

Docket: 2010-114(IT)G

BETWEEN:

STAN MCLEOD,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on July 9, 10, 11 and 12, 2013,
at Kelowna, British Columbia

By: The Honourable Justice Campbell J. Miller

Appearances:

Counsel for the Appellant: Terry S. Gill
Counsel for the Respondent: Bruce Senkpiel

JUDGMENT

The Appeal is allowed and referred back to the Minister of National Revenue for reconsideration and reassessment on the following basis:

- a) for the 2003 taxation year, Mr. McLeod's unreported revenue is reduced from \$83,088 to \$53,088 and he is liable for penalties pursuant to section 163(2) of the *Income Tax Act* (the "Act");
- b) for the 2004 taxation year, Mr. McLeod's unreported revenue is reduced from \$164,749 to \$9,673 and he is not liable for penalties pursuant to section 163(2) of the *Act*.

Signed at Ottawa, Canada, this 28th day of August 2013.

"Campbell J. Miller"

C. Miller J.

Docket: 2009-3881(IT)G

BETWEEN:

MONGOS GRILL LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on July 9, 10, 11 and 12, 2013,
at Kelowna, British Columbia

By: The Honourable Justice Campbell J. Miller

Appearances:

Counsel for the Appellant: Terry S. Gill
Counsel for the Respondent: Bruce Senkpiel

JUDGMENT

The Appeal is allowed and referred back to the Minister of National Revenue for reconsideration and reassessment on the following basis:

- a) for the 2003 taxation year, unreported revenue is reduced from \$83,536 to \$53,536 and the Appellant is liable for penalties pursuant to section 163(2) of the *Income Tax Act* (the "Act");
- b) for the 2004 taxation year, unreported revenue is reduced from \$165,428 to \$84,428 and the Appellant is liable for penalties pursuant to section 163(2) of the *Act*.

Signed at Ottawa, Canada, this 28th day of August 2013.

"Campbell J. Miller"

C. Miller J.

Docket: 2010-115(GST)G

BETWEEN:

MONGOS GRILL LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on July 9, 10, 11 and 12, 2013,
at Kelowna, British Columbia

By: The Honourable Justice Campbell J. Miller

Appearances:

Counsel for the Appellant: Terry S. Gill
Counsel for the Respondent: Bruce Senkpiel

JUDGMENT

The Appeal is allowed and referred back to the Minister of National Revenue for reconsideration and reassessment on the basis the Appellant had unreported revenues of \$53,536 in the 2003 taxation year and \$84,428 in the 2004 taxation year.

Signed at Ottawa, Canada, this 28th day of August 2013.

"Campbell J. Miller"

C. Miller J.

Citation: 2013 TCC 269

Date: 20130828

Docket: 2010-114(IT)G

BETWEEN:

STAN MCLEOD,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent,

and

Docket: 2009-3881(IT)G

BETWEEN:

MONGOS GRILL LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent,

and

Docket: 2010-115(GST)G

BETWEEN:

MONGOS GRILL LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

C. Miller J.

[1] These three cases stem from a net worth assessment of the Appellant, Stan McLeod. The Minister of National Revenue (the "Minister") reassessed both Stan McLeod and Mongos Grill Ltd. ("Mongos") under the *Income Tax Act* (the "Act") to increase their respective income by \$83,098 and \$164,749 in 2003 and 2004 in Mr. McLeod's case, and by \$83,536 and \$165,428 in 2003 and 2004 respectively in Mongos' case, along with gross negligence penalties pursuant to section 163(2) of the *Act*. There is also a Goods and Services Tax ("GST") assessment of Mongos in accordance with the findings of unreported income under the income tax assessment.

[2] The Appellant's position is that the Minister, assessing on a net worth basis, relied entirely on a single asset of Mr. McLeod's, being his shareholder's loan account in Mongos, and failed to recognize loans that Mr. McLeod received: \$155,000 from Mr. T. Day and \$30,000 from Ms. P. Crichton, which would significantly reduce the unreported income assessed by the Minister. The Appellant also maintains that the Government ignored a \$74,000 adjustment to the shareholder's loan account that would further reduce the net worth assessment.

[3] The Minister's position, firstly, is that the significant increase in Mr. McLeod's shareholder's loan account is not as a result of any funds Mr. McLeod injected into Mongos but simply internal accounting entries that shifted Mongos' sales revenue into Mr. McLeod's shareholder's loan account, effectively creating a shareholder benefit pursuant to section 15(1) of the *Act*, and hiding Mongos' revenue. In the alternative, the Minister argues Mr. McLeod had the significant unreported revenue from other sources.

