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to the House of Commons

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Chapter 6

Canada Revenue Agency—Resolving Disputes and Encouraging Voluntary Disclosures

Office of the Auditor General of Canada

The November 2004 Report of the Auditor General of Canada comprises eight chapters, Matters of Special Importance—2004, and Main Points. The main table of contents is found at the end of this publication.

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Chapter

6

Canada Revenue Agency

Resolving Disputes and
Encouraging Voluntary Disclosures

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Canada Revenue Agency
Resolving Disputes and Encouraging Voluntary Disclosures

Main Points

6.1 A key activity of the Canada Revenue Agency's Appeals Branch is resolving objections to income tax and GST assessments as well as appeals of Canada Pension Plan (CPP) and Employment Insurance (EI) rulings and assessments. We found that the Branch is resolving most of the income tax and GST objections it receives, and it is doing this in a way that is fair and impartial. As well, over half of the objections are resolved within the timeliness goals that the Agency has set. However, taxpayers can appeal their case to the Tax Court of Canada if they have not received a decision from the Appeals Branch after 90 days. Many of the Branch's timeliness goals for income tax objections exceed 90 days by a large margin.

6.2 The Branch is resolving CPP and EI appeals impartially but has difficulty resolving them in a timely way. The Agency needs to consider a more efficient overall process for dealing with CPP and EI rulings, which are issued by the Revenue Collections Branch, and any related appeals of those rulings, which are dealt with by the Appeals Branch.

6.3 The Appeals Branch also administers the Agency's Voluntary Disclosures Program. The program has encouraged taxpayers and GST registrants to correct past errors or omissions. However, we found that the program is not administered consistently across the country. Further, we are concerned that the Agency has gone beyond what Parliament was told the legislation supporting the program would be used for.

Background and other observations

6.4 Taxpayers and GST (or HST) registrants who disagree with assessments by the Canada Revenue Agency on income tax, GST, and excise tax matters can file an objection with the Agency. Affected parties who disagree with the Agency's rulings and assessments on Canada Pension Plan and Employment Insurance can appeal. These objections and appeals are reviewed by the Agency's Appeals Branch. In 2003–04, appeals officers adjusted about 62 percent of the income tax and GST assessments they reviewed.

6.5 The Voluntary Disclosures Program allows taxpayers and GST registrants to correct inaccurate or incomplete information previously reported to the Agency, or to disclose information not previously reported, without penalty or prosecution and sometimes with reduced interest. Its goal is to promote compliance with the tax laws. The Agency needs to analyze the program's results to ensure that this goal is being met.

The Agency has responded. The Canada Revenue Agency agrees with all of our recommendations. In its responses, it describes actions it will take to address the recommendations.

The Agency disagrees with our concern that it has gone beyond what Parliament was told the legislation supporting the Voluntary Disclosures Program would be used for. The Agency believes that the intent of Parliament is contained in the words of the acts passed by Parliament.

Introduction

HST—Harmonized sales tax, a combined tax in which the goods and services tax (GST) is added to the provincial sales tax in the provinces of New Brunswick, Nova Scotia, and Newfoundland and Labrador, and collected by business owners

Excise tax—A tax imposed on certain goods such as tobacco, wine, jewellery, and certain types of vehicles

6.6 Taxpayers and GST (or HST) registrants who disagree with assessments by the Canada Revenue Agency (CRA) on income tax, GST, and excise tax matters can file an objection with the Agency. Affected parties who disagree with the CRA's rulings and assessments on Canada Pension Plan and Employment Insurance (CPP and EI) can appeal. These objections and appeals are reviewed by the Agency's Appeals Branch; the Branch's mandate calls for it to conduct these reviews fairly and impartially. A taxpayer, registrant, or affected party who disagrees with the Branch's decision can appeal to the courts.

6.7 The Branch administers one of the government's largest administrative dispute resolution services. At March 2004, the Agency reported that almost $7.6 billion of income tax or GST assessments were in dispute.

6.8 The Branch had a budget in 2003–04 of about $80 million and some 1,200 full-time-equivalent staff. Objections and appeals are processed in Tax Services Offices and Tax Centres across the country. Headquarters staff provide policy direction and technical support and help resolve complex cases.

6.9 **Income tax, GST, and excise tax objections.** The income tax, GST, and excise tax objections process starts when a taxpayer or registrant files an objection with the Agency, setting out the background and reasons for the objection. In most cases, the taxpayer or registrant disagrees with an assessment issued by the Agency. The assessment usually originates in the Agency's Assessment and Client Services Branch or, in the case of an audit, in the Compliance Programs Branch. The disagreement may be with the facts of the case, the Agency's interpretation of how the laws apply to the facts, or both.

6.10 There are three possible outcomes to a valid income tax, GST, or excise tax objection. An appeals officer can recommend that the Chief of Appeals

- confirm the assessment, thereby rejecting the taxpayer's or registrant's arguments;
- allow the objection in full, thereby overturning the assessment; or
- confirm part of the assessment and overturn part of it (vary the assessment).

6.11 Taxpayers and registrants who disagree with the Branch's decision have the right to appeal to the Tax Court of Canada. If there is no such appeal of the decision, the issues in dispute are considered resolved, even where the taxpayer or registrant disagrees with the Branch's decision but is not willing to pursue the issue further.

