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L.L.P. Attorneys

Newsletter

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M*[tre] *Jean-François Dorais, M. Tax

Tax audits of unreported offshore accounts held by Canadian residents: the draft assessment / calculation of the tax debt

The Canada Revenue Agency's (CRA) reach and audit powers abroad are explained in more details in our previous newsletters entitled "The Exchange of Financial and Tax Information in Canada … A Constantly Evolving Situation" (by Pierre Lessard) and "Offshore Bank Accounts: the Tax Authorities' Audit Powers" (by Pierre Girard).

This newsletter focuses on the civil (as opposed to penal/criminal) implications awaiting a taxpayer who failed to report either (i) any income earned abroad and/or (ii) the existence of income producing assets held abroad.

Combatting offshore non-compliance

The CRA has given specialized teams the mandate of combatting offshore non-compliance.

Various tools are at the CRA's disposal in order to gather data regarding Canadian taxpayers earning income or having assets abroad, namely:

- tax and financial information exchange agreements;
- the CRA's broad audit powers, including the possibility to send requirements in Canada and abroad;
- the Offshore Tax Informant Program (OTIP)[1]; and
- the review and analysis of international electronic funds transfers[2].

In 2018, the Government of Canada published a new study on the compliance of Canadian taxpayers and their related entities abroad, in which the CRA disclosed the results of the international tax audits it performed between 2014 and 2016.

The CRA reported that notices of reassessment were issued to 570 taxpayers, covering the 2005 to 2014 taxation years and representing a total of 284 million dollars in additional income tax.

The demographic profile of the audited taxpayers is mainly comprised of taxpayers from Quebec (25.5%), Ontario (29%) and British Columbia (28.5%).

The standard draft assessment

If the CRA finds that a Canadian taxpayer has earned income abroad, and/or has not reported the existence of his or her foreign investments, it will make changes to said taxpayer's tax returns notwithstanding the fact that (i) the taxpayer's banking documentation may be incomplete and (ii) certain taxation years may be statute barred. Penalties may also be applied.

Interest at the rate prescribed by regulation will be calculated on any unpaid taxes and penalties, and added to the taxpayer's tax debt.

Example of a draft assessment issued by the CRA

For example, consider the case of a Canadian taxpayer who transferred an amount of $250,000, in 2000, to a foreign investment account located in Switzerland.

Let us assume that:

(i) the foreign account was closed in 2013;

(ii) the taxpayer has not made any subsequent capital contributions to the foreign account;

(iii) the taxpayer has never reported the income he or she has earned in, or the existence of, said foreign account to the Canadian tax authorities;

(iv) the CRA is in possession of the bank statements of the foreign account for the 2007 to 2013 years inclusively; and

(v) the CRA is aware of the opening date of the foreign account.

Calculation of income earned abroad

a) The 2007 to 2013 years

The annual income earned in the foreign account from 2007 to 2013, calculated based on available bank statements, will be added to the Canadian taxpayer's income annually.

Depending on the composition of the foreign investment portfolio, the taxpayer will have earned interest income, dividend income and/or capital gains/losses, and will have incurred management and/or safekeeping fees, depending on whether or not the foreign investment portfolio was administered by an external manager.

For the purposes of our example, let us assume that the taxpayer earned interest income that was reinvested yearly in the acquisition of bonds and similar securities. If the Canadian taxpayer has obtained an average return of 3.4% annually during the 2007 to 2013 years, his or her income, net of financial expenses, would be as follows:

Year	Net income	Yield (taxpayer)	Yield (OECD – Switzerland)	Difference
2007	$11,566.05	3.40%	2.93%	0.47%
2008	$11,959.29	3.40%	2.90%	0.50%
2009	$12,365.91	3.40%	2.20%	1.20%
2010	$12,786.35	3.40%	1.63%	1.77%
2011	$13,221.09	3.40%	1.47%	1.93%
2012	$13,670.60	3.40%	0.65%	2.75%
2013	$14,135.40	3.40%	0.95%	2.45%
Total/Average	**$89,704.69**	**3.40%**	**1.82%**	**1.58%**

b) The 2000 to 2006 years

Since the bank statements are no longer available for those years, the CRA has different methods to estimate the annual income earned by the taxpayer in his or her foreign account.

