



Economic Headwinds Increase Prospects of Tax Evasion: Criminal Offence Can Carry Draconian Penalties

by Ralph Cuervo-Lorens

Originally published in *Blaneys on Business* (June 2010) - [Read the entire newsletter](#)



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The following article is by Blaney McMurtry partner Ralph Cuervo-Lorens. Ralph is a national authority on tax evasion litigation and is co-author of the leading Canadian text on the subject, published by Carswell (Thomson-Reuters), the highly regarded legal publisher. Tax Evasion focuses on the management and defence of tax evasion charges at all levels. It has been cited by Canadian courts and is used by private and public tax advisors across Canada, including Canada Revenue Agency personnel.

The tax-reporting season has just come to a close for most Canadian businesses and residents. Millions of returns have been filed. Billions of dollars have been paid. And, in probably tens of thousands of cases, crimes have been committed in the process — to use the most common example, by “buyers,” who are required to pay tax, and by “sellers” who are required to charge tax, or by both.

Much of this crime will have been committed unwittingly. In many instances, the perpetrators will not be aware that they have engaged in a *Criminal Code* offence.

The criminal offence in question is tax evasion. Most ordinary people would consider some of it innocent... almost prankish at the small level. But, in the eyes of international, federal and provincial authorities, it is anything but. It is very serious business with serious consequences for the economy and in particular for the person who is caught. Everybody who is convicted of tax evasion will be subject to draconian penalties and is labelled a criminal for life.

Governments are always attuned to the possibility of tax evasion. They have been particularly sensitive to it in the last few years, however, because of the battering that the global economy has taken and the financial desperation to which this battering has led.

Every year, the Canada Revenue Agency (CRA) decides on the areas of business and commercial life that it will monitor specifically for tax evasion offences. The recent areas of focus are the underground economy, GST/HST payment compliance, contraband tobacco, and over-aggressive tax planning.

Despite the criminal nature of tax evasion, most of us have probably committed it. A recent CTV poll showed that 58 per cent of Canadians would accept an offer to evade taxes when buying goods or services (by paying cash and taking no receipt). A Gallup poll showed that 73 per cent of respondents said they would do so. And this is among otherwise law-abiding citizens. Simply put, tax evasion is the most widespread economic crime in the world.

What Exactly is Tax Evasion?

Tax evasion as defined in the *Income Tax Act* (ITA) is, broadly speaking, any wilful omission to pay tax (or, in the words of an old court case, “the intentional commission of a fraud on the public purse” through some affirmative act or omission that intends to evade or defeat a tax or the payment of a tax.) “Affirmative act(s) or omission(s)” are things such as deceit, subterfuge, camouflage, concealment, attempts to colour or obscure events or make things appear other than they are.

Some aspects of the offence worth noting are that intent is required for the offence to be proved. In addition, all related “conspiring” activity, whether active or passive, direct or indirect, is also considered tax evasion. And while no specific scheme need be proved, the common defence of “due diligence” is not available. There is effectively no limitation period. The CRA has the ability to prosecute no matter when the alleged offence was committed.

Tax evasion cases are limited only by human ingenuity. They can range from under-reporting income or failing to report income to failing to file, filing more than a year late if tax is owed, or failing to declare taxable income from any source.

The list can be very long: concealing sales or income, making false declarations on a return, failing to report income on questionable transactions, failing to accurately record retail sales tax, filing false GST returns as part of a scheme to obtain fraudulent GST refunds, destroying records, making deceptive statements or declarations, evading customs duty by under-invoicing and by mis-declaring quantity and product-description.

At a more mundane level, the list can include a retailer offering to let a customer pay cash and providing a false out-of-province address to avoid paying sales tax. It can also include an accountant who “saves” the client money by inflating business expenses, such as cost of goods, to lower the overall business tax owing.

Another favourite is lowering income by reporting only credit card sales and not cash transactions. A contractor “forgets” to report the \$10,000 in cash he receives for building a pool. A business owner tries to deduct \$100,000 of personal expenses in the calculation of his business taxes. A person falsely claims that she made charitable contributions, or she significantly overestimates the value of property donated to charity. The executor of a \$5 million estate files a tax return omitting property and claiming the estate is only worth \$100,000, thus owing much less in tax. Or the owner of a company who uses his corporate credit card to pay for family vacations and then deducts these “corporate” expenses on the company’s tax return and fails to report them on the owner’s personal income tax return as additional income...

Some common tax evasion *schemes* include the understatement or omission of gross revenues/receipts (including “skimming” money off the top of a sale and declaring only what is left); claiming fictitious or improper deductions (including the “padding” of expense accounts); false allocation of income (including diverting income onto the tax return of someone who had nothing to do with earning the money but who has a lower tax rate); improper claims, credits or exemptions (including fraudulent or bogus applications for tax benefits).

With regard to this last category, we read in the news not long ago about the troubles of Cinar Corp., the Quebec entertainment company. Cinar applied for, and received, nearly \$8 million in tax credits and Telefilm funding for a number of its productions. Unfortunately, these had been written by U.S. scriptwriters, which rendered them ineligible for the tax credits. The subsequent investigation disclosed that Cinar had asked a former employee to draw up “subcontracts” for the purpose of paying American writers. It was this employee who was credited as the lead writer on the application for the tax credits (No mention was made of the U.S. writers). The thought had been that citizenship was irrelevant in this context.