[4] The case will turn on whether I find Mr. McLeod, Mr. Day, Mr. Ellis (Ms. Crichton's nephew who arranged the \$30,000 loan) and Mr. Lotoski (Mr. McLeod's accountant) credible in their explanations of the loans and the shareholder loan adjustment.

General background

[5] Mr. McLeod started Mongos, a Mongolian food restaurant in Kelowna, in September 1999. He owned 99% of Mongos and was a director and officer and

basically the moving force of Mongos. Mongos operated as a restaurant as well as running a catering service. It closed for renovations from December 2002 to August 2003 to add a cigar bar and martini lounge.

[6] The business did not fare as well as Mr. McLeod had hoped, even after the renovations. In May 2004, he hired Mr. Fay, an experienced chef and executive in the food and beverage business, who suggested the business was not being run as it should. Mr. McLeod, along with Mr. Fay determined, after a couple more years of operation, that the business should indeed be shut down, which it was in 2006. At that time, the assets of the business were sold to a third party for \$159,000.

Audit

[7] The Canada Revenue Agency ("CRA") commenced its audit of Mr. McLeod and Mongos in the summer of 2006. While there was some lengthy testimony by Mr. Axelson, the auditor, of the audit process, I wish only to highlight the pertinent details. It was clear that Mr. Axelson did not find the Appellants nor their advisors as forthcoming as he would have liked.

[8] The audit did not start as a net worth, but a rough analysis of bank deposits of Mongos versus reported sales. A considerable discrepancy in that regard, plus the use by the Appellant of the shareholder loan account to record such a difference, caused the auditor to deem Mongos' books unreliable. He therefore proceeded to conduct a net worth assessment of Mr. McLeod. He did, however, turn around and rely on the deemed unreliable shareholder loan account to increase Mr. McLeod's net worth by over \$250,000.

[9] Mr. Axelson was not provided with personal bank statements nor given the opportunity to interview Mr. McLeod. I note that fairly early on, Mr. McLeod's accountant, Mr. Lotoski, did mention to the auditor there was a \$30,000 loan owed by Mr. McLeod; not until December 2007 was there any mention by Mr. Lotoski of any other loan. Mr. Axelson, in the summer of 2007, sought a personal expense questionnaire, which Mr. Lotoski testified he had provided. Mr. Axelson never received it. Few source documents were provided. While Mr. Axelson sent a proposal to Mr. Lotoski in December 2007, he did not get around to close the file and reassess until August 2008.

[10] Mr. Axelson determined that Mr. McLeod had only one asset, being his shareholder's loan account in Mongos. He further determined Mr. McLeod had no

liabilities, but that the shareholder's loan account increased by over \$250,000 during the two year audit period.

[11] At the Appeals level, the CRA was provided with a copy of a \$30,000 cheque evidencing a loan from Ms. Patricia Crichton, along with a one page document from Mr. T. Day, in the form of a letter dated February 27, 2008 confirming that he had lent Mr. McLeod \$155,000 for use in Mongos.

[12] From a review of the net worth it is clear that the increase in the shareholder loan account from \$139,381 in January 2003 to \$393,702 at the end of December 2004 was taken at its face value by the auditor and represents almost all of the amount of unreported revenue the Minister maintains Mongos received in 2003 and 2004. As indicated, the shareholder loan account was the only asset appearing on the net worth statement; no real estate, no cash, no investments, no cars, nothing else. The net worth assessment also shows zero liabilities. The Courts have described the net worth assessment as a blunt instrument – this is particularly blunt.

[13] Interestingly, the Minister assessed Mr. McLeod as receiving a subsection 15(1) of the *Act* shareholder benefit of \$83,088 in 2003 and \$167,749 in 2004 from Mongos. The auditor suggested that the bank deposits to Mongos' account were exact numbers and therefore looked more like revenue than shareholder loans. The Minister relies on the following assumptions in the Reply:

...

- y) bank deposits to the Company's bank account greatly exceeded reported sales revenue in both years – by \$69,596 in 2003 and \$152,117 in 2004;
- z) the unidentified bank deposits were unreported sales revenue of the Company;
- aa) the Appellant under-reported the Company's revenues;
- bb) the Appellant provided only the purported monthly sales total to his accountant for entry into the accounting records;
- cc) the Appellant directed that the difference between the total revenue figure he provided to his accountant and the total bank deposits be credited to his shareholder loan account as a contribution;
- dd) instead of crediting sales, the Appellant appropriated the unreported revenue of the Company by crediting the amount of the unreported sales revenue to the shareholder loan account;

- ee) thus Company sales revenue became an amount due to the shareholder;
- ff) the Appellant appropriated from his Company for his personal benefit the unreported business revenues identified in the net worth review;
- gg) in 2003 and 2004, the Appellant appropriated \$83,088 and \$164,749, respectively, from the Company;
- hh) the company conferred the \$83,088 and \$164,749 on the Appellant in his capacity as a shareholder;

...

