

ITD Global Conference on Taxation of Small and Medium Enterprises

**SME Audit and Verification Strategies and Techniques Based on Risk Detection
and Risk Selection**

(Parallel Session 4, Stream B)

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Canada Revenue
Agency

Agence du revenu
du Canada

Scope

This paper discusses audit and verification strategies used by the Canada Revenue Agency (CRA) to manage the tax reporting compliance of Small and Medium Enterprises (SMEs). It also identifies some cost-effective approaches governed by risk management practices that the CRA utilizes to best respond to the unique challenges for this group. This paper also provides an explanation of how the CRA approaches the identification and treatment of “fiscal dwarfism.” (While audit and verification also play a key role in addressing filing and registration compliance, this paper will not provide detailed guidance on these aspects.)

For the purposes of audit programs, CRA defines all self-employed individuals, small and medium-sized corporations, partnerships, and trusts as SMEs. Taxpayers in the Small Business Audit group are typically individuals and Canadian controlled private corporations with annual gross revenues of less than \$1 million. Medium Business Audit addresses corporations having annual reported revenues of less than \$250 million.

The term “taxpayer” is used within this paper to refer to not only persons required to file tax returns under the *Income Tax Act*, but also to those required to register under the provisions of the *Excise Tax Act*.

Given the purpose of the ITD forum and the socioeconomics of many of its members, the audit and verification strategies and techniques described in this paper will focus more particularly on the small and micro business sectors of the SME population.

Canada has achieved a substantial degree of tax harmonization without compromising policy flexibility. Pursuant to a number of Tax Collection Agreements, the CRA administers and collects a number of taxes and fees on behalf of certain provincial (excluding Quebec), territorial, and aboriginal client governments.

The term “client” is used to refer to these government entities (federal, provincial, territorial and First Nations) on behalf of which the CRA administers their tax and collection programs.

The Canadian Tax System

Canada is a parliamentary democracy governed by a House of Commons and a Senate. Canada consists of ten provinces and three territories, each of which have their own government and defined constitutional powers, including that of taxation. These two levels of government work together on a number of important areas of common interest, such as health and social welfare, agriculture, roads, tourism and immigration to name a few.

Canada imposes and collects taxes through a self-assessment system. This system is premised on the voluntary compliance of taxpayers and the mutual responsibility they share with the Agency to the efficient functioning of the tax system. In other words, those individuals, corporations, and trusts that are obliged to pay tax in Canada are expected to meet their responsibilities under the law with minimal intervention on the part of the Agency.



The Department of Finance, the Department of Justice and the CRA all play key roles in the federal tax system. The Department of Finance is responsible for drafting tax legislation and developing tax policies in accordance with the national goals of Canada's taxation system. The CRA is responsible for the administration and enforcement of all federal tax legislation. The Department of Justice handles litigation arising from appeals to specific tax cases as well the criminal litigation that arises in revenue prosecutions.

The CRA works to maintain public confidence in the fairness and integrity of the tax system through the effective delivery of its mission, which is to promote voluntary compliance through a combination of communication, quality services and responsible enforcement.

The CRA operates on the fundamental belief that taxpayers are more likely to comply with the law if they have the information, advice, and other services that they need to meet their obligations, which include paying taxes and providing information.

The primary legislation that CRA administers includes the *Income Tax Act*, the *Excise Tax Act* (which includes the Goods and Services Tax and the Harmonized Sales Tax (GST/HST), two of Canada's VAT taxes), the *Excise Act*; as well as administration (for reporting and collection functions) of the *Employment Insurance Act* and the *Canada Pension Plan*.

The Functional Model directs the day-to-day administration of the Agency. This model vests overall accountability for national policy and program development, and the achievement of national program results, in the headquarters branches. Our (five) regions are responsible for the "day-to-day" delivery of high quality programs and services in support of national program objectives and targeted results as outlined in the Corporate Business Plan, through the operations of local tax services offices and tax (processing) centres.

Defining Tax Compliance

The Canadian tax system is based on voluntary compliance and self-assessment. Taxpayers are expected to determine their own liability under the law and then pay the correct amount of tax.

Compliance with Canada's tax laws means that taxpayers:

- Register as required under the law;
- File returns on time;
- Report complete and accurate information to determine tax liability; and
- Pay all amounts when due.

Non-compliance is the failure by taxpayers to meet any of these obligations, for any reason. This can result from any number of issues and circumstances – from honest mistakes in interpretation and mathematical miscalculation to deliberate acts of tax evasion.

We realize that many factors can combine to influence tax compliance behavior. Some of these factors extend beyond the bounds of tax administration and relate to changing social and economic conditions. Therefore, compliance indicators must be analyzed in their proper context.

Although registration compliance is a risk that is not directly related to the audit function, registration compliance can affect the nature of reporting compliance risks that we subsequently must face through our SME audit programs. For example, if a taxpayer has successfully registered and entered into the tax system to commit GST refund fraud, responsibility for detection and intervention will fall to SME audit programs. In such cases it is often difficult to locate and audit these taxpayers and business activity may not be evident without the availability of reliable third-party information (e.g., credit bureaus, licenses, etc.). We must therefore incur proportionately much higher costs in verifying reporting compliance. It is therefore essential for purposes of audit that we obtain full and complete information at the time of registration and that we have an effective non-registrant detection program in place to address all forms of registration non-compliance as early as possible.

Canada's tax administration system is greatly aided by employers and other third-party information reporting. Both play a vital role in maintaining compliance among the 25 million individual taxpayers. The relative risk of individual non-compliance related to deductions at source is very low. In 2006-2007, the CRA obtained a total of \$251 billion in cash receipts from deductions at source by employers and third party reporting. In other words, almost 73% of total cash received by the CRA was remitted in this way with limited or no intervention on our part.

