ASSOCIATION OF CERTIFIED FRAUD EXAMINERS
MONTREAL CHAPTER
SIXTH ANNUAL FRAUD CONFERENCE - MAY 12, 2000

TAX FRAUD AND *MENS REA* FORENSIC ACCOUNTING

by

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"Taxes are the price we pay for a civilized society".

United States Justice Oliver Wendell Holmes

1. INTRODUCTION

Three departments play a key role in administering the income tax system in Canada:

- Department of Finance — responsible for the formulation of tax policy and the introduction of new legislation;
- Canada Customs and Revenue Agency ("CCRA" or "the Department") — oversees the administration and enforcement of the tax laws; and
- Department of Justice — provides legal advisory services and litigation services to both Finance and CCRA.

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The three departments interact in a number of ways, from finding the appropriate treatment of specific tax cases to updating tax legislation and administrative practices.

CCRA and the Department of Justice interact through (a) tax cases that require a legal opinion, (b) cases appealed to the Tax Court of Canada, the Federal Court of Appeal or the Supreme Court of Canada, (c) settlement proposals and (d) discussions concerning adverse court decisions.

In his 1999 report, the Auditor General of Canada estimated the underground economy[1] at between 4.2% and 4.5% of Gross Domestic Product ("GDP") in 1993[2]. At 4.5% of GDP in 1997, the size of the underground economy would have amounted to $38 billion, translating into a loss of income and commodity tax revenues of $12 billion for that year alone ($7 billion at the federal level and $5 billion provincially). The Auditor General noted that documents in the possession of CCRA indicate that surveys carried out by various organizations from 1994 to 1997 show than an alarming number of Canadians would be willing to participate in the underground economy:

> "In December 1994, a CTV Television Network poll indicated that 58 percent of Canadians would accept an offer to evade taxes when buying goods or services. In March 1997, a Gallup poll found that 73 percent of respondents said they would do so. While not necessarily indicative of a trend, these survey results suggest that Revenue Canada needs to involve the Canadian public more in combating the underground economy."

In connection with the Department's new name, "Canada Customs and Revenue Agency", Diane Francis of the *National Post*, recalls receiving an e-mail from a CCRA spokesman after she wrote her article about tax cheating and the underground economy. The spokesman stated:

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(1) Defined in terms of the value of transactions in goods and services that are hidden and result in the evasion of taxes.

(2) This was in line with Statistics Canada's estimate of 4.2% of GDP for that year.

> "I noticed that in your text, you refer to Revenue Canada. On Nov. 1, 1999, Revenue Canada became the Canada Customs and Revenue Agency. Consequently, I am contacting those journalists who are still using the obsolete departmental title. We would appreciate if your future articles could reflect the correct title in order not to confuse the Canadian public".

Ms. Francis replied:[3]

> "So I e-mailed him back, why was the name changed? Who decided this was important? And how much did it cost taxpayers to change a name that need not have been changed?"

The Auditor General also noted that new trends, such as the recent growth in self-employment and the introduction of e-commerce[4] as a means of conducting business, will create even more opportunities to hide income from tax authorities.

To develop new or revised tax compliance and administrative policies and procedures related to e-commerce, the Department intends to consult with the private sector.

CCRA has implemented an "Underground Economy Initiative" to combat tax evasion in the underground economy. It comprises seven initiatives, the objective of which is "to ensure integrity and fairness of the voluntary tax system by addressing underground economy activity and tax evasion to ensure a level playing field"[5].

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(3) *Financial Post*, March 9, 2000.

(4) E-commerce can hide the reporting of transactions for both income and commodity tax purposes. It raises practical difficulties of ensuring compliance, given that evidence about the identity and location of parties to a transaction may be difficult to obtain and assess. Existing record-keeping and maintenance standards may not be sufficient to reflect electronic transactions. Revenue Canada may also have difficulty accessing encrypted evidence if it does not have a decryption key. E-commerce makes it very difficult to determine the source and nature of income.

(5) The expected effects of the Initiative are increased voluntary compliance, changes in Canadians' attitudes toward tax evasion and increased compliance in targeted sectors.

CCRA's Underground Economy Initiative was intended to increase the chance that unreported income would be detected, to enforce the payment of taxes from unreported income, to develop new activities to support taxpayers in meeting their tax responsibilities and to deter taxpayers from participating in the underground economy. During the past five years, to strengthen its resources to deal with the underground, the Department assigned a staff of 1,200 to implement this Initiative. Of these, 1,000 auditors are allocated to four targeted business sectors:

- Construction;
- Jewellery;
- Hospitality; and
- Automotive. [6]

In 1997-98, 63% of Underground Economy Initiative audits completed in these four sectors related to the construction sector.

The Auditor General has specifically recommended that the Department should reconsider its audit focus for the Underground Economy Initiative to include taxpayers in all sectors having a high risk of unreported income. He also suggested that the Department record and report (a) the additional gross income identified by its Underground Economy Initiative and non-Initiative enforcement activities, (b) the additional tax due on this unreported income and (c) how much of the reassessed additional taxes the Department actually collects. CCRA should also improve the

(6) In the U.S., there are nearly fifty IRS *Audit Technique Guides* containing examination techniques, common and unique industry issues, business practices, industry terminology and other information to assist IRS examiners in performing examinations. See Appendix D.

targeting and selection of income tax files to increase the effectiveness of its Underground Economy Initiative audit activities in identifying unreported income.[7]

In total, the tax impact attributable to the 1,000 staff assigned to the four targeted business sectors, income tax and GST audits over the last five years is approximately $500 million. However, the tax impact attributable to *unreported gross income* as result of the Initiative audits is much less than the $500 million reported.

Several countries now have legislation requiring the reporting of *cash* transactions over a certain amount. Canadian legislation currently requires recording of these transactions by banks, but not centralized reporting to an agency mandated to follow up on suspicious transactions. The reporting is helpful in discovering money-laundering activities and in tracking cash sales, which may result in unreported income for tax purposes.

In the words of *National Post*'s Diane Francis:

> "Welcome to tax evasion, Canadian-style.
>
> "This is a country where waiters always pocket tips without declaring them as income, and where small retailers routinely skim their tills in order to hide revenue from the taxman. It's where people brag about buying cigarettes or booze or electronic goods smuggled in through U.S. border points or Indian reservations.
>
> "These things go on all the time and with growing acceptance, despite the fact that they are all criminal acts.
>
> …
>
> "Paying a carpenter cash for home renovations means he can avoid remitting the sales taxes and GST to governments, and can afford to offer a discount.
>
> "Waiters, barbers, babysitters, mechanics and tradesmen of all descriptions readily accept cash under the table. Many have set up business to do just that. Some even

(7) For a good summary of the comprehensive enforcement process, see G.H. MacCracken, "Preventing Tax Evasion Through Enforcement: The Government Perspective", *Corporate Management Tax Conference*, Canadian Tax Foundation (Toronto: 1988), page 2:14.

> double-dip, collecting welfare, Workers' Compensation or Employment Insurance benefits while working for cash and hiding that income."[8]

Ms. Francis, who has not only written a series of articles, but a book[9] about cheating, also notes that it is not simply income tax and commodity tax that is evaded; there are those who defraud the government of Employment Insurance ("entitlement fraud").

She states:

> "There is absolutely no foolproof way — except by dramatically lowering taxes — that governments can stem the tax avoidance, tax evasion, and cancerous growth of the underground economy. Canada is in a precarious position. The world's longest undefended border, which we share with the United States, is a gigantic sieve through which contraband, cash, and tax anarchists pass hourly with total impugnity. But cross-border shopping, retirement south of the border, and smuggling are only part of the problem. Criminal rouses such as swaps, hiding assets, and over- or underinvoicing strategies can evade millions in a crack". *10* ,

Tax evasion not only affects the public treasury, but also, for example:

- Shareholders of a company;
- A company's trade and other creditors; and
- The spouse of a shareholder in matrimonial and/or other matters.

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(8) "They've created a nation of cheats", Tax Report 2000, *the Financial Post of National Post*, Toronto, Wednesday, March 1, 2000.

(9) *Underground Nation: The Secret Economy and the Future of Canada*, Key Porter Books Limited (Toronto: 1994).

(10) *Ibid*., page 19.

1.1 Tax Avoidance v. Tax Evasion

The distinction among tax evasion, tax avoidance and tax planning can be, and is, often difficult to draw. Tax avoidance is not a criminal offence. Taxpayers have the right to reduce, avoid or minimize their taxes by legitimate means. One who avoids tax does not conceal or misrepresent, but shapes and pre-plans events to reduce or eliminate tax liability within the perimeters of the law.[11]

Tax evasion involves a fraud on the public purse, through some affirmative act to evade or defeat a tax, or payment of tax. The types of offences by a taxpayer are referred to in subsection 239(1) of the *Income Tax Act*.[12] Examples of affirmative acts are deceit, subterfuge, camouflage, concealment, attempts to colour or obscure events, or make things appear other than the way they are (*simulacra*). Such schemes include:

- Understatement or omission of gross revenues/receipts (including skimming);
- Claiming fictitious or improper deductions (including padding);
- False allocation of income (including diverting); and
- Improper claims, credits or exemptions (including fraudulent or bogus entitlement applications).

