

Chapter 2

Revenue Canada

Underground Economy Initiative

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Revenue Canada

Underground Economy Initiative

Main Points

2.1 Revenue Canada has reported that the tax impact (taxes resulting from enforcement actions) of its activities to address the underground economy was \$2.5 billion over five years; however, this includes the results of both regular ongoing enforcement programs and the Underground Economy Initiative. The actual tax impact attributable to the detection of unreported income by the 1,000 staff allocated to Initiative audit activities is much less than the \$500 million reported.

2.2 It is difficult to assess the overall success of the Initiative in combatting the underground economy because the Department does not measure and report on the full range of Initiative activities and how they have changed taxpayer behaviour.

2.3 Revenue Canada needs to assess the role that social marketing might play in making the public aware of the societal costs of unpaid taxes and in soliciting its support to combat the underground economy. Polls indicate that an alarming number of Canadians would be willing to participate in the underground economy. The Department also needs to strengthen the activities that promote voluntary compliance by businesses.

2.4 The underground economy is a difficult and complex problem to solve and the size of the tax loss is significant. The problem requires continuous attention and sustained efforts from Revenue Canada and all Canadians.

Background and other observations

2.5 The underground economy results in tax evasion and represents an estimated annual loss of federal and provincial tax revenues of \$12 billion. Tax evasion is not a victimless crime. It puts honest businesses at a competitive disadvantage and, in some cases, out of business. It also causes honest taxpayers to bear the tax load of those who cheat. If left unchecked, underground economy activity could lead to a loss of faith in the fairness of Canada's tax system.

2.6 In 1993, Revenue Canada announced a new initiative to combat the underground economy by allocating 200 staff to its non-filers and non-registrants program and 1,000 staff to the audit of small businesses, where most of the underground economy activity exists. Thirty-five percent of the Department's audit staff for small and medium-sized businesses are now involved in the Underground Economy Initiative audit activities.

2.7 The Initiative as planned was, in our view, a balanced approach to combatting tax evasion in the underground economy. It included activities to promote voluntary compliance in small businesses such as community visits and consultations with industry associations. As well, it involved other federal departments, provincial and municipal governments and private sector organizations in sharing information to better deal with the underground economy.

2.8 The Department can improve its targeting of audits for the detection and reassessment of unreported income. As well, legislative opportunities exist to strengthen existing incentives to deter participation in the underground economy.

Revenue Canada has agreed to take action to address our recommendations.

Introduction

The underground economy

2.9 Definition. The “underground economy”, a term familiar to most Canadians, is commonly defined as activities that result in income that has been earned but not reported for tax purposes. The definition may include illegal activities, such as smuggling tobacco and liquor, drug trafficking and money laundering.

2.10 In this chapter, we refer to the underground economy as legal transactions in goods and services that are “hidden”, resulting in the evasion of taxes. Examples of sectors where the underground economy is a concern include home repairs and renovations and auto repairs. Transactions in the underground economy often take place with cash because one party, or sometimes both parties, wants to make sure that no visible record exists. Participants in the underground economy cross all economic

sectors; they range from those who operate businesses on a full-time basis to “moonlighters”, and include those who do business with them. Exhibit 2.1 shows an example of a complex underground economy scheme.

2.11 Factors often cited as contributing to the underground economy include higher tax rates, the growing complexity of the tax law, changes in public attitudes toward taxation and government in general, a low perceived risk of getting caught, opportunity (that is, no withholding of taxes at source), and a perception of minimal consequences. Tax commentators have also said that the “visibility” of the GST and the associated disillusionment that accompanied its introduction has fuelled the growth of the underground economy.

2.12 Effects. The underground economy results in tax evasion, and tax evasion is not a victimless crime. It puts honest businesses at a competitive disadvantage and, in some cases, out of business. Exhibit 2.2 illustrates how the

The underground economy results in tax evasion and represents an estimated annual loss of federal and provincial tax revenues of \$12 billion.

A contractor had not filed his tax return. Revenue Canada issued a filing requirement and obtained a tax return and related financial statements.

A review of the tax return and financial statements showed that the contractor owned two corporations. The gross income of these two corporations was \$3.5 million for three years. As the financial statements of these two corporations showed no salary expenses, Revenue Canada suspected that the contractor paid his employees in cash or “under the table”. The contractor’s return was sent to audit.

Auditors found that the corporations were in reality selling invoices to other contractors (clients). On behalf of these clients and on their request, the corporations would send invoices to the clients’ customers for work done. Customers would pay the corporations. The corporations would keep 5 to 10 percent of the payments and would remit the difference to their clients (those who did the work).

As the corporations did not keep proper books and records, auditors could not identify the clients or, indirectly, the employees of these clients. Auditors also found that the contractor went bankrupt in August 1997, and also had in 1991.

The \$3.5 million of gross income reported by the corporations was in reality the salaries of the clients’ employees. No income tax had been withheld on these salaries by the corporations or the clients and remitted to Revenue Canada. Using an average tax rate of 20 percent, Revenue Canada estimated that this represented about \$700,000 in lost federal taxes alone. The contractor never paid taxes on his commissions (from \$175,000 to \$350,000). The case illustrates how certain contractors used an old scheme – selling invoices – to conceal income.

Exhibit 2.1

A Complex Underground Economy Scheme – Example

Revenue Canada identified the following scheme in reviewing a taxpayer’s payments to various contractors.

