

Chapter

7

Canada Customs and Revenue Agency

International Tax Administration:
Non-Residents Subject to
Canadian Income Tax

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

International Tax Administration: Non-Residents Subject to Canadian Income Tax

Main Points

7.1 The Canada Customs and Revenue Agency reports that in 2000–01 about \$3 billion in tax was paid by over 1.7 million non-residents who earn income from Canadian employment, contract services, investments, pensions, and other sources taxable in Canada. The Agency’s non-resident enforcement activities have added an additional \$350 million in tax.

7.2 The Agency provides a range of services to help non-residents meet their income tax obligations: responding to inquiries; issuing waivers, which reduce the tax withheld on payments to non-residents; and establishing three film industry services units to better service the film and television industry. It also plans to increase its on-line services.

7.3 Many divisions of the Compliance Programs Branch carry out activities to verify compliance with the non-resident tax regime, but they are not guided by a formal risk assessment or a comprehensive compliance strategy to address non-resident tax risk.

7.4 There are gaps in non-resident enforcement: verification of capital gains tax owed by emigrants is inadequate, and high-income non-residents have not been required to file tax returns and pay all taxes owing.

7.5 When reviewing the tax consequences of the sale of Canadian property by non-residents, the Agency has improved its challenging of complex transactions undertaken by non-resident corporations to reorganize their Canadian assets and has identified additional current and future taxes.

Background and other observations

7.6 In some respects, electronic capture and matching programs and automatic compliance routines for non-resident data lag behind domestic tax data.

7.7 The Canada–Barbados Income Tax Agreement is providing opportunities for aggressive tax planning that challenge the Agency’s enforcement capability and may cause significant unintended reductions to the tax base.

The Agency has responded. The Canada Customs and Revenue Agency’s responses to our recommendations are included in the chapter. The Agency agrees with the 10 recommendations, and its responses describe a number of actions under way to deal with them.

Introduction

7.8 Each year, in addition to processing tax returns from over 20 million Canadian residents—individuals, corporations, and trusts—the Canada Customs and Revenue Agency processes the withholding tax and tax returns of over 1.7 million non-residents who have earned income from Canada. Canadian residents must include their worldwide income in their tax calculations. Foreign income reporting by Canadians and taxing non-residents on their Canadian-source income are the two sides of international tax.

7.9 Non-residents pay Canadian income tax on the income earned in Canada from the following sources:

- employment;
- providing services or carrying on business in Canada;
- investment income such as interest and dividends;
- pensions, royalties, and rent; and
- selling certain types of property, such as real estate or shares of a private corporation.

7.10 Under various sections of the *Income Tax Act*, people who pay such income to non-residents are legally obliged to withhold on account of taxes, and non-residents may be obliged to file a tax return. The Act and bilateral treaties between Canada and other countries define how much tax the payers of income must withhold. In certain circumstances, the withholding tax may be reduced or eliminated with the Agency's approval.

7.11 The Agency's responsibilities for taxation of non-residents go beyond processing and auditing non-resident tax returns. They include ensuring that Canadian payers of income to non-residents understand and comply with their obligations. In 2000, over 1.7 million non-residents received more than \$42 billion in income such as interest, dividends, pensions, and royalties from Canada. Most non-residents are not obligated to file a return since the payer is required to withhold the appropriate tax.

Non-resident tax administration employs several parts of the Compliance Programs Branch

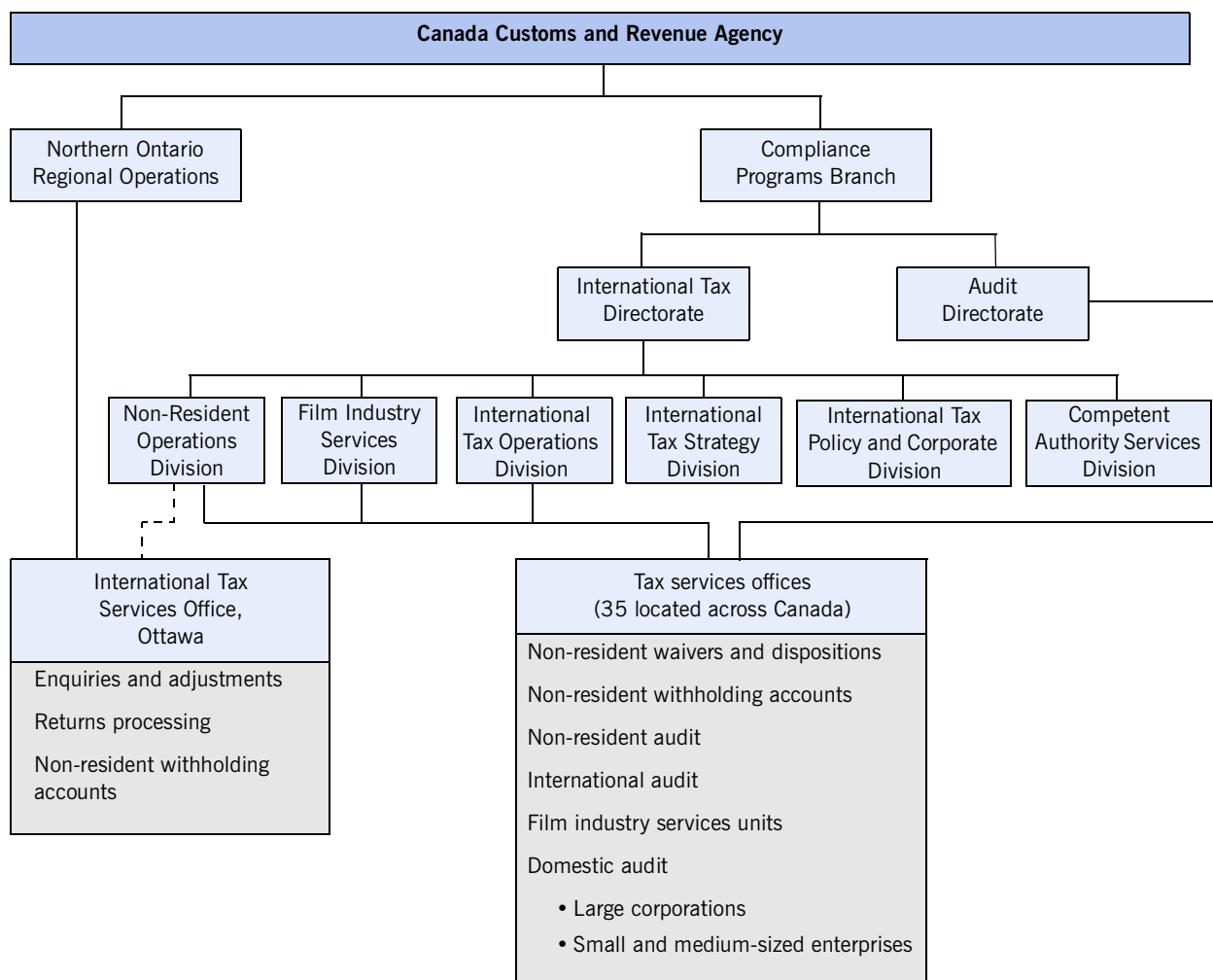
7.12 Several divisions in the Agency provide services to non-residents and ensure that they comply with the non-resident tax provisions (Exhibit 7.1). Within the Compliance Programs Branch, the International Tax Directorate develops and defines tax administration programs and systems to ensure compliance with the legislation and treaties that apply to non-residents and international transactions. It also provides the tax services offices with guidance and technical assistance on non-resident and international tax issues.