6.12 **CPP and EI appeals.** CPP and EI appeals frequently deal with the issue of whether a worker is an employee or is self-employed. Only employees are subject to payroll deductions by their employers for CPP and EI. A worker, an employer, the Minister of Social Development (for CPP), or the Employment Insurance Commission (for EI) can ask the Agency's Revenue Collections Branch for a ruling on whether employment was pensionable (qualified for

CPP benefits) or insurable (qualified for EI benefits), what the earnings were, and how long the employment lasted. Any of those parties can appeal the ruling; the appeal will be reviewed by the Appeals Branch.

6.13 The Agency's auditors audit employers to determine whether they have deducted the correct amounts from their employees' pay for income tax, CPP contributions, and EI premiums. Employers have the right to appeal any assessment that results from an audit.

6.14 The Appeals Branch may confirm the original CPP/EI ruling or assessment, reject it, or vary it. An affected party who disagrees with the decision can appeal to the Tax Court of Canada.

6.15 **Voluntary Disclosures Program.** The Appeals Branch also administers the Voluntary Disclosures Program. The program allows taxpayers and registrants to correct inaccurate or incomplete information previously reported to the Agency, or to disclose information not previously reported, without penalty or prosecution and sometimes with reduced interest. Its goal is to promote compliance with the tax laws.

Focus of the audit

6.16 The Appeals Branch is responsible for resolving income tax, GST (or HST), and excise tax objections and CPP and EI appeals; for working with the Department of Justice Canada in preparing cases for litigation; for co-ordinating the income tax and GST fairness provisions that allow the Agency to waive or cancel all or part of any interest or penalty owed by a taxpayer or registrant; and for administering the Voluntary Disclosures Program. This audit covered income tax and GST (but not HST) objections, CPP and EI appeals, and the Voluntary Disclosures Program.

6.17 The objectives of the audit were to determine

- whether the Appeals Branch of the Canada Revenue Agency is resolving objections to income tax and GST assessments and appeals of CPP/EI rulings and assessments in a way that is fair, timely, and impartial; and
- whether the Voluntary Disclosures Program is encouraging compliance and protecting the tax base.

6.18 The Branch's work in the area of litigation was covered in our 1998 Report, Chapter 5, Interdepartmental Administration of the Income Tax System. The administration of the fairness provisions was covered in our 2002 Report, Chapter 2, Tax Administration: Write-Offs and Forgiveness. Further information about the objectives, scope, approach, and criteria for this audit can be found at the end of the chapter in **About the Audit.**

Observations and Recommendations

Income tax and GST objections

Most objections are resolved by the Appeals Branch

6.19 The Agency received about 73,200 income tax and GST objections in 2001–02, 69,900 in 2002–03, and 59,000 in 2003–04. The number of objections in 2001–02 and 2002–03 were unusual; many of them concerned how the interest portion of recent pay equity settlements was to be taxed. That issue is currently being adjudicated in the courts.

Pay equity settlements—Lump sum compensation payments given to certain employees based on gender discrimination that had occurred between 1982 and 1997

6.20 The annual number of objections resolved administratively by appeals officers has varied significantly, from 59,300 in 2001–02 to 64,600 in 2002–03, to 57,600 in 2003–04. Historically, over 93 percent of the decisions made by appeals officers are accepted by the taxpayer or registrant who objected. The other seven percent are appealed to the Tax Court of Canada or the Canadian International Trade Tribunal because the taxpayer or registrant disagrees with the decision and is willing to pursue the issue further.

6.21 Objections range from simple to complex; the majority are simple, as in these examples:

- A taxpayer is assessed because he failed to provide information requested by the CRA to support a deduction he made on a tax return; he objects to the assessment and provides the information.
- A taxpayer is assessed because she did not report interest income shown on a T5 information slip; she objects to the assessment, explaining that the T5 information was wrong.

Complex objections usually follow an assessment made as a result of an audit.

6.22 The breakdown of decisions on simple and complex objections in 2003–04 is shown in Exhibit 6.1. Simple objections represented 77 percent of the total number of objections and complex objections represented 23 percent. But those proportions are reversed when the dollar amounts in dispute are considered: simple objections account for about 25 percent of the total dollars in dispute and complex objections for about 75 percent.

6.23 We expected the Branch to keep track accurately of how the amounts in dispute were resolved, but we found that it has not done so. Without this information, the Branch does not know and cannot report how much of the taxes in dispute it confirmed or how much it returned to the taxpayers and registrants who objected to their assessments.

6.24 The Branch's objective is to resolve tax disputes. By their very nature, tax disputes involve money. Keeping track only of the number of objections filed and how they were resolved is not sufficient for management to understand the impact of the decisions made by appeals officers, nor the potential risks to the tax base triggered by objections from taxpayers and registrants. It is also essential that the dollar results of the Branch's decisions be recorded to a level of accuracy that permits good analysis and reporting. This may involve using estimates in low-risk cases.

