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Managing Tax Debt in Canada: A Challenge for Public Finances

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Managing Tax Debt in Canada: A Challenge for Public Finances
(Background Paper)

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MANAGING TAX DEBT IN CANADA: A CHALLENGE FOR PUBLIC FINANCES

1 INTRODUCTION

The Canada Revenue Agency (CRA) is responsible for administering income tax, the goods and services tax/harmonized sales tax (GST/HST) and most other taxes on behalf of the federal government. The CRA also has agreements with all provinces and territories, except Quebec, to collect provincial and territorial taxes on their behalf.¹

One of the CRA's main responsibilities is to ensure that taxpayers meet their obligations by paying the taxes they owe. In Canada, 94% of individuals and 90% of corporations pay their taxes on time and without CRA intervention.²

When the CRA is unable to collect the amounts owing in a timely manner, this is referred to as tax debt. Despite the CRA's best efforts, this tax debt is steadily growing. As of 31 March 2013, it was \$31 billion,³ an increase of \$2 billion (or nearly 7%) over the previous year.

This publication addresses the issue of tax debt as it relates to Canada's public finances. It first presents the concept of "tax debt." It then discusses the changes to federal tax debt in recent years – and related concepts – and presents the observations of the Office of the Auditor General of Canada on this subject. The final part of this paper analyzes the legislative framework related to the collection of tax debt.

2 TAX DEBT

It is important to clarify from the outset what constitutes tax debt for the federal government.

We speak of federal tax debt only when income, GST/HST, or another tax assessment is issued to an individual or a corporation, and the assessed amount is not collected by the payment deadline. For instance, for an individual with employment income, taxes on the income earned during the year are due by 30 April of the following year;⁴ otherwise the amount owing is added to tax debt.

Tax debt also includes interest and penalties related to the unpaid amounts.

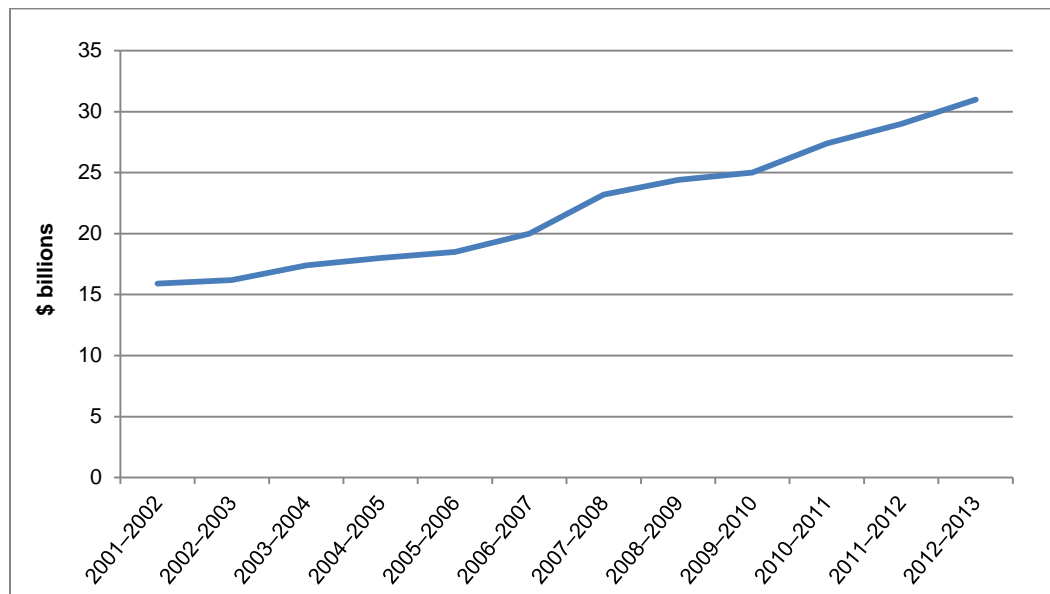
Sums not paid to the federal government because of the underground economy are not included in tax debt. This is also the case for assessed amounts challenged by taxpayers before the CRA or in court, which stood at \$11.6 billion on 31 March 2013.⁵

3 CANADA'S TAX DEBT OVER TIME

While the government takes steps to reduce spending, tax debt continues to climb, despite the fact that the CRA has assigned about 4,000 employees and an annual budget of more than \$240 million to collecting it.⁶

As mentioned earlier, total tax debt was at \$31 billion at the end of fiscal year 2012–2013, an increase of \$2 billion (close to 7%) over the previous year. It has almost doubled since 2001–2002 (see Figure 1).

