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Report of the
**Auditor General
of Canada**
to the House of Commons

FALL

Chapter 3
Income Tax Legislation



Office of the Auditor General of Canada

The Fall 2009 Report of the Auditor General of Canada comprises Matters of Special Importance—2009, Main Points—Chapters 1 to 8, Appendices, and eight chapters. The main table of contents for the Report is found at the end of this publication.

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Chapter

3

Income Tax Legislation

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Income Tax Legislation

Main Points

What we examined

The Department of Finance Canada is responsible for formulating tax policy at the federal level and for developing the legislation and regulations needed to implement federal tax measures. In the past, the Department has developed legislative amendments to address technical deficiencies in the *Income Tax Act*, in order to more clearly convey the intent of the legislation or to make it easier for taxpayers to comply with it. Packages of technical amendments have first been released for public comment and then tabled in Parliament in the form of a technical bill. Usually these amendments do not involve any reconsideration of tax policy.

The Canada Revenue Agency is responsible for applying and interpreting the *Income Tax Act*—one of the longest and most complex pieces of Canadian legislation. The primary goal of the Agency as Canada's tax administrator is to ensure that taxpayers comply with their obligations and that Canada's tax base is protected.

We looked at how the Department of Finance Canada develops technical amendments for tabling in Parliament; we did not examine the process for developing legislative amendments that involve changes in tax policy.

In addition, we examined how the Canada Revenue Agency provides taxpayers and its tax auditors with guidance on the application and interpretation of the *Income Tax Act*, and how it assists the Department of Finance Canada in identifying and developing technical changes that may be needed in the legislation. The audit covered the period from 2004 to 2009, with relevant historical information reviewed back to 1973.

Why it's important

Canada's tax system relies on taxpayers to self-assess and pay the income taxes they owe. According to the Canada Revenue Agency, most taxpayers will meet their tax obligations if given the proper tools and information.

Taxpayers' ability to comply with tax legislation depends on their understanding of how the rules apply to their own circumstances.

When the intent of the legislation is not clearly conveyed by the words, taxpayers may find it difficult to assess the income taxes they owe and this could foster tax avoidance. Uncertainty about how the law should be applied can also add to the time taken and costs incurred by tax audits and tax administration.

What we found

- No income tax technical bill has been passed since 2001. Although the government has said that an annual technical bill of routine housekeeping amendments to the Act is desirable, this has not happened. As a result, the Department of Finance Canada has a backlog of at least 400 technical amendments that have not been enacted, including 250 “comfort letters” dating back to 1998, recommending changes that have not been legislated.
- Department of Finance Canada staff are well-informed about the identified issues, but they do not make effective use of available electronic tools to record, track, and prioritize them for possible legislative amendment.
- The Agency’s processes for tracking and monitoring issues in the Act are not adequate. The Agency has no formal database to keep track of the identified legislative issues and their disposition. Issues are validated, and analysis of some of them is carried out. However, there is no systematic review of their impact on compliance or on the tax base. As part of the annual Budget process, the Agency selects a relatively small number of outstanding issues as priorities for communication to the Department, based on the assessment of senior Agency officials.
- The Agency provides guidance to taxpayers and tax practitioners in the form of advance income tax rulings, technical interpretations, Income Tax Interpretation Bulletins, as well as tax guides and pamphlets, to name a few. Tax practitioners we interviewed value the rulings process. However, in the past three years, the Agency has not met its timeliness standard for issuing advance income tax rulings. In addition, some of the information in the Agency’s Income Tax Interpretation Bulletins is no longer current and the public is not always made aware of that fact.

The Agency and the Department have responded. The Agency and the Department agree with all of our recommendations. Their detailed responses follow each recommendation throughout the chapter.

Introduction

The need for clarity in tax legislation

3.1 The *Income Tax Act* is the central component of the federal income tax system, and it sets out the rules for compliance and provides for the administration of the Act. Other elements of this system include the Income Tax Regulations, tax treaties, and court decisions. For the system to work for both tax administrators and taxpayers, the Act's clarity must be maintained.

3.2 Our system of income taxation depends on taxpayers self-assessing their tax obligations based on a clear understanding of the law. For many tax filers, the main guidance for self-assessment is the income tax form and tax guides that are prepared by the Canada Revenue Agency.

3.3 When the intent of the statute is not clearly conveyed by its words, Canadians may not be able to easily self-assess or correctly calculate their taxes. Where necessary, tax administrators will offer additional guidance to Canadians on how tax law is interpreted and on how it is applied to their circumstances. Legislative drafters in the Department of Finance Canada may propose amendments to sections of the Act, for Parliament to approve, if lack of clarity compromises Canadians' ability to comply or the Act does not adequately reflect the underlying policy. These proposed amendments are first released to the public for comment and then tabled in Parliament in a technical bill or, occasionally, in a budget bill. These amendments may be relieving (resulting in less tax) or tightening (resulting in more tax).

3.4 The Supreme Court of Canada has said that tax laws should be certain, predictable, and fair so that taxpayers can order their affairs intelligently.

3.5 The application of tax provisions may become uncertain for a number of reasons. For example, a court decision may overturn an interpretation established by the Canada Revenue Agency. The Department may indicate the intent to propose legislative changes, but taxpayers will not know the exact nature of the proposed changes until they are enacted. Taxpayers may be uncertain when they file the current year's tax return, and they may have to choose between filing under the current legislation or the proposed legislation. New forms of business transactions may also challenge the application of the current provisions. Another type of uncertainty arises if a proposed amendment is not enacted for more than a year, but is to be passed

with retrospective effect (that is, only from the current date but affecting arrangements from before that date). Retrospective amendments can change the tax result and require a change in the tax assessment issued by the Canada Revenue Agency.

3.6 For taxpayers, the negative effects of uncertainty may include

- higher costs of obtaining professional advice to comply with tax law;
- less efficiency in doing business transactions;
- inability of publicly traded corporations to use proposed tax changes in their financial reporting, because they have not been “substantively enacted”;
- greater cynicism about the fairness of the tax system; and
- increased willingness to use aggressive tax plans.