Because tax evasion is a crime[13], the Crown has the obligation to establish, in addition to the *actus reus*, criminal intent beyond a reasonable doubt. The *actus reus* must be tied to the *mens*

(11) See W. Lefebvre, "Tax Avoidance — An Update", Meredith Memorial Lectures, 1990, Faculty of Law, McGill University, page 389; W.I. Innes, *Tax Evasion in Canada*, Carswell (Toronto: 1987).

(12) RS.C. 1985 c.1 (5th Supp.), as amended (the "Act").

(13) See *Thomson Newspapers Ltd. et al* v. *Director of Investigation and Research et al* [1990], 54 CCC (3d) 417; 1 SCR 425 and *R.* v. *McKinlay Transport Ltd*., [1990] 1 SCR 627; 55 CCC (3d) 50.

rea. Crown counsel must prove the existence of *mens rea* in court. Obviously, each case will be decided on its own facts, as noted in the *Redpath Industries* decision (*supra*). To prove or disprove the *mens rea*, counsel will generally rely upon the work of the Special Investigations' forensic accountant who will testify as to whether the taxpayer established a scheme to evade tax.

Before outlining the *mens rea* forensic accounting applicable to tax evasion, it would be useful to review the "badges of fraud" listed on Appendix B; they outline some of the methods used by tax evaders to suppress taxable income. One must keep in mind the distinction between "tax evasion" and "tax avoidance"; the former term includes the types of offences by a taxpayer referred to in subsection 239(1) of the Act.

The Ontario Court of Appeal referred to the tax evasion as follows in *Re Ramm*:

> " ... to make false or deceptive statements in a return ... is to commit a crime, and a serious crime, rather than to contravene a statutory law not originally regarded as criminal."[14]

Taxpayers should also mindful of the principle enunciated by Bergeron J. in *R.* v. *Redpath Industries Ltd. and Dominion Sugar Company Ltd.*:

> "In a tax evasion charge, it must appear *prima facie* from the evidence that the taxability is clear-cut, obvious, indisputable, unquestionable from lack of reporting, before entering the examination of the other facts of the charge, e.g., whether the undisputable taxability, based on income gained, proven and undeclared, leads to a conclusion beyond a reasonable doubt that it was wilfully omitted by a taxpayer in his tax returns."[15]

(14) [1958] OR 98 at 102.

(15) 84 DTC 6349 (Que. S.C., Criminal Division).

With respect to the offences contemplated in subsection 239(1) of the Act, the tax evader must be found to have guilty or evil intent (*mens rea*) before he or she may be convicted. That is, even though tax evasion may be a *malum prohibitum* type of crime, evidence of *mens rea* and *actus reus* must be proven by the Crown beyond a reasonable doubt.[16]

2. CCRA SPECIAL INVESTIGATIONS

This paper proposes to address, among other things, the gathering of evidence and data by CCRA's Special Investigations (SI) Agents (and the United States Internal Revenue Service's Criminal Investigation (CI) Special Agents, or "Accountants with Badges") the forensic accountants to demonstrate that there has been the omission or suppression of income that would otherwise be subject to tax and, further, that there is "guilty" knowledge on the part of the taxpayer. I shall also identify some of the defences advanced by the taxpayer's accounting expert.

The CCRA's *Tax Operations Manual* (No. 11) ("TOM"), a very comprehensive document, makes the following policy statements:

> **1111 OBJECTIVE AND GOALS**
>
> (1) The objective of Special Investigations is to plan and administer criminal investigation programs that will provide maximum deterrence to non-compliance by investigating, penalizing and recommending prosecution of significant cases in all categories of taxpayers for deliberate or wilful evasion practices.
>
> (2) Inherent in the objective are the following goals:
>
> (A) Recommending prosecution in all cases where a full-scale investigation has been carried out and the evidence accumulated indicates guilt beyond a reasonable doubt.

(16) See, also, Bruno J. Pateras, "Tax Evasion After the Charter", Meredith Memorial Lectures, 1990, Faculty of Law, McGill University, pages 442-449.

(B) Stem the infiltration of organized crime into our society through investigation of persons engaged in criminal activities.

(C) Maintain court prosecutions in the General and Special Enforcement programs by recommending prosecution of significant cases in all Districts in appropriate categories.

(D) Achieve and maintain a [deleted pursuant to Section 16(1)(b) of *Access to Information Act*] court prosecutions to non-prosecution cases.

(E) Continue to seek higher court fines and, where appropriate, imprisonment.

(F) Inform the public with respect to Special Investigations activities.

(G) Encourage referrals from other sections of the department by creating a co-operative working relationship.

1112 LEADS, CASE SELECTION AND DETERMINATION

(1) The success of the Special Investigations program is dependent on a continuing flow of leads. A significant proportion of leads to tax evasion should come from those engaged in the verification of tax returns and the examination of taxpayers records. Management in all Sections of Head Office and District Offices should instruct staff under their control to be on the alert for indications of wilful non-compliance with any of the Acts administered by the Department. They should ensure that all cases where criminal investigations may be warranted are referred to Special Investigations.

(2) Tax evasion is the commission or omission of an act knowingly, the conspiracy to commit such an act or the involvement in the accommodation of such an act, which can result in a charge being laid in the Criminal Court under subsections 239(1) and (2) of the Income Tax Act. It may be accomplished by one or a series of acts, transactions, schemes, arrangements, or devices, whereby the tax is reduced or completely evaded. It usually involves the deliberate omission of revenue, the fraudulent claiming of expenses or allowances, or the deliberate misrepresentation, concealment or withholding of material facts. Tax evasion can also be accomplished by failing to file tax returns.

(3) Only cases with a prosecution potential will be selected for full-scale investigation. The end results should be clearly taxable and not open to interpretation.

Some of the more relevant sections of the TOM are:

- Standards of case development;
- Document examination;
- Procurement, provision or exchange of information and documents;
- Law, evidence, court procedures and jurisprudence;
- Witnesses and exhibits;
- Reports and correspondence;
- Training aids and staff development;
- Preparation of special investigations reassessments reports;
- Guidelines for the Canada/U.S. simultaneous criminal investigation program;
- Leads, case selection and determination;
- Seizure of records;
- Publicity;
- Voluntary disclosures;
- Attempted bribe cases, threats, lawsuits, etc.
- Commendation letters, legal opinions from Department of Justice;
- Travel costs re arrest and return of tax evader by RCMP.

CCRA has also issued *Information Circular IC73-10R3*, entitled "Tax Evasion", dated February 13, 1987.

The tax investigators will examine the evidence so as to determine whether there has been an offence under subsection 239(1) of the Act. If the Crown proceeds by way of summary conviction under section 239, the taxpayer will be liable, if convicted, to a fine of 50% to 200% of the federal tax evaded, or a fine and a term of imprisonment not exceeding two years. However, because subsection 239(3) provides that a person who is convicted under section 239 is not liable to pay a penalty under either section 162 (late filing) or 163 (gross negligence) "unless the person was assessed for that penalty *before* the information or complaint giving rise to the conviction was laid or made" (emphasis added), CCRA can issue a *civil* assessment (or reassessment) *before* laying criminal charges, so as to not be prevented under subsection 239(3) from also levying civil penalties.

While the evidence is being gathered and organized, a list of potential witnesses is prepared along with a summary of their expected *viva voce* testimony and, where appropriate, forensic accounting procedures will be applied with a view to tracing, documenting and drafting a report as to the relevant transactions.

The courts have held that, when a case is put in the hands of SI, even if the statute is otherwise a regulatory one, the case at that moment becomes a criminal investigation.[17]

Special Investigations Branch may make an inquiry[18] authorized by section 231.4 of the Act. Such inquiry is an "investigative tool" in the criminal process; however, it is not normally implemented until the more conventional methods of investigation have been exhausted. In considering inquiries under section 231.4 of the Act, the Supreme Court of Canada considered a taxpayer's "safeguards" and "privacy" under the search and seizure provisions of the Charter.[19]

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(17) *The Queen* v. *Norway Insulation Inc.*, 95 DTC 5328 (Ont. Gen. Div.); *R.* v. *Harris*, 95 DTC 5653 (S.C.B.C.); *Re Yang and the Queen* (1996), 31 OR (3d) 66 (Ont. Gen. Div.).

(18) Subsection 231.4(3) of the Act and sections 4 to 8 of the *Inquiries Act*, R.S., c. 1-11.

(19) *Hunter* v. *Southam* [1984] 2 SCR 145; *R.* v. *Dyment* [1988] 2 SCR 417; and *R.* v. *Plant* [1993] 3 SCR 281.

With respect to the *actus reus*, the forensic accountant will also provide the necessary tools to demonstrate whether or not there was tax evasion or at least an attempt thereat. In this respect, the accountant will examine primary evidence including books of account and other accounting records of the taxpayer, third-party documents and the statements or representations obtained from potential witnesses.

