

P. 58

THE FINANCIAL AND ESTATE PLANNING COUNCIL OF MONTREAL

**DEALING WITH REVENUE CANADA, TAXATION
ON VOLUNTARY DISCLOSURES**

January 19, 1998

**DEALING WITH REVENUE CANADA, TAXATION
ON VOLUNTARY DISCLOSURES
MONTRÉAL TAX SERVICES OFFICE**

*Daniel P. Bousquet, CGA
Revenue Canada, Taxation*

Policy

Revenue Canada, Taxation considers its policy on voluntary disclosures¹ as an important and decisive means of promoting tax compliance by taxpayers by allowing them to correct their tax situation, while benefiting from the waiver of administrative penalties and, in certain cases, criminal prosecutions for tax evasion.

Revenue Canada, Taxation constantly promotes its voluntary disclosure program by participating in conferences and public presentations and in publishing articles in specialized publications. These participations are part of its service to clients mandate.

Results

The actual voluntary disclosure policy of Revenue Canada, Taxation in connection with Income tax has been met with great success in the last few years, due mainly to better knowledge by tax professionals of our voluntary disclosure program.

Between 93 and 97, the number of voluntary disclosures has increased by more than four hundred percent (400%), at the Federal level, from two hundred and sixty-eight (268) voluntary disclosures for the fiscal period 92-93 to one thousand one hundred and six (1,106) for the fiscal period 96-97.

The results for the year ended last March 31 are impressive:

	<u>National</u>	<u>Montreal</u>
Increase in Taxable Income	100 Millions	14 Millions
Federal Tax Collected	25.4 Millions	3.5 Millions

In addition, an amount in excess of 100 Millions Dollars, for the Montreal Tax Services Office, was brought back to Canada from foreign countries.

¹ Information Circular 85-1R2

Types of disclosure

There is almost no limit as to the number of irregularities that a taxpayer may wish to correct:

- **Failure to Declare Income (Canadian or Foreign Sources)**

Any deemed disposition as a result of death, all or part of its sales, salaries, taxable benefits, dividends, bonuses, commissions, investment income, pensions, royalties, or any other type of taxable income.

- **Deduction of Expenses**

Personal expenses, false or fictitious expenses, non admissible expenses, etc.

- **Failure to File a Tax Return**

The penalties for late filing, when a taxpayer has already filed in the past, are waived by voluntary disclosure, only when the taxpayer has ceased to file for a period of at least two (2) years.

- **Deductions at Source**

Deducted but not remitted and/or not deducted.

A voluntary disclosure cannot be invoked by a taxpayer for the purpose of filing an election that was not filed in the prescribed delays nor to claim a refund pertaining to a statute-barred year.

Corporation and appropriation

When the voluntary disclosure provides for restitution of assets appropriated by the shareholder, the funds recovered will not be taxed in the hands of the shareholder, as long as the disclosure complies with our requirements.

Essential conditions

There are three (3) essential conditions for a disclosure to be considered voluntary:

It must be voluntary.

It must be verifiable.

The tax must be paid.

Voluntary

To be voluntary, the disclosure must be initiated by the taxpayer before Revenue Canada, Taxation undertakes an audit, an enquiry or other measures concerning any Federal taxes or duties, such as excise taxes, customs duties, income tax or GST.

For example, a disclosure must not result from measures undertaken by Revenue Canada, Taxation either directly by contacting the taxpayer, its representatives or an employee in the course of an audit or enquiry, nor indirectly by Revenue Canada, Taxation contacting with third parties in the course of an audit or enquiry pertaining to the taxpayer.

Any disclosure made after initiation of these measures would not be considered voluntary, unless Revenue Canada, Taxation may reasonably conclude that the taxpayer could not be aware that Revenue Canada, Taxation had initiated an audit of the taxpayer's affairs.

For example, when the taxpayer has received a formal demand to file a tax return, the taxpayer cannot claim that his disclosure is voluntary.

Verifiable

The disclosure must include all information and documentation necessary for Revenue Canada, Taxation to verify the facts submitted; this may include information and documents that the taxpayer is not legally bound to keep and to maintain in accordance with the *Income Tax Act*.

N.B.: In the case of an estate, the inventory of the estate and the Last Will and Testament must be supplied.

Payment of the taxes

The taxpayer must immediately pay in full the taxes and interests resulting from the disclosure. In certain instances, arrangements may be negotiated with the Collection Department of the Tax Services Office, where justified by the financial situation of the taxpayer.

N.B.: The voluntary disclosure will not protect in any way amounts that were not disclosed.