Many wondered what exactly was so wrong with what Cinar had done. One thing that was wrong was that it received a tax benefit to which it was not otherwise entitled under Canadian tax law. Obtaining a tax benefit through the use of misleading or incomplete information is to commit the criminal offence of tax evasion under Canadian tax law. Severe consequences can follow.

There is certainly nothing wrong with arranging one's personal or corporate tax affairs in the most advantageous manner possible. Tax avoidance (or tax mitigation) is therefore to be distinguished from tax evasion. Similarly, tax evasion is very different from civil non-compliance with the ITA, such as failing to pay taxes on time or claiming, through error or mis-allocation, a deduction (which may, of course, result in more or less tax payable).

Hefty consequences if convicted

The great majority of tax evasion cases referred for prosecution are, in fact, prosecuted. The CRA's 2009 prosecution statistics are impressive: 98 per cent conviction rate, \$29.2 million in fines, 81 years in jail terms.

The law wants to make sure that the CRA has every tool at its disposal to make a tax evader pay. If convicted, you have to pay the full amount of the tax owing plus interest. In addition, you will have to pay penalties as high as 50 per cent of the unpaid tax plus, in all likelihood, a fine of between 50 per cent and 200 per cent of the tax evaded. For good measure, a jail term of up to five years on top of the fines could also be part of the punishment.

Consider also that a conviction gives you a criminal record, which will follow you everywhere, and a permanent blight on your credit rating. And you become exposed to seizures, without notice, of assets, wages, RSPs and the like for as long as the tax, penalties or interest remain unpaid.

Common Defences

The procedure and rules of the criminal law and the *Criminal Code of Canada* apply to tax evasion. An accused taxpayer therefore benefits from the presumption of innocence as well as the right to silence and the possibility of invoking *Charter* rights.

There are also "factual" defences. The allegations can be refuted or there may be perfectly reasonable explanations or reconciliations that can be offered. Or a close review of the patterns and history of the matter by a forensic accountant could disprove that there was an intention to evade.

The more "legal" defences are built around proving that the required element of intent was not present, that mere negligence was involved, that reasonable reliance was placed on tax advisors, or that age or infirmity were determining factors.

There are also some "pre-emptive" defence approaches that can be taken, rather than defences proper. The most common is voluntary disclosure under CRA's Voluntary Disclosure Program. There are also so-called "tax amnesties" that rely on a favourable exercise of discretion by the Minister of National Revenue. But, as the saying goes, the best defence is really not to evade taxes at all.

The Globalization of the Financial World and Tax Evasion

As we have suggested above, times of financial crisis have led to more non-filing and more tax evasion. It has reached a point where the International Monetary Fund (IMF) and other international organizations such as the Organization for Economic Cooperation and Development (OECD) have come to refer to tax evasion as a multi billion dollar problem on a global and unprecedented scale. This in turn has led to a worldwide effort aimed at curbing aggressive tax planning in all its forms.

Some countries have approached the issue as one of civic responsibility: paying tax is a social responsibility, not just a burden to be minimized. Others have drawn linkages between paying taxes and good corporate citizenship and governance. In Quebec, to use one severe example, a tax avoidance transaction that complies with the letter of the law but which violates the spirit of the law is

now considered evasion. There are many other examples of this trend. At the corporate level, there are new requirements to certify corporate tax systems and controls working in tandem with new requirements to report “uncertain tax positions”. On the risk management side, we are seeing a trend toward tax risk management becoming an integral part of any enterprise’s overall risk management system.

Two recent manifestations of these trends have had impacts on Canada. One, involving the LGT Group (Liechtenstein) and UBS, both international banks known and valued for secrecy, has been dubbed “The End of Bank Secrecy.” After a series of complex legal proceedings as well as threats from their national governments, both banks were compelled to disclose customer data. And note that the case was originally brought by foreign authorities. Some of these customers were Canadian residents and taxpayers.

Another Canadian result involved the Royal Bank of Canada with its brokers being targeted. The allegation was that RBC helped clients set up offshore accounts which were to be used to hide worldwide income. The “informant” here was a former LGT employee who became a paid German government informant.

And this appears to be just the beginning of a sea change in the area of tax collection. There is a “harmful tax practices” initiative at the international level that seeks to put an end to preferential tax regime jurisdictions, or “tax havens,” such as the Turks and Caicos. In addition, investigations into such big scale sport franchises as European soccer teams as vehicles for tax evasion have begun. The internationalization of commerce and finance means that these kinds of developments will affect every major country.

The Impact of Technology

The recent and massive increases in e-commerce and self-employment, both made possible or greatly facilitated by advances in technology, have opened another tax evasion front. A celebrated case involving eBay is one example. In this case, a U.S. company was forced by a Canadian court order to release identifying information as well as sales details for its “PowerSellers” (who the CRA suspected were not reporting online income). The data that the Canadian court order forced into the open were held in servers located in the U.S.

There is also the increasing use of complex software of various types designed to enable or hide tax evasion. Some software that works with point-of-sale systems and electronic cash registers, particularly in the hospitality and entertainment industries, for example, is a growing problem.

One type, for instance, allows a business to run two sets of books at the same time. If a business wanted to declare only \$39.99 for every \$49.99 sale it made, for example, it would instruct the software to create one report of the \$49.99 sales and another of the \$39.99 sales and then use the \$39.99 report for tax purposes.

How might the CRA find out that the fraudulent report had been filed? It is often tipped off by former and often disgruntled employees of the business. ■