



CURRENT TRENDS IN AUDIT PROCEDURES: A REVIEW OF THE  
GENERAL RULES AND WHAT TO LOOK OUT FOR WITH  
POTENTIAL CRIMINAL INVESTIGATIONS.

J. Andre Rachert

**Introduction**

This paper is addressed to practitioners, mostly accountants, who have watched the change in the Canada Revenue Agency's ("CRA") approach to audits in the last few years. A senior CRA official described this new approach to me as being similar to the difference between a *review engagement* and an *audit engagement* for the preparation of corporate financial statements. This likely means that the CRA is going to continue to ask for more and more information from taxpayers as part of the audit process and audits will continue to take up more accounting practice time.

The reality is that information technology gives the CRA easier access to all aspects of a taxpayer's life. Not so many years ago, a request for several years of bank statements would have been met with guffaws. Practitioners need to steel themselves for the continued increase in the scope of audit inquiries. If information exists or it can be created, the CRA will ask for it.<sup>1</sup>

There are three ways to react to the new approach.

The first approach is to resist the demands on the basis that the CRA has no right to intrude into taxpayer's lives. Despite recent cases such as *Stanfield*,<sup>2</sup> which might be seen as a move away from the free for all that exists after *Kitsch*,<sup>3</sup> *Ling*<sup>4</sup> and *Jarvis*,<sup>5</sup> the trend will likely be for courts to continue to affirm the CRA's right make requests for all manner of information related to the administration of the *Income Tax Act* ("ITA"). The second approach is for accountants to move quickly to comply with all audit requests. Expediency is sometimes the best policy. Regardless, accountants need to consider whether the increasing demands made by the CRA reflect a regulatory environment or are just a disguise for what is evolving into an adversarial relationship from the very early stages of audit inquiries.

Of course, if advisors just comply with all audit requests, then there is no adversarial relationship, at least between advisors and the CRA. Clients may not have the same opinion about the nature of their relationship with the CRA. For example, in *Ellingson v. MNR*<sup>6</sup> the taxpayer was the subject of drug related criminal charges in California, inquiries from the RCMP and the scrutiny of the CRA's Special Enforcement Program. Mr. Ellingson was probably a little surprised to learn that the Federal Court of Appeal felt he was not in an adversarial relationship with the government.<sup>7</sup>

The third option is for accountants to more openly recognise the inherent conflict in their roles as

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experts who manage their client's affairs to ensure compliance and advocates who try to protect their client's interests. Managing the dual roles of ensuring compliance while acting as advocates may be difficult. Regardless, the fiduciary relationship that exists between accountants and their clients likely mandates that accountants use their skills to represent their client's interests. The Supreme Court's comments in *Hodgkinson v. Simms*,<sup>8</sup> are an excellent reminder of where an advisor's duties lie.

[T]he very basis of the advisory contract is that the advisor will use his or her special skills on behalf of the advisee....

The finding of a fiduciary relationship in the independent professional advisory context simply does not represent any addition to the law. Courts exercising equitable jurisdiction have repeatedly affirmed that clients in a professional advisory relationship have a right to expect that their professional advisors will act in their best interests, to the exclusion of all other interests, unless the contrary is disclosed.

### **Anatomy of the Paper**

This paper canvasses three topics, moving from the general to the specific.

- (1) First, is a review of government publications as a means of predicting audit trends over the next few years.
- (2) Second, is a checklist of negotiation skills and brief discussion of when it makes sense to stop talking. This is not a legal analysis. Instead, it is an attempt to provide a framework for managing audits.
- (3) The third topic is suggestions for managing audits in light of new auditing and enforcement techniques and the judicial sanction of increased scrutiny of taxpayers. The approach advocated is a *quid pro quo* to the increased demands being made by the CRA. The author assumes that accountants, as the front line advisors in conflicts with the CRA, will need to take more direct control of audits, and perhaps more of an advocates role in protecting their client's interests. |

### **Current and Expected Trends.**

While at times it may seem that the political parties in control of the government do not proceed in an orderly basis with respect to setting policy, the same cannot be said of the CRA.

Tax practitioners recognise that the CRA usually flags its policy changes. Every spring practitioners dutifully read the annual federal budget report to discern trends in CRA policy and, more importantly, to keep their planning practices up to date.

Advisors involved in dispute resolutions will not likely get as much out of budget documents as practitioners with a focus on planning. This is because the CRA does not develop its day to day audit and investigation policy out of the budget process.

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Instead, the CRA develops that policy out of audits of its own activities. Criticism from a respected source, the Auditor General of Canada, is the engine driving the move to increased scrutiny. It only makes sense that the CRA would take audits of its own practices quite seriously. Politicians come and go, but the Auditor General is back every year to point out the CRA's foibles, failures and successes.

Here is what the policymakers have in store.

The following material is culled from the 2007 Federal Budget, the 2006 Federal Standing Committee on Finance, Report on the CRA,<sup>9</sup> and comments made in Auditor General reports starting in 2002.

The 2007 Federal Budget stated as follows in respect of audits and enforcement.

The CRA will be provided with additional resources to strengthen the enforcement of Canada's tax system in relation to foreign income and cross-border transactions. Particular emphasis will be placed on transfer pricing transactions and complex international tax avoidance cases.

Further resources will also be provided for the CRA to verify and collect taxes owing on income and sales generated in Canada. These resources will be used to find and challenge taxpayers participating in aggressive tax shelters, who fail to report all of their income, or who have made unsubstantiated GST/HST refund claims.<sup>10</sup>

### **Federal Standing Committee Reports**

The Federal Standing Committee on Finance released a report reviewing the CRA in December of 2006. The report is the summary of a legislative mandate set out in the *Canada Customs and Revenue Agency Act* to review the CRA every five years.<sup>11</sup> The report sets out the Committee's recommendations for the CRA.

