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A Status Report
of the
Auditor General of Canada
to the House of Commons

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Chapter 7
International Taxation—
Canada Revenue Agency



Office of the Auditor General of Canada

The February 2007 Status Report of the Auditor General of Canada comprises a Message from the Auditor General, Main Points—Chapters 1 to 7, an Appendix, and seven chapters. The main table of contents for the Report is found at the end of this publication.

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For copies of the Report or other Office of the Auditor General publications, contact

Office of the Auditor General of Canada
240 Sparks Street, Stop 10-1
Ottawa, Ontario
K1A 0G6

Telephone: 613-952-0213, ext. 5000, or 1-888-761-5953
Fax: 613-943-5485
Hearing impaired only TTY: 613-954-8042
Email: distribution@oag-bvg.gc.ca

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Chapter

7

International Taxation
Canada Revenue Agency

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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International Taxation

Canada Revenue Agency

Main Points

What we examined

We examined the Canada Revenue Agency's progress in addressing the significant recommendations we made in our 2001 and 2002 audits of non-resident taxation and taxation of international transactions of Canadian residents. In 2001 we reported that the Agency lacked an effective approach to assessing risk in its compliance work on non-resident tax files. Further, we found that the Agency did not have electronic data or data-matching systems for non-residents that were comparable with those used for detecting non-compliance by Canadian residents. We also said it was important that the Agency continue pursuing cases of aggressive tax planning and abuse of tax treaties.

In 2002 we reported that the Agency needed to improve its ability to assess the risks associated with taxing the international transactions of Canadian residents. We noted serious problems in the level of audit expertise in key tax services offices that handled the complex international tax audits of large corporations.

In this follow-up audit we looked at how the Agency currently identifies, plans, and staffs both non-resident compliance activities and international audits across the country.

Why it's important

A growing number of Canadian individuals, trusts, and corporations are undertaking transactions with entities in foreign jurisdictions, in many cases with related parties. This could result in diverting tax away from Canada. The Agency estimates that over 16,000 Canadian corporate taxpayers now report some type of foreign transaction with related parties. The Agency estimates the value of these transactions at over \$1.5 trillion in 2005.

Canada's tax treaties with other countries reduce the amount of tax that must be paid by non-residents on certain types of income earned in Canada. With the growing globalization of the workforce and international investment, it is important that the Agency be able to ensure that the correct amounts of tax are withheld and that

non-residents file returns if required and pay the taxes they owe. Last year over \$4.9 billion in taxes was paid by non-residents.

What we found

- Overall, the Agency has made satisfactory progress in implementing our recommendations. It has not fully implemented some of our recommendations, however, because they concern complex issues that take a long time to resolve or they require legislative changes that have not been made.
- The Agency has taken action to clarify administrative policies, to properly record both the time spent on international audits and the results of those audits, and to verify the payment of tax on capital gains by emigrants. It also continues to be vigilant in recognizing the tax risk associated with aggressive international tax planning and possible treaty abuse. With the additional resources it received in the February 2005 federal Budget, the Agency is developing its research capacity to identify new international tax planning schemes and has directed more resources to auditing international tax avoidance.
- The Agency has undertaken some good initiatives in developing risk assessment techniques and tools for planning audits of international tax issues. It has made satisfactory progress in implementing most elements of the risk assessment approach we recommended in 2002.
- The Agency has not developed any new initiatives to deal with the low level of international tax audit experience, which continues in some of the Tax Services Offices with the highest-risk files. A lack of expertise could result in an inconsistent international audit approach and coverage across the country, and a loss of tax.
- The Agency has not made satisfactory progress in implementing electronic data capture and matching of non-resident tax data which would improve both service to non-residents and non-resident tax compliance activities.

The Agency has responded. The Agency agrees with all of our recommendations. Its detailed response follows each recommendation throughout the chapter.

Introduction

7.1 The Canadian taxation rules that cover international transactions can be divided into two broad areas—the rules for Canadian-source income for non-residents and the rules for international transactions of Canadian residents.

7.2 The Canada Revenue Agency's (formerly the Canada Customs and Revenue Agency) non-resident tax administration activities include

- processing non-resident tax returns;
- providing waivers of Canadian income tax on income paid to non-residents, under conditions that include tax treaty provisions;
- providing certificates of disposition to non-residents who are disposing of certain property;
- auditing those who pay non-residents to ensure that the correct amount of tax has been withheld on various types of payments; and
- taking action when non-residents fail to file a required tax return in Canada.

7.3 The Agency's administration of the international taxation rules for Canadian residents' worldwide income centres on audits by international tax auditors in tax services offices (TSOs) across the country. If an audit of international transactions determines that the taxpayer's taxable income or tax liability needs to be adjusted, the Agency will reassess the taxes accordingly.

7.4 The TSO international auditors are supported by the Agency's headquarters in Ottawa. At its headquarters, the Agency develops and refines tax administration policies and systems to comply with the legislation and international tax treaties. It also gives TSOs guidance on administrative policy matters and technical assistance on international tax issues.