Year In question

The Information Circular does not restrict the maximum number of years for which we may accept a voluntary disclosure. Notwithstanding, without limiting the number of years for which Revenue Canada, Taxation may accept the disclosure, the time periods that follow would be considered reasonable for discussion purposes:

<u>SITUATIONS</u>	<u>YEARS</u>
1. <u>Non Filer</u>	Current + 6
If the total income for all the statute-barred years is less than \$50,000.- unless there were substantial income in the prior years.	Unprescribed
<u>Plus:</u> If there is an unexplained balance at the beginning of the period, 50% of the amount will be divided equally between the years that will be assessed.	
2. <u>Where Tax Returns were Filed</u>	
Undeclared income	Unprescribed
<u>Plus:</u> If there is an unexplained balance at the beginning of the period, 50% of the amount will be divided equally between the years that will be assessed.	

Scenario #1

Audit vs Voluntary Disclosure

Corporation : Yearly profits of \$200,000.
Undeclared income of \$100,000. yearly
Years in question: 92, 93 and 94

Sole Shareholder : Annual income of \$150,000.

<u>TAX ASSESSMENTS</u>	<u>AUDIT</u>		<u>VOLUNTARY DISCLOSURE</u>	
<u>Corporation</u>				
Fed. Tax (90M) and Prov. (18M)	\$108,000.		\$108,000.	
Penalty 163(2) 50%	\$ 54,000.		Nil	
Interest	<u>\$38,000.</u>	<u>\$200,000.</u>	<u>\$ 26,000.</u>	<u>\$134,000.</u>
<u>Individual</u>				
<u>Section 15(1)</u>				
Fed. Tax (75M) and Prov. (75M)	\$150,000.			
Penalty	\$ 75,000.		Ability to reimburse the	
Interests	<u>\$50,000.</u>	<u>\$275,000.</u>	<u>appropriation</u>	<u>\$0.</u>
<u>Tax Evasion (239)</u>				
<u>Summary Conviction</u> 50% to 200% (2 years)				
<u>Indictment</u> 100% to 200% (5 years)				
<u>Fine (100%)</u>				
Corporation	\$ 90,000.			
Individual	<u>\$ 75,000.</u>	<u>\$165,000.</u>		<u>\$ 0.</u>
TOTAL		<u>\$840,000.</u>		<u>\$134,000.</u>

N.B. In accordance with an agreement intervened between Revenue Canada, Taxation and Revenue Quebec, only one of the tax authorities would undertake criminal prosecution.

Tax heavens

A number of taxpayers, who had until then faithfully paid their taxes, were convinced, as result of attending a tax planning seminar or otherwise, to invest offshore, more precisely, in tax heavens.

While looking for a tax shelter, they were told that the income was accumulating without tax, they were not told or did not wish to understand that this tax shelter required that the income generated by the investments not be declared to the Canadian tax authorities.

They also failed to understand, at least immediately, that by not reporting the foreign investment income, they were committing an infraction in accordance to Section 239 of the *Income Tax Act*, by evading or attempting to evade payment of tax, since all Canadians are required to declare all their world income.

That the investments are made in the personal name of the taxpayer or through an offshore trust, subject to FAPI, the results are the same, failure to disclose the income constitutes tax evasion, which may results in substantial fines.

Estate liquidator

The dilemma faced by the liquidator and the heirs, when substantial foreign sums are discovered in tax heavens, is to decide if the practice of not disclosing income will be pursued or if this illegal situation should be corrected.

This choice is often made more difficult when the heirs and liquidator are not aware of Revenue Canada's voluntary disclosure policy, which allows a delinquent taxpayer to straighten out his tax situation.

We wish to draw to your attention that the transfer of the assets to the heirs will not free them from tax liabilities of the deceased, since the liabilities will follow the assets.

The advantages of a voluntary disclosure

For Revenue Canada, Taxation

- Quick collection of taxes.
- Very low administrative costs.
- Files settled in a brief period of time, without frictions nor contestations (appeals).
- Repatriation of foreign funds.

- Substantial investments in the Canadian economy of these sums which will, themselves, generate additional taxes.
- Complies with Revenue Canada's policies concerning its service to clients and a more human approach.

Heirs

- Allows them to repatriate substantial sums without the application of penalties.
- Allows them to benefit from these sums without having to explain their sources to the tax authorities .
- Prevents them from committing income tax evasion if they were to continue the deceased' course of action.
- Will prevent the application of Section 233 of the *Income Tax Act* concerning disclosure of foreign assets and the imposition of the substantial penalties provided by this Section.

Risk of not making a voluntary disclosure

Section 150(3) from the *Income Tax Act* imposes on the liquidator the obligation to file a tax return for the deceased, for the year, using the prescribed form.

It would not be wise for the liquidator, having knowledge of foreign income, of not including this income in the tax return. Even more so, when the liquidator is not an heir, why would he take any risk for the sole benefit of the heirs?

