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Report of the Auditor General of Canada

CHAPTER 3

Aggressive Tax Planning



Office of the Auditor General of Canada

OAG

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CHAPTER 3

Aggressive Tax Planning

Performance audit reports

This report presents the results of a performance audit conducted by the Office of the Auditor General of Canada under the authority of the *Auditor General Act*.

A performance audit is an independent, objective, and systematic assessment of how well government is managing its activities, responsibilities, and resources. Audit topics are selected based on their significance. While the Office may comment on policy implementation in a performance audit, it does not comment on the merits of a policy.

Performance audits are planned, performed, and reported in accordance with professional auditing standards and Office policies. They are conducted by qualified auditors who

- establish audit objectives and criteria for the assessment of performance,
- gather the evidence necessary to assess performance against the criteria,
- report both positive and negative findings,
- conclude against the established audit objectives, and
- make recommendations for improvement when there are significant differences between criteria and assessed performance.

Performance audits contribute to a public service that is ethical and effective and a government that is accountable to Parliament and Canadians.

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Introduction

3.1 The Canada Revenue Agency's mission is to administer tax, benefits, and related programs and to ensure taxpayer compliance with the *Income Tax Act*, the *Excise Tax Act*, and related legislation, on behalf of governments across Canada. As Canada's tax administrator, in addition to protecting Canada's tax revenue base, the Agency's primary goal is compliance: ensuring that taxpayers meet their compliance obligations.

3.2 The Department of Finance Canada is responsible for developing and evaluating federal tax policy. It is responsible for drafting legislation that clearly reflects the federal government's tax policies. It receives submissions from the Agency for legislative changes and suggests to the Minister of Finance whether changes to the *Income Tax Act* and related legislation are required.

Aggressive tax planning

3.3 Many taxpayers, including individuals, corporations, and trusts, use tax planning to organize their affairs to reduce or eliminate the amount of tax owing. Canadian courts have held that, in general, taxpayers have the right to enter into transactions that will minimize their tax liability. However, that right has been restricted in Canada by statutory anti-avoidance rules, including the General Anti-Avoidance Rule (GAAR). The GAAR may apply to tax plans that are considered aggressive, which the Agency defines as arrangements that push the limits of acceptable tax planning. The GAAR applies to a tax plan that respects the letter of the law but contravenes the object and spirit of the provisions of the *Income Tax Act*. It was introduced in 1988 to give the Agency increased abilities to challenge potential tax avoidance and abuses of the tax system. The GAAR may apply in a case where a transaction results in an abuse of the Act and related provisions; if so, the resulting tax benefit will be denied.

3.4 In its corporate risk profile, the Agency has identified aggressive tax planning (ATP) as one of the highest risks to its mandate of ensuring that taxpayers meet their compliance obligations. The ATP program, part of the Agency's Compliance Programs Branch, identifies emerging tax avoidance issues, arrangements, and products, and handles cases requiring a remedy for tax avoidance. It also has the mandate to apply the General Anti-Avoidance Rule, and to administer special audit programs for the Agency and for the provinces.

3.5 There are many different ways that a taxpayer can structure an aggressive tax plan. We have selected four examples from the numerous types of plans of which the Agency is aware. Of the four plans described in this chapter, two are used mainly by large business: offshore insurance and tech wrecks. The other two, RRSP strips and stock dividend value shift, are used more by individuals and small businesses. The Agency provided us with estimates of income, losses, and taxes reassessed; we did not audit these amounts. Furthermore, the amounts of taxes that will be reassessed will be a fraction of the income or losses identified.

3.6 Offshore insurance. In offshore insurance plans, Canadian businesses undertake a series of transactions to reinsure or “swap” their Canadian insurance portfolio with a foreign portfolio using a foreign affiliate—that is, a non-resident corporation in which the Canadian taxpayer owns 10 percent or more of the shares. The result is that income earned offshore is not taxed in Canada. The Agency estimated that the total amount of income from these plans from 2006 to 2013 was \$9.8 billion. The actual impact on tax that would be assessed for these plans would depend on the applicable tax rate of each taxpayer and the timing of the reassessment.

3.7 RRSP (registered retirement savings plan) strips. RRSP strips were designed to provide benefits to individuals who withdraw (or “strip”) funds tax-free from RRSPs that are normally locked in for a certain period and then receive income tax receipts for amounts that are three or more times the amount actually contributed to an RRSP. During the 2009–10 to 2011–12 fiscal years, the Agency reassessed taxpayers involved in this type of plan, resulting in a total of \$22 million in additional federal taxes being assessed.

3.8 Stock dividend value shift. Under this plan, a taxpayer who has sold property and realized a capital gain creates an artificial capital loss to offset the capital gain. The artificial capital loss is created by undertaking a series of transactions that involve the use of a stock dividend to effectively shift the value of shares between classes, selling one class of shares at an artificial loss. To date, the Agency has identified cases of stock dividend value shifts with total artificial capital losses of \$3.5 billion. The actual impact on tax that would be assessed for these plans would depend on the applicable tax rate of each taxpayer and the timing of the reassessment.

