

TaxTalk

TAX AUDITS

As a taxpayer (whether personal or corporate, etc.), you are required under the Income Tax Act [the 'Act'] to maintain and retain records that will enable your tax liability to be verified. To facilitate the administration and enforcement of the Act, Canada Customs and Revenue Agency ("CCRA") is given extensive powers to inspect your books and records and other documents in the course of conducting an audit, and also to issue requests or demands for information.

CCRA's powers to require you to keep records and supply information are extensive, and its entitlement to inspect documents when it conducts audits or investigations of taxpayers is broad, but in both cases they are not unlimited. The right of CCRA to audit a taxpayer's affairs and demand the production of documents, whether for a civil or criminal investigation, is subject to limitations imposed both under the Act itself and by court cases. In addition, taxpayers may continue to resist CCRA requests for documents protected by solicitor-client privilege where factual circumstances permit.

Canadian tax law in this area continues to evolve. Therefore, you as a taxpayer, need to be aware of your statutory obligations and, of equal importance, your rights, if they are not to be compromised in light of increasing demands by CCRA to ensure tax compliance.

What is an Audit?

Auditing is a way for CCRA to monitor and inspect all books and records including Goods & Services Tax ("GST") and income tax returns, customs import documents, and payroll records. Our tax system is a self-assessing one, and audits help CCRA maintain public confidence in the fairness and integrity of Canada's tax system.

How CCRA Selects Files to Audit

Your tax return is recorded in a computer system that enables CCRA to select returns to be audited. The system also lets CCRA sort returns into various categories to help with their selection process.

In some cases, CCRA will compare selected financial information for current and previous years of clients engaged in similar businesses or occupations. From computer-generated lists of returns for potential audit, CCRA will then choose specific returns to audit.

Most returns are selected in this way. There are other ways that files are selected:

1. Audit Projects

In some cases, CCRA tests the compliance of a particular group of taxpayers. If the test results indicate that there is significant non-compliance within the group, CCRA may extend its investigation to audit members of the group on a local, regional, or national basis. The recent audits of large donations of art are an example of this type of project.

2. Leads

Leads include information from other audits or investigations, as well as information from outside sources, including other taxpayers.

3. Secondary Files

Sometimes CCRA selects files for audit because of their association with other previously selected files. For example, if you are in partnership with another taxpayer, and that person's file has been selected for audit, it is usually more convenient for CCRA to review files of other partners at the same time.

How CCRA Conduct Audits

If you are selected, a CCRA auditor will contact you to arrange a convenient date and time to start the audit. We recommend that you phone your professional advisor at this time to inform them of the pending audit. In many cases, it is prudent for you to liaise with your advisor prior to the auditor's arrival.

The auditor may request to review, among many other things, the following records:

- the return or customs documents selected for audit;
- financial statements;
- audit reports from previous audits, if any; and
- corporate minutes.

On arriving at your place of business, the auditor should present an identification card. Before examining your books and records, the auditor may want to discuss the general nature of your business, or tour the premises to get a better understanding of the transactions recorded in your books.

The audit usually includes an examination of your records - ledgers, journals, bank accounts, sales invoices, purchase vouchers, and expense accounts. Throughout the audit, the auditor may need to get information and assistance from your employees, particularly those involved with your accounting.

CCRA's Fairness Pledge

The web-site for CCRA contains a document entitled "Our Fairness Pledge." Please refer to *Appendix 1* for details of this pledge. Taxpayers who are selected for audit should be aware of the principles outlined in the Appendix.

What Information Must Be Provided

As a legal matter, CCRA can request information and documentation "relating to the administration or enforcement of the Act." This term is interpreted very broadly, and there are very few limitations on the types of information and documentation that you can be required to disclose with respect to your affairs.