3.7 For the tax administrator, the negative effects may include

- higher costs for providing additional guidance and interpretations to taxpayers and tax auditors; and
- higher administrative costs for reprocessing the tax returns after an outstanding legislative amendment is enacted and for obtaining waivers to extend the limitation period for reassessment.

The result may be uncertainty in the amount of tax revenues to be collected by the government and possible loss of tax revenues.

3.8 If proposed technical changes are not tabled regularly, the volume of amendments becomes difficult for taxpayers, tax practitioners, and parliamentarians to absorb when they are grouped into a large package.

The roles of the Agency and the Department in providing clarity in tax legislation

3.9 **Canada Revenue Agency.** The Agency is responsible for administering the *Income Tax Act* and its regulations and related statutes, for collecting taxes, and for interpreting tax law. The Agency provides information to the Department of Finance Canada about compliance challenges and aims to make the Department aware of the need for technical amendments to the Act that it has identified. In order to give the correct legislative guidance, the Agency consults with the Department if the underlying policy intent of a provision needs to be better understood.

3.10 The Agency provides advice and guidance on the interpretation and application of the *Income Tax Act* to taxpayers and its tax auditors, as follows:

- It gives general information in guides and pamphlets, instructions on tax forms, and guidance through its telephone service and website.
- It gives more specific guidance through a series of Income Tax Interpretation Bulletins and Information Circulars, and through a publication called Income Tax Technical News.
- It gives advance income tax rulings on the application of the law to specific transactions proposed by taxpayers, upon request, for a fee. The Agency regards these advance income tax rulings as binding. It also gives non-binding tax interpretations and opinions to taxpayers who request them and to tax auditors in the midst of an audit, if the auditor and the taxpayer do not agree on the interpretation of a provision in the Act.

3.11 Department of Finance Canada. The Department is responsible for developing and evaluating federal tax policy. It is responsible for drafting legislation that clearly reflects the tax policies set by the federal government. It also advises the Minister of Finance on the need for technical changes and policy changes to income tax legislation to ensure that Canada's tax system functions effectively. The Department of Finance Canada is also responsible for developing technical amendments to income tax legislation. Technical amendments are changes made to correct anomalies that arise after the original measure was passed and to correct consequences that were not intended. These amendments are not intended to introduce new tax policy or change existing tax policy.

3.12 Although it is not required to do so, the Department also issues, upon request and where appropriate, **comfort letters** to taxpayers.

Comfort letters—Letters in which the Department of Finance Canada promises to recommend to the Minister that a minor, non-policy legislative change be made; usually these changes are made to provide relief to the taxpayer when the tax result is clearly not the one intended by the law.

Focus of the audit

3.13 The audit focused on activities within the Canada Revenue Agency and the Department of Finance Canada that identify and develop legislative amendments to correct technical deficiencies. It also focused on Agency activities that provide guidance to taxpayers and tax auditors on how to interpret and apply tax law. For purposes of this audit, we did not examine the process that seeks to bring about new policy changes through amendments to the Act or the more

general guidance provided by the Agency, such as tax guides, pamphlets, phone service, and its website.

3.14 We consulted 54 tax practitioners from across Canada who were referred to us by the Canadian Tax Foundation (an independent tax research organization) to find out

- how they use advance income tax rulings and income tax technical interpretations, issued by the Agency, and comfort letters, issued by the Department;
- how useful and timely they find the Agency's current legislative guidance; and
- what they see as the impact of technical legislative issues that have not been addressed.

3.15 We interviewed tax auditors who use guidance on legislative interpretation and application from the Agency and headquarters staff who provide it to them. We reviewed management information, where available, on these activities that describe the level of service.

3.16 We interviewed Agency officials who are responsible for identifying legislative issues and Department officials who are responsible for developing the technical amendments to address them. We reviewed their processes, inventories, and production levels. We also reviewed the process by which Department of Finance Canada provides comfort letters to taxpayers and then produces technical amendments. We have included five case studies to illustrate our observations. These appear throughout the chapter.

3.17 More details on the audit objectives, scope, approach, and criteria are in **About the Audit** at the end of this chapter.

Observations and Recommendations

The Department's legislative maintenance

The Department's methods to record and track legislative issues are not integrated

3.18 The Tax Legislation Division of the Department of Finance Canada receives information about technical issues in income tax legislation from the Canada Revenue Agency. It also receives comments and questions on tax laws from taxpayers; tax practitioners; tax groups, such as the Joint Committee of the Canadian Bar Association and The Canadian Institute of Chartered Accountants; and the Tax Executives Institute as well as from industry associations.

On average, the Division receives 125 written submissions a year, relating to many sections of the *Income Tax Act*.

3.19 One of the functions of the Division (and of other divisions within the Tax Policy Branch, the Agency, and the Department of Justice Canada) is to analyze instances of the federal government losing a tax case. The Division's role is to develop technical changes necessary to more clearly convey the policy intent of the income tax legislation, as it relates to the topic that was before the courts.

3.20 We examined whether the Department had a well-managed process in place to comprehensively record, track, and prioritize legislative issues, and whether it used this process to select issues for draft technical amendments. We found that Tax Legislation Division staff is well-informed about the issues, but the Department relies on basic, people-dependant processes. It does not use its available electronic tools effectively.

3.21 The identified technical issues sent to the Department are recorded in several ways.

3.22 Correspondence log. The Tax Legislation Division maintains a log of incoming letters and tracks progress in their responses. Some of these letters point out legislative issues that will need to be dealt with by amendments. Our analysis of the log shows that 74 percent of the letters received between 2004 and 2008 remain open and incomplete. Department officials told us that most of the letters did not identify technical issues that required legislative changes.

3.23 Electronic database. In the early 1990s, the Department developed an electronic listing of possible legislative issues to replace paper versions. This electronic tool was intended to help set priorities, allocate resources, and help officers' understanding both of the issues involved and the reasons for amending the tax legislation. This electronic tool can provide a historical record and searchable database of all issues that the Department has identified. It can also help the Department rank the numerous issues by priority.