New trends such as the recent growth in self-employment and the introduction of electronic commerce as a means of conducting business will create more opportunities to hide income from tax authorities.

underground economy hurts competition. Honest taxpayers lose business because customers may decide not to accept their bids or prices, which may be higher than those of vendors who fail to collect and remit the sales taxes, report their income and pay their fair share of income taxes.

2.13 The underground economy causes honest taxpayers to bear the tax load of those who cheat and puts at risk essential government programs such as health and social services. If left unchecked, underground economy activity could lead to a loss of faith in the fairness of Canada’s tax system.

At 4.5 percent of GDP, the underground economy warrants continuing government action

2.14 Size. Estimates of the size of the Canadian underground economy contained in many studies over the last 17 years have ranged from 3 percent to over 20 percent of gross domestic product (GDP). Our review of these studies indicates that differences in their objectives, definitions of the underground economy and measurement methodologies

explain the wide variation in these estimates. Taking into account the differences, our review concluded that a reasonable range of estimates of the underground economy — defined in terms of the value of transactions in goods and services that are hidden and result in the evasion of taxes — was between 4.2 and 4.5 percent of GDP in 1993. This range is in line with Statistics Canada’s estimate of 4.2 percent of GDP for that year. At 4.5 percent of GDP in 1997, the size of the underground economy would have amounted to \$38 billion. This figure translates into a loss of income and commodity tax revenues of \$12 billion for that year alone — \$7 billion at the federal level and \$5 billion at the provincial level.

2.15 Trends. New trends such as the recent growth in self-employment and the introduction of electronic commerce as a means of conducting business will create more opportunities to hide income from tax authorities.

2.16 The number of self-employed people grew by 38 percent from 1989 to 1997. In 1997 they represented 18 percent of the employed population, compared with 14 percent in 1989. Revenue Canada

Exhibit 2.2

How the Underground Economy Hurts Competition

This exhibit illustrates how difficult it is for honest businesses to outbid businesses operating underground.

By paying his workers “under the table”, an employer can reduce the cost for a worker employed legitimately by 40 to 50 percent. In general, this “cost reduction” arises from the non-payment of payroll taxes. The worker’s take-home pay may be increased by 30 to 40 percent when income taxes are not withheld at source and other payroll deductions are not made by the employer.

	Employer’s costs	Employee’s take-home pay
Regulated wage including benefits	\$ 1400	\$ 600
Underground wage	\$ 800	\$ 800
Reduction or increase	\$ 600	\$ 200

This above-noted example illustrates the situation of a dry-wall worker working a 40-hour week. In the regulated employment situation, the employee is paid in accordance with agreed union rates for a dry-wall worker (\$22.77 an hour in 1997) and employment benefits legislation. In the underground employment situation, the same dry-wall worker is paid at a rate of \$20 an hour. This is a rate that Revenue Canada auditors have observed in the underground economy. The employee’s take-home pay is net of income tax and other payroll deductions.

has taken steps to make the self-employed more aware of their tax obligations. These include increasing enforcement actions and, in conjunction with the Department of Finance, conducting reviews to better understand the work patterns of the self-employed, their income levels, and the opportunities they have to avoid reporting income.

2.17 Electronic commerce can hide the reporting of transactions for both income and commodity tax purposes. It raises practical difficulties of ensuring compliance, given that evidence about the identity and location of parties to a transaction may be difficult to obtain and assess. Existing record keeping and maintenance standards may not be sufficient to reflect electronic transactions. Revenue Canada may also have difficulty accessing encrypted evidence if it does not have a decryption key. Electronic commerce makes it very difficult to determine the source and nature of income.

2.18 In its response to the 1998 report of the Minister's Advisory Committee on Electronic Commerce, "Electronic Commerce and Canada's Tax Administration", Revenue Canada indicated that many of the issues raised by the Advisory Committee need further work. The Department intends to consult with the private sector in the development of new or revised tax compliance and administrative policies and procedures related to electronic commerce.

Focus of the audit

2.19 We examined the implementation of Revenue Canada's Underground Economy Initiative to combat tax evasion in the underground economy. We also reviewed how the Department accounted for the Initiative's results. Further details are found at the end of the chapter in the section **About the Audit**.

Observations and Recommendations

Revenue Canada's Strategy to Combat the Underground Economy

The Underground Economy Initiative was announced in 1993

2.20 In the early 1990s, there was a general perception that the underground economy was a growing problem and that the government had to do something more comprehensive to curtail it. In November 1993, Revenue Canada announced a strategy to deal with the underground economy. The strategy focussed on unreported legal transactions in goods and services on which taxes had not been paid. It did not deal with unreported income from illegal transactions such as bribery, fraud and sales of drugs, which are addressed through other Revenue Canada programs.

2.21 Revenue Canada's underground economy strategy consists of seven initiatives, which are collectively referred to as the Underground Economy Initiative. Exhibit 2.3 illustrates the range of the activities planned as part of the Initiative. The objective of the Initiative is "to ensure integrity and fairness of the voluntary tax system by addressing underground economy activity and tax evasion to ensure a level playing field." The Department expects that as a result of the Initiative, there will be increased voluntary compliance, changes in Canadians' attitudes toward tax evasion, and increased compliance in targeted areas.

