Intelligence MEMOS

From: Kenneth J. Klassen and Nick Pantaleo

To: Diane Lebouthillier, Minister of National Revenue

Date: September 29, 2020

Re: **Assessing the CRA: Evidence on Auditors' Incentives and Assessments**

Taxpayer compliance is critical to the integrity of the Canadian tax system. The Canada Revenue Agency (CRA) plays a crucial role through various activities to assist taxpayers with their compliance obligations. In particular, the prospect of an audit and any negative audit outcomes serve to encourage taxpayer compliance, particularly in Canada's self-assessment tax system.

Since it is an obvious impossibility to audit every transaction of every taxpayer for every taxation year, CRA must be selective. It conducts risk-based audits for select taxpayers and transactions it deems likely to be subject to non-compliance. The risk determination may include (i) the taxpayer's history of compliance (for example, does the taxpayer have a history of making errors); or (ii) the nature of the taxpayer's operational activities that raises the risk of transactions being mischaracterized or mistreated for tax purposes (for example, taxpayers with international operations).

In our recent C.D. Howe Institute paper, we explore incentives that CRA faces and some evidence on how CRA conducts audits, the time it takes CRA to conduct an audit, and the accuracy of CRA's reporting of the results of their audit efforts. The process matters, and it does affect the results. The ultimate taxpayer outcome includes the cost of reaching the end – in terms of time, dollars, and reputation – to the audited taxpayer, to the CRA, and to the country.

The importance of the audit process is self-evident. So is the need for high-quality audits. While audit outcomes are subject to appeals and court challenge, it is not desirable to rely frequently on appeals and the courts to ensure that the tax rules are fairly applied.

Building on earlier analysis, we note that incentives to increase assessments have been amplified by recent funding for the CRA that carries an expectation that additional tax revenues of $5 will be collected for each $1 spent, a "return" that is much higher than in the past. As well, additional tax revenues raised through taxpayer audit reassessments are explicitly linked to the CRA's measures of how much tax revenue theoretically exists versus how much is actually paid voluntarily (the tax gap).

Practitioners express concerns over poor CRA audit-process quality, suggesting the incentives facing CRA are having an adverse effect. The duration of CRA audits, the very high proportion of reassessments that are issued in the final two months of its fiscal year, and the rate at which reassessments are eventually ruled in the taxpayer's favour lend some evidence to the concerns over incentives.

We recommend calibrating the performance of CRA compliance activities to reduce emphasis on fiscal impact (an incomplete measure of revenues collected), and that fiscal impact be adjusted for final taxpayer assessment amounts, which does not occur at present. CRA has developed a measure of overall compliance and confidence that taxes will voluntarily be paid called, "validated risk," which can offset incentives arising from the emphasis on fiscal impact, and we recommend that this metric's use be expanded and emphasized.

And to the extent that fiscal impact continues to be used in some manner, it should be adjusted for subsequent reversals. While time lags can be long, estimates of an allowance for doubtful accounts already exists, suggesting that estimates, with subsequent adjustment, are at least plausible. Tracking of subsequent outcomes is also critical to informing risk assessments, audit selection, and field performance. The audit yield measure as discussed in a CRA report this year would be an alternative substitute for such an adjusted fiscal impact.

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