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Report of the
**Auditor General
of Canada**
to the House of Commons

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Chapter 4
Canada Customs and Revenue Agency—
Taxing International Transactions
of Canadian Residents



Office of the Auditor General of Canada

The December 2002 Report of the Auditor General of Canada comprises 11 chapters, Matters of Special Importance—2002, a Foreword, Main Points, and Appendices. The main table of contents is found at the end of this publication.

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Chapter

4

Canada Customs and Revenue Agency
Taxing International Transactions of
Canadian Residents

The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies, and practices of the Office of the Auditor General of Canada. These policies and practices embrace the standards recommended by the Canadian Institute of Chartered Accountants.

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Canada Customs and Revenue Agency

Taxing International Transactions of Canadian Residents

Main Points

4.1 The Canada Customs and Revenue Agency verifies that Canadian residents have complied with the tax rules on international transactions through audits carried out by specialized international auditors across the country. Our audit found that better risk assessment is needed to determine what compliance work should be undertaken in each tax services office and on a national basis. This is needed in order to provide an adequate check on the assessment of tax revenue from international transactions.

4.2 Expert staff is essential for an effective international audit program. The Agency must find ways to improve the program's human resource capability at a faster rate and explore ways to ensure that complex international audits are completed in a timely manner. In the Toronto area where 40 percent of large corporations file their tax returns, economic conditions have made recruiting and retaining international auditors difficult. The current staffing and level of training activities may not address this problem. In some tax services offices over one-third of the international audit staff have less than one year's experience and still require some training. Other staff, including some auditors of large corporations and auditors of small and medium businesses who were recruited without previous international tax experience still require basic international tax training.

4.3 The Agency needs to be more effective in carrying out audits of international issues. Strengthening its ability to provide advice on international business practice and providing economic analysis earlier in the audit process would reduce the time over which international audits are completed. The international audit program needs better information on the resources used to complete the audit of international issues, the tax reassessed, and the issues identified in reassessments in order to determine its future resource requirements and program directions.

Background and other observations

4.4 Canadian residents pay tax in Canada on their worldwide income. This includes the profits derived from sales of goods and services to non-residents, and dividends, capital gains, and interest resulting from their investments in foreign corporations or other foreign entities such as trusts.

4.5 There are specific rules that deal with the taxation of foreign transactions of Canadian residents. For example, transfers of goods and services between related parties must take place at arm's length prices. The foreign affiliate rules and the foreign accrual property income rules of the

Canadian *Income Tax Act* deal with dividends and other income from investments in foreign entities. Data reported by taxpayers to the Agency indicates that Canadian investments in foreign-related corporations and the value of cross border trade between companies within the same corporate group has increased significantly in recent years.

4.6 The International Tax Directorate of the Canada Customs and Revenue Agency administers the tax rules on international transactions with the assistance of several other divisions within the Agency. To ensure that taxpayers comply with the complex tax rules related to international transactions, the Agency uses information obtained from various sources, including information provided by taxpayers in tax returns and in other information returns. Based on this information, auditors select files and conduct audits on the international transactions made by taxpayers.

The Agency has responded. The Canada Customs and Revenue Agency agrees with our recommendations and in its responses, has indicated the actions it will take to address them.

Introduction

4.7 The Canadian tax rules that cover international transactions can be divided into two broad dimensions. In December 2001 we reported on how the Agency administers the tax rules for Canadian source income of non-residents. This Report covers how the Agency administers the tax rules for international transactions that involve Canadian residents. These tax rules include relevant sections of the *Income Tax Act* and Regulations as well as provisions of tax agreements between Canada and other countries.

4.8 Canadian residents pay tax in Canada on their worldwide income. If they carry on business outside Canada it may be either directly, or through related companies that are resident in other countries. If they invest in foreign corporations or have an interest in a foreign trust they may receive income such as interest, dividends, and capital gains.

4.9 Between 1996 and 2000, the amount of money that Canadian-resident corporations loaned to, and invested in foreign affiliates has increased from \$200 billion to over \$450 billion. The Agency collected data which indicates that Canada's top 50 corporations have over 1,300 foreign-affiliated corporations, trusts, and partnerships scattered throughout the world. This data also shows that the trade in goods and services within these corporate groups was over \$250 billion in 2000, while the value of dividends and interest received in Canada from investments in these related entities was over \$3 billion.

4.10 Foreign investments pose risks to Canada's tax base. The income from foreign investments is not as visible as Canadian source income and is more difficult to identify and verify. Income and capital gains may be diverted to tax havens and countries with preferred tax regimes to avoid Canadian tax. To encourage compliance and assist in identifying those risks, taxpayers must report details of their foreign investments.