7.13 Within the Directorate, the Non-Resident Operations Division and the Film Industry Services Division are responsible for administering the taxation of non-residents. These divisions have staff in Ottawa and in the tax

services offices across Canada. The International Tax Strategy Division, located in Ottawa, is responsible for specific compliance research in the international tax area, including non-resident issues.

7.14 The International Tax Services Office, which reports to the Northern Ontario Region and is located in Ottawa, provides assistance and information to non-residents who receive Canadian income and to those that pay investment, pension, royalties, and other such income. It also processes non-resident, emigrant, and immigrant tax returns and non-resident taxpayer requests for adjustments.

Exhibit 7.1 Organization of non-resident compliance activities



- - - Provides functional direction

7.15 The International Tax Directorate has 180 staff; 37 work directly in its Non-Resident Operations Division in Ottawa. The International Tax Services Office has 370 staff; the tax services offices across Canada have 395 international staff, 134 of them dedicated to non-resident work. In each of the six regions there is an international tax advisor who is partly dedicated to non-resident issues.

7.16 There are other groups working on non-resident tax administration. In tax services offices, about 20 international auditors assist non-resident program officers on complex non-resident matters. These matters could include determining whether a non-resident has a permanent establishment in Canada, or reviewing complicated dispositions of taxable Canadian property before establishing the tax payment required from the non-resident.

7.17 Some large tax services offices have been allocated resources over the past two years to review the activities of foreign trusts that do business in Canada or that have acquired significant Canadian assets.

7.18 Within the domestic audit side of the Compliance Programs Branch, auditors of small and medium-sized Canadian businesses are expected to audit certain non-resident and international tax matters along with other tax issues. They also audit, in collaboration with international auditors, similar-sized non-resident corporations doing business in Canada. Agency managers auditing large Canadian corporations are expected to plan and incorporate non-resident withholding issues in their audits; however, the non-resident audit team carries out the audit of the non-resident issues.

Focus of the audit

7.19 This chapter examines the non-resident aspect of international tax administration. In a later Report we will look at activities that verify compliance with the foreign income reporting obligations of Canadian residents and immigrants.

7.20 The objective of the audit was to determine whether rules and procedures are sufficient to secure an effective check on the assessment of tax revenues from Canadian income of non-residents.

7.21 Our audit focussed on several questions: Does the Agency have a risk assessment and a compliance strategy to manage the risks to non-resident taxation? How effectively has it carried out its compliance activities? How appropriately has it reported its performance data? How well does its functional guidance and assistance support the operational activities of its tax services offices? Further information about the audit objective, scope, approach, and criteria can be found at the end of the chapter in About the Audit.

Observations and Recommendations

Facilitation activities

The Agency provides many services to help non-residents meet their tax obligations

7.22 The Canada Customs and Revenue Agency provides many services, such as answering inquiries from non-residents and the payers of non-resident income and providing opinions on residency to those contemplating emigration. The Agency's international and non-resident Web pages (www.ccr-a-adrc.gc.ca/tax/nonresidents) provide information to non-residents on a variety of tax-related topics. The Agency also administers the waiver program, which authorizes payers to reduce or eliminate the amount of tax withheld on payments to non-residents as a result of a treaty provision or administrative policy. In 2000–01, the Agency waived over \$170 million in tax on income earned by non-residents for services in Canada. Recently the Agency established a Film Industry Services Unit in three of its tax services offices to better serve the film and television industry.

