How to avoid a tax audit

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The Canadian tax system relies upon self-assessment, which means, essentially, that you're trusted to be honest in your reporting, maintain good books, and hang on to the records needed to support your claim. And most people do just that.

Every year though, the Canada Revenue Agency (CRA) circulates an internal list of the major gaffes, intentional or otherwise, that taxpayers typically make on their returns. These ‛red flags' serve as the foundation of their review process, generally leading to an audit for the most offensive.

How does CRA single out the worst offenders? Well, its tax slip matching program tracks a couple of million T-4 slips issued by employers against employees' tax returns, to make sure the income was declared.

For the self-employed, it uses a statistical scoring system that compares the entries, or even the lack of them, on your return with what it expects to see. The greater the discrepancies, the higher your score and the better the chance you'll be investigated. And it's going one step further this year, testing a software program known as a "spider" that's designed to trawl the Internet searching for tax cheats.

The web crawling program, originally designed by Dutch tax authorities, sifts through e-commerce hubs such as gambling, auction and porn sites. It works by downloading a web page and its links, thus creating datasets of web content and transactions which the spider matches with information in various databases and tax records.

All of which means that a small percentage of taxpayers will pop up on the CRA's radar-screen, and be hit with a compliance audit, during which an auditor has the right to enter your business and demand that you answer his or her pointed questions.
Don't want to be among them? Then clearly it pays to avoid waving any red flags in CRA's face. Here are some of the items that the Agency typically watches for.

Overstated deductions

If you're self-employed and your overall deductions are huge – say, 60% – relative to income, you could easily be audited. The Agency is also skeptical of major changes in your year-to-year returns. If your expenses suddenly drop or jump off the scale, the system will probably flag you. And expect particular attention if your business seems to be going nowhere. No one sets out to have several years of consecutive losses, but once you've hit three, you should anticipate a query. Like your creditors, the CRA expects to see you generating more income each year, trimming your losses at the same time.

Underreported earnings

Cash businesses are also always high on the list. Each year, certain sets of taxpayers – construction, taxi, food-service and child-care workers have been past favorites – are targeted for additional scrutiny because it's just too easy for them to pocket some of the profits.

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

Economic reality

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

Large charitable donations

No one objects to someone being generous. It's just that CRA wants to see money, not promises, change hands. That's why they don't like arrangements like this: As the donor, you put down a security deposit and receive a much larger loan from an outside financial agency. Then both the deposit and the loan money are given to a charity in exchange for a tax receipt. In some cases, charities may get only a minimal amount of the money and the loan may not have to be paid back, despite the fact that you've already deducted it. CRA hates this one and have won several court cases over the past year, disallowing all or part of the deduction for the loan costs.

Child care costs

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

Home office deductions

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

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