

EXPERIENCIA DE PAISES IV

COUNTRY EXPERIENCES IV

The Administration of Individual Income Tax in Canada

Revenue Canada, Taxation

Introduction

Canadian income tax is collected under a self-assessment system based on a fair distribution of the tax burden through the assessment of income. However, under Canada's system of parliamentary democracy, tax legislation is also recognized as one means of controlling the economy and bringing about social change.

While Revenue Canada, Taxation administers the tax laws passed by Parliament, it is the Department of Finance that initiates the government's tax policy.

Simply stated, the goals of the income tax system are as follows:

- to raise revenues for federal and provincial governments;
- to allocate the tax burden in a fair and equitable manner;
- to encourage and/or discourage certain economic activities or investments;
- to encourage investment in Canada by Canadians;
- to encourage certain social objectives through provisions that allow, for example, deduction of charitable donations and deduction of contributions to registered pension plans;
- to facilitate the administration of the system and taxpayer compliance with the law.

The ideal of the Canadian income tax system calls for the equitable and fair collection of taxes through the application of clear and simple mechanisms. But it is the primary principle of fairness that provides policy makers with their most inviolate rule. Tax legislation that is simple and clear but fails to achieve a sufficient degree of fairness is not acceptable. However, tax legislation that is complex but at the same time achieves a fair application of the tax burden is acceptable and, in fact, most closely resembles reality in Canada.

It is also a reality that Canada is one of the largest countries in the world with a total area of more than 13 million square kilometres. The country's size and its relatively small population of about 25 million people makes it almost mandatory that the system of taxation include a network of regional or district offices. Today there are 30 district taxation offices, four sub-offices and seven taxation centres located across the country. These facilities bring the tax department closer to the people and improve communications and service in applying a complex piece of legislation.

One of the primary reasons for the complexity of the Income Tax Act in Canada is its use to effect social change. It is through tax measures that the government can encourage retirement savings, support construction of new housing or provide economic relief for a particular group of taxpayers. Provisions such as these and many others all require additional calculations and detailed explanation. The same holds true for the various Income Tax Act amendments designed to control and direct the economy.

Because of the variety of social and economic goals administered through Canada's tax system, it is not hard to see the potential for an imbalanced application of taxation. To a great extent, it is this chance of imbalance which leads to lengthy and often complicated legislation designed to anticipate any potential inequities.

Regardless of the changes made to tax legislation under different governments, the government of the day must always keep in mind that Canada's self-assessment system will break down if it does not have public support. While the system has occasionally come under attack, it is fair to say that it has enjoyed a history of support from the public. Canadians accept paying taxes as a reasonable responsibility. The majority of the country's 16 million individual taxpayers have tax deducted at source from salaries or wages, and fewer than two per cent become serious collection problems. In addition, Canada has a total of one million corporations and trusts which remit taxes directly.

This compliance and support is recognized as vital to the survival of the system and it is actively maintained through a continuing flow of information to taxpayers and a constant effort to upgrade service to the public. Because of the relative complexity of the tax system, full explanation of tax provisions is fundamental to ensuring taxpayer confidence.

In the following pages outlining Revenue Canada's approach to the different aspects of tax administration, it will become evident that under the self-assessment system, effective communications with taxpayers is essential to the success of almost every phase of the Department's operation.

The aspects of tax administration to be discussed include first, basic systems for assessment of tax returns; methods used to collect outstanding taxes; audit programs designed to ensure taxpayer compliance; and the sanctions applied when Canada's tax laws are violated. Finally, programs to inform and assist taxpayers in meeting their obligations will be examined.

Assessing

The Assessing Division of Revenue Canada, Taxation is the Department's front line as the only group that sees every tax return.

Last year Assessing received 15.7 million income tax returns from individual taxpayers and more than one million returns from corporations and trusts. As many as 600,000 returns a day arrived during the peak season before the April 30 filing deadline.

Approximately 50 per cent of these individual returns are channelled into a straightforward system which processes the error-free returns within four to six weeks. The balance of returns follow a more complex path which may include manual and computer checking; cross-checking with other returns; requests for additional information from taxpayers; correction of errors and consultation with other branches of the Department.