7.23 In administering the non-resident tax regime, the Agency undertook the following services in 2000–01:

- Processed over 250,000 telephone inquiries and 117,500 written inquiries from Canada and abroad. Inquiries ranged from requests for information to account adjustments.
- Maintained over 2,400 accounts for payers who withheld \$230 million in taxes on payments of \$1.7 billion to 29,000 non-residents who performed services in Canada.
- Maintained 80,000 accounts for payers who withheld \$2.3 billion in taxes on interest, dividend, pension, royalty, and other passive income payments of \$42 billion to 1.7 million non-residents.
- Issued 15,000 waivers.
- Processed 62,000 requests to reduce taxes on pension and rental income, about 37,000 for pension and similar income and 25,000 for rental income.
- Processed about 23,000 determinations of amounts to be paid on account of taxes by non-residents disposing of certain types of Canadian property, and collected \$607 million in taxes.
- Processed 300,000 non-resident, immigrant, emigrant, and part-year resident tax returns; 4,500 non-resident corporate tax returns; and 1,000 non-resident trust tax returns.

7.24 The Agency has had plans for several years to enhance certain services, but progress has been slow. Currently the International Tax Directorate is requesting funds to evaluate, plan, and develop services for non-resident taxpayers and the Canadian payers of their income. New on-line services would include general inquiries, filing of tax returns, account maintenance and adjustment requests, and residency determination. This initiative shows the importance the Directorate places on services to help non-residents meet their tax obligations.

7.25 Recommendation. 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.

Agency's response. The Canada Customs and Revenue Agency (CCRA) agrees with the recommendation. The Agency, in line with the Government On-Line strategy, recognizes the importance of these enhancements to electronic services. As such, this is an initiative that covers all areas within the CCRA, and the International Tax Directorate will continue to work with those other areas to improve its assistance to non-resident clients and Canadian payers.

Risk assessment **Assessing non-resident tax risk is essential to the development of a compliance strategy**

7.26 For the past two years, the International Tax Strategy Division of the International Tax Directorate has been responsible for the following:

- researching compliance in international tax;
- developing a strategy to manage taxpayer compliance in international tax; and
- assessing risks using models developed by the Agency's Compliance Research and Quality Assurance Directorate.

7.27 To date, the international tax compliance strategy has not assessed the overall tax at risk related to non-resident taxpayers as a group. Nor has it finished identifying the complexities of transactions and the non-compliance risks unique to Canadian income payers and non-residents who receive various types of Canadian income.

7.28 Many difficulties exist in identifying how non-residents and their Canadian payers fail to comply with tax requirements and in estimating the lost tax revenue. In some cases, the Agency has not collected the data required to do this work; in other cases, the data are not readily accessible.

7.29 Several areas of the Compliance Programs Branch carry out non-resident compliance activities (Exhibit 7.1). For example, international or domestic auditors audit non-resident corporations, while non-resident auditors audit non-resident individuals and Canadian income payers. International auditors also assist in reviewing the complex files on the disposition of taxable Canadian property. As well, the International Tax Services Office (ITSO) plays an essential role in assisting with non-resident tax compliance when reviewing taxpayer returns and adjustment requests.

7.30 The current international tax compliance strategy does not recognize the interrelated nature of the non-resident tax compliance functions undertaken in the tax services offices and the ITSO. For the waiver, election, and disposition certificate systems to function smoothly and provide efficient checks, the ITSO and the tax services offices must co-ordinate their activities. Taxpayer data and compliance activities must be well integrated, and management decisions must be based on the interrelated nature of managing non-resident tax risk.

Communication is important among the groups involved in verifying compliance with the withholding obligations of payers

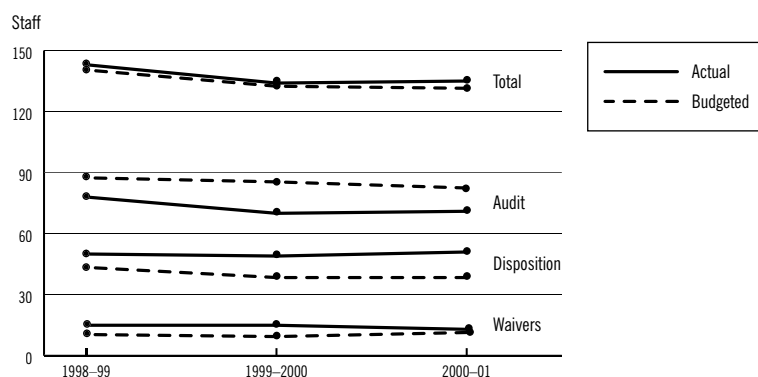
7.31 We observed that the workplan for verifying payers' compliance with their withholding obligations is not carried out as planned in the tax services offices we visited. According to the workplan, non-resident auditors are responsible for the non-resident part of all large corporation audits. However, we noted that they are not participating in all large corporation audits. Instead, the work is often carried out by international auditors. In addition, non-resident auditors are to respond to all requests for assistance from auditors of small and medium-sized enterprises, but there are few requests for assistance from domestic auditors.

7.32 According to the audit performance data from several large tax services offices, few small and medium-sized Canadian businesses have been reassessed for failure to withhold on account of tax on income payments made to non-residents. Our interviews indicated that few of the businesses have been selected by domestic auditors for an audit of payments to non-residents. We are concerned that some domestic audit groups are not sufficiently aware of non-resident tax issues.

7.33 More communication between the non-resident and the domestic audit groups and better awareness of non-resident issues among domestic audit groups could improve the management of non-resident tax risk. In one large office, we observed an example of communication between audit groups. Managers from both groups jointly scanned tax return information—looking for tax risk in payments made by Canadian corporations to their foreign parents or affiliates—and selected files for audit.

7.34 Data for the past three years show that some non-resident staff budgeted for audit activities were used instead to provide important services to non-resident taxpayers (Exhibit 7.2). We are concerned that this has left a gap in the planned non-resident audit activities.

Exhibit 7.2 Non-resident staff in audit, disposition, and waiver activities



Source: International Tax Directorate, performance reports

7.35 The special nature of non-resident taxes and the way the Agency currently structures its compliance activities heighten the need for risk assessment and an integrated strategy for maintaining non-resident tax compliance. Without knowing where tax is at risk, how much is involved, and how the compliance resources assigned actually detect and address non-compliance, we are concerned that the Agency's activities and staff dedicated to non-resident compliance may not be organized and deployed in the most effective way.

