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Best Practices in Tax Administration: A Look Across the Globe

Testimony Before the
Senate Finance Committee

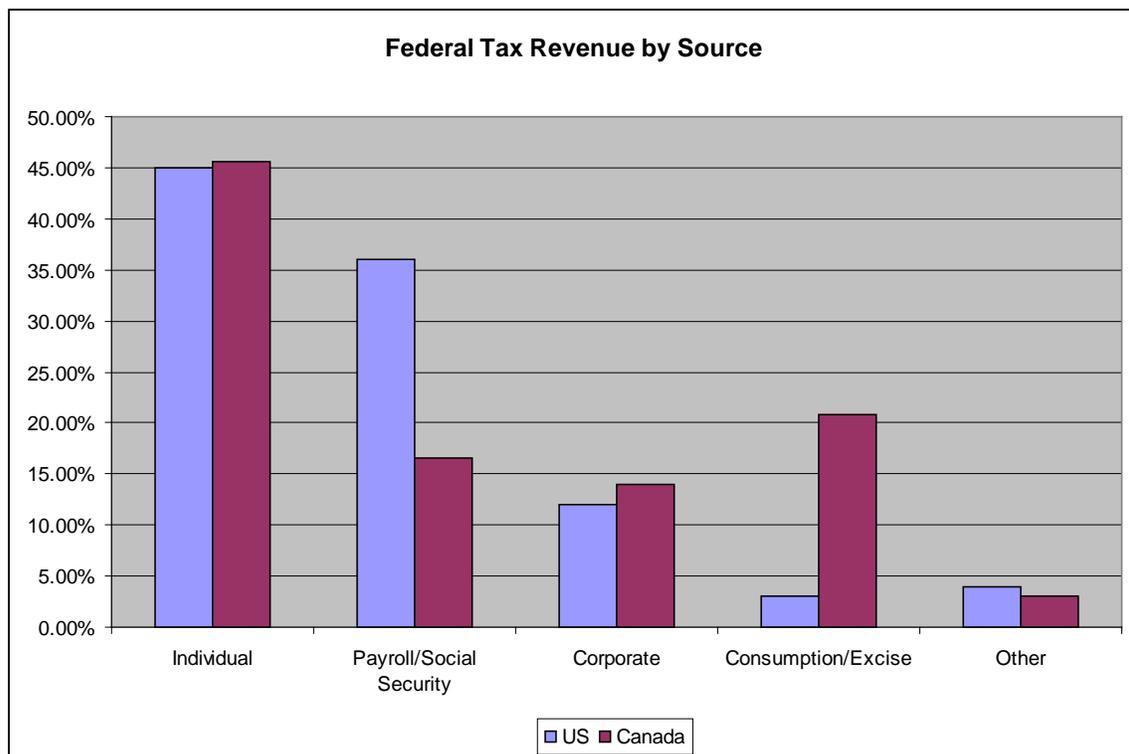
United States Senate

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Chairman Baucus, Ranking Member Hatch, and distinguished members of the Committee, thank you for inviting me to testify on best practices in tax administration. I have been asked to focus on tax administration in Canada with a view towards possible lessons for U.S. tax administration.

Comparability of U.S. and Canadian Tax Systems

The Canadian tax system has many similarities to the U.S. system, but also some notable differences. The following chart compares federal tax revenue by source for the U.S. and Canada.



While individual income taxes account for roughly the same share of federal revenue in both countries (about 45%), the U.S. relies more heavily on payroll taxes. In contrast Canada, with its national VAT (the goods and services tax), relies more heavily on consumption/excise taxes. Canada also collects a slightly higher share of its revenue from the corporate income tax (14% compared to 12% for the U.S.)

When comparing the administration of taxes in the U.S. and Canada, it is important to keep in mind the size differences of the two populations. In 2009, the Canadian population was about 34 million compared to over 300 million in the U.S.

