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FEBRUARY 11, 2011

Practitioners Testify to Flaws in Canadian Voluntary Disclosure Program

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Summary by taxanalysts

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Full Text Published by taxanalysts

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The House of Commons Standing Committee on Finance has held several hearings on offshore bank accounts following the October 2010 revelation by Canada's CBC News and *The Globe and Mail* that French authorities gave the Canada Revenue Agency a list of nearly 1,800 accounts held by Canadian citizens in HSBC Private Bank's Geneva branch. The account information was included in data purportedly stolen between 2006 and 2007 by Hervé Falciani, a French citizen and former information technology specialist at HSBC's Geneva branch who later fled to France. (For prior coverage, see *Doc 2010-21377* or *2010 WTD 190-2*.)

Canadian lawmakers expressed outrage over the possibility that many Canadians could be hiding money in offshore accounts, and the Canadian Parliament subsequently passed a resolution to hold hearings on how the government can strengthen its tax enforcement efforts. David H. Sohmer, a partner with Montreal law firm Spiegel Sohmer, and Scott D. Michel, a partner with Caplin & Drysdale in Washington, spoke with Tax Analysts about the testimony they provided to the committee.

Sohmer said he sought in his testimony to expose problems faced by taxpayers and practitioners with the CRA's voluntary disclosure program (VDP), which has been in place since 1973, and to highlight how friction between the federal government and Quebec may result in a loss of tax revenue. Sohmer noted that Canada doesn't have the political and economic leverage to adopt an aggressive U.S.-style approach to combating tax evasion.

"There's a tendency to thump all over the CRA by some Canadians who have fantasies about being like the IRS playing sheriff and beating up on UBS, scaring people into disclosing," Sohmer said. "The problem is that we just don't have that muscle -- our population is too small."

Sohmer said that because of Canada's relatively smaller size, it can't strike a balance, as the United States tries to do, between having an iron fist -- by going aggressively after offshore banks -- and offering a velvet glove in the form of a high-profile, special voluntary disclosure initiative. Rather, Canada must focus on improving the attractiveness of its VDP to encourage Canadians to come forward.

Sohmer noted that the VDP is designed in theory to provide for a predictable set of acceptable outcomes and that the VDP's terms are generous: Penalties are waived for a period of 10 years before the year in which relief is requested, and interest is reduced for years other than for the three years preceding the year of disclosure. "The problem is that the CRA doesn't practice what it preaches," Sohmer said, adding that the CRA gives tax officers substantial discretion in determining which years should be included in a disclosure.

"There is no statutory authority to provide relief from penalties for years other than the 10 years preceding the application for relief," Sohmer said. "So if a taxpayer gives them 20 years of records, they have no statutory authority to relieve years 11 through 20."

A far bigger problem with the VDP, Sohmer said, is Quebec's refusal to harmonize its own voluntary disclosure program with the CRA's. "Unlike in the United States, where state taxation is not a critical component to the federal government, in Canada the tax revenue is shared almost fifty-fifty between the federal authorities and the provinces," Sohmer explained. The federal government has a tax collection arrangement with all the provinces except Quebec, which has its own distinct individual and corporate income tax act. Quebec also has its own VDP and decided not to harmonize it with the federal government's VDP.

"Quebec's Ministry of Revenue insists on taxing an account's opening capital in year 6 as if it were income earned in year 6, despite the fact that there is no legislative authority for doing so," Sohmer said. "So where the portfolio has gone down in value, the tax on it can end up being confiscatory."

The result is that the federal government gets the short end of the stick, Sohmer said, adding that in one case he's handling now, the amount payable to the CRA is C $169,000, while the amount payable to the Quebec authorities is C $1.34 million. In another case, the amount payable to the CRA is C $44,000 and to Quebec is C $224,000. "Clearly that's not sustainable," he said.

