SURVIVING A TAX AUDIT

The three words "you're being audited" are enough to strike fear into the hearts and minds of most taxpayers. Even where everything's in order and there's nothing to hide, the thought of a tax audit conjures up visions of endless hours to be spent reviewing (and justifying) minor details of transactions and expenditures that took place years previously. And, of course, there's always the spectre of a huge tax bill at the end of the process, complete with interest and penalty charges, and maybe even the possibility of a criminal prosecution.

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While the Canada Revenue Agency (CRA) has a long reach, and its investigative, enforcement, and collection powers are very broad indeed, very few tax audits involve this kind of worst-case scenario. In most cases, assuming that the taxpayer's affairs are generally in order and there are no significant instances of unreported income or unsubstantiated claims for deductions or credits, an audit will usually be concluded with some adjustments being proposed by the auditor. The taxpayer and his or her representative will have the opportunity to discuss those proposed adjustments with the auditor and in most cases, matters can be resolved between the parties, with no need to resort to legal or collection actions. Where there have been misrepresentations or unjustified claims made on a tax return, the situation is different, but can still be resolved without the imposition of penalties or criminal prosecution, where the taxpayer takes advantage of the CRA's Voluntary Disclosure Program.

Why me?

When taxpayers are contacted by the CRA and informed that an auditor will be looking into their tax affairs, it's usually assumed that the CRA is on to something specific and that the auditor's job is to find and expose that something. That's not typically the case. There are a number of ways in which the Agency selects specific taxpayers for audit, and many of them don't necessarily involve any suspicion of wrongdoing on the part of the particular taxpayer.

The Agency carries out what it calls "audit projects", intended to test the compliance of a particular industry or group of taxpayers — for example, construction contractors, or restaurant owners or long-distance truck drivers. The CRA will test to determine whether there is a significant amount of non-compliance within a particular group, and if it determines that such is the case, then audits will be carried out on members of that group, either in a particular region or nationally.

An existing audit may also lead the CRA to other taxpayers. Where, for instance, a person who has claimed deductions arising from a tax shelter scheme is audited and some of the claims are found by the CRA to be unjustified, it's reasonable to think that others who made the same claims will eventually be contacted by the Agency. Or, where a business has failed to remit goods and services (GST) tax on sales, then the customers of that business may well be contacted to determine whether the requisite GST was actually charged to them and paid.

In most cases, returns are selected for review by the Agency on the basis of computer-generated lists that identify returns possessing what the CRA calls "audit potential". What that generally means is returns that are significantly different in some respect from returns filed by other taxpayers in the same occupation or industry. So, if your deductions in a particular area or in particular areas are out of line with industry norms, it's possible that your return will be flagged for further attention. It may well be that the difference is both reasonable and easily explained — a construction contractor whose travel expense deduction for a particular year is much higher than others in his industry may simply have worked on more long-distance jobs that year — a fact that is easy to establish and document. Or a taxpayer may have extraordinarily high medical expenses in a particular year because someone in the family had a serious illness — and once again, the question can be settled simply by providing the CRA with receipts documenting the medical costs claimed.

Finally, the "nightmare" scenario envisioned by many taxpayers is the anonymous tip provided to the CRA by a disgruntled ex-employee, a vengeful former spouse, or a jealous business competitor. While it's true that the CRA does receive and act on leads arising from outside sources, it's not in the Agency's interest to waste its finite time and resources on wild goose chases. A "tip" from any outside source that cannot be backed up by some kind of solid evidence or documentation is likely to be given very short shrift by the CRA.

How far back can the CRA go?

The Canadian *Income Tax Act* authorizes the CRA to re-assess tax returns for up to three years (four years for some types of corporations) after the date that the original assessment for the particular tax year was mailed, so any audit would have to be carried out within that time period. For example, if the CRA mailed a Notice of Assessment for

the 2015 tax year to the taxpayer on May 30, 2016, the Agency would be permitted to re-assess that return anytime up to May 30, 2019. However, the three-year limit on reassessments applies only where there has been no misrepresentation or outright fraud on the part of the taxpayer — for example, knowingly misstating income or claiming fraudulent deductions on the return. Where such misrepresentation or fraud has happened, there is no time limit on the CRA's right to re-assess — a reassessment can take place at any time, even decades after the filing of the return on which the misrepresentation was made.

There is one other circumstance that will extend the CRA's right to reassess past the usual three-year limit, and that is where a waiver is provided by the taxpayer, specifying matters or tax years for which the usual time limit is waived. The CRA will frequently ask a taxpayer to provide such a waiver where an audit (or negotiations with respect to findings made on an audit) are ongoing and the three-year time limit is about to expire. As a general rule, there's not much to be gained by refusing to provide such a waiver: a refusal to do so will usually mean that the CRA will, in order to preserve its collection rights, have to issue a Notice of Reassessment with respect to the amounts in dispute. Once that happens, the audit process or the negotiations arising out of that process are over, the taxpayer will have to file a Notice of Objection, and the whole matter will move to the Appeals Division of the Agency, from which the only further resort is to the courts.