The individual income tax systems in the U.S. and Canada each employ a rather broad tax base with graduated marginal tax rates. Like the U.S., Canada permits various deductions and credits, some of which are refundable. Examples of federal refundable credits in Canada are the Child Tax Benefit (a means-tested monthly payment to families with children), the Goods and Services/Harmonized Sales Tax Credit (a quarterly payment to help low and moderate income families offset some or all of the sales taxes they pay on purchases), and the Working Income Tax Benefit (which provides tax relief to eligible low-income working individuals and families). There are no itemized deductions in Canada and no AMT. Also in contrast to the U.S., married taxpayers in Canada are required to file separate tax returns, although their combined income is computed for purposes of assessing eligibility for means-tested tax credits. Another important difference is that the federal tax agency in Canada, the Canada Revenue Agency (CRA), administers the provincial individual income tax on behalf of 9 of its 10 provinces, the exception being Quebec. The provincial income tax relies on essentially the same base as the federal, but the provinces are free to set their own tax rates and offer various tax credits. The CRA also administers the provincial corporate income tax for 8 of the 10 provinces (the exceptions being Quebec and Alberta) and provincial sales taxes for 6 of the 10 provinces (including the recent additions of Ontario and British Columbia, both as of July 1, 2010). In an interesting arrangement, the province of Quebec administers the federal sales tax in its jurisdiction on behalf of the federal government.

On balance, the individual and corporate income taxes in Canada are less complex and burdensome to taxpayers. Among individual income taxpayers, a recent study by Francois Vaillancourt (2010) estimates that the average combined time and money cost of complying with federal and provincial individual income taxes in Canada amounted to between C\$162 and C\$235 per return for tax year 2007, or between 2.5% and 3.6% of the revenue raised by these taxes. In contrast, a paper by John Guyton et al. (2009) estimates that the U.S. taxpayer compliance burden of the federal individual income tax alone amounted to \$672 per return in tax year 2000, or 8.8% of the revenue raised. This U.S.-Canada difference in estimated individual income tax compliance burdens is striking.

With regard to the corporate income tax, a study that I conducted in 1997 revealed that large corporations in the U.S. experienced significantly higher costs of compliance than large Canadian corporations; this difference could not be fully explained by the larger relative size of the biggest U.S. corporations.

Technological Revolution in Tax Processing and Tax Services

Over the past 20 years or so, there has been a technological revolution in the processing of tax returns and the provision of taxpayer services. During the early 1990s, the method of processing personal income tax returns in Canada underwent more restructuring than it had in the preceding thirty years. In the preceding years, about 50% of all returns were subjected to manual front-end checking of returns against third party information slips and receipts prior to assessment. By 1994 only about 5% of returns were subject to these detailed up-front reviews, leading to substantially faster processing times and quicker refunds to taxpayers. The national roll out of EFILE in 1993 signaled the end to an era when taxpayers would routinely submit receipts and information slips along with their returns (although the change was somewhat more gradual for taxpayers who continued to file paper returns).

To compensate for less routine up-front checking prior to assessment, the new approach relied on more audit and verification activities post-assessment. The automated third party document-matching program was enhanced, and a new Processing Review program was instituted. Under this program, samples of taxpayers are subjected to reviews of selected credit and deduction items on their returns after taxes have been assessed and refunds issued. Typically, these taxpayers are contacted by mail and asked to submit additional information in support of their claims, such as receipts, cancelled checks, or bank statements. The Processing Review program includes both a random and targeted verification component. Under the former component, a sample of taxpayers is randomly selected for review. The results from these random reviews are then used to measure compliance rates with each of the various credit and deduction items and refine selection criteria for the targeted reviews conducted under the latter component. The Processing Review program represents an innovative approach to measuring and promoting compliance for certain key deduction and credit items. These reviews are much less intrusive and costly than ordinary audits.

Over time, additional technological innovations were introduced for filing returns, including the nationwide roll-outs of TELEFILE in 1998 and NETFILE in 2001. The former program allows taxpayers with fairly simple tax circumstances to file by entering commands over a telephone line, while the latter allows taxpayers to submit their tax returns over the Internet using agency-certified commercial tax preparation software. As is well known, electronic filing substantially reduces the cost of processing and storing tax returns and also reduces the incidence of certain types of errors.

New technologies also led to improvements in existing services. For instance, by the year 2000, advances in telephony made it possible to more efficiently route calls among different call centers to be answered by the first-available agent.

The emergence of the Internet created new opportunities for delivering a wide range of taxpayer services. Over time, the CRA website (<http://cra-arc.gc.ca>) has evolved to become a primary channel for many taxpayers who seek information and assistance.

