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Personal Tax – The CRA process and why compliance lets you sleep nights

I recently attended a week long Income Tax Practice course designed for accountants with significant tax work who function below the specialist level. The first session was on compliance and the costs of not following the rules. The next 14 lectures were on the intricacies of the Income Tax Act and Regulations and how to use the provisions of the Act to minimize or defer income taxes payable. If there was a theme to the week it would have been that the answer to concerns about over taxation are not in non-compliance but rather in using the provisions of the Act to obtain the best possible tax outcome in every situation.

The Canadian income tax system is honour based. Although filing is compulsory each taxpayer generally voluntarily declares his or her income before they receive a demand to do so.

Why we comply

Our tax system is not widely abused for several reasons. Most Canadians see the value received for the money paid. We all complain about line ups for medical care, bad roads and occasional large dollar waste like the sponsorship scandal but at the end of the day we realize that one of the reasons that Canada is consistently rated as one of the best countries in the world in which to live is because of the education, medical, social and other services for which our taxes pay.

We have voluntary compliance because the tax system is seen as inherently fair. It applies to everyone and we believe that most people are bearing their fair share of the tax burden. Our income tax is based on ability to pay. We are given basic exemptions from tax and then the rate we pay is on a graduated scale. The higher the person's income the higher the tax rate on the taxpayer's last dollar of income. To make the system fairer there are credits such as the Ontario property tax rebate, the GST Rebate and the Child Tax Benefit that are in part income based so that they provide tax relief to those who need it most.

The last reason for compliance and the one we often hear least about is that the Canada Revenue Agency (CRA) carries big clubs to ensure compliance with the system. If a taxpayer does not voluntarily comply with filing requirements, he or she will be assessed penalties and may face an arbitrary assessment based on a CRA estimate of the person's taxable income. Failure to subsequently file or to pay the assessment may result in the seizure of bank accounts or other assets.

The CRA process from initial review to "field" audits

I often am told that a deduction is allowable simply because someone claimed it on his or her tax return and it was not challenged. Unfortunately, the fact that an expense was allowed does not mean it was properly deductible under the Income Tax Act.

Most tax returns only go through two simple two levels of screening that generally do not assess the correctness of the deductions taken. Before a return is assessed the arithmetic accuracy of the return is checked and the information slips are matched to the amounts included on the return.

The next stage is the review phase. This begins with matching return information with the T-slips and carry forward information that are in the CRA's system and linking returns between spouses and other family members to ensure accurate personal amounts, other credits or deductions are being claimed based on the family member's net income (for example, the Child Tax Benefit, the spousal credit, transfer of tuition credits, the child-care deduction and spousal support). If discrepancies arise during this matching and linking stage, reassessments may be issued, or in some cases, where additional information is necessary, CRA will request that the taxpayer provide more information.

The next stage in the process may a post-assessment review in which a percentage of returns are selected for further review. These reviews target specific claims such as donations, child care, medical expenses, interest expense and tuition and education deductions.

Besides the post assessment review some returns will be selected for a "desk" audit. CRA reviews certain pre-selected income and expense items based on their assessment of the risk of overstatement or understatement of the particular item. The taxpayer may be required to submit receipts supporting items such as automobile expenses, entertainment claims, rental losses or interest expense. The documents are usually submitted by mail but the taxpayer can go to their local tax office to submit the proof for an income inclusion or expense item. The extent of the review depends on the outcome of the initial examination and if a taxpayer is unwilling or unable to provide adequate support a reassessment may be issued denying the claim or adjusting the income or expense amount.

The "real" audit, or what's known as the field audit only applies to businesses. This includes self-employed individuals and professional practices. About 10,000 to 15,000 thousand returns are selected annually for a field audit. Generally, a taxpayer is selected for a field audit if he or she receives a high-risk assessment as determined by the CRA system. The risk assessment is generated by a score of various pre-selected attributes or risk factors associated with the return, including the type of business, expenses claimed, magnitude of expenses claimed, variances in the level of revenue or expenses in relation to other similar businesses and more.

Being selected for a field audit does not mean that the taxpayer is suspected of wrongdoing. It may just be that he is involved in a business that the CCRA is targeting for review. As part of the field audit, the CRA auditor goes to the taxpayer's place of business and examines the books and records. The taxpayer will have plenty of notice and can usually arrange for suitable time for the audit to begin. The length of the audit varies greatly depending on how cooperative the taxpayer is, the availability and condition of the records and of course, the discrepancies that are discovered. The CRA generally examines two years of records, the current and preceding year, and perhaps more if discrepancies are found.

It is during these audits that the CRA powers for examination and for penalties come into play. Under audit the burden of proof is on the taxpayer to prove that the income and expenses claimed are complete, exist and are properly declared. The CRA has almost unlimited powers to demand a taxpayer's financial records and bank statements. If these records are incomplete, the CRA can assess on estimated income based on the taxpayer's assets and life style.

Penalties

The CRA has the power to impose significant penalties for non-compliance and for illegal avoidance or evasion of tax. The first level of penalties is designed to ensure that returns are filed on time. Late filing a tax return results in an automatic penalty of 5% of the unpaid taxes plus 1% per month up to 12% for a first offence. The penalties essentially double for a second or subsequent offence to a maximum of 40% of the unpaid balance. Wilful failure to file can also result in criminal penalties of up to $25,000 in fines plus up to one year in jail. In addition to the penalties, interest is charged at the CRA prescribed rate on any unpaid balance from the date the taxes payable were due.

If under audit there are corrections to a return that are the result of inadvertent errors then no penalties are likely to be assessed. But if False Statements, Negligent Omissions, Wilful Evasion of Tax and/or False Credit Claims are found, the penalties are 50% of the amount of the taxes avoided. In extreme cases, criminal charges can be laid which can lead to a maximum fine of 200% of the unpaid taxes plus up to five years in jail.

The higher penalties for wilful failure to file and evasion are seldom used. When most taxpayers are audited, if unintentional mistakes are found or expenses claimed in good faith are disallowed, the taxpayer will probably only be assessed the additional taxes and the interest on the unpaid amounts.

Conclusion

No one likes paying taxes and no person should pay a dollar more than they must. It is important, if you are self employed, have employment expenses or other deductions such as child care, that you keep your receipts to ensure that you receive full benefits for any tax deductions or credits.

Besides the penalties that the CRA can impose, a taxpayer will usually incur significant legal or accounting costs for non-compliance. The bottom line is, whether you believe in the system or simply fear the costs, voluntary compliance is in your best interest and will let you sleep nights.

This report is presented as a source of general information only and has been prepared based on information from various sources. Every effort has been made to ensure the accuracy of the information but this article is not intended as a substitute for competent professional advice tailored to the individual reader's particular circumstance.