In addition, in accordance with Section 159(2) of the *Income Tax Act*, the liquidator must obtain a certificate before distribution (TX-21); when applying for the certificate (TX-19), he will be required to certify that all the taxes have been paid and he will also file a copy of the will, including all codicils, a copy of the deed of trust if any, a copy of the inventory, etc.

Why would the liquidator risk paying himself taxes owed by the estate in addition to the possibility of facing prosecution, in certifying that all the taxes have been paid, when he is aware of the undeclared income and that assets of the deceased are not reflected in the inventory?

One must not forget that estates are not always wound-up without disputes, that certain persons may feel cheated and may consider making a denunciation to Revenue Canada, Taxation concerning these foreign assets, even more so when these relatives are not listed in the will.

Foreign tax

When dealing with a voluntary disclosure, which deals with assets in tax heavens, there may also be assets in other countries, with which Canada has a tax treaty.

In this context, we must note that any foreign tax paid on the foreign income may be claimed by the taxpayer as a foreign tax credit when completing his Canadian tax return.

Concerning succession duties, as a result of a deemed disposition of the foreign assets by a taxpayer at the time of his death, these succession duties would not give rise to a foreign tax credit in accordance with Section 126 of the *Income Tax Act*, since they cannot be assimilated to income tax, except as provided in the Canada-U.S. Tax Treaty.

Scenario #2

A taxpayer died on December 31, 1996 and had always filed his tax returns, which did not indicate any foreign investment income.

In 1986, he had earned a \$1,000,000. lottery and had invested this amount in a Swiss bank account on January 1, 1987, at a 5% interest rate.

At the time of his death, he had accumulated an amount of \$1,629,000. In this foreign account; the incomes earned in the last three (3) years were as follows:

- 1994: \$70,000. - 1995: \$74,000. - 1996: \$78,000.

Proposed Settlement

Years	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>Total</u>
Undeclared Interest Plus 50% of the unexplained amount as of 93.12.31⁽¹⁾	\$ 70,000.	\$ 74,000.	\$ 78,000.	\$ 222,000.
	<u>\$ 67,833.</u>	<u>\$ 67,833.</u>	<u>\$ 67,834.</u>	<u>\$ 203,500.</u>
Increase of the declared income	<u>\$137,833.</u>	<u>\$141,833.</u>	<u>\$145,834.</u>	<u>\$ 425,500.</u>
⁽¹⁾ Unexplained amount as of 96.12.31				\$1,629,000.
Less Interest assessed				<u>\$ 222,000.</u>
Capital as of 93.12.31				\$1,407,000.
Less Explained amount (lottery gains)				<u>\$1,000,000.</u>
Unexplained amount				<u>\$ 407,000.</u>
@ 50%				<u>\$ 203,500.</u>

N.B. There has been no withdrawals from the account since its opening.

Procedures

The taxpayer or his representative may communicate with the Tax Services Office where the taxpayer has filed his last return or, if he is a non filer, the office where he resides or has resided.

The person responsible for the voluntary disclosure program is usually a member of the Special Investigation Dept. In Montreal, you may contact either Gino Vita (496-1526) or Daniel P. Bousquet (283-5516).

How to proceed

The contact may be made in several ways, such as by mail, telephone call or visit by the taxpayer or his representative to the Tax Services Office.

The first contact may be on an anonymous basis; the date of the disclosure is the date of the first contact. The name of the taxpayer must be disclosed within thirty (30) days of the initial contact.

The purpose of the anonymous contact is not to accept a voluntary disclosure without disclosing the name of the taxpayer, but to meet with the representative of the taxpayer to discuss the implications of a voluntary disclosure.

The purpose is also, in light of the facts communicated to Revenue Canada, Taxation to ensure if the eventual disclosure would qualify under the criteria of Information Circular 85-1R2.

When the taxpayer or his representative files amended returns totalling more than \$25,000. of additional income with the Taxation Center, these returns are referred to the Tax Services Office where he resides for analysis; the rules mentioned herein would apply.

Verification

When a voluntary disclosure has been made, the file is transferred to the Audit Section where an auditor is assigned to the file and would review the facts disclosed; generally the auditor will not limit himself to those facts and may proceed to a complete audit of the taxpayer's affairs.

The audit completed, the auditor will present his report to the Special Investigation Division. Only at that time, will the disclosure be accepted or refused, depending on the correctness of the facts submitted by the taxpayer or his representative, as ascertained by the auditor.

The taxpayer or his representative will be made aware of Revenue Canada's decision by the auditor when he completes his file.

Please note that the taxpayer may not claim, while making a voluntary disclosure, the application of the fairness package. The matter must be one of voluntary disclosure or one of the fairness package, but not a combination of both.

Prepared by:
Daniel P. Bousquet
Leader, Liaison and Development Section
Special Investigations Division
Montreal Tax Services Office

January 1998