2.22 **The announced Initiative was multi-dimensional.** The Underground Economy Initiative as planned was, in our view, a balanced approach to combatting tax evasion in the underground economy. It was intended to increase the chance that

The Underground Economy Initiative as planned was, in our view, a balanced approach to combatting tax evasion in the underground economy.

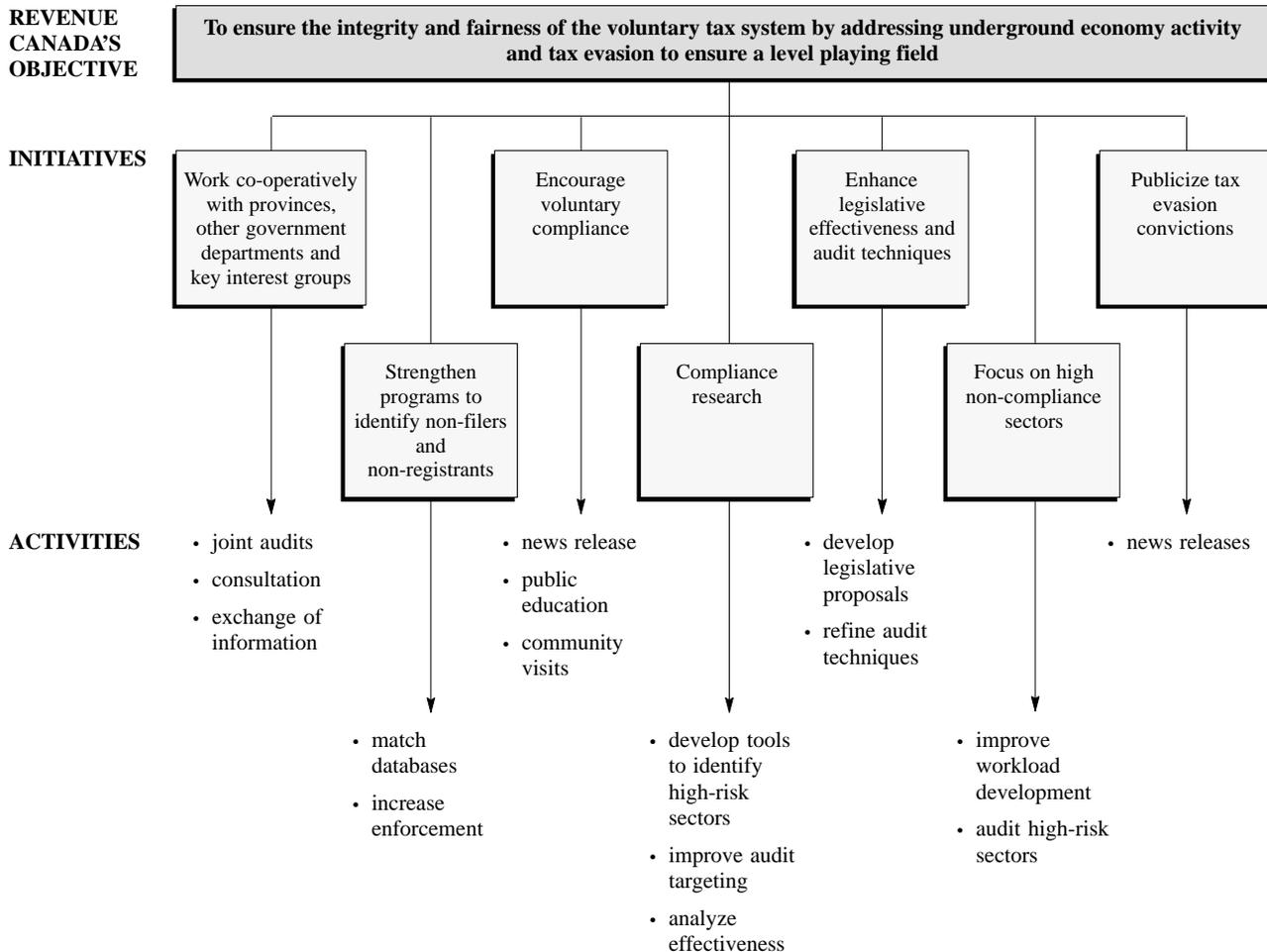
unreported income would be detected, to enforce the payment of taxes from unreported income, to develop new activities to support taxpayers in meeting their tax responsibilities and to deter taxpayers from participating in the underground economy. Activities included encouraging voluntary compliance through community visits to business establishments, educating the public, partnerships with other governments and business organizations, enforcing

compliance by auditing in areas of high non-compliance and supporting compliance efforts with additional research.

2.23 Research undertaken by other tax administrations also points to the conclusion that a multi-dimensional approach is needed to influence the compliance behaviour of corporations and individual taxpayers, and to effectively combat the underground economy.

Exhibit 2.3

The Underground Economy Initiative



Source: Adapted from Evaluation Study – Revenue Canada's Underground Economy Strategy

Implementation of the Underground Economy Initiative

2.24 Revenue Canada has strengthened its resources to deal with the underground economy in the last five years. The Department allocated 1,200 staff to implement the Underground Economy Initiative. Of these, 1,000 auditors are currently allocated to four targeted business sectors. The other 200 staff were allocated to the non-filers and non-registrants program.

2.25 In addition to the Initiative's resources, a significant number of additional staff have been assigned to small business audits over the past three years. We found that these staff have been trained to audit small business taxpayers who have inadequate tax records.