4.11 In the last decade foreign trade has increased from 50 percent of gross domestic product to over 80 percent. More than 50 percent of Canada's international trade is between related parties such as a Canadian corporation and its foreign affiliates. Canadian tax rules require that the buying and selling of goods and services between related parties must take place at arm's length prices. Canadian companies may attempt to reduce the income they report in Canada either by selling goods and services to foreign-related parties at prices that are lower than arm's length prices, or by purchasing goods and services from related parties at prices that are higher than arm's length prices.

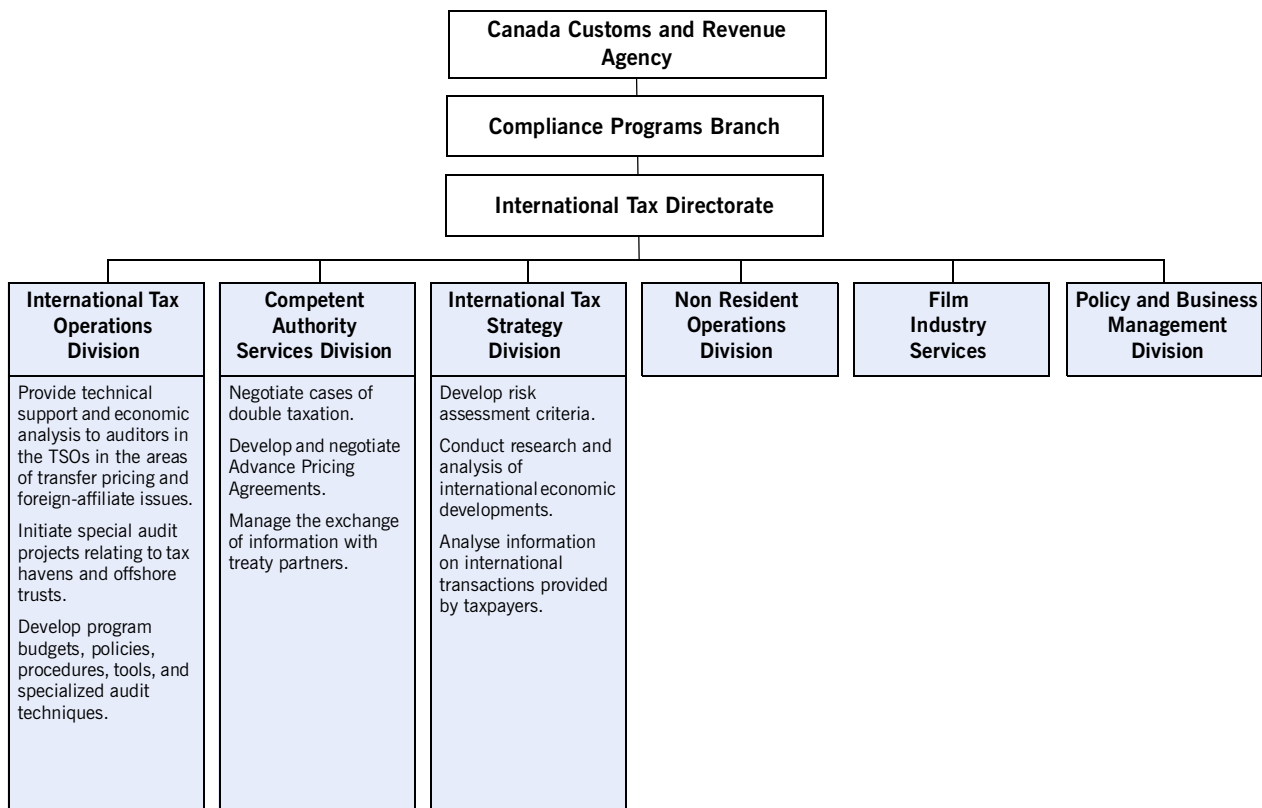
The Agency's International Tax Program

4.12 The International Tax Directorate, located in the Agency's headquarters in Ottawa, and the international audit program in tax services offices across the country are the focal point of the Agency's International Tax Program.

4.13 The International Tax Directorate, a part of the Compliance Programs Branch, was established in November 1991 to enable the Agency to respond to international tax issues in a consistent and timely way. The Directorate’s role is to develop and refine tax administration programs and systems to ensure that Canadians and non-residents comply with the legislation and treaties that apply to international transactions. The Directorate also provides guidance on policy matters, and technical assistance to the tax services offices on international tax issues. In this year’s audit we focussed on the divisions of the International Tax Directorate with responsibilities for the taxation of international transactions of Canadian residents (Exhibit 4.1).