Figure 1 – Federal Tax Debt, 2001–2002 to 2012–2013



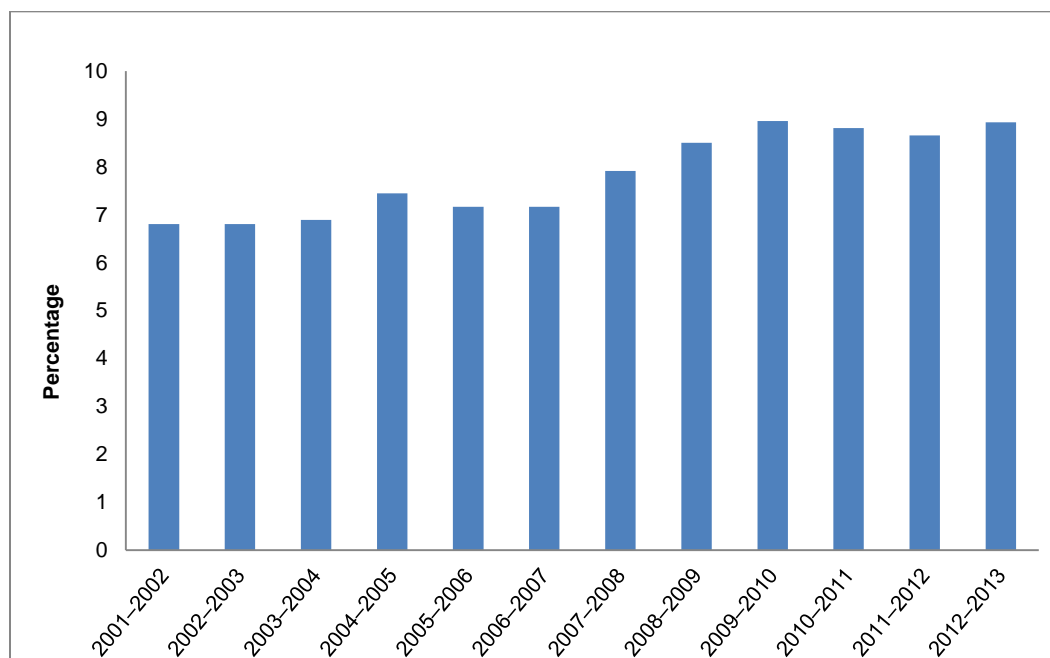
Source: Figure prepared by the author based on data from Canada Revenue Agency, [Annual Report to Parliament](#), from 2001–2002 to 2010–2011. For 2011–2012, the data are taken from Office of the Auditor General of Canada, [“Status Report on Collecting Tax Debts – Canada Revenue Agency,”](#) Chapter 3 in *2013 Spring Report of the Auditor General of Canada*, 2013, while for 2012–2013, the data are taken from Senate, Standing Committee on National Finance, [Second Interim Report on the 2014–15 Main Estimates](#), May 2014.

Note that the taxes to be collected by the CRA have increased since 2009, especially since the Agency is now involved with the following additional taxes:

- since 2009, it has been administering the Ontario corporate provincial tax; and
- since 2010, it has been collecting the harmonized sales tax for British Columbia and Ontario.

Over the last five years, tax debt has represented about 9% of net tax revenue, compared to 6.8% in 2001–2002 (see Figure 2).

Figure 2 – Federal Tax Debt as a Percentage of Net Tax Revenue, 2001–2002 to 2012–2013



Note: Since 2009–2010, about 43% of tax debt has been owed for less than 1 year, 42% for between 1 and 5 years, and 15% for more than 5 years.