The CRA and the Department of Finance appear to take the recommendations quite seriously. For example, the report recommends the institution of an ombudsman's office in the CRA. In May of 2007, the Minister of Finance announced the institution of an ombudsman's office to enhance the CRA's accountability and service to the public.

For this paper, three recommendations are particularly important. In summarised form the recommendations are as follows.

1. Recommendation 6: the CRA should allocate adequate resources to collections and compliance. In particular, the CRA should allocate resources to taxpayers who pose a higher risk for non-compliance.
2. Recommendation 7: the CRA should provide objective evidence that it is having success in its efforts to eliminate the underground economy.
3. Recommendation 11: the CRA should undertake its mandate in a manner that minimises the disruption to the normal functioning of business's and that the frequency and duration

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of the audit should reflect the businesses risks or the history of non-compliance.

Recommendation 11 is important if only because it is one of the few places where the costs of compliance are mentioned. It will be interesting to see how the CRA manages conflicting recommendations to ensure compliance, while intruding less on businesses.

The most interesting part of the report is the degree to which the Committee relies on the comments of the Auditor General of Canada for its findings. In fact, a review the Auditor General's reports for the last several years, are a roadmap for current and future trends in audit.

### **Auditor General Reports**

The following material is culled from recent Auditor General reports as a means of showing practitioners where some of the current policy initiatives had their genesis. A review of the 2006 and 2007 report is a practical guide to where dispute resolution practices will be focused over the next few years.

#### **2002<sup>12</sup>**

The 2002 report included an audit of the CRA's administration policies. The Auditor General commented as follows.

1. The controls the CRA has put in place to guard against inappropriate forgiveness of interest and penalties are deficient. While the CRA has improved its administration of the fairness provisions, the fact that it does not record the amounts waived in interest and penalties and the reasons for waiving them is still a concern. The approval and monitoring processes also need to be strengthened and consistency and procedural fairness enhanced.
2. The CRA has reasonable controls in place to guard against inappropriate write-offs of taxes owed. However, it needs to strengthen the system by taking accrued interest into consideration and grouping related-party accounts together when considering approval to write off an account.
3. The CRA needs to take administrative action and/or seek legislative action to minimize the effects of a recent court decision that held that provincial limitations, which range from 2 to 20 years, apply to the collection of federal income taxes. The decision could prevent the Crown from collecting over \$1 billion in owed income taxes and could result in different treatment of taxpayers who live in different provinces
4. Unlike businesses in the private sector, which can choose whether and to whom they will grant credit, the CRA must accept as accounts receivable all taxes owed by taxpayers. For the three-year period ended 31 March 2001, taxes owed that were written off averaged about \$1 billion a year.
5. The CRA needs to strengthen the policies and procedures it has in place to guard against inappropriate writing off of taxes owed and to provide for fair, consistent, and equitable

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treatment of taxpayers.

6. The policies and procedures the CRA has put in place to guard against the inappropriate forgiveness of interest and penalties and to provide for fair, consistent, and equitable treatment of taxpayers are deficient. The CRA needs to be consistent and fair in waiving the interest due on funds held in trust that are remitted late.
7. The CRA needs to develop an enforcement response to deter businesses from keeping trust money that does not belong to them. In administering the legislation introduced in December 2001 that allows small businesses to defer corporate tax instalments, it needs to find a way to reduce the risk to collecting the taxes owed.

### **2004<sup>13</sup>**

In 2004 the Auditor General audited the Appeals Division of the CRA and made the following comments.

1. The Appeals Branch is resolving objections to income tax and GST assessments in a way that is fair and impartial. The CRA needs to ensure that appeals officers fully grasp the importance of assessing the potential risks to the tax base from the objections they review and completing the risk assessments regularly.
2. More work is needed to improve the efficiency of the overall process for CPP and EI rulings, which are issued by the Revenue Collections Branch, and any related appeals of those rulings, which are dealt with by the Appeals Branch.
3. The Voluntary Disclosures Program inconsistent administration across the country raises concerns about whether the CRA is protecting the tax base. As well, The Auditor General is concerned that the CRA has gone beyond what Parliament was told the legislation supporting the program would be used for.

### **2005<sup>14</sup>**

In 2005 the Auditor General examined the Audit Division of the CRA to assess how well the CRA identifies and manages risk for individuals and domestic trusts as well as how efficiently the CRA uses information from third parties to verify personal income levels. The report makes the following comments.

1. The CRA's processing review program has a well-designed and well-executed risk-based approach for selecting and verifying deductions and credits that individuals have claimed on their tax returns but may not be fully entitled to.
2. The CRA's matching program needs to improve how it manages risk when it verifies that taxpayers have reported the full income shown for them on information slips submitted by third parties.
3. The CRA does not systematically evaluate the tax revenue at risk in domestic trusts when choosing the tax returns it verifies. There are also deficiencies in the CRA's review

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activities for tax returns of domestic trusts.

4. For example, the only measure of its performance in this area is whether a return was processed in the time that the CRA allots in its service standard; it lacks information on corrections that its assessors make; and it does not compare deductions claimed by trusts for allocation to beneficiaries against the amounts that the trust reported on the information slips provided to beneficiaries.

### **2006<sup>15</sup>**

For 2006, the objective of the Auditor General was to examine whether the CRA efficiently collects tax debts. This included personal taxes, corporate taxes, GST, payroll and source deductions. The report makes the following comments. |

1. Tax debt continues to grow at a faster rate than total taxes paid, and ageing accounts are a problem. The Auditor General found that the CRA's approach to assessing tax debts for risk continues to have major weaknesses that impede their timely and efficient collection. The Auditor General also found that the CRA has taken some steps to handle tax debts efficiently, but much more needs to be done.
2. Management lacks the information it needs to understand the makeup of the tax debt and to develop strategies and allocate resources in a way that would significantly improve the situation. It also lacks the information it needs to determine whether it is using efficient and timely processes to collect tax debts.
3. The CRA has known for many years what it needs to do to improve the collection of tax debt, but it has had difficulty achieving significant breakthroughs. It now has a strategic vision that sets a course for the future. The major challenge for the CRA is to turn that vision into reality through detailed planning, focussed management attention, and measurement of results.