The CRA Approach to Risk Management

We strive to minimize the compliance burden for taxpayers by streamlining administrative processes and providing quality service. In those instances where individuals and businesses either unintentionally or intentionally fail to fully comply, we use a wide range of mechanisms (levers) – including those found in our verification and enforcement programs – to induce taxpayer compliance and to protect Canada's revenue base. When taxpayers disagree with us, we provide them with the opportunity for redress, which is a formal, objective review of their file. This fosters taxpayers' confidence in the fairness of our self-assessment system, and encourages them to meet their obligations voluntarily.

Detecting and addressing non-compliance are so vital to the protection of Canada's revenue base that work toward achieving this result occurs almost everywhere in the CRA. Indeed, efforts toward this expected result are explicitly reported in three of our five program activity sections (Assessment of Returns and Payment Processing, Filing and Remittance Compliance, and Reporting Compliance) and are implicit in the other two (Taxpayer Assistance and Appeals).

As part of our (front-end) assessment of returns and payments processing, we detect and address non-compliance by individuals through pre-assessment and post-assessment reviews.

Despite the convenience and compliance benefits that third-party reporting provides, a risk remains that taxpayers will make errors on their tax returns, choose to under-report income, or overstate

deductions or tax credits. Once tax returns are filed, we therefore conduct pre-assessment reviews based on a risk-scoring approach to select returns for detailed review. These reviews detect errors and omissions that result in significant reassessments every year, including \$107.4 million in additional tax assessed in 2006-2007.

Our post-assessment work involves targeted reviews based on risk assessment and random reviews. Through our matching program, we compare amounts reported by individuals for a wide range of income and deduction items (such as wages and registered pension plan contributions) with the amounts reported on third-party information slips. For the minority of taxpayers who make reporting errors, the matching process allows us to effectively identify and correct these errors.

The Compliance Programs Branch has Agency-wide responsibility for compliance strategy, policy and research, and is the branch most responsible for functions related to reporting compliance. That is to say, our Branch shares the responsibility for the achievement of overall tax compliance with several other branches in the Agency. These other branches are responsible for a multitude of other forms of compliance and service, including registration, filing, and payment of taxes, providing tax information and assistance, redress and appeal functions, as well as administering numerous benefit programs.

Underpinning our compliance approach is our use of risk management to identify current as well as emerging compliance risks, and to assess them for their potential effect on the revenue base and on compliance in general. We then develop strategies for mitigating the greatest risks to compliance. These strategies address specific segments of the tax population or particular areas of non-compliance, using a mix of instruments and activities, such as outreach activities or audits. Part of our risk management strategy is to maintain an audit presence across all industry sectors and for all types of taxpayers. Overall, we believe this approach helps promote voluntary compliance and deters non-compliance by increasing the credibility and visibility of our compliance programs.

The Compliance Programs Branch uses the Compliance Measurement Framework (CMF) as a structured, comprehensive, and dynamic approach for monitoring and measuring compliance as well as for evaluating and refining our approach to addressing non-compliance. It lays out key concepts, constructs, and the operational definitions for the study of compliance.

The CMF consists of five inter-related elements:

- Compliance definitions define the four key compliance requirements that will be the focus for our research;
- Program mapping aligns tax programs and services to one or more of the four key compliance requirements to provide a consolidated view of the CRA's efforts and influences in support of compliance;
- Taxpayer segmentation outlines our approach for segmenting the taxpayer population as a basis to analyse and understand trends, issues and behaviours of relevance to compliance strategies;

- Compliance indicators provide the essential building blocks for tracking compliance outcomes, trends and developments using proxy measures that are derived from a variety of internal and external data sources; and
- Measurement methods describe the methodologies for collecting and processing data for each indicator or set of indicators.

To facilitate further research into and analysis of compliance, the CMF partitions the Canadian taxpayer population into the following segments:

- Individuals (T1 returns).
- Businesses:
 - Self-employed individuals (T1 returns).
 - Corporations (T2 returns).
 - GST/HST registrants.
 - Employers.
- Trusts (T3 returns).
- Charities.

Apart from a static “corporate” view of the main taxpayer groups (as listed above) for analyzing macro perspectives of compliance, we also segment the taxpayer base using a customized approach to conduct studies of specific taxpayer segments based on their business/lifestyle practices and other associated risk factors.

Also included in the CMF are macro-indicators, which we use to evaluate reporting compliance trends and to determine if trends in economic data could provide an early indication of a change in the levels of compliance. Other matters include:

- Monitoring and analysis of the socioeconomic context in which the Canadian economy operates, e.g., globalization. This type of macro-economic research provides context to specific compliance indicators that results in better decision-making. Statistical modeling and analysis of these trends can also be made using internal and external data, which may then be programmed into our risk assessment models.
- Measuring reporting compliance with confidence requires reliable estimates of the extent to which taxpayers accurately determine and report their tax liabilities in their returns. Tax administrations including the CRA agree that the most meaningful direct evidence on reporting compliance is derived from carefully auditing/verifying a random sample of tax returns that is representative of the entire population. The Core Audit Program (CAP) provides this information for the small and medium business population, including self-employed individuals.
- The monitoring and analysis of public opinion research is used to determine areas of evolving risk and opportunities for program improvement. This work includes the various annual CRA surveys (conducted by market segments) as well as the surveys conducted for CRA by external parties e.g., EKOS “Rethinking Government” survey and the Centre de Recherche sur l'Opinion Publique (CROP) studies prepared for CRA.

The detection of non-compliance relies on effective risk management to identify emerging compliance risks and to assess them for their potential effect on the revenue base. We then work to mitigate the greatest risks. This may involve adjusting priorities using a mix of instruments and activities to address specific taxpayer segments or particular areas of non-compliance.