The Minister then goes on to describe the issue as:

...

- a) in 2003 and 2004, the Company conferred \$83,088 and \$164,749, respectively, on the Appellant in his capacity as a shareholder; ...

This does not strike me as a net worth assessment as much as simply a subsection 15(1) of the *Act* shareholder appropriation, based on Mongos recording the excess of deposits over sales, emanating from the sales ledgers, as a shareholder's loan. The Minister is saying these are sales hidden in the shareholder loan account. The Minister has a two-pronged approach set out in the Reply as follows:

14. The Appellant's yearly changes in net worth and personal living expenditures were as set out in Schedules I, II, III and IV. The discrepancies between those figures and his reported incomes in those years arose from incomes that the Appellant earned and failed to report. As such, the Appellant earned and failed to report respective incomes of \$83,088 and \$164,749 in 2003 and 2004, calculated with reference to section 3 of the Act.
15. In 2003 and 2004, the Company conferred the \$83,088 and \$164,749 on the Appellant in his capacity as a shareholder. As such, those amounts must be included in the Appellant's income under subsection 15(1) of the Act.
16. Alternatively, if all or part of the \$83,088 and \$164,749 was not appropriated from the Company in 2003 and 2004, respectively, which is expressly denied, those amounts are unreported business income from another source or sources that the Appellant earned and must be included in the income of the Appellant pursuant to subsection 9(1) of the Act.

[14] Frankly, whichever, argument the Minister puts forward, the issue I find relates to three items:

- a) did Mr. McLeod have a liability in the form of a \$155,000 loan from Mr. T. Day, funds which were injected into Mongos forming part of the shareholder's loan account?
- b) did Mr. McLeod have a liability in the form of a \$30,000 loan from Mr. Ellis' aunt, Ms. Crichton, which also was part of the shareholder's loan account?
- c) was the shareholder loan account for the period in question overstated by approximately \$74,000, which is evidenced by a 2005 accounting adjustment which I will explain shortly?

I will deal with the facts surrounding each of these in turn.

\$155,000 loan

[15] In late 2002, Mr. McLeod had discussions with his friend, Mr. Tim Day, as well as with his brother, about a new concept for the restaurant; the idea of adding an upscale cigar bar and martini lounge. Mr. Day had several other businesses, primarily in the printing industry, though one of which was the sale of cigars. My impression from Mr. Day is that he dabbled in the cigar trade, admitting that he was his best customer – he liked cigars.

[16] Mr. Day testified that on one occasion in supplying cigars to a bar, he was struck by the amount of cash the bar had on hand. This left a favourable impression such that he saw a profitable opportunity for Mr. McLeod's expanded bar. He claimed that he proceeded to provide Mr. McLeod funds to assist with the bar renovations.

[17] Mr. Day described his investment in Mongos as a loosey-goosey arrangement. The deal was Mr. Day would be a 50/50 partner with Mr. McLeod in owning the business, yet he would wait to see how profits went before finalizing that arrangement. Indeed, profits never materialized to the point that Mr. Day actually became a part-owner. The monies he says he provided to Mr. McLeod therefore remained more in the form of a loan. Mr. Day and Mr. McLeod put nothing in writing evidencing the arrangement other than a ledger which I will have more to say

about shortly. Mr. Day claims that as Mr. McLeod was a good friend, he was prepared to do this on handshake basis.

[18] Mr. Day claims that the \$155,000 was advanced in cash and that it came from a cache of money that he had accumulated over the years and that he simply kept in cash. He maintained he did not want to put the money in the bank, only to have to pay tax on any interest earned. This is a somewhat peculiar concept. He believed he could turn the cash to more profit by the purchase and sale of businesses. He identified a few businesses in this regard.