Where information is lacking or no return has been filed, the Department may apply the provisions of the Act based on information available from various sources. However, the processing of a return with insufficient or no information from the taxpayer will often result in a tax bill greater than necessary, since the Department cannot be aware of all potential deductions to which the taxpayer may be entitled.

When a return arrives, it is opened and any payments recorded before it goes through the first

check to ensure figures on information slips agree with those entered on the return and that all supporting documentation has been provided. The information is then "captured" by the computer which will automatically display any mistakes on a video screen or totally reject the return to ensure that mistakes are examined and corrected.

Where an error is discovered to be a taxpayer error, an explanation is printed out on the notice of assessment mailed to the taxpayer. After processing is completed, notices of assessment and, where applicable, refund cheques are mailed out to each taxpayer. This procedure may also result in a taxpayer-requested adjustment, when the taxpayer feels the provision of additional information will result in a change in assessment. For the year ending March 1984, the Department processed 842,055 such requests.

Each year the Department also reviews the tax return forms and accompanying guides to ensure they meet the changing needs of a constantly changing Income Tax Act. Data is also examined to determine the parts of the return producing the most taxpayer errors. This information is then used to help further simplify the guides and returns in an overall effort to facilitate taxpayer compliance.

The special simplified return, which is sent to about 50 per cent of individual taxpayers, also greatly facilitates taxpayer compliance and helps ensure fast, accurate processing. This return is sent to a computer-selected list of taxpayers whose previous year returns indicate they do not need the more detailed general return.

The volume of returns to be assessed demands that the Assessing Division establish certain internal tolerance levels for initial assessing of returns. The myriad of potential federal and provincial deductions makes it impossible to verify every deduction claimed, although Assessing can establish, through analysis of computer data, which areas of the return need the most attention. Furthermore, areas of concern change from year to year, thus preventing the danger of establishing identifiable types of deductions which are not checked.

Since the profile of data stored and tracked by Revenue Canada is unique, it is difficult, if not impossible for taxpayers to predict which area of returns will receive greater or lesser attention. The result is a scientific approach to achieving the greatest efficiency which at the same time has all the characteristics of a random approach from the taxpayer's point of view.

Examination after initial assessing

Examination provides for a more detailed review of tax returns after the initial, high-volume processing task is completed. It includes three operations: post-assessing, matching and office examination.

Post-assessing consists of the examination of certain claims for deductions or exemptions, either by comparison with prior year returns or the supply by the taxpayer of additional supporting documents or the application of a wider knowledge of the legislation than would be practical at the initial assessing stage. Post-assessing also includes the validation of specified percentages of claims for provincial tax credits.

Matching consists of the verification of income reported by taxpayers against information slips received from payors such as employers and banks, for example.

Office examination consists of the reassessment of certain categories of income within district offices where the necessary contacts with the taxpayer can be made by telephone, letter or office interview. The taxpayers are typically those in receipt of income from sales, investments and rentals. Files requiring examination at the taxpayer's place of business are handled by Taxation's Audit Division.

Assistance to taxpayers

To assist taxpayers in understanding their obligations under Canada's self-assessment system, the Department provides a public enquiry service through its 30 district taxation offices, and provides information in person, by telephone and by letter, at the rate of some eight million enquiries a year. More information on the various programs for assistance to taxpayers is contained in the section, Information and Assistance to the Public.

Not just raising tax revenue

Most employees of Revenue Canada, Taxation would agree that their jobs would be far simpler if their only task was to collect tax revenue. However, this is not the only task and the complicating factors include: vast information storage to accommodate the many tax provisions that allow information from one year to be applied over a period of 10 years and more; complicated formulae, which are not infrequently changed from year to year; and constantly changing deductions to provide tax relief for particular groups, encourage Canadians to spend

or invest in certain areas, change the tax base or accomplish other economic goals which can lead to social change.

The Department must not only store increasingly large amounts of data, but also at times actually stockpile returns while waiting for Parliament to give final approval to proposed budget measures that affect the Income Tax Act. However, over the years, Assessing Division has developed the capability to react quickly to these changes, although at times it requires innovative and imaginative management to avoid major delays.

