



TW Tax Practitioners Group

Indirect verification of income – Net worth
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Indirect Verification of income (IVI)

A key focus of the CRA's Small and Medium Enterprises (SME) Program is to identify and deter the underground economy sector.

The audit tool of direct testing may not provide an accurate determination of the taxpayer's income as the income may not have been reported.

Factual audit vs. IVI audit

Factual audit

- Reliance on business books and records
- Direct testing of the business records
- Follows a top down approach

IVI

- Scope extended beyond the business books and records
- Review of taxpayer's personal records, looks at the "big picture" ie. lifestyle

Supporting IVI tests

To determine the risk of non-compliance, supporting IVI tests are conducted, they include:

- Bank deposit analysis
- Rough net worth
- Source and application of funds
- Ratio analysis

Supporting IVI tests

- Tests are performed to determine risk of unreported income
- Tests may lead to an assessing technique if additional risk is uncovered

IVI Assessing Techniques

The hierarchy of the assessing IVI techniques for income tax is:

1. Assessing Net Worth
2. Assessing Projections
3. Assessing Unidentified Bank Deposits

IVI Decision Tree

Reset

INCOME TAX ASSESSING IVI DECISION TREE

The auditor must complete a Bank Deposit Analysis (BDA), including all business, personal and spousal accounts, and then proceed to answer the following questions.

NOTE: Supporting IVI tests (BDA, Source and Application of Funds, Rough Net Worth, and Ratio Analysis) must be completed at the early stages of the audit, prior to addressing factual adjustments.

ASSESSING NET WORTH Consider Assessing Net Worth as the first choice of Assessing IVI technique.	YES	NO	WP
1. Records and books of account are inadequate, inaccurate, or unreliable.	<input checked="" type="radio"/>	<input type="radio"/>	
2. Lack of internal controls/Insufficient segregation of duties.	<input checked="" type="radio"/>	<input type="radio"/>	
3. Income reported by the taxpayer does not support their lifestyle (Summary Withdrawal Analysis).	<input type="radio"/>	<input checked="" type="radio"/>	
4. Third-party information, including leads, indicates unreported income.	<input type="radio"/>	<input checked="" type="radio"/>	
5. It is a cash-based business.	<input type="radio"/>	<input checked="" type="radio"/>	
Conclusion #1 - Does at least one of these conditions exist?	<input checked="" type="checkbox"/>		

Results of IVI tests completed (only BDA and one other test are mandatory)	Amount at risk	WP	Material	
			YES	NO
BDA			<input checked="" type="radio"/>	<input type="radio"/>
Source and Application of Funds			<input type="radio"/>	<input type="radio"/>
Rough Net Worth			<input checked="" type="radio"/>	<input type="radio"/>
Ratio Analysis (insert name of main ratio relied on)			<input type="radio"/>	<input type="radio"/>

	YES	WP
Conclusion #2 - Does at least one of these tests indicate a potential for a material amount of unreported revenue?	<input checked="" type="checkbox"/>	

Decision

The tree indicates you should proceed with assessing net wor

IVI Test vs. IVI Technique

Difference between IVI test and IVI technique

- Tests are not as detailed, part of risk assessment for unreported income
- Technique is based on sufficient audit evidence and used to calculate the actual amounts of unreported income

Why a file is selected for IVI Testing

Based on a number of factors, including:

- Family income vs. average family income in taxpayer's neighbourhood
- Number of dependants
- Increasing investment income
- Real property transactions
- Property tax or rent paid
- Increase in the shareholder loan payable from the corporation
- Credible information from informants
- Inherent risk in the taxpayer's industry

Why a file is selected for IVI Testing

Cases where there is a high probability of

- An accumulation of business and personal assets
- A reduction of business and personal liabilities
- Personal expenditure and lifestyle that is not consistent with reported income

When is IVI testing used

- Books and records are non-existent, or inadequate, or unreliable
- Lack of internal controls/insufficient segregation of duties
- Income reported does not support taxpayer's lifestyle
- Third-party information indicates unreported revenue
- Cash based business

What is a net worth assessment

- Net worth Assessment is an indirect verification of income (IVI) technique that the CRA can use
- The unreported income per Net Worth is derived from the taxpayer's documents/financial records
- Upheld in court many times
- Legislative authority to (re)assess a return using IVI is found in subsection 152(7) of the ITA

Assessing Net Worth Calculation

Individual's net worth (NW) can be determined as:

$$\text{NW} = \text{Assets} - \text{Liabilities}$$

The change in net worth can be determined as:

▲ $\text{in NW} = \text{NW at end of tax year} - \text{NW at beginning of tax year}$

Assessing Net Worth Calculation

$$\begin{aligned} & \blacktriangle \text{ in net worth} \\ & + \text{ personal expenditures} \\ & \underline{+/- \text{ tax related adjustments}} \\ = & \text{ Income per adjusted net worth} \\ - & \underline{\text{ Total income reported (Line 150)}} \\ = & \text{ Discrepancy} \end{aligned}$$

Records and Requirement Letters

- Taxpayer to provide all business **AND** personal records. Refer to RC4188 “What you should know about audits”
- Personal records include bank statements, credit card statements, line of credit statements, loans and mortgage statements and detailed shareholder loan ledger
- Personal or business records of other individuals/entities not being audited may also be reviewed
- Third party requirement may be issued

Net Worth Assessment involving unincorporated business

- Business assets and liabilities are included as it is owned by the individual (sole proprietor).

Net worth assessment

- Subsection 9(1) to the individual taxpayer for unreported income

Net Worth Assessment involving Corporations

- Corporation and shareholder(s) are separate legal entities. The net worth audit is conducted on the individual shareholder
- No corporate assets and liability included other than the shareholder's loan account and share ownership
- Net worth assessment
 - Subsection 15(1) to the individual for shareholder appropriation
 - Subsection 9(1) to the corporation for unreported income

Statute Barred periods

- The audit period may be expanded to include returns for which the normal reassessment period has expired. I.e. Statute barred years

Subsection 152(4)

- Reassessment after the normal reassessment period permitted if the taxpayer 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 ITA

Penalties

Subsection 163(2) ITA: False statements or Omissions

Penalty is applicable when a person knowingly or under circumstances amounting to gross negligence makes a false statement or an omission on their return. Penalty is 50% of the tax payable on the unreported income

Subsection 163(1) ITA: Repeated Failures to Report Income

Penalty is applicable when a person repeatedly fails to report an amount required to be included in income. Penalty is 10% of that amount

Notice of Objection - Appeals

Most common items objected to:

- Non-taxable sources of funds and loans (from friends, family etc.)
- Reassessment under subsection 152(4) for statute barred periods

Notice of Objection - Appeals

Non-taxable sources and loans from family and friends:

Verbal evidence

- Evaluated against other corroborating evidence

Additional documents

- Substantial documentation may be referred back to audit for review and recommendation
- The file is **not** re-audited
- Mandatory referral per Audit Appeals Protocol
Refer to RC4067

How can Tax Practitioners assist

How can you help with your client's IVI audits ?

- Co-operation
- Provide all financial records (as indicated in the audit engagement letter) right away
- Provide full disclosure of bank accounts/financial accounts. The Agency will find undisclosed accounts through 3rd party requirements
- Inform business clients to keep their personal records
- Review with clients pamphlet RC 4188 "What you should know about audits"