We are always working to improve and refine our risk assessments to better identify non-compliance. This year, we incorporated more provincial risk factors into our risk assessment systems. These factors related to provincial residency and income allocation.

In 2004, the Agency undertook a comprehensive assessment of the risks facing tax administration in Canada, from a horizontal, cross program, Agency-wide perspective. This "Compliance Review" resulted in the identification of four key risk areas:

- Aggressive Tax Planning;
- GST/HST Fraud;
- Underground Economy; and
- Non-filers/ Non-registrants and Revenue Collections.

This analysis and related findings were used to develop comprehensive multi-year strategies and plans to address each of these risks as well as to develop an agenda for the Agency to strengthen the integrity of the tax system, both in the short and long term, including recommendations for legislative changes and business cases for additional resources.

The CRA is now in the process of conducting a second Compliance Review, a process that may result in the identification of new compliance priorities and corresponding strategic plans.

CRA also takes an organizational approach to risk management.

On a "corporate level", the Compliance Programs Branch (CPB) recently created the Compliance Strategy Directorate to enhance the overall Branch management of issues, to increase the policy/strategy development capacity of the Branch and to provide a focal point from which to manage CRA's relationships with international partners.

The Headquarters Compliance Committee (HQCC) and the CPB Branch Compliance Committee (BCC) have been created to provide forums for enhancing the coordination and management of compliance strategies on an Agency and Branch-wide basis. Members of these committees are senior CRA executives with the authority and vision to take the necessary actions in specific cases where cross-program issues must be addressed and/or programs need to be adjusted. These committees facilitate the flow and sharing of information across participating areas and functional lines.

The Branch has centralized all functions of compliance research and risk assessment into the Research, Risk and Business Management Directorate in order to provide a centre of excellence that provides a broad range of services and corporate support:

- The Risk Assessment Division is responsible for developing strategies and processes to examine returns, assess risk and identify potential audit issues developing and implementing sophisticated, electronic risk assessment systems to select and target enforcement actions, providing field training in the use of these systems and assessing their effectiveness and providing a center of expertise on risk assessment.
- The Research Division supports the Agency's development of effective compliance strategies through comprehensive research and analysis of the factors that contribute to compliant and non-compliant behaviour, identification of emerging compliance trends and of the impacts of compliance programs and initiatives on CRA taxpayers.
- The Compliance Systems Redesign Division is responsible for developing and implementing a comprehensive suite of information technology solutions in order to enhance the Agency's capacity to manage compliance programs more effectively and deliver its core business in a more integrated and efficient manner.

The CRA Research Network was formed several years ago to facilitate the exchange of information on research activities and results within the CRA research community, to optimize CRA research investments and to identify opportunities for collaborating on research activities where there is common interest and mutual benefit. The Network consists of directors involved in conducting social, economic and/or compliance-based research within the CRA.

The Federal/Provincial/Territorial Underground Economy Working Group was created in 2000 by CRA and the provincial and territorial departments of Revenue and Finance to work in partnership to reduce participation in the underground economy through research, information sharing, sharing of best practices, communication, education, and enforcement.

The Suspicious Activities Working Group was created in 2006 to provide Agency guidance and direction on actual and emerging issues related to suspicious or suspected fraudulent activities in our T1 population to develop solutions ensuring participation by all impacted areas and taking preventative measures without compromising taxpayer service.

We have also reorganized functions within the Small and Medium Enterprises Directorate to improve our risk management capabilities.

The High-Risk Compliance Strategy Division was recently created to develop and evaluate the impact of comprehensive compliance strategies aimed at maximizing compliance of SMEs. The strategies take into consideration various factors such as industry sectors, business sizes and unique characteristics of taxpayer/registrant groups. Implementation of the strategies is undertaken through risk analysis, program development, education and audit initiatives and consultations with clients and other stakeholders.

The Workload Development and Business Analysis Division was recently created to provide functional guidance, tools and support to the regions and field offices for workload development and intelligence gathering in relation to SMEs. This division also allows senior management to make informed decisions about how to approach compliance issues and where opportunities for

program improvements may exist. WDBAD also acts as a liaison for SME audit programs with CPB's Research, Risk and Business Management Directorate.

We also work collaboratively with our field offices to develop program approaches, working tools and training for certain industries (e.g., oil and gas, banking, insurance, etc.) where audits are more technically difficult and a high level of expertise is required. This can then be shared horizontally across the Agency.

What strategies are available to cost effectively manage the SME audit program and optimize results?

The CRA utilizes a broad range of tools and instruments to manage the reporting compliance of small and medium enterprises, including:

Service/Education

A key element in a balanced and fair approach to compliance management is providing information, service and education to taxpayers in respect of their obligations under the various tax legislation they are responsible to comply with.

Our Agency has recently taken steps to reduce the compliance burden on small and medium-sized business. The Minister of National Revenue created the Action Task Force on Small Business Issues. Its mandate is to identify which of our administrative practices imposed the greatest burden on small businesses, develop solutions to reduce this burden, and introduce a systemic approach to burden reduction within the CRA. The final report, entitled *Helping Small Businesses by Reducing the Compliance Burden*¹, was released in March 2007. It identified over fifty initiatives that the CRA will undertake in support of real burden reduction. We are committed to implementing these initiatives and sustaining the focus on burden reduction in the years to come in a manner consistent with our overall accountability for tax compliance, revenue collection, and taxation data collection.

During the last five years, one of the ways in which we have made significant progress in improving our tax administration has been the development and implementation of an electronic service strategy that allows taxpayers to choose from a variety of secure, automated, self-service channels. We have made a major effort to serve their needs by simplifying processes and providing faster access to information and services through the Internet, through the provision of *My Account* and *My Business Account*. CRA is focused on providing excellent service to individuals and businesses, thereby making it easier for them to understand and comply with their tax obligations.