What we found in 2001 and 2002

7.5 In Chapter 7 of our December 2001 Report, we commented on the Agency's activities involving non-residents who owe income tax in Canada. We found that

- there were gaps in enforcement; for example, capital gains were not adequately verified for emigrants leaving Canada, and action

was not consistently taken against non-residents with large Canadian-source incomes who were required to file tax returns and pay all taxes owing;

- the Agency did not use its non-resident tax data effectively to identify non-compliance with tax withholding, reporting, and filing obligations; and
- the electronic capture of non-resident tax data was lagging behind the electronic capture of domestic data.

7.6 As a result of our 2001 audit, the Public Accounts Committee requested a hearing, which was held in March 2002. In June 2002, the Committee issued a report with recommendations to enhance agency reporting of non-resident activities and specifically requested a response to their report. The Government sent an overview response in October 2002 and followed up with a detailed response in January 2003.

7.7 In Chapter 4 of our December 2002 Report, we reported on the Agency's administration of the rules for taxing Canadian residents' international transactions. We reviewed the Agency's international tax risk assessment and international audits, which addressed compliance with the rules for **transfer pricing**, **foreign affiliates**, and **Foreign Accrual Property Income (FAPI)**, particularly the compliance of Canada's largest corporations.

Transfer price—The price at which services, tangible property, and intangible property are traded across international borders between related parties.

Foreign affiliate—A non-resident corporation in which a Canadian taxpayer, or a Canadian taxpayer and related persons, owns 10 percent or more of the shares.

Foreign Accrual Property Income (FAPI)—Certain types of passive income (for example, interest on investments) that are earned by a controlled foreign affiliate.

7.8 In 2002, we again focused on the role of tax risk assessment. We found deficiencies in the

- identification of tax risks in international transactions,
- selection of corporate files subject to an audit of international transactions,
- planning of audits of international transactions of large corporations, and
- integrity of the data in the foreign reporting database.

7.9 We were concerned about the lack of international audit expertise in key Canadian TSOs and the lack of adequate technical support for international auditors. Economists were not involved early enough in the audit of transfer pricing issues. Formal requirements for taxpayers to provide information and requests for foreign-source information from foreign jurisdictions (using related tax treaties) were not used enough to ensure the timely completion of audits. Auditors did not have enough information on industry sectors to properly

understand the global business practices of different industries and the international tax implications of those practices.

7.10 We were also concerned about the quality of the information that the Agency collected on the time that various audit staff spent on international audits and the results of audits of international transactions.

7.11 Our audits of the non-resident tax administration and international tax administration focused on the activities of the International Tax Directorate at the Agency's headquarters, where the functional responsibility resided for both programs, and on the non-resident and international tax operations in the TSOs.

7.12 In the 2001–02 fiscal year, the Directorate had a Non-resident Operations Division, an International Tax Operations Division, and an International Tax Strategy Division. These divisions were responsible for guidance on audits, waivers, and risk assessments. Non-resident tax returns were assessed at the International Tax Services Office (ITSO). ITSO also provided information services to non-resident taxpayers and those who made payments to non-residents.

Important changes since 2002

7.13 Organizational changes. In April 2005, the Agency launched an internal review which resulted in a significant reorganization of its headquarters' non-resident and international tax administration programs and a restructuring of the Compliance Programs Branch. The new structure was announced in January 2006 and finalized in September 2006.

7.14 When it restructured the Compliance Programs Branch, the Agency combined its International Tax Audit activities with Tax Avoidance and Large Business Audit activities to form the new International and Large Business Directorate. This new Directorate includes

- the International Tax Division, which has 60 staff members; and
- the Competent Authority Services Division, which is responsible for international exchange of taxpayer information, for advance pricing agreements, and for inter-jurisdictional negotiations under Canada's tax treaties.

7.15 The Agency also combined its headquarters' responsibility for the audits of non-resident taxes with income tax audits of small- and medium-size corporations and with GST audits to form the Small and

Medium Enterprises Directorate. The processing of non-resident tax returns, and the follow-up with non-residents who do not file tax returns when required to do so, is now the responsibility of the Agency branches that process domestic tax returns and handle domestic non-filers. In total there are 50 headquarters staff members in non-resident operations.

7.16 The risk assessment and compliance research activities for international tax and non-resident tax were combined with those of other compliance programs in the Research, Risk, and Business Management Directorate of the Compliance Programs Branch. A separate Compliance Strategy Directorate was also created in the Branch.

7.17 The restructuring has not yet affected how audit operations are organized in the TSOs. As of 31 March 2006, there were 320 international auditors and researchers and 210 non-resident auditors and program officers in TSOs across the country. Amalgamating the international, tax avoidance, and large business audit programs at the headquarters level gives the Agency the opportunity and the flexibility to redesign audit operations and to redeploy auditors to these three programs in the TSOs.