4.14 The Directorate personnel participate in working groups of the Organization for Economic Co-operation and Development. These working groups study ways to avoid double taxation, prevent fiscal evasion, and ensure that the application of transfer-pricing guidelines, legislation, and practices are in line with tax treaties. They also participate at meetings of the Pacific Association of Tax Administrators and the Seven Countries Tax Haven Group to share information on common international tax issues and best practices. One of the Association’s current initiatives is to develop a model documentation package that taxpayers could prepare to avoid penalties,

Exhibit 4.1 Divisions of the International Tax Directorate responsible for taxation of international transactions of Canadian residents



Source: Canada Customs and Revenue Agency

if an audit indicates that sales to and purchases from related parties have not taken place at arm's length prices. The objective is to have a documentation package that will meet the requirements of the four member-countries.

4.15 Over the last five years, the Directorate has more than doubled in size, from 80 to 200 employees. The number of Directorate staff assigned to support the international audit program in the tax services offices has increased from 10 to 46.

4.16 While the Directorate provides overall program direction and administrative guidance, the tax services offices across the country carry out the bulk of the audit activities. In 2001–02 there were 238 international audit staff in 31 tax services offices. Plans call for a total of 278 staff by the end of 2002–03.

4.17 International auditors in tax services offices across the country carry out audits; if they determine that the taxpayer's taxable income or tax liability needs to be adjusted, a tax reassessment statement is issued to the taxpayer. These auditors interact with other staff throughout the Agency to complete the audit. In the tax services offices the international auditors can select files for audit or work on files referred by auditors examining domestic transactions. In the case of large corporations the Agency's policy is to review the returns of 875 corporations with gross revenue of more than \$250 million, for each tax year. Large-file case-managers co-ordinate all aspects of these audits.

4.18 Three field advisory units provide expert advice on foreign-affiliate and other international tax rules to the auditors in the tax services offices. Each field advisory unit has eight to ten employees located in Ottawa. Within these units the Directorate currently employs six economists to assist the international auditors in completing transfer-pricing audits. In addition, there is one technical advisor who resides in each of the six regions and who is also responsible for providing advice on technical issues to international auditors in their region.

4.19 The Agency also has 18 industry specialists, located in tax services offices across the country. International auditors can consult these industry specialists for advice on tax and business issues specific to industry sectors, such as financial institutions, forestry, and information technology.

4.20 The international auditors can also refer matters through the International Tax Directorate to the International Sections of the Income Tax Rulings Directorate, Policy and Legislation Branch, or to the Agency's Legal Services Unit. This is done in cases where auditors want a determination of how the tax laws should be interpreted in relation to the facts of a taxpayer's specific situation. These referrals are often necessary given the complex nature of the international tax rules, and the organization, and transactions of multinational businesses.

4.21 If at the end of an audit an international auditor determines that the taxable income reported by a related party in another country should have been reported by the taxpayer in Canada, this can result in the taxation of the

same income in two countries. If a tax treaty exists between Canada and the other country, the taxpayer can request the assistance of the Competent Authority Services Division for relief from double taxation. The staff of the Division, including both auditors and economists, will review the case and attempt to resolve the matter with their counterpart in the other country. In the past year the Division participated in resolving the issues in over 100 requests for competent authority assistance. The taxpayer may also file a notice of objection with the Agency's Appeals Branch.

4.22 The performance report prepared by the International Tax Directorate indicates that in the year ending 31 March 2001, international auditors had completed 1,430 cases and reassessed an additional amount of about \$778 million in taxes. Over 350 of these cases involved international transactions made by large corporations that resulted in tax reassessments of over \$300 million.

Focus of the audit

4.23 The objective of the audit was to determine whether the procedures which the Agency is currently using, provide an adequate check on the assessment of tax revenues from the international transactions of Canadian residents.

4.24 Our audit focussed on several questions: Does the Agency have a risk assessment and a compliance strategy to manage the risks to the taxation of international transactions? How effectively has it carried out its activities to verify compliance with the rules? Has it reported its performance accurately? How well does its functional guidance and assistance support the operational activities of its tax services offices? We placed particular emphasis on the Agency's review of international transactions of Canada's largest corporations. Further information about the audit objectives, scope, approach, and criteria can be found at the end of the chapter in About the Audit.

Observations and Recommendations

Assessing international tax risk

4.25 Our view is that the international audit program's national priorities to allocate resources should be based on an assessment of which taxpayers and types of transactions are most at risk of being non-compliant with the tax rules relating to international transactions. Compliance risks exist in international transactions involving large corporations, as well as smaller businesses, individuals, partnerships, and trusts, and need to be fully identified and assessed to appropriately allocate resources.

National program guidelines can be improved to better reflect an overall assessment of international tax risk

4.26 Annually the International Tax Operations Division prepares national planning guidelines directing how tax services offices should allocate their international audit resources between various types of international audits.

The original guidelines for 2002–03 indicate that 51 percent of international audit workload in tax services offices should be directed to individual audits and audit projects identified by the International Tax Directorate or international auditors in the tax services offices. The guidelines indicate that 49 percent of the workload should be directed to assistance on files selected for audit by domestic auditors. This allocation of audit resources should better relate program activities to an overall identification and assessment of the international tax risk presented by different taxpayers or types of transactions.