Another approach we take to serve and educate our taxpayers, particularly small business, is through our tax seminar program. We have designed three modules for small business that provide

¹ The Task Force report is provided on the ITD Conference site under "additional papers" <http://www.itdweb.org/SMEconference/SubmitPaper.aspx> (2nd last).

important information about starting a small business, registering for a GST/HST account, payroll requirements including T4 slip preparation, and a number of other tax compliance issues.

Outreach

To provide clear answers as quickly as possible, CRA offers access to a number of services to help small businesses understand and meet their tax obligations:

- The CRA website provides most of the tax information and forms that small businesses require to comply.
- CRA provides 1-800 toll free telephone service to provide access to business window agents who are trained to provide a wide range of information and services for businesses and self-employed individuals.
- CRA community visits send CRA auditors out to businesses in the community. This increased visibility in the community enhances communication and transparency between the CRA and taxpayers, thereby encouraging voluntary compliance.
- Both as a compliance tool and to provide better service, we also conduct books and records reviews, particularly for new businesses and those operating in businesses where books and records are more problematic.
- CRA conducts training sessions hosted by non-profit organizations to increase the awareness of non-residents and prospective immigrants about their tax obligations and entitlements. Our “newcomer brochure” was published to better address the needs of immigrants. In fact, CRA personnel make numerous presentations to trade schools, new Canadians, non-residents and others who may lack knowledge of and/or are new to the tax system.
- We also work with schools to deliver the "Responsible Citizenship and Canada's Tax System" as well as “Teaching Taxes” courses, which explains to students the importance of the tax system within society, where tax dollars go and provides basic information about the tax system as a whole.
- The Stakeholder Relations Division of the Scientific Research & Experimental Development (SR&ED) Directorate offers information seminars to claimants to provide a general overview of the SR&ED program and explain the program's eligibility criteria, what expenditures are eligible, and how to file a claim.

CRA’s other outreach services include issuing Tax Alerts, attendance at business seminars, home and trade shows, as well as appearances at numerous speaking engagements.

The CRA is also putting much greater emphasis on the tax compliance of charities. Over the last few years, the Charities Directorate has been concentrating on developing and implementing a comprehensive reform package designed to strengthen the regulatory environment for charities.

The Charities Directorate is also offering free information sessions to registered charities, commonly referred to as “The Charities Road show”, at venues all across Canada. These sessions discuss various topics of interest, changes to the law, and common compliance issues with the goal to enhance the ability of charities to provide complete submissions and to help reduce their

administrative burden. This year's topics are: financial statements & books and records; sanctions; auditing charities; participation in tax shelters; gifting and receipting.

The Minister also recently announced a Taxpayer Bill of Rights, which includes a right to expect the Agency to warn taxpayers about questionable tax schemes in a timely manner. Informing possible donors through such means as Taxpayer Alerts or Road shows are just a few examples of the ongoing outreach program for charities.

Third party reporting

Reliable and complete third party reporting significantly enhances CRA's ability to conduct sophisticated electronic analysis in a cost-effective manner. It is also a strong enabler of higher levels of voluntary compliance by improving our detection (and visibility) of the financial transactions being reported.

In the case of information slips, CRA requires electronic filing (summary and detail) for: payments made by trusts, partnerships, banks and other financial institutions; payments made as wages, or for dividends and interest; as well as payments made under particular business relationships, such as service contracts with federal government departments. These information slips provide evidence of business and financial transactions and allow for data matching to tax returns. These slips also are the basis for stronger actions to be taken in cases where returns have not been filed.

CRA has also developed systems to address specific sectors of non-compliance – a good example of this is the Contract Payment Reporting System (CPRS) that was developed in 1999 in consultation with the construction industry. This system forms an integral part of our overall strategy to deal with non-compliance in the new housing construction and home renovation sectors and (more recently) with government contract service providers.

Partnering and Intelligence-Gathering

CRA has developed information exchanges with other federal government departments and other levels of government, as provided for by law, to partner and leverage access to other government databases (e.g., transportation, liquor, etc.) to address such issues as residency, business activity, etc.

Some examples of the work we do with the provinces and territories – as partners, stakeholders and clients – are as follows:

- The Senior Revenue Officials' Conference is held annually and attended by federal, provincial and territorial Assistant Deputy Ministers and equivalents responsible for fiscal and taxation matters in order to share information and provide direction to committees and working groups they have created to advance federal/provincial/territorial cooperation in tax administration.
- The Federal-Provincial-Territorial Underground Economy Working Group (FPTUEWG) meets twice a year to continue work on current initiatives. A Steering Committee and

several project teams have been established to undertake efforts focused on four identified key issues:

- Balancing attitudes towards taxation;
- Joint taxpayer research;
- MOU/data sharing; and
- Enforcement projects.

Other examples of information we obtain from provincial and territorial partners include:

- Alberta re oil and gas well ownership.
- New Brunswick re non-resident directors of New Brunswick corporations.
- Nova Scotia re access to listings of all Nova Scotia Unlimited Liability Corporations.

We are also in the process of improving our opportunities to work with tax intermediaries such as lawyers, accountants and tax preparers to get our compliance messages across to targeted groups.

CRA is constantly seeking ways to develop intelligence capability and capacity, and to find new ways to obtain and use information as we develop our understanding and ability to manage the constantly changing tax compliance landscape.