Documentary forensic-accounting evidence is presented in court in two forms:

1. *Primary*, which includes individual accounting documents in original form, obtained directly from the taxpayer or other parties (such as suppliers); and

2. *Secondary*, which includes schedules, exhibits, summaries, graphs, charts, etc. which are based on the original source-documents.

While secondary evidence may not, in and of itself, be evidence, it has been admitted to assist the trier of fact in understanding the primary evidence. In my own experience in financial litigation, I prepare and file summaries and schedules in court based on primary source documents such as receipts, cancelled cheques, credit card vouchers, and so forth. Graphics are often prepared to assist the court in understanding the sales and profit trends of the business. Schedules of company credit card charges can be categorized into business and personal expenses over a period of years (vacation, travel, meals, golf club, home repairs, paintings, etc.).

While financial auditing may be intended to uncover departures from acceptable accounting and auditing standards and practises, forensic accounting (or fraud auditing) looks at substance over form and involves more analysis and intuition than straight financial auditing. For example, financial auditing considers materiality, but in tax-fraud auditing even a $5 transaction may uncover a pattern of possible evasion.

Corporate (commercial) fraud on the other hand, as opposed to tax evasion, often involves artificially *increasing* income rather than suppressing it. Employees who misappropriate funds, or the owner who attempts to portray a better financial picture for the bank or a possible purchaser, will tend to inflate sales and/or understate expenses. With tax evasion it is the opposite. The tax auditor will therefore review documents and make such inquiries as to ensure that sales are recorded and that purchases are *bona fide* and fully documented. As regards overhead expenses, the SI agent may communicate with third-party suppliers to ensure that there is a corresponding side to the alleged transaction. In simplest terms, a restaurant receipt for $120 would have a serial number reflected on the receipt or even the charge card slip. The SI accountant can go directly to the restaurant and request a copy of the serially pre-numbered original bill and compare it with the taxpayer's receipt.

There may, of course, be defences against CCRA's position. The allegations of the Special Investigations Branch can sometimes be refuted; there may be explanations or reconciliations. Sometimes the taxpayer's forensic accountants might reconstruct certain transactions to the satisfaction of the court, bringing forth the defences through expert evidence.

Once again, the burden of proof tax evasion cases is on the Crown. The forensic accountant can assist in proving (or disproving) the facts and whether there was an intention to evade taxes.

If CCRA is successful in having a taxpayer prosecuted for nondisclosure of income, the total liability could amount to significantly *more than the undeclared income* itself. For example, assuming that the undeclared *income* was $200,000, taxes, interest and penalties, in aggregate, could well exceed $300,000, as shown in the following schedule:

Federal income tax	$ 66,000
Quebec income tax	36,000
Penalties (civil) — Federal and Quebec	51,000
Interest thereon — say	81,000
Fine imposed for tax evasion (equals Federal income tax evaded)*	66,000
Total	$300,000

* Technically, under paragraph 239(1)(f) of the Act, the fine could be up to 200%.

Tax fraud is not limited to income tax evasion through undeclared income. It also includes that perpetrated by "entitlement fraudsters" concerning with respect to employment insurance, welfare and workers' compensation, as well as government incentive grant fraud such as that alleged by the RCMP to have been committed by certain executives of Cinar.

(Documents filed by the RCMP last month at the Quebec Court in Montreal contain allegations that Cinar Corp. of Montreal received nearly $8 million in tax credits for productions that were written by U.S. scriptwriters. More specifically, it is alleged that three directors of Cinar had asked a former employee who had worked for the company between 1990 and 1996 to draw up "subcontracts" for purposes of paying American writers; however, it was this former employee who had been credited as the lead writer on Cinar's application for tax credits.[20] The amount of provincial tax credits as well as funding from Telefilm Canada was nearly $8 million. The tax credit applications are alleged to have made no mention of the American writers who were paid by the Canadian employee credited as the lead writer on the tax credit applications.

Quite apart from these claims, there are also allegations that undisclosed related-party transactions include major renovations to the Westmount home of Cinar's co-founders/ controlling shareholders, as well as remuneration to their live-in nanny. Apart from securities-

(20) According to the *Financial Post* (of the *National Post*), April 15, 2000, the information was obtained after the RCMP and the Sûreté dû Québec raided the offices of the Société de développement des entreprises culturelles.

regulation concerns, how were these booked in Cinar's accounts: "repairs and maintenance" and "salaries", respectively, or "loans receivable — directors (shareholders)"?

2.1 SI Training

Head Office of CCRA maintains a library of slides, illustrating current fraud practices and the audit techniques giving rise to their detection. Use of the slides is very effective as a training supplement for new Investigators, staff on rotation, Field, Business and Basic File auditors, as well as staff in other Sections who have a responsibility to detect and develop leads to fraud. The slides are provided by Head Office personnel at any District Office, on request. Such requests come from the Chief of Audit or the responsible Section Chief in a District Office and are directed to the Chief, Investigation Services. Head Office also supplies packages of appropriate slides and case write-ups from its continuously updated library.

In order to achieve maximum effect, District Offices are requested to screen their cases on a continuing basis, to submit the names of cases on which overt action has been taken, which best illustrate how the fraud lead came about and how the pattern(s) of evasion followed. Most desirable are those which provide, or could have provide, the lead into a case during the original field audit and for which suitable documents for photographing or photocopying, preferably originals, are available.

Special Investigations has a training course which consists of thirty lessons and reading assignments.[21] It is geared toward all new SI staff members within the first six months of their assignment to the section. There is also a Special Investigations Initial Training Course, which is of ten days' duration, and given in the field (under the direction of Head Office personnel) to investigators who will have normally completed the above-noted self-study orientation training

(21) No. 1301.

course.[22] Moreover, there is an SI Advanced Training Course.[23] Its objective is to provide staff assigned to the Special Investigations Section with formalized in-depth training that will assist them in developing cases to meet prescribed standards and to present these cases in Court with a minimum of supervision. Eligibility for the Advanced Training Course is generally restricted to those SI staff members who have attended the Initial Training Course.

Where practical, on-the-job training includes attendance at Court by the Investigator in the capacity of a spectator, particularly in contested cases. This is intended to assist him or her, who may have little or no court experience, in preparing for the role as Crown Witness.

SI personnel also attend information sessions[24] which review and discuss updated current Departmental policies and procedures. This is for those who have completed at least four years of service in Special Investigations and who will, in all probability, remain in the section for some extended period of time.

CCRA has a "case complexity factor rating system", designed to measure the complexity of investigating tax evasion cases, to provide a basis for assignment of cases, and to facilitate planning of future staff requirements. When it is decided to open a Preliminary Investigation on a referral, it is preferably assigned to an Investigator of a grade and level who will satisfy the anticipated complexity of a resulting full-scale case. All known information which would contribute to the weight of the criminal factors is applied when assigning a Preliminary Investigation to avoid, as much as possible, any subsequent change to the complexity rating and required reassignment of, or other special arrangements for, the case.

TOM section 11(19)3.6 describes the Rating Guidelines and also outlines method of evasion, distinguishing among those which are classified as:

---

(22) No. 1302.

(23) No. 1304.

(24) No. 1305.

- Standard.
- Complex.
- Inter-company transactions.
- Precedent-setting scheme.
- Accommodation employed.
- International transactions, tax havens.

Based on this "point system", cases are assigned to investigative staff. The more points recorded, and the more of a "complexity rating", the higher the level of complexity (determined by "points" recorded) and therefor the higher the "assigned grade" of investigator.[25] A special form, TC20CR, entitled "Special Investigation Case Complexity Factor Rating", is used for such purpose.

3. THE IRS PROGRAMS

The U.S. Internal Revenue Service has two criminal investigation programs: (1) the General Enforcement Program, under which the identification and investigation of income tax evasion cases of substance, having prosecution potential, is a primary objective, and (2) the Special Enforcement Program, which encompasses the identification and investigation of that segment of the public which derives substantial income from illegal activities and violates the tax laws of other related statutes in contravention of the Internal Revenue laws.

(25) For example, based on points recorded on the T20CR form, 15 to 22 points would be assigned an AU 2 grade; if the complexity rating code indicates, say, 11, the assigned grade would be AU 1, whereas if the code were 44, the complexity rating would be AU 4.

The IRS' Criminal Investigation (CI) Division's most important duties are to foster voluntary compliance and act as a deterrent to persons who knowingly disregard this obligation.[26] The majority of these investigations involve white-collar financial crimes with emphasis on individuals who earn income from legal industries. General Tax Fraud Investigations encompass the broadest base of taxpayers and involve individuals from all facets of the U.S. economy.

The IRS has a Return Preparer Fraud Program[27] which levies civil penalties against unscrupulous and incompetent paid tax-return preparers, who claim excessive expenses, deductions, credits or exemptions on clients' returns. They may even manipulate income figures. In some cases the clients may not even have knowledge of the excessive amounts claimed. The *mens rea* relating to the tax-return preparer is to derive financial benefit from the fraud by:

- diverting a portion of the refund to himself or herself;
- increasing clientele by developing a reputation for obtaining large refunds for clients; and/or
- charging excessive fees.