3.9 Tech wrecks. In a tech wreck, the tax losses realized by one corporation are used to reduce the income of another corporation that it does not control, known as an unaffiliated corporation. The

name “tech wreck” arose from the use of losses among companies in the technology sector. The *Income Tax Act* allows affiliated corporations to use losses within a corporate group. Using the tax losses of unaffiliated corporations is an example of going beyond the legislation’s intent. The Agency estimates that corporate losses used to reduce income under this type of plan total approximately \$3.5 billion. The actual impact on tax that would be assessed for these plans would depend on the applicable tax rate of each taxpayer and the timing of the reassessment.

3.10 Status of the selected aggressive tax plans. Exhibit 3.1 summarizes the four selected aggressive tax plans’ status as of the time of the audit, showing if, when, and how they were resolved.

Exhibit 3.1 Status of the four selected aggressive tax plans as of 30 November 2013

Aggressive tax plan	Progress in stopping the use of these plans
Offshore insurance	Unresolved*
RRSP strips	The 2011 federal budget stopped the use of these plans.
Stock dividend value shift	The courts ruled to deny the tax benefits.
Tech wrecks	The 2013 federal budget stopped the use of these plans.

* See Subsequent Event at the end of the report for additional information.

3.11 Although participating in ATP is not a criminal activity, in the course of its ATP program work, the Agency may come across cases that have crossed the line into tax evasion. Tax evasion is a deliberate contravention of the law, whereas tax avoidance arguably arises from legitimate differences in interpretation with no deceit involved and full disclosure. The scope of our audit did not include tax evasion or other activities subject to criminal investigation.

Focus of the audit

3.12 Our audit focused on how the Canada Revenue Agency manages the Aggressive Tax Planning program and how the Department of Finance Canada responds to requests for legislative changes to address the ATP issues that the Agency identifies. More specifically, the objectives of our audit were to determine whether

- the Agency is protecting the tax revenue base by detecting and correcting this type of non-compliance and deterring the use of ATP; and

- the Department of Finance Canada has appropriate processes in place to provide timely analysis and, where required, legislative drafting regarding issues of aggressive tax planning identified by the Agency.

3.13 The audit covered the period between 1 April 2010 and 30 November 2013. Case study audit work covered the period from the date each aggressive tax plan was detected to November 2013. More details about the audit objectives, scope, approach, and criteria are in **About the Audit** at the end of this chapter.

Observations and Recommendations

Detecting and correcting non-compliance

3.14 We examined whether the Canada Revenue Agency has tools and processes in place to detect and correct aggressive tax planning (ATP).

The Canada Revenue Agency has a number of ways to detect aggressive tax plans

3.15 The Agency detects aggressive tax plans through

- risk-based audits, including large business audits and the Related Party Initiative, which manages the compliance of individuals and family groups with a net worth greater than \$50 million;
- referrals from auditors and the Agency's Income Tax Rulings Directorate;
- voluntary disclosures from taxpayers;
- informant leads;
- legislatively mandated reportable tax avoidance transactions; and
- publicly available information, including on the Internet and from various tax forums.

3.16 In our examination of four selected types of aggressive tax plans, we found that the plans were detected through referrals from the field auditors and from the Agency's Income Tax Rulings Directorate. The Directorate, which provides taxpayers with **advance income tax rulings**, is an important source of business intelligence in detecting aggressive tax plans since it receives details about proposed transactions and is able to identify trends and plans.

Advance income tax ruling—A written statement given by the Canada Revenue Agency to a taxpayer, stating how the Agency will interpret and apply specific provisions of existing Canadian income tax law to a specific transaction or transactions that the taxpayer is contemplating.

Promoter—A person who

- sells, issues, or promotes the sale, issuance, or acquisition of a tax shelter;
- acts as an agent or adviser; or
- accepts consideration in respect of a tax shelter.

3.17 In 2013, new legislation was introduced that requires taxpayers, **promoters**, and tax advisers to disclose information when certain criteria are met that could assist the Agency in identifying some aggressive tax plans. Similar legislation has been in effect for several years in the province of Quebec and in a few other countries, such as the United States, the United Kingdom, and Australia.

The Canada Revenue Agency has not fully evaluated whether it is able to detect high-risk large business files

3.18 The transactions or series of transactions that make up an aggressive tax plan can be very complex, and the Canada Revenue Agency often does not have detailed information describing the purpose and result of the transactions. Extensive analysis is often needed to detect and understand such plans. Therefore, to ensure the Agency is able to detect an aggressive tax plan, a systematic process is required to identify high-risk files.