[19] I turn now to the ledger proffered as the best evidence of the loan. This was in the form of a black ledger book which only had one page of entries, titled "Loan to Stan McLeod re: Mongos restaurant to purchase 50% ". The ledger then went on to make the following entries:

		TOTAL
November 17, 2002	\$20,000	\$20,000
January 5, 2003	\$15,000	\$35,000
March 12, 2003	\$ 5,000	\$40,000
May 25, 2003	\$10,000	\$50,000
July 3, 2003	\$ 5,000	\$55,000
September 10, 2003	\$ 5,000	\$60,000
October 15, 2003	\$ 5,000	\$65,000
December 10, 2003	\$10,000	\$75,000
January 18 2004	\$25,000	\$100,000
February 3, 2004	\$10,000	\$110,000
March 15, 2004	\$25,000	\$135,000
May 3, 2004	\$20,000	<u>\$155,000</u>
	TOTAL	<u>\$155,000</u>

After the two columns, there are also two headings for the initials of both Mr. McLeod and Mr. Day: all entries appear to have been initialled. It is clear that a different pen was used for different entries. This document only came to light the week before trial. Mr. Day's explanation was that he left Canada and moved to Costa Rica a few years ago, where he still lives. He came back to Canada for this first time to visit family and friends and for this trial in early May of this year. When he left Canada, he took some records of his businesses with him and stored some with his daughter here in Canada. According to Mr. Day, only upon his recent return in going through his records that were left in Canada did he come across this ledger.

[20] Mr. McLeod confirmed that he initialled this ledger, though at discovery he had stated that the amounts received from Mr. Day were in smaller amounts of \$1,000, \$2,000 or \$3,000, always in cash. This is not in accord with the ledger.

[21] A review of bank deposits shows no major cash deposits lining up with the time of the loan advances set out in the ledger. Mr. McLeod explained that the cash would often go directly to the contractors and suppliers working on the restaurant renovations. The financial statements of Mongos indicate an increase in leasehold improvements of only approximately \$81,000 over the period in question. Mr. McLeod did suggest that some of the funds from Mr. Day may have been used for operations, yet the restaurant was shutdown for the renovations for approximately eight months.

[22] With respect to the repayment of this loan, Mr. Day testified that he received approximately \$48,000 from Mr. McLeod when Mr. McLeod sold the assets of Mongos in 2006. Further, after Mr. McLeod sold Mongos, Mr. Day asked Mr. McLeod to do renovations for his business, OK Blue Printing, the cost of which went to offset the loan. Mr. Day said he kept track of the cost to know when it equated to a repayment, though he produced no records in that regard. He suggested it was fully repaid by the summer of 2006.

[23] Before describing Mr. McLeod's explanation of the repayment of the loan, it is necessary to explain what occurred after the demise of the restaurant in 2006. Mr. McLeod was asked by Mr. Day to join him in the printing business, as Mr. Day felt Mr. McLeod had significant contacts in Kelowna. They incorporated a company in British Columbia in November 2006 to operate OK Blue Printing.

[24] In June 2008, they sold the printing business and Mr. McLeod took out his share, \$223,250, as what was described in the company's books as a management salary. In fact, this amount, which was actually paid to Mr. McLeod, was recorded as

having been received by Mongos (now called S and R Industries Inc.) and then out to Mr. McLeod to pay down his shareholder's loan.

[25] With that background, I now turn to Mr. McLeod's explanation of the repayment, which seems to have gone through a couple of transformations. At discovery, Mr. McLeod explained he repaid the loan to Mr. Day from the \$223,250 proceeds received on the sale of his interest in the British Columbia company. On undertakings, he explained he was working at OK Blue Printing in order to repay Mr. Day in non-monetary terms. Then, in a letter in July 2013, he corrected that answer by indicating that the cost of the renovation of the OK Blue Printing business, including labour and materials, were paid by the Appellant and these were tracked and treated by Mr. Day as a full repayment of the Appellant's loan to Mr. Day. The \$223,250 funds received by the Appellant upon the sale of OK Blue Printing were his share of the profits due to him as a shareholder of and provider of services to OK Blue Printing business.

[26] Mr. McLeod's accountant, Mr. Lotoski, testified he was aware of the money advanced by Mr. Day to Mr. McLeod, though it was not until some significant time into the audit that he first raised this with CRA, notwithstanding he was handling the tax dispute on Mr. McLeod's behalf from the outset. The CRA audit started back in 2006.

[27] I had the impression there was certainly no love lost between Mr. Lotoski and the CRA officials. Mr. Lotoski stated that when asked for a personal expense from the CRA for Mr. McLeod, this would not necessarily require a mention of any personal loans, yet upon filling in the personal expenditure questionnaire, he did include such loans. This struck me as contradictory. The questionnaire was not provided to CRA until a long time after Mr. Lotoski indicated that it had been.

[28] Mr. McLeod's brother testified briefly. I found him to be straightforward. He said that he was often lending money to his brother so that he could survive, as he put it.