### **2007<sup>16</sup>**

For 2007 the Auditor General examined the CRA's progress in improving its collection of tax from non-residents and taxing international transactions of Canadian residents. The report makes the following comments.

1. The Canada Revenue CRA faces even greater challenges in the administration of international tax rules than it does for domestic tax administration. These challenges include obtaining taxpayer information, working with foreign governments, and coping with the more complex underlying laws.
2. The CRA still requires access to better information to improve the effectiveness of its strategic risk assessment activities for international transactions. It must ensure that the audit coverage of and the approach to international audits of large corporate taxpayers is consistent across the country.
3. The CRA has made satisfactory progress in addressing some of our recommendations for

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non-resident tax administration. However, mandatory identification numbers for non-residents are needed, before all the recommended improvements can be made to non-resident services and compliance activities.

Many of the Auditor General's recommendation from 2002 and 2004 have been implemented over the last few years. For example, the Voluntary Disclosure Program has moved back to the Investigations Division and has become much narrower in its focus. The *Markevich*<sup>17</sup> decision on the application of provincial limitation periods was dealt with very swiftly by the federal government. |

Based on the comments in the 2005, 2006 and 2007 reports, advisors can expect the following trends in audit over the next few years.

1. Increased use of third party information to verify personal income levels.
2. More audits of domestic trusts.
3. Increased scrutiny of transactions involving non-residents.
4. Greater focus on international transactions.
5. A revamping of the Collections program to ensure a higher level of collection.

## **Audit Management: Negotiation**

### **A Checklist of Negotiation Skills for Advisors Involved in Audits**

There is a vast market for literature providing advice on negotiating and how to become a better negotiator. Books on how to "win" in negotiations are so common and promise so much that we should all be able to access secret negotiation strategies that will allow us to hypnotize our adversaries and make them do our bidding.

In tax law there is an abundance of tax literature describing complex strategies to minimize tax. A lot is written about tax laws, planning, wills, estates and corporate reorganizations. Apparently, there is also a vast market for this type of literature.

There is next to nothing written about how to negotiate with the CRA. I suppose that judicial decisions can be seen as writing about failures in negotiation. In one sense case law results from negotiations that have gone so poorly that the parties, at great cost, decided to put the outcome of their dispute into the hands of a third party.

From one perspective, negotiating with the CRA or any taxing authority is an oxymoron. It does not matter if you are as sweet as honey or as sour as vinegar, the government will come back every year for more taxes. The CRA does not need a taxpayer's business in the same way that a car dealership or a restaurant wants to have repeat business. For most people, there is no option of taking your business elsewhere. The frustration of dealing with a monolith may explain why most writing about tax boils down to how to create efficient tax structures rather than how to convince the tax man to be nice.

Regardless, everyone who I know that deals with the CRA is incredibly focused on how to



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negotiate the best deal for their clients. These are very bright, educated people who usually approach the CRA with a clear idea of what the proper result should be on a file. The most successful of these practitioners, whether they are lawyers or accountants, employ the tools of negotiation. More importantly, these advisors seem to have a clear idea when it's time to move on. To put it another way, the best advisors seem to know how to provide information to the CRA and when the provision of information is not only a waste of time, but might actually be detrimental. |

### **Cribbing From the Law Society**

The British Columbia law society offers annual seminars on negotiation strategy. In 2007 Martin Latz<sup>18</sup> was the course instructor. The skills Mr. Latz discussed are not magic. Regardless, reviewing negotiation strategies is a valuable exercise for advisors who manage CRA audits.

Mr. Latz teaches what he calls the "Five Golden Rules". Variations of these strategies can be found in other negotiation books. The descriptions and examples provided by Mr. Latz may have resonated as good advice because they were tailored to a legal audience.<sup>19</sup>

#### **Martin Latz' Five Golden Rules of Negotiation.**

1. Information is Power - So Get It!
  - a) Negotiation power goes to those who listen and learn. It's thus critical to ask questions and get as much relevant information as you can throughout the negotiation process.
  - b) Instead of trying to convince the other side of the strength of your case or why the other side should agree to a position, start by getting information, develop rapport, develop relationships, ask for information, find out your counterparts' reputation, probe their goals, needs, interests, and options.
2. Maximize Your Leverage
  - a) How much does your client want or need that deal or settlement, and how much does your client's counterpart need it?
  - b) What are your and their clients' alternatives if an agreement is not reached? What can you and your client do to strengthen your leverage?
  - c) Maximizing leverage can be especially challenging since the parties must be willing to settle or proceed to court. Court is the ultimate leverage for litigators. Litigators must signal an interest in settling. The more they signal an interest in settling (and thus not trying their case), the weaker their leverage becomes.
3. Employ "Fair" Objective Criteria
  - a) Fairness and the perception of fairness are key elements in many legal negotiations. Look for relatively objective standards, like market value, precedent, efficiency, or expert opinion. |
  - b) Standards can provide an independent and objective view of the issues. This can

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depersonalize the negotiation and help preserve their relationships.

### **4. Design an Offer-Concession Strategy**

- a) Understand the psychological dynamics underlying concession behavior, as well as improve your ability to evaluate your counterpart's "flinch" point.
- b) A crucial offer-concession element in the legal arena involves making sure your counterpart walks away feeling like he or she achieved a good deal
- c) Build in "room to move" with offers so the other side will feel like they have received a decent result.