3.19 Beginning in the 2010–11 fiscal year, the International and Large Business Directorate began to phase in a new approach to promote compliance for large businesses, including ATP users. Under the approach, all taxpayers that are part of the large business population are assessed annually for risk through a process called the National Risk Assessment Model (NRAM). A key component of this process is to identify those who are more likely to have undertaken aggressive tax planning. Taxpayers assessed by the NRAM process as being at higher risk of non-compliance are subjected to more extensive review than taxpayers judged to be low risk.

3.20 We looked at the NRAM process for selecting high-risk files because the Agency has identified the large business population as a priority in its Compliance Programs Branch program business plan. This is due to the level of risk, the complexity of the tax issues involved, and the amount of potential tax resulting from audits, including additional federal and provincial taxes assessed, plus interest and penalties. We found that through the NRAM process, the Agency has developed indicators to assist ATP auditors in detecting potential ATP files. However, we noted that while the Agency has taken steps toward evaluating the NRAM's effectiveness in identifying ATP, it has not completed this work. Without fully testing the effectiveness of this key detection tool, the Agency cannot be certain that high-risk cases are in fact being identified and selected for follow-up.

3.21 Recommendation. In order for the Canada Revenue Agency to obtain assurance that its aggressive tax planning risk assessment tool

properly identifies the high-risk files, it should complete the testing of the National Risk Assessment Model's effectiveness.

The Agency's response. Agreed. The Agency is committed to testing the effectiveness of its risk assessment tool, the National Risk Assessment Model (NRAM), to ensure that it is selecting the highest-risk cases. This will be accomplished through the built-in feedback provided as part of the NRAM automation project, to be completed in the 2014–15 fiscal year.

The Agency will test the effectiveness of the NRAM against audit findings as files selected under the model are completed.

Ongoing evaluation will commence in the 2015–16 fiscal year. The result of this evaluation will form part of the continuous refinement of the NRAM and its associated risk criteria.

The Canada Revenue Agency has had success in correcting non-compliance

3.22 When the Canada Revenue Agency suspects that a taxpayer is using an aggressive tax plan, it takes certain steps. First, it determines whether a technical provision and/or a specific anti-avoidance provision in the Act can be applied and, if so, it applies that provision. If not, the Agency determines whether a section of the *Income Tax Act* referred to as the General Anti-Avoidance Rule (GAAR) applies. If the Agency determines that the GAAR does not apply, it will not reassess the file. If the Agency determines that the GAAR applies, it conducts a reassessment. If the taxpayer does not appeal the reassessment, the issue is considered resolved. If the taxpayer does appeal the reassessment, the matter may ultimately be resolved by a court decision. Whatever the outcome of these previous steps, the Agency may also request changes to the tax legislation to prohibit a particular aggressive tax plan. Legislative changes are not usually retroactive in effect, so they will not apply to plans that have already been completed.

3.23 The decision of whether the GAAR is applicable is made by a committee of representatives from the Agency, the Department of Finance Canada, and the Department of Justice Canada (the GAAR Committee). Once the GAAR Committee decides that the GAAR will apply in a particular case, the taxpayer is reassessed. Alternatively, if the taxpayer had requested an advance income tax ruling, a ruling is given that the GAAR will apply. (The taxpayer may also withdraw the request for a ruling.)

3.24 We examined whether the Agency is using the GAAR as an effective tool to correct and deter the use of aggressive tax planning. In our examination of the four selected types of aggressive tax plans, we noted that files of all those types were referred to the GAAR Committee. For example, the Agency has known about the offshore insurance plans described in paragraph 3.6 since at least 2000. There have been variations of this type of plan, but despite the variations, the plans have similar tax implications. To date, three files involving offshore insurance plans have been referred to the GAAR Committee. One file was referred to the GAAR Committee in 2003; it decided that the GAAR would not apply. A second file was referred to the Committee in 2006, and it decided that the GAAR would apply. The taxpayer was reassessed and appealed, resulting in a settlement, and the case did not proceed to court. A third file was sent to the GAAR Committee in December 2011, and in April 2013 the Committee decided the GAAR would apply. In July 2013, the Department of Finance Canada requested some statistical information on the issue, which the Agency provided. At the time we completed our audit, this issue had not been resolved. See **Subsequent Event** at the end of the report for additional information.

3.25 In the case of stock dividend value shifts, the Agency identified the issue in 2002. In June 2003, the issue was presented to the GAAR Committee. The Agency alerted the Department of Finance Canada about this type of plan in February 2004. The Department recommended legislative changes to disallow stock dividend value shifts; however, the changes included in the March 2004 federal budget did not fully address the issue. In July 2004, the Agency issued a note to its auditors in the field, informing them to be alert for this type of transaction and advising them to refer cases to headquarters for consideration by the GAAR Committee, if warranted. In April 2005, the Agency again made a request to the Department of Finance Canada for legislative changes. The Agency also communicated its position through a conference of tax professionals in 2007, and it issued a tax alert to taxpayers in 2009. Ultimately, the issue was resolved by three Federal Court of Appeal decisions in 2012 and early 2013, confirming the Agency's use of the GAAR to disallow tax benefits from this type of transaction. All three decisions are binding.