[29] Mrs. McLeod, Mr. McLeod's mother, who served as bookkeeper of Mongos, also testified that she was aware Mr. Day was helping out financially.

[30] So, did Mr. Day lend \$155,000 to Mr. McLeod to put into Mongos. Clearly, if the entries in the ledger of the advances were made at the times indicated from 2002 to 2004, then this would be a significant corroboration of Mr. McLeod's and Mr.

Day's story. There are several factors, however, that cast suspicion on the veracity of this document:

- a) the ledger book itself has a few pages missing before the page in question and then no other entries at all;
- b) Mr. Day appears quite content to operate on a handshake basis with his friend yet has this detailed, dated, one page ledger;
- c) the ledger does not accord with Mr. McLeod's explanation of the amounts (small denominations) of the advances – one would presume advances of \$20,000 and \$25,000 would be noteworthy; and
- d) this critical piece of evidence shows up a week before trial in 2013 notwithstanding the audit started seven years earlier and the Appellant, and certainly Mr. Lotoski, must have appreciated the significance of obtaining evidence such as this.

[31] The Appellant's answer to the suspicion cast on this document is, first, why would Mr. Day fabricate anything as he has no personal interest in the matter; second, given Mr. Day's absence from the country until recently, it is perfectly plausible the document could only recently have to come to light; and third, Mr. McLeod has suffered concussions over the years due to an active sporting life and serving as a bouncer and, therefore, his memory has been affected explaining the discrepancy between his discovery evidence and the ledger. This latter reason has only been raised at trial.

[32] I suggested to counsel that an expert in handwriting or ink analysis might have been helpful in examining the document. The Respondent had considered seeking an adjournment for that purpose but decided not to. Counsel for the Appellant indicated the willingness on the part of the Appellant to have such an analysis done.

[33] I am satisfied, given Mr. Day's interest in Mr. McLeod's concept, especially as it relates to a cigar bar, and given that Mr. Day had some means (though I am not convinced the means was a \$200,000 cash accumulation), and given Mrs. McLeod's testimony, which I find credible, that she was aware Mr. Day was helping out (though apparently not aware of many details), that Mr. Day did provide some financial assistance to Mr. McLeod. I have not been convinced, however, it was necessarily \$155,000. I am not prepared to rely on the recently produced one page ledger as definitive proof of loans in the amounts indicated.

[34] The improvements to the restaurant which took place from January 2003 to August 2003 were shown in the books (albeit a year later) at around \$81,000. According to Mr. Day and Mr. McLeod, \$100,000 was lent after the reopening of the renovated restaurant, at a time when, according to Mr. McLeod, business was pretty good. That did not last long.

[35] I am also concerned not just with the different stories between Mr. Day and Mr. McLeod as to how the loan was repaid, but also with Mr. McLeod's own varying story. No, the pieces of the \$155,000 loan puzzle do not fit neatly together.

[36] The dilemma I am faced with is the conclusion that, yes, Mr. Day did assist Mr. McLeod, and consequently, Mongos, financially, but then not having sufficient proof to determine the extent of that financial assistance. I will turn to this after addressing the \$30,000 loan and the mechanics of the shareholder loan account.

\$30,000 loan

[37] Mr. Ellis, a licensed real estate agent, was a neighbour of Mr. McLeod. Indeed, Mr. Ellis sold his house to Mr. McLeod for approximately \$400,000, but kept the property in his own name while Mr. McLeod made monthly payments. A contract of purchase and sale dated August 15, 2000 set out the payment arrangement. Only now, according to Mr. McLeod, are the final payments being made to transfer legal title to him.

[38] Mr. Ellis claims his aunt, Patricia Crichton, was looking to invest some money when she moved to the Okanagan in 2002. Mr. Ellis was aware that Mr. McLeod was planning on expanding Mongos and needing financial help. According to Mr. Ellis, Ms. Crichton was concerned about the stability of a restaurant and the fact that Mr. McLeod did not own the property he lived in.

[39] In June 2003, Ms. Crichton wrote a cheque to Mr. McLeod for \$30,000. In October 2003, according to Mr. Ellis, to address his aunt's concerns, the following agreement was drawn up and signed by Mr. Ellis, Mr. McLeod and Ms. Crichton:

October 31st 2003

This Agreement is between Patricia Crichton and Stan McLeod, Patricia agrees to loan Stan \$30,000.00 towards the finishing of the garage presently under construction at 512 Zdralek Cove in Kelowna B.C.

Stand agrees to repay the full amount on or before April 1st 2004 along with an interest amount of \$1500.00 bringing the total to 31,500.00.