As a practical matter, a taxpayer who is being audited by the CRA should likely have professional counsel. Certainly, professional counsel should be sought if the CRA is requesting a waiver from the taxpayer, to ensure both that providing the waiver is in the taxpayer's best interests and that the terms of the waiver are drafted so as to limit the CRA's continuing right to re-assess specifically to the matters in dispute.

What happens on an audit?

There are two types of audits carried out by the CRA: an office audit, which, as the name implies, takes place at a CRA office, and a field audit, which is conducted at the taxpayer's place of business. Wherever the audit takes place, the kinds of documents reviewed are usually the same, and include the following: the return(s) selected for audit, financial statements of the business, and any audit reports generated by previous audits. The auditor will likely also want to look at ledgers, journals, bank accounts, sales invoices, purchase vouchers, and expense accounts in the course of conducting the audit. Generally, the auditor is interested in the documents that support or underlie the information that was provided to the CRA on the particular return or returns under review.

Particularly if the audit is a field audit, carried out at the taxpayer's place of business, the auditor may want to speak to employees of the business to obtain clarification or explanations of documents being examined, especially employees such as bookkeepers or accounting staff who were involved in the preparation of those documents.

When the audit is complete

Once an auditor has finished reviewing the various documents that pertain to the tax year or years under audit, he or she will likely have prepared a list of "adjustments" to the return or returns. While it's a common perception that an audit can only increase the tax payable by a taxpayer, an auditor can in fact propose adjustments that will either increase or decrease a taxpayer's tax liability for the year(s) in question.

The list of proposed adjustments is presented to the taxpayer or his or her representative and discussed with them. The taxpayer can request some time to consider the proposed adjustments, and that time will be provided, assuming that the request is justified in light of the number and nature of the adjustments and the length of time requested. During that time, the taxpayer may provide the auditor with additional information, which may in turn result in a change in the proposed list of adjustments. If agreement on all issues can be reached, a Notice of Reassessment will be issued summarizing the changes to which the auditor and the taxpayer have agreed. Where agreement cannot be reached, a Notice of Reassessment will be issued outlining the changes that the CRA proposes to make with respect to the tax year(s) under review.

The appeals process

Once the Notice of Reassessment has been issued, the taxpayer has essentially two options. He or she can pay the amount owing and be done with the matter. However, if a Notice of Reassessment has been issued because the taxpayer and his or her representative were unable to come to agreement with the auditor on the question of what was or was not owed and the taxpayer believes that he or she is right and wishes to pursue the matter further, the next step is to file a Notice of Objection in response to the Notice of Reassessment.

The Notice of Objection (for which there is a standard form, available on the CRA Web site) must be filed with the CRA within 90 days after the mailing date on the Notice of Reassessment. While the use of the CRA's standard form is not mandatory, it is recommended, both because it makes it clear that an objection is being made and because using the form will allow the taxpayer to ensure that all the required information is provided.

Once the Notice of Objection is filed, the matter moves to the Appeals Division of the particular Tax Services Office, where it is considered by an appeals officer who was not involved in the original assessment. The determination of that appeals officer is then reviewed and approved by the District Chief of Appeals, and the results are communicated to the taxpayer. If the results of the appeals process are unsatisfactory to the taxpayer, the next step is an appeal to the Tax Court of Canada. Where legal action is contemplated (and probably before, at the point at which agreement could not be reached with the original auditor), professional legal and/or accounting advice is strongly advised.

Keeping tax records

The best way to get through an audit quickly and with a minimum of time away from the business is to provide the auditor with clear, accurate, and complete business and tax records. Even if there is no suggestion of error or fraud in the conduct of the business, incomplete or disorganized tax and business records will mean that the auditor will need more assistance from the business owner or his or her staff in finding the required information. And, of course, it's up to the taxpayer to maintain the records necessary to support any deductions or credits claimed on the tax return. Where claims have been made but the documentation to support them can't be produced, the claim will be denied, even though it may have been legitimately made. So what are a business owner's responsibilities when it comes to keeping tax and business records?

The first, and most obvious, requirement is that every business owner must keep records for the business. It's up to the business owner to decide whether those records should be in paper or electronic format, or a combination of the two, but whatever the format, the records kept must contain the information needed to calculate the business's tax obligations and entitlements. The business owner must also retain source documents that verify or support the information contained in the records (for instance, receipts to document the amount claimed for deductible travel costs incurred during the tax year). Finally, any other documents that pertain to the computation of income tax or goods and services tax liability, such as logbooks, accountants' working papers, or tax returns from prior years, must be retained with the business's books and records.