7.36 Recommendation. The Canada Customs and Revenue Agency should fully assess the tax risk in all areas of non-resident activities and develop an integrated strategy to manage these risks.

Agency's response. The Canada Customs and Revenue Agency agrees with this recommendation. Work on establishing a tax risk assessment framework for international tax issues is under way but is not yet fully integrated with the existing International Tax Compliance Strategy.

The International Tax Compliance Strategy was introduced in May 2000 and mirrors the broader CCRA compliance strategy. Its basis is a fully integrated risk assessment process designed to develop ongoing and verifiable risk assessment criteria that direct compliance actions in all areas of international taxation. Consideration of the non-resident tax regime is an integral part of this strategy.

The Agency has already analyzed and identified major compliance risks in the non-resident area. For example, we have undertaken risk analyses on Part XIII payments and tax (Withholding Tax on Income from Canada of Non-Resident Persons) with a view to ascertaining the type and size of payments involved, the amounts of taxes withheld, the completeness and quality of the reported data, as well as the extent of potential related compliance issues.

Other information filed by resident taxpayers will be used to analyze and assess compliance in the non-resident program. In this regard, the CCRA will be using the T106 reporting form (Information Return of Non-Arm's Length Transactions with Non-Residents) to develop risk-assessment criteria in the non-resident program.

This form contains valuable information regarding interest and royalty payments to non-residents.

Furthermore, a task force on International Tax Programs was created in April 2001 to review the workload in the tax services offices, the appropriate organizational structure to address the workload, and the personnel required to do it. The goal is to provide for an integrated workflow that maximizes efficiency and effectiveness.

Also, while enforcement activities relating to non-resident withholding tax compliance are carried out by non-resident program staff in the tax services offices, the International Tax Directorate continues to enhance its communications with other audit programs in order to ensure that there is a

broader understanding of non-resident issues throughout the Agency organization. In this regard, the International Tax Directorate is presently reviewing the relationship of the small and medium-sized enterprise audit to international audit. The results from this review will dictate what action may be taken to improve on such relationships.

The Agency's performance reporting does not produce complete information on the results of its non-resident compliance activities

7.37 The International Tax Directorate's performance report, prepared for use within the Agency, provides information on the following:

- statistics on resources used and results achieved in various areas of non-resident operations;
- results of audits undertaken by non-resident auditors;
- number of calls, letters, and enforcement actions handled by non-resident account maintenance officers;
- number of waivers and certificates of disposition issued and the amount of tax collected and protected.

7.38 However, the report fails to include the following as part of the non-resident results:

- reassessments by domestic auditors of large corporations and small and medium-sized enterprises that fail to withhold on account of taxes on payments to non-residents for services performed in Canada;
- additional tax reassessed by international auditors of non-resident individuals, corporations, and trusts; and
- adjustments made by auditors to taxes owed by non-residents after reviewing complex dispositions of capital property.

These results are reported under other program activities.

7.39 The report provides information on the total tax paid by non-residents when disposing of property held in Canada. It does not identify separately the additional tax reassessed by the International Tax Directorate when it undertakes the compliance review of the disposition, which generally accounts for a small portion of the total tax. By reporting the total tax collected, the results of the compliance activity are not clearly identified.

7.40 The report focusses on the tax revenue that was protected when applications for waivers by non-residents were denied by the Agency. We believe that providing waivers is a service to non-residents and the total value of taxes waived could be reported as a service provided by the Agency.

7.41 More accurate reports on the amounts and sources of non-resident taxes reassessed by auditors in each of the Agency's audit programs could contribute valuable information for assessing non-resident taxes at risk. The current management information system could be used to produce better reports.

7.42 Recommendation. 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.

Agency's response. The Canada Customs and Revenue Agency agrees with this recommendation and will continue to examine ways, within available resources, to enhance complete and accurate reporting of non-resident activities on a global basis, in an effort to assist in the identification of tax at risk and the continued development of a comprehensive risk assessment for non-resident taxation.

Compliance activities

The Agency is not routinely checking emigrant tax returns for compliance with the obligation to report capital gains

7.43 Each year over 35,000 Canadians emigrate, and the tax returns for their final year as residents are processed by the International Tax Services Office. Before assessing an emigrant's tax return, the Office carries out several initial checks on the return to verify personal exemptions, moving expenses, and claims for refundable tax credits such as the goods and services tax and child tax credits. If the checks indicate non-compliance, the tax return is selected for a review of the credits claimed.

7.44 As part of a long-standing feature of emigration, taxpayers are considered to have disposed of their shares of publicly traded corporations at current market value when they leave Canada. The taxpayer must report the unrealized capital gain on these shares and pay the tax. When the Agency processes the tax return, it does not undertake an initial check for compliance in reporting the unrealized capital gain and paying the tax. If the final tax return were matched against previous tax returns that indicate dividend income or capital gains and losses, the Agency could detect non-compliance and forward the tax return for review.

7.45 In 1996, legislation was announced to broaden the type of capital property an emigrant is considered to have disposed of and to specify the format for reporting these types of capital property. It also permitted emigrants to provide security to the Agency instead of a tax payment. These amendments came into effect in June 2001, retroactive to October 1996.

7.46 With these new migration rules, a greater basket of capital property is considered disposed of on emigration. This makes it even more important that the Agency establish a screening mechanism to identify compliance problems in the reporting of unrealized capital gains by emigrants on their last tax return as Canadian residents.