7.18 Changes to funding. In the 2005 federal Budget, the Agency was given \$30 million a year to address Aggressive International Tax Planning. The Agency uses these funds to research schemes used to avoid paying tax in Canada and to increase the number of international auditors and tax avoidance auditors in TSOs across Canada.

7.19 Legislative change. In the 2004 federal Budget, the government introduced a change to the *Income Tax Act*. The intent behind this change was to make it clear that the Act's general anti-avoidance rule applies to Canada's income tax treaties, and it could be used to deny a tax benefit under a tax treaty if "abusive tax avoidance" has occurred. The amendment was retroactive to 1988 and came into effect in 2005.

7.20 In addition, the following legislative changes occurred:

- In December 2002 and in February 2004, Finance Canada released draft legislation that proposed amendments to the FAPI and foreign affiliate rules.
- In 1999, amendments to the foreign investment entity and non-resident trust rules were initiated; in June 2000, August 2001, October 2002, October 2003, and July 2005, draft legislation was released. In November 2006, a Ways and Means motion was

tabled to introduce an Act implementing these rules, and the related Bill C-33 received its first reading in the House of Commons.

Focus of the audit

7.21 The objective of our audit was to assess the Canada Revenue Agency's progress in responding to our 2001 and 2002 chapters on Non-residents Subject to Canadian Income Tax and on Taxing International Transactions of Canadian Residents.

7.22 More details on the audit objective, scope, approach, and criteria are in **About the Audit** at the end of this chapter.

Observations and Recommendations

The Agency's role in tax administration

7.23 Overall, the Canada Revenue Agency has made satisfactory progress in implementing our recommendations. However, it is important to note that some of our recommendations have not been fully implemented—some because they were more complex than others and required more effort and others because they require legislative changes that have not been made. We considered these factors when we made our overall conclusion.

7.24 The Agency is not solely responsible for maintaining international tax compliance in Canada. For example, the Tax Litigation Services at Justice Canada is responsible for litigating abusive international tax avoidance schemes.

7.25 Finance Canada is responsible for initiating changes to the tax legislation and negotiating Canada's tax treaties that protect Canada's right to tax international transactions.

7.26 The Agency's principal responsibilities for maintaining international tax compliance include

- devising tools or studies to identify possible areas of non-compliance with international tax rules;
- carrying out audits to determine the correct amount of tax to be paid, often using the transfer pricing or foreign affiliate rules;
- advising Finance Canada if the current legislation may result in abusive tax avoidance; and

- providing information to taxpayers on international tax compliance and advance rulings on specific international transactions.

7.27 International norms and conventions are also important for defining international tax compliance. For example, the Organisation for Economic Co-operation and Development (OECD) has produced a set of guidelines that most tax administrations use to verify transfer prices.

7.28 In addition, bilateral tax treaties allocate the taxing rights between Canada and another jurisdiction so taxpayers do not have their incomes taxed twice. They also provide mechanisms for exchanging taxpayer information and settling transfer pricing differences. Under the Canada–US tax treaty, the Competent Authority Services of both countries review disputed audit results that are related to transfer pricing issues and try to negotiate an agreement.

7.29 The Agency has become increasingly concerned about the tax risks associated with international transactions. Since 2004, aggressive tax planning, which includes international tax compliance, has been one of the Agency’s top four compliance priorities. Furthermore, the number of corporations who report having foreign affiliates and the value of the investment in and the flow of business between these affiliates continue to grow. In 2005, over 16,000 corporations indicated that they had undertaken a transaction with a foreign affiliate; in 2004, over 72,000 individuals indicated that they had property (as defined in the *Income Tax Act*) worth over \$100,000 in a foreign jurisdiction.

7.30 The Agency’s concern about non-compliance with international tax rules appears to be justified by the overall international audit results. Last year, the Agency’s total international audit reassessments were \$941 million, compared to \$778 million reported in 2001. Additional tax assessed on international transactions by large corporations was \$729 million—compared to \$300 million reported in 2001—which represented 33 percent of the value of all reassessments in large corporate audits.

Risk assessment

Most elements of international tax risk assessment and audit identification have improved

7.31 Our 2002 recommendation for strengthening the Canada Revenue Agency’s ability to assess the international tax risk was broken down into five elements, identifying the different levels where risk assessment needed to be strengthened.

7.32 The Agency has made satisfactory progress in addressing four of the five elements related to risk assessment; the main progress was made in file selection and workload development in the tax services offices (TSOs) (Exhibit 7.1).

7.33 The Agency developed an electronic tool called the Compliance Measurement Profiling and Assessment System (COMPASS) that is being used to screen for audit issues in small- and medium-sized business files.