Exhibit 6.1 Breakdown of decisions on simple and complex income tax and GST objections in 2003–04

Decision	Simple objections		Complex objections		Total objections	
	Number of decisions	Percentage of simple objections	Number of decisions	Percentage of complex objections	Number of decisions	Percentage of total objections
Assessment confirmed	14,158	38.3	3,748	34.1	17,906	37.3
Objection allowed in full	15,021	40.6	2,218	20.2	17,239	35.9
Assessment varied	7,810	21.1	5,026	45.7	12,836	26.8
Total	**36,989**	**100.0**	**10,992**	**100.0**	**47,981**	**100.0**

Source: Analysis of Canada Revenue Agency Appeals Branch database

6.25 **Impartiality.** Our interviews and file reviews indicate that appeals officers are impartial in reaching their decisions. The Branch's quality monitoring reviews have also found this to be the case. In examining the facts of an objection and the applicable laws, officers refer to the Agency's documentation supporting the assessment in question (which may include an auditor's report), together with representations made by the taxpayer or registrant. These representations often include new information that was not provided previously or was unavailable at the time of the audit. Appeals officers also review applicable legislation, court cases, and Agency policies, and they discuss the case with appropriate experts when necessary.

6.26 Appeals officers are expected to do more than check the accuracy of an audit. They are expected to try to resolve disputes administratively. If that is not possible, the taxpayer or registrant can appeal the decision to the Tax Court of Canada, which is a more expensive solution. There are many ways to resolve disputes administratively, from simply explaining the basis for an assessment, to reaching a common understanding of the facts involved and the applicable laws, to agreeing on a settlement.

6.27 While appeals officers must follow the law and the Agency's policies in deciding on an objection, they can agree to settle when appropriate. For example, an auditor disallowed a large portion of a taxpayer's automobile expenses because the taxpayer had not kept a travel log showing separately the distances travelled for business purposes and those travelled for personal purposes. The taxpayer objected to the assessment, claiming that the automobile was used mainly for business purposes. Through discussion and review of supporting documents, the taxpayer and the appeals officer were able to settle on a figure for expenses that was higher than the auditor had allowed but lower than the taxpayer had claimed. In some cases, reaching a settlement is fairly straightforward. In other cases it can be difficult, and the settlement may be completed by appeals officers at headquarters.

6.28 Most objections to an assessment are assigned to an appeals officer who is at the same job classification level as the assessor or auditor who issued the

assessment. Classification levels generally reflect the competencies and experience required for a position, with higher levels requiring more competencies and experience. But the highest classification for auditors is AU6, whereas AU3 is the highest for appeals officers in the field (at headquarters it is AU4). Therefore, an appeals officer can be asked to resolve an objection to an assessment prepared by an auditor at a higher classification level. The more junior appeals officer could allow the objection and reject the auditor's assessment. This happens in practice, and it does not seem logical or appropriate, particularly in complicated cases where the issues are often highly technical and call for the judgment and experience needed to allow taxpayers and registrants to exercise their rights while protecting the public purse. At the time of our audit, the Branch was developing a human resources strategy to address issues such as the competencies and experience required for appeals officers.

6.29 **Alternative dispute resolution.** Mediation can be a useful technique when a consensus is possible and both sides see its benefits. For example, a taxpayer says an asset that has been sold has a fair market value of $100,000 for calculating the capital gain on the sale; the Agency's valuators say the fair market value is $150,000. If the parties are willing to settle, a mediator may find an acceptable resolution to the disagreement. The Agency has discussed using mediation for several years, but appeals officers and taxpayers have seldom used it.

6.30 **Feedback to auditors.** The offices we visited provide appeals decisions regularly to technical advisors in the Compliance Programs Branch. Appeals officers frequently change assessments issued by auditors from the Compliance Programs Branch that are the subject of a taxpayer's or registrant's objection. It is important that the auditors understand why the changes are made. It could be that the taxpayer or registrant gave the appeals officer information that was unavailable at the time of the audit, or the auditor made an error in applying the law to the facts. Technical advisors told us that they review the appeals decisions to identify common errors made by auditors and areas where training would help clarify the auditors' understanding of the law. They communicate this information to the auditors in team meetings and training sessions.

The Branch is working to improve timeliness

6.31 Over the last few years, the Agency has emphasized shortening the length of time it takes to resolve an objection. Timeliness goals set by the Branch were met in over half of the cases in 2003–04 for income tax and GST objections (Exhibit 6.2). The goals are based on historical averages and what the Branch considers a reasonable expectation, given the resources available and a desire to maintain quality.

6.32 Taxpayers have a legal right to appeal their case to the Tax Court of Canada if they have not received a decision from the Appeals Branch within 90 days of filing an objection. We found that many of the Branch's timeliness goals for income tax objections exceed 90 days by a large margin, and they include only the time that an appeals officer actually spends working on the

Exhibit 6.2 Over half of the timeliness goals for resolving income tax and GST objections were met in 2003–04

File	Timeliness goal (days)	Files that met goal (percentage)
Income tax		
Initial assessing	88	57.0
Post assessing	88	53.4
Assessing—other	112	64.8
Office audit	156	58.9
Tax avoidance	195	81.6
Special investigations	196	62.8
Small business audit	197	60.6
Special audit	214	53.6
Medium business audit	271	65.7
Large business audit	332	69.0
GST	182	74.7

Source: Analysis of Canada Revenue Agency Appeals Branch database

objection. They do not include time during which the appeals officer may be waiting for the resolution of a similar issue in a court case or for a response from headquarters or another Agency branch (for example, headquarters has 180 days or six months to respond to an appeals officer's request for a legal or other opinion). It is not difficult to see why a complicated dispute can take one or two years to resolve. However, most taxpayers appear willing to wait for an administrative decision before appealing to the courts.

