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TAXPAYERS OBLIGED TO PROVIDE TAX ACCRUAL WORKING PAPERS DURING AN AUDIT

— *Larry Nevsky, Associate, Dentons Canada LLP, Toronto*

Wolters Kluwer regularly features Dentons Canada LLP articles examining cases and topics of special interest.

Tax Accrual Working Papers Explained

Taxpayers undergoing financial statement audits are generally required to prepare tax accruals, also known as uncertain tax positions, to account for and disclose material items where the tax treatment is either unclear or the subject of dispute with the tax authorities. Frequently, the taxpayer's own employees prepare the tax accrual working papers which, for instance, under the United States Generally Accepted Accounting Principles ("US GAAP") and International Financial Reporting Standards ("IFRS"), require significant analysis of all tax positions that are less than certain. The tax accrual working papers are then provided to the financial statement auditors to establish a value for the contingency that is recorded as a liability on the financial statements. Since tax accrual working papers are created to outline all material tax positions where uncertainty exists, they could provide a road map to tax auditors outlining where the risks lie and can be used by tax auditors to establish reassessment positions that the tax auditors may not have otherwise identified. Furthermore, even where a taxpayer takes a reasonable filing position, the tax accrual working papers may outline less favourable alternative filing positions. For this reason, taxpayers would generally not want to provide their tax accrual working papers to the tax authorities.

Moreover, while it is understood that taxpayers are required to maintain these documents for accounting and securities law purposes, it is unlikely that taxpayers need to maintain tax accrual working papers pursuant to the *Income Tax Act* (Canada) (the "ITA") or the *Excise Tax Act* (Canada) (the "ETA"). Specifically, section 230 of the ITA and subsection 286(1) of the ETA only require the maintenance of such books and records as will enable the taxes payable or the amounts that should have been collected, withheld, or deducted to be determined. Since tax accrual working papers are not required to determine any of these amounts, but are prepared only to outline the risks associated with the tax positions taken for financial accounting purposes, it is certainly arguable that they do not fall within the scope of these statutory requirements.

CRA's Published Policy on Tax Accrual Working Papers

The Canada Revenue Agency ("CRA") takes the position that tax accrual working papers "relate" to the books and records of taxpayers. Accordingly, the CRA may inspect tax accrual working papers during the course of a tax audit pursuant to subsection 231.1(1)

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of the ITA or subsection 288(1) of the ETA, which provide the CRA the right to inspect, audit, or examine the books and records of a taxpayer or any document that relates or may relate to the information that is, or should be, in the books and records of the taxpayer. However, in a published policy, the CRA stated that information from third parties will be sought when the taxpayer cannot or will not provide information. The CRA also provided that tax accrual working papers will not be routinely required.

The *BP Canada* Case

Whether or not a taxpayer is required to provide the CRA with an issues list from its tax accrual working papers during the course of a tax audit was the subject of an application brought before the Federal Court of Canada by the Minister of National Revenue in *BP Canada Energy Company v. Minister of National Revenue* (2015 FC 714), seeking a compliance order requiring BP to produce its tax accrual working papers.

In *BP Canada*, the Minister candidly argued that it sought to obtain BP's tax accrual working papers to assist the CRA in expediting its audit not only for the years for which the tax accrual working papers were prepared but also for subsequent tax years — thus implying that the documents were not required for the audit but were simply helpful as a matter of convenience for the auditor. The Minister presented herself as being in an inherently disadvantaged position in Canada's self-reporting tax system. In requesting the tax accrual working papers, the Minister argued that she was merely performing her obligation to verify the accuracy of BP's tax return.

BP argued that the Minister may have broad authority in her audit powers, but the provision of the issues list is not required to fulfill her duty to administer the ITA. Moreover, the issues list reflected BP's subjective opinion regarding potential tax risks and, in this case, related to statute-barred taxation years. Accordingly, BP's position was that these documents could not be viewed as relating to the determination of taxable income under the ITA. BP also argued that even if the statutory test is met, the Federal Court would be required to justify the exercise of its discretion and would not be able to do so in this case. BP provided a number of reasons why the Federal Court should not exercise its discretion, including that the disclosure of the issues list amounted to a compulsory "self-audit", that the Minister's own policy and practice demonstrated that the issues list is not required to complete the audit, and that disclosure of tax accrual working papers would be contrary to public interest in the full and frank disclosure of tax risks for financial reporting purposes.