### **5. Control the Agenda**

- a) Effectively managing the negotiation process is very challenging. For example understanding how deadlines create results will give you a leg up in your negotiations.
- b) If your counterpart tries to control the agenda, negotiate it. Not in an overly aggressive way. But in a way that satisfies both parties' interests.

Approaching an audit as a negotiation may be helpful in field audits. Field audits are often protracted events. Advisors are doing more than discussing technical aspects of the ITA. There is almost always an opportunity to move the goal posts in an audit. If a meeting does not go well, it might be helpful to review what happened through a negotiation checklist.

## **Limits of Negotiation, Cognitive Bias and When to Stop Talking**

Practitioners must accept that negotiation with a monolith is not the same as negotiating a business deal. For example, the second golden rule "Maximize Your Leverage" does not easily apply to dealings with the CRA. In most business negotiations one effective way to maximize leverage is to have alternatives. Having another buyer or seller waiting in the wings is tremendous leverage. It is difficult to maximize your client's leverage when your counterpart really has nothing to lose and at times appears to have an endless supply of resources.

The only realistic alternative to negotiating a settlement at audit is to proceed to an objection or to court. There is no other deal waiting in the wings. The structural limits of the audit process limit an advisor's ability to maximize their client's leverage.

Research in cognitive psychology indicates that "cognitive biases" in negotiators are often a feature in failed negotiations.<sup>20</sup> These biases seem to be part of the human condition and are adaptive in many situations. |

Of particular concern in an audit, where the flow of information is often a one way street, is the concept of "confirmation bias." Confirmation bias occurs where decision makers seek out and interpret evidence that confirms a particular point of view and ignore evidence contrary to those views. It is not that uncommon for an advisor, at the end of an audit, to feel like only some of the submissions or material given to the auditor were accorded any weight.

Particularly competent advisors seem to know when to stop providing information. While there is

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no general rule about when that time has arrived on a file, it is usually safe to conclude that negotiations are stalemated when the audit has dissolved into a series of arguments or if the auditor appears to have made up his or her mind no matter what a practitioner says or does.

If the auditor is not listening, the solution is to end the audit.

If the audit result is unsatisfactory, take the matter to the Objection stage. Hopefully, the Appeals officer will be able to see the file differently than the auditor. It is also a good time for the advisor to check their own cognitive biases. An independent review of the file by a colleague or a tax lawyer before submissions are made at the Objection stage might be the most valuable action taken on a file.

## **Suggestions for Managing Audits: Making the Rules Work**

### **The Current Limits**

The 2003 following comments by Howard Kellough Q.C.<sup>21</sup> on the apparent scope of the CRA's authority to make demands on taxpayers and their advisors continue to apply today.<sup>22</sup>

#### **Privilege**

Both the Trial Division and Appeal Court denied a claim for privilege regarding materials produced by BDO Dunwoody. That is, the courts confirmed that there is no accountant-client privilege. This confirms existing case authority such as *Susan Hosiery Ltd. v. MNR*. The Court rejected taxpayers claim for a "class" or "case by case" privilege in respect of advice and materials provided by Dunwoody.

#### **Scope of Requirement**

It is apparent that CCRA is not content with requesting merely source documents. Auditors may request correspondence, tax files, working papers, telephone records and "all tax planning memoranda" but now are requesting responses to questions that are in the form of interrogatories without providing the taxpayers with any due process to respond under examination. When this point was raised before the Court of Appeal, it | was dismissed without any seeming concern by the Justices...

One can expect that CCRA will take advantage of it and perhaps find that accountants are fertile ground for finding their road map to the structure or obtaining other information. One can expect further court challenges although it may take a decision of the Supreme Court of Canada to correct the open-ended and rather loose judgment of the Federal Court of Appeal. In the meantime, accountants should consider protecting their clients by working through legal counsel.

The courts can only limit the actions of the CRA within the confines of the legislative framework of the ITA. To date, the courts have chosen to assume that the increasing demands made by auditors do not violate the provisions of the ITA.

Realistically, the judiciary provides two avenues for managing an audit.

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1. Requests for information must be for purposes relating to the administration and enforcement of the ITA.<sup>23</sup>
2. The taxpayer's right to silence overrides the obligation to provide information if the CRA is engaged in a criminal investigation of the taxpayer's affairs. It is reasonable for an accountant to be assured that an audit is not an investigation or evolving into an investigation.

The case law that approves the broad scope of the CRA's authority to request information does not say that accountants are not allowed to ask why the information is necessary. Nor does it say that it is unreasonable for advisors to make inquiries of the auditor assigned to the file.

As front line advisors, accountants play a valuable role in protecting their clients' rights. Ensuring that clients do not make statements that will be used in criminal investigations or that such an investigation is not underway is also a reasonable duty for an accountant in an audit.

To paraphrase the Golden Rules of Negotiation, in an audit, an accountant should be concerned with obtaining information and controlling the audit processes. If an intractable dispute arises, a litigator will appreciate all of the information that an accountant has been able to glean from the CRA. Furthermore, obtaining information during an audit has the effect of crystalizing issues that might still be resolved and letting the accountant know when they are wasting their time with submissions.

### **Who's Calling Please?**

Audits come in many guises. Basically, any CRA contact that involves a request for information can be considered to be an audit function.

Usually, the first contact from the CRA is either by telephone or through a letter. Often just knowing which branch is conducting the audit will be an invitation for an accountant to obtain more information or provide enough information to let the client know that they have a significant problem. An accountant may also decide that the most prudent course of conduct is to not provide any substantive information based on which branch of the CRA is conducting the audit. Currently, the main audit branches are as follows.<sup>24</sup>

#### **(1) Audit/Verification and Enforcement**

This is the audit branch of the CRA. It conducts the bulk of business and personal audits. There are subgroups in this branch. Personnel from those branches usually list their section name in correspondence.