With respect to income tax audits, section 231.1 of the Act gives CCRA the authority to carry out audits of a taxpayer's books and records and to make audit enquiries. Section 231.2 of the Act enables CCRA to give notice (usually 30 days) to any person requiring them to provide any information or any document for any purpose related to the administration or enforcement of the Act. Any person who fails to comply with the request is guilty of an offence and is liable on summary conviction to a fine of between \$1,000 and \$25,000, or both a fine and imprisonment for a term not exceeding 12 months.¹ As such, CCRA's requests should not be treated lightly.

There are two limitations that may be available in some circumstances to restrict the scope of the CCRA audit. First, you can refuse to provide information or documentation that is privileged.² Secondly, you must comply with a request pursuant to sections 231.1 to 231.4 of the Act unless you are "unable to do so".³ Therefore, inability to comply can be used as an excuse for failure to provide information to CCRA.

It is prudent that you make a reasonable attempt to respond to CCRA's requests to the extent that you are able to do so. As mentioned, failure to comply with a requirement under section 231.1 or 231.2 is a criminal offence under section 238 of the Act. This is a "strict liability" offence, and therefore the defence of "due diligence" is available. This means that the accused person can avoid liability by proving he or she took all reasonable care—that is, that he or she did what a reasonable person would have done in the circumstances.

¹ Per subsection 238(1) of the Act.

² Certain correspondence between taxpayers and their legal counsel can be privileged.

³ Per subsection 231.5(2) of the Act. "Unable to do so" is not defined. In one case the court held that it was beyond the ability of a taxpayer to properly prepare a statement of assets and liabilities and other statements that were required by CCRA.

Delays in the Audit, and How To Avoid Them

Audits usually take one or two weeks, but could be delayed for a number of reasons. For instance, you may want to consult with your advisors, or you may be called out of town on other business before the audit is completed. Similarly, the auditor may ask for an interpretation from CCRA Headquarters on a particularly complex or contentious point of law.

Many times, delays will be created if the auditor chooses to, or is requested to, put their questions in writing.

Well-kept records will reduce the time required to complete the audit.

Normally, for income tax, CCRA cannot reassess you more than three years after the initial notice of assessment unless you have made a "misrepresentation attributable to carelessness, neglect or willful default" or you have committed fraud. If, during the audit, the three-year deadline is approaching, the auditor may request that you sign a waiver to keep the return from going 'statute-barred', and thus not open to re-assessment in respect of outstanding issues.

If you do not provide the waiver, the auditor may reassess in the worst light, and thus it is often prudent to provide the waiver so that the issue can be resolved at the audit level.

Finalizing an Audit

When the audit is completed, the auditor may propose certain adjustments to your return, and will prepare a summary of the proposed adjustments.

Initially, the auditor will discuss the summary with you or your representative. If you request it, or if it is reasonable to expect that you will need some time to analyze the proposed adjustments, the auditor will confirm the proposal in writing and allow a reasonable time, usually 30 days, for a reply.

If you provide additional information within this "reply" period, the auditor will consider it and will issue a new proposal letter, if applicable.

If there are no proposed adjustments to your return, the auditor will inform you of this when the audit is completed. Once the audit is finalized, if there are changes to the reported amounts, you will be issued a *Notice of Reassessment*.

The auditor's role is to determine the correct amount of duty or tax payable. This may mean that your taxes are adjusted downward and you could get a refund as a result. However, a refund is an exception - most audits lead to additional taxes being assessed for non-compliance.

What To Do If You Disagree With a Tax Assessment

An assessment or reassessment by CCRA may be incorrect. You are entitled to contest factual issues and the application of law.

If you do not understand or you disagree with a reassessment you could call or visit the Client Assistance Section of your tax services office or write to the tax centre that processed the reassessment. Many times, it is prudent to consult with a professional advisor to help resolve the dispute.

Potential Waiver of Penalties and/or Interest

If the audit results in an additional amount of tax or duty owing, then penalties and interest may be assessed in addition to the tax. CCRA can waive or cancel interest or penalties when they result from events that are beyond your control. For example, a serious illness may prevent you from filing an income tax or GST/HST return by the required deadline.