In addition, BP specifically argued that the issues list should not be compelled because doing so would fundamentally offend the principles of the self-reporting tax system that the Minister administers as a matter of law and would single out a certain class of taxpayers who are required to prepare tax accrual working papers for non-tax purposes. In making this argument, counsel for BP described in vivid detail how allowing the CRA to request tax accrual working papers effectively shifts the audit work from the Minister to the taxpayer.

The Federal Court Decision

In granting the compliance order requiring BP to provide the requested tax accrual working papers, the Federal Court found that while the Minister may not need the tax accrual working papers to complete an audit, if the Minister wants them, she should have them. The Federal Court did not accept BP's "road map" argument or its "self-audit" argument and put weight on the fact that the issues list was already prepared and, thus, no additional work would be required by the taxpayer. Instead, the Federal Court endorsed the Minister's audit approach in this case, stating that the Minister's request for tax accrual working papers is not part of a fishing expedition if the Minister knows that she wants a clear road map to be used for current and future audits.

The Federal Court also provided a broad interpretation of the types of documents that may be requested by the Minister pursuant to subsection 231.1(1) of the ITA, stating that they relate to the taxpayer's records. The Federal Court found that while the ITA may not require that these types of documents be retained, if they are retained for another reason, the documents can be requested by the Minister. This was held to be the case by the Federal Court despite BP's argument that in doing so the Minister unfairly prejudices a certain subset of taxpayers who are required to prepare tax accrual working papers for non-tax reasons. Here, the Federal Court found the Minister's argument more compelling. The Minister provided that tax accrual working papers allow the Minister to identify and audit additional

items where taxpayers take positions "that are on the line" which may be disputed by the taxpayer and, ultimately, decided upon by the Tax Court of Canada.

Caution Required by Taxpayers

The decision in *BP Canada* clearly outlines the Federal Court's opinion that tax accrual working papers need to be produced when requested pursuant to section 231.1 of the ITA. It also supports the Minister's policy argument that using tax accrual working papers allows the CRA to challenge more tax positions before the Tax Court of Canada. Accordingly, despite arguments to the contrary made by BP, this decision condones a shift in the burden and cost of the tax audit function from the CRA to taxpayers in cases where tax accrual working papers are prepared.

While BP will likely file an appeal, this Federal Court decision nevertheless serves as an important reminder that the CRA is becoming increasingly aggressive in its audit practices and the legislation affords the CRA extremely broad powers to obtain a wide array of information from taxpayers. As such, taxpayers as well as tax advisers should be cognizant of the potential disclosure obligations when preparing and maintaining tax accrual working papers.

A number of tax lawyers from Dentons Canada LLP write commentary for Wolters Kluwer's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for Wolters Kluwer's* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for Wolters Kluwer's* Federal Tax Practice *reporter and the summaries for Wolters Kluwer's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by Wolters Kluwer:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Dentons Canada LLP and a member of the Editorial Board of Wolters Kluwer's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

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CURRENT ITEMS OF INTEREST

Quebec To Appeal Plan by the Federal Government To Regulate the Canadian Capital Markets

On July 7, 2015, the Quebec government announced that it would launch an appeal to the Quebec Court of Appeal to challenge the new federal plan to create a pan-Canadian body to regulate its capital markets.

Stéphanie Vallée, the Minister of Justice and Attorney General, stated that "regulation of securities trading is too important a matter to run the risk of its hinging, in whole or in part, on legislation whose legal basis is potentially unconstitutional. Given this new attempt by Ottawa to set up a pan-Canadian commission, Québec needs to apply to the Court of Appeal once again".

In 2011, the Supreme Court of Canada confirmed that securities regulations fall essentially under the domain of the provinces. Quebec intends to defend that right vigorously.

CRA Amends Regulations Governing Mandatory Electronic Filing of Prescribed Information Returns

On June 10, 2015, the Canada Revenue Agency published amended regulations which reduce the mandatory electronic filing threshold from 500 to 50 information returns for those prescribed returns listed in subsection 205.1(1) of the *Income Tax Regulations*.

