The Tax Man Cometh

Authors: Jeff Pniowsky

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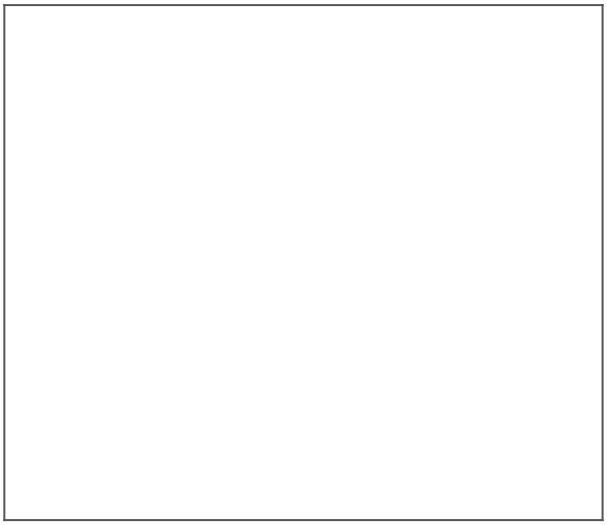
It is finally spring. The snow has melted, the flowers bloom, children put down their video games and leave their winter dens behind to frolic in the sunshine. What better time then to discuss the draconian powers of the Canada Revenue Agency. Although there may be clear skies overhead, on the horizon spring storm clouds brew.



Okay, that may be a bit melodramatic, but if you or a client has ever had to endure a CRA audit the experience can be a lot more frightening than a spring storm. We are told we have “rights” as citizens, that there are checks on government power, yet it seems that when it comes to dealing with one particular arm of the government – the CRA – all of these rights fall by the wayside and the state has all the power. Worse still, they’re exercising their power in order to confiscate our (or our clients’) money. Sometimes a lot of our money – scary stuff indeed. This post will canvass the tax audit and appeal process, provide explanations for the CRA’s seemingly endless powers, touch upon some key issues of the law in this area and hopefully provide some guidance to you and your clients who may be facing, or will one day face, a tax audit.

1. The Audit

Initial contact from auditor

An audit usually begins with a standard letter from an auditor requesting an opportunity to see your books and records. They may identify a particular issue or area of concern or they

may want to see “everything”. Usually they will limit the inquiry to particular taxation years. With individuals and small corporations the CRA can go back and reassess three years from the original date of assessment/filing and four years for large corporations, unless they can establish fraud or negligence in which case they can go back further.

In many instances the request for documents or information will be in the form of a simple letter. In some instances the CRA will issue a request by way of a formal “requirement for information.” A formal requirement is a letter that will cite the section of the Income Tax Act (ITA) which requires you to legally comply with the request, it will have particulars of the documents/information sought, and it will contain a warning that failure to comply may result in prosecution. It will also have a deadline.

Broad powers to compel production of documents – what are we required to provide to the auditor?

Usually everything they’re asking for. The inquiry powers under the ITA are broad and the restrictions few. The test the courts use to determine the validity of a request for information is whether it is for a purpose related to the enforcement of the ITA (though some cases suggest the search must be part of a “serious inquiry”). Apart from requests made for some improper purpose unrelated to the ITA, the CRA will be entitled to access. Complaints to the courts of requests being a “fishing expedition” are usually not successful since the very nature of an audit is in some ways “fishing” for information that the CRA does not yet know about.

The Supreme Court of Canada reviewed these inquiry powers in the context of a taxpayer’s claim that it violated his Charter rights, and found that a taxpayer’s expectation of privacy in the context of an audit is very low. The reason is based on the nature of how we report taxes. We have a self-reporting system in which we are asked in good faith to report taxes ourselves (as compared to a more intrusive system in which the state looks at your affairs and reports for you). The trade off is that the state must be given broad powers in those instances where it seeks to verify the accuracy of our self-reporting.

“Documents” include a broad array of information, stored electronically or otherwise. Given the amount of data we now maintain in various forms such as in emails, hard drives and off site storage, the burden of complying with a requirement – both physical and from a cost perspective – can be significant. This can be a particularly contentious issue when the requirement is not addressed to the taxpayer but to a third party who is in no way involved with the subject of the audit, save for having information the CRA wants.

Third party requirement issues – privileged/confidential info and costs

In many audits the CRA will limit its requests for information to the targeted taxpayer. In more significant matters, however, requests for information will go out to various third parties the CRA believes may have information relevant to an audit, including to financial institutions, advisers, and accountants of the taxpayer.