Exacerbating the problem is that the so-called revenue rule, under which one sovereign state will not enforce the tax laws of another, can result in both Ottawa and Quebec getting the shorter end of the stick, Sohmer said. He explained that Canadians emigrate far more frequently to the United States than Americans do to Canada and that the revenue rule could prevent Canada and Quebec from collecting tax from emigrants when the tax liability arises under Canadian law because of an inheritance. He noted that Article XXVI A of the Canada-U.S. treaty (Assistance in Collection) is an exception to the revenue rule but that the provision likely doesn't apply to situations in which the tax liability of U.S.-resident children arises under Canadian law merely because of an inheritance.

"Both Ottawa and Quebec lose in that situation," he said. Even in situations in which a parent dies in Quebec and leaves his money to children who have moved to another province, it is arguable that the revenue rule would not allow Quebec to enforce its tax law in other provinces, Sohmer said.

"A failure to resolve the Quebec-Ottawa issue may result in a material reduction in potential tax revenue," he added.

"Ottawa is in a very difficult position, and I'm not sure this is something that can be handled legislatively," Sohmer said. "The Quebec-Ottawa problems have been with us for a long time. There are a lot of people who want to exploit this friction, and I think Quebec is exploiting this now."

However, with an election coming up, even the possibility of having billions of dollars repatriated to Canada by improving the voluntary disclosure process may not be enough to convince Ottawa to stir the pot and pick a fight with Quebec, Sohmer said.

A U.S. Perspective

Michel said he gave an overview of the U.S. government's ramped-up enforcement efforts in the last three years following revelations that employees of Swiss bank UBS helped U.S. clients hide assets in offshore accounts. Michel explained to the committee how the U.S. government "leveraged" the publicity from the UBS scandal to encourage more than 15,000 Americans with unreported offshore accounts to come forward through a special settlement initiative that offered reasonably certain, and capped, civil monetary penalties. (On the same day the hearing was held, the IRS announced details of a second special voluntary disclosure initiative. For prior coverage, see *Doc 2011-2714* and *2011 WTD 27-1* .)

Despite the extraordinary response to the IRS's special disclosure initiatives, Michel noted that the program did not run as smoothly as it could have, and he highlighted how the U.S. -- or any other country developing a disclosure program -- could design a more effective disclosure policy. He explained that a disclosure program should provide a clear path, without any sense of trickery or risk, for someone who has not been compliant to come forward and avoid criminal prosecution. Regarding liability for civil penalties, there should be a balance between a "one size fits all" approach and one that takes into account particular circumstances in a given case.

Michel added that once a taxpayer is accepted into the program, every effort should be made to process the matter efficiently and rapidly. Finally, any successful disclosure program should be combined with effective and highly publicized enforcement efforts, such as the U.S. Justice Department's prosecution of several UBS account holders and its pursuit of bankers, lawyers, accountants, and others associated with tax noncompliance.

Michel said that there seemed to be disagreement among the committee members on the benefits of having a voluntary disclosure program and that there were many back-and-forth questions as to where the government should draw the enforcement versus compliance line. "There were a couple of hard-liners who couldn't imagine why the tax authorities needed to exercise any degree of leniency, that if there was sufficient enforcement brought to bear, people would comply," he said. "And then there were people on the other side whose view was that yes, we should be enforcing the law, but if you don't provide people a clear way to come in, then you're going to lose on the compliance side."

"My sense of the room was that the leanings were more in the latter direction, that there was a recognition that you need to have a voluntary disclosure policy," Michel said.

Tax Analysts Information

Jurisdiction: Canada
Subject Areas: Compliance
Expatriate tax issues
Fraud, civil and criminal
Information reporting
Author: Parillo, Kristen A.
Institutional Author: Tax Analysts
Cross Reference: For prior coverage of the disclosure of HSBC account holders, see *Doc 2010-21377* or *2010 WTD 190-2*.
For prior coverage of the second IRS special disclosure initiative, see *Doc 2011-2714* and *2011 WTD 27-1*.
Tax Analysts Document Number: Doc 2011-2906
Tax Analysts Electronic Citation: 2011 WTD 29-3