Entry into Force of the New Tax Convention and Related Protocols Between Canada and New Zealand

The new Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and related protocols between Canada and New Zealand entered into force on June 26, 2015.

Article 28 of the new Convention states that the provisions generally have effect in Canada in respect of tax withheld at the source on amounts paid or credited to non-residents, on or after the first day of August 2015, and in respect of other Canadian tax, for taxation years beginning on or after the first day of January 2016.

The new Convention replaces the tax convention signed on May 13, 1980.

RECENT INCOME TAX INTERPRETATIONS

This is a regular feature summarizing recent noteworthy income tax interpretations issued by the Minister of National Revenue. Copies of these interpretations can be found in the Wolters Kluwer online Federal Income Tax service, under Window on Canadian Tax.

Refundable Medical Expense Supplement — Meaning of "Adjusted Income"

The refundable medical expense supplement varies with adjusted income. Where a spouse dies in the year, the spouse's income to the date of death must be taken into account in calculating adjusted income.

— *External Technical Interpretation, Business and Employment Division, ¶13,030 (French)*

Recovery of Withholding Tax on Repayment of Debt

Withholding tax previously paid on a corporate debt owed to a non-resident may be recoverable where the debt is subsequently repaid. The Canada Revenue Agency confirmed that the recovery is available where the repayment is made to a person other than the original lender, but to whom the debt had been assigned.

— *External Technical Interpretation, International Division, ¶13,027*

CCA Claim by Partnership Having Ceased To Exist

A partnership transferred property with an accrued terminal loss to an affiliated person and was therefore deemed to continue to own depreciable property on which it could claim capital cost allowance ("CCA"). The partnership was to be wound up. Whether it could claim CCA depended on whether the property had ceased to be owned by an affiliated person within 30 days of the wind up.

— *External Technical Interpretation, Business and Employment Division, ¶13,024 (French)*

RECENT CASES

Summary conviction for tax evasion resulted in fine and conditional sentence

The accused was charged with wilful evasion or attempt to evade compliance with the *Income Tax Act* and the failure to remit goods and services tax. The Crown proceeded summarily and the accused pled guilty. The question for determination by the Court was the appropriate penalty to be imposed.

The accused was required to pay a fine and serve a conditional sentence. The Court noted that in arriving at an appropriate sentence it was required to consider the three objectives of deterrence, denunciation, and rehabilitation. As well, the existence of aggravating or mitigating factors would affect the sentence to be imposed. There were two such aggravating factors, being the significant amount of taxes evaded and goods and services tax not remitted, and the breach of trust committed by not fulfilling the obligation to honestly and accurately report income. However, the accused had no criminal record, had pled guilty to the charges, and had recently experienced both the loss of his spouse and health problems, all of which were mitigating factors. A joint submission with respect to sentencing had been put forward, which called for a fine equal to 75% of the taxes evaded and a 20-month conditional sentence. The Court concluded that the sentence jointly proposed was well within the range of an appropriate sentence for the charges and accepted the joint submission.

¶49,091, *Leung*, 2015 DTC 5059

Appeal allowed where Tax Court erred in striking part of Crown's pleadings

The taxpayer claimed capital cost allowance ("CCA") with respect to a licence which it had purchased to market a specific pharmaceutical. The Minister of National Revenue disallowed the claim for CCA on the basis that the licence was an unregistered tax shelter. The taxpayer appealed from that finding to the Tax Court of Canada. Before the Tax Court, the taxpayer was granted an order striking certain portions of the Crown's pleadings and the Crown was granted an order allowing it to amend those pleadings. The taxpayer appealed from the order allowing amendment of the Crown's pleadings and the Crown cross-appealed.

The Crown's cross-appeal was allowed and the appeal by the taxpayer was dismissed. The jurisprudence provides that a claim is only to be struck if it is plain and obvious that, assuming the facts pleaded to be true, the pleading discloses no reasonable cause of action or has no reasonable prospect of success. The question on the Crown's cross-appeal, therefore, was whether the Tax Court erred in its assessment of whether the Crown had a reasonable prospect of success in relation to its claim that the taxpayer's licence was a tax shelter.