Perhaps the greatest single complicating factor in assessing Canadian tax returns is the ever-changing legislative measures, which lead to administrative changes that must be applied. While the Division has a limited advisory role in the development of new measures, it is not a major influence in this process. If a new provision in the Income Tax Act will accomplish a certain end but add to the administrative problems of Revenue Canada, then that is frequently the price to be paid. However, the Department is not without protection and if a particular change to the Act represents an impossible administrative situation then the change would have to be modified.

Because most Canadian taxpayers receive refunds or enclose payment when they file their tax returns, Assessing Division is not concerned with the few who do not pay on time. The task of pursuing these individuals is assigned to Collections Division.

Collections

The Collections Division of Revenue Canada, Taxation must deal with that minority of taxpayers which does not readily comply with the Income Tax Act. While there are payment options open to the delinquent taxpayer, most of those options lead to payment of the tax bill. Cases dealt with by Collections will result in payment, arrangement for payment, provision of security in lieu of immediate payment or legal action to secure payment.

Collection action becomes necessary because of unpaid balances on returns filed, unremitted source deductions or unpaid balances on reassessments.

However, difficult economic times have caused an increase in the amount of "uncollectable" taxes as well as an increase in the number of outstanding accounts and dollars owing.

Most Canadian taxpayers never deal with the

collection people since the vast majority have tax deducted at source or faithfully pay their tax through instalment payments. It is the balance of less than 20 per cent who receive debit assessments from the Department and, of these, only 10 per cent will become serious collection cases.

There are almost 17 million taxpayers in Canada and the current collection data shows that about three million debit assessments were raised for the fiscal year 1983-84.

A series of routine notifications usually results in payment from most taxpayers in this group, and serious cases referred to the district offices for collection number slightly less than 300,000 files in 1983-84. This latter group represents almost \$3 billion in tax debts. The projected total revenues to be collected by Taxation for the current year is \$62 billion.

Payment is due 30 days after assessment or reassessment. Collection notices begin as a computer-generated reminder and an indication of taxpayer obligations. Subsequent notices indicate that failure to pay could lead to legal action.

Because the majority of taxpayers pay their taxes when due, departmental policy provides for a firm approach in dealing with delinquents so as not to discriminate against those who pay promptly. At the same time the Department recognizes that there are at times circumstances that may prevent immediate payment. In these cases, taxpayers, immediately upon receiving a notice of assessment, should contact the Collection Section of the local district office in order to make arrangements for payment which are acceptable to the Department and in line with the taxpayers's ability to pay.

Taxpayers who do not contact the Department to make arrangements to pay their tax bill are ultimately subject to fairly severe action, including garnishment of income and bank deposits and seizure of assets. Furthermore, the Department is empowered to issue third party demands which provide for diversion to the Department of money owed to the taxpayer.

There are a certain number of cases where the tax owing is simply uncollectable and this occurs in the case of individuals as well as companies and corporations. In a system where the tax department may go back four years (in cases of suspected fraud there is no limit) and reassess a taxpayer, the taxpayer's ability to pay may have changed to the point where it is not possible to collect. Tight

economic times in 1984 may make it difficult or impossible to pay a reassessment on a 1980 return.

Another factor contributing to slow payment of taxes is the interest charged on the unpaid balance. Historically, interest on unpaid taxes has been well below the going market rate so that taxpayers may be tempted to delay paying taxes while they pay other outstanding debts with higher interest rates than those of Revenue Canada. The Department is also seeing an increase in delinquency with companies holding employees' source deduction of tax in trust, rather than remitting them to Taxation as required by law. For some companies, these withheld funds represent a temptation to ease a cash flow problem during difficult economic times.

These two factors can lead to an attitude of "pay the taxman last". One of the results of this attitude is predictable in economic terms — bankruptcy. Since the Department, under the law, cannot publicly discuss individual cases without the taxpayer's authorization, the public impression can be that Taxation has driven the company into bankruptcy. In fact these companies have usually been operating outside the law in using the employee tax funds held in trust and not paying their own taxes when they are legally due.