7.47 Recommendation. 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.

Agency's response. The Canada Customs and Revenue Agency agrees with this recommendation. The CCRA will continue to take steps to ensure that this screening mechanism is included in the processing systems under development for the taxpayer migration rules.

Difficulties in determining whether a non-resident has a permanent establishment in Canada

7.48 An important condition of the non-resident tax regime is whether a non-resident carrying on business in Canada has a permanent establishment or fixed base in Canada. If there is no permanent establishment or fixed base, a bilateral tax treaty may exempt from Canadian tax all the income earned from a service. In such a case, the Agency would issue a waiver, and no tax would be withheld from the payments to the non-resident. If a waiver were not requested initially and taxes were withheld, the non-resident individual or corporation could request a refund by filing a tax return and appropriate documentation with the International Tax Services Office. The Office processes about 1,200 refund requests from non-resident corporations each year; about 20 percent of these are based on the claim of no permanent establishment in Canada.

7.49 International tax auditors who assist non-resident program officers in the local tax services offices determine whether a permanent establishment exists. Over 200 determinations are made across Canada each year. If a non-resident has a permanent establishment in Canada, the Canadian net income is taxed at Canadian rates.

7.50 In 2000 a non-resident successfully challenged in court the Agency's way of determining whether a permanent establishment exists for non-resident professional service providers. The court decided that there was no permanent establishment because the non-resident did not have control of the space where he was providing a training service at the Canadian payer's premises. The International Tax Directorate issued a communiqué in March 2001 explaining that it will apply the court decision on a case-by-case review of the facts.

7.51 The Agency estimated that, at the time the case was decided, there were 46 similar cases with \$262 million of gross Canadian revenue that required a determination of permanent establishment status. Each month, additional cases with similar facts are referred for a determination as a result of non-resident requests for refunds.

7.52 We reviewed recent files on permanent establishment determination in the tax services offices we visited. We are concerned that the Directorate's communiqué has not given auditors sufficiently clear direction on how a determination should be made.

7.53 Many cases are still puzzling the auditors. Some involve non-resident corporations providing specialized services to their Canadian subsidiary corporations on a long-term or repetitive basis.

7.54 Tax services offices urgently need clearer guidance to help them provide consistent opinions on permanent establishment that would be in accordance with the internationally accepted definition provided by the Organization for Economic Co-operation and Development and with Canada's treaty obligations.

7.55 Recommendation. The Canada Customs and Revenue Agency should review cases requiring a determination of permanent establishment and develop clearer decision-making criteria for its tax services offices.

Agency's response. The Canada Customs and Revenue Agency agrees with this recommendation. A permanent establishment determination is based on the particular facts in each situation. Therefore, all permanent establishment determinations must be reviewed on a case-by-case basis. An International Tax Directorate communiqué issued in March 2001 to its tax services offices discusses the factors to be considered in making permanent establishment determinations on facts similar to those in the subject court decision. There are procedures in place at the International Tax Directorate when assistance is required on any international tax issue, including determining whether a permanent establishment exists, and an auditor in a tax services office may request assistance under these procedures.

The International Tax Directorate will also continue to work toward clarifying the principles involved in permanent establishment determinations through correspondence, discussions, and workshops with the auditors in the tax services offices. As well, the International Tax Directorate is preparing a guide for the auditors to assist them in making permanent establishment determinations.

The Agency has strengthened its capability to review complex dispositions of taxable Canadian property in some offices

7.56 Non-residents are required to obtain clearance certificates when they dispose of certain types of Canadian property, including real estate, shares of private corporations, and oil and gas leases. If the seller does not pay tax and obtain the clearance certificate, the purchaser becomes liable for the tax owed. Each year the Agency reviews the clearance applications and issues about 22,000 certificates of disposition (Exhibit 7.3).

Exhibit 7.3 Certificates of disposition

	1999	2000	2001
Certificates issued	22,427	20,961	22,787
(\$ millions)			
Value of transactions	52,620	64,000	110,500
Tax identified by audit	10	110	280*
Total tax and security collected	120	300	600

*Includes three cases totalling \$215 million.

Source: Canada Customs and Revenue Agency

7.57 For the majority of these certificates that involve residential real estate, the review of the selling price and cost of the property is straightforward. Non-resident program officers carry out the reviews, with the assistance of real estate appraisers when necessary. However, reviewing certificates that involve non-resident corporations reorganizing their Canadian assets—mostly shares of Canadian subsidiary corporations—can be much more complex.

7.58 In several of the more complex files we reviewed, the Agency had discovered transactions that appeared to result in highly structured international tax avoidance. These transactions potentially posed a significant risk to the tax base, particularly in future years.

7.59 In the tax services offices we visited, reviews of complex transactions are carried out by an international tax auditor. One office has an international auditor with a tax avoidance background, and valuations of privately held corporations are sometimes carried out. Care is taken to review these transactions for the tax due on account of the current disposition and for the tax consequences of all related transactions. The requirement to obtain a certificate of disposition provides the Agency with the opportunity, in some cases, to view “real time” international tax planning. We encourage the Agency to fully use that opportunity to review the tax implications of the transactions.

7.60 In the smaller tax services offices, non-resident program officers may not recognize the complexity of a transaction and not refer it for a review, or an international tax auditor may not be available to undertake a review. We are concerned that complex international dispositions may not be reviewed in all offices by people with the appropriate skills.

7.61 Recommendation. 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.

Agency’s response. The Canada Customs and Revenue Agency agrees with this recommendation and will continue to provide training and learning to all staff directly and indirectly involved with the issuance of certificates. The Agency recognizes the benefits of a well-trained staff, and new training courses and learning tools are being developed to supplement those that currently exist.