4.27 A project originally identified as needing significant resources for 2002–03 was the completion of the audit of income of taxpayers involved in foreign trusts. The foreign trust project was initiated in 1999 and the resources currently allocated to the project are based on an estimate that there was \$400 million in additional income to be reassessed in Canada in relation to specific offshore trusts, and the associated Canadian taxpayers which were selected for audit. The results to date show that fewer than 60 percent of the completed audits have resulted in non-compliance being identified. Other files are still under audit.

4.28 However, the Agency does not yet have a final position on reassessing the Barbados spousal trusts we noted in our 2001 Report, Chapter 7, International Tax Administration: Non-Residents Subject to Canadian Income Tax. International audit staff which were allocated to this task are not trained to enable them to complete this project work in 2002–03.

4.29 The original program guidelines were modified after discussions with the tax services offices. The final national planning guidelines for this year call for 56 percent of the auditor's workload to be allocated to assisting domestic auditors in completing audits of international issues. This is a reduction from the 65 percent of the previous year, but with a slight increase in the number of cases to be completed due to an increase in staff. In audits completed in previous years, we observed cases where international issues identified for audits had been deferred or delayed because international audit staff were not available. With the number of resources assigned to this task, international auditors have not been able to meet the objective of the international audit program that is to participate in all audits of large corporations. This was the case in all of the large tax services offices we visited.

4.30 The Agency says that the program guidelines are based on the assessment and weighing of various risk factors. However, we have seen little information and analysis concerning the assessment of international tax risk, in different types of files. Nor did we see the basis for weighing these risks that would support the current allocation of international audit resources. More needs to be done to improve the information and analysis to evaluate international tax risks and support program guidelines.

International audit planning for large corporate audits must be improved

4.31 Identifying specific transfer prices and international transactions of a large corporation that may not be in compliance with Canada's tax laws or treaties is a complex process. To effectively identify and assess the risk of non-compliance with tax rules in international transactions, international auditors need to know how different businesses operate worldwide and be able to interpret the international information provided on the various documents filed by a taxpayer. As well, auditors must gather significant additional information about large corporate taxpayers before a decision can be made to focus an audit on a specific transaction or issue.

4.32 A concern with inadequate audit planning was raised by the International Audit Quality Assurance Review, which was undertaken by the Agency in six tax services offices in the past two years. In our audit work we reviewed some ongoing audits to see if the concern raised by the Quality Assurance Review had been addressed. Several large corporate international audits were proceeding with no specific international audit issues identified and documented in the audit planning documents used internally. In addition, specific international audit issues were not identified in the letter sent to the taxpayers giving details of the audit including specific issues and transactions to be examined.

4.33 Currently the international audit program in the tax services offices is required to provide audit staff to identify and audit the international tax issues in a large corporation when the large-file case-manager starts the audit. This assistance is required in the audit of 875 major corporations and the 7,700 Canadian corporations they control. It includes reviewing the international transactions between all of these corporations and their foreign affiliates.

4.34 The international audit section in the tax services offices would be better able to plan the international component of large corporate audits, and to apply its limited audit resources to the audits with the greatest risks of non-compliance if the relative international tax risk in the large corporations that will be audited that year could be assessed in advance. This annual planning would indicate to the International Tax Directorate and senior managers responsible for the audit of large corporations in tax services offices what international tax risks the international auditors have identified but would not be able to address in an audit this year. This level of international tax risk assessment and workload planning for the audit of large corporations would also be useful in identifying overall international tax risk for consideration in future program guidelines.

4.35 We have also observed that the time and resources applied to international audit planning could be used more effectively if a co-ordinated risk identification model was available to provide guidance in identifying and assessing the risk of non-compliance in international transactions in a particular corporate group. The development and use of such a model would provide consistency in the international audit approach and assist in the training of international auditors.

Tools must be applied to select small and medium businesses for international audits

4.36 Domestic auditors also need to apply tools to screen for international issues in a more systematic way for risk assessment purposes when identifying small and medium companies for audit. In the past two years international auditors have received few requests for their assistance in auditing international transactions of small and medium companies. The data in the Agency's information management system show that few audits of international transactions of small and medium companies were completed by domestic auditors. Some international compliance issues have been identified in these companies by international auditors.

4.37 Currently auditors of small and medium companies do not consistently screen the data provided by taxpayers on international transactions and investments in non-residents who are related to them. Also the auditors need additional training to properly access and utilize the different databases in selecting companies for audit. New screening tools being developed by the International Tax Strategy Division could be used by auditors of small and medium companies to identify international tax risk.