Ultimately, however, collection is not an overwhelming task as the offending companies and individuals make up a very small percentage of the taxpaying public.

Audit

The Audit Division of Revenue Canada, Taxation is charged with the responsibility of ensuring the integrity of Canada's self-assessment system of taxation. Unlike the Special Investigations Division, which deals specifically with cases of tax evasion, the audit function ensures that the taxpaying public reports the proper taxable income in accordance with the Income Tax Act. During the 1982-83 filing season, Revenue Canada accomplished this task to the extent that the Department recovered \$656,666,576 in taxes resulting from audits.

It should be noted, however, that this audit procedure is not applied to the total income-taxpaying public of almost 17 million. Routine assessing techniques such as cross-matching of information serve to easily verify the majority of returns. An advantage of the Canadian self-assessment system is that more than 80 per cent of taxpayers are employees and have their taxes deducted at source by their employers. The audit

program is mainly concerned with the less than 20 per cent of taxpayers who have other sources of income, which are not necessarily reported automatically to Revenue Canada, Taxation.

Audit Division systems and procedures primarily verify information and calculations made by the taxpayer and provide the relevant interpretations of the tax legislation and regulations. For instance, a taxpayer may correctly report a \$10,000 expenditure when the Act allows only for a \$5,000 deduction.

While audit does not necessarily question the veracity of the information provided by the taxpayer, it will try to ensure that all the required data has been reported. Once satisfied that all the necessary information has been provided, the auditor must clearly present the Department's interpretation of the provisions of the Act. The taxpayer, of course, is given every opportunity to present alternative arguments with supporting information. Should a difference of opinion persist after an assessment or reassessment is discussed, the taxpayer is legally entitled to appeal Taxation's decision.

Individuals and companies selected for audit fall under two broad programs. The national program is based on a detailed profile of taxpayer groups, with audit activity based on extensive historical data and the identification of trends or anomalies. Other audit cases are identified by more specific procedures such as cross-checking files, compliance problems outlined by local and regional staff and increasing use of the computer in analysing information on hand.

Approximately one third of the audit capability and staff is applied to the national program, while the remaining two thirds is engaged in identifying regional or local compliance problems, industrial sector compliance problems and providing support for the projects under the national program. Regional variations in audit activity is understandable in a country the size of Canada, and the regional office in the Maritimes may be concerned with compliance of fishermen while the Toronto office is much more likely to be concerned with compliance in the industrial sector.

All auditors are also aware that "audits lead to other audits". Because of the interrelated nature of many returns filed, audits themselves are a primary source in identifying other returns that should be audited. Furthermore, local audit activity will, at times, be studied and, where appropriate, be applied on a nation-wide basis.

The National Program

Each year the Audit Division must decide how to apply its limited resources most effectively to the national audit program. The very largest corporations are audited almost yearly, while slightly smaller companies can count on an audit every two or three years. Middle-sized and small-sized companies and individuals are audited less frequently.

Although the largest group audited is made up of the smaller companies and individuals, the smallest group, made up of large corporations, receives the most concentrated attention. Simply put, the Audit Division must apply its resources in such a way as to identify the greatest amount of undeclared taxable income. This potential exists to the greatest extent with the largest corporations. Another equally important consideration is the degree to which an audit will encourage improved compliance, either generally or within a certain group.

While the system tends to audit a lower percentage of the smaller returns, this is being offset by increased use of the computer. By applying computer software systems, the Division is better able to select small business audits with reduced expenditures of supervisory time. The supervisor's time is more efficiently used as the computer takes over the preliminary steps of workload selection. Audit also has a program to upgrade its planning capability in order to cut down on the number of audits which result in no change in assessment.

Under the national audit program, head office analyses the profile and level of compliance among various established groups. This analysis produces lists of taxpayers and groups of taxpayers for potential audit. These lists are sent to the district offices along with guidelines suggesting the level of audit activity within each group.

Returns may then be audited through an office audit or a field audit. The office audit is a relatively simple procedure where information can be obtained or verified on the telephone or by letter. The field audit involves an auditor or audit team conducting a more thorough audit on the premises of the taxpayer. Audits may be conducted at any time up to four years after the date of mailing of the original notice of assessment. However, there is no time limit in cases of fraud or misrepresentation or where a taxpayer has filed a waiver specifying matters on which a reassessment may be issued.