6.33 In an effort to be more responsive to taxpayers and registrants, the Branch now requires that they receive a letter within 30 days of filing an objection; the Agency reports that this requirement is met in most cases. The letter acknowledges that the objection has been received and estimates how long it will take for an appeals officer to contact the taxpayer or registrant. Because an appeals officer has not yet reviewed the objection, however, the letter does not address the specific issues the taxpayer or registrant is disputing. Furthermore, any misunderstanding that the taxpayer or registrant may have about the assessment or any need for further documentation to resolve the dispute is not addressed until an officer reviews the objection. A preliminary review of the objection by an appeals officer and contact with the taxpayer or registrant for more information where needed could help resolve the objection sooner.

Risk to the tax base is assessed inconsistently

Tax base—Income, including capital gains, and commodity transactions of Canadian and non-resident individuals, corporations, and other entities subject to Canadian income taxes, GST, and other taxes

6.34 In our 1998 Report, Chapter 5, Interdepartmental Administration of the Income Tax System, we pointed out that the Agency and the departments of Finance and Justice had adopted and were implementing a strategy for managing the risks to the tax base in the dispute resolution process. The key risk is that legislative deficiencies or administrative shortcomings will not be identified in a timely manner and, as a result, the Crown will have to refund hundreds of millions of dollars to taxpayers and registrants following an unfavourable court decision on a case.

6.35 The Appeals Branch issued a directive on risk management for income tax and GST objections in July 2003, updating a 1996 directive. The update defined and discussed risk management and provided a tool for risk detection and assessment. In the following months, headquarters staff made presentations to some regions on the importance of risk assessment. We found inconsistent use of the risk detection and assessment tool in the offices we visited. Our interviews with appeals officers suggested that many had not yet fully grasped the importance of assessing risk or of using the risk detection and assessment tool. Until officers assess the risks of all objections on a consistent basis, the Branch is in danger of not identifying in a timely way any legislative deficiencies or administrative shortcomings that arise through the objections process. We note that the Branch's quality assurance and monitoring reviews have raised similar concerns.

Tax at risk—The amount of tax that a taxpayer or registrant is disputing

6.36 Risk assessments would also help identify issues for the "important issues" list that the Agency uses as part of the risk management process. Reviewed by a risk management committee and issued quarterly, the list describes current high-risk court cases and indicates the amount of tax at risk in each case. A case is considered to be high-risk if it involves a lot of money or if it has implications for tax policy, tax administration, or social policy.

Screener—Appeals officers or clerks responsible for initially reviewing income tax and GST objections to determine whether the objection is valid and to record "tombstone" data before the objection is assigned to an appeals officer

6.37 We found that the screeners are familiar with the important issues list. They use it regularly to determine whether a new objection has issues similar to those on the list. If it does, headquarters is notified so the amount of tax at risk can be included with similar cases on the important issues list, and the objection is set aside until the lead case on the list is resolved. This allows the Agency to keep track of the total tax at risk with each issue, and it prevents officers from making decisions that might be contrary to the law as a result of the decision on the lead case.

6.38 We found that appeals officers are also aware of the important issues list but do not refer to it regularly to ensure that they are not trying to resolve issues similar to those on the list. It is important that appeals officers refer to the list regularly, because they have a better understanding than screeners of the issues in dispute. Furthermore, objections do not always include enough information for the screener to determine whether the issues are similar to those on the list.

6.39 **Recommendation.** The Canada Revenue Agency should

- accurately record, monitor, and report the amounts involved in disputes that are resolved administratively, using estimates where appropriate, to understand the impact of the decisions made by appeals officers and the potential risks to the tax base triggered by objections;
- complete the human resources strategy for the Appeals Branch, including reviewing the competencies and experience required for appeals officers and the related classification levels, and implement it to help ensure that the Branch has the right people at the right levels; and
- develop a plan to strengthen appeals officers' awareness of the importance of managing risks to the tax base and to encourage their use of the tools already in place; implement the plan; and monitor the results.

Agency's response. The Agency agrees with the importance of recording the amounts disputed and resolved and we will capture this information in a cost-efficient manner. We will also ensure that the importance of this issue is reinforced to Agency staff, and the Agency will monitor for consistency in the application of the policy.

The Appeals Branch is in the process of implementing changes to its field office organizational structure. This will include a comprehensive human resources strategy to ensure that linkages between classification, competencies, training, and accountabilities are in place to complement annual and multi-year business plans and budgets.

The process of risk management continues to evolve and the Agency has made significant enhancements to this process. They include an expanded risk management committee, which includes members from other functional areas of the Agency; a risk management working group that leads the identification of important issues and develops strategies thereon; and an ongoing process with field operations to outline the importance of and underlying reasons for risk management, concurrent with the development of regional risk management committees to provide input to the risk management working group.

CPP and EI appeals

Most appeals are not resolved on a timely basis

6.40 The Appeals Branch receives over 5,000 CPP and EI appeals annually. About half of these appeals are of rulings issued by the Agency's Revenue Collections Branch on questions related to whether a worker is an employee or is self-employed. The other half are appeals by employers who have been assessed amounts for CPP and EI that they did not withhold from their employees and remit.