3.24 Despite the important features of this electronic database and the fact that it was introduced more than 15 years ago, it is not being used consistently in the Tax Legislation Division. Since its inception, hundreds of possible technical issues have been entered into the database; however, only two items have been recorded in the last year. Division officers and chiefs maintain and rely primarily on their own individual parallel lists of legislative issues. Rather than using the electronic database to maintain an up-to-date and prioritized

inventory, the practice in the division is to manually consolidate the chiefs' lists with the officers' lists periodically. A partial consolidation in October 2008 identified 178 outstanding technical deficiencies from these lists.

3.25 Comfort letters. When the Department sends a comfort letter in response to a taxpayer request, it keeps a paper copy in a binder. Over the years, some of the issues identified in comfort letters have been entered into the electronic inventory. The inventory contains an incomplete electronic summary of these letters and their legislative issues.

3.26 Department officials told us that they use their professional judgment to determine which legislative deficiencies should be a priority for the development of draft legislation. No formal criteria exist for identifying priority legislative amendments, but Department officials attach broad priority rankings (low, medium, high) to particular items as they arise. They consider issues raised in comfort letters to be high priority.

3.27 Recommendation. The Department of Finance Canada should use an integrated and consistent process for recording, tracking, and prioritizing all technical issues for possible legislative amendment.

The Department's response. Agreed. While systems are in place to manage and keep track of technical issues for possible legislative amendment, improvements can be made with regard to database management and usage. The Department will undertake, as resources permit, to consolidate its system for ensuring that technical issues are documented and catalogued consistently and that this system is maintained and kept up to date as new issues arise, and as existing issues are addressed.

The last income tax technical bill was passed by Parliament in 2001

3.28 The concept of a tax bill that would be separate from the federal budget and would provide technical amendments to the *Income Tax Act* first arose in 1978, when the Canadian Tax Foundation set up a committee on the federal budget process. In 1982, the government adopted a committee recommendation to propose non-policy amendments in an annual technical bill. The government produced these technical bills for a number of years.

3.29 In the 1991 Report of the Auditor General, Chapter 2, we expressed concerns that income tax comfort letters were given without public announcement. In response, the Department of Finance Canada stated that “the government intends to release a package of income tax technical amendments on an annual basis, so that taxpayers will not be subject to more lengthy waiting periods as in the past before amendments are released to the public.” While comfort letters have since been regularly released to the public, very few technical bills have been introduced or passed in recent years. In the last 18 years, only four such income tax bills have been enacted (Exhibit 3.1).

Exhibit 3.1 Only four income tax technical bills have been enacted since 1991

Year the bill was introduced	Bill number	Date of Royal Assent
1992	Bill C-92/C-15	12 May 1994
1993	Bill C-27	15 June 1994
1995 to 1997	Bill C-28 (Div B)	18 June 1998
2001	Bill C-22 (Part 1)	14 June 2001

Source: OAG audit files

3.30 The most recent package of technical amendments was released to the public on 20 December 2002. Between 2002 and 2006, more measures were added to the package. Some amendments, including those regarding foreign investment entities and non-resident trusts, were considered to be changes in policy. The technical portion of this bill consisted of 282 pages, with 155 clauses of amendments, to address legislative deficiencies dating back to 1996. The package was tabled as a bill in the House of Commons in November 2006, but it died when Parliament was prorogued in 2007, and an identical bill tabled in 2007 died when Parliament was dissolved in 2008 (Exhibit 3.2). As of the date of this audit, the technical amendments from this bill have not been reintroduced in the House of Commons. Two examples of the effects of a delay in technical amendments are in the two case studies that follow Exhibit 3.2.

Exhibit 3.2 The one technical bill that was tabled in Parliament since 2001 has not been enacted

Chronology of the Bill	
20 December 2002	Minister of Finance Canada released for consultation a package of technical amendments.
27 February 2004	Minister of Finance Canada released a revised package of technical amendments that included the December 2002 amendments and additional ones developed since 2002.
18 July 2005	Minister of Finance Canada released for consultation a revised package of technical amendments.
29 November 2006	A Notice of Ways and Means Motion to introduce a bill with the technical amendments was tabled in the House of Commons. The Bill also included rules regarding foreign investment entities and non-resident trusts. This became Bill C-33.
15 June 2007	Bill C-33 received third reading in the House of Commons.
14 September 2007	Parliament was prorogued; Bill C-33 died on the order paper.
29 October 2007	Bill C-10 was introduced in the House of Commons. It was identical to Bill C-33.
December 2007 to June 2008	The Senate Standing Committee on Banking, Trade and Commerce held several hearings to discuss Bill C-10.
7 September 2008	Parliament was dissolved; Bill C-10 died on the order paper.

As of the date of substantial completion of our audit, 24 June 2009, technical amendments from Bill C-10 had not been reintroduced.

Sources: 1. For bills tabled prior to 29 January 2001, see Parliament of Canada House Bills website.
2. For bills tabled on or after 29 January 2001, see Parliament of Canada LEGISinfo website.

Routine technical change

This case study illustrates the key problem identified in this chapter: 14 years after the need for a non-controversial technical amendment was identified, it still has not been made.

Many professionals and small businesses operate as a partnership. Under existing rules in the *Income Tax Act*, when a partner leaves a partnership at any time other than at the start of the partnership's fiscal year, the timing for calculating income and recognizing capital gains does not match. This can lead to the exiting partner paying double tax.

Before 1995, the Agency was able to administer tax law so that no double tax would be paid. However, in 1995 the Agency had to change its way of interpreting the law because new rules came into force in the Act.

The Department of Finance Canada released draft legislation to correct this problem in 2002. The Canada Revenue Agency has been applying the draft legislation so that double taxation is avoided. However, the draft legislation originally tabled in Bill C-33 has not yet been passed (see Exhibit 3.2).

Source: OAG audit files

Court case response—restrictive covenants

When a taxpayer sells a business, part of the selling price may be linked to an agreement by the seller to not compete with the business carried on by the buyer. This kind of agreement is called a non-compete agreement, or restrictive covenant. The common understanding of tax policy and its interpretation by the Canada Revenue Agency was that amounts received by a vendor in respect of a restrictive covenant on the sale of shares of a corporation were taxable. However, court decisions in 2000 and 2003 ruled that these amounts were generally not taxable.