2.26 Revenue Canada has signed memoranda of understanding with all provincial governments to increase co-operation to combat the underground economy more effectively. It has also signed memoranda of understanding with Human Resources Development Canada to promote the exchange of information on Employment Insurance payments and income reported for tax purposes.

2.27 The Department has consulted with private sector organizations and associations and has promoted voluntary compliance through visits to businesses. It has also been active in pursuing certain legislative changes such as the introduction of a new mandatory requirement for reporting income in the construction industry, and a new reporting system for all federal government services contracts.

2.28 All Initiative resources were allocated to the enforcement area. The 1,200 staff are essentially involved in enforcement activities such as auditing and detecting non-filers. The Department did not devote staff with specialized skills to implementing the voluntary compliance

activities of the Initiative. Enforcement staff have carried out some of these activities, while other activities have not been implemented.

2.29 Proposed communication activities have not been carried out. The Underground Economy Initiative included activities aimed at making the public aware of the social inequities and costs arising from unpaid taxes and at generating support for Revenue Canada's enforcement actions. Although a few specifically targeted communication projects have been carried out to date, Revenue Canada has not implemented general public awareness activities. The Department has not even conducted the necessary research to determine whether social marketing activities such as broad-based advertising could be a valuable tool to combat the underground economy. The Department has advised us that it has begun conducting such research.

2.30 Documents in Revenue Canada's possession indicate that surveys carried out by various organizations from 1994 to 1997 show that an alarming number of Canadians would be willing to participate in the underground economy. In December 1994, a CTV Television Network poll indicated that 58 percent of Canadians would accept an offer to evade taxes when buying goods or services. In March 1997, a Gallup poll found that 73 percent of respondents said they would do so. While not necessarily indicative of a trend, these survey results suggest that Revenue Canada needs to involve the Canadian public more in combatting the underground economy.

2.31 Revenue Canada should complete research to determine how to implement its social marketing activities to make taxpayers aware of the costs of the underground economy to society and legitimate business.

Surveys carried out by various organizations from 1994 to 1997 show that an alarming number of Canadians would be willing to participate in the underground economy.

In some communities, 30 percent of the businesses contacted had either not filed a return or not registered for the GST.

Department's response: Revenue Canada agrees with the recommendation and will complete research to determine how to implement its social marketing activities. As reflected in the chapter, the Department is already conducting research to gain insights into how best to communicate about the underground economy. The Department's aim is to:

- *determine how Canadians respond to concerns regarding the underground economy and its impacts on social programs;*
- *determine whether a broad-based advertising campaign would be an effective way in which to raise general public awareness of the underground economy and of what the Department has been doing to deal with it, and, if so, what messages and media would have the most impact; and*
- *improve and expand its existing communications efforts targeted at specific industry sectors and related consumers.*

Social marketing will be a long-term initiative. In addition to extensive research, social marketing entails obtaining the support and active involvement of a number of partners. These partners include other federal government departments and the provinces. Also, we will continue our co-operative communications activities with private sector associations.

The Department has met with a number of stakeholders to explore interests and commitment. We are also currently conducting public opinion research in the home renovation sector, to be completed by 31 March 1999, with the view of developing a social marketing plan and other communication-related strategies for that sector, as well as for the general public.

2.32 Activities undertaken to promote voluntary compliance by businesses have declined. The

Underground Economy Initiative included activities to increase voluntary compliance by business taxpayers. Two of these activities were visits to business establishments in selected communities and increased consultations with business associations.

2.33 Revenue Canada has undertaken visits to business establishments to remind them of their tax responsibilities and to note taxpayer names and business numbers for future follow-up action. During these visits, staff provide taxpayers with a package of information to help them voluntarily comply. Revenue Canada's quarterly reports on the Initiative's activities show that the number of visits to businesses has declined over the past two years. In 1995–96 and 1996–97, over 120 community visits — or an average of 60 per year — were made. In 1997–98, Underground Economy Initiative auditors made only 37 community visits. Consultations were initiated with over 400 business associations, but quarterly reports indicate that few follow-up meetings have been held over the past year.

2.34 The recent decline of efforts in community visits and consultations is worrisome, as it diminishes the role that the activity referred to as “encourage voluntary compliance” can play in combatting the underground economy.

2.35 It is also worrisome that the Department's response to the information obtained during the community visits has often consisted of enforcement actions. These community visits have indicated high rates of non-compliance. In some communities, for example, 30 percent of the businesses contacted had either not filed a return or not registered for the GST. The Department's response to this situation was to refer the files to the non-filers program or to the audit function. Other follow-up activities to assist the taxpayers in understanding and

meeting their tax reporting responsibilities could be used.

2.36 We noted, for example, that to help reduce non-compliance in the transition to the Harmonized Sales Tax, a Tax Services Office had undertaken an innovative practice of extending assistance to taxpayers. Using its Client Services staff, it started an outreach program that involves meeting with taxpayers individually to better explain their tax obligations and to promote voluntary compliance with the new Harmonized Sales Tax. Although not an Underground Economy Initiative activity, the Department considers this program successful in attacking the underground economy.

2.37 Revenue Canada should strengthen its Underground Economy Initiative activities to promote voluntary compliance by businesses.