Exhibit 7.1 Progress in addressing our 2002 recommendations

Auditor General's December 2002 Report, Chapter 4	
Recommendation	Progress
The Canada Customs and Revenue Agency's ability to assess the international tax risk should be strengthened by (paragraph 4.43)	
<ul style="list-style-type: none"> 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. 	○
<ul style="list-style-type: none"> developing a risk assessment model to plan the audit of international issues of large corporations. 	●
<ul style="list-style-type: none"> 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. 	●
<ul style="list-style-type: none"> using tools to screen for international issues to select small and medium companies for audit. 	●
<ul style="list-style-type: none"> implementing better controls over the integrity of data in the foreign reporting data base. 	●

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

7.34 In one of the TSOs we visited, COMPASS was being used to screen files for international tax risks, by accessing and analyzing the information that was supplied by taxpayers and was stored in the foreign reporting database. This file screening allowed potentially non-compliant small- and medium-sized corporate files to be referred directly to an international auditor, even if there was no indication that there were any domestic tax issues that needed to be reviewed.

7.35 COMPASS can also be used to assess risks in a broader range of files. In one of the TSOs we visited, COMPASS has been used to assess the level of international transactions in all TSO files. As the Agency improves its electronic methods for screening information, its assessment of international tax risk for corporations of all sizes, and the resulting audits, could become more efficient.

7.36 Since our audit in 2002, the number of referrals of international audit issues from domestic auditors to international auditors of small- and medium-size corporations has increased by 15 percent. This increase suggests that domestic auditors have become more aware of international tax issues and international tax risks.

7.37 In addition, the Agency has undertaken a project that focuses on wealthy Canadian taxpayers who are associated with domestic and foreign corporations and trusts. The Agency did an in-depth review of taxpayers that paid less than \$100,000 in federal tax and then selected several for audit. Based on the audit results to date, the Agency is continuing its efforts to identify significant international non-compliance in transactions between wealthy individuals and their foreign corporations and trusts.

7.38 We found that the Agency has also made satisfactory progress in developing risk assessment tools and audit planning guidance for international audits of large corporations. Auditors now have checklists and other planning tools to help them determine whether the corporation may be non-compliant and to begin transfer pricing and foreign affiliate audits. The development of these tools is often the result of initiative shown by experienced international auditors in the TSOs.

7.39 We also found that the international auditors in the TSOs we visited had improved the way they documented their audit planning for the large corporate audit files.

7.40 According to the contemporaneous documentation provision of the *Income Tax Act*, which has been in effect since 1998, when an auditor requests the documentation that supports the transfer price

used by the taxpayer, the taxpayer is required to produce this information within three months. We did not assess the timeliness or quality of the information provided by the taxpayers. However, we did note that the audit planning checklists included a requirement to make such a request, as called for in the 2004 directive the Agency issued to its international auditors.

7.41 The Agency has reviewed and improved the controls for maintaining the integrity of the data in the database that contains the foreign reporting information that taxpayers submit annually. This foreign reporting database is now frequently used in the TSOs to identify files for audit.

Strategic risk assessment needs to be improved

7.42 The Agency's progress in improving the information and analysis used for the assessment of overall international tax risk by transaction type or taxpayer type has not been satisfactory (Exhibit 7.1).

7.43 In 2002, we observed that the guidelines on the allocation of international audit resources to audit files, on the number of audits that should be completed, and on the average number of hours each audit should take, were not developed with an in-depth understanding of the types of international non-compliance issues that are likely to be found in various types of taxpayer files.

7.44 Since 2002, the program guidelines have changed—the time budgeted for an international audit of a large corporation has increased significantly, and audit results are recorded more accurately. However, the Agency still does not have enough information to properly identify and assess emerging international tax compliance issues.

7.45 Most of the risk assessment data that the Agency uses comes from its foreign reporting database, the schedules attached to corporate tax returns, and the documentation required for transfer pricing. In addition, the Agency now uses publicly available information on international transactions from various security commissions and on international operations in corporations' annual reports.

7.46 Other tax administrations have access to more strategic taxpayer information than the Agency to do high-level strategic assessment of international tax risks. For example, in the United States, the Internal Revenue Service (IRS) has voluntary discussions with corporate taxpayers before they file their tax returns. This pre-filing initiative gives the IRS an early view of the evolving international operations of

multi-national corporate taxpayers and of the changes to international business practice.

7.47 The Australian Taxation Office has access, for audit purposes, to all of the information on large international cash flows collected by the Australian Transaction Reports and Analysis Centre. However, because of the Canadian government’s privacy concerns, the Canada Revenue Agency does not have similar access to the information that the Financial Transactions and Reports Analysis Centre (FINTRAC) collects. FINTRAC’s legislation only allows it to disclose designated information to the Agency if FINTRAC determines that in addition to money laundering or terrorist financing, the information suggests possible tax evasion.

7.48 In the United States, corporate taxpayers are required to report much more broadly on their transactions with foreign affiliates. Under the US tax laws, if a single foreign person owns at least 25 percent of a US corporation, the corporation must disclose who its owners are and report all of its commercial transactions with its foreign affiliates.

7.49 The United States also has 20 “exchange of information” agreements with countries with which it does not have formal tax treaties. These agreements expand the IRS’ information, by giving it access to taxpayer information held in those countries. All of these additional sources of information allow the revenue authority to better assess the evolving tax risk from international transactions and may have a positive impact on compliance.