Institutions and advisers are given access to a multitude of confidential or privileged information in the course of providing services to their clients and they are bound, both in contract law and by provincial and federal privacy statutes, to keep private information confidential. Such confidentiality is subject to certain overriding laws, one being the power of the CRA to compel the production of information and documents. Care must be taken in circumstances where you are being asked to provide such information: you are bound to comply with the CRA, but one must not to disclose anything other than what is being asked for. The following are some important issues when considering a response to a request for information:

- Is the request a formal requirement, or merely an informal request? A letter may contain some wording creating the appearance that it is a formal requirement for information, when in fact it is not.
- Is the recipient properly identified? Is the taxpayer? In tax law "form matters" and an improperly identified party may affect the validity of the request. Particular care must be taken when dealing with corporate entities that have multiple subsidiaries, or are part of a broader related group.
- What are the parameters, taxation years involved, types of documents requested? The requirement may lack sufficient particularity to make compliance possible, or practically impossible. One is legally bound to comply, but there is case law that says we cannot be held to impossible standards. Cost, while a crucial issue to the recipient, is generally not a concern to the CRA. In the right circumstances, however, cost may be relevant in establishing "impossibility" of compliance.
- What is the "deadline" for compliance? The ITA requires a reasonable time be given, which will vary depending on the circumstances. The CRA's practice is to generally default to 30 days. Once the date has been set (often without consultation with the recipient) the CRA is reluctant to provide extensions of time, and legal counsel may need to contact the Department of Justice to formally deal with the issue since not providing the information within the time stipulated is considered a failure to comply.
- Will the request include solicitor and client privileged documents?

Solicitor and client privilege – beyond CRA's reach

There is a special relationship which the law holds supreme – one between the lawyer and his client. The underlying rationale for this rule is that without such strict confidences being legally maintained, justice itself would suffer since the citizenry would be less inclined to be frank with their counsel and would thus be deprived of their full recourse under the legal system. Some time ago, the Supreme Court of Canada determined that the privilege is a substantive rule of law, rather than a procedural or evidentiary issue. The import of that

decision was that, as a matter of law, the privilege would be overriding in all legal contexts. The ITA also contains specific exclusions regarding the production of solicitor and client privileged information.

Not being a lawyer or working at a law firm, this issue is still critical to you

Personal and corporate transactions, no matter how simple or complex, are usually multidisciplinary. Lawyers and their legal opinions are often a part of these transactions. When faced with a requirement for information, you are bound by law not to disclose privileged information.

Generally speaking, all communications between a lawyer and client for the purposes of providing legal advice are privileged. Opinions, notes, messages, and drafts of lawyers' work are usually included. The fact that a non-client third party possesses the documents may or may not mean privilege has been "waived". Privilege may be considered "waived" when it has been disclosed to someone outside the lawyer client relationship, though the law in this area is complex, and I would recommend consulting legal counsel in all circumstances where privilege may be an issue.

Accountants' or other advisors' work/communications – are they privileged?

No. But there are some important qualifications. There is no specific accountant-client privilege recognized in the common law or in the ITA. This, coupled with the fact that the CRA appears to be using requirements on accounting firms with greater frequency, has caused much consternation in the industry. Accountants are called upon to dissect, analyse and report on their clients' affairs, often focusing on the very issues that the CRA is concerned with – the tax position. If the CRA can simply require an accountant to fully disclose his/her clients' affairs to them, the audit function becomes extremely simple since the accountant may have spelled out all of the tax implications in the form of a risk assessment or tax plan. The harm done to the accountant-client relationship is obvious, as taxpayers may be effectively denied expert advice on seeking to minimize their taxes given a reluctance to disclose their affairs to an advisor who may one day be providing a blueprint for an audit. The right of a taxpayer to minimize their taxes in conducting their affairs has long been recognized in our system of taxation, and a argument can be made that by allowing the CRA to directly take accountants' notes, working papers and tax advice, they are indirectly infringing on this principle.

Accountancy groups are currently lobbying to change the law, but right now, accountants

hold no special relationship of legal privilege with their clients. However, all is not lost. It is important to recognize that the obligation to produce may not be absolute. Many tax plans or other tax advice of accountants also involve lawyers' input, if not principal involvement. There are some emerging trends in the law dealing with "common interest privilege", unintended waiver, and the accountant being a conduit for legal advice, which together (or in some cases individually) may operate to maintain confidentiality under the solicitor and client privilege for accountants' work.

2. The Proposal and Reassessment

Usually at the end of an audit, the CRA will send the taxpayer a proposal letter outlining why they intend to reassess and the amounts involved. They will then invite the taxpayer to provide a response and an opportunity to provide any additional facts. This is likely not the only time the taxpayer or their representatives have communicated with the auditor, but it serves as a formal notice that they are looking for a last formal response.

Caution should be taken at any stage of communications with the CRA, particularly when formal responses are requested. As will be described further below regarding the tax appeal stage, what you say may form the basis of an assessment against you, which you will then be required to disprove. While one must always be truthful in responding to the CRA, one must also be careful. There has been many an occasion where mere miscommunication, improperly phrased statements, simple error or a failure to appreciate the legal ramifications of the issue at hand, has led to assumptions being made by the CRA which the taxpayer later regrets. This may or may not be overcome at later stages, but even if it can be reversed, an ounce of prevention is worth a pound of cure. Legal counsel experienced in dealing with tax disputes should be involved at the earliest stages of the audit process in instances where there are factual or legal complexities which can be subject to varying interpretation, particularly where there is a significant monetary exposure and the ounce of prevention becomes a ton of cure. Of course if there is any possibility the CRA may be advancing a criminal evasion investigation, legal counsel should be consulted immediately.