6.41 In 2003–04 the Branch resolved about 4,700 CPP and EI appeals administratively. Historically, about 65 percent of appeals decisions are accepted by those who appealed. The other 35 percent are appealed to the Tax Court of Canada because at least one of the appellants disagrees with the administrative decision and is willing to pursue the issue further. Because

often several appellants are involved, and determining whether a worker is an employee or is self-employed is not always a straightforward matter, it can be difficult for the Agency to get agreement from appellants on its administrative decision.

6.42 Timeliness goals set by the Branch for CPP and EI appeals were met only about 46 percent of the time in 2003–04 (Exhibit 6.3). We were told that this rate reflects the increasing number of complex appeals that take longer to resolve.

Exhibit 6.3 Forty-six percent of the timeliness goals for CPP and EI appeals were met in 2003–04

File	Timeliness goal (days)	Files that met goal (percentage)
CPP/EI benefits non-pending	90	55.7
CPP/EI benefits pending	75	43.6
Appeals following an audit	105	44.2
Average of all file types		**46.3**

Source: Analysis of Canada Revenue Agency Appeals Branch database

6.43 We found that appeals officers are impartial in examining the laws and facts that apply to the disputed ruling or assessment. They often send questionnaires to all the parties involved in a disputed ruling and interview some or all of them to double-check the facts in the file or to fill gaps in the information collected by the Revenue Collections Branch's rulings officer. However, the overall process is inefficient because often both the rulings officer and the appeals officer contact the parties to ask for roughly the same information. Furthermore, in resolving disputes administratively the role of appeals officers is not to conduct investigations and determine the facts but to review the facts and the laws that apply to each case. A review of the respective roles of appeals officers and rulings officers and how those roles are being carried out could help identify ways to streamline the overall process.

6.44 **Recommendation.** The Canada Revenue Agency should improve the efficiency of the overall process for Canada Pension Plan and Employment Insurance rulings and related appeals.

Agency's response. The Agency agrees with this recommendation and has already initiated a review of the CPP/EI appeals redress process in 2004, in order to identify and address inefficiencies in the process.

The review is focussed on addressing timeliness and procedural issues and risk management of files; it involves representatives from all program partners, including Human Resources and Skills Development Canada, the Department of Justice Canada, and the Revenue Collections Branch of the Agency.

A preliminary report will be prepared by the end of 2004.

Voluntary Disclosures Program

Response from taxpayers and registrants has been good

6.45 The Voluntary Disclosures Program allows taxpayers and GST (or HST) registrants to correct inaccurate or incomplete information previously reported to the Agency, or to disclose information not previously reported, without penalty or prosecution and sometimes with reduced interest. Its goal is to promote compliance with the tax laws.

6.46 The program has been around for many years. It was administered by the Investigations Division of the Agency until 1999, when it was transferred to the Appeals Branch as part of the Agency's fairness initiative. An information circular published in 1973 indicated that taxpayers who made a complete and voluntary disclosure would not be prosecuted or assessed penalties for gross negligence. This policy was extended to GST registrants in 1991. Amendments to the *Income Tax Act,* introduced in 1991 as part of the government's fairness initiative, gave the Minister of National Revenue the authority to waive or cancel any interest or penalty payable under the Act. An updated information circular on the program was published in 2000 and revised in 2002.

6.47 The number of voluntary disclosure requests increased from 2,500 in 2000–01 to 6,100 in 2003–04; the associated federal income tax and GST (or HST) assessments increased from about $140 million to an estimated $459 million. The $459 million is unusually high, due to two large disclosures. The Agency's records show that the issues most frequently disclosed by taxpayers and registrants are

- domestic business income not previously reported;
- failure to collect and remit GST;
- information returns not previously submitted;
- foreign wages and benefits not previously reported; and
- domestic and foreign interest and dividends not previously reported.

6.48 The Agency has actively promoted the program in recent years and attributes at least some of the increase in disclosures to that promotion. We note that while it is fairly easy to find information about the program on the Agency's Web site, the information is limited to the information circular published in September 2002, although the program has seen several changes since that circular was published (see examples in paragraphs 6.63 and 6.66). The changes are reflected in guidelines to staff but have not been made public so that all taxpayers and registrants would have equal access to the Agency's policies for the program.

6.49 The Agency reviewed its administration of the program and reported the results of that review internally in February 2004. The review highlighted the inconsistent administration of the program across the country, the need to revisit certain policies such as "no-name" or anonymous disclosures (see paragraph 6.59), and the need to capture and analyze performance information to manage the program effectively. The Agency has developed an

action plan to address the issues raised in the review and is beginning to implement it.

The way the program's legislative authority is being used raises concerns

6.50 The Agency notes that the legislative authority for the program is subsection 220(3.1) of the *Income Tax Act* and sections 88 and 281.1 of the *Excise Tax Act.* These authorities are similar; essentially they allow the Minister of National Revenue to waive or cancel all or any portion of any penalty or interest otherwise payable under the Acts (amounts waived have not yet been charged; amounts cancelled have already been assessed).

6.51 When subsection 220(3.1) was introduced in 1991, the Department of Finance told Parliament in its Technical Notes that the Minister's discretion to waive or cancel penalties and interest would generally be used in cases where taxpayers had encountered extraordinary circumstances that were beyond their control. The Department gave some examples of extraordinary circumstances:

- natural or human-made disasters such as flood or fire;
- civil disturbance or disruption of services, such as a strike;
- recent serious illness or accident that prevented or delayed the filing of a return or making of a payment; and
- erroneous information received from the Agency in the form of incorrect written answers or errors in published information.