7.50 Recommendation. The Canada Revenue Agency should seek access to broader information on current international business practices of industry groups and on specific taxpayer transactions when it can demonstrate that this access would improve the identification and assessment of the emerging international tax risks or improve compliance with international tax rules.

The Agency’s response. The Agency agrees that access to additional information would further enhance its ability to identify and assess emerging international tax compliance issues and has taken steps to increase its risk assessment capacity. The Agency will continue to explore avenues and opportunities to increase its access to information, including working with other tax administrations to combat global tax compliance risks.

Tax havens and tax treaties

Non-resident trusts have been reassessed

7.51 The Agency has made satisfactory progress in addressing our 2001 recommendation on tax treaties (Exhibit 7.2). In our 2001 audit, we noted that Canadian tax revenue could be lost if non-residents and Canadian residents use Canadian tax treaties inappropriately. We gave the example of the series of transactions that transferred property, mostly shares of privately held Canadian corporations, first to a spousal trust in Canada and then to a trust in Barbados. Taxpayers were planning to use the Canada-Barbados tax treaty to avoid paying capital gains tax in Canada when the property was eventually sold. There is no capital gains tax in Barbados.

Exhibit 7.2 Progress in addressing our 2001 recommendations

Auditor General's 2001 Report, Chapter 7	
Recommendation	Progress
The Canada Customs and Revenue Agency should continue to be vigilant in ensuring that tax treaties are not used inappropriately to reduce Canadian tax and, if necessary, should seek legislative or treaty changes to protect Canada's tax base. (paragraph 7.91)	●

- **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.
- **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

7.52 By 2005, the Agency had identified 72 trusts—with capital gains of over \$600 million—that were created to avoid Canadian tax, and it reassessed them. The Agency's Appeals Branch upheld the reassessments. Some taxpayers have settled with the Agency and unwound the trusts; others are appealing to the Tax Court. The tax treaty with Barbados has not been amended.

The Agency has a new aggressive international tax planning initiative

7.53 Aggressive International Tax Planning (AITP) is a recent Agency initiative to identify and respond to international transactions that may be designed to avoid paying income tax in Canada. In the February 2005 federal Budget, the Agency received an additional \$30 million per year, which was to be used to respond to the growing risk of international tax avoidance, in particular, the use of tax havens. The Agency split the resources equally between international tax audit and tax avoidance audit.

7.54 Most of the resources have been used to increase audit coverage in these areas. Specifically, the Agency has added 140 international and avoidance auditors to TSOs across Canada. The Agency also deployed 39 experienced auditors to do research studies in 11 of the larger TSOs, designated as “centres of expertise.” Their research involves

- reviewing emerging international tax schemes,
- developing new risk assessment models, and
- recommending necessary legislative or treaty changes.

7.55 This research initiative has been in existence for just over a year, and over 50 research projects have been identified. It is too early to say what impact this initiative will have on future audits or legislative changes.

7.56 The Joint International Tax Shelter Information Centre (JITSIC), which was formed in April 2004, is a significant new international development that is helping to identify potential tax treaty abuse. Under bilateral tax treaties, the United States, Canada, Australia, and the United Kingdom now have permanent representatives who share taxpayer and transaction information at the JITSIC in Washington. These representatives can use the information to determine if transactions in one jurisdiction resulted in abusive tax avoidance in another.

7.57 The JITSIC initiative demonstrates how information sharing among treaty partners can be used to identify potentially abusive tax avoidance. On 3 August 2006, the Agency and the IRS issued their first joint press release, in which they

- commented on the work of the JITSIC,
- informed taxpayers of a tax shelter arrangement about which they had been exchanging information, and
- warned taxpayers against participating in the tax shelter.

The information from this press release also appeared on the newly constructed Taxpayer Alert section of the Agency’s web page.

International auditor expertise and support

International auditor expertise in the Toronto offices has not improved

7.58 In our 2002 audit, we expressed concern about the lack of adequately trained and experienced international auditors to undertake the complex audits of the international transactions of the largest corporations that involve transfer pricing and foreign affiliate

issues. Our specific concern was that the audit approach and coverage across the country might be inconsistent, because of the relative inexperience of the international auditors in the four TSOs in the greater Toronto area (GTA). At that time, over one third of the international auditors in two of the GTA offices had less than one year of experience.

7.59 In 2002, we also pointed out that 40 percent of the large corporations that file foreign information returns reside in the GTA. We believed this indicated that significant international tax risk existed in these TSOs, and we observed that the Agency needed to look for more timely and effective ways to complete those audits.

7.60 In 2006, we found that the situation had not changed significantly (Exhibit 7.3). We still observed a lack of adequate international audit experience in some of the GTA offices, and we continue to be concerned that this may result in an inconsistent international audit approach and coverage in large corporate audits.