3. The Appeals Stage of the CRA and on to the Tax Court

If a taxpayer is unable to convince the CRA that the proposal to assess additional taxes is wrong, the CRA will issue a "notice of reassessment." Unlike the proposal letter, it will explain virtually nothing about the nature or basis of the reassessment, other than the amounts involved. Some auditors send an accompanying explanatory letter, but not always. In some instances where a proposal letter has not been sent nor an explanatory letter, deciphering the basis of reassessment is extremely difficult.

The CRA has an internal appeal mechanism if you wish to dispute the reassessment. You must file a “notice of objection” with the Chief of Appeals of the CRA within 90 days of receiving your reassessment. If you are late you may be able to get an extension of time, but you must have an explanation that includes evidence of a continuing intent to appeal and reasons why it would be equitable to grant the extension. Note that you are statute barred from appealing if you have not applied to extend the time to object within one year and ninety days from the date of the reassessment. There are no exceptions and this rule is absolute.

While the CRA has a separate “Appeals” group that will consider your objection, the degree to which you will get a hard second look will depend on a number of factors, including who the Appeals officer is. It is also important to remember that this is not a truly independent tribunal, but rather another arm of the same government body that is seeking to reassess you.

When contemplating whether to object to a reassessment it is important to remember that the CRA may not be correct. In fact the CRA is often not correct. Taxpayers and their advisers sometimes fall into the trap that the CRA has the “official” word on the subject and therefore should be given deference. If you’ve ever had occasion to attend a Tax Court hearing, you will have seen that the CRA is simply a party to the dispute and they hold no special place of prominence. Also, the cautionary note in the proposal section ab0ve equally applies to the appeals stage. When you are appealing, you are taking on an adversarial position contrary to the State’s position and all communications with the CRA should be made with that context in mind and with the knowledge that you may be building the CRA’s case against you or your client.

Following the notice of objection, the CRA will vacate, vary, or confirm the reassessment. Upon receiving a notice of confirmation (or another notice of reassessment if the reassessment is being varied, but not completely confirmed), you will have 90 days to appeal to the Tax Court of Canada. As with objections, you have up to one year and 90 days from the date of confirmation to apply for an extension of time to appeal, otherwise you will be statute barred.

4. The Tax Court – “Demolishing” the CRA’s Assumptions

The Tax Court is a branch of the Federal Court and the tax disputes that go before that body are substantially the same as any other court: there is a judge, there are witnesses and documentary evidence, counsel represents the taxpayer (other than in very minor disputes involving less than $12,000 called the “informal procedure”) and Crown counsel represents the CRA. Aside from being a specialized court dealing only with tax issues, there is one

notable difference that makes the Tax Court unique. Recall at the beginning of this post I referred to our self-reporting system, and how such a system entails the CRA having broad powers to compel documentary production. The nature of the self-reporting system also has a dramatic affect on how appeals are conducted and who has the burden. In appeals to the Tax Court the taxpayer has the burden of "demolishing" the Crown's assumptions, because the taxpayer is deemed to know his own affairs given that we are allowed to self-report. The nature of this burden is not only fundamental to conducting a successful appeal before the Tax Court, it should be fundamental to guiding your responses to the CRA throughout the audit process, for it is during the earlier process that the foundation of the Crown's assumptions are laid.

The Crown's reply to the Notice of Appeal – the "Assumptions"

Once the Notice of Appeal is filed in Tax Court, the Crown is tasked with filing a "Reply to the Notice of Appeal." It is the Reply that will form the framework of the case and determine what evidence will need to be called in order to rebut the specific "assumptions" of fact that the Crown is relying on to support the reassessment. The Crown almost never conducts inquiries over and above what is in the CRA file in preparing the Reply. This means that the assumptions come entirely from the CRA. Absent those circumstances where third party requirements or requests have been issued by the CRA (which happens relatively infrequently) the CRA's assumptions come from the taxpayers themselves, or their advisers, and are accumulated in the audit report, appeals report, and records of communications with the taxpayer. Almost every communication with the taxpayer is recorded in a computer log called a T2020.

The building of a successful appeal to the Tax Court starts from the very first communication with the CRA during the audit. A "theory of the case" is always more effective when established and implemented at the outset rather than after the fact. While responses to the CRA must always be honest, what is presented, and how it is presented, may tip the scales on a reassessment costing in the tens or even hundreds of thousands of dollars. How to "win" an appeal before the Tax Court is a subject that can fill an entire book. To those who are not trained in the art of tax litigation, simply being aware that the assumption building process starts from day one means you are ahead of the game. However, in matters of some legal or factual complexity, and particularly where significant amounts are in dispute, involving a tax litigator early on may be invaluable to you or your client in the long term.