Department's response: Revenue Canada agrees with the recommendation and has always made activities to promote voluntary compliance a key part of the Department's balanced approach to addressing the underground economy. As noted in the chapter, Revenue Canada undertakes numerous activities to promote voluntary compliance. Emphasis will be placed on increasing the number of community visits and on maintaining relationships that have been established with private sector associations. Also, the social marketing research being undertaken by the Department will provide useful information on the types of activities that are most likely to be effective in encouraging voluntary compliance.

In particular, Revenue Canada considers its community visits to be an excellent opportunity to assist taxpayers in understanding and meeting their tax reporting responsibilities. In addition to leaving taxpayers with a package of information to help them comply voluntarily, staff offer to answer questions

taxpayers might have and to provide assistance on-the-spot or shortly afterward. Appropriate enforcement action is taken only if a taxpayer has still not complied after information and assistance have been provided.

2.38 External sources of information can improve detection of unreported income. The underground economy is generally characterized by a large number of small transactions that collectively amount to several billion dollars of unreported income. In this context, the efficient detection and assessment of relatively small amounts of unreported income pose enormous challenges to Revenue Canada.

2.39 The use of external sources of information complements Revenue Canada's internal information and can improve the identification of non-filers and the selection of audit files. These sources yield additional information about both the income paid to taxpayers and the wealth of taxpayers identified as possibly not having fulfilled their tax responsibilities. Such information contributes to detecting the worst cases of unreported income and providing more certainty before an enforcement action is undertaken.

2.40 Over the last five years, the Department has obtained more than 70 databases from other federal departments, provincial and municipal governments and private sector sources and matched them against its own databases. For example, one Tax Services Office (TSO) obtained a private sector database of payments made to contractors, and preliminary results indicate that substantial unreported income may exist in a segment of the resources sector. Another TSO received a database of payments made to city construction contractors. When matched against the contractors' filed returns, a sample of payments indicated that 40 percent had not reported these payments. At the time

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of our audit, the Department was finalizing its enforcement response.

2.41 We found that access to provincial information varied from region to region and among TSOs. For example, only one provincial government provided a database on workers compensation; two provided information on property assessments and one on land registries. Most provided information on motor vehicle registration. Our examination also showed that one particular Tax Services Office had requested 22 provincial databases, but after 18 months the majority still had not been received.

2.42 The Department has signed memoranda of understanding with all provinces to increase co-operation in dealing with the underground economy. Most provinces have identified a representative to work with Revenue Canada to facilitate the data exchange. The provinces benefit from Revenue Canada's activities to counter the underground economy because under current tax collection agreements, they receive the provincial share of any tax reassessment flowing from Revenue Canada's audits.

2.43 We recognize that governments are obliged to protect the privacy of information provided to them, and a process is needed to allow for the proper exchange of information between federal departments and other levels of government. However, it is also important for Revenue Canada to have efficient access to data that can be used to detect unreported income, especially income from government payments.

2.44 Revenue Canada should collaborate with other levels of government and other partners to access the data that can be used to detect unreported income.

Department's response: Revenue Canada agrees with the recommendation and will continue to collaborate with the other

levels of government and other partners to access the required data. As discussed in the chapter, Revenue Canada makes extensive use of external sources of information to complement internal information, to identify non-filers and to assist in selecting files for audit. Matching of Revenue Canada databases with external databases has been and continues to be a key tool used by the Underground Economy Initiative in identifying and auditing cases of unreported income. As paragraph 2.42 indicates, Revenue Canada has agreements with all provinces to increase co-operation in dealing with the underground economy. The agreements facilitate the exchange of information, as well as other co-operative activities. The existence of these arrangements demonstrates the importance that the Department places on the use of external databases.

Revenue Canada recognizes the compliance benefits that accrue from increased sources of data. As the Department continues to work in closer collaboration with its provincial colleagues, and as it moves to proposed Agency status and explores new business opportunities with them, information sources of benefit to the Department's programs will be explored.

At the same time, Revenue Canada is committed to ensuring that the confidentiality provisions of the legislation administered are fully respected, and that the Treasury Board Guidelines regarding data matching are observed. Furthermore, the compliance benefits of data matching must be carefully balanced with Canadians' regard for privacy. Consultation with the Office of the Privacy Commissioner is undertaken on an ongoing basis, as required.

2.45 More research is needed to support Underground Economy Initiative activities. Auditors need a good knowledge of the sectors they are auditing if they are to be effective at detecting and assessing unreported income and

combatting local underground economy activity. They need to understand, for example, the nature of the operations in those sectors. They also need to be able to assess the risks of non-compliance for a given sector and to develop an appropriate compliance approach.

2.46 Revenue Canada committed itself to undertaking research aimed at gathering appropriate information to support the enforcement activities included in its Underground Economy Initiative. Departmental documents refer to the importance of developing sector profiles to assess the risk of unreported income in economic sectors and to understand the business operations of these sectors. Accordingly, we inquired into whether the Department had developed profiles for the four sectors that it had decided to target in carrying out its Initiative: construction and renovation; used car sales and auto repairs; hospitality; and jewelry. We found that the Department had not completed the profiles for all the sectors when it decided to focus on them. Two sector profiles are still in draft form.

2.47 Revenue Canada should complete the development of its sector profiles in order to better audit underground economy issues.

Department's response: As noted in the chapter, departmental documents refer to the importance of developing sector profiles to assess the risk of unreported income in economic sectors and to understand the business operations of these sectors. Revenue Canada agrees with the recommendation to complete the development of these sector profiles and is currently in the process of doing so.