The Audit branch conducts two main types of audits, desk audits and field audits. A desk audit is a review of a tax return and usually focus on the verification of expenses or credits claimed on a tax return. A desk audit is usually quite narrow in scope and can usually be dealt with by providing documentation supporting claimed expenses or credits.

Field audits, as the name suggests, are conducted in the community. These audits can be

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very complex. Over the past few years these audits have been increasingly instituted with broadly worded written requests for information. Field audits are the meat and potatoes of the Audit division. Field audits are usually the starting place for all the other enforcement activities of the CRA.

### **(2) Tax Avoidance**

Any contact from an auditor in the Tax Avoidance Group, means the client is already in trouble. The Tax Avoidance group manages GAAR audits, shelter audits, and special projects such as charity schemes and other avoidance activities.

Contacts from Tax Avoidance should be treated very carefully. The CRA already has a clear idea about the veracity of the transactions under review. Proposals for the assessment of gross negligence penalties are a common trait of early correspondence from the Tax Avoidance Group.

Since the CRA usually has a fairly clear opinion on the facts when the Tax Avoidance group is involved, most taxpayers are in a defensive position at the outset of an audit. There is probably little that can be done to change the mind of the auditor regarding any proposed tax result. Instead, the focus should be on minimizing the facts that support any proposed gross negligence penalty assessment.

### **(3) Collections Division**

The Collections division conducts quasi-audits as part of their debt collection function. The assessments prepared by the collections division have the innocuous sounding name | "memorandum assessment." The audit is usually related to section 160 " " of the ITA. The collector has information on hand that indicates that a taxpayer has received property for less than fair market value from another taxpayer who has an unpaid tax debt.

The collections division also issues Jeopardy Assessments after conducting quasi-audits. In a Jeopardy Assessment the CRA has concerns that assets that might be used to pay a tax debt may (or are) be relocated to a jurisdiction that will prevent the CRA from collecting the debt.

Prior to a Jeopardy Assessment or section 160 assessment, the taxpayer may receive a letter advising that the particular assessment is being considered. The letter will invite submissions.

Submissions to the CRA collector are usually ineffective. After all, the collector is proposing to issue the assessment based on their review of the facts. The best way to ensure that submissions will be effective is to have a clear idea of the errors in the facts and law that the collector is relying on.

### **(4) Special Enforcement Program (SEP).**

This program audits persons suspected of deriving income from organized crime or any other criminal activity.

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Contacts from this group should be referred to legal counsel. The client should be instructed to retain legal counsel who has experience in criminal law and tax law. All practitioner advice should be provided as part of the team providing legal advice to the client. Accountants should be retained specifically to assist legal counsel in the provision of legal advice.

### **(5) Investigations. (Also called Special Investigations, Criminal Investigations, SI.)**

This group is not normally thought of as conducting an audit function. It is not unusual for personnel from this branch to complete audits that have been referred to them from the Verification and Enforcement branch. It is also not unusual for the first contact with the Investigations division to be by a group of investigators armed with a search warrant.

- a) Contacts from this group should be referred to legal counsel.
- b) The client should be instructed to retain legal counsel who has experience in criminal law and tax law.
- c) All practitioner advice should be provided as part of the team providing legal advice to the client. Accountants should be retained specifically to assist legal counsel in the provision of legal advice.
- d) Accountants should be aware that they may be material witnesses in criminal litigation.
- e) Their status should be reviewed with their own (meaning different) legal counsel | than the client's representative.
- f) If the accountant could be charged or is in some way culpable, the accountant's insurer should be advised and an independent accountant should be retained to assist on the file.
- g) The accountant and the client should not end their relationship unless there is a clear conflict of interest or it makes strategic sense to do so.
- h) Audit results outside the scope of the criminal investigation need to be reviewed. If a criminal investigator completed the audit, there is no guarantee that it was done correctly. Sometimes clients are so focused on the criminal investigation that the regular audit conclusions are ignored.

### **Managing Audits: Ensure Information Flows two Ways.**

Not surprisingly, the best way to control an audit is to obtain information before providing information. Desk audits normally do not require a significant amount of explanation from the CRA contact person. However, it does not hurt to at least contact the person making the request and ask some basic questions.

- 1) Which branch and section is the inquiry coming from?
- 2) Who is the auditor's team leader?
- 3) How was the client selected for audit?
- 4) What is the concern?

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Those questions should be asked in every audit situation.

### **Initial Contact Letters**

Over the past few years CRA auditors have been initiating audits by sending template letters requesting vast amounts of material for even routine audits. These letters can be disheartening since the CRA sets a tone of suspicion with requests for vast amounts of material and demands for third party verification.

Auditors do not work in isolation. The auditor's team leader has more flexibility than the auditor. In some cases, it may be necessary to work around the auditor. Having the team leader's name on file is a good idea.

The first response to the initial contact on a field audit should be the same as it is in a desk audit.

1. Which branch and section is the inquiry coming from?
2. Who is the auditor's team leader?
3. How was the client selected for audit? |
4. What is the concern?
5. Instruct the auditor that the client has been told not to respond to any inquiries directly. All inquiries will be redirected to the advisor.

Of course, the preference is to obtain a written response from the auditor on these preliminary inquiries. Written requests set a tone of professionalism. The best way to get a written response is to make the inquiries in writing. The initial contact letter should also advise the auditor to direct communications to the accountant's office.

Some branches of the CRA are more reluctant to deal with taxpayers through the filter of an advisor. The auditor does not have to abide by request to funnel contacts through the accountant's office.

The client needs to be advised as follows:

1. Do not have any discussions with the CRA without the advisor being present.
2. Do not make any written responses to the CRA without the advisor's review.
3. Fees will be charged and the audit will impact the business.
4. The CRA audit inquiry letter needs to be shared and reviewed with the client. Usually, the letter is sent to the client and copied to the accountant. The client has frantically forwarded the letter wondering what is going on.