An example of this is the International Tax Directorate’s development of a tool that simplifies the non-resident certificate of disposition process by providing tax services office staff with access to all relevant taxpayer information, thus ensuring current and future tax compliance for this program. This new mainframe system, called the Non-Resident & Emigrant Dispositions Database, is presently in the testing phase in a number of the tax services offices and is anticipated to be in use on a national basis before the end of this fiscal year.

Electronic capture of non-resident tax data is lagging behind domestic data

7.62 The Agency does not make full use of its non-resident tax data to effectively identify non-compliance with tax withholding, reporting, and filing obligations, or to undertake initial enforcement activity. Several problems exist in these data:

- they are not accessible electronically;
- the different systems used to store the data do not communicate automatically; and
- the data stored in these systems lack a common taxpayer identifier.

7.63 For example, the data produced by Canadian employers showing income earned and taxes withheld are recorded electronically and matched against the income and taxes reported by Canadian resident employees and some consultants on their tax returns. The same data produced for most non-resident consultants are not recorded electronically and cannot be matched against the data reported by non-residents who file a tax return.

7.64 Electronic data capture and matching could detect inaccurate reporting on tax returns and could also automate some non-resident enforcement activities. For example, the data captured on payments made to non-resident service providers or on income and expense waivers could be used to generate requests to file tax returns.

7.65 Non-residents who elect to make tax remittances based on their net rental income instead of their gross rental income must file a tax return. Our review showed that the Agency allowed some non-residents who had not filed tax returns to continue to make instalments for several years based on their net rental income. These net rental income elections could be matched electronically so that a non-resident who applied for a third net election before filing a tax return would automatically be denied. The Agency automatically takes action in cases of Canadians whose income data indicate that a tax return is expected.

7.66 The International Tax Services Office cannot access the database with information on certificates of disposition when it processes the tax return of a non-resident who has disposed of property. If a taxpayer does not attach the certificate to the tax return when requesting a tax adjustment, the Office will often forward the return to the tax services office that issued the certificate to verify that the tax was paid. Access to the database would free non-resident staff in tax services offices from having to validate information manually.

7.67 Generally, electronic data capture and matching of non-resident tax information seem to lag behind domestic tax information. By improving the electronic data capture and matching programs and centralizing some initial enforcement activities in the International Tax Services Office, non-resident staff in the tax services offices would be free to concentrate on other activities. Those activities could include identifying non-residents who owe additional tax or payers who have failed to withhold tax on payments to non-residents and who have not been identified in data already available to the Agency.

7.68 Recommendation. 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.

Agency's response. The Canada Customs and Revenue Agency agrees with this recommendation. Presently, the CCRA is pursuing ways to link information stored in our systems in order to enhance our compliance efforts.

To improve our ability to validate information on filed returns, the International Tax Services Office (ITSO) and all tax services offices will have access to the Non-Resident & Emigrant Dispositions Database, containing all information on certificates of disposition. It is now in the testing phase in a number of the tax services offices, with an anticipated national roll-out before the end of this fiscal year. This will allow all tax services offices, including the ITSO, to access all relevant information relating to non-resident dispositions, thus substantially reducing the time necessary to validate information on the filed returns.

Beginning in 2001 we have revised our administrative procedures and information system used to process rental income earned by non-residents of Canada. We can thus verify client data annually and ensure that their filing obligations or payment of their fair share of taxes under Part XIII of the *Income Tax Act* have been met.

The International Tax Directorate is also currently working on bringing all non-resident information return data on-line, such as the reporting of the information relating to services provided in Canada by non-residents.

In addition, efforts have already been made to clearly and meaningfully distinguish between the roles of the ITSO and the other tax services offices with respect to both our compliance and our enforcement programs. For example, in addition to the regular enforcement of non-resident withholding, compliance projects specific to the ITSO have been implemented in that office. These programs are aimed at recovering potential lost tax dollars, and they benefit from the centralized knowledge base and expertise situated in the ITSO. Furthermore, we are in the process of gathering information from our offices nation-wide with respect to their workloads and responsibilities in an effort to continue to work toward providing them with streamlined instructions based on this and related input.

There are some inconsistencies in non-resident tax administration

7.69 One goal of tax administration is consistency. Given any set of facts, a taxpayer should expect the same treatment from all of the tax services offices across Canada. To achieve this, central administration communicates its policies to field offices in a number of ways: manuals and communiqués, training courses, regional conferences, electronic tools, and consultations with technical specialists. However, we noted several inconsistencies among the tax services offices in some operational and reassessment practices.

7.70 For example, the Agency audits the rental income of non-residents when asked to issue a certificate of disposition. The number of years of rental income reassessed varies among tax services offices. Some tax services offices issue the certification of disposition only after completing the tax reassessment for the rental income. Other offices issue the certificate even if the tax reassessment on the rental income is not completed—which diminishes the probability that the unpaid tax on rental income will be collected.

7.71 When finalizing a determination of no permanent establishment, some offices calculate the employee deductions owed in Canada by non-resident corporations before approving a refund, while others do not.

7.72 Tax services offices have differing requirements before an employer can reduce the amount of income tax it withholds from a non-resident employee. One office reassessed an employer who had failed to withhold tax on income paid to a non-resident employee for services provided outside Canada, because the employee had not obtained a waiver from the Agency. In a similar situation, another office took no action against the employer.

7.73 We also observed inconsistencies in the amount of tax that payers were reassessed when auditors found a failure to withhold taxes on payments to non-residents for services. In some cases, the tax was reassessed based on the non-resident's expected final Canadian tax liability. In other cases, the tax was reassessed based on the full amount of the contract payment, even when it was clear that the non-resident would be taxed on a lesser amount. The amounts at stake can be important. In one particular case, the difference between the two approaches could make a difference of tens of millions of dollars. The way penalties and interest charges are applied to these reassessments is also inconsistent.

