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Assessing Practices, Audits & Voluntary Disclosures 2012

Presentation to:

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By: Sydney Sweibel
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The Search for Unreported Income

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- Statistics Canada has estimated that almost \$444 billion of unreported income was earned in Canada from 1992-2008 (not including income from illegal operations, illegal drugs, or prostitution)
- As governments struggle to cut expenses and generate revenue, CRA has redoubled their efforts to identify unreported income and collect the resulting taxes owing.

The Search for Unreported Income

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- CRA is proud of its global reputation as an aggressive assessor
- CRA is 50% the size of the IRS, whereas Canada has 10% the population of the U.S.
- In 2009, Canada collected roughly the same amount of tax revenue as China, a country 38 times the population of Canada

High Net Worth Project / Related Party Initiative

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- An OECD initiative adopted by the CRA
- Audit designed to focus on wealthy individuals (net worth of \$50M +) with complex structures (30+ entities)
- Begins with receipt of questionnaire of 20+ pages

High Net Worth Project / Related Party Initiative

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- Questionnaire seeks information regarding individual's connections (directly or indirectly) to:
 - unlisted companies;
 - private trusts;
 - partnerships;
 - joint ventures; and
 - “further entities”
- Questionnaire may also inquire into the value of each of these entities

High Net Worth Project / Related Party Initiative

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- CRA follow up from questionnaire could involve:
 - Assignment of senior tax auditor
 - Audit lasting 3 + years
 - Regular follow-up audits if individual's structure meets "high-risk" criteria

Trust Audits

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- Initiative by CRA's Aggressive Tax Planning Division
 - Questions the substance of a trust's residence in low-tax Alberta
 - Questionnaires sent to Alberta-based trustees

Trust Audits

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- Letters request information regarding:
 - Nature of the trustee appointment
 - Relationship of trustee to trust
 - Qualifications of trustee
 - Nature of trustee's remuneration
 - Duties and responsibilities of trustees
 - Nature of trustee's decision-making power
 - Amount of trustee's control over trust assets
 - Trustee's responsibility for preparing trust accounts and reporting to beneficiaries

HSBC (Suisse) Stolen Data:

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Timeline

- 2007: HSBC Private Bank employee steals digital information re clients of the Swiss bank
- January 2009: French authorities apprehend employee & seize stolen data
- January 2010: France returns original data to Switzerland but keeps copy
- Spring 2010: Canada requests copy of data from France
- July 2010: CRA sends out HSBC-related audit letters
- Spring 2011: RQ sends out HSBC-related audit letters

HSBC (Suisse) Stolen Data:

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What does it contain?

- HSBC has compiled a summary of the data that it believes was stolen
- The stolen data may include:
 - The names and nationalities of those who:
 - Are beneficial owners of the account
 - Have signing authority on the account
 - Have a power of attorney in the event of the beneficiary's death

HSBC (Suisse) Stolen Data: What does it contain?

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- The stolen data may also include:
 - The name of the account
 - When the account was opened and closed
 - The value of the account at specific points in time from 2005 to 2007
 - Related accounts
 - Other personal information regarding the account holders

HSBC (Suisse) Stolen Data: Developments

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- Both CRA and RQ audit letters contained 20+ page questionnaire very similar to High Net Worth Project
- CRA audits have progressed very slowly even where the taxpayer is cooperative
- RQ audits are progressing more quickly but none in our office have closed to date

HSBC (Suisse) Stolen Data: Developments

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- Where Taxpayer does not comply with audit:
 - CRA has threatened to issue compliance orders to compel the production of documents (most taxpayers comply before such an order is issued)
 - RQ will proceed with arbitrary assessment based on information in stolen data

HSBC (Suisse) Stolen Data: CRA Audits

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- Tax treatment on audit of unreported income in offshore accounts similar to voluntary disclosure treatment with the addition of penalties
- Net income and net capital gains taxed each year for which bank statements are available (10 years +)
- Value of capital at beginning of review period (the “Opening Capital”) is not subject to tax
- No interest relief on overdue tax payable

HSBC (Suisse) Stolen Data: CRA Audits

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Applicable Penalties:

- CRA proposes 50% penalty on tax payable for each year under review (163(2) ITA)
- CRA proposes 5% penalty on value of capital held in account at beginning of review period for each year under review (162(10) ITA)
- It is possible to negotiate the application of penalties to fewer years where the facts of the case support it.

HSBC (Suisse) Stolen Data: RQ Audits

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- RQ has not articulated how they will treat taxpayers who comply with the audit
- Where taxpayers do not comply with the audit, RQ will assess arbitrarily based on the information contained in the stolen data.