In response to the court decisions, the Minister of Finance issued a news release in 2003 announcing his intention to propose amendments to the *Income Tax Act* that would generally treat amounts received in this way as ordinary income for tax purposes (or in some important exceptions, as a capital gain). As with the case study on the routine technical change, proposed amendments were tabled in Parliament in bills C-33 and C-10, but have not been enacted.

Currently, taxpayers can report such amounts for tax purposes based on the court decisions or based on the draft legislation. If a taxpayer chooses to report based on the court decisions and the tax year becomes **statute-barred** before the new rules are enacted, the Agency would not be able to reassess the returns. This would result in a loss of tax revenue for the government.

Statute-barred—The date beyond which the Minister may no longer re-examine the tax return and issue a reassessment. Normally this date occurs three or four years after the initial assessment.

Source: OAG audit files

The Department has a backlog of necessary technical amendments

3.31 The list of outstanding technical amendments to the *Income Tax Act* has been growing. In addition to the 155 clauses of technical amendments included in Bill C-10, we estimate that there are at least 250 technical amendments identified by the Department that have not yet been drafted or released for comment.

3.32 The Department cannot fix this problem alone. However, in the past, it has released packages of proposed technical amendments to the public for comment. This practice informed taxpayers and tax practitioners about proposed changes even though they were only included in a bill some time later. By releasing draft amendments for comment, taxpayers are alerted to proposed changes and any concerns can be considered before the bill is introduced in the House of Commons. Over the past two years, apart from the draft legislation needed to implement technical changes identified in the previous budget, the Department has not released for comment any draft clarifying legislative proposals. Department of Finance Canada officials told us their practice was to release new draft proposals for comment only after the current technical bill had received royal assent.

3.33 Department officials have also told us that undertaking the work to develop and draft technical amendments to remedy identified technical legislative deficiencies is not the Tax Legislation Division's

only priority. They indicated that their main priorities are giving policy advice to the Minister and developing annual budget implementation legislation.

3.34 A recommendation concerning the current backlog of technical amendments appears at the end of this section.

Priority issues in comfort letters are not being legislated on a timely basis

3.35 Comfort letters issued to taxpayers do not bind the government. A comfort letter clearly states that the Department will recommend to the Minister that an amendment be made, but the actual amendment to income tax law is a matter for Parliament. The topic of comfort letters was discussed during various hearings of the Senate Standing Committee on Banking, Trade and Commerce in 2007 and 2008 as part of Parliament's review of Bill C-10. During these hearings, the Senate was told that although comfort letters do provide clarity and a level of assurance to taxpayers and tax practitioners, they are not law and, therefore, still require an amendment to the *Income Tax Act*.

3.36 During our interviews with tax practitioners across the country, we sought their views on the comfort letter process. Most of them were pleased that the letters were issued in a timely manner, and they thought that these letters were essential to facilitating economic activity and were an integral part of how Canada's tax system functions. However, the practitioners expressed a need for the legislative changes that the comfort letters identified to be enacted. Currently, the accounting rules for preparing a public corporation's financial statements require them to be based on tax legislation that has been substantively enacted. Consequently, the tax results of a comfort letter cannot be used in preparing audited financial statements.

3.37 Between 1996 and 2008, the Department of Finance Canada issued 297 comfort letters. Only 46 of the issues dealt with in these comfort letters have become law. Some of these identified issues became amendments and were included in Bill C-10, which did not become law; other amendments have not yet been drafted. According to Department officials, legislation has not been developed or released for most comfort letters issued after 2002. Thus there are as many as 250 identified legislative deficiencies that require technical amendments from comfort letters alone.

3.38 The following case study is an example of the uncertainty that taxpayers face when an income tax return has been filed based on a comfort letter.

The taxation of dividends was dealt with in a comfort letter but not passed into law

A corporation that pays dividends on certain preferred shares has to pay tax under Part VI.1 of the *Income Tax Act*, but it can claim a deduction from income to approximate this tax paid. Until a legislative change is made, the cost of financing a corporation's operations with preferred shares has increased. This is because a corporation will typically pay tax under Part VI.1 at a rate of 40 percent on the amount of dividends paid. It is then entitled to a deduction equal to three times the amount of Part VI.1 tax paid. When the combined federal and provincial corporate tax rate has been 33.33 percent, the tax saved from the deduction has equalled the Part VI.1 tax paid. Because the combined tax rate has been reduced in recent years, the tax saved from the deduction is no longer sufficient to offset the Part VI.1 tax paid. This would, if not corrected, result in increased financing costs that were not anticipated when the preferred shares were issued.

The Department of Finance Canada issued a comfort letter in 2002 stating that it would recommend that changes be made to the deduction. The changes were part of Bill C-33 and Bill C-10 (described in Exhibit 3.2) and remain outstanding some seven years later.

Source: OAG audit files

Taxpayers are assessed based on comfort letters

3.39 The Department issues about 30 comfort letters each year. These are released under Access to Information requests and published by private sector tax information services. Other taxpayers may use these comfort letters to calculate their tax liabilities. The Agency has no processes to identify and monitor the taxpayers who have carried out transactions based on comfort letters. This creates a risk that tax returns that have been completed based on a comfort letter may become statute-barred before the legislative change described in the comfort letter is enacted by Parliament. The Agency does not manage this risk by obtaining waivers from the taxpayers, which would allow it to later reassess the tax return based on the existing law, should the legislative change outlined in the comfort letter not be made. Although we are not aware of any situation when Parliament refused to enact a proposed change to the Act that had arisen from a comfort letter, we are concerned that taxpayers are assessed based on letters, the draft legislation for which may not be tabled and passed for years.

3.40 Recommendation. The Department of Finance Canada should

- develop and implement a plan to address the current backlog of necessary technical amendments; and
- regularly develop and release draft technical amendments, including those that arise from comfort letters, so that taxpayers and tax practitioners know what changes will be made and can provide input to the Department.