7.74 Recommendation. To achieve consistency, the International Tax Directorate should finalize guidance on outstanding administrative policies and monitor their application by the tax services offices.

Agency's response. The Canada Customs and Revenue Agency agrees with this recommendation and has been working diligently at finalizing guidance on administrative policies. The International Tax Directorate will continue to develop and/or enhance administrative policies in order to ensure that all clients receive fair, consistent, and equitable treatment under the Canadian income tax system. In this regard, the International Tax Directorate has met with a number of stakeholders, including its International Tax Advisory Committee that consists of recognized experts, to explore areas of concern and will continue its communication efforts with the private sector associations. The International Tax Directorate considers that this continued consultation will provide for administrative policies that are clearer and more relevant to specific industries, which will both strengthen consistency and improve voluntary compliance. The CCRA is also working closely with the Department of Finance in this undertaking to ensure that new administrative rules are consistent with government tax policy.

The International Tax Directorate ensures national consistency and balanced program delivery by providing functional direction, program support, policies and guidelines, technical assistance, and an accountability framework to the tax services offices for all non-resident activities; by monitoring program performance and results; and by participating in quality reviews. The Directorate currently monitors the application of administrative policies in the tax services offices and will continue this practice as new, enhanced policies are introduced.

The Agency has not followed up on some high-income non-residents who did not file tax returns

7.75 In some cases, the Agency has not estimated, identified, or collected the Canadian tax that non-residents may owe beyond the amounts withheld at source for services provided in Canada.

7.76 An International Tax Directorate study revealed that in a particular tax year, fewer than 2 percent of non-resident individuals and fewer than 20 percent of non-resident corporations who receive payments for services in Canada filed a tax return. The study identified a number of individuals who had not filed tax returns and the estimated amount of the unpaid tax. Of 31 non-resident individuals who had each received over \$1 million, 29 had not filed a tax return. Twenty were actors who are not entitled to tax exemptions under the applicable tax treaty and whose entire Canadian income is taxable. The potential amount of tax owed for that tax year by these 20 non-residents was estimated by the Agency at \$10 million. The Agency took no action on these cases and did not analyze the tax at risk for subsequent taxation years, giving some non-residents what amounts to partial tax forgiveness.

7.77 In June 2001, against this backdrop of non-compliance, legislative changes to the tax regime for non-resident actors in the film and television industry received royal assent. The changes were made to simplify the tax filing requirements for non-resident actors and to reduce the paperburden. Actors now are subject to a final tax of 23 percent of gross income and no longer are required to file tax returns.

7.78 The Agency has created film industry services units in three major tax services offices. In addition to providing better service to the industry when tax waivers are requested, the units will also audit compliance with the provisions of the *Income Tax Act*. Currently the Agency has no specific plans to deal with non-residents who did not file tax returns.

7.79 Recommendation. The Canada Customs and Revenue Agency should consistently take action when it identifies non-residents who have not complied with tax filing requirements.

Agency's response. The Canada Customs and Revenue Agency agrees with this recommendation. All non-residents, including non-resident actors, are subject to withholding taxes at source for services provided in Canada. With respect to the situation involving non-resident actors, as noted in this chapter, in order to address non-compliance, the CCRA and the Department

of Finance engaged in meaningful consultations with the film industry to ensure a consistent and fair approach to the taxation of individuals within that industry. These discussions led to changes in the compliance regime for this industry and resulted in the establishment of a dedicated film industry function, three film services units in the field, new legislation enacted for the film industry, and industry-specific waiver guidelines.

Also, the study carried out by the CCRA on non-resident compliance resulted in a number of conclusions and recommendations that are actively being pursued by the CCRA and the Department of Finance. These involve policy and procedural changes, system changes, and legislative changes in order to enhance the compliance and enforcement efforts for non-residents.

There is also continuing routine enforcement in relation to all non-resident compliance issues. The CCRA will continue to improve the selection of income tax files to increase the effectiveness of its efforts to achieve compliance with its tax filing requirements for non-residents.

The Agency has reviewed the files of other high-income non-resident employees

7.80 Many high-income non-resident employees are athletes who play for Canadian professional sports teams. As non-resident employees, these individuals file tax returns and claim a Canadian tax exemption on the income earned for services provided outside Canada. To verify their returns, the Agency must determine that they are not Canadian residents and that their total income reported for services in Canada is correct.

7.81 In the 1990s, the Agency started to review the residency status of all non-resident athletes and the income reported on their tax returns. The Agency also worked with Canadian professional sport teams to develop a formula for allocating an athlete's income to services in Canada and services in the U.S. Non-resident athletes can reduce Canadian taxes through bonuses and retirement compensation arrangements, which may be taxed at a lower rate than employment income. The Agency continues to review these arrangements to ensure compliance with the provisions of the *Income Tax Act* and its Regulations.

7.82 Over the last three years, the Agency has also reviewed the tax returns of non-residents working for airlines domiciled in Canada. In certain cases, auditors have challenged the residency status of the taxpayer; in other cases, they have questioned the allocation of income for services provided inside and outside Canada. As a result, the Agency has reassessed the tax returns of over 200 taxpayers, for additional tax of \$2.9 million.

Electronic commerce is an emerging issue in non-resident tax administration

7.83 Electronic commerce—businesses offering electronic services or the sale of goods electronically—is an emerging issue in international taxation. It challenges two central concepts of international tax agreements:

- **The character of the income.** For example, payments to non-residents for royalties and for goods and services are taxed at different rates under domestic tax legislation and tax treaties. Electronic commerce often

blurs the distinction between payments of royalties and payments for goods and services.

- **Where the income is earned.** Business income is taxed under most tax treaties in the country where the business has a permanent establishment or fixed base. In electronic commerce, the source of business income becomes unimportant.