6.52 Further, Parliament was told that the Minister would not use the provision unless the taxpayer had taken a reasonable amount of care in attempting to comply with the requirements of the Act. The Department said that if the taxpayer had delayed paying or complying because of neglect or lack of awareness, the penalty or interest would not be cancelled or waived.

6.53 We support the goals of the Voluntary Disclosures Program and acknowledge the good response from taxpayers and registrants. However, we are concerned that the Agency has gone beyond what Parliament was told the legislation supporting the program would be used for. The overall thrust of the Department of Finance's Technical Notes related to subsection 220(3.1) of the *Income Tax Act* is that the provision is to be used to provide some relief to taxpayers when they find themselves in extraordinary circumstances that are generally beyond their control. In the case of the Voluntary Disclosures Program, many of the disclosures relate to income that was intentionally never reported. Using subsection 220(3.1) to waive the penalties and some of the interest on those disclosures clearly goes beyond the overall thrust of the Technical Notes and may go beyond what Parliament intended the subsection to be used for.

Administration of the program has inconsistencies

6.54 Administering the program is a difficult balancing act. On the one hand, officers want to encourage taxpayers and registrants to correct past errors or omissions and become compliant. On the other hand, they need to

ensure that the program is fair to compliant taxpayers and registrants and is not seen as a free ride or a reward for non-compliance. This calls for a lot of judgment on the part of officers, and solid support from headquarters, to ensure that the balance is maintained and the program is administered consistently across the country. We found that the program is not administered consistently, and we are concerned that the balance is not being maintained.

6.55 **Changing use of the program.** The information circular says that taxpayers and registrants may use the program to correct inaccurate or incomplete information or to disclose information not previously reported, without penalty or prosecution. Officers told us that they thought the primary goal of the program was to encourage those who had been evading tax to come forward and set the record straight without fear of penalty or prosecution. In many ways, the information circular and the guidance given to the officers reflect this view. However, officers find themselves handling more and more cases of taxpayers and registrants who want to correct errors made on past returns without incurring a penalty.

6.56 Officers need to use a lot of discretion and judgment in dealing with these different types of disclosures. In some offices, the staff administering the program may not have enough experience and training to exercise their discretion in a way that promotes the consistent administration of the program across the country. Further, there is no job description or classification for officers of the program and no specific training requirements; most Tax Services Offices are using appeals officers. We note that the Agency recently provided its officers with a Web-based self-training module on the program.

6.57 **Enforcement actions invalidate a disclosure.** The information circular says that a disclosure may not qualify as a voluntary disclosure if it is found to have been made with knowledge of an audit, investigation, or other enforcement action initiated by the Agency. We found that officers checked to see whether there was any enforcement action underway before approving a voluntary disclosure. In most cases this was a relatively easy task. In some cases an enforcement action had started but the taxpayer or registrant had been unaware of it, so the disclosure could still be considered voluntary.

6.58 In a few cases, the taxpayer or registrant was aware that an audit was underway. In such situations, officers are advised to use their discretion in determining how closely the audit relates to the voluntary disclosure the taxpayer or registrant has attempted to make. Only if there is a close connection will the disclosure be considered invalid. For example, if auditors were doing a restricted audit (an audit that focusses on one to three issues) of income tax issues and the taxpayer/registrant wanted to make a voluntary disclosure related to GST, the disclosure would probably be considered valid because it is unlikely that the audit would have discovered a GST issue. Given the changing use of the program, it is likely that officers will have to make more of these judgment calls.

6.59 **Anonymous or "no-name" disclosures.** The information circular points out that those who are unsure that they want to make a voluntary disclosure are entitled to discuss their situation anonymously or as a hypothetical case. We found inconsistencies in the application of this policy from office to office.

6.60 The program provides protection from penalties and prosecution on the understanding that the disclosure is voluntary, complete, and not triggered by an Agency enforcement action such as an audit. In the case of an anonymous disclosure, it is not clear when that protection begins. Some officers told us they would give protection from the date of the first contact, when they would likely have little information about the taxpayer or registrant, the amounts involved, and whether the disclosure would even qualify under the program. Other officers told us they would give protection only from the date when they had enough information to determine that the disclosure could be accepted under the program. Still other officers felt that no protection should be provided until the name of the taxpayer or registrant was revealed.

6.61 The guidelines state that protection should be granted from the date on which the taxpayer or registrant is identified or when the Client Agreement Form is signed, whichever date is earlier. There is a risk in providing protection too early, before the officer has enough information to determine that the disclosure can be accepted under the program. But being too strict risks discouraging non-compliant taxpayers and registrants from coming forward.

6.62 We noted one GST case that highlights the difficulties with anonymous disclosures and enforcement actions (see page 16, A voluntary disclosure of goods and services tax). The issues the Agency had to deal with were the effective date of protection for an anonymous disclosure and whether an enforcement action had been initiated before that date. Complicating this case was the difficulty of calculating the amounts involved and the length of time it took from the initial contact to the disclosure of the name of one of the companies involved. As we have noted, applying the program is a balancing act. At the same time, we believe that taxpayers and registrants should have to identify themselves fairly early if they want to receive the program's protection from penalties and prosecution.