Audit staff

As the Income Tax Act is used more and more as a tool for social change and balance, the job of the auditor becomes more complicated, from the point of view of both training and dealing with the taxpayer. Auditors must understand not only the purely revenue-based aspects of the Act but also the provisions introduced to effect social change. These provisions include such things as the child tax credit, deductions related to retirement plans and deductions related to donations to charities. The intent of provisions such as these is not so much to raise revenue, as to fairly distribute the tax burden.

This developing aspect of the Canadian tax system also means that auditors are dealing with an increasingly complex system. They must spend more time explaining legislation to the taxpayer and this increasingly involves a precise written explanation. Auditors are also dealing more often with tax professionals representing a taxpayer. And tax professionals, whether lawyers or accountants, may have a greater knowledge and understanding of certain areas of the Act than the auditor, who must have a working knowledge of most or all of the legislation.

Finally, auditors must also be alert for signs of tax evasion, for their recommendations often provide Taxation's Special Investigations staff with important leads.

Sanctions Applicable to Income Tax Violations

The self-assessment system of taxation, like any tax system, has its share of taxpayers who do not fulfill their lawful tax obligations, either knowingly or unknowingly.

Tax legislation in Canada provides for examinations, investigations and penalties in cases of tax avoidance, which is the incorrect application of the legislation, and tax evasion, which is failure to comply, with full knowledge and intent. In technical terms, tax evasion is the commission or omission of an act knowingly with the intent to deceive so that the tax reported is less than the tax payable under the law, or a conspiracy to commit such an offence. This may occur if a taxpayer deliberately omits reporting revenue, fraudulently claims expenses or allowances, or deliberately misrepresents, conceals or withholds material facts.

Revenue Canada, Taxation is also improving its programs to identify and prosecute non-filers.

Departmental computers incorporate programs to detect late filers and non-filers. Offenders are identified from previous years' filing records and other sources of information. In addition, special projects conducted by the Department help to trace delinquents.

Wilful failure to file can also result in both civil and criminal proceedings. A civil penalty may amount to as much as 50 per cent of the tax evaded while criminal prosecution could result in fines of up to \$10,000 and/or six months in jail or both a fine and a jail sentence.

In cases of tax violations Revenue Canada, Taxation may impose, under the legislation, financial penalties. However, additional fines and imprisonment are handed out only by the judicial system. Information and recommendations for prosecution for tax evasion are provided by the Special Investigations Division of the tax department. The federal Department of Justice then is responsible for conducting criminal court proceedings.

Penalties under the civil procedure and fines and jail sentences under criminal procedure are the only legal punitive measures applied to tax evasion and avoidance.

The Special Investigations Division is comprised of about 500 information-gathering staff, who investigate cases when there is a clear indication of tax evasion. However, there are several other factors taken into consideration before a full-scale investigation is launched.

Once Special Investigations is satisfied they are dealing with a probable case of tax evasion, they must also look at the availability of evidence, the dollar value of the case and the potential for publicity.

They will likely not proceed if they are dealing with an individual who has left the country. It is an economic fact of life that there is a cost/dollar return ratio that cannot be totally ignored. And finally, a major criterion is the potential for publicity upon conviction, since a primary goal of Special Investigations is to provide a deterrent to other taxpayers who may be contemplating tax evasion.

The main source of serious leads on tax evasion is the Audit Branch of Revenue Canada, Taxation, although information is also provided by other areas of the Department and a great many leads of lesser potential come from the general public. Special Investigations will receive as many of 8,000 to 9,000

leads in a year, although the inventory of cases under active examination at any given time numbers between 500 and 700. The Division DOES NOT initiate its own investigation projects and is essentially used as an investigative and enforcement tool to further examine matters brought to light by those engaged in these operations of the Department.

However, investigations generate investigations. The close study of one file or case will bring to light indications of offences by other taxpayers.