Auditing/Verification

Where taxpayers need intervention to accurately and completely fulfill their obligations, we maintain a range of compliance strategies. Primary among these is the conduct of audits and examinations of tax issues relating to personal and corporate income taxes and GST/HST. These activities assure that the law is properly understood and respected and is guided by risk management principles and systems that help us focus our assistance efforts.

CRA puts significant resources into the audit and verification of SMEs as the primary means to verify reporting compliance. In the 2007-2008 operating year (ending March 31) the Compliance Programs Branch will invest approximately \$343 million and utilize approximately 5300 audit staff to conduct thousands of audits and verifications of SMEs across Canada.

In the small business segment of the SME population, the Small Business Audit Program uses a “combined” audit approach where auditors address compliance risk for both income tax and GST/HST. The approach is aimed at reducing the compliance burden for taxpayers/registrants while at the same time improving program efficiency and effectiveness.

Our audits are almost always done electronically through the utilization of an MS Windows-based proprietary Audit Laptop System (Win/ALS). Win/ALS is a suite of inter-connected programs that supports the electronic conduct and reporting of income tax and GST/HST audits. This suite of programs provides auditors with an electronic download of pertinent taxpayer data, a library of working paper templates/audit programs, as well as the ability to electronically upload audit results to mainframe systems, and the ability to electronically archive the completed audit file for future reference and study, such as for quality assurance or for data mining to further risk assessment, amongst other activities.

Electronic commerce audit personnel are made available in the field to advise and assist SME auditors in obtaining electronic records, particularly in situations where such records may be incomplete and/or maintained in multiple formats. These specialists have the tools and expertise to address the challenges in order to provide SME auditors with as much information as possible so they can conduct quality audits that will effectively address the non-compliance in each case.

Auditing small and medium enterprises requires the use of special audit and verification techniques in those cases where there is a lack of sophisticated internal controls, books and records that auditors normally rely upon to evaluate the accuracy of amounts reported. This is more common in industries where cash transactions are frequent and for smaller amounts. In such cases, auditors must place less reliance on sales records maintained by the taxpayer and must find alternative (yet systematic) means to mitigate these audit risks.

One of the approaches increasingly used by audit staff to the verification of the revenues and expenses of these types of businesses is that of Indirect Verification of Income (IVI) audit techniques such as net worth assessment, third-party information, sales projections based on key input costs, bank deposits and comparison of household budgets to Statistics Canada data. We also look for inconsistencies between declared income and the apparent business success and/or lifestyle we see. These audits often result in the detection of reporting gaps that the taxpayer must then provide evidence to explain or refute.

Some other specific services that we provide to SME's to assist them in their reporting compliance include:

- Business Enquiries addressed by business auditors (via telephone and in person);
- Advanced Rulings to explain tax consequences of proposed transactions; and
- Advance Pricing Arrangement Program for improved international compliance regarding transfer pricing.

Enforcement

Where the taxpayer becomes uncooperative and refuses to provide information, we have the ability to seek legal requirements for the production of such information. Similarly, we have a series of graduated penalties that can be applied to compel production of required information in such cases.

The *Income Tax Act*, the *Excise Tax Act* and other laws that the CRA administers provide a broad range of penalties for offences such as tax evasion, making false statements or omissions, misrepresentation made in tax matters by a third party, failure to pay taxes, failure to disclose income, failure to file in a prescribed manner and/or refusal to file a tax return, as well as late filing and remitting of trust accounts (payroll, GST/HST). These penalties can include fines, third-party claims, seizures, and criminal prosecution.

Some examples of our penalty regime include:



- Civil penalties, which apply when a taxpayer is late in filing a tax return and/or when a taxpayer refuses to file a tax return.
- Third-party civil penalties, which apply to promoters of tax shelters to deter tax shelter or tax shelter-like promotions where inflated asset values and other faulty assumptions are knowingly applied.
- Third-party civil penalties, which apply to a person who makes or participates in, assents to, or acquiesces in the making of false statements that could be used by or on behalf of another person for purposes of the *Income Tax Act* or the *Excise Tax Act*. This penalty could be applied to a person preparing a tax return, to a person providing tax advice to a specific person, or to an appraiser or valuator preparing a report for a specific taxpayer or a number of persons who can be identified.
- A number of penalties are levied against employers to enforce the deducting, remitting and reporting requirements of the *Canada Pension Plan*, *Employment Insurance Act* and the *Income Tax Act*.
- Penalties and interest are charged when a registrant is either late or deficient in paying or remitting net tax or instalments to the Receiver General as required under the *Excise Tax Act*.
- In relation to international transactions, where the CRA has reassessed transfer pricing adjustments that exceed a penalty threshold, penalties may apply unless it can be demonstrated that the taxpayer has made “reasonable efforts” through contemporaneous documentation requirements to determine and apply arm's length transfer prices.
- A general anti-avoidance rule (GAAR) is found in both the *Income Tax Act* and in the *Excise Tax Act*. This is a statutory business purpose test that is intended to prevent taxpayers from obtaining a tax benefit from transactions undertaken primarily for the purpose of avoiding, reducing or deferring the payment of tax, or increasing a refund or rebate or other amount, where no other anti-avoidance provision is applicable.

Tax fraud and tax evasion represent the most flagrant instances of non-compliance with tax statutes. The Agency's recourse in such cases is to work with the Department of Justice to prosecute the taxpayer. Our success rate is quite high – we obtained convictions in 94% of cases we prosecuted in 2004-2005. Court convictions are publicized in local, regional and national media to communicate the consequences of fraud committed against the Canadian public and to maximize the deterrent effect of these convictions.

Furthermore, we have a Special Enforcement Program (SEP) that is responsible to conduct audits and undertake other civil enforcement actions on individuals known or suspected of deriving income from illegal activities (e.g., organized crime). This program works closely with various police organizations.