Source: Figure prepared by the author based on data from Canada Revenue Agency, [Annual Report to Parliament](#), from 2001–2002 to 2010–2011. For 2011–2012, the data are taken from Office of the Auditor General of Canada, [“Status Report on Collecting Tax Debts—Canada Revenue Agency,”](#) Chapter 3 in *2013 Spring Report of the Auditor General of Canada*, 2013, while for 2012–2013, the data are taken from Senate, Standing Committee on National Finance, [Second Interim Report on the 2014–15 Main Estimates](#), May 2014.

4 ALLOWANCE FOR DOUBTFUL ACCOUNTS

From an accounting perspective, tax debt is a financial asset for the federal government, since it is an amount receivable from taxpayers, analogous to accounts receivable for a private company.

To account for the fact that some taxpayers will never pay the taxes owed, the federal government establishes an allowance for doubtful accounts. This cumulative allowance is based on the CRA’s best estimate of the possibility of collecting the assessed amounts, plus related interest and penalties, that have not yet been paid.

According to the general principles set out in the *CICA Public Sector Handbook*,⁷ taxes receivable are shown on financial statements at their net realizable value, once the allowance for doubtful accounts is deducted.

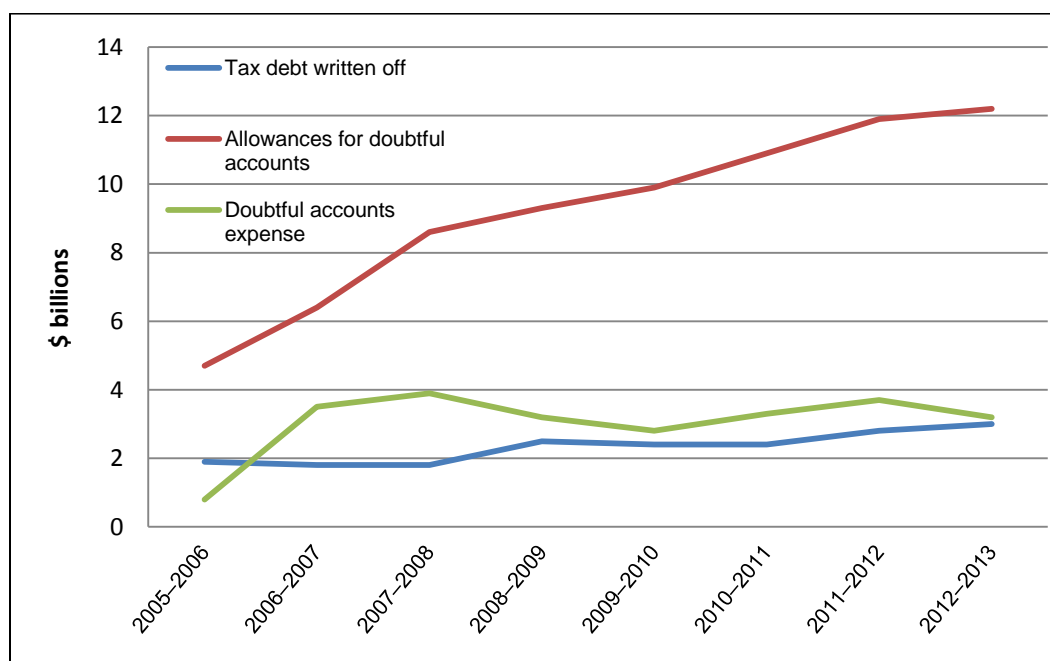
For 2012–2013, the government estimated that \$12.2 billion would never be collected.⁸ The allowance for doubtful accounts has almost doubled since 2006–2007, when the amount was \$6.4 billion.