3.26 The Agency completed an analysis of GAAR decisions made in 2012. According to that analysis, 80 cases thought to use any type of aggressive tax planning were referred to the GAAR Committee in 2012, and the GAAR was found to apply in 77 cases (96 percent of referrals). We asked for the GAAR Committee decisions and found

that for the period under audit, 33 percent of GAAR decisions had not been documented. Therefore, we could not complete our analysis to confirm this result.

3.27 Based on the Agency's data from the time the rule was introduced in 1988 to 12 September 2013, the GAAR Committee has determined that the GAAR applied in a total of 897 out of 1,163 cases (77 percent of all cases referred). The main reason cited for denial of the GAAR was that the Committee determined that the case complied with the object and spirit of the *Income Tax Act*.

3.28 According to the Agency, since 1988, 54 GAAR cases have been litigated in the courts, and the Minister of National Revenue has been successful in 28 of those cases; that is, the GAAR applied to the plans, and the tax benefits obtained were denied. Sometimes the Department of Finance waits to see if the courts will resolve an issue rather than recommending legislative change. Since the court process can be very lengthy, it often takes many years before an issue is resolved. In the meantime, the Agency has to find taxpayers who implement similar aggressive tax plans, reassess them, and await the courts' decision. When the Agency loses a case, its Adverse Decision Committee meets to discuss next steps, including the possibility of requesting legislative change. The Agency regards a lost case as a learning experience, since it clarifies how the courts view GAAR application to a particular aggressive tax plan.

A formal learning path for auditors is in place, but the Canada Revenue Agency does not track the formal training of auditors working on aggressive tax planning

3.29 Aggressive tax planning transactions tend to be complex, and determining the impact of a transaction is not always clear. Furthermore, when a plan is detected and addressed (through the GAAR or changes in legislation), promoters of these plans begin looking for other legislative loopholes to avoid or minimize taxes payable. Therefore, to do good-quality audit work, it is important for ATP auditors to have a solid understanding of legislation and to be aware of which ATP plans are being used. Acquiring such knowledge through formal training, mentoring, information sharing, and internal communication is essential for ATP auditors so that they can detect and properly assess potential ATP transactions. We examined whether the Canada Revenue Agency trained its ATP auditors to detect and make recommendations to correct the use of aggressive tax planning.

3.30 The Agency's professional development team has developed a learning path for ATP auditors that specifies the courses and other

training activities, such as mentoring, that should be performed for each level of ATP auditor. We asked for evidence to show which courses were taken by ATP auditors so that we could compare that information with the learning path developed by the Agency for ATP auditors. Because of inaccurate employee information and computer system limitations, the Agency was unable to demonstrate that the formal training was provided to ATP auditors.

3.31 The Agency relies on its regional offices to know the courses to be followed for each level of ATP auditor and to identify the learning gaps, the courses that are needed, and the number of ATP auditors who require training. However, because headquarters has limited access to individual employee training information, it does not track which courses ATP auditors have already received, and it has not identified the full extent of potential training gaps.

3.32 We also looked at how the Agency informed its ATP staff about the four selected aggressive tax plans described in this chapter. We found that the Agency had communicated to its ATP auditors through technical news bulletins, information sessions, or webinars to make ATP auditors aware of the nature of the plans and how they could be identified. We found that the Agency adequately communicated information relating to the four selected aggressive tax plans to ATP auditors.

3.33 Recommendation. The Canada Revenue Agency should monitor the progress of aggressive tax planning auditors against their learning path and use that information to identify gaps and provide training where needed.

The Agency's response. Agreed. The Agency will develop a training framework to monitor the training histories of aggressive tax planning (ATP) auditors against their learning paths. This information will be used to identify and address training gaps.

The framework will be developed by October 2014. By March 2015, we will have identified training gaps and will be in a position to better target training needs.

Detering aggressive tax plans

3.34 We examined whether the Canada Revenue Agency is deterring taxpayers from using aggressive tax planning (ATP). Deterrents can include publishing news releases regarding tax arrangements that the Agency plans to audit, working with associations of tax professionals to create awareness of the Agency's view of the various aggressive tax plans, and applying penalties to tax preparers and other third parties.

The Canada Revenue Agency applies penalties to third parties

3.35 Third-party civil penalties came into force in 2000. They are meant to deter third parties from making false statements or omissions in relation to income tax or goods and services tax / harmonized sales tax matters that result in non-compliance with the *Income Tax Act* or *Excise Tax Act*.