The purpose of a Special Agent's investigation is to obtain facts and evidence. His/her primary aim is to determine whether the person under investigation has committed a criminal violation, and, if the facts disclose violations subject to criminal or civil penalties within the jurisdiction of the CI Division, to obtain whatever evidence is required to sustain criminal proceedings or the assertion of civil penalties. This require general planning. In this connection, the Special Agent is provided with the following guidelines:

(26) Chapter 3, Tax Crimes—General, Handbook 9.5, *The Investigative Process*, Section 3.2.6(3).

(27) *Investigative Process Handbook*, [9.5]3.2.11.

- The special agent should first determine what he/she is attempting to prove. This involves and an evaluation and analysis of the allegation to ascertain whether the available facts indicate a violation within Criminal Investigation Division jurisdiction and what evidence must be obtained to establish the elements of the crime. A work chart or other plan of procedure may then be developed. This essentially involves a determination of listing of information and evidence required and the probable source thereof.

- All criminal investigations should be commenced and concluded as expeditiously as possible. They should be conducted impartially and thoroughly to obtain all pertinent information and evidence. Duplication in investigations, unnecessary inconveniences to the public and unnecessary embarrassment to the taxpayer should be avoided. Appropriate courtesy should be shown when soliciting information.

- Investigations should be terminated when sufficient evidence to convict has been accumulated and there are no reasonable grounds to expect that further investigation may produce significant results in relation to the available evidence and to the additional investigative time and effort involved. The special agent will seek out all who are implicated in the crime and obtain definitive evidence as to their implication, to the extent reasonable. Investigations with less prosecution potential should be closed when there are insufficient resources in the foreseeable future for completing them and there are others of greater potential for development as substantial or flagrant criminal violations or having a greater deterrent potential.[28]

3.1 IRS CI Special Agents

Tax fraud was alleged by the U.S. Internal Revenue Service as early as 1919, in which year the Commissioner of Internal Revenue had six experienced Postal Inspectors transferred to the Bureau of Internal Revenue, thus establishing the first Special Agents in the Special Intelligence Unit.

As noted in Section 7.1 below, Al Capone, "Public Enemy Number One", was jailed for tax evasion in the U.S. back in 1931. Since then, other gangsters have been imprisoned on U.S. federal tax charges, including Godfather John Gotti of New York and crime boss Rocco Infelise of Chicago. Other notables convicted on tax evasion in the U.S. are former U.S. Vice-President

(28) IRS *Fraud Handbook*, Section 313.

Spiro Agnew, hotel owner Leona Helmsley, baseball stars Pete Rose and Darryl Strawberry, and television evangelist Jim Bakker.

In the words of the IRS:

> "Whenever greed leads to crime, from income tax evasion to international money laundering, you'll find an **INTERNAL REVENUE SERVICE SPECIAL AGENT** following the financial trail. IRS Criminal Investigation (CI) Special Agents or "Accountants with a Badge" are intensely involved in eliminating these money-related crimes. As duly sworn law enforcement officers, with accounting expertise, CI Special Agents investigate complex cases involving financial tax crimes, narcotics, organized crime, and public corruption".

As part of the IRS' CI Mission Statement, the IRS states that:

> "When individuals or corporations attempt to corrupt the American system of taxation through fraudulent or illegal activities, Criminal Investigation Special Agents step in to enforce the tax and money laundering laws. The fact is all income is taxable, even income obtained from defrauding the American people and the U.S. government or from illegal transactions."

A review of the Internal Revenue Service's Criminal Investigation Division was completed in April 1999 by the Honourable William H. Webster, who headed a task force which included, among others, Special Agents from the Secret Service, Customs, Alcohol Tobacco and Firearms as well as the Federal Bureau of Investigation (the "Webster Commission").

The CI Mission states that CI Special Agents have earned the distinguished title, "Accountants with Convictions".[29] Special Agents are supported by Tax Fraud Investigation Assistants.

In addition to the *Fraud Handbook*, the IRS has an extensive "Market Segment Specialization Program" as contained in the Program's *Audit Technique Guides*. These are listed in Appendix D

(29) Extracted from the IRS recruiting material.

and are available through the U.S. Government Information Sales Program, Government Printing Office, Washington, D.C. 20401.

The *Audit Technique Guides* outline the books and records the IRS agent might maintain, and highlight business practices in each of the selected industries. Many of these *Guides* point the IRS agent to the areas of potential unreported income, padding of expenses, non-compliance in respect of withholding-tax requirements, and so forth. For example, Chapter 1 of the *Pizza Restaurant Guide* is entitled "The Pizza Industry – Skimming, Cash Payroll, Cash Purchases". This *Guide* includes an "Initial Pizza Restaurant Information Document Request" as well as suggested questions for the initial interview with the owner.

The *Pizza Restaurant Guide* recommends that the IRS agent look specifically for the following:

- Personal living expenses well above reported income;
- Assets acquired possibly with skimmed receipts;
- Accumulation of funds in various bank accounts, with no reported income;
- A low gross profit percentage;
- Assets such as automobiles, personal residence, etc., which could be indications of unreported income;
- Other lavish expenses with no non-taxable sources of income.

A typical method — albeit indirect — used to reconstruct the gross receipts of a pizza restaurant is the "ingredient mark-up computation" (see Percentage Mark-up Method in Section 7.5 and Unit and Volume Methods in Section 7.6).

In *Maltese* v. *Commissioner*[30] the Tax Court ruled in favour of the IRS, where the taxpayer failed to keep adequate records for the pizza restaurant's sales, cost of sales and expenses. Not all of the restaurant's receipts were deposited and some of the expenses were paid in cash. The court found for the IRS, which had used supplier information to reconstruct the income. The IRS determined corrected gross receipts from the estimated number of pizzas which could be made from the amount of flour purchases during the years in question. However, because the IRS failed to compare the pizzas sold by the taxpayer with those sold by retail chains which provided the information on which the reconstruction was based, it was criticized by the court. The *Pizza Restaurant Audit Guide* therefore instructs IRS agents to support the application of the method by careful documentation of the quantity of flour the taxpayer would need to produce a given number of pizzas.

To further substantiate the ingredient mark-up computation, IRS examiners are asked to also consider applying a traditional indirect method, such as using the bank deposits, net worth or some other indirect method, to prove that the taxpayer is skimming the cash and the disposition of these funds.

The *Pizza Restaurant Audit Guide* also includes a section entitled, "Second Method of Determining Income/Proof of Skim":

> "Although the unit volume computation indicates the possibility of skimmed income, the use of another traditional indirect method would help to confirm the fact that the owner is skimming. Consider the use of an accepted indirect method of proof such as a bank deposit analysis, source and application, net worth or any other method to support the unit volume calculation. Attempt to look beyond the books and records. Consider factors such as the purchase of assets, the taxpayer's financial status, the lack of a salary or draw from the business, to determine which method should be used. … Coordinate with the Fraud Coordinator if the unit volume computation shows substantial amounts of unreported income and the disposition of the skimmed income can be documented.
>
> …

(30) TC Memo 1988-322.

> "Consideration should also be given to whether additional information can be gotten by contacting former employees. Usually, these individuals know exactly how the business was operated and may be helpful in identifying schemes used by the owner … .
>
> "If appropriate, the examiner can also go to a bank or banks near the taxpayer and ask the head teller if the taxpayer comes in and makes cash conversions. (Small bills into large denominations.)"

4. EXCHANGE OF INFORMATION

4.1 Province of Quebec

There is an agreement between the Minister of National Revenue and the Minister of Revenue of Quebec regarding the exchange of certain information.[31] The purpose of this agreement is to increase co-operation between the parties as to the administration of the income tax legislation for which each is responsible, by means of a greater exchange of information of mutual interest concerning any taxpayer. The agreement sets out certain information which is to be provided automatically, as distinct from that which will be requested on specific cases.

4.2 United States

Canada and the United States have a Simultaneous Criminal Investigation Program under which each country selects mutually acceptable cases for investigation. Both countries will then separately and simultaneously investigate the selected entities within their respective jurisdictions. There is no obligation on the part of either country to investigate all potential cases selected by the other country; each country can participate in whichever investigation it chooses. For those cases where a simultaneous criminal investigation is to be conducted, a letter will be

(31) Concluded August 24, 1988.

issued to the Chief of Special Investigations in the District Office concerned, delegating to him or her the authority to conduct the investigation.

Under the Program, each country conducts its own investigation separately, but will meet at regular intervals, or whenever necessary, to discuss the findings to-date and decide on appropriate courses of action, if appropriate. A copy of the minutes of these meetings is forwarded through channels to the Director General, Compliance Research and Investigations directorate. A CCRA representative from Head Office, Special Investigations Division, may be present at such meetings.[32]

All formal exchanges of information are conducted through the Competent Authority[33] under the *Canada-U.S. Income Tax Convention*. This does not preclude discussions or the examination of documents by either country; if copies of the documents are obtained, this must be formalized by a request through the Competent Authority.[34]

Where assistance is needed in the administration of the Act, the Department's policy is to use the RCMP on search actions in all areas where they have primary Criminal Code jurisdiction and on Special Enforcement Program search actions. When searches are planned, which are not covered under the above-noted circumstances, the District Office might seek the assistance of the police force which has primary Criminal Code jurisdiction in the area of the search action. Chiefs of Special Investigations may liase with local police chiefs within their districts, i.e., at the municipal level, to make the necessary arrangements.