Disclosures

The CRA Voluntary Disclosures Program (VDP) allows taxpayers to come forward and correct inaccurate or incomplete information or disclose material they did not report during previous dealings with the CRA, without penalty or prosecution. The VDP also accepts information that is less than one year overdue, except when disclosures are being made to avoid late filing charges. The

most important condition for this program to apply is that the taxpayer must initiate the disclosure before we start any compliance action or investigation.

We are still working to redefine program objectives and performance measurement criteria and fully integrate the VDP with other compliance activities.

What challenges do SMEs pose to auditing and verification activities?

For the most part, our audit interactions with SMEs are positive and we do not encounter significant challenges relative to any other segment of the taxpayer base.

However, in those cases where SMEs are not compliant in terms of meeting their tax compliance obligations, we can encounter a number of challenges to the effective audit of tax compliance. These might include:

- Incomplete business and/ or tax records;
- Weaker internal controls and less breadth/ depth of management;
- Underreporting income/ overstating deductions and/ or tax credits;
- Working on a cash-basis and transacting in cash;
- Availability and/or reliability of third-party information;
- Level of audit cooperation;
- Incentive to use the tax system as a “source of last resort” for financing;
- Timeliness of information and the relative lack of time we have to conduct audits;
- High rates of bankruptcy and business turnover;
- Identity theft and multi-cell fraud (e.g., VAT carousels);
- Internet/Virtual economy/Cross-border transactions;
- Non-resident maintained books and records; and
- Utilizing electronic suppression of sales technologies (e.g., Zapper).

The underground economy represents one of the largest challenges we face in CRA in managing the tax compliance of SMEs. The underground economy consists of activities which may be both productive in an economic sense and legitimate (provided certain standards or regulations are complied with) but which are deliberately concealed from public authorities usually to avoid the payment of taxes or to avoid meeting certain standards or administrative requirements.

One of the sectors we have identified as part of the underground economy and one that is more prone to underreporting revenues is the hospitality sector (restaurants). One of the most popular means to suppress sales is to utilize electronic suppression of sales technologies, such as “Zapper.” The CRA is actively working with provincial counterparts (through the FPTUEWG) to address Zapper and other point-of-sales suppression technologies.

The explosion of internet-based business activity is creating new compliance challenges that fiscal authorities must address. For its part, the CRA is developing an Internet compliance strategy built on our experience from a number of Internet Business Audit Projects (IBAP)

There have been three phases to this project so far:

- **IBAP 1 (2002-2003):**
The objectives of the initial project were to: (1) evaluate the compliance level of approximately 200 small & medium Internet businesses vs. the traditional “brick & mortar” businesses; (2) identify ECommerce audit issues; (3) gain knowledge of the business environment and practices used relative to eCommerce; and (4) develop eCommerce information, training and tools.
- **IBAP 2 (2003-2005):**
Addressed Canadian business operating within Canada, with on-line transactional capabilities.
- **IBAP 3 (now in progress) which has two parts:**
IBAP3A - Audits of Canadians using the Internet to conduct business abroad; and
IBAP3B2 - Non-Resident businesses using Internet to conduct business in Canada.

We are also actively consulting with Canadian Internet industry to encourage more complete and transparent identification at the time that they take on new subscribers.

The CRA regularly conducts research and evaluates tools and techniques that may enhance its compliance activities. This includes meeting with other government tax administrations to discuss tools and techniques. One of subjects has been the use of web crawling tools as a method to identify businesses operating on the Internet. At present, these tools are being explored to see if there is potential. The CRA is working to understand their capability and determine our ability to use them in the Canadian environment. It should be noted that these tools use information that is already available in the public domain through the Internet.

We will continue to look for opportunities to impose the least burden possible on small businesses, while providing the CRA with the information it needs to confirm compliance with tax-related obligations through our work with SMEs as we work together to implementing the recommendations of the Action Task Force on Small Business Issues.

How do risk management techniques support this effort?

Some of the techniques that CRA utilizes to identify risks/ assess program impacts include:

- Monitoring tax data relative to indicators of socioeconomic change.
- Analyzing program results and relating these to tax-at-risk, changes in compliance indicators, etc. (i.e., Core Audit, Compliance Measurement Framework, etc.).
- Monitoring and evaluating programs for program effectiveness:
 - Periodic program reviews;
 - Regular program monitoring;
 - Program evaluations;
 - Quality Assurance reports; and

- Internal audits and Office of Auditor General audits – including regular follow-ups.
- Conducting surveys and studies:
 - Public and industry surveys;
 - Behavioral studies; and
 - Compliance research studies.
- Sharing of ideas and best practices with foreign and domestic tax administrations through our participation in various forums and bilaterals, including the OECD and the Inter-American Center of Tax Administrations (CIAT).

To assess and improve our tax administration, we must also know how well our services and programs are achieving their objectives. We have a legal responsibility as an Agency to our clients to report on our achievement of programs and services we administer on their behalf, and we have an obligation to the Canadian public to report on how we have met our service standards.

These reports provide a review of activities and developments in the three main areas of our relationships with the provinces and territories:

- The CRA's delivery of programs for the provinces and territories, such as income tax and benefits.
- The co-operation between administrations in delivering similar federal and provincial or territorial programs.
- The CRA's support of provincial and territorial social programs through authorized exchanges of taxpayer information.

The Agency has worked diligently to build relationships with other countries through various organizations and associations. The Canada Revenue Agency plays a significant leadership role in various international fora, which provides us with many opportunities to work with foreign tax administrations towards developing a better understanding and appreciation for changes and developments within world economic and fiscal systems that may affect compliance management and require adjustments to our program strategies.