2.48 Taxpayers with a high risk of unreported income exist in all sectors. In narrowing the focus of Underground Economy Initiative audits to four sectors (construction, jewelry, hospitality and automotive), the Department wished to concentrate its enforcement resources where it believed they would have the

largest and most visible impact.

Sixty-three percent of Underground Economy Initiative audits completed in 1997–98 in these four sectors were related to the construction sector.

2.49 Taxpayers with high risk of unreported income exist in all economic sectors. However, audits conducted by regular business auditors in these sectors may not focus as strongly as Underground Economy Initiative audits on identifying unreported income. It may be time to reconsider the distinction between small business audit and Initiative audit and expand the focus on unreported income to the highest-risk taxpayers in all sectors. The necessary training and management guidelines for team leaders need to be in place to support this broader approach to combatting tax evasion.

2.50 Revenue Canada should reconsider its audit focus for the Underground Economy Initiative to include taxpayers in all sectors with a high risk of unreported income.

Department's response: Revenue Canada agrees to consider expanding its audit focus for the Underground Economy Initiative to include taxpayers in all sectors with a high risk of unreported income. Any expansion would have to take into consideration the resource implications and be balanced against the Department's ability to maintain a large and visible impact in the selected sectors.

Results and impacts of the Underground Economy Initiative

2.51 Five years have passed since the Underground Economy Initiative was announced. We expected the Department to measure and report clearly the tax impact and other results of the Initiative's activities. This information is important to make decisions about the future of the Initiative — whether it should be discontinued, maintained, expanded or integrated in ongoing departmental operations. The information is also important to determine what strategies are

It may be time to reconsider the distinction between small business audit and Underground Economy Initiative audit and expand the focus on unreported income to the highest-risk taxpayers in all sectors.

Revenue Canada has reported that the tax impact of its activities to address the underground economy was \$2.5 billion over five years; however, this includes the results of both regular ongoing enforcement programs and the Underground Economy Initiative.

the most effective in combatting the underground economy.

2.52 It is difficult to assess the success of the Underground Economy Initiative enforcement activities in detecting unreported income. The Department has reported that its activities to combat the underground economy resulted in a \$2.5 billion tax impact (taxes resulting from enforcement actions) for the period November 1993 to 31 March 1998. However, the \$2.5 billion includes both the results of regular ongoing enforcement programs and the results of the Initiative.

2.53 We examined the \$2.5 billion for results attributable to the Underground Economy Initiative (see Exhibit 2.4).

2.54 The \$2.5 billion includes an amount of \$1.6 billion that represents the total tax impact of the non-filers and non-registrants program for that period. This program is a regular enforcement program that has existed for many years. The Underground Economy Initiative only intensified the use of this program by

adding 200 staff to its 550 pre-existing staff. The Department has never reported the incremental tax impact of the 200 additional staff. During this time, the Department also reported that the number of returns obtained as a result of the non-filers and non-registrants program dropped from 509,000 in 1993–94 to 441,000 in 1997–98.

2.55 Of the reported \$2.5 billion tax impact, about \$600 million accounts for audits that the Department has recorded as Initiative audits. Initiative income tax and GST audits account for about \$300 million each.

2.56 Of the \$300 million GST tax impact, about \$100 million resulted from GST audits done by ministère du Revenu du Québec officials. The resources allocated to the Initiative were not used to carry out these audits.

2.57 Of the \$300 million resulting from income tax audits, we were interested in determining how well the Underground Economy Initiative audits had detected and reassessed unreported income. Revenue Canada’s systems do not record separately the amount of additional gross income that its auditors have identified and reassessed. This makes it difficult for the Department to account for the impact of the Initiative’s audit activities in addressing unreported income.

2.58 We reviewed over 90 Initiative income tax audit files from four Tax Services Offices to identify the unreported income detected by these audits. Over 40 percent of these files did not involve unreported income; rather they included reassessments due to technical matters such as incorrect capital cost allowance claims, disallowance of tax shelter losses and other losses, and income arising from shareholder loans. Although the tax impact of these types of reassessments was attributed to the Initiative, it is unrelated to underground economy activity.

Exhibit 2.4

Tax Impact of \$2.5 Billion Attributed to Activities to Combat the Underground Economy

(November 1993–31 March 1998)

Non-filers and non-registrants program (regular and Initiative)		\$ 1.6
Underground Economy Initiative audits		
Revenue Canada		
Income Tax	\$.3	
GST	<u>.2</u>	
	.5	
Ministère du Revenu du Québec		
GST	<u>.1</u>	.6
Non-Initiative audits of self-employed taxpayers		.2
Non-Initiative special projects in 1994–95		.1
Total		\$ 2.5

Source: Revenue Canada

2.59 The results of our file review led us to conclude that the tax impact attributable to unreported income found in these Initiative income tax audits was significantly less than the reported \$300 million for that period. This suggests that the targeting and selection of Initiative income tax audit files need to be improved to increase the effectiveness of the Department's efforts in combatting the underground economy.

2.60 In total, the tax impact attributable to 1,000 staff assigned to Initiative income tax and GST audits over the last five years is about \$500 million. In our view, the tax impact attributable to unreported gross income as a result of Initiative audits is much less than the \$500 million reported.