Rationalization of Service Channels

Currently, there are four main channels for providing taxpayer services: Internet, telephone, mail, and in person. The costs associated with these different channels can be very substantial. For instance, a 2004 report by Accenture indicates that a typical client transaction conducted over the Internet costs the Canadian government only about \$1, compared to \$8 by telephone, \$38 by mail, and \$44 over the counter. In recent years, the CRA service strategy has been to encourage taxpayers to use the more cost-effective and accessible service channels for transactions, such as the Internet and the telephone. Beginning in 2007, the CRA transformed its in-person service to service by appointment at tax services offices. An agent is assigned to the taxpayer and has time to review and gather relevant information about the taxpayer's query in advance of the meeting. The CRA reports finding that the majority of clients who call for appointments are able to obtain the information or assistance they need over the phone without the need to come in for an office visit.

Innovative Services

The emphasis of the current CRA service strategy has been on increasing the availability and take-up of taxpayer self-help services. The CRA has introduced a number of innovative self-help options in recent years for taxpayers, including:

- My Account – This online service portal was launched in 2003 and has been expanded over time to provide individual taxpayers with a wide range of self-help options. It allows taxpayers to view their personal tax and benefit information, such as:
 - Tax returns;
 - Account balance and payments on filing;
 - Certain third-party information returns;
 - Installments;
 - Tax benefit account and payment information; and
 - Direct deposit information.

Taxpayers are also able to make a variety of changes to their account, such as:

- Amend tax returns;
 - Formally dispute a tax assessment or determination;
 - Apply for tax benefits;
 - Arrange for direct deposit;
 - Authorize a representative to view taxpayer information; and
 - Set up a payment plan.
- My Business Account – This online service portal was launched in 2006 and has been expanded over time to provide business taxpayers with a wide range of self-help options, including:
 - View account balances, transactions, remitting requirements, endorsements, direct deposit information, addresses, operating names, and correspondence;

- File or transmit returns and view their status;
 - Transfer payments;
 - Transfer accounting data to an Auditor (electronic transfer of accounting data);
 - Calculate a future balance and installment payments;
 - Provide a nil remittance;
 - Register a formal dispute (Notice of objection or appeal);
 - Manage operating names;
 - Authorize or manage representatives' access;
 - Make online requests (such as requests for interest review, transfer of credit, refunds and payment search, additional remittance vouchers, copies of notices and statements and customized statements, and to stop the CRA from sending certain information by mail).
- Represent a Client – This online service provides authorized taxpayer representatives a secure, single point of access to multiple clients' information.
 - My Payments – This online feature was introduced in 2009 and provides a way for individuals and businesses to make electronic payments via a secure link with participating Canadian financial institutions.
 - Telefile Service for Seniors – This service allows certain taxpayers age 65 and over to file their income tax return over the telephone by only answering a few “yes” or “no” questions. Taxpayers are not required to enter their income, deductions, or non-refundable credit amounts, which are calculated automatically using information already available to the CRA.
 - Smartlinks – This service initiative helps taxpayers to obtain the information they require, while contributing to an understanding of taxpayer multi-channel usage, behavior decision processes, preferences, and satisfaction. This initiative aligns telephone and Internet service by allowing users of the CRA website to link to the CRA telephone assistance service. The telephone service links are strategically located within complex or high interest topics on the website. When one of these “smartlinks” is clicked, the taxpayer is asked to complete a brief form with his or her telephone contact information. Shortly after submitting the form, the taxpayer is contacted by a call agent who has been informed of the web page where the taxpayer found the smartlink. At the end of the call, the taxpayer is asked to complete a brief survey to gain insight into the effectiveness of specific web pages, improve agent training, and target outreach activities.
 - Automated Benefits Application – The Automated Benefits Application (ABA) is a joint partnership between the CRA and the Vital Statistics Agency (VSA) of the participating province/territory. Upon consent, the provincial/territorial VSA registering the birth will send the applicant's registration information over a secure communication network to the CRA. The CRA will then determine if the applicant is eligible for benefits such as the Canada Child Tax Benefit and various provincial tax benefits. In addition, the child will automatically be registered for the Goods and Services/Harmonized Sales Tax Credit.

Despite increasing adoption of self-help services by taxpayers, the CRA has found that many taxpayers continue to prefer to receive assistance over the phone, particularly those

with complex issues or concerns. The CRA has found that telephone enquiries have evolved in recent years from a mix of 50% simple and 50% complex to 20% simple and 80% complex. In response to the increased complexity of queries at call assistance centers, the CRA has made improvements in software and reference materials to better insure that call agents have access to the tools and information they need to assist clients. In addition, calls regarding certain complex topics are now routinely referred to CRA specialists at “Centers of Expertise” to help insure that they are properly addressed.