Our Systems-based Approach to Risk Management

CRA utilizes a suite of systems-based capabilities to identify, manage and address tax reporting compliance, including:

- Macro indicators;
- Systems-based initial screening of tax returns;
- GST/HST edit checks;
- Data matching;
- COMPASS - Compliance, Measurement, Profiling and Assessment System;
- CPB Compliance Laboratory; and
- General Index of Financial Information (GIFI).

CRA employs substantial front-end systems that screen and score 100% of the tax returns filed in order to detect and address high-risk returns. An example of this is the Confidence Validity (CV) program reviews conducted in the Tax Centres that results in approximately 1-2% of all returns examined to be taken to a secondary review for further review and possible referral to audit.

GST/HST edit checks perform a similar role in the processing of VAT returns and rebate claims. A large number of electronic tests are employed to identify those returns that possess characteristics that we have identified as most likely to contain error or fraud. These returns and rebate claims then reject to a national electronic workload system, where they are reviewed and (if necessary) audited by field audit staff.

Data matching involves bringing together data from different sources and comparing or matching it and is a highly effective way to process large volumes of information in order to identify specific taxpayers for further action or investigation. Most of this data matching is done by the CRA in the Tax Centres using statutory electronic third-party information. However, customized risk assessment and workload development is done in HQ and in the field using an issues-based approach. (In all cases, such matching is subject to privacy legislation and the CRA is accountable to the Office of the Privacy Commissioner for such activities.)

The tool most commonly used to conduct risk assessment and workload development is the COMPASS (Compliance, Measurement, Profiling and Assessment) System. This is a workload development and decision support system that uses Online Analytical Processing (OLAP) tools such as Power Play and Impromptu to conduct aggregate analysis of risk according to a customized variety of criteria and at various levels of detail. This allows authorized users to drill-down to the detailed data behind the aggregate figures. This system provides a dependable, consistent and accurate national compliance measurement, profiling and assessment decision support solution with the ability to carry out sophisticated analysis accessing a shared source of integrated data in relation to resident and non-resident individuals, corporations and trusts for both income tax as well as GST/HST compliance.

Over the past two years, the CRA has developed a Compliance Laboratory. This is a local, standalone computer network that has been designed specifically to allow authorized researchers using state of the art research tools in order to identify and assess tax compliance risks, by:

- Bringing together all the necessary data to assess risk (e.g., financial statement information, industry classifications, third party information, benchmark information, etc.); and
- Making the linkages across the data to assess risk (e.g., corporations, shareholders, controlled companies, trusts, GST accounts, partnerships, joint ventures, provincial data, flow through entities, etc.).

All corporations (except insurance companies) are required to file General Index of Financial Information (GIFI) information with their T2 corporate income tax returns. This is an electronic filing of the items commonly reported on income statements, balance sheets and statements of retained earnings. GIFI provides an efficient means to collect financial information in a codified format and represents a key source of electronic information for effective risk assessment. It is also

worth noting that all tax preparation software packages approved by the CRA must include a GIFI component.

How can tax administrations identify and control “fiscal dwarfism”, i.e., medium to large firms segmenting to avoid the “spotlight” and/or to benefit from favourable tax schemes and treatment?

This is a growing phenomenon that is negatively affecting tax administrations. By using such tactics as segmenting their operations, forming any number of separate legal entities and by using any number of special purpose entities/vehicles/companies (e.g., trusts, limited partnerships, special corporations), much larger (natural) economic entities are able to fulfill narrow and specific tax-planning objectives, either to reduce effective tax rates and/or to obtain lower effective compliance scrutiny by tax authorities.

From the CRA perspective, there are a number of approaches to counter this phenomenon:

- “Whole of corporate group” approach and understanding economic relationships;
- Identification and monitoring of special purpose entities;
- Comprehensive information gathering;
- “Related Parties Initiative”;
- CRA participation in the “Leeds Castle” Group and “JITSIC”;
- Statutory reporting to securities regulators;
- National workload identification and control; and
- Local management and service of large business accounts.

Some other approaches that CRA takes that assist in countering “fiscal dwarfism” include:

- Exchange of Information; and
- Legislative filing requirements, deterrents and remedies (e.g., partnerships and trusts)

The “whole of corporate group” approach is used by the CRA to address the compliance of economic groups that may include individuals, partnerships, corporations, trusts and other special purpose entities. For example, a separate identification and workload control system for Medium-to-Large Taxpayers, called the Basic File Inventory Control System (BFICS) is used. This system is an integral component of the larger Audit Information Management System (AIMS). Field office managers use this system to control the selection, monitoring, and audit of the largest and most complex corporate returns and those related/associated cases and files, including SMEs.

The CRA has developed the Related Parties Initiative (RPI) in response to the collective tax risk posed by groups that consist of several related economic entities, both domestic and offshore, that frequently employ special-purpose entities (e.g., limited partnerships, private charitable foundations, trusts, and special corporations) to achieve favorable business and tax results. The legal/structural complexity of these groups makes compliance management very difficult and time consuming. Therefore, the CRA requires audit and other staff with considerable experience, expertise and soft-skills.

The CRA has invested additional funding to address a number of these cases outside of normal operational limits re time and resources, with detection risk being the most important element to be addressed. For example, sometimes these high, net worth groups may not be evident unless the assets and activities of all entities are first identified and combined and (then) identification of the controlling high wealth individual(s) is the key connection to the actual decision maker(s) for the group. To properly understand sophisticated tax planning and have the basis to look at general anti-avoidance transactions, these economic relationships must be identified and well understood. Also, once these groups are identified, it is vitally important to systematically gather and update the information maintained for the group, and analyze and update the relationships as they are constantly changing.

The goals of the RPI initiative are to:

- Increase understanding of the business structure of related parties;
- Identify the type and magnitude of compliance issues and tax at risk;
- Develop compliance strategy for such taxpayers; and
- Identify legislative or program changes required to address compliance issues.