3.36 It is the Canada Revenue Agency's responsibility to determine whether to apply third-party penalties. In determining whether these penalties are applicable, a tax auditor may refer to the Agency's guidance materials, such as an information circular on third-party penalties. When a case for such penalties is established, the file is sent to the Third-Party Penalty Review Committee. Its members include senior representatives from the Agency, the Department of Finance Canada, and the Department of Justice Canada. The Committee reviews each case and endorses or rejects a recommendation to apply the third-party penalty.

3.37 For the period from the 2009–10 to the 2012–13 fiscal years, the Agency recommended the application of third-party penalties in 118 cases to the Third-Party Penalty Review Committee. The third parties included some promoters of RRSP strips. Of the 118 cases,

- 48 cases were approved to apply third-party penalties,
- 22 were denied, and
- 48 were still being assessed at the end of the audit period.

Of the 48 cases in which third-party penalties were approved, the total value of penalties assessed was \$63.3 million (the median penalty was approximately \$440,000). Although it is not possible to measure the extent to which penalties were a deterrent, their use probably has had some impact on the behaviour of promoters and tax preparers.

Measuring performance

3.38 As part of our objective to determine whether the Canada Revenue Agency is detecting, correcting, and deterring non-compliance, we examined whether the Agency measures the performance of its aggressive tax planning (ATP) program. The Agency has identified three main performance indicators for the program: staff salary utilization, tax earned by audit (TEBA), and the quality of file assessments. We reviewed the adequacy of these performance indicators for measuring program results. We also reviewed whether the Agency analyzes and addresses the variances between its performance targets and actual results.

There are gaps in how the Canada Revenue Agency measures the performance of its Aggressive Tax Planning program

3.39 Having three performance measures that provide indicators of the Agency's use of resources and the outcome and quality of audit efforts provides good feedback on the Aggressive Tax Planning program's success. However, we found there could be some improvements in the interpretation of the results of these performance measures.

3.40 Salary utilization. This performance indicator measures how much the Canada Revenue Agency actually spends on ATP program salaries versus the annual budget for these salaries. For the 2012–13 fiscal year, the Agency budgeted almost \$41.6 million in salary costs and spent just over \$37.0 million, or about 89 percent of budgeted salaries. The program currently has a target of using at least 90 percent of its annually budgeted salaries. The target in the 2011–12 fiscal year was flexible since a business transformation was taking place.

3.41 Tax earned by audit (TEBA). This indicator is the Agency's internal measure of the additional federal taxes adjusted as a result of the ATP program. TEBA excludes amounts that can be reassessed with little or no effort on the part of program staff, such as adjustments initiated by the taxpayer. TEBA is not used to evaluate an individual auditor's performance; it is calculated for each region to measure the program's results. TEBA includes audit adjustments to a tax return that immediately affect federal income tax payable, as well as adjustments with future-year implications. TEBA for the ATP program used to include the following components, which were subsequently excluded:

- provincial taxes assessed on interprovincial tax avoidance audits;
- third-party penalties assessed; and
- “tax protected” value—for example, an adjustment to the **paid-up capital** of a share.

Paid-up capital—A calculation based on the relevant corporate law. The amount calculated under corporate law is usually referred to as the “stated capital” of the class of shares. The stated capital is subject to adjustment by specific provisions of the *Income Tax Act* in order to determine the paid-up capital of the class of shares.

3.42 Because the TEBA amount does not include the components listed above, it does not provide ATP program management with a complete picture of the results. However, the amount the Agency reports to Parliament regarding the results of all of its activities to resolve non-compliance is called the “fiscal impact.” It includes TEBA, provincial taxes, interest, and penalties, and provides Parliament with a more complete measure of the results of audit assessments.

3.43 The Agency exceeded its TEBA target in the 2010–11 and 2011–12 fiscal years. The target increased substantially in the 2012–13 fiscal year and was not met. The Agency determined that this result was due to several factors, including challenges in implementing a business transformation project in the ATP program’s directorate, and underperformance in one region. The exclusion of some components (listed in paragraph 3.41) that had been previously counted toward TEBA results also contributed to the lower results. The Agency determined that its recent business transformation project should improve future results. We found that when the Agency misses its targets, such as TEBA, it analyzes the reasons and takes action.

3.44 The ATP program objectives include identifying and addressing non-compliance, as well as promoting voluntary compliance. TEBA is a useful measure for the short-term result of the ATP program’s compliance efforts (assessed taxes on non-compliant taxpayers). However, when the Agency is successful in promoting voluntary compliance, the amount of TEBA could actually go down. TEBA does not capture results such as

- the deterrent effect, resulting in fewer taxpayers participating in aggressive tax plans and therefore fewer reassessments; and
- legislative changes to deter taxpayers from undertaking plans, leading to fewer reassessments.

As a result, we find that while TEBA is a useful measure of the immediate results achieved by audit activities, it is not an adequate measure of the ATP program’s long-term success.