By calculating the average annual difference between (i) the annual return obtained in the foreign investment portfolio over the 2007 to 2013 years and (ii) the OECD's annual rate of return for similar investments over the same period, the CRA will be able to estimate the gross income earned in the portfolio over the 2000 to 2006 years.

As such, to return to our example, if the average annual spread over the 2007 to 2013 years (the spread between the actual annual return and that of the OECD) is 1.58%, CRA will deem that the taxpayer has obtained an average gross annual return over this period that is 1.58% higher than the rate of return of the OECD for similar investments, over such period.

Since the CRA is in possession of the bank statements of the foreign account for the 2007 to 2013 years, it knows the value of the foreign investment portfolio as at December 31, 2006 (re: $340,177.85).

By extrapolating the average spread (for 2007 to 2013) between the actual return and that of the OECD to the 2000 to 2006 years, the CRA will accordingly be able to estimate the income earned in the foreign investment portfolio during the 2000 to 2006 years, using the annual rates of return published by the OECD during this period, as follows:

Year	Yield (OECD – Switzerland)	Difference	Estimated yield	Estimated income	Balance (market value) of the foreign account / year-end
2000	3.93%	1.58%	5.51%	$13,778.57	$263,778.57
2001	3.38%	1.58%	4.96%	$13,087.19	$276,865.76
2002	3.20%	1.58%	4.78%	$13,238.14	$290,103.90
2003	2.66%	1.58%	4.24%	$12,304.55	$302,408.44
2004	2.74%	1.58%	4.32%	$13,068.36	$315,476.81
2005	2.00%	1.58%	3.58%	$11,298.58	$326,775.39
2006	2.52%	1.58%	4.10%	$13,402.46	$340,177.85

c) The capital initially invested abroad

The CRA will want to know the origin/nature of the capital initially invested, and tax such amount, depending on the circumstances. In our example, let us assume that the CRA considers that the taxpayer's explanations as to the origin of the funds are well founded, and decides not to tax the capital initially invested (re: $250,000 invested in 2000).

In the event that the CRA decides to tax the capital initially invested, the financial impact shall be devastating, considering the interest, calculated at the prescribed rate, which has accumulated on the tax debt since the opening of the foreign account.

d) The calculation of payable taxes

Once the unreported income has been determined for the 2000 to 2013 taxation years, the CRA will calculate the annual taxes, based on the taxpayer's graduated tax rates.

These unpaid taxes will bear interest at the rates prescribed by regulation.

Applicable penalties

a) Penalties pertaining to unreported income

Penalties equal to 50% of the taxes evaded may be applied, in addition to the payable taxes, for each of the 2000 to 2013 years.

b) Penalties pertaining to undeclared foreign investment

A Canadian taxpayer who owns investments abroad, the cost of which exceeds CDN $100,000, is required to report the existence of these investments on his or her tax returns every year. This declaration, commonly referred to as "Form T1135", does not give rise to any payable taxes.

However, failure to file this declaration in accordance with the Act and within the prescribed time limits results in penalties that may exceed by several times the income generated by these same assets. This penalty applies to all taxation years beginning after 1997.

This penalty corresponds, as the case may be, to the greater of the following amounts, namely (i) $2,500 per year, (ii) $12,500 per year, or (iii) 5% of the cost of unreported foreign assets if the taxpayer, knowingly or under circumstances amounting to gross negligence, makes a false statement or an omission in his return. These penalties also bear interest.

In practice, depending on the circumstances, the CRA has the discretion whether or not to apply this 5% penalty. For the purposes of this newsletter, we have made our calculations on the basis that the CRA would apply the 5% penalty on the 2003 to 2014 years.