Better information is needed to identify international tax risk

4.38 Beginning in 1996 Canadian residents were required to report ownership interests in foreign affiliates, transfers of property or loans to a foreign trust, and distributions from foreign trusts. Since 1998 they must also report certain foreign properties with a cost greater than \$100,000. These requirements, along with the existing requirement to report information on non-arm's length transactions with non-residents were intended to address the concern that income has been inappropriately transferred to tax havens. These requirements are also intended to help Canadians report their world-wide income accurately.

4.39 The Agency has begun to monitor and analyse the information reported in order to conduct risk assessments. Before the Agency can rely on this information and use it to make decisions on compliance programs, it must do more to determine the extent of non-compliance with the foreign reporting requirements. In addition we have noted two multi-billion dollar errors in the information on Canadian foreign investments which Agency officials prepared from one of its foreign-reporting databases. This leads us to question the strengths of the current controls over the completeness and accuracy of the data.

4.40 In December 1997 we were asked by the Governor General in Council to examine the requirement to report specified foreign property over \$100,000. In our Report of June 1998, Examination of the Requirements to Report Specified Foreign Property Under Section 233.3 of the *Income Tax Act*, we concluded that the requirement is an appropriate mechanism within an overall strategy to both enhance compliance with the laws that require reporting of foreign-source income, and provide the Agency with information to verify taxpayers' self-assessments.

4.41 We encouraged the Agency to monitor the reporting regime for offshore investments annually. We also suggested the Agency should evaluate after two to three years whether the regime provides the desired information and is meeting its objectives of enhancing compliance with the law without being overly burdensome.

4.42 In January 2002, the Agency completed a review of the requirement to report specified foreign property over \$100,000 as part of its overall review of the foreign-reporting requirements. It noted that in 1999, 51,000 taxpayers had completed the required information return. The Agency concluded that the information return is best suited for computer-based risk assessment and currently has limited analytical usefulness. It is considering making changes after discussions with stakeholders.

4.43 Recommendation. The Canada Customs and Revenue Agency's ability to assess the international tax risk should be strengthened by

- improving the information and analysis used to assess the overall tax risk from international transactions and types of taxpayers to better determine international audit program guidelines,
- developing a risk assessment model to plan the audit of international issues of large corporations,
- evaluating the international tax risk in all large files that will be audited in a given year before developing the workload of the international auditors,
- using tools to screen for international issues to select small and medium companies for audit, and
- implementing better controls over the integrity of data in the foreign reporting database.

Agency's response. The Canada Customs and Revenue Agency (CCRA) agrees with this recommendation. We will continue to do risk assessment and improve on the risk assessment process already in place.

On September 26, 2002, the Minister of National Revenue reported on CCRA's Future Directions initiative, which includes examining the Agency's approach to large businesses and small and medium enterprises. Through the implementation of this initiative, compliance will be enhanced as greater attention will be focussed on managing the risks of particular clients or client groups.

Work on enhancing our risk assessment framework for international tax issues is underway and will be fully integrated with the existing International Tax Compliance Strategy. This fully integrated risk assessment process, with its ongoing and verifiable risk assessment criteria, will form the basis for directing compliance actions in all areas of international taxation.

Currently, audit resources are allocated to tax services offices based on file complexity, workload populations, groups of taxpayers, and types of transactions in accordance with their perceived international tax risk. CCRA

is actively pursuing ways to link information stored in our various databases in order to enhance the assessment of international tax risk.

International issues that are identified through our risk assessment processes are included in the overall large file audit plan and international auditors participate in the initial screening process. Resources are allocated to the files where potential tax risk is a concern. Resource requirements are adjusted as new issues of a higher priority are identified. Therefore, flexibility is essential to the effective delivery of the international audit program.

The risk of each file is assessed at the beginning of a large file audit, and international auditors re-evaluate this risk on an ongoing basis during the audit. We will enhance this process by giving additional training to auditors in order to identify these risks by regions and industry sectors. CCRA will also accelerate its systems-based risk assessment. These measures will assist CCRA in evaluating the overall international tax risk in large files.

CCRA agrees that we should be more vigorous in applying our screening mechanisms to select small and medium companies for international audit. CCRA has initiated a study of the linkage between our International and Small and Medium Enterprises programs to foster cooperation and partnerships and is working to determine, for workload development purposes, systems-based criteria in identifying small and medium companies with potential tax risk relating to international issues.

We will also provide additional program guidance to field auditors on risk assessment of international tax issues and more formalized training sessions to teach all auditors how to properly access and utilize International's different databases.

CCRA is aware of the data integrity issues in an earlier version of one of our foreign-reporting databases. Action had been taken in 1996 to change the foreign-reporting form, and install better validation controls to reduce data-input errors. CCRA will continue to improve the analytical usefulness of the various foreign reporting information returns and ensure complete and accurate information is available to all users.