7.61 In July 2006, two of the GTA offices indicated that more than 40 percent of the international auditors responsible for large corporate audits had less than two years of international audit experience. In addition, although they have previous audit experience, four of the ten international audit team leaders in these offices had less than one year of international team leader experience. And yet, these offices were responsible for the international audits of almost 30 percent of Canada's large corporations with international transactions.

7.62 International tax non-compliance, measured by tax audit recoveries, continues to be a significant audit issue in large corporations. In the last four years, about 30 percent of the large corporate reassessments across the country have come from audits of international tax issues. We noted a wide range in the value of international reassessments across TSOs with a similar size international staff. We also found that during this same period, only 25 percent of these international audit recoveries have come from the GTA offices where more than 40 percent of the large corporations that indicate non-arm's length international activity file their tax returns.

7.63 After four years, we have seen little progress in this area. As a result, tax recoveries may be lost in Toronto. In addition, the wide range of audit results across TSOs may indicate an inconsistent approach and coverage in international audits of large corporations across the country.

Exhibit 7.3 Progress in addressing our 2002 recommendations

Auditor General's December 2002 Report, Chapter 4	
Recommendation	Progress
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. (paragraph 4.50)	○
The Canada Customs and Revenue Agency should strengthen aspects of its management and support of international audits by (paragraph 4.60)	
<ul style="list-style-type: none"> formalizing requirements and requests to produce information related to offshore transactions. 	○
<ul style="list-style-type: none"> involving economists earlier in the audit process and having them work in closer collaboration with the international auditors. 	●
<ul style="list-style-type: none"> providing international auditors with better information on global sector-specific business issues. 	○
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. (paragraph 4.67)	●

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

7.64 The Agency has not adopted any new initiatives—as we recommended in 2002—to ensure that complex international audits in the GTA offices are completed by staff members who have enough experience to ensure consistency in audit approach and coverage. One way to deal with this problem is to assign the particularly complex GTA audits to more experienced international auditors from other TSOs.

7.65 Recommendation. The Agency should develop appropriate strategies to ensure that the international audit approach to, and the coverage for, large corporate taxpayers, relative to tax risk, is consistent across the country.

The Agency's response. The Agency agrees with the importance of ensuring that the highest risk international audit issues for large corporate taxpayers are identified and audited consistently across the country. Building on organizational changes that the Compliance

Programs Branch made in January 2006 that have improved the Branch's overall flexibility in using resources, the Agency is analyzing how to best address the Auditor General's concerns as well as considering other options to further strengthen its international audit expertise.

Audit staff need expertise specific to industry sectors

7.66 The Agency has not made satisfactory progress in addressing our 2002 recommendation that it give international auditors better information on global business issues specific to industry sectors (Exhibit 7.3).

7.67 The Agency employs economists to help auditors with transfer pricing audits. Since 2002, it has increased the number of economists to 16. International auditors are satisfied with the service the economists provide. However, the economists who are involved in the transfer pricing audits, most having only a few years experience, are not experts in specific industry sectors. The Agency also employs industry specialists, although few of them are involved in international audits.

7.68 With few exceptions, neither the Agency's international auditors nor the large corporate auditors are specialists in particular industry sectors. Each TSO is responsible for auditing all corporate taxpayers filing tax returns in its area and is only responsible for audits of those taxpayers.

7.69 Because specific industries are concentrated in certain TSOs, the Agency does have some international audit specialization in the financial services and oil and gas sectors in those TSOs. However, large corporate taxpayers in other industry sectors are spread out across the country, and the Agency has no specialized auditors to deal with their international audit issues.

7.70 Specialized audit teams that are responsible for audits of specific industry sectors across the country would make audits more efficient, improve the support for audit results, and assure taxpayers that their particular area of international business practice is well understood.

Use of provisions for requesting taxpayer information has not improved

7.71 Canada's tax treaties give the Agency the power to request taxpayer information from foreign jurisdictions. In 2002, we found that these provisions were not being used effectively. We also found that the Agency was not routinely exercising its legislated power to formally

require taxpayers to produce the foreign-source information necessary to complete international audits. Both of these powers are to be used only when taxpayers have not provided the information voluntarily, after receiving repeated requests from the Agency.

7.72 The Agency is still not routinely using these provisions in situations where taxpayers failed to provide the information it requested. In the 2004–05 fiscal year, the Agency only used the treaty provisions to request information from foreign governments 135 times, and, on average, it took over 400 days to receive this information. This is similar to what we found in our 2002 report. In 2004, the Agency—out of the 800 international audits underway or completed that year—only issued eight requirements to taxpayers to produce foreign information.

Non-resident operations

Electronic non-resident services have not yet been provided

7.73 In 2001, the Agency identified a number of improvements it could make to the non-resident electronic services. Progress in making some of these improvements has been unsatisfactory (Exhibit 7.4). We were particularly concerned when we compared Canadian non-resident services with those in other jurisdictions. Both the Internal Revenue Service, in the United States, and the Australian Taxation Office offer electronic filing of tax returns, electronic account adjustments, and an electronic quick response mechanism to non-residents. In Canada, residents have had access to electronic filing since 1993, but non-residents must still submit paper tax returns. The initiative to introduce electronic filing for non-residents began more than five years ago but has not progressed since then.