A waiver of penalties and/or interest is made through the fairness provisions in the *Income Tax Act* and *Excise Tax Act* (with respect to GST) which are intended to help CCRA administer the legislation fairly. These provisions apply to individuals, testamentary trusts, small business owners and corporations. All requests for relief under fairness legislation should be submitted in writing to your local tax services office.

The Objection Process

Under income tax and GST legislation, you can file an objection if you disagree with your *Notice of Assessment* or *Notice of Reassessment* and you think that the law has been applied incorrectly or you disagree with the amount in question.

For income tax you will need to send a letter, or complete and send Form T400A, *Objection*, to the Chief of Appeals at your tax services office or tax centre.

If you are an individual (other than a trust) or if you are filing for a testamentary trust, you must file your objection by the later of:

- one year after the due date of the return; or
- 90 days after the date CCRA mailed your *Notice of Assessment* or *Notice of Reassessment*.

In every other case, you have to file your objection within 90 days of the day CCRA mailed the *Notice of Assessment* or *Notice of Reassessment*.

For GST objections, you will need to use form GST159, *Notice of Objection (GST)*, to file your objection. You must file it at your tax services office within 90 days of the day CCRA mailed the *Notice of Assessment* or *Notice of Reassessment*.

When CCRA receives your objection, the Appeals Division will conduct an independent review of the assessment (the Appeals Division is independent of the Audit Division). If the Appeals Division agrees with you in whole or in part, CCRA will adjust your return and send you a *Notice of Reassessment*. However, if the Appeals Division disagrees with you, CCRA will send you a *Notice of Confirmation* confirming that the assessment was correct.

If you still do not agree, you can appeal CCRA's decision to the Tax Court of Canada. You have 90 days from the date CCRA mails their decision on your objection (a *Notice of Reassessment* or a *Notice of Confirmation*). You can also file an appeal to the Tax Court of Canada if CCRA does not notify you of its decision within 90 days of the date you filed your income tax objection, or within 180 days of the date you filed a GST objection.

Any amounts paid to prepare and negotiate with respect to an objection or appeal are deductible, whether they are paid to an accountant, lawyer or other representative. It is CCRA's policy to also allow a deduction for expenses incurred in the audit, even if you never file an objection or appeal.

Collection of Disputed Amounts

If you object to or appeal an income tax assessment, CCRA will usually postpone collection action on amounts in dispute until 90 days after it mails its decision to you. CCRA will not postpone collection action on some disputed amounts, such as taxes you had to withhold and

remit, e.g. employee tax deductions, GST collected, etc.⁴ Also, collection action is not deferred for 50% of the disputed amount for corporations which meet the definition of a "large corporation."⁵

If you object to a GST or "large corporation" assessment, collection action may be postponed. However, you may have to post acceptable security while CCRA is reviewing your objection.

If you lose your appeal to the Tax Court, CCRA will resume collection action even if you appeal the Court's decision to a higher court. However, CCRA will accept security in lieu of payment while your appeal is outstanding.

Audit Risk Areas

The following lists some of the items that can lead to errors and potentially to an adjustment on an audit.

- **Documentation:** Inadequate documentation automatically flags a return for special attention. Taxpayers need to understand what information is required to be filed and make every effort to comply. Other information/records must be retained for possible review.
- **Shareholder vs. Employee Benefits:** Employees and shareholders both are taxed on most benefits received. Companies usually can deduct only the cost of a benefit conferred on an employee. Where the individual is both a shareholder and an employee, the deductibility of the benefit cost is determined by the capacity in which the individual received the benefit. It is important to correctly report any benefits.
- **Automobile Benefits:** Automobile benefits reported on a T4 are often incorrectly calculated. A frequent error is forgetting to include the GST portion of the benefit. Another error relates to whether or not allowances are taxable and thus reportable on T4 slips issued to employees.

⁴ These items are amounts that you collect in trust for the government.

⁵ A large corporation is a corporation subject to tax under Part I.3 of the Income Tax Act. Part I.3 tax is generally payable when the taxable capital of the corporation (and its corporate group) exceeds \$10,000,000.