7.84 The Organisation for Economic Co-operation and Development, through a number of task forces, is developing guidelines for member countries on the taxation of electronic commerce. Canada participates on some of these task forces. The Agency's Tax Avoidance and Special Audits Division (part of the Compliance Programs Branch's Audit Directorate) manages the electronic commerce initiative. It is still to be determined how the audit of businesses with no permanent establishment will proceed worldwide.

The Canada–Barbados Income Tax Agreement is being used to reduce Canadian tax

7.85 During our review of non-resident files, we noted that the Agency has discovered a number of schemes developed to exploit the Canada–Barbados Income Tax Agreement. Canada usually signs tax treaties to avoid double taxation. Barbados does not tax capital gains. However, the Agreement allows a resident of Barbados to claim a Canadian tax exemption on a capital gain that would otherwise be subject to Canadian tax. The Agency is currently reviewing transactions that move capital gains from Canada to Barbados.

7.86 In one scheme, ownership of a private Canadian corporation is held by a trust that resides in Barbados. The capital gain on the sale of the shares is subject to Canadian tax because the shares are taxable Canadian property. The trust sells the shares and claims an exemption from the Canadian tax under the Agreement. The gain is not taxed in Barbados.

7.87 Another scheme, referred to as the offshore spousal trust scheme, shifts an unrealized capital gain from Canada to Barbados. This scheme involves the following series of transactions:

- shares in a Canadian company are sold at tax cost to a trust that resides in Barbados, in favour of the taxpayer's spouse;
- the trust then sells the shares at fair market value back to the individuals who owned them originally; and
- the trust then claims an exemption from Canadian tax under the Canada-Barbados Agreement.

The transactions are intended to increase the tax value of the shares to their current fair market value. If the scheme is successful, any subsequent gain realized from a sale of the shares to an arm's-length third party will be reduced by the artificial increase in the tax value of the shares.

7.88 The Agency has identified 53 examples of this scheme that have moved over \$800 million in capital gains to Barbados from Canada. It is currently examining this scheme to determine if it can be challenged successfully.

7.89 In another scheme, a company residing in a tax haven owned a Canadian company. When the shares of the Canadian company were sold, any capital gain realized would be subject to Canadian income tax. The company shifted its residence from the tax haven to Barbados and, under the Agreement, claimed a Canadian tax exemption on the capital gain. During our audit, we saw one transaction that the Agency challenged successfully, recovering over \$50 million in tax.

7.90 Tax avoidance schemes may also take advantage of other treaties. A number of years ago, the Agency identified schemes involving other tax treaties to which Canada was signatory. The schemes allowed capital gains to escape Canadian tax under certain conditions. The *Income Tax Conventions Interpretation Act* was subsequently amended to allow Canada to tax the capital gain.

7.91 Recommendation. 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.

Agency's response. We agree that the Canada Customs and Revenue Agency will continue to be vigilant to ensure that tax treaties are not inappropriately used to reduce Canadian tax. As noted in paragraph 7.90, CCRA officials promptly seek legislative or treaty changes where necessary to protect Canada's tax base.

Conclusion

7.92 Over 1.7 million non-residents receive taxable income from more than 80,000 Canadians. In 2000–01, non-residents paid about \$3 billion in taxes on this income. This amount is likely to increase with the growth of multinational corporations, global investment opportunities, and international skilled workers.

7.93 The Agency plans to offer more electronic services to help non-residents meet their tax obligations. However, its non-resident compliance activities are carried out by many divisions of the Compliance Programs Branch. Until a risk assessment is completed and a comprehensive compliance strategy is put in place, we are concerned that the appropriate attention may not be paid to all elements of non-resident compliance. The Agency needs to report the results of all its non-resident compliance activities in order to improve the usefulness of its performance management information and aid in the assessment of risk. The Agency could also make better use of its non-resident taxpayer data to direct non-resident enforcement activities and ensure that they are consistent.

7.94 Using the information provided by non-residents when they dispose of Canadian property, the Agency is able to detect potentially abusive international tax planning by non-resident corporations and trusts active in Canada.

7.95 The growth of electronic commerce will increase the complexity of non-resident taxation. We encourage the Agency to continue its participation in the international forums that will set the guiding principles.

About the Audit

Objective

The objective of the audit was to determine whether rules and procedures are sufficient to secure an effective check on the assessment of tax revenues from Canadian income of non-residents.

Scope and approach

The audit focussed on the following activities of the Agency:

- fostering compliance with the sections of the *Income Tax Act* that require payers of Canadian income to non-residents to withhold and remit tax on that income;
- assisting non-resident taxpayers to obtain waivers or reductions in their taxes; and
- encouraging non-residents, including emigrants, to comply with their obligations to file tax returns and pay the correct amount of tax.

We reviewed the International Tax Directorate's non-resident risk management plan and operations. Our work was conducted in the Directorate's headquarters, in the International Tax Services Office in Ottawa, and in selected tax services offices. We reviewed selected audit files, interviewed Agency management and staff, and analyzed performance data on the results of non-resident compliance activities. We looked at the assistance provided by specialized international auditors in some complex matters involving non-residents and by other domestic audit groups involved in auditing non-residents. We looked at the head office administrative support provided to these activities, and at the strategic advice and direction provided on risk assessment and development of a compliance strategy for non-resident activities. We also discussed non-resident operations and policies with the private sector.

Criteria

Our audit is based on the following criteria:

- The Agency should understand the tax risks associated with non-resident taxation and have a non-resident compliance strategy to manage these risks.
- The Agency should have the capacity to satisfactorily carry out its non-resident compliance activities.
- The International Tax Directorate should provide timely functional guidance and assistance to non-resident operations in the tax services offices.
- The International Tax Directorate should measure and report meaningfully on the results of non-resident compliance activities.

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