The Department's response. Agreed. Tax legislation is prepared by the Department and then tabled in Parliament by the Government. Recent practice with respect to legislative proposals to implement technical amendments (commonly known as tax “technical bills”) has been to await Parliament’s consideration and adoption of one technical bill before proceeding to release for public comment another package of proposed draft technical legislative amendments. This procedure has minimized potential confusion for taxpayers and their advisors (for example, by having different amendments to the same section of the *Income Tax Act* before Parliament and released in draft form for comment) and, in an environment in which draft technical bills have been considered and adopted by Parliament within a reasonably short period following their original release in draft form, has not resulted in any inordinate delay in the preparation and release of subsequent technical amendment packages.

Where proposed technical legislative amendments are not enacted within a reasonably short period following their original release in draft form, the Department recognizes that the current practice of seeking to defer the release of a new package of the draft technical amendments may raise different issues relating to taxpayer uncertainty. To reflect these competing factors, the Department agrees to consider whether there are circumstances where it would be appropriate to bring forward for consideration a subsequent draft technical amendments package, notwithstanding the fact that the previous technical bill had not yet been adopted by Parliament.

The Agency's legislative maintenance input

The Agency does not have a comprehensive system to track, record, and prioritize legislative issues

3.41 We examined whether the Canada Revenue Agency maintains a complete list of legislative issues that it has identified as needing technical amendments, and whether it communicates these to the Department of Finance Canada. We found that the Agency uses several methods to identify technical issues, but it does not refer all issues to the Department and does not keep a consolidated inventory.

3.42 The Agency's Legislative Policy Directorate of the Legislative Policy and Regulatory Affairs Branch acts as the link between other branches of the Agency and the Department for identifying tax legislative issues. The Directorate receives information about legislative issues from Agency branches in several ways and communicates regularly with the Department. Occasionally, other areas of the Agency will contact the Department directly, but they need to inform the Directorate of any technical issues.

3.43 Referrals from the Agency. Various branches within the Agency identify legislative issues and communicate these to the Directorate. Staff in the Directorate ensure that the issues are valid and analyze some of them. They do not systematically review what impact these issues might have on compliance or on the tax base. The Directorate will communicate issues that it thinks need legislative amendments to the Department when they are identified; last year, it sent about 20 letters to the Department.

3.44 The Directorate exchanges many emails with the various branches in connection to their ongoing discussions of legislative issues—about 26,000 in the past four years. It is difficult to assess how many technical issues are described in these emails as they are not catalogued by the Directorate.

3.45 Agency input into the budget process. Another approach that the Legislative Policy Directorate uses to gather and communicate details on important issues identified by Agency staff is to request a list of priority issues from the Agency's branches before the annual federal budget is developed. Although the budget generally deals with tax policy issues, occasionally a technical issue will be included in the budget. In advance of the 2008 Budget, the Directorate compiled a list of 47 suggestions for changes to the legislation from within the Agency. From these 47 suggestions, it sent 10 to the Department. Six of these ten issues were addressed in the 2008 budget; two of the six that were addressed were technical. The issues that the Agency forwards to the Department before the Budget is introduced are chosen based on an assessment and prioritization by senior Agency officials. The Agency's Policy Committee, chaired by the Assistant Commissioner of the Legislative Policy and Regulatory Affairs Branch, makes this assessment. Agency officials told us that they do not necessarily refer all technical issues that they think need to be addressed by a legislative amendment to the Department. Instead, they choose the ones that they think will fit the theme of the Budget. The same changes considered to be priorities may be referred to the Department year after year if necessary.

3.46 Agency input to technical bills. When the Directorate is informed by the Department that a technical bill is being prepared, it prepares a list of Agency priorities for legislative change to send to the Department. As there is no consolidated list of issues, the Directorate contacts various Agency branches to ask for their list of outstanding issues, and checks its own files. The current list of income tax legislative issues identified by the Compliance Programs Branch includes approximately 150 items. The lists of issues submitted to the

Department (for possible inclusion in a technical bill) in 2008 and in 2005 contained 108 and 54 items, respectively. The following case study is an example of an important technical issue that was identified by the Agency.

Canada Revenue Agency identifies a potential legislative issue

This is an example of the Canada Revenue Agency identifying a potential legislative issue and communicating it to the Department of Finance Canada.

The *Income Tax Act* contains many provisions that are designed to ensure that a corporation's tax losses cannot be used by unaffiliated corporations unless certain conditions are met.

In recent years, some transactions have been designed to get around these rules, described as "tech-wreck" restructurings. The name arose from the use of losses originating in the technology sector.

The Agency's Legislative Policy Directorate wrote to the Department on 1 February 2001, following up on a request from the Income Tax Rulings Directorate about inappropriate use of losses.

The Agency's Legislative Policy Directorate wrote to the Department on 8 March 2004 regarding more recent inappropriate corporate reorganizations involving losses.

A meeting was held in August 2005 on the trading of non-capital losses and other losses. Staff from the Agency and the Department attended.

The Agency's Legislative Policy Directorate wrote to the Department again in 2007 on the same issues involving loss trading and informed the Department of another scheme that it believed was resulting in tax revenue losses. The Agency again asked the Department to recommend legislative amendments.

To date, the issue remains unresolved.

The Agency has stated in Income Tax Technical News #34 that it will apply the General Anti-Avoidance Rule to such transactions. Any resulting litigation will likely take several years before the uncertainty is resolved.

Source: OAG audit files

3.47 Overall, technical issues identified within the Agency are not systematically tracked and monitored and they are not formally documented by managers. Directorate files on legislative issues are not electronic, and it does not keep a correspondence log related to these issues. At present, only seven staff in the Directorate deal with changes to income tax legislation, so without an electronic record, the loss of one or two senior people could have a major impact on how effectively the Agency identifies and communicates the accumulated technical issues to the Department.

3.48 Recommendation. The Canada Revenue Agency should create an electronic database to help validate, analyze, and prioritize identified technical issues that should be referred to the Department of Finance Canada and to track how they are addressed.