HSBC (Suisse) Stolen Data: RQ Audits

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Arbitrary Assessments:

- RQ taxes the value of the account as presented in the stolen data
- Value is divided by the number of years since the account was opened (10+ years probable)
- The quotient is treated as unreported income in each year
- Interest applied to overdue tax payable at prescribed rates
- 50% penalty also applicable

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- Given tax treatment of offshore accounts on audit, voluntary disclosure is clearly preferable option
- CRA & RQ have very different approaches to VD treatment of undeclared income in offshore accounts.
- No changes to treatment announced since late 2010

Voluntary Disclosure Update

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Federal Policy

- Net income & net capital gains taxed each year for which bank statements available (eg. 10 years + depending on the bank)
- Opening Capital is not subject to tax
- Interest applied to overdue tax payable with 4% interest relief for statute-barred years
- If taxable income or net capital gains can be determined for periods beyond 10 years, tax payable will be subject to full interest rates and penalties (T1135, etc.) for stub period. (*Bozzer*)

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Quebec Policy

- Net income & net capital gains taxed for 6 years.
- Opening capital taxed in its entirety unless it is proven to have tax-exempt or tax-paid origins.
- Interest charges:
 - Not applicable for statute-barred years (3) and opening capital.
 - Applied at prescribed rates for last three years.

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Quebec Policy (cont'd)

- Exchange Rate Policy for Statute-Barred Years & Opening Capital:
 - Shares, similar assets, and net capital gains included at 50% at actual Bank of Canada exchange rates.
- Cash, Bonds, Fiduciary Deposits, and net income included at 100% at December 31, 2009 Bank of Canada exchange rates.

Voluntary Disclosure Update

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Trips & Traps of Voluntary Disclosures

Difficulty of Explaining Opening Capital to RQ:

- Requires documentary proof that origins of Opening Capital were tax-exempt or tax-paid.
 - Anecdotal and/or affidavit evidence insufficient.
- Explained Opening Capital still subject to tax on all income and increases in value of capital since account became subject to tax in Quebec.

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Trips & Traps of Voluntary Disclosures (cont'd)

Restrictions on Multiple Disclosures:

- Voluntary Disclosures must be complete.
- Use of voluntary disclosure to resolve minor tax reporting omission may preclude a taxpayer from making subsequent disclosure in respect of more substantial omission.
- Problematic where voluntary disclosure program only means to resolve certain tax reporting omissions:
 - eg. VD filed to resolve T1134 filing omission may preclude taxpayer from making 2nd disclosure of undeclared offshore bank account if account existed when 1st disclosure filed.

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Trips & Traps of Voluntary Disclosures (cont'd)

Restrictions on Disclosures by Taxpayer Linked to Audit

- Voluntary disclosures must be voluntary.
- Taxpayer may not file a VD after he has received notification of an audit of his financial affairs
- Taxpayers may also be denied VD treatment if application precipitated by the audit of a third party.
- *eg.*, VD by consultant for unreported income from largest client rejected because application for VD made after CRA initiated audit of the client's expenses. (*L'Heureux*)

Voluntary Disclosure Update

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Trips & Traps of Voluntary Disclosures (cont'd)

Ongoing Audits

- Taxpayers who are the subject of ongoing audit may not be eligible for VD treatment.
 - eg. Where taxpayer is subject of annual audit for which reassessments issued; taxpayer may believe audit complete with each reassessment. CRA takes position that audit is ongoing, thereby disqualifying taxpayer from VD program if audit and VD issues are connected.

Notes on CRA:

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Changing Approach

- Shift away from personal contact:
 - CRA working groups more centralized (call centres, centres of expertise, etc.)
 - National / regional intake centres (eg. Appeals, voluntary disclosures, and fairness)
 - Standardized processes and policies
 - Online and telephone self-service tools

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Changing Approach

- CRA employs more policy-based than rule of law approach to files
 - CRA will fight tax practices that they do not like, whether or not they are technically correct (applying the “smell test”)
 - Taxpayers must go past objection stage for resolution

Notes on CRA:

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Changing Approach

- Taxpayer dispute resolution not a CRA priority:
 - More than 50% of all audits are progressing to the objection stage
 - Auditors' success measured by the size and number of their reassessments; objections that are overturned in litigation irrelevant to auditor
 - Objections resolved very slowly (eg. In 2010, the Appeals Branch completed their review of all objections dating from 1980s)

Notes on CRA:

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Pending Cuts

- Announcements re CRA staff cuts are imminent
 - Will be made after bulk of 2011 T1s have been processed
 - Possible that up to 10% of workforce affected
 - Cuts are not likely to be popular with taxpayers or tax practitioners