In light of the foregoing, the following is a summary of the adjustments that would be made to the Canadian taxpayer's tax returns by the CRA in a typical draft assessment:

Year	Foreign Income	Estimated taxes	Penalty (50% income)	Penalty (5%)	Interests	Total
2000	$13,778.57	$3,541.09	$1,770.55	$0	$11,089.68	$16,401.32
2001	$13,087.19	$3,167.10	$1,583.55	$0	$8,733.00	$13,483.65
2002	$13,238.14	$3,203.63	$1,601.81	$0	$7,932.99	$12,738.43
2003	$12,304.55	$2,977.70	$1,488.85	$0	$6,543.26	$11,009.81
2004	$13,068.36	$3,162.54	$1,581.27	$15,773.84	$26,757.37	$47,275.03
2005	$11,298.58	$2,734.26	$1,367.13	$16,338.77	$23,436.51	$43,876.66
2006	$13,402.46	$3,243.40	$1,621.70	$17,008.89	$21,219.90	$43,093.88
2007	$11,566.05	$2,798.98	$1,399.49	$17,587.19	$17,561.12	$39,346.79
2008	$11,959.29	$2,894.15	$1,447.07	$18,185.16	$15,500.52	$38,026.90
2009	$12,365.91	$2,992.55	$1,496.27	$18,803.45	$14,110.02	$37,402.30
2010	$12,786.35	$3,094.30	$1,547.15	$19,442.77	$12,703.73	$36,787.95
2011	$13,221.09	$3,199.50	$1,599.75	$20,103.83	$11,275.66	$36,178.74
2012	$13,670.60	$3,308.29	$1,654.14	$20,787.36	$9,834.70	$35,584.48
2013	$14,135.40	$3,420.77	$1,710.38	$21,494.13	$8,286.62	$34,911.90
Total	$**179,882.53**	$**43,738.25**	$**21,689.13**	$**185,525.39**	$**194,985.08**	$**446,117.84**

As such, the Canadian taxpayer's total tax liability under these circumstances would be $446,117.84[3]. In the event that CRA determines that the initial capital is taxable, then the taxpayer's debt would rise up to $743,705.19. The main difference resides in the interests that kept accruing on the tax debt since 2000.

Provincial tax debt

For a taxpayer who resides in Quebec, a similar calculation must be made, except for the fact that the 5% penalty, calculated on the cost of foreign property, does not exist under the provincial legislation, which significantly reduces the taxpayer's debt.

In addition, it is Revenu Québec's administrative policy not to calculate interest on penalties, which further reduces the taxpayer's debt in Quebec, compared to the taxpayer's federal debt, in similar circumstances.

Conclusion

Once the draft assessment is issued, the tax authorities will allow the taxpayer an initial period of 21 days to respond.

There are several arguments a taxpayer can raise in response to such draft assessment.

To discuss further, contact a member of our tax team.

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1. Except for a few cases, every individual is eligible for the OTIP; irrespective of where he is located in the world. When all the conditions are met, the informant is entitled to a reward representing 5%-15% of the income tax collected, but only if the assessment exceeds $100,000 in tax (excluding penalties and interests).
2. Since January 2015, financial institutions and other "reporting entities" have the obligation to report all international electronic transfers in the amount of $10,000 or more. Financial institutions also have this obligation when multiple electronic transfers adding up collectively to more than $10,000, are made over a period of 24 hours by the same person or entity, or on his or its behalf.
3. Interest is calculated as at June 30, 2019.

For more information, please contact one of the team members:

Jean-Roch Boivin
514 925-6331
jean-roch.boivin@lrmm.com

Jean-François Dorais, M. Tax
514 925-6376
jean-francois.dorais@lrmm.com

Pierre Girard, M. Tax
514 925-6422
pierre.girard@lrmm.com

Pierre Lessard, M. Tax
514 925-6322
pierre.lessard@lrmm.com