Some accountants feel vaguely guilty about charging fees for managing an audit. My guess is that guilt stems a feeling that the audit is somehow the accountant's fault. The client needs to understand that managing an audit is labour intensive. Discounting fees or not charging to manage an audit is an invitation to disaster. Only the most diligent practitioner will give preference to non-paying clients when paying clients are making demands for the practitioner's

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time.

### Negotiating Information Requests.

The CRA has advised the community of tax professionals that it will continue to expand the scope of audit inquiries. The Auditor General continues to push the CRA to do more to ensure that taxes are collected. The courts have not indicated that the CRA has reached some kind of threshold in the scope of its inquiries.

An accountant's ability to limit the scope of the inquiry will be more successful if it is based on the pragmatics of the file and a continuous review of the rote requests sent out in template audit letters. Threatening to put the demands in the letter before a judge at an early stage is a waste of energy.

There are a number of practical ways to manage inquiries. The key throughout the audit process is to keep everyone involved focused on the reasons for the audit and the best way to efficiently address the auditor's concerns. The auditor also needs to be continually reminded of the costs and impacts of the audit. Accountants have used some or all of the following negotiation strategies to keep audit's running smoothly.

1. Foremost is the ability to break onerous demands into pieces that can be adequately managed. On some audit files it almost seems as though the audit request letter has been taken word for word from the CRA template. Accountants need to spend time disassembling auditor's requests for information.
  - (a) Request a time budget from the CRA auditor. How much time have they allocated for the audit. A budget from the auditor may be of assistance in determining how much time the accountant will spend on the file.
  - (b) Auditors may refuse to explain the reasons for the audit or specific concerns on a particular file. This may stem from a feeling that the client is hiding something.
    - (i) Accountants need to explain clearly the expense of providing every piece of paper requested.
    - (ii) If the auditor gets to choose the priority items, concerns about client honesty should be allayed early in the audit.
    - (iii) If the auditor is concerned that the client is hiding something, is there more going on with the file than the auditor has let on.
  - (iv) Break down the requests into years.

For example, if an auditor wants 4 years of bank statements, explain the cost of obtaining the statements. Have the auditor explain the reason for the request. If, for example, the auditor is looking for unreported deposits, 1 year of bank statements may be a sufficient sample to show that the client has not been making unreported deposits into the account.



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- (v) The auditor should be reminded of the CRA "one plus one" administrative policy. Usually, audits are for the current year plus one year back. There should be clear reasons why that policy is not being adhered to.
  - (c) Offer to provide samples before undertaking arduous document compilations. Again, the auditor should explain the reason for the request. The CRA has used sampling in audits for years. The current regime seems to be moving away from sampling to requests for all documents. There has not been a clear explanation from the CRA why sampling is unsatisfactory.
  - (d) Generic requests for "all working papers" are unhelpful. The auditor should provide more detail than a request for all working papers. Again, the auditor should be able to explain how a document relates to the enforcement of the ITA.
2. This process of seeking explanations from the auditor for all requests and reviewing material before it is provided to the auditor should continue throughout the audit process.
  3. Document reviews should take place at the accountant's office. Requests for copies of documents should be dealt with at the accountant's office.
  4. Finally, anything that is going to be provided to the auditor should be reviewed with the client.

### **Access to the Client**

1. Access to the client should be restricted to situations where the accountant can be present.
2. The auditor may want to visit the client's business. Sometimes there is no clear reason for the visit. The auditor should be asked to explain why a visit is necessary. Site visits should be supervised by the accountant.
3. The auditor may want to visit the client's home. Paragraphs 231.1(2) " " & (3) of the ITA require judicial authorisation before an auditor can require a visit to the taxpayer's home. The only reason to allow an auditor into a client's home is if there is a home office or the home is an asset of the business.

### **Planning Material.**

5. The CICA has requested the CRA adopt a policy of restraint in respect of requests for working papers.<sup>25</sup> To date, the CRA does not appear to have adopted any such policy.
6. Requests for planning material are becoming commonplace. If the planning material has been provided by anyone other than a lawyer or advisors who are assisting a lawyer in the provision of legal advice, there is little chance of privilege attaching to any documents.<sup>26</sup> Any hope for controlling access to planning material needs to be dealt with in advance of the audit. There are several good articles on managing planning materials.<sup>27</sup> Detailing how to

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manage planning material is beyond the scope of this paper.

### **Requirements Checklist**

If a file has moved to the stage that the auditor is issuing Requirements<sup>28</sup> it is likely that the audit is not going well. The period for compliance for a Requirement is determined by CRA policy. There needs to be some kind of reaction in that period so that the accountant does not face the risk of being charged with failing to comply.<sup>29</sup> The following is a checklist for compliance.

1. Immediately give written advice to the client that a Requirement has been issued and that it must be complied with unless the client wishes to challenge it in court.
2. Request that the client obtain legal advice.
3. Provide a copy of the Requirement to the client's lawyer. Provide access to all materials to that lawyer so the client and the solicitor can determine if a claim of solicitor-client privilege should be made.
4. Do not turn over documents prior to determining whether the Requirement is valid. It makes sense to obtain a lawyer's opinion on the issue.
5. Do not cull any files after the Requirement is served. Only remove documents after obtaining independent legal advice that it is permissible.
6. Do not redact third party names in the files without receiving independent legal advice that it is permissible.<sup>30</sup>
7. Only answer interrogatory type questions after consultation with colleagues and legal counsel. The client should be provided with a copy of any answers. Remember that interrogatories turn the accountant into a material witness.
8. The normal time frame for compliance is 30 days after the Requirement has been formally served. Ask for an extension in writing if the period is unreasonable. Even where the time for compliance has expired, the CRA will often not proceed with non-compliance sanctions if the response is made before the matter is sent to the Crown for review.
7. Where the Requirement requests that documents be created, do not automatically reject that request. In legal transactions many lawyers want to create the documents because doing so, creates control. If there is some advantage to creating a document do so without complaint.