It is important to differentiate between two items that cause the accumulated allowance for doubtful accounts to fluctuate each year:

- “Doubtful accounts expense”: The amount estimated by the government and booked as an expense in its financial statements for a given fiscal year. It is added to the allowance for doubtful accounts.
- “Tax debt written off”: The amount definitively established as uncollectable either because the government has lost track of the individual or corporation owing taxes, or because of bankruptcy, for example. It is deducted from the allowance for doubtful accounts.⁹

Over the past five years, on average the doubtful accounts expense has been \$3.2 billion and the tax debt written off \$2.6 billion (see Figure 3).

Figure 3 – Federal Government Allowance for Doubtful Accounts, Tax Debt Written Off and Doubtful Accounts Expense, 2005–2006 to 2012–2013



Source: Figure prepared by the author based on data from Canada Revenue Agency, [Annual Report to Parliament](#), from 2005–2006 to 2012–2013.

Although the allowance for doubtful accounts is an estimate, it directly affects the total government debt, while in the case of amounts that are eventually collected, there may be minimal if any financial impact for the government. The government could even realize a gain, since it generally charges interest – and sometimes a penalty – on taxes owing.¹⁰

5 COMMENTS FROM THE OFFICE OF THE AUDITOR GENERAL OF CANADA

Over the years, the Office of the Auditor General (OAG) has been interested in how the CRA manages tax debt, and it has commented on it.

As early as 1994, the OAG notified Parliament of the CRA's shortcomings with respect to collecting income tax debts.¹¹

5.1 THE 2006 REPORT

Twelve years later, in its 2006 report,¹² the OAG once again sounded the alarm by making the following observations:

- The CRA lacks the information it needs to have a full understanding of the makeup of tax debt (e.g., collectible and uncollectible debt) and the causes for its growth in order to develop strategies and allocate resources in a way that would improve the situation.
- The allowance for doubtful accounts is more than one quarter of total tax debt.
- The CRA lacks the information it needs to determine whether it is using efficient processes to collect tax debt (e.g., a summary of collection actions and a record of amounts collected).
- The CRA's approach to assessing the risk of tax debt continues to have major weaknesses, despite the improvements made (e.g., the lack of profiles of tax debtors with a high risk of non-payment).
- The aging of accounts receivable is a problem.

However, in the same report, the OAG also found that the CRA had taken some steps to handle tax debts efficiently, by:

- updating its automated system that manages low-risk tax debts;
- opening a national call centre;
- establishing national pools to better manage workload; and
- improving the procedures for collecting large tax debts.

5.2 THE 2013 REPORT

Seven years later, the OAG once again addressed tax debt in the third chapter of its spring 2013 report to Parliament. The audit on which the report was based revealed that the CRA had made satisfactory progress on implementing many of the recommendations in the 2006 report.¹³

Specifically, the OAG noted good progress made by the CRA regarding:

- improvements to account management;
- the establishment of new tools for collectors; and
- the instituting of a national strategy to manage the inventory of tax debts.

According to the OAG,

[t]he Agency now has much more information about the makeup of the tax debt, which is a major accomplishment. It has completed many research projects to gather this information. The tax debt has continued to increase, from \$18 billion in 2006 to \$29 billion in 2012. The Agency needs to continue to refine its strategies to deal with this continued growth. ...

The Agency still needs to improve its risk scoring and performance measures. It also needs to develop a way to keep track of its research recommendations more strategically. Completing its work on the logic model would enable the Agency to establish more meaningful performance measures.¹⁴

Regarding the CRA's risk-scoring processes, the OAG wrote the following:

When we reviewed the additional criteria for accounts over \$10 million, we found that the Agency did not meet its targets for danger of loss reviews; they were either missing or not adequately documented in 17 of the 39 accounts that required them. A danger of loss review is important, since it will allow the Agency to act quickly where the taxpayer may be disposing of assets instead of paying a tax debt.¹⁵

The CRA accepted the OAG's recommendation and said that, by April 2014, it would undertake a review of its targets for danger of loss reviews on large accounts to determine their appropriateness. The measures taken by the CRA could appear in the CRA's annual report to Parliament for 2014–2015.