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(32) TOM 11(22)3.5.

(33) Under Article III(1)(g). For Canada this is the Minister of National Revenue and for the U.S. it is the Secretary of the Treasury (or their respective representatives). For an analysis of the principal components of the Competent Authority process, see C. Lemelin and R. Deanehan, "The Competent Authority Process: A Canadian and U.S. Comparative Analysis" (1998), Vol. 46, No. 3, *Canadian Tax Journal*, page 657.

(34) TOM, Section 11(22)4.

5. ACCOUNTANT AND CLIENT PRIVILEGE

5.1 Canada

The Taxation Committee of the Canadian Institute of Chartered Accountants and CCRA's Assistant Deputy Minister, Policy and Systems Branch, had reached agreement on broad guidelines for the use of formal Requirements in obtaining information from professional accountants. CCRA does not recognize any right of privilege by accountants in relation to documents, or communications between the accountant and his or her client. Solicitor-client privilege will, however, be extended to copies of the lawyer's correspondence which are in the hands of the accountant or the client in all cases other than search and seizure situations. Where a search action is being carried out, the solicitor-client privilege will be recognized only with respect to documents in the possession of a lawyer pursuant to subsection 232(3) of the Act.

CCRA's guidelines *vis-à-vis* accountants are as follows:

> "(1) The Department will continue to request accountants to produce specific working papers for examination, when they are necessary to reconcile the clients' records or contain closing or balancing adjustments which are relevant to the Tax Returns. In such situations, these particular working papers are an extension of the clients' records and accountants will be expected to produce them, on request.
>
> "(2) In addition, the Department may request specific items of additional information from accountants for the proper completion of a field audit. However, it is not the policy of the Department to request access to accountants' working papers generally or to scrutinize them in the course of conducting a field audit.
>
> "(3) In cases of tax avoidance, information will be first obtained from the taxpayer. At the same time, information may be requested from the accountant, if it is felt that he has relevant knowledge or material. To the extent that such information is not produced or pertinent pieces seem to be missing, a formal Requirement under section 231.2 may be served upon the accountants.
>
> "(4) The following additional rules are set out for the guidance of Department staff:
>
> > "(A) Section 231.2 compels provision of information or production of documents. It does not authorize seizing of documents. Unless the accountant willingly agrees to surrender his files, workpapers and/or documents, or any

> records belonging to his client, they can only be seized and removed under authority of subsection 23.3(1). If copies only will be adequate for departmental purposes, they can be made under authority of subsection 231.5(1). In most cases it is prudent to make certified copies of pertinent items.
>
> "(B) Where a search on a taxpayer is being executed under subsection 231.3(1), his accountant(s) must be the subject of a separate warrant and, as indicated in TOM 1175.8(3)(a), the search of his premises will normally extend only to files and documents pertaining to the taxpayer whose affairs are under review.
>
> "(C) A formal Requirement under paragraph 231.2(1)(b) may also be served upon an accountant when the accountant's working files are necessary to reconcile the client's records or tax returns and cannot be obtained on a voluntary basis.
>
> "(5) In non-fraud cases, referred to Special Investigations for assistance, consideration should be given to whether the Requirement for production of the required information should be served on the taxpayer rather than on the accountant. The Chief of Special Investigations should be satisfied that the quantum in the file and the urgency of the information justify such action, before agreeing to the service of a Requirement on an accountant.
>
> "(6) An accountant's working papers and files are not to be used to quote the accountant's opinion to the taxpayer.'[35]

5.2 United States

There is no privilege between and accountant and a client under U.S. common law or federal law. While the accountant's working papers belong to the accountant, they are not privileged and must be produced. A taxpayer may be required by summons to produce an accountant's working papers in his/her possession; nor may an attorney refuse to produce working papers prepared by the taxpayer's accountant (other than those prepared at the attorney's request in connection with a pending investigation). However, an accountant employed by an attorney, or retained by a taxpayer at the attorney's request to perform services essential to the attorney-client relationship, may be covered by the attorney-client privilege.

(35) TOM, Section 11(11)3.6.

In 1998, the U.S. Congress added section 7525 to the *Internal Revenue Code*, creating an accountant/client privilege extending to tax advice (not tax return preparation). In a subsequent case before the U.S. Tax Court, *U.S.* v. *Richard Fredrick,*[36] the Seventh Circuit considered a number of issues, including whether an accountant's numerical information and working papers are eligible for privilege. The answer was "no". With respect to documents prepared by a taxpayer's lawyer or accountant in connection with an IRS audit, the Court held that these could be privileged only if they discuss statutory interpretations or case law. If, however, these documents relate to the calculation of the taxpayer's tax liability or the accuracy of the return that was filed, they are not privileged.

6. VOLUNTARY DISCLOSURES

6.1 Canada

Revenue Canada's policy with respect to voluntary disclosure is contained in *Information Circular 85-1R2*[37]. If the rules for making a voluntary disclosure are complied with, the taxpayer will be liable only for taxes and interest with respect to the amount(s) disclosed and will not be subject to late filing penalties and/or penalties for gross negligence and possible prosecution.

The policy applies to corporations and individuals making voluntary disclosures provided the following conditions are met:

> "a) Voluntary disclosure — The taxpayer has to initiate the voluntary disclosure. A disclosure is not considered to be voluntary if it arises when Revenue Canada, Taxation has begun audit or enforcement action.

(36) 99-1 USTC ¶50, 465, 83, AFTR 2d 1870, CA-7.

(37) *Voluntary Disclosures,* October 23, 1992. CCRA has also issued GST Memorandum 500-3-4, dated June 28, 1991, dealing with voluntary disclosures with respect to the Goods and Services Tax.

> "b) Verification — Each voluntary disclosure should include enough details to allow the facts to be verified.
>
> "c) Incomplete disclosure — If disclosure is voluntary but incomplete, the disclosed information will be considered voluntary. However, the taxpayer will be subject to penalties, prosecution, or other, relating to any substantial undisclosed amounts.
>
> "d) Payment — The taxpayer must pay the total amount of any taxes and interest owing, or make acceptable arranges for paying such amounts.
>
> "e) Procedure — A person can make a voluntary disclosure by contacting Revenue Canada, Taxation. That person will not need to make a detailed submission at the first contact. However, the taxpayer must do so within a period of time that is mutually agreed upon the initial contact will be considered to be the date of the voluntary disclosure."

6.2 United States

The IRS, similar to CCRA, has a voluntary disclose policy. It does not guarantee immunity from prosecution, but may result in no prosecution recommendation.

A voluntary disclosure occurs when the communication is:

- truthful;
- timely;
- complete;
- when the taxpayer shows a willingness to, and does in fact, co-operate with the IRS.[38]

As in Canada, a disclosure is "timely" if it is received before:

(38) See IRS District Director Pattern Letter 2527(p).

(a) the IRS initiated an inquiry that is likely to lead to the taxpayer, and the taxpayer is reasonably thought to be aware of that investigative activity, and

(b) some event known by the taxpayer occurred, which event is likely to cause an audit into the taxpayer's liabilities.

In this latter connection, CCRA's policy differs in that while the Department is not concerned why the taxpayer made the disclosure (provided it was not because of an imminent audit or an audit already in progress), if the disclosure is because an employee, business associate or spouse threatened to contact CCRA, it would still not preclude the disclosure from being considered voluntary by the Department.

7. PROVING UNDECLARED INCOME

The CCRA tax auditors are the "front-line troops" of enforcement; the next line includes agents of the Special Investigations branch.

The CCRA forensic accountant must gather relevant evidentiary documents, interview potential witnesses and piece together the elements that are necessary to prove that a crime was committed (i.e., tying the *actus reus* to the *mens rea*). Once the investigation is completed, a report is prepared containing a summary of the relevant facts, a list of potential witnesses interviewed and summaries of their "will say" statements, the cash/income flows charted, the chronology of events, exhibits, charts and schedules, as well as copies of related documents. The original documents are introduced at trial; copies thereof append the investigator's report.

Because *mens rea* relates to fraudulent intent, it must be demonstrated that there was a pattern of evasion sufficient to establish that it was not simply an oversight by the taxpayer. Often the taxpayer being investigated pretends that the isolated omission of certain income was due purely to an oversight; if, however, there is a pattern, then it is unlikely to be human error. Proof is

generally made by indirect or circumstantial evidence falling into one of the following two categories:

- Clandestine behaviour by the taxpayer, lacking credible or plausible explanation ("I won it gambling"!)[39]; and
- Repeated pattern of failing to report all income.

Five principal indirect[40] methods of proving unreported income are used by the Special Investigators and IRS Special Agents:[41]

1. Net Worth;
2. Expenditures;
3. Bank Deposits;
4. Percentage Mark-up; and
5. Units and Volumes.

In order to prove that a substantial amount of additional tax is due and that there was a wilful attempt to evade it, the correct taxable income in excess of that reported must be established. This is done by the direct approach (which involves proof of specific items relating to sales,

(39) See, however, *Dowling* v. *The Queen* [1996] 2 CTC 2340D (T.C.C.) and *Markowitz* v. *MNR*, 64 DTC 397 (T.A.B.).