The Agency's response. Agreed. An electronic database is being developed and will be in place by the end of 2009. Further, a strategy is being developed to enhance the Agency's legislative recommendation process.

The Agency's legislative guidance

The Agency is not meeting its own time targets for advance income tax rulings for taxpayers

3.49 The Canada Revenue Agency provides guidance to taxpayers to enable them to self-assess and comply with the law. Some of this guidance is more complex and is intended for users who need more detailed information. If the Agency's guidance is not timely or correct, taxpayers may inadvertently fail to comply with the law or they may become frustrated because the information they need is not available. Either may lead to a loss of tax revenue or an overpayment that later must be adjusted. We looked specifically at the guidance provided when the interpretation and application of the legislation may be unclear.

3.50 The Income Tax Rulings Directorate is part of the Agency's Legislative Policy and Regulatory Affairs Branch. Its mandate is to interpret Canada's income tax law and explain how Canada's tax law applies to given situations. This includes providing advance income tax rulings for a fee and technical interpretations of income tax law to taxpayers (either directly or through tax auditors who are dealing with taxpayers). It produces Income Tax Interpretation Bulletins and the Income Tax Technical News, which describe the Agency's interpretation of income tax legislation. The Directorate also participates in tax conferences where it provides information about its interpretive positions. The tax practitioners we interviewed generally find the guidance provided by the Directorate to be helpful.

3.51 An advance income tax ruling provides certainty to a taxpayer who receives it by guaranteeing the income tax effect of certain transactions the taxpayer plans to undertake. The rulings involve some of Canada's most complex tax issues and the tax revenue implications can be significant.

3.52 Each ruling outlines how the Agency will interpret certain provisions of Canada's income tax law. These rulings are not published by the Agency but are released by the Agency under Access to Information provisions, with confidential details removed. The Agency's position on certain technical matters developed in a ruling may be of interest to other taxpayers. The rulings are available to those who subscribe to private sector tax information services.

3.53 The Directorate also provides technical interpretations when asked to do so. These interpretations give guidance in a hypothetical situation and are also released under Access to Information provisions. The Agency provides about 250 advance income tax rulings and 1,200 technical interpretations to taxpayers and 1,000 technical interpretations to its auditors each year.

3.54 We examined whether the Agency had well-managed processes in place to provide timely guidance to taxpayers on the interpretation and application of income tax provisions to enable them to self-assess and comply with the law.

3.55 Generally, tax practitioners we interviewed told us that they value the Agency's advance income tax rulings service because it provides them with certainty about clients' proposed business transactions.

3.56 They also told us that they find the response times from the Income Tax Rulings Directorate for advance tax rulings and technical interpretations to be slow. Some said that they no longer request technical interpretations and advance income tax rulings because they find that the response time is too long to enable them to meet their clients' needs.

3.57 The Agency has met its service standard target of 90 days for income tax technical interpretations in five of the last six years. However, this standard is based on "controllable time," which includes only the time when the file is being worked on by the directorate or any other government department. This may explain the practitioners' perception of a lack of timeliness.

3.58 The Agency has recognized in its Annual Report to Parliament that it has not met its own service standards for advance income tax rulings and acknowledged that this may result in taxpayers undertaking questionable transactions—potentially leading to reduced compliance and more costly audit and appeals activities (Exhibit 3.3).

3.59 Agency officials and tax practitioners told us that one reason for the lack of timeliness is that the requested rulings are becoming more and more complex. Very few involve simple transactions that can be dealt with quickly; the Agency recognizes the tax risk associated with the proposed transactions. Moreover, 61 percent of the current staff in the Income Tax Rulings Directorate was not employed in 2004, so they are still gaining experience. The Agency's branch business plan recognizes the challenge, but does not have a concrete plan to improve

its performance in the short term. Management believes that the addition of 16 new staff in the past year, once they gain more experience, will help with timeliness.

Exhibit 3.3 In recent years, the Canada Revenue Agency has not met its own targets for issuing advance income tax rulings

Fiscal year	Advance income tax rulings Target is 60 days (of time within the government's control)		Income tax technical interpretations Target is 90 days (of time within the government's control)	
	Average number of days to issue to taxpayers	Rating standard: Met or Not Met	Average number of days to issue to taxpayers	Rating standard: Met or Not Met
2002–03	60 days	Met	78 days	Met
2003–04	57 days	Met	82 days	Met
2004–05	62 days	Met	75 days	Met
2005–06	84 days	Not Met	87 days	Met
2006–07	94 days	Not Met	105 days	Not Met
2007–08	101 days	Not Met	89 days	Met

Source: Canada Revenue Agency's Annual Report to Parliament 2007–08, and prior years

3.60 Recommendation. The Canada Revenue Agency should develop more concrete plans to meet its own target times for issuing advance income tax rulings, given the significance of the rulings to proposed business transactions.

The Agency's response. Agreed. The Agency will formally evaluate these performance standards to ensure they adequately reflect the time needed for issuing advance rulings, given the increased complexity of these cases. This study of turnaround times and trends will be completed in 2010.

It is not known whether the guidance provided to tax auditors is timely

3.61 We examined whether the Agency had a well-managed process in place to provide timely guidance to Agency auditors across the country on the interpretation and application of income tax law. We found established processes to provide the guidance needed, but management does not have any reliable information on whether or not it is timely.

3.62 The Agency has established an internal, 60-day standard for responses to queries from auditors of small and medium businesses, although there is no standard response time established for queries from large corporations. However, the Agency does not record or track the actual response time to any of these queries. As a result, the Agency does not know whether the guidance it provides to its own auditors is timely.

Users are not always aware that some Income Tax Interpretation Bulletins are obsolete

3.63 Income Tax Interpretation Bulletins are produced by the Income Tax Rulings Directorate. They provide the Agency's technical interpretation and position on certain provisions of income tax law. For the majority of taxpayers, the explanations of income tax law available in the Agency's other publications, such as tax guides and pamphlets, are sufficient.