Audit skills are developing slowly

4.44 In our 1998 Report, Chapter 24, International Tax Directorate: Human Resource Management, we wrote about the difficulties in staffing the international audit positions. Since our last audit, additional international audit staff have been hired. There are currently 238 international audit staff in the tax services offices across the country, with an expansion planned for this fiscal year. In the last four years there has also been a significant number of departures of senior international audit staff to both other audit areas of the Agency and the private sector.

4.45 In some of the tax services offices we visited, over one third of the international audit staff have less than one year's experience and still require some international tax training. As well, some large-file auditors, small and medium business auditors, appeals officers, and the International Tax Directorate staff who have been recruited without previous international tax experience still require basic international-tax training.

4.46 The Agency's internal reports show that last year over 300 people were given the Agency's introductory training course on international tax law. This met over 90 percent of the requests for instruction. However only 13 percent of the requests for 400 places for the advanced course on "Foreign Affiliate and Foreign Accrual Property Income Rules" were satisfied. Twenty nine percent of the requests for instruction on international audit techniques were met. The Agency is shifting its focus on training to on-line learning. However high quality international audit training delivered by experienced practitioners is still needed to improve the competence of the international audit staff.

4.47 Our file reviews and interviews with auditors, team leaders, and section managers indicate that formal training alone does not produce competent international auditors. Strong on-the-job learning with experienced and technically competent team leaders, section heads, or international field advisors is required. This strong technical mentoring is sometimes lacking, most particularly in foreign affiliate issues, since there are few experts in this area across the country or in the International Tax Directorate in Ottawa.

4.48 The range of audit tasks in the international audit sections of a tax services office requires audit skills and technical knowledge in international issues ranging beyond those required for the positions currently classified for this audit function. At the most complex end of large corporate audits, the degree of expertise and experience to identify and audit international transactions in these files is extremely demanding. There are other tasks that could more appropriately use more junior level staff than are currently available. Having a broader range of audit positions in most tax services offices would also assist in international auditor development and possibly assist with auditor retention. Addressing this concern is within the mandate of the International Tax Programs Task Force, which was created within the Agency in April 2001.

4.49 The current staffing and the level of training activities may not be able to address the economic and labour force realities in some communities. In the Metro Toronto tax services offices there has been a shortage of experienced international auditors for some time. An internal report shows that these are the same offices that are responsible for the audit of the large Canadian companies which report nearly 40 percent of all foreign affiliates. The Agency needs to look for new ways to undertake the complex international audits of large corporations that file in these tax services offices in a more timely and effective manner. We have observed international auditors from one tax services office assisting another tax services office where experienced international auditors were not available to undertake an audit.

4.50 Recommendation. The International Tax Directorate and the tax services offices should seek ways to improve the international audit program's human resources capability at a faster rate and explore ways to ensure that complex international audits are completed by experienced international auditors.

Agency's response. The Canada Customs and Revenue Agency (CCRA) agrees with this recommendation and will continue to provide training to all staff involved with international tax audits. CCRA recognizes the benefits of a well-trained staff, and new training courses and innovative learning tools are being developed to supplement those that currently exist.

In addition, mentoring is encouraged and our headquarters staff regularly visits tax services offices to discuss cases and provide technical support to the international auditors, team leaders and managers.

As well, the International Tax Programs Task Force was created in April 2001 to review the workload in tax services offices, the appropriate organizational structure to address the workload, and the personnel required to deliver international tax programs. The goal is to provide for an integrated workflow that maximizes efficiency and effectiveness. Senior management is in the process of finalizing the recommendations of the Task Force.

CCRA continues to staff positions as expeditiously, efficiently and cost-effectively as possible to meet its operational objectives, at the same time exploring new alternatives and improving those aspects of planning and staffing processes that are under its control to ensure complex international audits are completed by, or guided by experienced international auditors.

CCRA will increase its international tax research abilities, auditor expertise, and training capabilities in the highly complex areas of transfer pricing, foreign affiliates, and offshore trusts.

Audit management must be strengthened

4.51 In our review of audit files with significant transfer pricing and investment income issues, we found that often an excessive amount of time had elapsed from the beginning to the end of the audit of these issues. It was not uncommon to find audits that took more than three years to complete. We found that often delays in file progress can be attributed to the following aspects of international audit management.

Obtaining foreign-based information from taxpayers in a timely way is essential

4.52 Audit files show that international auditors experience difficulties in getting requested documents, and answers to their queries from taxpayers. Taxpayers often claim that the required documents are kept outside the country, and are unavailable, or are covered by secrecy provisions of the foreign jurisdictions. Many of the audits of large corporations we reviewed were done under an agreement signed by the taxpayer, which defined response times for providing information. In these cases, the time that the taxpayer took to provide information was much longer than agreed. We have observed cases where answers to queries are incomplete after a year. It is therefore important that

- the information requested from taxpayers be as precise as possible,
- auditors actively pursue outstanding requests for information,

- auditors review all the requested information for completeness as soon as possible after being received, and
- the Agency take available measures to obtain foreign-based information.