6 LEGISLATIVE FRAMEWORK

To be successful in its mission of collecting unpaid taxes, the CRA needs a robust legislative framework so that it has sufficient means and time to check tax returns, assess taxpayers and collect amounts owing. This section briefly examines the legislative framework available to the CRA to properly fulfill its role.

6.1 LIMITATION PERIODS¹⁶

Under Canada's Constitution, the general power to prescribe the time within which an action must be taken falls under provincial jurisdiction.¹⁷ However, the federal Parliament, through its vested powers, can set time limits that apply to areas in its exclusive jurisdiction under the Constitution, such as federal income tax and the GST/HST.¹⁸ Parliament is therefore able to pass the necessary legislation to collect unpaid taxes within a timeframe that it deems appropriate.

People still believe that unpaid tax amounts can be collected indefinitely. The CRA was of the same opinion until March 2003, when the Supreme Court of Canada stated the opposite in *Markevich v. Canada*.¹⁹

In this case, given the silence of the *Income Tax Act* (ITA)²⁰ on the limitation period for collecting tax debt, the Supreme Court placed the Crown under the six-year limitation period prescribed by section 32 of the *Crown Liability and Proceedings Act*. As a result of this decision, the CRA had to forgo almost \$800,000 in tax revenue. However, Parliament subsequently amended section 222 of the ITA²¹ to establish a 10-year limitation period.²²

However, in cases of *criminal* tax evasion,²³ the general rule regarding criminal offences – that there is no limitation period – applies. Consequently, tax evaders are always liable to be charged and to have to pay back their tax debt with interest and penalties.²⁴

6.2 THE POWER TO COLLECT TAX DEBT FROM CANADIAN RESIDENTS

In *Markevich*, Justice John Major reminded the government of the significant collection powers set out in the ITA.²⁵

- Specifically, the CRA has the authority to collect amounts owing by garnishing moneys payable to taxpayers by a third party, such as wages or other forms of income. Generally, the garnishment continues until the taxpayer's tax debt is paid in full or the taxpayer proves that the garnishment causes undue financial hardship.²⁶
- The ITA also authorizes the CRA to seize and sell the taxpayer's goods and chattels to recover amounts owing.²⁷

It is worth noting that these collection powers cannot be exercised until 90 days after the later of the mailing of a notice of assessment or the mailing of a confirmation or variation of the assessment, or until the taxpayer's appeal has been finally determined by the Tax Court of Canada.

7 CONCLUSION

As mentioned previously, tax debt has been steadily growing for over 10 years. Since the OAG's recommendations in 2006, the CRA has taken steps to address certain shortcomings in collecting tax debt.

In its *Annual Report to Parliament 2010–2011*, the CRA stated the following:

We have implemented strategies to address this issue, including our Payment Compliance Action Plan, which addresses the underlying cause of payment non-compliance at the behavioural level. Nonetheless, we anticipate that the level of tax debt will continue to grow over the short to medium term.²⁸

The CRA appears to have been correct on the latter point, since tax debt has now reached \$31 billion.

It is true that the federal government has legislative tools to allow it to collect taxes. However, given the rising tax debt, one may wonder about the causes of the increase and, among other things, whether the CRA's legislative means are adequate.

It will be interesting to follow tax debt changes over the coming years and the impact of the changes made by the CRA in response to the recommendations in the OAG's most recent report on the matter.²⁹

To facilitate understanding of the issue and to monitor developments, it would be helpful if the CRA resumed including the tax debt balance and relevant, detailed information on the issue in its annual reports to Parliament.³⁰

