Position

[14] The appellant submits that there is no evidence to suggest that he knowingly misrepresented his income.

[15] The primary source of the funds at issue was the appellant's brother's company, as indicated by the cheque stubs and bank statements showing that the money went in and then out. There were 90 occasions on which money was deposited and withdrawn on the same day.

Respondent's Position

[16] The respondent submits that I should not accept the explanation offered by the appellant with regard to the deposits made into his personal bank account. The respondent points out that approximately 200 deposits were considered in the CRA's deposit analysis, while the appellant has provided only 175 cheque stubs in support of his explanation. Thus, the respondent submits, at the very least there are 25 deposits for which no explanation has been given and those should be considered as unreported income of the appellant.

Analysis

[17] Subparagraph 152(4)(a)(i) of the Act, which governs time limits for assessments, reads as follows:

(4) Assessment and reassessment [limitation period] – The Minister may at any time make an assessment, reassessment or additional assessment of tax for a taxation year, interest or penalties, if any, payable under this Part by a taxpayer or notify in writing any person by whom a return of income for a taxation year has been filed that no tax is payable for the year, except that an assessment, reassessment or additional assessment may be made after the taxpayer's normal reassessment period in respect of the year only if

(a) the taxpayer or person filing the return

(i) has made any misrepresentation that is attributable to neglect, carelessness or wilful default or has committed any fraud in filing the return or in supplying any information under the Act, or . . .

[Emphasis added.]

[18] The reassessments relating to the 2003 and 2004 taxation years were issued after the expiration of the normal reassessment period. Pursuant to subparagraph 154(4)(a)(i), where the Minister issues a reassessment in relation to a taxation year after the expiration of the normal reassessment period, the Minister has the onus of establishing that the taxpayer has made a misrepresentation and that that misrepresentation was attributable to neglect, carelessness or wilful default, or that the taxpayer has committed fraud in filing his tax return or in supplying information under the Act in relation to that taxation year.

[19] The audit method selected by the CRA to make the reassessments has a direct bearing on the Court's determination as to whether or not the respondent has discharged her burden of proof under subparagraph 152(4)(a) of the Act. The CRA itself recognizes this by outlining a hierarchy among the three indirect methods most commonly employed to determine discrepancies between reported and unreported income. In its audit manual dated March 2008, the CRA states that the net worth method must be considered and used first unless it is impossible to obtain the information required in order to complete the net worth statement showing the evolution of the taxpayer's assets and liabilities and personal living expenses over the relevant period. On this subject, the manual states the following:

The sections that follow discuss the CRA policy with respect to the use of Indirect Verification of Income (IVI) as an assessing technique where a taxpayer/registrant's books and records are non-existent or inadequate, or where audit findings indicate that revenue has not been accurately recorded in the books and records.

The IVI techniques discussed are:

13.4.0 Net Worth;

13.5.0 Auditing Unidentified Bank Deposits;

13.6.0 Assessments Based on Projections.

The most frequently used IVI technique is the Net Worth Statement and is the primary IVI technique used in the CRA. Auditors are expected to use the net worth method whenever the information is available to allow proper preparation of the document.

The team leader must be consulted and approve the appropriate IVI technique for the audit as part of the Audit Plan.

[20] At trial, I asked the auditor why he did not resort to the net worth method to determine the appellant's undeclared income. My question did not elicit a clear response from the auditor. The CRA audit manual takes 25 pages to describe the methodology to be applied by a CRA auditor in completing a net worth audit. Two pages are devoted to describing the techniques for a deposit audit. It is obvious that the net worth audit will produce a more reliable picture of the taxpayer's financial situation and of the discrepancies between his lifestyle and spending habits and his reported income than will the other methods described in the manual. Given the lack of a response to my question, I am left to conclude that, for reasons that remain unclear, the auditor found the elaborate methodology of the net worth method daunting in the circumstances of this case. I do not share that view.

[21] The appellant, whom I found to be a credible witness, provided a plausible explanation for the deposits, namely that his personal account was used to assist his brother in his business operations since the appellant could withdraw immediately up to \$500 for each cheque deposited in his account. The testimony of the appellant is consistent with that of his brother, whom I also found to be a credible witness. Further, the cheque stubs and bank statements also corroborate the appellant's explanation.

[22] There were 175 stubs provided in evidence, and they account for most of the 200 or so deposits made in the appellant's personal account during the periods in question. The other 25 were likely loans from the appellant's brother, although a detailed explanation of those deposits was not provided.

[23] The credible explanation offered by the appellant distinguishes this case from *Lacroix*, a case in which the taxpayer was found to have made a misrepresentation of facts.¹ There, the appellant was not able to provide a credible explanation for the discrepancy that the CRA auditor found in doing a net worth assessment, and so the Minister was found to have discharged the burden of proof placed upon him by subparagraph 152(4)(a)(i). In the case at bar, there is a credible explanation, and the Minister has not provided any contrary evidence. Rather, the Minister has relied on submissions pertaining to the appellant's credibility without providing any objective evidence to contradict the appellant's evidence or to attack the appellant's credibility generally. The outcome in this case may have been different if the respondent had been able to show that the appellant's lifestyle did not correspond with the amount of income that his family reported each year. For these reasons the appeals are allowed and the reassessments are vacated.

Signed at Ottawa, Canada, this 11th day of February.

“Robert J. Hogan”

Hogan J.

¹ *Lacroix v. The Queen*, 2008 FCA 241, 2009 DTC 5029 at para. 30.

CITATION: 2013 TCC 11

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REASONS FOR JUDGMENT BY: The Honourable Justice Robert J. Hogan

DATE OF JUDGMENT: February 11, 2013

APPEARANCES:

Counsel for the Appellant: Kenneth J. Brodt

Counsel for the Respondent: Bryn Frape

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