In case of default the loan will be registered against the property 512 Zdrlek Cove which is presently owned by Shawn Ellis and will stay in his name until the termination of this loan.

In case of default the outstanding amount will accrue interest at a rate of 2% per month.

This contract is legal and binding, signed in Kelowna B.C. this 31st day of October 2003

[40] The agreement refers to the money to be used for Mr. McLeod's personal garage, not Mongos. Mr. McLeod had taken out a building permit to build a garage in 2003 yet he insisted the funds went to Mongos' renovations and that he did not start work on the garage renovations until 2004.

[41] Mr. Ellis was confused as to how the loan was repaid, suggesting it may have been repaid back in 2004 or perhaps that he paid his aunt and Mr. McLeod simply reimbursed him. Mr. Lotoski, Mr. McLeod's accountant, confirmed that Mr. Ellis did repay Ms. Crichton. Mr. Lotoski went on to suggest that Mr. Ellis had previously loaned Mr. McLeod \$200,000 and that debt was bumped up by \$30,000 so that effectively Mr. McLeod's debt to Ms. Crichton shifted to Mr. Ellis, which Mr. Lotoski said was settled recently.

[42] The agreement of October 31, 2003 has a handwritten note purportedly from Patricia Crichton indicating the loan was repaid in 2009.

[43] There are two hurdles for the Appellant to overcome to have the \$30,000 loan reduce the net worth assessment. First, it must be found to have gone to Mongos and, therefore, increase the shareholder loan account. Only then should there be an offsetting liability in the net worth. Secondly, it must not have been repaid until after 2004.

[44] On the first issue, what works against Mr. McLeod is the reference in the agreement of October to the loan going towards the garage and not to Mongos, plus the timing of Mr. McLeod's obtaining a building permit. What works for Mr. McLeod is his own testimony that he used the funds in Mongos, Mr. Ellis' testimony that that was what the loan was intended for, and to the best of Mr. Ellis' knowledge what it was used for, Mr. Ellis' testimony that the agreement was drawn the way it was simply to satisfy his aunt, Mr. Lotoski's testimony the monies were

needed to pay Mongos' supplies and contractors, and, according to Mr. McLeod, the personal renovation (garage and cabana) was not undertaken until 2004.

[45] Again, I reach a similar conclusion on the \$30,000 loan as with the \$155,000 loan, and that is, there was a loan, but in this case, is there sufficient proof to determine whether all of the \$30,000 went into Mongos. I had the clear impression from the witnesses and Mr. McLeod himself, that Mr. McLeod did not have a strong business acumen. He relied on others. His ability was more working with his hands – construction and repairs, than the business side of running a restaurant. The most plausible explanation is that Mr. McLeod simply took the \$30,000 and used it wherever he liked and needed funds at the time. He had a history of borrowing. Frankly, he was not particularly well served by his professional advisors: accounting of monies in and out of Mongos could have been clearer.

[46] With respect to the second issue, I am prepared to give Mr. McLeod the benefit of the doubt and conclude that the loan was not repaid until after 2004. This accords with Mr. Lotoski's explanation and Mr. Ellis' somewhat fuzzy recollection.

Shareholder loan account

[47] This case at its core is centered on Mongos' shareholder loan account. That was the only asset relied upon by the CRA in coming to their net worth assessment, yet they have expressed real concern as to how the shareholder loan account was used. Frankly, I found Mr. Lotoski's explanation not a beacon of clarity. It struck me as somewhat arbitrary and, indeed, an all too convenient shortcut method of accountancy. It invites the very scrutiny that has come to pass.

[48] I will attempt to first describe how Mr. McLeod and Mr. Lotoski suggest the shareholder loan account was used. I will then look at a \$74,000 adjusting entry that the Appellant argues should come off the net worth.

[49] The real dispute here is that the CRA believes the shareholder's loan account was used to simply hide revenues. The Appellant and his advisors suggest the shareholder loan account served as a sort of clearing house, but, ultimately reflected the injection of funds by Mr. McLeod (including the two loans).