Certain other innovative services have been developed in recent years to address the needs of specific groups of individuals and businesses. One example is the “Learning About Taxes Program”. Developed by the CRA in conjunction with educational agencies in several provinces, this is a structured program for teaching students about taxes. It is supported by a website that provides access to resource materials for both students and teachers.

The province of Quebec administers its own personal income tax system. It currently has an online service that permits one to download information that can be imported into tax preparation software, including available third-party information slips covering earnings from such sources as employment, public and private pensions, annuities, and investments (including interest, dividends, and royalties).

Setting Service Standards and Monitoring Performance

Part of achieving high quality service for taxpayers is setting standards and measuring performance against those standards. Since its transformation from a department to an agency in November 1999, the CRA has made substantial progress on both fronts. It now has some 46 service standards covering its main service activities and it has an automated system to compile data from its various programs about actual performance against its service standards. The CRA conducts annual third-party surveys to evaluate client satisfaction with its services and programs. Satisfaction levels have been fairly stable since 2005. Approximately 62% of those taxpayers who have had direct contact with the agency give it a positive rating, while 19% are neutral. The CRA has recently conducted a large-scale internal review of its service standards to evaluate whether any existing standards should be modified or new ones introduced. In addition, the CRA is exploring ways to take client feedback into account when establishing or changing standards.

Enforcement Issues

In recent years, Canada has devoted significant attention to the following tax enforcement issues:

Charities – Tax Shelters and False Receipting

There are more than 85,000 registered charities in Canada. They are exempt from paying tax on their income, and the federal government allows taxpayers to claim a tax deduction or a tax credit for charitable donations to reduce the income tax that they pay.

The CRA is responsible for monitoring the operations of these charities to make sure they comply with the requirements of the *Income Tax Act*. The CRA has expressed concerns about some tax shelter gifting arrangements and has issued a number of news releases and tax alerts warning taxpayers about them. In many cases, charities involved in these arrangements have been issuing donation receipts in excess of the cash invested or property donated, and often the cash received is not used for charitable purposes.

The promoter of a tax shelter in Canada is required to obtain a tax shelter identification number, the purpose of which is to allow the CRA to identify and track tax shelters and determine whether to audit them. A tax shelter may have multiple promoters. Despite the Agency's tax alerts and the promoter's mandatory disclosure, some taxpayers continue to invest in tax shelter gifting arrangements. The Agency estimated that, as of 31 December 2009, there have been approximately 172,300 participants in these arrangements, with \$5.4 billion in reported donations. The number of participants and the amount of donations claimed has been declining each year from a peak in 2006. The Agency makes it clear that it intends to audit all those involved with tax shelter gifting arrangements—the promoters, the registered charities, and the participants. As of 31 March 2009, the Agency had completed over 69,000 reassessments of taxpayers who participated in tax shelter gifting arrangements and had denied almost \$2 billion in charitable donations.

Some charities have also been caught providing inflated receipts for donations and some tax practitioners have been caught conspiring with charities to sell taxpayers false donation receipts. The CRA has aggressively prosecuted these cases through a project known as "Trident".

Aggressive Tax Planning

Some tax intermediaries promote aggressive tax plans and schemes that go beyond the spirit of the law and are designed to obtain tax advantages that were not intended by governments. These abusive schemes and transactions are used to reduce, avoid, or evade taxes, sometimes through international transactions, particularly through the use of tax havens. The CRA has been increasingly targeting areas like aggressive tax planning and tax havens through partnerships with provinces and international tax administrations. In addition, it has established "centers of expertise" that focus on the identification of aggressive tax planning schemes and develop strategies to address them. The agency also has been working to refine its risk assessment and management tools to improve its ability to address this issue.

The increased CRA focus on aggressive tax planning has led to an upswing in income tax disputes by taxpayers participating in these schemes, which has created some resource strains within the agency's litigation function.

Underground Economy

The CRA has been collaborating with other levels of government and trade associations to improve its capacity to identify possible underground economy activities, such as

taxpayers whose reported incomes are inconsistent with their purchases of real estate and other large assets.