### **Gross Negligence Penalties Checklist.**

In most audits the taxpayer and the advisors are well advised to provide more information rather than less, since the lack of information usually leads to negative assumptions on the part of the auditor. When a gross negligence penalty is being proposed, accountants need to resist the temptation to provide information. |

The CRA seems to be making the leap from gross negligence penalties to criminal charges more

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frequently than it has in previous years. The wording of subsection 163(2) " " and paragraph 239(1)(a) " " & (d) " " of the ITA differ semantically, but the practical differences between the provisions are difficult to discern.

163(2) provides as follows:

Every person who, knowingly, or under circumstances amounting to gross negligence, has made or has participated in, assented to or acquiesced in the making of, a false statement or omission in a return, form, certificate, statement or answer... filed or made in respect of a taxation year for the purposes of this Act, is liable to a penalty.

239(1)(d) of the Act. Paragraphs 239(1)(a) " " and (d) " " read as follows:

(1) Every person who has

(a) made, or participated in, assented to or acquiesced in the making of, false or deceptive statements in a return, certificate, statement or answer filed or made as required by or under this Act or a regulation,...

(d) wilfully, in any manner, evaded or attempted to evade compliance with this Act or payment of taxes imposed by this Act,

is guilty of an offence and, in addition to any penalty otherwise provided, is liable on summary conviction

The only obvious substantive difference between "knowingly" as described in subsection 163(2) " " and "wilfully" as described in paragraph 239(1)(d) " " is the level of proof required to prove the penalty. For a civil penalty the Minister need only prove the gross negligence on a balance of probabilities. In a criminal prosecution the Minister must prove "wilful behaviour" beyond a reasonable doubt.<sup>31</sup>

The main reason to avoid making submissions prior to the assessment of civil gross negligence penalties is that there is no Charter protection for explanatory statements made in the context of a civil assessment.<sup>32</sup> In other words, the statements made in the hopes of fending off a civil gross negligence penalty can be used to assist in the criminal prosecution of a client.

In tax fraud cases criminal defense counsel are often exasperated when they discover that their client has made a series of statements to the CRA. Anyone who has ever watched an episode of *Law & Order* knows that the accused should not talk to the cops. These same defense counsel are equally exasperated when they read *Ling* and *Jarvis* and their clients (and tax lawyer and | accountants) explain that they did not know they were talking to the cops. The general rule, as explained eloquently to the author by one criminal lawyer, is "shut up."

Despite such sage advice, the best way to defeat gross negligence penalties is by providing a credible alternative explanation of the impugned events.<sup>33</sup> Indeed, in criminal prosecutions, even where the accused does not testify, the defense usually proffers an alternative explanation for the transactions being reviewed.

In circumstances where gross negligence penalties are contemplated, accountants and their

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clients should generally not respond to friendly invitations to make submissions unless the response is clearly exculpatory. The following checklist may be helpful if gross negligence penalties are proposed.

1. Obtain a copy of the draft penalty report if possible. If not possible, obtain a written summary of the facts supporting the assessment.
2. In writing, request confirmation whether the auditor has contacted Special Investigations. If the answer is anything other than "no", refer the matter to legal counsel.
3. In writing, request confirmation whether the auditor will refer the matter to Special Investigations. Normally, the response will be, "it depends."
4. In writing, request confirmation whether the auditor will refer the matter to Special Investigations if the client *does not* make any submissions. If the answer is anything other than "no", refer the matter to legal counsel.
5. Decline requests for personal interviews with the client to discuss gross negligence penalties.
6. If the auditor attends at the accountant's office with a supervisor or any other CRA personnel in tow to discuss concerns that might lead to gross negligence penalties, obtain a summary of the concerns. Do not make submissions at that time.
7. Review the 2005 article by O'Neil,<sup>134</sup> it provides a good summary of considerations that need to go into any submissions. Courts have considered the following in determining whether penalties should apply.
  - (a) The sophistication of the taxpayer.
  - (b) The amount of income at issue. |
  - (c) The recurrence of the event.
  - (d) Possible reliance on an accountant or a financial adviser.
  - (e) The credibility of the client as a witness.
  - (f) The honest belief that the unreported income was not taxable.
8. The safe course of conduct is to let the auditor draw conclusions based on the facts already on hand. Only make submissions if they are clearly exculpatory.
9. Failure to make submissions will probably lead to the assessment of gross negligence penalties. The report that accompanies the assessment has the effect of crystalizing the basis for a gross negligence assessment. Advise the client of the probable results of not making submissions.
10. Obtain a copy of the penalty report. Review it with the client and file an objection if necessary.

If the auditor is considering gross negligence penalties, accountants need to consider whether the

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result is a foregone conclusion. The only way to make that determination is to inquire why penalties are being considered. If it appears that a penalty assessment is inevitable then any submissions that are not clearly exculpatory will only be used to support the assessment. Remember that the Minister has the onus to prove the penalties. It is not unusual for client submissions to be used in support of the assessment.

### **Closing Comments**

The tension between compliance and advocacy continues unabated. Professor Edwin Harris made the following comments about tax law (particularly penalties) in a 1988 CTF paper.

When our tax law is both oppressive and defective, there is little point in counting on Revenue Canada to provide, through the exercise of restraint, the safeguards that are absent from the legislation. What seems to be required is a recognition (which is at best only partial in the Charter of Rights, and which the courts may once have displayed but seem to have forgotten) that, since fines and penalties are confiscatory in nature and are an invasion of taxpayers' rights, both their imposition and their amount ought to be justified in every case....

A government truly concerned about taxpayers' rights would, at a minimum, cause Parliament to amend the legislation so that if and when a criminal penalty is imposed on a taxpayer, any civil penalty assessed for the same conduct or omission must be withdrawn.