(40) In this context, the term "indirect" means that the unreported income is estimated indirectly (imputed) and not by proving its receipt by the taxpayer.

(41) Richard M. Wise, "Forensic Valuations: Valuing a Business Without Accurate Financial Statements", International Appraisal Conference of the American Society of Appraisers (Houston, 1997).

expenses, etc.)[42] or the indirect approach (which is based upon circumstantial evidence relating to the taxpayer's income). With respect to the direct method, the Special Investigations auditor attempts to establish that the taxpayer's transactions during the taxation year were not accurately reflected in the income tax return, thereby wilfully understating the income tax liability.

The indirect methods are outlined below.

7.1 Indirect Method Assessments

The Net Worth Method was founded in the U.S. in 1931, in the celebrated case of *Capone* v. *United States.*[43] Al Capone was a Chicago racketeer who had built up a major bootlegging operation. He continuously and successfully evaded being indicted for any crime. U.S. President Herbert Hoover gave the go-ahead to the Government to convict "Public Enemy Number One". In a two-pronged attack, one branch of the U.S. government looked to indicting Capone on bootlegging charges, while another branch, the Internal Revenue Service, attempted to prove income tax evasion.[44] Capone had typically paid his expenses in cash, or had others pay for his expenditures. Capone's big mistake, however was that he left a highly visible trail: he acquired a large estate in Florida from brewer Clarence Busch. This provided the IRS with proof that Capone had unreported income, i.e., the illicit income from bootlegging, Capone's spending, notwithstanding that it was mainly in cash, provided the IRS and the Court with sufficient evidence of Capone's income. In 1931, Capone was convicted of tax evasion.

(42) Tax returns reflect income based on the specific item or specific transaction method, i.e., amounts booked.

(43) 51 F. 2d 609.

(44) Although the bootlegging revenue was illegal, an earlier U.S. Supreme Court decision, *United States* v. *Sullivan*, 274 US 259 (1927), ruled that illicit income was nonetheless subject to tax and had to be reported.

Years later, the U.S. Supreme Court accepted the proof offered by the IRS using the Net Worth Method in *Holland* v. *United States.*[45] The Court noted, however, that the Net Worth Method is "fraught with danger for the innocent" (listing some of these dangers), but concluded that the pitfalls inherent in the method do not preclude its use; rather a high degree of care should be exercised in its application.[46]

In Canada, the Department issued an arbitrary assessment with respect to another type of illicit operation, namely a call-girl operation.[47] In 1960, Ms. Eldridge, seven other call-girls and two telephone operators were convicted of conspiring to live from the avails of prostitution. The material seized by the Vancouver police conclusively established the guilt of the accused persons each of whom pleaded guilty to the charges laid against them and they were sentenced to varying terms of imprisonment. The records were obtained from the police by CCRA, which then "undertook an exhaustive and painstaking reconstruction of the respondents' [financial and fiscal] affairs". Such reconstruction formed the basis of notices of assessment being issued for taxes and penalties. The case makes interesting reading, as it goes into extensive detail of Ms. Eldridge's business affairs. While freely admitting that she was engaged in an illegal and illicit business, and agreeing with the Department's reconstruction of her gross income, Ms. Eldridge told the Court that "it was incongruous that the government should seek to live on the avails of prostitution"! Mr. Justice Cattanach retorted by referring to the words of Rowlatt, J. in *Mann* v. *Nash*[48]:

> "It is said again: 'Is the State coming forward to take a share of unlawful gains?' It is mere rhetoric. The State is doing nothing of the kind; they are taxing the individual with reference to certain facts. They are not partners; they are not principals in the

(45) 348 US 121.

(46) The U.S. Supreme Court considered three other cases that year (1954): *U.S.* v. *Calderon*, 348 US 160; *Smith* v. *U.S.*, 348 US 147; and *Freidberg* v. *U.S.*, 348 US 142.

(47) *MNR* v. *Olva Diana Eldridge*, 64 DTC 5338 (Exchequer Court).

(48) [1929-1932] 16 TC 523.

> illegality, or sharers in the illegality; they are merely taxing a man in respect of those resources. I think it is only rhetoric to say that they are sharing in his profits, and a piece of rhetoric which is perfectly useless for the solution of the question which I have to decide."

In the United States, Treasury Regulation 1.446 authorizes the IRS to compute income in accordance with whatever method clearly reflects income, in cases where the taxpayer maintains no records, or the financial records are inadequate and unreliable. The percentage or unit volume method has been considered an acceptable method of proving income in the U.S. Tax Court. Also, the Tax Court has allowed the use of third-party supplier records in ascertaining the cost of goods and the gross profit resulting from business activities where the records are inadequate.

7.2 Net Worth Method

The Net Worth Method is useful where:

- The taxpayer keeps no books or records;
- The taxpayer *does* keep books and records, but:
  - they are not available;
  - they are incomplete;
  - refuses to produce them;
- Another indirect method of proving income was applied, and the Net Worth Method is used to corroborate it.

In Canada, the Net Worth Method has been successfully applied by CCRA in *Dowling* v. *The Queen*[49] and *Moench* v. *Minister of National Revenue*.[50]

In order to establish the correct tax payable and uncover indications of tax fraud, it is sometimes necessary to determine the taxpayer's net worth (and that of the spouse and family members, if significant) at the beginning and end of the period under review, using the taxpayer's signed net worth as a guide, and to determine the reasonableness of the income reported on the individual income tax returns filed. This may require working backwards and forwards from submitted net worths.

In many cases, net worth discrepancies will be used as a basis for criminal tax prosecutions. Therefore, as much detail as possible is obtained for all assets and liabilities shown on statements filed.

Access to bank and brokerage accounts are arranged in accordance with regular audit procedure and photocopies are obtained and analyzed to determine living costs. If it is not apparent, the taxpayer is questioned as to the source of funds for living.

Audits of business operations, whether corporate or otherwise, are performed pursuant to regular auditing standards. Furthermore, the need for specific additional information is identified. Data gathering and analysis could include information regarding details of share ownership, volume and location of records, identity of larger customers and suppliers and details of transactions, details of shareholder's advance and loan accounts, examination of cancelled cheques and expense vouchers, etc.[51]

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(49) [1996] 2 CTC 2340D (T.C.C.).

(50) 67 DTC 127 (TAB). In the U.S., the leading cases authorizing use of the Net Worth Method by the IRS are *Holland* v. *U.S.*, 348 US 121, 54-2 USTC 9714; *Smith* v. *U.S.*, 348 US 147, 75 S.Ct. 194, 54-2 USTC 9715; and *Friedberg* v. *U.S.*, 348, US 142, 75 S.Ct. 138, 54-2 USTC 9713.

(51) TOM 11(20)5.3.

The typical calculation of net worth for purposes of income reconstruction is generally performed along the following lines:[52]

ANALYSIS OF NET WORTH*

	1992	1993	1994	1995	1996	1997
Net worth as of December 31	$550,000	$575,000	$600,000	$725,000	$818,000	$1,025,000
Annual change		25,000	25,000	125,000	93,000	207,000
Add living expenses		48,000	52,800	58,080	63,888	70,277
Less funds from known sources		(18,000)	(75,000)	(38,000)	(65,000)	(88,000)
Total funds from unknown sources		$55,000	$2,800	$145,080	$91,888	$189,277

* This analysis is a "summary". Appendix C reproduces a more detailed net worth analysis, extracted from the IRS material.

IRS Special Agents are told that, in preparing the net worth statement or summary for use in a criminal case, they should ensure that:

(a) It follows the taxpayer's method of accounting.

(b) The cost of assets and actual amount of liabilities are used. The value (such as market, reproduction, and the like) of these two items is not considered. Normally, unless the taxpayer agrees to the estimated amount, estimated non-deductible expenditures are eliminated from the net worth computation, although, in some cases, it has appeared proper to include some minimum estimated living expense figures.

(c) Good accounting principles are followed. For example, bank balances should be adjusted (reconciled) for outstanding cheques and cash (deposits) in transit.

(52) See H. Sharp, CPA, CFE, and G.P. Snodgrass, "Use of the Net Worth Method to Reconstruct Income", *Income Reconstruction: A Guide to Discovering Unreported Income*, American Institute of Certified Public Accountants (New York: 1999), page 11.

(d) Technical adjustments that increase income have been eliminated (for example, unintentional errors or omission relating to capitalized expenses, depreciation, revaluation of the basis of property, and changing inventory basis; or doubtful items such as unidentifiable commingled funds).

Typical defences to the Net Worth Method include:

- There was no "wilfulness" by the taxpayer;
- The SI agents have incorrectly calculated the opening net worth, and the closing net worth (which *may* be correct) merely includes the discovery of assets already owned (and not included in opening net worth);
- Increases in net worth are from non-taxable sources, such as gifts, loans and inheritances;
- The SI agents have used erroneous accounting procedures to calculate net worth;
- Inventories have been inadvertently overstated;
- The taxpayer is holding assets or funds as a nominee; and
- The opening net worth hand substantial cash on hand which CCRA failed to consider.