3.64 The Income Tax Technical News is also produced by the Income Tax Rulings Directorate and gives the Agency's technical interpretation of various provisions of income tax law and informs users of a new or revised position. The Income Tax Technical News began in 1994 and, to date, 40 issues have been published.

3.65 Information Circulars provide information to the general public on administrative, enforcement, or procedural matters that relate to income tax law.

3.66 Most tax auditors and many tax practitioners told us that they begin their research into a legislative interpretation question with Income Tax Interpretation Bulletins as their source of guidance. As of 31 December 2008, there were 272 bulletins in effect. Tax auditors and tax practitioners have told us that, although they are aware that some of the guidance in the bulletins may not be up to date, they continue to rely on them to support their positions when they are uncertain about how to interpret income tax law. Agency statistics indicate the importance of the bulletins, using as evidence the 1.5 million page views of the bulletins on its website for the fiscal year ended 31 March 2009. These views were from users external to the Agency and do not include Agency staff. Users may also access the bulletins through their subscription to private sector tax information services.

3.67 Although the Income Tax Rulings Directorate's Policies and Procedures Manual contains a clear process for developing and producing an Income Tax Interpretation Bulletin, we found that there is no formal process to monitor whether it is still current or to decide

whether it needs to be withdrawn or revised. Since 2003, only 29 of the existing bulletins have been revised and only one new one was issued. The Agency told us that the production and revision of bulletins is not a priority, in part due to resource constraints.

3.68 We expected that if all or part of an Income Tax Interpretation Bulletin was no longer correct, the Agency would communicate this to users by updating the bulletin. We found that there is no indication in the bulletin itself that specific paragraphs may no longer be current; there is only the general comment in the index listing of all bulletins that the information in certain ones may not be up to date. The Agency does provide information about new interpretive positions in its Income Tax Technical News publication. However, this approach requires a user to know that a specific bulletin may be out of date and to read all issues of Income Tax Technical News to see if anything has been said about the one they plan to rely on. The Agency may issue a special release of the bulletin to communicate changes. However, the user may be required to do further research, such as looking at changes to the legislation, conference presentations, current articles, and recent court cases to establish the correct interpretive position. The following case study is an example of the effect of an out-of-date bulletin.

Example of an Interpretation Bulletin that is out-of-date

A scholarship, fellowship, bursary, prize, research grant, and other kind of financial assistance for scholars is included in income in the year received, subject to a “scholarship exemption.” The scholarship exemption may result in a full deduction from income, resulting in no tax owing. The Agency issued Income Tax Interpretation Bulletin IT-75R4 on 18 June 2003. This IT discusses the taxation of the scholarships and similar prizes. It indicates the scholarship exemption exempts the first \$500 and in some cases the exemption is \$3,000.

In fact, the scholarship exemption changed for taxation years after 2005. The full amount may qualify for the exemption, and therefore not be subject to tax. IT-75R4 does not reflect the legislative change and can mislead a user into reporting the wrong amount on the tax return.

Source: OAG audit files

3.69 Recommendation. The Canada Revenue Agency should improve the information it provides to users about specific paragraphs in Income Tax Interpretation Bulletins that are no longer accurate, so that they can more readily comply with the *Income Tax Act*.

The Agency’s response. Agreed. The Agency provides taxpayers and tax practitioners with up-to-date technical information such as pamphlets, guides, tax return packages, technical opinions and conference responses. Given that there are several other mediums that

provide this type of technical information, the Agency may opt to cancel its inventory of Interpretation Bulletins. To that end, the Agency will evaluate this option during 2010 and ensure practitioners are consulted and aware of any subsequent plan of action to either update these bulletins or cancel them.

Conclusion

3.70 Some aspects of maintaining the clarity of the *Income Tax Act* are not being well managed, which creates difficulties for taxpayers and administrative complications for the Canada Revenue Agency. Although the government has agreed a number of times to introduce annual technical bills to correct identified deficiencies, it has not done so. The last technical bill on income tax law received royal assent in 2001. Each year, more deficiencies are identified, contributing to an ever-growing backlog of needed technical amendments.

3.71 The Department of Finance Canada alone cannot correct this situation, but it can do more to bring the urgency of the problem to the attention of the government and Parliament and make known, by releasing draft amendments for stakeholder comment, how the important technical deficiencies will be remedied.

3.72 Although the Agency does collect information from its own operations about technical issues in tax legislation, it records them in various ways, does little to analyze their impact, and does not communicate all of the identified issues requiring amendments to the Department of Finance Canada. The Department has weaknesses in its own process for recording and monitoring legislative issues.

3.73 The Agency's guidance to taxpayers and its own tax auditors, through advance income tax rulings and technical interpretations, has well-managed aspects, but the advance income tax rulings are not being provided in a timely manner. Income Tax Interpretation Bulletins are frequently referred to by taxpayers and tax practitioners, but are not being kept up to date. Revising these bulletins is not a priority for the Agency, and the public is not always made aware of the fact that a bulletin may be obsolete.

About the Audit

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by The Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

Objectives

The objective of the audit was to determine whether

- the Canada Revenue Agency has well-managed processes in place to help taxpayers comply with the *Income Tax Act*, by providing timely guidance to clarify the interpretation and application of the legislation; and
- the Agency and the Department of Finance Canada have well-managed processes in place to identify and develop technical amendments to the income tax legislation considered necessary to more clearly reflect the policy intent, to facilitate compliance, and to protect the tax base.

Scope and approach

Our audit focused on two areas of administration of the *Income Tax Act*: the activities that respond to compliance problems related to taxpayer uncertainty arising from the application and interpretation of the income tax legislation and the processes in place to develop the necessary technical legislative changes in a timely manner. We focused our work in specific sectors of the Agency and the Department, with our main focus being directed at the Agency's Legislative Policy and Regulatory Affairs Branch and the Department's Tax Policy Branch.

During our audit, we interviewed tax services office auditors and reviewed documents they gave us. We then interviewed headquarters staff to understand how the Agency ensures that it is providing tax auditors and taxpayers with consistent guidance on how to apply and interpret tax legislation.