Twenty years later, there do not appear to any brakes on the ability or desire of the government to pry open people's lives. Many CRA employees I have spoken to over the past few years have expressed frustration with some of the directions being taken by the CRA. However, that frustration does not mean that these people are not going to do their jobs. Professor Harris directed his criticisms at senior levels of government, the policy makers, not the front line | workers.

Accountants are on the front line of protecting taxpayer's rights. The lawyers who end up representing taxpayers in courts rely heavily on the work done by a client's accountant. There is no one approach that can apply to all clients and all dealings with the CRA. Nevertheless, if a CRA auditor advises an accountant that he or she is being a pain in the ass, the proper response just may be that "it is part of the job."

End |

### **Footnotes**

- <sup>1</sup> One of the more obvious changes in audits is the increased use of net worth analyses in regular audits. This issue is going to be discussed in detail in the second day of this conference under the topic "Anatomy of a Net Worth Audit". A discussion of indirect proof of income will be left to that paper.
- <sup>2</sup> 2005 DTC 5454, 2005 FC 1010.
- <sup>3</sup> MNR v. Kitsch et al., 2003 DTC 5540 (FCA).

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- 4 2002 SCC 74.
- 5 *Jarvis v. The Queen*, [2002] 3 SCR 757.
- 6 2006 FCA 202, reversing 2005 FC 1068.
- 7 *Ibid*, at paragraph 34.
- 8 [1994] 3 SCR 377 at paragraphs 415 to 417
- 9 Federal Standing Committee on Finance, *Parliamentary Review of the Canada Customs and Revenue Agency Act a Value Proposition or a Failed Experiment* (2006, Communication Canada-Publishing Ottawa, Canada K1A 0S9).
- 10 Federal Budget, Chapter 5, March 19, 2007: Improved Auditing and Enforcement
- 11 *Canada Revenue Agency Act*, 1999, c. 17, section 89.
- 12 See Chapter 2 of the April 2002 Report of the Auditor General. Comments from each report are summarised and not referenced by specific paragraph or page numbers.
- 13 2004 Report of the Auditor General of Canada Chapter 6 - Canada Revenue Agency - Resolving Disputes and Encouraging Voluntary Disclosures.
- 14 2005 Report of the Auditor General of Canada, Chapter 3 - Canada Revenue Agency-Verifying Income Tax Returns of Individuals and Trusts.
- 15 2006 Report of the Auditor General of Canada - Status Report - Chapter 8 - Canada Revenue Agency-Collection of Tax Debts.
- 16 2007 Report of the Auditor General of Canada - Status Report - Chapter 7 - International Taxation-Canada Revenue Agency.
- 17 *The Queen v. Markevich et al.*, 2003 DTC 5185 (SCC).
- 18 Mr. Latz has published an interesting book on negotiations: *Gain The Edge! Negotiating To Get What You Want*. St. Martin's Press, 2004.
- 19 The summary is from an online edition of the Wisconsin Lawyer, Volume 77, no. 11, November 2004. "*The Five Golden Rules of Negotiation for Lawyers*."
- 20 See Babcock, L. & Loewenstein, G., (1997). Explaining Bargaining Impasse: The Role of Self-Serving Biases, *Journal of Economic Perspectives*, American Economic Association, vol. 11(1), 109-126. Miller, D. T., & Ross, M. (1975). Self-serving biases in the attribution of causality: Fact or fiction? *Psychological Bulletin*, 82, 213-225.
- 21 Howard J. Kellough, QC, "Information Requirements and Privilege Under the Act," 2003 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2003), 2:1-23.
- 22 The article by Mr. Kellough focused on requirements issued to third party advisors. However, the comments in the article also apply to general audit powers.
- 23 See section 231.1 " " of the ITA.
- 24 The names of the various branches change regularly. For example, the Audit Division changed its name to Verification and Enforcement around 2002, but appears to have changed its name back to "Audit" in 2006
- 25 Government Publications — Income Tax Technical News, No. 34 — Income Tax Technical News

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- 26 Supra footnote 3.
- 27 For example see, *Putting Together a Winning Deal — A Litigator's Perspective* — Al Mehji, Gerald Grenon & Jenny P. Mboutsiadis, *Canadian Petroleum Tax Journals* — 2003 Volume 16, No. 1, 4,; Brian R. Carr, Jerry Lalonde, and Ralph Neville, FCA, "The New Civil Penalty Proposals," Report of Proceedings of Fifty-First Tax Conference, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 18:1-22.
- 28 Usually under section 231.2 " " of the ITA
- 29 238(1) of the ITA.
- 30 For a discussion of redaction see Jasmine Sidhu, James W. Murdoch and Sheila M. Crummey, "Current Cases," (2005), vol. 53, no. 4 *Canadian Tax Journal*, 1061-1073.
- 31 In both circumstances there is an implicit invitation for the taxpayer to explain their actions. An unreasonable explanation fails in either case (see *Baynham et al. v. The Queen* 98 DTC 6648 (FCA)).
- 32 See Colin Campbell, "Application of the Charter to Civil Penalties in the Income Tax Act," (2002), vol. 50, no. 1 *Canadian Tax Journal*, 1-22.
- 33 Bruce S. Russell, "Avoiding Evasion: Tax Advisers' Professional Responsibilities," Report of Proceedings of Fifty-Sixth Tax Conference, 2004 Conference Report (Toronto: Canadian Tax Foundation, 2005), 35:1-10.
- 34 Kathleen M. O'Neill, FCA, Nancy E. Hopkins, QC, Stephen S. Heller, Peter R. Stephen, CA, Jack Bernstein, "Current Tax Issues: An Update," Report of Proceedings of Forty-Sixth Tax Conference, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 2:1-150.

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