3.45 The Agency has taken some steps to develop better measures of the ATP program’s success. For example, a recent Agency initiative with the large business sector (see paragraph 3.19) includes plans to measure the impact of audit and compliance activities on taxpayers’ future behaviour. We encourage the Agency to implement these planned measures and to expand this approach to the ATP program, where feasible. The Agency told us that it is participating with tax administrations in some other countries that are looking at ways to measure the success of changing taxpayer behaviour; these include measuring compliance performance from the perspective of preventing and deterring non-compliance for the large business segment.

3.46 Recommendation. The Canada Revenue Agency should re-evaluate its performance measures for its Aggressive Tax Planning program and develop measures and indicators to better reflect program success.

The Agency's response. Agreed. The Agency is currently exploring opportunities to enhance the measurement of its Aggressive Tax Planning program. A list of relevant performance measures will be completed by March 2015.

In addition, the Agency is continuously seeking to identify ways to measure the effectiveness of audit intervention on voluntary compliance. This is a complex issue that is confronting several tax administrations. The Agency is currently participating in various forums, including the Organisation for Economic Co-operation and Development's (OECD) Forum on Tax Administration, to explore solutions.

3.47 Quality of file assessments. The Canada Revenue Agency defines a good-quality audit as one that is selected based on a sound determination of risk, properly planned and executed in accordance with the plan (which is updated as necessary) and with established policy, procedures, and legislation. Furthermore, appropriate reasons should be given for each decision in Agency records and in communications with taxpayers and their representatives. Weaknesses in audit quality may result in significant costs. For example, there may be additional costs if the legislation is not properly applied and many files are appealed by taxpayers. Poor risk assessments may result in auditors missing files that may otherwise result in significant tax assessments. Excessive time spent on low-risk files uses resources that could be more effectively used for high-risk files.

3.48 Each year, the Agency reviews a sample of completed audit files from its four audit programs in the International and Large Business Directorate—international, large, basic, and aggressive tax planning files—to determine whether the audit work has been done properly. The results of these reviews are considered to be a key performance indicator for the Aggressive Tax Planning program. We examined whether the Agency took appropriate action to address weaknesses identified by its quality assurance program.

3.49 We found that in 2012, the Agency reviewed a sample of 89 audits out of a total of 1,242 ATP files completed during the 2010–11 fiscal year. Ten of these files (11 percent) were returned to the field because of material deficiencies in the audit work performed, such as significant issues not addressed by the tax auditor. The most recent review, in 2013, produced similar findings.

3.50 The Agency developed a number of recommendations for improvement based on the results of its 2012 quality review, such as

ensuring that all required risk assessments are completed and retained in the audit file. We reviewed the Agency's plans to address the deficiencies identified in the quality review and found that it responded by introducing additional controls over audit work.

Amending legislation

3.51 As mentioned in paragraph 3.22, amending legislation is one way to address aggressive tax planning (ATP). We examined whether the Canada Revenue Agency has appropriate processes in place to identify aggressive tax plans requiring possible legislative changes, and whether it makes timely submissions to the Department of Finance Canada. We also examined whether the Department of Finance Canada has appropriate processes in place to analyze the submissions and to recommend legislative changes.

The Canada Revenue Agency submits aggressive tax planning legislation issues to the Department of Finance Canada for resolution

3.52 The Canada Revenue Agency's Legislative Policy Directorate acts as the link between the Agency and the Department of Finance Canada with respect to, among other things, tax legislative issues identified by the Agency. The Directorate receives information about legislative issues in several ways and communicates regularly with the Department. Occasionally, other areas of the Agency will contact the Department directly.

3.53 One approach that the Legislative Policy Directorate uses to gather and communicate details on important issues is to request a list of priority issues from the Agency's branches before the development of the annual federal budget, in which the government announces its intended legislative and policy changes. The issues that the Agency forwards to the Department before the budget is introduced are chosen based on an assessment and prioritization by senior Agency officials. The same issues considered to be priorities may be referred to the Department year after year, if necessary.

3.54 One of the priority requests of the Agency was RRSP strips, which the Agency first identified in the late 1990s. In September 2009, it submitted a business case to the Department of Finance Canada to inform the Department of the nature and magnitude of the issue. In the 10 years after it first learned of the plan, the Agency collected information, communicated with the Department, and undertook some projects to understand the extent of the problem. It also undertook a number of outreach activities on RRSP strips, such as communicating with taxpayers and issuing tax alerts. Several proposed

legislative changes to the *Income Tax Act* were announced in the 2011 federal budget to stop the use of these plans.

3.55 In another example of a request from the Agency that resulted in legislative change, in February 2001, the Agency notified the Department of Finance Canada of the inappropriate use of losses through tech wrecks. The Agency followed up with the Department on this issue in 2004 and 2006. In the meantime, ATP program headquarters kept auditors in the field informed about this type of transaction. The Agency reassessed taxpayers involved with tech wrecks and referred some cases to the General Anti-Avoidance Rule Committee. Changes to the *Income Tax Act* were announced in the 2013 budget to block this type of planning. The changes prevent a corporation from selling income-producing assets to an unaffiliated corporation in return for non-voting shares, and using the second corporation's losses to offset its own income. Anti-loss trading rules were introduced for trusts so that taxpayers cannot avoid the loss-trading restrictions by using a different business structure.