2.61 Collection of the \$2.5 billion impact is uncertain. As we have pointed out in previous audits, Revenue Canada's systems do not track how much of the reassessed taxes the Department actually collects. This is important because under tax collection agreements, provinces are paid for taxes assessed on their behalf, even if they are not collected.

2.62 Revenue Canada should record and report the additional gross income identified by its Underground Economy Initiative and non-Initiative enforcement activities, the additional tax due on this unreported income, and how much of the reassessed additional taxes the Department actually collects.

Department's response: Outstanding accounts receivable result from a number of tax assessments including income tax, GST/HST (Harmonized Sales Tax) and source deductions. Such assessments can relate to unreported gross income, as well as to other adjustments. The net amount owing can be affected by various items such as the availability of loss carry forwards and carry backs and the assessment of penalties and interest. Furthermore, payment of taxes occurs in many ways including offsets and

installments. Associating the source of the tax, or the specific type of adjustment relating to that tax, with a payment in respect to an amount owing would require a number of assumptions, as a direct linkage would not appear to be feasible.

Although Revenue Canada's systems currently record the aggregate amount of adjustments made to income and expenses, the systems do not separately record the amount of additional gross income. Recognizing that modifications to systems can be costly and must be balanced against other departmental priorities, the Department will explore options to record the additional gross income identified by its enforcement activities.

Notwithstanding the complexity of matching as discussed above, Revenue Canada will also explore options to improve the reporting of collection activity in terms of how much of the additional taxes reassessed from underground economy activities is actually collected.

2.63 Revenue Canada should improve the targeting and selection of income tax files to increase the effectiveness of its Underground Economy Initiative audit activities in identifying unreported income.

Department's response: As noted in the chapter, the Initiative involves a balanced approach with one of its main objectives being to detect unreported income.

The Department has been making significant improvements to its risk assessment systems using external data sources to detect unreported income and estimate taxes at risk. Income tax files that these risk assessment systems identify as being at high risk for unreported income will be used as a basis for file selection for Initiative audits.

In addition, as indicated in paragraph 2.71, the Contract Payment Reporting System for the construction industry, which was implemented on a mandatory basis beginning January 1999, will

The tax impact attributable to unreported gross income as a result of Underground Economy Initiative audits is much less than the \$500 million reported.

Appropriate indicators of performance for the Underground Economy Initiative need to be identified and publicly reported.

provide data that will assist the Department in finding unreported income by matching reported payments to subcontractors against income reported on their tax returns.

Revenue Canada will continue to improve the targeting and selection of income tax files to increase the effectiveness of its Initiative audit activities.

2.64 Performance indicators are not in place. As indicated in paragraph 2.21, the objective of the Underground Economy Initiative is “to ensure integrity and fairness of the voluntary tax system by addressing underground economy activity and tax evasion to ensure a level playing field.” The expected effects of the Initiative are increased voluntary compliance, changes in Canadian’s attitudes toward tax evasion, and increased compliance in targeted sectors.

2.65 To date, the principal performance measurement that Revenue Canada uses to assess the results of its actions against the underground economy is the tax impact.

2.66 The Underground Economy Initiative includes various important activities that may not result in an immediate tax impact, but that are intended to bring about behavioural change, leading to longer-term compliance of taxpayers. Because behavioural change is difficult to measure, a wide range of performance indicators is needed to measure and report on the performance of the Initiative activities and on their long-term effects on compliance.

2.67 The Department has considered several indicators that could be used to measure and report the results of the broad range of Initiative activities. These include information on the number of non-filers identified and the tax found to be owing following a community visit; the number of voluntary disclosures or informant leads following a community visit; the number of non-filers who

continue to file after being served with a requirement to file; the number of taxpayers who, following an audit, continue to report incomes at the level identified by the audit; the number of requirements issued to keep books and records; the number of taxpayers who, after being required to keep proper books and records, continue to do so; the number of penalties for negligence issued following an audit; and the number of net-worth audits completed. However, the quarterly reports of the Initiative and the Department’s annual Performance Report do not contain performance information on the full range of Initiative activities.

2.68 We noted that the Department was developing certain tools to better enable it to assess the performance of all enforcement activities, including the Underground Economy Initiative. One of these tools is a new core audit program. Under this program, a sample of randomly selected returns will be audited to estimate the extent of non-compliance in a particular taxpayer population. One of the Department’s objectives for the program is to obtain statistically valid rates of non-compliance by industry sector, and an insight into the relative importance of major sectoral issues such as unreported income and sales, overstated expenses or technical issues. A pilot project is expected to be conducted in 1999–2000.

2.69 Appropriate indicators of performance for the Underground Economy Initiative need to be identified and publicly reported. Without them, Revenue Canada cannot account for either the performance of the various Initiative activities — individually or collectively — or the extent to which the activities have changed taxpayer behaviour.

2.70 Revenue Canada should develop indicators to measure and report the results of the full range of Underground Economy Initiative activities.

Department's response: As acknowledged in the chapter, Revenue Canada has considered several indicators that could be used to measure and report the results of the broad range of Initiative activities. In addition, although behavioural change is difficult to measure, a wide range of performance indicators is needed to measure and report on the performance of the Initiative activities and on their long-term effects on compliance.

As indicated in paragraph 2.68, Revenue Canada is in the process of developing a core audit program to better enable it to assess the performance of all enforcement activities, including the Underground Economy Initiative. The core audit program started in January 1999. Guidelines, including a listing of the audits that must be completed as part of this program by the end of December 1999, have already been provided to field staff.