How It Is Done

Once SI has conducted a preliminary examination of a case and decided they have a probable situation of evasion, they will then decide on a course of action based on the previously outlined criteria. Next they gather all available information and, if necessary, also enter into a search and seizure operation. In practice, however, search and seizure occurs only about 40 to 50 times a year, in extreme cases.

There are two types of seizure procedures. One is entered into with the authorization of the judicial system and the other through power granted under the Income Tax Act. The former allows for a full search of the taxpayer's business premises, all relevant residences and any other specified areas which might contain records that could provide evidence of the offence. Files and records may then be seized. The latter provides only for the seizure of records already exposed to the investigator by the taxpayer. These files and any others the taxpayer is willing to provide may be seized but there is not an active search involved.

Special Investigations provides a detailed report of the evidence in the investigation along with a recommendation for prosecution. Actual, pertinent records are subsequently presented in court as part of the testimony of the Special Investigations personnel and other witnesses involved.

The Justice Department will then prosecute either by summary conviction or by indictment. Summary conviction allows for a fine of not less than 25 per cent of the unpaid taxes and not more than double the unpaid taxes as well as the possibility of up to two years in jail. Indictment, which is used in some extreme cases, provides for similar financial penalties and a mandatory prison term of from two months to five years.

Special Investigations Staff

The people who develop the Special Investigations cases are, for the most part, either accountants or individuals with broad taxation backgrounds. However, they must all take a series of courses

designed to teach them how to collect information and at the same time comply with the complex requirements of the Income Tax Act, the legal requirements for evidence in a court of law and the rights of the taxpayer. Furthermore, they are allowed to take part in the various parts of the Division's work only as they become fully familiar with those procedures.

Information and Assistance to the Public

In Canada, providing a thorough and broad information service to the taxpaying public has long been a tradition that has paid major dividends. This practice serves a dual purpose - it makes it easier for taxpayers to understand the law and fulfil their tax obligations and promotes support of the self-assessment system.

While there has been an income tax system in Canada since 1917, the modern history of tax reform began in 1962 with the appointment of the Royal Commission on Taxation. Sweeping changes resulting from the Royal Commission were made law in December 1971 - within weeks Revenue Canada launched the largest single information distribution program ever undertaken by a department of the Canadian Government.

The Department distributed 25 million copies of various tax reform pamphlets, ran a nation-wide advertising campaign, handled three million enquiries through 28 district offices and established many other special programs to answer a variety of needs.

In many ways the current level of information and service to the public is an accumulation of measures introduced over the years. Today, the many services to the public may be placed into two categories - information generated by the Department and sent to taxpayers and the many structures and mechanisms for providing tax information and advice.

The Department currently provides about 600 different forms and explanatory guides to cover every conceivable taxpayer situation and a similar number of interpretation bulletins and information circulars which provide detailed information on the more complicated portions of the Act. These bulletins and circulars contain official departmental interpretations and procedural explanations which are continually used by tax professionals in the private sector.

The Information Services Branch of the Department has responsibility for developing and maintaining a wide range of information programs. Among

these are a series of explanatory pamphlets, films and public service announcements for radio and television, an annual review, news releases and background papers for the media, and articles for various publications.

Reporting functionally to the Branch are public relations officers in the district offices, involved in local information and media programs. These public relations officers are generally drawn from operational branches of the Department and well qualified to deal with the many technical questions that arise. They distribute information material, work with the media and are also engaged in seminars and speaking engagements to explain various parts of the Income Tax Act and distribution of material.

Some 700 enquiries officers in the district offices provide counter and telephone information on the filing and status of tax returns and refunds, explain

assessment notices and answer general questions. Last year, they responded to more than eight million enquiries by telephone and in person. The basic idea of this regional network was established not long after the creation of the Department in 1927.

Last year, this service was augmented by nine seasonal tax assistance centres to serve taxpayers in smaller centres during the peak filing season. In addition, a variety of other services such as storefront service centres and special programs provide information and assistance to the handicapped, senior citizens and other taxpayers with special needs.

The Department also takes part in an ongoing series of consultations with professional and special interest groups. These meetings serve a two-fold purpose, assisting professionals in the application of the law and providing the Department with valuable feedback from the private sector.