[50] Mr. Lotoski set up the deposit clearing account for Mongos. All the sales and tax recorded by Mrs. McLeod in Mongos' books are added to this notional account. Monthly deposits are shown in the account offsetting sales (that is, credit clearing account and debit bank account). Similarly, any draws would be credited against the

clearing account and debited to the shareholder's loan account. Mr. Gill, counsel for Mongos, described the rationale is that "small businesses will often draw funds out of their sales or cash, pay for expenses, or even pay for personal expenses and not account for them with receipts so, at the end of the month is that occurs there is going to be a shortfall, the deposit clearing account will not balance and that shortfall will then go against the shareholder loan account, will reduce the amount of the shareholder loan account. If that taxpayer brings the accountant receipts showing what the cash is for, then that adjustment is reversed and they get a credit to their shareholder loan account for those receipts. Now the flip side of that is what we have seen in this case. There was not a shortfall at the end of each month, quite often there was an excess leftover...and the way that the accountant treats this is he gives a credit to the shareholder loan account on the assumption that to the extent that there is more cash around than what the sales records show, then that has been contributed by the shareholder from his own funds."

[51] In looking at this notional account in Mongos' general ledger for 2003, one can see a credit of bank deposits in October 2002 for example, followed by a debit of cash daily sales. At fiscal year end (September 2003), the ledger shows a balance of \$76,953, which, according to the Appellant, shows that \$76,953 more has been deposited to the bank than reflected in sales. Mr. Lotoski then zeros out the account by adding that amount to the shareholder loan account.

[52] In the 2004 general ledger, Mr. Gill took me to the leasehold improvements account and shareholder loan account which shows approximately \$81,000 in leasehold improvements and an equivalent addition to Mr. McLeod's shareholder's loan account, all entries dated June 30, 2004. Mr. Gill suggests this late date being the time when Mr. McLeod likely submitted receipts notwithstanding the work was done the previous year. I heard no direct evidence on this point.

[53] The final item to address with respect to the shareholder loan account is how the catering revenue was dealt with. Mrs. McLeod testified that while she handled the daily bookkeeping, tallying sales from the restaurant's servers and preparing daily entries (though not for the period of renovations from December 2002 to August 2003) the catering revenues were not reflected in the books, but were deposited into the bank (often by Mr. McLeod's girlfriend). According to Mrs. McLeod, Mr. Lotoski's firm dealt with the catering revenue, which she believed was allocated by him to the shareholder loan account. This resulted, according to Mr. Lotoski, in an overstatement of the shareholder loan account, for which he made an adjusting entry in August 2005, backing out \$74,076. Mr. Lotoski acknowledged he could not

actually figure out what period the catering revenue related to. Frankly, I was not clear from his testimony how he came to the \$74,000 figure.

[54] The Respondent's position in reviewing these ledgers is that because amounts that got deposited are not round numbers, they look more like revenue than shareholder's loan injections. This seems more speculation than fact. I am more troubled by how money Mr. McLeod received from Mr. Day or Ms. Crichton ultimately shows up in the shareholder's loan account, when Mr. McLeod left me with the impression that he got cash from Mr. Day and paid cash out to contractors and for supplies.

[55] The Respondent also questions the almost \$400,000 increase in the shareholder loan account from 1999 to the end of 2004 as not credibly being funded by Mr. McLeod. Something else is going into that shareholder loan account according to the Respondent. The Respondent suggests that Mr. McLeod either appropriated revenues from Mongos into the shareholder's loan account or he had income from his other business, Stan's Mechanical, that he has under-reported. There is virtually no evidence as to what Stan's Mechanical did or did not do.

[56] Where does this all lead? Frankly, it leads to a messy net worth assessment based entirely on a shareholder's loan account, with no other assets or liabilities. The Respondent's position is simply that Mr. McLeod had a significant unexplained increase in his one and only asset – his Mongos shareholder's loan account. The Respondent's first position is that the shareholder loan account does not reflect loans from Mr. McLeod to Mongos but rather an accounting appropriation of Mongos' revenue. In the alternative, the increased net worth is from some other source. The Respondent need not identify the source. As indicated by Justice Pelletier in *Réjean Lacroix v Her Majesty the Queen*¹:

18. In my view, this jurisprudence does not establish a rule to the effect that the Minister may not use the net worth method to add unreported income to a taxpayer's income unless the Minister can establish the source of the unreported income. Our tax collection system is based on the taxpayer's self-reporting of the income he or she has earned during a taxation year. Should the Minister doubt, for whatever reason, the accuracy of the taxpayer's return, the Minister may conduct an investigation in such manner as deemed necessary. The Minister may then make a reassessment. If the taxpayer appeals the reassessment, the Minister does not have to prove the facts giving rise to the reassessment. In the reply to the notice of appeal, the

¹ 2009 DTC 5029.

Minister need only set out the presumptions of fact used in the reassessment. The onus is on the taxpayer, who knows everything there is to know about his or her own affairs, to “demolish” the Minister’s assumptions; otherwise, they are presumed to be true.

Justice Pelletier went on to state:

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.