The Department of Finance Canada makes legislative proposals, but we cannot conclude whether it follows its processes to provide timely analysis of aggressive tax planning issues

3.56 Officials from the Department of Finance Canada rely to a large extent on the Canada Revenue Agency to identify aggressive tax plans and prioritize the issues that require legislative change. Once the Department receives a proposal for a legislative change from the Agency, its Tax Policy Branch analyzes the proposal. The Department has systems to track potential legislative changes as they are analyzed. It may hold further discussions with Agency officials. The Agency may provide additional data on the magnitude of the issue, as well as a detailed business case to support the submission.

3.57 We asked the Department of Finance Canada about the work completed on the priority issues sent by the Agency from 2011 to 2013 for the Department's consideration in developing the annual federal budget (see paragraph 3.53). Specifically, we asked to see evidence of the work done by officials to ensure that the Department considered all priority issues received from the Agency over the three-year audit period, even if a decision was made that no legislative change would be recommended to the Minister. We also asked the Department for similar details on the work it did on referrals from the Agency on the four selected aggressive tax plans.

3.58 We were provided with a description of the process used to analyze potential legislative changes, the template used in budget briefings, information about budget measures announced by the Department, and some analysis. We were also provided with some information from the systems used to track proposed legislative changes relating to technical (non-budget) items either enacted or released for public comment during the audit period. We were able to see that most of the requests from the Agency in the three years under audit were addressed by the 2011–2013 federal budgets.

3.59 We have not been able to examine how specific requests from the Canada Revenue Agency for legislative changes to block aggressive tax plans were analyzed by Department staff. The Department determined that this information constitutes a Cabinet confidence outside the scope of the Auditor General’s access entitlements under existing orders-in-council. For that reason, the Department did not grant access to the requested information. Therefore, we cannot determine whether the Department of Finance Canada has followed its processes in providing timely analysis of requests from the Agency.

Conclusion

3.60 We concluded that overall, the Canada Revenue Agency’s Aggressive Tax Planning (ATP) program has tools to detect, correct, and deter non-compliance. The Agency has established a training plan for ATP auditors and has put in place performance measures to evaluate the ATP program results. However, there is a need to complete the evaluation of the effectiveness of the Agency’s National Risk Assessment Model, there are weaknesses in the ATP performance measures, and improvement is needed in monitoring the training of ATP staff.

3.61 Since we were not provided with the requested documentation from the Department of Finance Canada, we cannot conclude whether the Department has followed its processes to provide timely analysis of the legislative issues regarding aggressive tax planning, although it is apparent that most of the Agency’s priority requests from 2011 to 2013 have been addressed in recent budgets.

Subsequent Event

3.62 The federal budget tabled on 11 February 2014 proposed changes to address offshore insurance plans, described in paragraph 3.6 of this chapter. The proposed changes amend the existing anti-avoidance rule to clarify that it applies to this type of plan. The budget measure will apply to taxation years of taxpayers that begin on or after the budget date. As of the date this report was sent to print, the budget measure had not received royal assent.

About the Audit

The Office of the Auditor General's responsibility was to conduct an independent examination of the Canada Revenue Agency's Aggressive Tax Planning (ATP) program and to provide objective information, advice, and assurance to assist Parliament in its scrutiny of the government's management of resources and programs.

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set out by the Chartered Professional Accountants of Canada (CPA) in the CPA Canada Handbook—Assurance. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

As part of our regular audit process, we obtained management's confirmation that the findings reported in this chapter are factually based.

Objectives

The first objective of this audit was to determine whether the Canada Revenue Agency is protecting the tax base by deterring the use of aggressive tax planning, and detecting and correcting this type of non-compliance. The second objective was to determine whether the Department of Finance Canada has appropriate processes in place to analyze on a timely basis the Agency's requests for legislative changes regarding issues of aggressive tax planning, and whether the Department proposes required legislative changes to the Minister of Finance.

Scope and approach

We focused our audit efforts on the Aggressive Tax Planning program, which is a part of the International and Large Business Directorate within the Canada Revenue Agency's Compliance Programs Branch. We assessed some of the priorities that the Agency had identified in the areas of detecting and correcting aggressive tax planning, deterring the use of ATP, training staff, and measuring performance. We also examined four types of plans—offshore insurance, RRSP strips, stock dividend value shift, and tech wrecks; this included examining how the Agency's ATP program was applied to address these plans. We chose these cases based on both quantitative criteria (which aggressive tax plan was used the most often) and qualitative criteria. It was determined that the cases selected must be ones

- that can be explained clearly to the average reader,
- of interest to Parliament,
- with a larger fiscal impact, and
- where we can protect the identity of a taxpayer.