7.74 A key obstacle to processing non-resident information (tax returns, waiver requests, and account adjustments) electronically is the fact that not every non-resident that does business with the Agency has a unique identifier. Although the Agency has been issuing tax numbers to non-residents since 1999, it is not yet mandatory for non-residents to obtain these numbers and share them with those from whom they receive payments.

7.75 A recent Agency study estimated that over 80 percent of the income slips issued to non-residents, for business income earned in Canada, were issued without a unique identifier. The same study found the information that the payer included on these slips, such as country of residency and withholding rate, was often incorrect.

Exhibit 7.4 Progress in addressing our 2001 recommendations

Auditor General's 2001 Report, Chapter 7	
Recommendation	Progress
The Canada Customs and Revenue Agency should implement its plans to improve assistance to non-resident taxpayers and their Canadian income payers in meeting their tax obligations. (paragraph 7.25)	○
The Canada Customs and Revenue Agency should collect performance data for all non-resident activities in a way that enables it to identify tax risk and produce a comprehensive risk assessment for non-resident taxation. (paragraph 7.42)	○
The Canada Customs and Revenue Agency should introduce a screening mechanism to identify taxpayers' compliance with the obligation to report capital gains when they become non-residents. (paragraph 7.47)	●
The Canada Customs and Revenue Agency should ensure that all certificates of disposition involving complex transactions are reviewed by appropriately trained staff for current and future tax compliance. (paragraph 7.61)	●
The Canada Customs and Revenue Agency should increase its efforts to bring electronic capture and matching programs for non-resident tax data up to the standards of domestic tax data, and streamline simple enforcement activities between the International Tax Services Office and the tax services offices. (paragraph 7.68)	○
To achieve consistency, the International Tax Directorate should finalize guidance on outstanding administrative policies and monitor their application by the tax services offices. (paragraph 7.74)	●
The Canada Customs and Revenue Agency should consistently take action when it identifies non-residents who have not complied with tax filing requirements. (paragraph 7.79)	●

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

7.76 For domestic tax administration, each Canadian taxpayer has a Business Identification Number (BN), for business taxpayers, or a Social Insurance Number (SIN), for individuals, and the Agency uses these numbers to match taxpayer information electronically. Until using similar unique identifiers is mandatory for non-residents, processing taxes and identifying non-filers will be inefficient and often ineffective. The United States has had mandatory tax identification numbers for non-resident individuals, corporations, and trusts since 1996.

Several non-resident operations have improved

7.77 The Agency has made good progress in implementing some of the recommendations in our 2001 audit of non-resident tax administration (Exhibit 7.4). It completed a project that assessed whether emigrating taxpayers were complying with their obligation to pay the capital gains taxes on publicly traded shares when they leave Canada. The Agency has found significant non-compliance and intends to expand the scope of the assessment to include other types of property.

7.78 In addition, the Agency has recognized the importance of having experts review complex transactions of non-residents that result in the disposition of Canadian property. In all the offices we visited, we observed that trained international auditors were reviewing the transactions, and an on-line manual for reviewing the disposition of property has been developed.

7.79 Since 2001, the Agency has given the tax services office (TSO) staff clearer administrative guidance on non-resident policies and has issued new manuals and communication bulletins to TSO auditors and taxpayers. In addition, the legislative changes made in 2001 for the taxation of non-resident actors and the Agency's film services unit activities respond to our 2001 recommendation about high-income non-residents who failed to file tax returns.

Non-resident risk assessment and data matching is still deficient

7.80 The Agency has not finished developing its electronic data system for non-resident and emigrant dispositions. After more than five years in development, this system is still not fully implemented in all TSOs across the country.

7.81 The Agency has had some inconclusive results in its compliance and risk assessment studies of the investment, pension, and business income paid to non-residents who are subject to Canadian tax. These results were inconclusive, partly because the data quality on the information slips that the payers provided was poor, and partly because the Agency found it difficult to match various pieces of information to the same taxpayer. The mandatory issuance and use of a non-resident tax number would permit the Agency to match electronic data, improve compliance and risk assessments, and streamline enforcement activities.

7.82 The Agency staff who perform non-resident processing and compliance activities, many non-residents, and those who make

payments to non-residents would all benefit from the use of a non-resident tax number. Last year there were

- 36,000 payments to non-residents for services performed or employment in Canada;
- 21,000 requests for waivers of withholding tax on business income, under treaty provisions or based on projected net income;
- 36,000 requests for a disposition certificate upon the sale of Canadian property;
- more than 1.9 million payments to non-residents of passive income from Canada, such as pension or interest payments;
- 82,000 requests for reductions of the taxes on pension or rental income; and
- more than 422,000 non-resident tax returns filed.