In this last connection, where the taxpayer alleges that he or she had substantial cash on hand which the SI agents did not consider, the questioning may be along the following lines:

- How much cash was there on hand, physically (and not in banks) at the beginning and end of each relevant year?

- How much cash was there on hand at the date of the interview?
- What were the sources of cash referred to above?
- Where was the cash kept?
- Who knew about the cash?
- Did anyone ever count it?
- On what was any cash spent?
- When?
- Are any records available with respect to the cash alleged to be on hand?
- What were the denominations of the cash on hand, big bills or small bills?[53]

7.3 Expenditures Method

This method considers the taxpayer's annual expenditures — instead of increases in net worth — to determine income for tax purposes. However the Department nonetheless must determine, with reasonable certainty, the taxpayer's opening net worth. As noted in the excerpt from the judgment below, the court, in a divorce case, was satisfied that the husband had income far greater than that reported on his tax return, due to his lavish lifestyle (paid for by the company).

The Expenditures Method is very similar to the Net Worth Method in that the relationships among income, personal expenditures and increases/decreases in the taxpayer's assets are the same under both methods.[54]

(53) See IRS *Investigative Process Handbook*, Chapter 9, for commentary concerning CI agents of the IRS.

(54) As with the Net Worth Method, there is no statutory provision expressly authorizing use of the Expenditures Method; however, there are a number of cases in which the U.S. courts have approved the use thereof.

The Expenditures Method is based on the theory that if the taxpayer's expenditures during a given year exceed reported income, and the source of such expenditures is unexplained, it may be inferred that such expenditures represent unreported income. The similarity is further indicated by the fact that the same items or accounts used in determining taxable income by the Net Worth Method are also considered when the Expenditures Method is employed.

Appendix C gives an example of the calculation of undeclared income using the Expenditures Method.

Taxpayers have attempted to defend against this indirect method by advancing similar arguments to those in net worth cases outlined above. Because the Expenditures Method is not quite as thorough as the Net Worth Method, the latter is generally preferred.

In 1996, the U.S. Internal Revenue Service began using a new auditing approach called "financial status" (previously called "economic reality") auditing for purposes of uncovering unreported income. This involves interviews by IRS agents of the taxpayer (or often his accountant).[55] For the last few years, the IRS has been equipping and training its field agents to perform their examination of tax returns in such a manner as to ensure that the return reflects the economic reality or financial status of the taxpayer, as evidenced by his or her lifestyle.

7.4 Bank Deposits Method

Applying this indirect method, the presumption is that all bank deposits and cash expenditures arise from taxable sources except as shown to be otherwise (e.g., gifts, loan repayments, lottery winnings, liquidation of assets, etc.). The opening cash on hand must be determined at the very outset. Where large, single items are concerned, the tax auditors may apply the "specific item"

(55) The IRS had agreed with the AICPA that the agents could work exclusively with the taxpayer's CPA who has a power of attorney and it would not be necessary to interview the taxpayer. See James L. Craig, Jr., "Guidance on Financial Status Audits: It's Not Just for CPAs", *CPA Journal*, New York State Society of Certified Public Accountants, July 1996.

method, by identifying the specific items such as a real-estate sale, etc. Where the proceeds are material, the failure to report them would be tax evasion. As the Department must establish that the deposits reflect *current* income, it must therefore show that the taxpayer was engaged in an income-producing business, that he or she made periodic deposits in his/her bank, that such deposits have been analyzed to eliminate non-income items and/or income items which may be duplications of amounts actually accounted for and reported (or amounts which have been earned in prior years). The analysis may indicate that certain withdrawals from the bank account represent business expenses. The Bank Deposits Method has been approved by the court in Canada[56] as well as in the U.S. courts. In *Gleckman* v. *United States*[57], a 1935 decision, the court stated:

> "If it be shown that a man has a business or calling of a lucrative nature and is constantly, day by day and month by month, receiving monies and depositing them to his account and checking against them for his own use, there is most potent testimony that he has income, and, if the amount exceeds exemptions and deductions, that the income is taxable.
>
> " … the bank deposits and large items of receipts by Mr. Gleckman do not, therefore, stand entirely alone as the sole proof of the existence of a tax due from him, but they are identified with business carried on by him and so, are sufficiently shown to be of a taxable nature."

The main defence in bank deposits cases (other than lack of *mens rea*) is that the spasmodic nature or unconventional amounts of the deposits indicate that prior accumulated funds, not current receipts, are involved; that the deposits reflect, in whole or in substantial part, non-income items, income items attributable to other years, or duplication of current income items already accounted for by the taxpayer.

(56) *Zaconi* v. *MNR*, 71 DTC 521 (T.A.B.) and *Estate Booher* v. *MNR*, 71 DTC 620.

(57) 80 F. 2d 394 (8th Cir. 1935).

The proof as to the cash a taxpayer had on hand at the beginning of the taxation year in question is relevant to the Bank Deposits Method to prove income. If the deposits or expenditures are from funds accumulated in prior years, they do not represent current income items.

The general formula for determining taxable income using the Bank Deposits Method, for a taxpayer whose only source of income is from a business, may be summarized as follows:

Total deposits*	$ -
ADD: Payments made in cash**	$ -
Subtotal	$ -
LESS: Non-income deposits and items (loans, gifts, transfers, etc.)	$ -
Total receipts	$ -
LESS: Business expenses and costs	$ -
Net income from the business	$ -
LESS: Deductions and exemptions	$ -
Taxable income	$ -

* If the taxpayer lists cheques on the deposit slip but deducts an amount withdrawn by him/her in cash, only the net amount of the deposit is used in computing total deposits.

** All substantiated payments made in cash (including business expenses, personal expenses, capital expenditures, etc.) are added to total bank deposits. As adjustments will subsequently be made for non-income deposits and items, it is immaterial whether the cash used was derived from a taxable or non-taxable source.

A more detailed computation of undeclared income is found in Appendix C.

7.5 Percentage Mark-up Method

This method is used when the other more "traditional" methods of proving income are not possible. Under this method, which is used mainly in connection with retail operations, the income statement is restructured using mark-ups, mark-downs, gross profit percentages, etc. based on industry "averages". The taxpayer's own records such as price list, sales invoices,

purchase invoices, freight in and customs duties, etc. are reviewed and percentage mark-ups calculated where such documents provide a reasonable basis (and are authentic, i.e., not doctored).

Because of the subjectivity involved with respect to factors considered by the SI agent, such as specific type of merchandise involved, the geographic location, the size of the taxpayer's operation, the relevant period, merchandising policy, etc., it may be difficult to prove with any high degree of accuracy what the real income of the operation is.

7.6 Unit and Volume Methods

Determining, or verifying, the gross receipts of a business can sometimes be done by multiplying the number of units sold by the selling price per unit. If this can be done with reasonable accuracy, the gross profit margin can then be applied to determine the gross profit of the business before overhead expenses. Determining the number of units sold is generally geared to some performance function, i.e., gallons consumed, garments made, etc.

With respect to a bar operation, for example, the investigator would obtain copies of purchase invoices from the liquor board and, based on the establishment's posted prices for the drinks and estimated volume consumed, a sales figure could be reconstructed. These types of calculations are described in detail in the IRS Market Segment Specialization Program (see Appendix D). A good example relates to the investigation of a pizza operation.[58]

Interestingly, some of the method used to reconstruct a taxpayer's business income are those applied by professional accountants and business valuators in determining damages for lost

(58) See also Richard M. Wise, "Forensic lunch: Unravelling the sandwich caper", *The Bottom Line*, Butterworths (Toronto: April 1994), page 15.

profits. That is, "but for" the alleged actions of the defendant, what would the business income of the plaintiff have been?[59]

8. DEVELOPMENT OF FRAUD

Under the guidelines in the TOM, the CCRA investigator is requested to briefly state the source of the lead (another case, third-party records, assessing, etc.) and describe the following details encountered by the Departmental officer, if applicable:

- Why he/she was on the premises.
- What he/she found.
- Where it was found.
- Why it attracted his/her attention.
- What he/she did with it.
- Any other information considered of potential value for lead development in other Districts.[60]

The investigator is requested to outline the steps taken to date, the results achieved and any apparent pattern of fraud. If there appears to be tax fraud, the investigator will set out and summarize, by year, the quantum of the fraud. The supporting narrative describing the fraud practices are given particular attention, with emphasis on evidence of wilful intent. If photocopies of documents relating to the fraud are available to help clarify the transactions involved, they will accompany the Prosecution Report.

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(59) See, for example, Richard M. Wise, "Quantification of Economic Damages", *The Journal of Business Valuation*, Proceedings of the Fourth Joint Business Valuation Conference of The Canadian Institute of Chartered Business Valuators and the American Society of Appraisers, Montreal, September 24 and 25, 1998 (Carswell), pages 361 to 412.

(60) TOM 11(16)5.8.