Where the business owner chooses, as most do now, to maintain the required books and records in electronic format, further requirements are imposed, mostly relating to the accessibility of those records. The computerized records kept must be capable of being easily converted into an electronically readable format that can be made available on request. As well, those computerized records must be maintained in electronic format, even where hardcopy is available. Even where the business owner delegates or contracts out some or all of the accounting or tax responsibilities — for example, to a payroll administration company or to an accountant — the responsibility for ensuring that records are maintained as required remains with the business owner. Finally, where a computerized record keeping system is changed, the business owner remains responsible for ensuring that records created and maintained under the former system remain accessible and can be provided in a readable format upon request. Generally, tax records must be maintained by the taxpayer for a period of six years following the end of the year to which the records relate.

Voluntary disclosure

The taxpayers who have the most to fear from a tax audit are, of course, those who have something to hide – most often, income that was not reported or deductions or credit claims which were either inflated or entirely fabricated. But even in these circumstances, it's possible to avoid penalty charges and criminal prosecution, by taking advantage of the CRA's Voluntary Disclosure Program (VDP). As the name implies, the VDP allows taxpayers to come forward

and correct inaccurate or incomplete information or to disclose information that they have not reported in previous years, without penalty or prosecution. To be valid, a disclosure by a taxpayer under the VDP must meet the following four conditions:

- the disclosure must be voluntary;
- the disclosure must be complete;
- the disclosure must involve the application or the potential application of a penalty; and
- the disclosure must generally include information that is more than one year overdue.

The most important of these conditions is the first: that the disclosure must be voluntary. In this context, a voluntary disclosure cannot be made where the taxpayer is aware of audit, investigation, or other enforcement activity that the CRA is intending to carry out and that activity would be likely to result in the discovery of the information being disclosed. In other words, a voluntary disclosure cannot be made once the CRA has commenced or intends to commence audit or enforcement activity with respect to the information that is the subject of the disclosure. However, where the enforcement or investigation activity relates to one specific area of the taxpayer's affairs, that activity may not preclude a voluntary disclosure in other areas. For example, where the CRA is investigating or auditing a taxpayer in connection with a source deduction (payroll) issue, the taxpayer may still be able to make a voluntary disclosure with respect to unremitted goods and services tax, as the CRA views the two to be separate issues.

It's worth noting that voluntary disclosure can be made with respect to not only the income tax affairs but also goods and services tax matters and, perhaps most significantly, source deductions. Where a business is in financial difficulty, it is most often source deductions that fall into arrears, as the business owner seeks to use those funds as a source of cash flow or financing for the business instead of remitting them to the CRA as required.

It's also possible to make a "no-name" disclosure to the CRA. The taxpayer can hold discussions with a VDP officer with respect to his or her situation on an informal, non-binding basis and receive information about the availability of the VDP in the taxpayer's circumstances and, in general terms, about the possible tax implications of the disclosure. Once the taxpayer and his or her advisors decide to make a formal voluntary disclosure, the taxpayer's identity must be disclosed, and the CRA will then provide a final and binding decision with respect to the information that has been disclosed. The CRA provides a standardized form for taxpayers wishing to make a voluntary disclosure (whether on a formal or a "no-name" basis), and that form, the RC199E, is available on the Agency's Web site.

Once the formal voluntary disclosure has been made, the taxpayer will be liable for all unpaid taxes, together with interest on those unpaid amounts. However, the CRA will not assess penalties and no criminal prosecution will be brought. Even on the issue of interest charges, some leeway is available, as the Minister possesses the discretion to grant partial relief from interest charges levied with respect to interest relating to assessments on returns that were due more than three years previously.

The penalties that the CRA is able to assess can be significant, and, of course, the possibility of a criminal prosecution for tax evasion is the ultimate sanction in tax matters. The ability to avoid both through a voluntary disclosure is a significant benefit to a taxpayer who would otherwise be at risk. However, the making of a formal voluntary disclosure is a significant step, and any taxpayer who is considering taking that step should do so only with the benefit of professional legal and tax advice.

Conclusion

Being audited by the tax authorities is high on everyone's top-ten list of experiences to avoid, and the costs and consequence for those who have been either delinquent or deceptive in their filing or remitting practices can be severe. However, the taxpayer who has maintained good records and has complied with his or her tax obligations is likely looking at nothing worse than a few relatively minor adjustments to past returns. And, where that's not your situation, consideration can always be given to "coming clean" by making a voluntary disclosure to the tax authorities of past transgressions, paying the piper, and moving forward with a clean slate.