In addition, in its compliance performance reported entitled Compliance: From Vision to Strategy, the Department has published performance indicators that relate in part to the underground economy. These indicators indicate the rate of filing of individual tax returns and the level of self-employment income reported for tax purposes. In both cases, these indicators demonstrate some improvement in compliance.

Nevertheless, Revenue Canada agrees with the recommendation and will continue to implement additional indicators for 1999-2000.

Legislative Opportunities to Deter Tax Cheats

2.71 Reporting requirements.

Beginning 1 January 1999, construction contractors will be required both to record all payments they make to subcontractors who provide construction services and to report those payments to the Department. The reporting system has been operating

voluntarily since 1996 and has now become mandatory. These data will assist Revenue Canada to find unreported income by matching reported payments to subcontractors against their tax returns. The Department plans to look at expanding similar reporting requirements to other sectors that provide home renovation services.

2.72 Legislation has also been introduced to require that federal government departments and Crown corporations issue information slips for services they purchase from suppliers. Departments will begin issuing information slips in 1999 and Crown corporations will begin the next year.

2.73 Requesting a refiling. Revenue Canada could pursue legislative authority to undertake another form of enforcement action. For instance, the State of Massachusetts can compel a taxpayer who has filed an insufficient or incorrect return to determine the correct tax liability and file a proper return. The law allows a penalty of up to double the amount of tax owing if it is subsequently found that the taxpayer failed to file a proper return. This provision comes into play once there is probable cause. Some basis of fact must exist that gives cause to believe that a return is insufficient or incorrect.

2.74 Monetary penalties. In each of the last three years, Revenue Canada issued about 5,000 requirements to file an income tax return and charged more than 2,000 taxpayers for failing to file. The prosecutions that follow take place in the court system and include a minimum \$1,000 fine. Revenue Canada could consider prescribing an administrative monetary penalty, both for failing to file an income tax return when a requirement has been issued and for failing to keep adequate books and records. The Department could also impose more onerous record-keeping requirements on taxpayers with a serious history of underreporting.

Revenue Canada could pursue legislative opportunities to deter tax cheats.

Revenue Canada has so far focussed its efforts on enforcement activities and has not fully implemented other key activities included in its Underground Economy Initiative.

2.75 Reporting cash transactions.

Several countries now have legislation requiring the reporting of cash transactions over a certain amount. Canadian legislation currently requires recording of these transactions by banks, but not centralized reporting to an agency mandated to follow up on suspicious transactions. The reporting is helpful in discovering money-laundering activities and in tracking cash sales, which may result in unreported income for tax purposes.

Conclusion

2.76 Revenue Canada has always had programs to detect and deter the non-reporting of income. In 1993, in response to a perceived growth in the underground economy, the Department announced a new initiative. As planned, Revenue Canada's Underground Economy Initiative was to include 1,200 staff in a multi-dimensional and balanced approach to combat the underground economy.

2.77 In implementing the Initiative over the past five years, Revenue Canada has strengthened its resources to detect and audit unreported income by allocating more staff to its non-filers and non-registrants program and to the audit of small businesses, where most of the underground economy activity exists. Thirty-five percent of its audit staff for small and medium-sized businesses are now involved in Initiative audit activities.

2.78 It is difficult to assess the success of the Initiative enforcement activities in detecting unreported income. The Department includes both the results of regular ongoing enforcement programs and Initiative activities in the reported results of a \$2.5 billion tax impact. In

addition, it does not separately record unreported income and the related additional tax identified through audit. However, in our view, the tax impact attributable to the detection of unreported income by the 1,000 staff allocated to Initiative audit over the five years is much less than the \$500 million reported.

2.79 The Department has so far focussed its efforts on enforcement activities and has not fully implemented other key activities included in its Initiative. The underground economy involves both businesses and their customers. Revenue Canada needs to complete research to determine how to implement its social marketing strategy to make the public aware of the societal costs of unpaid taxes and to solicit its support in combatting the underground economy. The Department also needs to strengthen the activities that promote voluntary compliance by businesses and improve its targeting of audits to detect and reassess unreported income. As well, there are legislative opportunities to strengthen existing deterrents to participation in the underground economy.

2.80 The Department has not reported appropriate performance indicators and measured the results of the full range of Initiative activities intended to encourage taxpayers to report all their income.

2.81 Through the Underground Economy Initiative, Revenue Canada has recovered some additional taxes and sent a message to tax cheats in some sectors that it is determined to deal with the problem. However, the underground economy is a difficult and complex problem to solve and the size of the tax loss is significant. The problem requires continuous attention and sustained efforts from Revenue Canada and all Canadians.



About the Audit

Objective and Scope

The objective of the audit was to determine how well Revenue Canada has implemented its Underground Economy Initiative and reported the results.

The audit took place at Revenue Canada headquarters in Ottawa and at various departmental offices throughout the country.

Criteria

To combat the underground economy, we would expect the Underground Economy Initiative to have in place:

- adequate information on the size of the underground economy and the areas of high non-compliance;
- appropriate tools and techniques to detect, reassess and deter underreporting of income by taxpayers;
- effective activities to promote taxpayers' awareness of their income reporting obligations;
- appropriate measurement and reporting of the impacts of the Initiative; and
- effective co-operation with other jurisdictions and other government departments.

Audit Team

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