Section 11(16)8.4(6) of the TOM summarizes the Department's policy with respect to the calculation of the taxes evaded:

> "This is one of the key sections of the main body of the Prosecution Report. In order to secure a conviction in tax evasion cases, it is necessary to prove to the Court the *mens rea* of the taxpayer in the fraudulent practices. Accordingly, the evidence that illustrates the taxpayer's wilful intent should be drawn to the reader's attention. All points noted to be pertinent to establishing *mens rea* should be listed and related.
>
> "The general rule is that the net unreported income, after allowing all unclaimed expenses relating to or paid with the unreported income, must be added to the income or loss initially assessed and taxes on this revised figure should then be calculated. The tax initially assessed should be deducted from such taxes, the difference being the tax sought to be evaded. However, any allowable expenses paid out of the unreported income may be claimed, as well as any increase in an elective claim which relates to the unreported income.
>
> "There are however special rules:
>
> - If the taxpayer was attempting to evade taxes in the year in which the Department took its overt action, the Department could consider prosecuting on this tax sought to be evaded, even though the taxpayer files a correct tax return later.
> - Unclaimed capital cost allowance and reserves, that are elective in nature and defer income indefinitely, should not reduce income for purposes of calculating tax sought to be evaded, unless they are related to the fraud recommended for prosecution.
> - Claims which are not elective in nature, such as general averaging, should be allowed when applicable.
> - If there is suppressed income in a loss year and the loss, or a portion thereof, had as such been applied improperly to reduce taxes in other taxation years, the tax sought to be evaded should include the taxes saved by the taxpayer in all those taxation years. Similarly, if the addition of suppressed income results in the disallowance of the small business deduction in other taxation years, the tax sought to be evaded should include the taxes saved by the taxpayer in the other taxation years where the small business deduction was improperly claimed.
> - A loss carryback, if outside the prosecution period, should not be allowed to reduce tax evaded for prosecution.[61]

(61) For example, if the prosecution period is 1995 to 1997, a 1998 loss would not be carried back to 1997 in the calculation of tax sought to be evaded.

- In the case of an accommodater, the tax that was sought to be evaded should be limited to the transaction in which he or she has knowingly participated. This would include, if the accommodation involved a corporation, both the corporation taxes and the taxes, if any, resulting from appropriations effected by the accommodation."

The following example helps to explain the foregoing:

EXAMPLE FROM TOM

CALCULATION OF TAX SOUGHT TO BE EVADED

CORPORATIONS

		TAXATION YEARS			
		1994	**1995**	**1996**	**1997**
Net income initially assessed (loss)		$10,000	$(35,000)	$15,000	$16,000
DEDUCT: Losses applied		(10,000)	35,000	(15,000)	(10,000)
Taxable income		NIL	NIL	NIL	6,000
Tax assessed	(A)	NIL	NIL	NIL	1,500
Net income (loss) initially assessed		10,000	(35,000)	15,000	16,000
ADD: Unreported Income		8,000	19,000	25,000	20,000
Revised net income (loss)		18,000	(16,000)	40,000	36,000
DEDUCT: Losses applied		(16,000)	16,000	NIL	NIL
Revised Taxable Income		2,000	NIL	40,000	36,000
Revised Tax payable	(B)	500	NIL	10,000	9,000
Tax assessed	(A)	NIL	NIL	NIL	1,500
Tax evaded in the period	(B) – (A)	500	NIL	10,000	7,500

NOTES: — a straight 25% tax rate was used in this example.
— by applying CCRA's "Best Case Concept" theory, the 1994 taxation year would be excluded from the prosecution period.

9. COLLECTING TAXES

9.1 Collection — Jeopardy Assessments

Special Investigations also work closely with the Collection Department to ensure that losses from taxpayers under investigation are minimized. As a taxpayer is normally interviewed and questioned during the course of an investigation, investigators are required to take every opportunity to urge payment on account of the overdue tax liability.

Immediate collection action on assessment is described as "jeopardy assessments".[62] Normally, the recommendation by Special Investigations to invoke the relevant provisions of subsection 225.2 of the Act is foreseeable and considered for some time prior to the date on which the collection action is sought. If a taxpayer is about to leave Canada, section 226 may apply, pursuant to which the taxes, interest and penalties of the taxpayer for the *current* taxation year, which normally would not be able to be arbitrarily assessed before the date the return was due to be filed, can be demanded and assets seized. In other words, the Department may demand the tax liability for the current year of departure even though the due date for filing and payment has not yet even arrived.[63]

When CCRA refers a matter to the Department of Justice and recommends prosecution, it will convey the following information:

- The taxpayer(s) investigated, the years involved and the identification of the related business(es);
- What the taxpayer has done, including the methods used and the amounts involved;

(62) Subsection 225.2(2) of the Act.

(63) Subsection 226(1) and TOM 11(11)9.1(10).

- *Mens rea*, covering the points mentioned in the Prosecution Report, so that a reader of the referral letter will have a complete understanding of this important aspect of the case;
- Any others involved in the fraud practices;
- Federal tax taken to court;
- Recommendation as to charges that should be laid (but not for a specific course of action, e.g., indictment proceedings or jail sentences);
- Taxpayer's representations and significant health conditions;
- Status of account, including (as obtained from the Collections Division):
  - Amount of assessment or reassessment;
  - Amount collected;
  - Balance outstanding and change from initial amount;
  - Enforcement actions taken to date;
  - Anticipated problems;
  - Other pertinent data affecting payment of the account.[64]

(64) Immediately prior to the date of sentencing, the foregoing information is updated for the Department's counsel, who may use it in speaking to the amount of the fine or the length of the jail sentence. The referral letter is signed by the District Director, after the prosecution case receives a quality review by Head Office personnel.

9.2 Prosecution Report

The Prosecution Report[65] sets out concisely the alleged offence and the section and subsections of the Act that have been violated. This is expressed in simple, non-legal, layman's terms, so that the reader can quickly grasp the proposition that must be proved. While this might be used by the Crown as the basis for a charge, no attempt is made to draft the charge itself.

When a corporation and shareholders are involved, there is normally one charge (global) against both parties jointly under paragraph 239(1)(d) of the Act. There will also be one charge (global) under this provision against the shareholder, personally, for the evasion of tax on appropriations and on the omission of other income. Charges under paragraph 239(1)(a) for each taxation year involved are laid against the individual in respect of his or her own returns and, if applicable, against the corporation and the shareholder in respect of the corporation's returns.[66]

The agent lists (with respect to each return that will be entered into evidence) the type of return involved, the date and place of filing, who signed it, the income reported and assessed, and the amount of tax previously assessed.

The Prosecution Report contains a case outline as to the type of fraud uncovered in the years under investigation. For example, if there were suppression of sales and inflated costs, this section would show the extent and quantum of each, together with a brief description of how the fraud was accomplished.

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(65) Part "B".

(66) It is recognized that, in certain cases, there will be exceptions, where charges under other paragraphs are warranted.

9.3 Prosecution Publicity Report

The Department publicizes prosecution results. It has a Communications Directorate and a District Office public affairs officer.

The Communications Directorate and Head Office Special Investigations Division are provided with a report setting out the details of all publicity obtained on the prosecution, including copies of newspaper coverage, listings of television and radio coverage and any other media coverage, as well as details of all publicity obtained on interviews. This report also includes the estimated number of hours required to monitor publicity, broken down by hours spent on preparing and disseminating publicity on the case and hours spent on checking for publicity emanating from other District Offices.

10. CONCLUSION

In closing, I note the words of Mr. Justice Cory, a few months after the *Thomson* and *McKinlay*[67] decisions, in a majority judgment in *Knox Contracting Limited* v. *R.*[68]:

> "Section 231.3 provides for the issuance of search warrants where they may afford evidence of an 'offence' under the Act. Section 239 describes those offences. They are by their very nature criminal. Upon reading s. 239 the key descriptive words spring from the page, such as: 'false or deceptive statements', 'to evade payment of a tax imposed by this act, destroyed, altered, mutilated, secreted […] records', 'false or deceptive entries' and 'wilfully … evaded'. The section speaks of fraud, deception, destruction and alteration of documents, false statements, false documents and the wilfull evasion of income tax.

(67) *Supra*, footnote 13.

(68) [1990] 2 SCR 338.

> "It is readily apparent that those who commit these offences have deliberately committed acts which by their very nature come well within the definition of what constitutes criminal law. The offences described in s. 239 are 'clearly harmful to the State'. The fact that these offences may be prosecuted upon indictment and that terms of imprisonment of up to 5 years may be imposed serves to further strengthen the conclusion that these offences are criminal in nature.
>
> "The criminal nature of making false or deceptive statements on income tax returns has long been recognized."[69]

Mr. Justice Cory concludes:

> "It is fitting and appropriate that the s. 239 offences be considered as criminal law."[70]
>
> …
>
> "The entire system of levying and collecting income tax is dependent upon the integrity of the taxpayer in report and assessing income. If the system is to work, the returns must be honestly completed. All taxpayers have the right to know that it is a criminal violation to commit any of the offences described in s. 239. The Act imposes a public duty. A breach of that fundamentally important public duty should constitute a criminal offence."[71]

(69) *Ibid*., at 348-349.

(70) *Ibid*., at 349.

(71) *Ibid*., at 350.