NOTES

1. Under these agreements, the federal government returns to each province and territory the total amount of its provincial income tax that has been set and assumes the tax collection risk. In return, the federal government keeps the interest and penalties on these amounts.
2. Office of the Auditor General [OAG], "[Status Report on Collecting Tax Debts – Canada Revenue Agency](#)," Chapter 3 in *Spring 2013 – Report of the Auditor General of Canada*, 2013, p. 103.
3. Senate, Standing Committee on National Finance, [Second Interim Report on 2014–15 Main Estimates](#), May 2014, p. 25.
4. [Income Tax Act](#), R.S.C., 1985, c. 1 (5th Supp.), s. 156.1.
5. Senate, Standing Committee on National Finance (2014), p. 25.
6. OAG (2013), p. 89.
7. Chartered Accountants of Canada, "PS 3510 Tax Revenue," *Public Sector Accounting Standards*.
8. Canada Revenue Agency [CRA], [Annual Report to Parliament 2012–2013](#), p. 136.
9. The relationship between the three items can be summed up as follows:

$$ADA_{(\text{current fiscal year})} = ADA_{(\text{previous fiscal year})} + DAE_{(\text{current fiscal year})} - TDWO_{(\text{current fiscal year})}$$

ADA = allowance for doubtful accounts
 DAE = doubtful accounts expense
 TDWO = tax debt written off
10. In 2014 the CRA charged 5% interest on any tax balance outstanding on the due date.
11. OAG, "Revenue Canada – Collecting Income Tax Debts," Chapter 29 in *1994 Report of the Auditor General of Canada*.
12. OAG, "[Canada Revenue Agency – Collection of Tax Debts](#)," Chapter 8 in *2006 May Status Report of the Auditor General of Canada*.
13. OAG (2013), p. 88.
14. *Ibid.*, p. 107.

15. Ibid., p. 96.
16. Limitation periods are essentially the periods within which the government can take action to collect the amounts owing.
17. [Constitution Act, 1867](#), 30 & 31 Victoria, c. 3 (U.K.), ss. 92(13) and 92(14).
18. Ibid., s. 91.
19. [Markevich v. Canada](#), [2003] 1 SCR 94.
20. [Income Tax Act](#), R.S.C., 1985, c. 1 (5th Supp.).
21. Section 222 of the *Income Tax Act* deals with the collection of tax debt. It was amended by section 50 of the [Budget Implementation Act, 2004](#), S.C. 2004, c. 22.
22. In British Columbia, Manitoba and Newfoundland and Labrador, the limitation period for the collection of a provincial tax debt is 30 years. In Ontario and Alberta, the collection of tax debt is not subject to a time limit.
23. According to the CRA's interpretation:

Tax evasion is the commission or omission of an act knowingly, the conspiracy to commit such an act or involvement in the accommodation of such an act, which can result in a charge being laid in the Criminal Court under subsection 239(1) of the *Income Tax Act*.

(CRA, "[Tax Evasion](#)," Circular IC-73-10R3, February 1987, para. 8).
24. [R. v. Dudley](#), [2009] 3 S.C.R. 570.
25. In *Markevich*, Justice John Major made the following statement on behalf of the Supreme Court of Canada regarding the collection powers set out in the *Income Tax Act* (ITA):

The various collection mechanisms enumerated in the ITA provide the Minister with an extensive range of remedies to recover debts [from Canadian residents]. The Minister may certify an unpaid tax amount (s. 223(2)) and register the certificate in the Federal Court (s. 223(3)), at which point the certificate is deemed to be a judgment of that court. The Federal Court can then issue a certificate, notification, or writ evidencing the s. 223(2) certificate, which can be used by the Minister to create a charge, lien, priority, or other interest on property in any province (ss. 223(5) to 223(8)). Under the garnishment provision of s. 224(1), the Minister may require a third party who is indebted to the taxpayer to make payments directly to the Minister. The Minister may also order the seizure and sale of the taxpayer's goods and chattels under s. 225(1). These collection powers cannot be exercised until 90 days after the later of the mailing of a notice of assessment or the mailing of a confirmation or variation of the assessment, or until the taxpayer's appeal has been finally determined by the Tax Court of Canada (ss. 225.1(1) to 225.1(4)).
26. Section 224 of the ITA pertains to garnishment.
27. Section 225 of the ITA pertains to the seizure of goods, chattels or movable property.
28. CRA, [Annual Report to Parliament 2010–2011](#), p. 45.
29. OAG (2013).
30. The tax debt balance has not been included in the CRA's annual reports to Parliament since 2011–2012.