Our reviews of audit files as well as the Agency's own quality review studies show that these measures had not been taken in a large number of audits.

4.53 We have observed that the exchange of information provisions under the tax treaties, which Canada has signed, with 75 countries have not been used frequently. Auditors generally request the information directly from the taxpayer but often did not receive the needed information. A request for information from a treaty partner according to the terms of the treaty generally was not issued when taxpayers did not reply.

4.54 In the audits we reviewed we did not find that any requirements had been issued to taxpayers to produce foreign-based information. Interviews with auditors indicated that they believe that the agreements entered into with taxpayers do not allow the Agency to issue a formal demand to provide information. More timely action to formalize requirements that taxpayers produce information related to offshore transactions would permit audits to move forward.

4.55 One of the underlying reasons for audit delays in the past may have been that experienced economists were not available to give input on audits that involved transfer-pricing issues. In many cases, the auditors did not request an economist's help until late in the audit process. This often resulted in a new series of queries to the taxpayer, adding to the delay.

4.56 Information for a transfer-pricing audit is gathered by the international auditor in the tax services office before the economist's input can be made. However, auditors and economists together can best decide on the specific information needed from the taxpayer early on in the audit. To reduce the time needed to complete audits, transfer-pricing audits must be referred to the economists earlier in the audit process, and economists must work in closer collaboration with the international auditors.

Good global business knowledge is important

4.57 Every auditor we spoke to confirmed that the key to a successful international audit is having a good understanding of how a business organizes its operations on a worldwide basis. Further discussion with auditors and our review of audit files revealed that international auditors often need to get this information from other sources within the Agency. They do not often seek the input of industry specialists when planning and carrying out their audits. We also saw audit delays as a result of the inability of the international auditor to evaluate information provided by taxpayers on their international business operations.

4.58 The position of industry specialists requires individuals that have developed an understanding of the context in which corporations operate in a specific sector, and thus are able to provide information to help international auditors better target their audit procedures and questions. Through

discussions with participants and a review of the agenda and presentations, we have seen the value of the national sector-based conferences, in particular the national banking conference, which was organized by Industry Specialists Services and included international compliance issues.

4.59 However some of the business questions arising from the international audits of specific transfer pricing and investment income issues may be beyond even the expertise of the industry specialists. While the national conferences and industry-specific issue lists provided by Industry Specialists Services are positive initiatives in that they include international issues, there is still a need to provide international auditors with better information on sector-specific business issues in a global context, in order to facilitate the audit process.

4.60 Recommendation. The Canada Customs and Revenue Agency should strengthen aspects of its management and support of international audits by

- formalizing requirements and requests to produce information related to offshore transactions,
- involving economists earlier in the audit process and having them work in closer collaboration with the international auditors, and
- providing international auditors with better information on global sector-specific business issues.

Agency's response. The Canada Customs and Revenue Agency (CCRA) agrees with this recommendation.

Where the auditor believes that the taxpayer has or ought to have documentation relating to offshore transactions, and such documentation is not provided by the taxpayer, requirements should be used to obtain the requested documentation. CCRA has already initiated a process of obtaining input from various areas of the Agency and the Department of Justice to facilitate the usage of formal requirements.

We will continue to emphasize in training sessions provided to all staff involved with international tax audits the importance of formalizing requirements that taxpayers produce information related to offshore transactions.

Also, CCRA will continue to encourage international auditors to request the input of an economist as early as possible in the audits of complex transfer pricing transactions. Presentations have been made to field staff on a regular basis regarding the role of the economist. More timely guidance from the economists so the appropriate information will be requested from taxpayers early in the audit can be expedited with an increase in economist resources.

CCRA recognizes that international auditors in the field and economists in headquarters need to have all the necessary information on global sector-specific business issues on audits being undertaken. CCRA will ensure there is an efficient sharing of knowledge among its specialists, including any specialized industry knowledge affecting international issues. Specialists in CCRA also participate in various international fora. The sharing of this

global sector-specific business knowledge among different areas of CCRA, including international auditors in the field, will result in a more successful international audit.

Management information for program planning

4.61 The Agency collects information on the number of hours spent auditing international tax issues, the number of cases completed and the expected tax recovery. This information along with other indicators are used to measure the performance of the international audit program. A three-year historical average of direct hours and recoveries per case are also used to determine the expected number of cases to be completed in the future and resulting tax recoveries for a given level of staffing.

4.62 A “case” is used as the basic unit of measurement of performance. Direct audit hours and tax reassessments are recorded for each case. When auditing large companies and their associated corporations, a case was opened for every year audited and for every associated corporation audited. The audit of large corporations covered one to five years. As a result, one audit of the international transactions of a large corporation can be reported as several cases.