We interviewed 54 tax practitioners from across the country. Each was asked a series of questions developed by the audit team. The tax practitioners were referred to us by the Canadian Tax Foundation and reflected a target population of senior tax practitioners (both accountants and lawyers) with practices in larger Canadian cities and with client bases composed of both large and small clients. We wanted to hear the views of a target population that would be most likely to use the services of both the Canada Revenue Agency and the Department of Finance Canada in the course of their work. We conducted these interviews over a 19-month period in Vancouver, Calgary, Toronto, and Montreal.

Criteria

Listed below are the criteria that were used to conduct this audit and their sources.

Criteria	Sources
We expected that the Canada Revenue Agency had well-managed processes in place to provide timely guidance to Agency officials and taxpayers on the interpretation and application of income tax provisions through advance income tax rulings, technical interpretations, information circulars, income tax interpretation bulletins, and the Income Tax Technical News.	<ul style="list-style-type: none"> • Canada Revenue Agency, 2008–09 to 2010–11 Legislative Policy and Regulatory Affairs Branch Business Plan, pages 7, 13, 14, and 36 • Canada Revenue Agency, 2008–09 Report on Plans and Priorities, Appendix C, page C-2
We expected that the Department of Finance Canada had well-managed processes in place to identify, analyze, prioritize, and draft technical amendments to ensure the effective functioning of Canada's tax system.	<ul style="list-style-type: none"> • Department of Finance Canada, 2007–08 Report on Plans and Priorities, page 18
We expected that the Agency had well-managed processes in place to monitor taxpayers who have been assessed based on comfort letters.	<ul style="list-style-type: none"> • Canada Revenue Agency, 2006–07 Annual Report to Parliament, page 9
We expected that the Agency had well-managed processes in place to identify, analyze, and prioritize amendments needed to address the lack of clarity in the <i>Income Tax Act</i> and to communicate these to the Department of Finance Canada in a timely manner.	<ul style="list-style-type: none"> • Treasury Board of Canada Secretariat, Risk Management Policy, Preface, • Canada Revenue Agency, 2008–09 to 2010–11 Legislative Policy and Regulatory Affairs Branch Business Plan, page 7 • Canada Revenue Agency, 2006–07 Report on Plans and Priorities, page 45

Management reviewed and accepted the suitability of the criteria used in the audit.

Period covered by the audit

The period under audit is from 2004 to 2009. Other historical documents reviewed were pertinent to the time period under audit and were published as far back as 1973.

Audit work for this chapter was substantially completed on 24 June 2009.

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Appendix List of recommendations

The following is a list of recommendations found in Chapter 3. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Response
The Department's legislative maintenance	
<p>3.27 The Department of Finance Canada should use an integrated and consistent process for recording, tracking, and prioritizing all technical issues for possible legislative amendment. (3.18–3.26)</p>	<p>Agreed. While systems are in place to manage and keep track of technical issues for possible legislative amendment, improvements can be made with regard to database management and usage. The Department will undertake, as resources permit, to consolidate its system for ensuring that technical issues are documented and catalogued consistently and that this system is maintained and kept up to date as new issues arise, and as existing issues are addressed.</p>
<p>3.40 The Department of Finance Canada should</p> <ul style="list-style-type: none"> • develop and implement a plan to address the current backlog of necessary technical amendments; and • regularly develop and release draft technical amendments, including those that arise from comfort letters, so that taxpayers and tax practitioners know what changes will be made and can provide input to the Department. (3.28–3.39) 	<p>Agreed. Tax legislation is prepared by the Department and then tabled in Parliament by the Government. Recent practice with respect to legislative proposals to implement technical amendments (commonly known as tax “technical bills”) has been to await Parliament’s consideration and adoption of one technical bill before proceeding to release for public comment another package of proposed draft technical legislative amendments. This procedure has minimized potential confusion for taxpayers and their advisors (for example, by having different amendments to the same section of the Income Tax Act before Parliament and released in draft form for comment) and, in an environment in which draft technical bills have been considered and adopted by Parliament within a reasonably short period following their original release in draft form, has not resulted in any inordinate delay in the preparation and release of subsequent technical amendment packages.</p> <p>Where proposed technical legislative amendments are not enacted within a reasonably short period following their original release in draft form, the Department recognizes that the current practice of seeking to defer the release of a new package of the draft technical amendments may raise different issues relating to taxpayer uncertainty. To reflect these competing factors, the Department agrees to consider whether there are circumstances where it would be appropriate to bring forward for consideration a subsequent draft technical amendments package, notwithstanding the fact that the previous technical bill had not yet been adopted by Parliament.</p>

Recommendation	Response
<p>The Agency's legislative maintenance input</p> <p>3.48 The Canada Revenue Agency should create an electronic database to help validate, analyze, and prioritize identified technical issues that should be referred to the Department of Finance Canada and to track how they are addressed. (3.41–3.47)</p>	<p>Agreed. An electronic database is being developed and will be in place by the end of 2009. Further, a strategy is being developed to enhance the Agency's legislative recommendation process.</p>
<p>The Agency's legislative guidance</p> <p>3.60 The Canada Revenue Agency should develop more concrete plans to meet its own target times for issuing advance income tax rulings, given the significance of the rulings to proposed business transactions. (3.49–3.59)</p> <p>3.69 The Canada Revenue Agency should improve the information it provides to users about specific paragraphs in Income Tax Interpretation Bulletins that are no longer accurate, so that they can more readily comply with the <i>Income Tax Act</i>. (3.61–3.68)</p>	<p>Agreed. The Agency will formally evaluate these performance standards to ensure they adequately reflect the time needed for issuing advance rulings, given the increased complexity of these cases. This study of turnaround times and trends will be completed in 2010.</p> <p>Agreed. The Agency provides taxpayers and tax practitioners with up-to-date technical information such as pamphlets, guides, tax return packages, technical opinions and conference responses. Given that there are several other mediums that provide this type of technical information, the Agency may opt to cancel its inventory of Interpretation Bulletins. To that end, the Agency will evaluate this option during 2010 and ensure practitioners are consulted and aware of any subsequent plan of action to either update these bulletins or cancel them.</p>

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