[57] The Respondent maintains the Appellant has not offered a credible explanation. Indeed, the Respondent’s view is that none of Mr. McLeod’s, Mr. Lotoski’s, Mr. Day’s and Mr. Ellis’ testimony are to be believed. That is a lot of lying.

[58] There is a reason net worth assessment trials are not at the top of Tax Court judges’ list of favourite cases. The Respondent often flies by the seat of its pants, having received insufficient source documents and often little cooperation, and consequently relying on guess work and gross assumptions; for example, that Mr. McLeod has only one asset, no liabilities and the determination of that asset is suspect. Not a well founded starting point.

[59] The Appellant often suffers from sloppiness or lack of attention to detail or bookkeeping that may result in inaccurate reported income, but pleads the huge numbers suggested by the CRA simply do not make sense: for example, a restaurant business doing poorly, renovating for eight months and surviving for a couple of years is unlikely to have an additional \$250,000 revenue over a two year period, especially when for eight months of those two years it was closed for renovations. As always, reality is likely somewhere between the opposing positions. Such cases scream out to be settled, something I suggested to the Parties but was met with a complete absence of enthusiasm. Indeed, each side represented they wanted to make submissions on costs depending on my Judgment.

[60] Dealing first with the individual Appellant, Mr. McLeod. Has he explained the approximate \$240,000 increase in his net worth (being effectively the increase in his shareholder loan account)? He has maintained he received \$185,000 of loans as

described herein. As I have indicated, I believe Mr. McLeod did receive financial help. What I am uncertain about with respect to the \$155,000 Mr. Day loan is how accurate is that \$155,000 figure. With respect to the \$30,000 Ms. Crichton loan, how much of that went into Mongos and how much was used personally by Mr. McLeod.

[61] I find that based on Mr. Day's interest in helping with renovations, and the ledgers indicating an injection of approximately \$81,000 for leasehold improvements, that I accept Mr. McLeod borrowed \$81,000 from Mr. Day to go into Mongos, recorded in the books in 2004.

[62] On balance, I accept Mr. Ellis' explanation of the nature of the \$30,000 loan from his aunt to Mr. McLeod, in that it was to assist Mr. McLeod in his restaurant business, in 2003, notwithstanding the form of the agreement. The timing accords more with Mr. McLeod using such funds in his restaurant.

[63] I find that \$74,076 was mistakenly included in Mr. McLeod's shareholder loan account in 2004 as it represented catering revenue, and accept the subsequent year's adjusting entry reversing that amount out of the shareholder loan account for purpose of Mr. McLeod's net worth assessment. The effect of these conclusions is to reduce Mr. McLeod's unreported income in 2003 from \$83,088 to \$53,088 (Crichton loan) and to reduce his unreported income in 2004 from \$164,749 to \$9,673 (\$81,000 loan from Day recorded in 2004 plus \$74,076 shareholder loan adjustment). Given the significance of the unreported income in 2003 compared to income reported, I find Mr. McLeod's conduct was such that it amounted to gross negligence and he is subject to section 163(2) of the *Act* penalties for 2003.

[64] With respect to Mongos, I am satisfied there was a failure to report revenues, most likely catering revenue, though not to the extent suggested by the Respondent. In 2003, I reduce the unreported income from \$83,536 to \$53,536 and in 2004, I reduce the unreported income from \$165,428 to \$84,428. The adjusting entry in 2005 by Mr. Lotoski to remove \$74,076 from the shareholder loan account is, I presume, a recognition that at least that amount was catering revenue in 2004. I find it was significantly more than that. GST Adjustments should follow accordingly.

[65] With respect to penalties, I find that Mongos is subject to the section 163(2) of the *Act* penalties for 2003 and 2004 given the significance of the unreported revenue.

[66] In the circumstances, I make no award of costs, but should either Party wish to make costs submissions, I ask that they do so by September 30, 2013.

Signed at Ottawa, Canada, this 28th day of August 2013.

"Campbell J. Miller"

C. Miller J.

CITATION: 2013 TCC 269

COURT FILE NO.: 2010-114(IT)G, 2009-3881(IT)G and
2010-115(GST)G

STYLE OF CAUSE: STAN MCLEOD V HER MAJESTY THE
QUEEN
MONGOS GRILL LTD. V HER MAJESTY
THE QUEEN

PLACE OF HEARING: Kelowna, British Columbia

DATE OF HEARING: July 9, 10, 11 and 12 2013

REASONS FOR JUDGMENT BY: The Honourable Justice Campbell J. Miller

DATE OF JUDGMENT: August 28, 2013

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