Canada also has a Contract Payment Reporting System under which individuals, partnerships, and corporations whose primary activity is construction are required to make an annual report of their payments to subcontractors for construction services to the CRA. This information is matched against taxpayer records to identify nonfilers as well as filers who have understated their income. A related initiative requires the reporting of contract payments made by federal departments, agencies, and crown corporations for services supplied to those bodies.

As part of its underground economy strategy, the CRA has in place a record-keeping initiative. Under this initiative, limited reviews of books and records are conducted by CRA auditors to help promote compliance with both the Income Tax Act and the Excise Tax Act. It is focused mainly on industries involved in cash transactions where record-keeping practices are often in need of improvement. In comparison to audits, a limited review of book and records require less time and resources. Furthermore, such reviews are less adversarial and intrusive to the client.

The CRA has undertaken a variety of pilot projects over the past several years to test alternative outreach strategies and exploit additional sources of information to address noncompliance in the underground economy.

Large Corporation Issues

The CRA defines large taxpayers as businesses with gross revenues in excess of \$250 million. Within the approximately 900 corporate taxpayer groups that meet this definition are some 6,000 related entities. These groups account for over one half of all corporate income tax revenue. About one half of the audits within this group concern international tax issues.

In the past, the CRA's audit strategy was to examine 100% of the largest businesses over a two year period. However, in recent years the CRA has determined that about 89% of adjustments result from 20% of the large businesses. Accordingly, it plans to concentrate more of its audit resources on this 20% high-risk segment.

In the future, high-risk taxpayers will be informed of their risk profile based on defined criteria such as effective tax rates for specific industries, history of compliance, and behavior (such as participation in tax avoidance schemes). In addition, high-risk taxpayers will be notified that resources previously dedicated to low-risk taxpayers, will be refocused to concentrate on high-risk businesses and the identification of aggressive tax planning schemes and emerging issues.

Correspondingly, low-risk taxpayers will be informed of their low-risk profile and the consequent effect of this status such as reduced audit interventions and greater certainty of their tax liability. Low-risk taxpayers will be subject to monitoring to insure continued

compliance (e.g. with new audit issues) and to validate the development of the risk assessment models.

Related Tax Parties

Recent media coverage suggests that the CRA has begun a new initiative that focuses on wealthy individuals, their families, and the various entities (such as corporations, trusts, and partnerships) with which they are associated. The focus is reportedly on individuals and their related groups with a net asset value of C\$50 million or more, and who have related entities that number about 30 or more. Reportedly, the CRA is interested in learning about the affairs of these groups and the risk of noncompliance.

Electronic Sales Suppression

In addition to the federal enforcement initiatives, the Province of Quebec has undertaken a major initiative to address electronic sales suppression activities in the restaurant sector. It is believed that large amounts of cash are being skimmed with the aid of software (zappers or phantomware) that removes selected electronic records of sales from electronic cash registers, leading to evasion of sales and income taxes. To combat this activity, all restaurants in the province are being required to install sales recording modules (SRMs) that will make it much easier to determine whether skimming has occurred. This is one of several alternative technical solutions that have been adopted in different jurisdictions to address the zipper problem.

Core Audit Program

The CRA has a Core Audit Program which estimates the non-compliance rate among selected segments of the small and medium enterprise population by randomly selecting enterprises for audit. This information is employed to monitor compliance trends and refine risk assessment and workload selection criteria.

Possible Lessons for the U.S.

1. Many of the current electronic self-service options for taxpayers in Canada would be attractive to U.S. taxpayers.
2. The Canadian Processing Review Program provides an interesting model for cost-effectively targeting specific credit and deduction items to promote compliance in a systematic way. The National Research Program data would likely be useful for developing selection criteria for selective verification of tax offset items where noncompliance issues have been identified.
3. While the National Research Program (NRP) provides very good information about compliance with selected taxes, relatively small random audit studies may represent an effective approach for learning about compliance rates and assessing risks for taxes not covered by the NRP.
4. The use of pilot programs for testing the effectiveness of new services and enforcement strategies before wider implementation is a desirable strategy.

5. Enhanced partnerships with sub-national jurisdictions and industry trade groups can create opportunities for improving compliance.
6. Electronic sales suppression is a potentially important issue not only for state sales taxes, but also for federal and state income taxes. Electronic sales suppression may be (or may become) prevalent in industries where cash transactions are frequently undertaken (such as restaurants, grocery stores, convenience stores, hairstylists). The SRM solution in Quebec is one of several possible approaches to address this problem.

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