

Revenue Canada: How to avoid a Canadian tax audit

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The Canadian income tax deadline is just days away. Millions of Canadians are scrambling this weekend to complete their taxes online or on paper. Our federal and provincial tax systems depend on "self-assessment." That means taxpayers are trusted to be honest in their reporting income and deductible expenses, maintain accurate accounts, and keep those receipts up to seven years afterwards. To ensure taxpayer honesty, however, routine as well as 'red flag' tax audits are regularly conducted on Canadian individuals and companies.

CRA-ARC regularly reviews Canadian tax returns for mistakes - innocent or intentional

Most Canadians and corporations are truthful on their tax returns. However, the Canada Revenue Agency (CRA-ARC) Agence du Revenu du Canada knows that honest and dishonest mistakes occur. To catch these blunders - innocent or criminal - the federal tax department actively reviews and investigates taxpayers (see last week's story on Canadians convicted of tax evasion).

So how do you avoid a Canadian income tax audit?

It doesn't matter whether you NetFile your Canadian tax return or file it the old-fashioned way - on paper - some tax audits are impossible to dodge. The CRA-ARC annually conducts routine reviews of various industries, randomly choosing tax returns for more detailed examination. Most of these audits simply verify that Canadians are honestly completing their tax information.

However, 'red flag' audits focus on major blunders that taxpayers routinely make on their returns. These 'red flags' usually lead to a compliance tax audit for the worst offenders.

So what makes a 'bad' income tax return stand out.

The CRA-ARC computers matches millions of T-4 tax slips issued by all Canadian employers against employees' tax returns to ensure all income was declared.

For self-employed Canadians, a statistical scoring system compares entries, or the lack thereof, on their tax returns within industry standards. Too many discrepancies? The higher your score and better the chance your tax return will be pulled and investigated.

Now the feds are also using 'spiders' - software designed probe the Internet - to snare tax cheats. This web-crawling program probes e-commerce websites, building databases of web content and transactions to compare against tax records.

As a result, a small percentage of Canadian taxpayers will be hit with a compliance audit, which allows a CRA-ARC tax auditor to enter your home or business to demand detailed answers to their inquiries.

Want to avoid this situation? Don't wave red flags in front of the CRA-ARC bull!

Here are things that the Canadian tax agency tries to catch:

Overstating expenses and deductions

If you're self-employed and your overall expenses are huge - upwards of 60% - relative to income, you could easily be audited. Revenue Canada is also skeptical of major changes in your year-to-year returns. If your deductions suddenly drop or jump off the scale, the computer system will probably flag you.

And expect particular attention if your business seems to be going nowhere. No one aims to have several years of consecutive losses, but once you've hit three in a row, you should anticipate an assessment. Like your creditors, the CRA-ARC expects to see your company producing more income each year, while reducing your losses at the same time.

Underreported earnings

Cash industries are also always high on the appraisal list. Every year, certain businesses - construction, taxi, food-service and child-care, etc. - are targeted for additional scrutiny because it's just too easy for taxpayers to pocket money rather than declare it.

When the CRA-ARC embarks on such a review project, it audits a higher percentage of people within a set industry. Booming real estate markets in Alberta and agents' subsequent promotional and entertainment expenses have been on the watch list, for instance. So is the mushrooming home renovation business in many cities in Canada. If you work in these Canadian industries, chances of scrutiny are higher even if your own affairs are completely aboveboard.

Economic reality of your lifestyle

CRA-ARC has always looked at people's lifestyle when it suspected unreported income, but its assessment techniques are becoming increasingly sophisticated. For example, a postal code check will quickly highlight someone living in a neighbourhood they don't appear to afford. It's also now much easier to electronically cross-reference bank or credit records, property tax rolls, even vehicle and boat registrations to search for missing income.

Large charitable donations

No one objects to Canadians being generous. It's just that CRA-ARC wants to see actual dollars, not promises, change

hands. That's why they don't like dubious arrangements like this: As the donor, you put down a security deposit and receive a much larger loan from an outside financial agency. Then both the deposit and loan money are given to a charity in exchange for a tax receipt. In some cases, charities may get only a minimal amount of the money and the loan may not have to be paid back, despite the fact that you've already deducted it.

Revenue Canada hates this one and has won several court cases over the past year, disallowing all or part of the tax deduction for the loan costs.

Child care costs

Parents claiming child care expenses this year would be well-advised to double check their documentation. Aside from trying to catch the usual cash-only deals, the CRA-ARC is always on the lookout for parents trying to write off their own teenagers as babysitters (relatives have to be over 18 to qualify), piano, tennis, or singing lessons (the primary objective has to be the protection and security of the kids), or those trying to pad the numbers with ineligible camp and school costs. The newest wrinkle this year: Trying to deduct the costs of student bus passes that are actually provided free by the local school board.

Home office deductions

It seems every second person you meet these days claims to be working at home. This trend has not been lost on the tax authorities. They're coming down hard on those trying to write off too large a portion of home mortgage interest, maintenance and other personal costs. They're particularly interested in taxpayers who try to deduct their home office expenses without attaching the required T777 form.

Remember, since you're only allowed to deduct the business-related portion of your expenses, most home-office deductions should not exceed 15 - 20% of your home's overall square footage under usual circumstances.

If you are an honest Canadian taxpayer, a CRA-ARC tax audit should not be feared. Keep accurate books on hand to fully support any income and expenses you claim. Routine audits may actually catch mistakes in your favour. If you have been dishonest while filing your incomes taxes in Canada, however, you should be afraid of been audited. If you do receive notice of a Revenue Canada compliance audit, seek legal and accounting advice immediately to ensure you proceed correctly to minimize the impact of any innocent or intentional errors you have made completing your Canadian income tax return. It always pays to be honest!