6.63 **Interest relief.** While the information circular makes no mention of interest relief under the program, the guidance given to officers does—it says that taxpayers and registrants are expected to pay a reasonable amount of interest. But it also authorizes officers to consider relief of part of the interest charged on assessments of older-year returns. In particular, officers may consider reducing the interest rate by 4 percent for income tax assessments on the years preceding the latest three years for which returns were required. For example, a taxpayer voluntarily discloses that she did not report dividend income from an offshore investment for the years 1995 to 2002. Using the guidance, the officer would consider reducing the interest rate by 4 percent for the years 1995 to 1999. The guidance goes on to say that there may be

A voluntary disclosure of goods and services tax

Several GST registrants, some of whom were related, discovered in the spring of 2000 that they had made an error in remitting the GST on certain transactions. The registrants' representative contacted a Voluntary Disclosures Program officer in May 2000 to say that the registrants wanted to voluntarily disclose the error to avoid the penalties that normally would be charged. No names and few details were provided to the Agency at that time.

Agency officers and the representative continued to discuss the issue until May 2002, when the representative signed the Client Agreement Form on behalf of the registrants and provided specific information about the error, including an estimate of the amounts and the number of companies involved. However, the names of the companies still were not disclosed, and their representative asked that the effective date of protection under the program be 1 May 2000, the date when the Agency was first contacted.

In September 2002, the representative again wrote the Agency noting that one of the companies, still unnamed but called B company, had been contacted for a GST audit in April 2002. The audit would include part of the period covered by the proposed voluntary disclosure. The representative argued that under the Voluntary Disclosures Program the company should still be entitled to protection, because the effective date of protection was 1 May 2000 (according to the Agency's policy, it should have been May 2002, the date the Client Agreement Form was signed, but local officers decided to override the policy). The auditor was not told that B company had applied for a voluntary disclosure.

In June 2003 the representative wrote to the Agency, indicating that the GST auditor was proposing to assess B company for the tax on transactions that were part of the proposed voluntary disclosure, as well as the related interest and penalties. The representative then identified the company. After much discussion, the Agency agreed in February 2004 to accept the disclosure as voluntary and to waive the penalties and interest that would have been assessed after the audit.

exceptional circumstances that warrant interest relief of more than 4 percent, but it does not give any criteria to consider in making that decision.

6.64 We found that officers were automatically reducing the interest rate by 4 percent on all voluntary disclosures that covered more than three taxation years, without considering whether the interest that would then be paid was a reasonable amount based on the nature of the disclosure. Headquarters officials had advised them to proceed in this way so that the rate of interest paid on voluntary disclosures would be the same as the government's Treasury Bill rate over the short term.

6.65 **Inconsistency with the "fairness provisions."** Under legislation referred to as "fairness provisions," the Agency can waive or cancel all or part of any interest or penalty owed by a taxpayer because of a delay or error by the Agency, circumstances beyond the taxpayer's control, or the taxpayer's inability to pay. The goal is to help taxpayers resolve problems that arise in these situations. Fairness requests are handled by staff at all Tax Services Offices and Tax Centres. Each request is considered separately, and the decision takes into account the facts presented by the taxpayer. The Appeals Branch has overall responsibility for co-ordinating the use of the fairness provisions. In our view, the policy of automatically providing interest relief for

voluntary disclosures is inconsistent with the Agency's practices in providing interest relief under the fairness provisions, because it does not take the facts of each disclosure into consideration.

6.66 **Years to be assessed.** Voluntary disclosures must be complete disclosures. However, some amounts that are disclosed may not be assessed. While the information circular does not discuss this, the guidance given to officers does. For example, if a taxpayer knowingly has not reported income from offshore investments for the last 20 years, the taxpayer must disclose this and the officer has to determine how much of that income is to be assessed. Making that decision means finding the balance between what the taxpayer owes and what the taxpayer is willing to pay to become compliant, taking into account that the result also has to be fair to taxpayers who have been compliant. The guidance states that when omissions have occurred in any of the most current six years for which taxes are due, the officer should include those years in the assessment. But when the omissions also occur in years other than the most current six, the officer must determine whether other years should also be included by considering factors such as

- how material the omission is in relation to the amounts originally reported;
- whether a significant portion of the omission relates to years prior to the most current six;
- the taxpayer's or registrant's compliance history; and
- how long the taxpayer or registrant has been non-compliant.

6.67 We found that there were significant inconsistencies in the way this guidance is followed across the country. Taxpayers and registrants in similar circumstances are not being treated consistently.

Analysis of results is needed

6.68 The Agency is collecting some information on the Voluntary Disclosures Program. Each quarter, officers report the number of cases closed, the types of issues disclosed (such as failure to collect and remit GST), and the amounts of additional tax assessed. However, the Agency is not using this information in any detail to determine whether the program is meeting its objectives or to help it manage the program. In part this is because officers are not reporting the information consistently, and there is no computer program to roll up the results.

6.69 Nor is the Agency analyzing the types of cases being processed under the program. This is important information because it can indicate sources of non-compliance, information that would help the Compliance Programs Branch improve its compliance programs. For example, in 2003–04 the largest number of voluntary disclosures dealt with previously unreported domestic business income. This would suggest that the Compliance Programs Branch should review the work it does to detect unreported domestic business income.