- **Ignored Limitations:** Many times, the automobile limit deductions are ignored. A return can also be red flagged if other items are ignored. For instance:
 - only 50% of most food, beverage, and entertainment costs are deductible
 - the maximum automobile cost that qualifies for capital cost allowance when the automobile is used in a business is \$30,000 (plus GST and PST).
- **Goods and Services Tax:** GST related errors include incorrect identification of GST exempt sales, improperly calculating input tax credits, and not claiming input tax credits for GST paid on capital acquisitions.
- **Inadequate Consideration:** Errors occur when a company sells something to a controlling shareholder (or a member of his or her family), or the shareholder sells something to the company. If the selling price is less than fair market value, the vendor proceeds are deemed to be the higher amount, thereby increasing any taxable gain. Alternatively, where the actual price is higher than fair market value, the purchaser's allowable tax cost will be the lower amount. Both of these scenarios can create a double tax situation.
- **Unreported Income:** All bonuses must be reported on employees' T4 slips, and all dividends and interest paid must be reported on T5 slips. Dispositions of depreciable assets should be reported on the appropriate capital cost allowance schedule. Assets transferred on a tax deferred rollover basis must be reported, even if no tax is payable on the transfer.
- **Employed vs. Self-Employed:** Many individuals who provide services prefer to be self-employed so they can potentially deduct more expenses. The nature of the relationship between an individual and a company

determines the employment status; merely saying that someone is self-employed does not make it so. There are several tests to be used to determine the proper status.

- **Unpaid Bonuses:** In order to deduct bonuses accrued at the end of the company's tax year which are to be paid in the following year, a legal liability must exist at the end of the corporate year-end. To avoid problems in this regard, there should be a director's resolution to declare the bonus, the bonus must be paid (or credited) within **180 days** after the year-end, and tax must be withheld and remitted.⁶
- **Capital Cost Allowance:** Frequent errors include misclassification of depreciable assets, carrying forward the wrong balances from one year to the next, not prorating the capital cost allowance claim for a short year, incorrect cost allocation on the purchase of more than one asset, and creating rental losses through the claiming of capital cost allowance in respect of rental properties.

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To conclude, CCRA audits can be intimidating. Although the powers of CCRA to inspect your books and records are broad, there are limits to their scope and you, as a taxpayer, do have certain rights and avenues to pursue if you should disagree with CCRA.

In most cases, it is prudent to obtain professional advice to guide you through the process to obtain a fair result.

⁶ Taxes withheld must be remitted with the appropriate payroll remittance for the period in which the bonus is paid or credited. The due date for this remittance will be dependent on your average monthly remittances in the past.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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TaxTalk is prepared by our Tax Group

The web-site for CCRA contains a document entitled “Our Fairness Pledge,” which reads as follows:

Our Fairness Pledge

- Our fairness commitment is based on service that is responsive, consistent, and impartial.
- Our actions must reflect objective yet considerate application of the law.
- We recognize that our clients have specific needs and concerns.

Information

We will give our clients information that is accurate and understandable. We will explain the laws in language that is plain and clear. We will provide all our services in English and French and, in some cases, other languages too.

Timeliness

We will advise our clients of the time it will take to provide the requested service. We will strive to meet that time, and we will continually work toward improving our response time.

Consistency

We will apply laws consistently and equitably. While each situation is unique, we will ensure our clients are treated equally under similar circumstances.

Impartial Review

We will provide our clients with review processes that are accessible, transparent, and impartial.

Flexibility

We understand that every client has specific needs and concerns. We will endeavour to provide relief when circumstances warrant.

Client Support

We will act in the interests of our clients according to our role under the law. We will inform our clients of their rights and obligations under the law, and will ensure that they are aware of the credits, benefits, and overpayments available to them.

Accountability

We recognize that our commitment to being fair requires a continuous effort. We will measure, maintain, and enhance our commitment to fairness. We will report annually to Parliament and the public on our fairness achievements.