Our audit approach included

- interviews of ATP auditors, team leaders, and managers at a sample of the tax service offices;
- interviews with the management team at Canada Revenue Agency headquarters;

- interviews with key management and staff at the Department of Finance Canada; and
- review and analysis of relevant ATP documentation of the Agency and the Department.

Criteria

Criteria	Sources
To determine whether the Canada Revenue Agency is protecting the tax base by deterring the use of aggressive tax planning (ATP) and detecting and correcting this type of non-compliance, we used the following criteria:	
<p>The Agency delivers an effective ATP operational program by</p> <ul style="list-style-type: none"> • developing tools to detect potential ATP files and identify and correct ATP cases, • providing training and communication to staff on ATP tools, • developing a performance indicator system that measures the achievements of the program, and • applying third-party penalties and referring cases to enforcement for potential criminal prosecution in accordance with the <i>Income Tax Act</i>. 	<ul style="list-style-type: none"> • Corporate Risk Profile 2012–2013, Canada Revenue Agency • Compliance Programs Branch Program Business Plan, Canada Revenue Agency, June 2011 • OECD Guidance Note: Compliance Risk Management: Managing and Improving Tax Compliance, Chapter 7, Evaluating the Outcomes, Organisation for Economic Co-operation and Development, October 2004 • Supporting Effective Evaluations: A Guide to Developing Performance Measurement Strategies, Treasury Board of Canada Secretariat
<p>The Agency has appropriate processes in place to</p> <ul style="list-style-type: none"> • identify and analyze aggressive tax planning schemes that may necessitate legislative change, and • make timely submissions to the Department of Finance Canada for its analysis and consideration. 	<ul style="list-style-type: none"> • Corporate Risk Profile 2012–2013, Canada Revenue Agency • Compliance Programs Branch Program Business Plan, Canada Revenue Agency, June 2011
To determine whether the Department of Finance Canada has appropriate processes in place to provide timely analysis and, where required, legislative drafting, regarding issues of aggressive tax planning identified by the Agency, we used the following criteria:	
<p>The Department of Finance Canada has appropriate processes in place to provide timely analysis and, where required, legislative drafting, regarding issues of aggressive tax planning identified by the Agency.</p>	<ul style="list-style-type: none"> • Report on Plans and Priorities 2012–13, Department of Finance Canada

Management reviewed and accepted the suitability of the criteria used in the audit.

Period covered by the audit

The audit covered the period between 1 April 2010 and 30 November 2013. Case study audit work covered the period from the date each aggressive tax plan was detected to November 2013. Audit work for this chapter was completed on 30 November 2013. A subsequent event was noted with the tabling of the federal budget on 11 February 2014.

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Appendix List of recommendations

The following is a list of recommendations found in Chapter 3. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Response
Detecting and correcting non-compliance	
<p>3.21 In order for the Canada Revenue Agency to obtain assurance that its aggressive tax planning risk assessment tool properly identifies the high-risk files, it should complete the testing of the National Risk Assessment Model's effectiveness. (3.14–3.20)</p>	<p>Agreed. The Agency is committed to testing the effectiveness of its risk assessment tool, the National Risk Assessment Model (NRAM), to ensure that it is selecting the highest-risk cases. This will be accomplished through the built-in feedback provided as part of the NRAM automation project, to be completed in the 2014–15 fiscal year.</p> <p>The Agency will test the effectiveness of the NRAM against audit findings as files selected under the model are completed.</p> <p>Ongoing evaluation will commence in the 2015–16 fiscal year. The result of this evaluation will form part of the continuous refinement of the NRAM and its associated risk criteria.</p>
<p>3.33 The Canada Revenue Agency should monitor the progress of aggressive tax planning auditors against their learning path and use that information to identify gaps and provide training where needed. (3.29–3.32)</p>	<p>Agreed. The Agency will develop a training framework to monitor the training histories of aggressive tax planning (ATP) auditors against their learning paths. This information will be used to identify and address training gaps.</p> <p>The framework will be developed by October 2014. By March 2015, we will have identified training gaps and will be in a position to better target training needs.</p>

Recommendation	Response
<p>Measuring performance</p> <p>3.46 The Canada Revenue Agency should re-evaluate its performance measures for its Aggressive Tax Planning program and develop measures and indicators to better reflect program success. (3.38–3.45)</p>	<p>Agreed. The Agency is currently exploring opportunities to enhance the measurement of its Aggressive Tax Planning program. A list of relevant performance measures will be completed by March 2015.</p> <p>In addition, the Agency is continuously seeking to identify ways to measure the effectiveness of audit intervention on voluntary compliance. This is a complex issue that is confronting several tax administrations. The Agency is currently participating in various forums, including the Organisation for Economic Co-operation and Development’s (OECD) Forum on Tax Administration, to explore solutions.</p>