The tax compliance of this type of high wealth-led, related party group has also become a top issue for many tax authorities, including the IRS and the ATO. It has also been identified as a top priority for the “Leeds Castle” Group – a group that consists of the commissioners of the revenue bodies of Australia, Canada, China, France, Germany, India, Japan, South Korea, the United Kingdom and the United States that meet regularly to consider and discuss issues of global and national tax administration in their respective countries.

In addition, the United States, the United Kingdom, Canada and Australia (recently joined by Japan) have established two Joint International Tax Shelter Information Centres (JITSIC). This is a joint effort to identify, develop and share information about abusive tax avoidance transactions on a real-time basis. Work at JITSIC has identified abusive transactions that otherwise wouldn’t be known to the JITSIC member countries.

Another source of information available to the CRA is the statutory reporting that individuals and corporations must comply with under the requirements of securities regulators (amongst others). Insofar as this information is prepared in a manner consistent with that required for tax reporting (e.g., generally accepted accounting principles) then these reporting sources provide a further opportunity to evaluate the degree to which a taxpayer is providing full and accurate reporting for tax purposes.

The Basic File Inventory Control System (BFICS) is a national inventory and workload control system that is used to specifically identify and manage all large file cases and their associated control groups. BFICS allows authorized users in each local field office to update any BFICS file with local information/knowledge in a standardized format, and to obtain standardized reports from the system. This system allows national workload control of an entire economic group of taxpayers and is designed to address issues like “fiscal dwarfism”. BFICS is automatically updated on a daily basis using a wide variety of tax and audit data obtained from other Agency systems.

In addition to this national systems-based workload control, Large File Case and Account Managers manage compliance at local levels using local knowledge and continuous contact using a single-window approach to delivery of Agency services – often this is managed using an Audit Protocol or a Service Agreement. These case and account managers are responsible to stay abreast of the developments in their assigned cases that could affect the tax compliance of the taxpayer, even when audit action is not occurring.

The Agency's Business Number (BN) and VAT systems are also designed to identify and report on account relationships, whether legal or economic, and this information is used to monitor economic relationships and legal restructuring.

CRA audit personnel also have access to third-party databases, e.g., Industry Canada and Statistics Canada, to identify relationships and conduct intensive research. Furthermore, library services are placed in many of our larger offices, which are capable of researching entities using various internet-based sources of information (e.g., financial media sources, securities regulators databases, etc.).

Exchange of Information and Memoranda of Understanding

The CRA operates under the terms of some 300 Memoranda of Understanding (MOU) and agreements with federal, provincial and territorial departments and agencies for the communication and exchange of information. Interpretation and administration of these agreements is the responsibility of the Client Relations Directorate, which is responsible for the management of federal, provincial, territorial and aboriginal affairs on behalf of the Agency.

The CRA also operates under the terms of numerous income tax conventions (86 in force, 3 pending ratification and 15 under negotiation) from which authority is provided to exchange information. The authority for exchanging information is vested with the "Competent Authorities" of the Contracting States and the treaties specifically state that any such exchange of information must only take place between these names Competent Authorities.

Tax treaties include provisions for the exchange of information (EoI) be it automatic, specific or spontaneous, as well as in cases of Simultaneous Audit and provide good sources of information.

These exchanges facilitate the ability of CRA to manage the tax compliance of SMEs, particularly in those cases where information, mind and management may be located/maintained outside of Canada given our role in the international economy, thereby making audit and verification more difficult to accomplish without the assistance of the foreign-based fiscal authority.

Statutory reporting requirements are lower for partnerships and trusts

The statutory reporting requirements for trusts and partnerships have been lower than for corporations and individuals, providing a benefit to special-purpose entities and making them more attractive as vehicles to effect "fiscal dwarfism". In Canada, the CRA is seeking legislative

amendments to strengthen the tax reporting of partnerships and is also in the process of defining legislative amendments for trusts that will strengthen the reporting requirements for these entities that will put them on a level playing field with individuals and corporations vis-à-vis reporting requirements. Specifically, we are concluding a study that was designed to identify subsets of the trust population to ensure that enhanced reporting requirements are balanced to the risks present in each segment.

Trusts are now receiving considerable Agency attention through studies, pilot audits and proposed legislative changes that are designed to put these entities back on a level playing field for reporting requirements/burden vis-à-vis individuals and corporations.

Conclusion

Tax compliance of the small and medium enterprises segment of the taxpayer population is a substantial challenge. The sheer size and diversity of the SME taxpayer population makes it difficult to evaluate and manage the various compliance risks in a coordinated/consistent fashion across the broad range of SME taxpayer segments. Furthermore, scarce resources provide very thin rates of audit and verification coverage for SMEs, making it very difficult to conduct audits in all cases where assisted compliance is either appropriate or required.

However, the CRA has developed a multitude of strategies, systems and organizational approaches that effectively identify and manage the compliance unique to each segment. We employ an electronic approach to manage the enormous amount of information that is required to effectively risk-assess the population and intervene with scarce audit resources in only the most appropriate circumstances.

There are many reasons that justify investments in SME audits. We must promote fairness and transparency in the entire tax system, across all market segments and categories of taxpayers. The SME taxpayer base represents the “broad middle” of the economy and society and it is our compliance management of this segment that is the most visible. It is also the segment that bears the greatest relative burden of compliance and we must find ways to reduce this burden, particularly for taxpayers who do not meet their obligations. SME audit programs also address the informal economy, which may be the most important sector in terms of maintaining a high level of confidence in the integrity of the Canadian tax system, where taxpayers are expected to pay no more than their “fair share” of the total tax burden.