7.83 The Agency maintained more than 90,000 accounts for those who made payments to non-residents and withheld tax, and more than \$4.2 billion was deposited to these accounts.

7.84 Recommendation. The Agency should seek legislative changes to make it mandatory for all non-resident individuals, corporations, and trusts, subject to Canadian tax administration, to have and use tax numbers.

Agency's response. The Agency agrees that the use of mandatory tax numbers would assist it in strengthening certain aspects of its compliance programs. The Agency will review this recommendation as well as other administrative and legislative options to determine the most appropriate approach to addressing the concerns identified by the Auditor General.

Conclusion

7.85 The Canada Revenue Agency faces even greater challenges in the administration of international tax rules than it does for domestic tax administration. These challenges include obtaining taxpayer information, working with foreign governments, and coping with the more complex underlying laws.

7.86 The recommendations we made in 2001 and 2002 addressed the Agency's ability to meet these challenges. Overall, the Agency has made satisfactory progress in responding to those recommendations. The Agency took important steps to improve its ability to identify

potential non-compliance with the tax rules that apply to Canadian taxpayers' international transactions. These steps included improving its risk assessment tools and introducing initiatives to detect aggressive international tax planning. The Agency still requires access to better information to improve the effectiveness of its strategic risk assessment activities for international transactions. It must ensure that the audit coverage of and the approach to international audits of large corporate taxpayers is consistent across the country.

7.87 The Agency has made satisfactory progress in addressing some of our recommendations for non-resident tax administration. However, mandatory identification numbers for non-residents are needed, before all the recommended improvements can be made to non-resident services and compliance activities.

About the Audit

Objectives

The objective of the audit was to assess the Canada Revenue Agency's progress in implementing the recommendations made in Chapter 7 of our 2001 Report, on non-residents subject to Canadian income tax, and in Chapter 4 of our December 2002 Report, on taxing international transactions of Canadian residents.

Scope, approach, and criteria

We assessed the Agency's progress on the recommendations from the 2001 and 2002 audits, in particular the recommendations related to risk assessment and human resource capacity, since these are key to the Agency's ability to effectively assess compliance.

Our audit work was conducted in the International Tax Directorate at the Agency's headquarters and the International Tax Services Office in Ottawa and in the tax services offices in Halifax, Toronto West, Toronto Centre, Toronto North, Calgary, and Vancouver. We reviewed the Agency's annual reports on the status of its implementation of the recommendations, conducted interviews with the Agency's staff, and reviewed relevant documentation.

We expect the Agency would

- assess the tax risks associated with non-resident taxation;
- assess Canadian taxpayer compliance with the Canadian income tax rules for international transactions;
- have the capacity to satisfactorily carry out its non-resident and international compliance activities;
- provide timely, functional guidance and assistance to non-resident and international operations in the tax services offices; and
- measure and report on the results of non-resident and international compliance activities.

Audit work completed

Audit work for this chapter was substantially completed on 15 August 2006.

Audit team

Assistant Auditor General: John Rossetti

Principal: Jamie Hood

Director: Brenda Siegel

Wilson Ford

Sophia Khan

Rodney Newcombe

For information, please contact Communications at 613-995-3708 or 1-888-761-5953 (toll-free).

Appendix List of recommendations

The following is a list of recommendations found in Chapter 7. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Response
Risk Assessment	
<p>7.50 The Canada Revenue Agency should seek access to broader information on current international business practices of industry groups and on specific taxpayer transactions when it can demonstrate that this access would improve the identification and assessment of the emerging international tax risks or improve compliance with international tax rules. (7.42–7.49)</p>	<p>The Agency agrees that access to additional information would further enhance its ability to identify and assess emerging international tax compliance issues and has taken steps to increase its risk assessment capacity. The Agency will continue to explore avenues and opportunities to increase its access to information, including working with other tax administrations to combat global tax compliance risks.</p>
International auditor expertise and support	
<p>7.65 The Agency should develop appropriate strategies to ensure that the international audit approach to, and the coverage for, large corporate taxpayers, relative to tax risk, is consistent across the country. (7.58–7.64)</p>	<p>The Agency agrees with the importance of ensuring that the highest risk international audit issues for large corporate taxpayers are identified and audited consistently across the country. Building on organizational changes that the Compliance Programs Branch made in January 2006 that have improved the Branch’s overall flexibility in using resources, the Agency is analyzing how to best address the Auditor General’s concerns as well as considering other options to further strengthen its international audit expertise.</p>
Non-resident operations	
<p>7.84 The Agency should seek legislative changes to make it mandatory for all non-resident individuals, corporations, and trusts, subject to Canadian tax administration, to have and use tax numbers. (7.73–7.83)</p>	<p>The Agency agrees that the use of mandatory tax numbers would assist it in strengthening certain aspects of its compliance programs. The Agency will review this recommendation as well as other administrative and legislative options to determine the most appropriate approach to addressing the concerns identified by the Auditor General.</p>

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