The resolution of that question turned on the Tax Court's interpretation of the statutory definition of a tax shelter and specifically on the issue of representations made. The appellate Court reviewed the conclusions reached by the Tax Court with respect to that definition and held that the Tax Court found that a tax shelter could be found to "exist regardless of who makes the statements or representations so long as they are made to the taxpayer". That being the case, it was an error on the part of the Tax Court to find that the Crown's pleadings were deficient because the Crown did not specify on whose behalf the statements or representations were made. As the Crown's cross-appeal was allowed, there was no need for the appellate Court to consider the taxpayer's appeal.

¶49,095, *Kinglon Investments Inc.*, 2015 DTC 5064

Taxpayer failed to show malice on part of CRA officials, and claim for public misfeasance dismissed

The taxpayers brought an action for damages against the Canada Revenue Agency ("CRA") arising from a civil audit and criminal investigation relating to the taxpayer's income tax and GST returns. The taxpayer had operated a sole proprietorship that carried on businesses, including horse lodging, horse ranching, and a summer horse camp for girls. After noticing that the taxpayer had filed tax returns for several years with negative income, the CRA conducted an audit of the taxpayer's 2000 and 2001 taxation years. Having concluded that the taxpayer had deliberately understated revenue and overstated expenses, the auditor sent a letter to the CRA investigations branch recommending a criminal investigation. The criminal investigation looked into the tax returns for 2000–2005 and sought a search warrant, based largely in part on the auditor's findings with extrapolations for the latter four years. The information to obtain ("ITO") search warrants assumed the unreported income and overstated expenses was about $800,000. The search warrant was executed in March 2007 and five boxes of documents were seized. After going through the seized information, the adjustment to the taxpayer's income was revised downwards to $487,000 and a recommendation was made to lay criminal charges. The taxpayer was notified in March 2009 that no criminal charges would be laid,

although reassessments were issued. The taxpayer filed notices of objection to the reassessments and declared bankruptcy in April 2008. He was discharged from bankruptcy in August 2009. On June 30, section 160 assessments were issued against the three daughters to whom their father had transferred the ranch property in 2002 or 2003. The taxpayers claimed that various CRA officials deliberately engaged in unlawful conduct in the course of the audit, the criminal investigation, and the process resulting in the reassessments, causing them embarrassment, distress, and humiliation. They originally sued for damages on the grounds of negligence, trespass, violation of Charter rights, and misfeasance in public office. All the grounds were struck except for misfeasance.

The action for damages was dismissed. To be successful, the taxpayers must show, on a balance of probabilities, that the CRA officials engaged in deliberate unlawful conduct with the awareness that it was unlawful and likely to injure the taxpayers. Malice must be shown on the part of the CRA. While there were some mistakes made in the analysis of revenue and expenses, they were not done maliciously and the CRA did the best it could given the taxpayer's disorganized record keeping. Being wrong is not enough to establish malice or intent to injure. There was no agreement or collusion among CRA officials to inflate the taxpayer's income. The search warrant was obtained lawfully. While the amounts of overstated expenses and under-reported income were substantially decreased after the search warrant was executed, the ITO was clear that the numbers had been extrapolated and the only way to get definitive numbers was by the execution of the search warrant. All the actions undertaken by the CRA were appropriate. There was extensive communication with the taxpayer during the course of the audit and after the search warrant was executed. The taxpayers had access to all the seized documents. The taxpayers gave contradictory and evasive testimony and had no evidence to support their allegations, one of which was that information had been unlawfully altered. The onus was on the taxpayers to establish their case on a balance of probabilities and they failed to do so.

¶49,092, *Foote*, 2015 DTC 5060

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For Wolters Kluwer Limited

Tara Isard, Senior Manager, Content
Tax & Accounting Canada
(416) 224-2224 ext. 6408
email: Tara.Isard@wolterskluwer.com

Natasha Menon, Senior Research Product Manager
Tax & Accounting Canada
(416) 224-2224 ext. 6360
email: Natasha.Menon@wolterskluwer.com

Wolters Kluwer Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.wolterskluwer.ca

PUBLICATIONS MAIL AGREEMENT NO. 40064546
RETURN UNDELIVERABLE CANADIAN ADDRESSES TO CIRCULATION DEPT.
330–123 MAIN ST
TORONTO ON M5W 1A1
email: circdept@publisher.com