6.70 The Agency is not following up on taxpayers and registrants who have come forward through the Voluntary Disclosures Program to ensure that they remain compliant. This is particularly important to prevent misuse of the program.

6.71 **Recommendation.** The Canada Revenue Agency should

- implement its February 2004 action plan, with particular emphasis on aspects designed to ensure that the program is administered consistently across the country;
- analyze the results of the program to determine whether its objectives are being met; and
- follow up on taxpayers and registrants that have used the program to ensure that they remain compliant.

Agency's response. The Agency agrees with the recommendation and has started the following:

- Implementing the February 2004 action plan that will address consistency issues.
- Enhancing the analysis capacity of the Appeals Branch.
- Monitoring periodically and addressing risk associated with future non-compliance. A review is currently underway to identify, analyze, and assess ongoing compliance of clients, and based on the results, we will be incorporating voluntary disclosures into the Agency's issue-based risk assessment system.

The Agency notes that the Auditor General believes the CRA has gone beyond what Parliament was told the legislation supporting the Voluntary Disclosures Program (VDP) would be used for. The Agency maintains, with the reassurance of the Department of Justice Canada, that the intent of Parliament is contained in the words of the acts as passed by Parliament. Furthermore, since enactment of the legislation in 1991, circumstances covered by the VDP policy have been the subject of various parliamentary debates.

Conclusion

6.72 The Appeals Branch is resolving objections to income tax and GST assessments in a way that is fair and impartial. As well, over half of the objections are resolved within the timeliness goals the Agency has set. However, taxpayers can appeal their case to the Tax Court of Canada if they have not received a decision from the Appeals Branch after 90 days. Many of the Branch's timeliness goals for income tax objections exceed 90 days by a large margin. The Agency needs to ensure that appeals officers fully grasp the importance of assessing the potential risks to the tax base from the objections they review and completing the risk assessments regularly.

6.73 The Appeals Branch is having difficulty resolving appeals of CPP and EI rulings and assessments in a timely way, although it resolves them impartially. More work is needed to improve the efficiency of the overall process for CPP and EI rulings, which are issued by the Revenue Collections Branch, and any related appeals of those rulings, which are dealt with by the Appeals Branch.

6.74 Taxpayers and registrants are using the Voluntary Disclosures Program to become compliant, by correcting inaccurate or incomplete information previously reported to the Agency or by disclosing information not previously reported. However, the program's inconsistent administration across the country raises concerns about whether the Agency is protecting the tax base. As well, we are concerned that the Agency has gone beyond what Parliament was told the legislation supporting the program would be used for.

About the Audit

Objectives

The objectives of the audit were to determine

- whether the Appeals Branch of the Canada Revenue Agency is resolving objections to income tax and GST assessments and appeals of CPP/EI rulings and assessments in a way that is fair, timely, and impartial; and
- whether the Voluntary Disclosures Program is encouraging compliance and protecting the tax base.

Scope and approach

The audit focussed on the Agency's policies and procedures for reviewing

- notices of objection from taxpayers and registrants who disagree with the Agency's decisions in income tax and GST; and
- appeals from workers, employers, the Minister of Social Development (for CPP), or the Employment Insurance Commission (for EI) who disagree with the Agency's rulings and assessments on CPP and EI.

The audit also reviewed the Agency's administration of the Voluntary Disclosures Program, which allows taxpayers and registrants to correct inaccurate or incomplete information previously reported to the Agency, or to disclose information not previously reported, without penalty or prosecution and sometimes with reduced interest.

We did not include the fairness provisions which provide for forgiving interest and penalties to taxpayers unable to comply with the law due to circumstances beyond their control. The administration of these provisions was covered in our 2002 Report, Chapter 2, Tax Administration: Write-Offs and Forgiveness. We also did not include the Branch's work in the area of litigation, which was covered in our 1998 Report, Chapter 5, Interdepartmental Administration of the Income Tax System.

We conducted our audit work at the Agency's head office, eight Tax Services Offices, and two Tax Centres. We reviewed selected cases, interviewed management and staff, and analyzed data, monitoring reports, and other information provided by the Agency.

Criteria

Our audit was based on the following criteria:

- Reviews and decisions should be based on an impartial examination of the laws and facts applicable to the contested Agency decision.
- Performance goals should be established for timeliness in completing appeals decisions, and actual completion times should be measured against the set goals.
- The Agency should have a risk management strategy, and to protect the tax base it should implement a process for dealing with risks related to objections and appeals.
- The Agency should ensure that the objections and appeals process is transparent.
- The Agency should have a strategy and implement a process to ensure that it has the right people in the right place at the right time and that they are adequately trained to do the work assigned.
- The Agency should monitor and analyze the results of disputes to determine how effective it is in resolving contested decisions and to improve its effectiveness.
- The Voluntary Disclosures Program should be designed and implemented in such a way that it encourages non-compliant taxpayers to comply while at the same time protecting the tax base. The implementation of the procedures should be monitored regularly.
- The Agency should have adequate information about the Voluntary Disclosures Program to ensure that it is meeting its intended objectives.

- The Voluntary Disclosures Program should operate within the legislative authority provided to the CRA and the fairness policies established by the CRA.

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