4.63 International auditors open an additional case to continue recording international audit activities if domestic auditors close their case before the audit of the international issues is finished. The tax services offices have developed different practices to record the continuation of the audit of the international issues.

4.64 As a result of these practices the number of cases completed in a year is significantly larger than the number of actual audits completed. For 2000–01, the International Tax Directorate reports completing 360 cases where international auditors have audited the international transactions of large corporations. We estimate that this represents about 270 actual audits.

4.65 These methods of counting the number of cases results in the International Tax Directorate not having correct information on the number of hours needed to complete an audit and the tax reassessment resulting from the audit. Better performance information could be used to develop guidelines on the direct hours needed to complete audits of differing sizes and complexity. This would give management more meaningful information on which to make decisions when allocating resources to international audits.

4.66 We observed other deficiencies in the information.

- Currently many domestic auditors record their time to domestic audit activities while auditing international issues. The total hours spent auditing international issues should be recorded regardless of whether the work is done by an international audit specialist or a domestic auditor.
- International Tax Directorate specialists and economists do not record direct hours spent on cases.

- Auditors do not always report the description of the income and tax changes they have made accurately. Management uses this information to determine which areas of non-compliance are most subject to changes.

4.67 Recommendation. The Canada Customs and Revenue Agency should gather better information about the time needed to actually complete audits of the international transactions of large corporations and the result of those audits.

Agency's response. The Canada Customs and Revenue Agency (CCRA) agrees with this recommendation and will continue to examine ways to enhance reporting of time spent on international tax activities to ensure it is complete and accurate. Guidance for the field on case management is under development and will clarify certain issues relating to the definition of a "case" in order to assist international auditors to report their time spent more accurately.

CCRA agrees that tighter controls need to be exercised when information is being entered in the Agency's systems. CCRA will ensure that reconciliations are done on a regular basis with respect to income and tax changes processed on reassessment between its main reporting system and its supplementary system.

Conclusion

4.68 Better assessment of the risk of taxpayers not complying with the tax rules on international transactions is needed to determine what compliance work should be undertaken in order to provide an adequate check on the assessment of tax revenue. The International Tax Directorate and other areas of the Compliance Programs Branch could reduce the time over which audits of international issues are completed by strengthening their ability to provide advice on international business practice and economic analysis earlier in the audit process. The international audit program needs better information on the resources used to complete the audit of international issues, the tax reassessed, and the issues identified in reassessments to determine its future resource requirements and program directions.

4.69 The Agency must find ways to improve the international audit program's human resource capability at a faster rate, and explore ways to ensure that complex international audits are completed. In the Toronto area where 40 percent of large corporations file their tax returns, economic conditions have made recruiting and retaining international auditors difficult. The current staffing and level of training activities may not be able to address this problem. In some tax services offices over one-third of the international audit staff have less than one year's experience, and still require some training. Other staff, including some auditors of large corporations and auditors of small and medium businesses who were recruited without previous international tax experience still require basic international tax training.

About the Audit

Objective

The objective of the audit was to determine whether Canada Customs and Revenue Agency's current procedures provide for an adequate check of the assessment of tax revenues from the international transactions of Canadian residents.

Scope and approach

The audit focussed on the activities within the Agency to foster compliance with the sections of the *Income Tax Act* covering the international transactions of Canadian residents. There are specific rules that deal with the taxation of foreign transactions of Canadian residents. For example, transfers of goods and services between related parties must take place at arm's length prices. The foreign affiliate rules and the foreign accrual property income rules of the Canadian *Income Tax Act* deal with dividends and other income from investments in foreign entities.

We reviewed the International Tax Directorate's plan for managing international tax risk and audit operations. We paid particular attention to the activities of the International Tax Operations Division in the Directorate's headquarters in Ottawa and of the International Audit Section in selected tax services offices. We selected and reviewed audit files, interviewed Agency management and staff, and analysed performance data on the results of audits of international transactions of Canadians. We focussed on compliance activities directed at Canada's largest corporations and the relationship that exists between the international audit specialists and the auditors of large corporations who co-ordinate their activities. We also looked at the support provided by head office to international audit activities, and the strategic advice and direction provided on risk assessment, and development of a compliance approach. We also discussed international audit operations and policies with the private sector.

Criteria

Our audit was based on the following criteria.

- The Agency would assess the tax risks associated with Canadian taxpayer compliance with the Canadian income tax rules related to international transactions and implement a compliance strategy to effectively manage these risks.
- The Agency would have the capacity (resources and systems) to satisfactorily carry out its international compliance activities.
- The International Tax Directorate would provide timely functional guidance and assistance to international operations in the tax services offices.
- The Agency would have accurate information on the nature and extent of its international compliance activities.

Audit team

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Related audit work

See also Chapter 11, Other Audit Observations, Department of Finance: Tax arrangements for foreign affiliates have eroded Canadian tax revenues of hundreds of millions of dollars over the last ten years.