

Net Worth

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PREPARING FOR A REVENUE CANADA AUDIT

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A few months after you filed your tax return you may receive an unpleasant surprise courtesy of the Canada Customs and Revenue Agency (the "CCRA"), formerly Revenue Canada. The CCRA may notify you that your tax return has been selected for an audit. Why did they select you? What should you expect? How can you defend yourself? This article will attempt to provide some insight into the answers to these questions and hopefully diminish your fear of the tax audit by guiding you through the stages of the audit process.

Before going any further, it is extremely important to realize that while there are certain legal and procedural approaches that are the same for each and every audit, these specific approaches are about the only thing similar between one audit and the next. Although the CCRA claims that its primary objective is to achieve uniformity of interpretation and application of the law, each audit is influenced by a multitude of different considerations varying from the size of the business audited, to the specific nature of the items audited, to the personality of the auditor.

As opposed to employees who represent a relatively low risk of tax evasion from the CCRA's point of view, the small to medium sized businesses are perceived as much higher risk. Considering a significant number of deductions for these businesses, it should not come as too big a surprise that they are audited more often than

employees who have only minimal tax deductions. The CCRA can select one of the two basic categories of audit examination:

The first category, called **desk audit**, is generally used in all simple cases. The auditor sends you a "review letter" asking for more information and/or documentation supporting one or more items in your tax return. Although the desk audit may represent just a minor irritant to you, it is important to take it seriously and respond within the requested time. Make sure you provide the auditor with all of the requested information or documents but do not volunteer any more information than requested. We suggest that you ask your accountant to review the information prior to mailing it to the auditor. Such a review is quite inexpensive and might save you a lot of anguish as well as money.

When you are unable to provide the requested documents in the allotted time frame, you may request an extension. Always make your extension of time request in writing. Although the desk audit is just a minor and very restricted type of audit, the failure to respond might lead to a full denial of deductions, imposition of penalties and interest, or even to a full-fledged audit.

The second category, called **field audit**, is more complex. At the beginning of the audit the auditor usually contacts you and schedules the date

and time for a meeting. However, on certain occasions the auditor asks for all the accounting records without scheduling a meeting and sometimes the auditor makes a written request without talking to you at all. If you are subjected to the full-fledged field audit, you should immediately contact an accountant knowledgeable of the CCRA practices. The accountant will be instrumental in managing the audit and communicating with the CCRA auditor on your behalf.

In order to understand the audit process, it is best to look at it from the auditor's perspective. As such, the majority of tax audits proceed through the following four stages:

STAGE 1: IDENTIFICATION STAGE

During this pre-audit stage the CCRA screens the files for a potential audit. The CCRA's selection of your tax return could be based on a computer based analysis of your financial statements and tax returns, comparisons with other firms in your industry, referrals from other audit sections (e.g. GST, employee benefits, etc), special projects (e.g. audit of the majority of companies in a specific industry), information provided by outside parties (e.g. "snitch lines", disgruntled employees, upset former spouses, etc.), or the file might be just randomly selected by the CCRA's computers.



City Hall, Mississauga, Ontario

“Tax audit is often perceived as a frightening experience whether you try to fully comply with the law, or whether you take some liberties with the interpretation of the Income Tax Act.”



Yorkville: Bloor St. and Avenue Rd.

Once the file has been selected for an audit, the auditor reviews the company's structure and obtains all the files of all the associated and related companies kept by the CCRA, including the personal tax files of the major shareholders. The auditor then reviews the industry data, the volume and type of transactions, and considers the risk of non-compliance and the significance of various transactions (i.e. company size, transaction size, potential recurring losses, unusual transactions, etc). Next, the auditor prepares an audit plan, contacts you and asks for the supporting information and documentation.

When the auditor contacts you, you should immediately spring into action. Your first plan of attack should be to present yourself in a cooperative manner, remembering always that you are only required to produce all of the requested material, but nothing more. Withholding the requested documents from the auditor or providing an excessive amount of documents to the auditor to "bury him or her in paper" is not to be recommended. On the contrary, these ill-advised tactics might be quite dangerous.

On the one hand, the withholding of documents from the auditor often leads to an automatic reassessment where the auditor automatically disallows all of the unsupported expenses. Such an approach is actually preferred by the auditor -- he or she does not have to spend much time going through the receipts and invoices (not exactly the most exciting part of an auditor's job) while achieving a large tax adjustment.

On the other hand, to "bury the auditor in paper" is also risky. You should realize that the auditor has usually more time to go through all the documents than you or your accountant. Consequently, the auditor often finds many

new leads while sifting through all the documents. The new leads may extend the audit into new areas or other companies. To say that this tactic can backfire is a serious understatement.

STAGE 2: INFORMATION GATHERING STAGE

During the information gathering stage the auditor asks the taxpayer about his or her business, tours the company, and obtains a basic understanding of more complex transactions (such as transfers of assets, transaction with related parties, etc.). The auditor also reviews accounting and tax records, issues the preliminary queries and starts conducting interviews with the company's staff (if considered necessary). In general, the auditor identifies the significant issues and attempts to collect as much information as needed for the development of his or her own assessment.

The information gathering stage is extremely important from your point of view. You should designate a contact person and channel all the audit inquiries through this person. You should also try to keep all the communication with the auditor in a written form in order to avoid reinterpretation of the facts by the auditor. Do not try to answer the auditor's queries immediately, but allow sufficient time to properly prepare and review your written responses. Although you should provide honest answers, do not disclose more information than necessary to answer the auditor's questions.

STAGE 3: INFORMATION ANALYSIS STAGE

During this stage the auditor identifies potential adjustments, reviews the supporting evidence in detail to quantify any potential adjustments, and develops the legal arguments supporting his or her position. In some cases the

auditor issues additional queries or asks for additional interviews. The auditor may also discuss any potential areas of disagreement with you.

The information analysis stage is probably the most important stage of the audit from your point of view. Once the information analysis stage is over, it is usually extremely difficult to alter the auditor's position on any contentious issue. You should try to prevent any misunderstanding of facts by keeping communication with the auditor as open as possible.

Three different kinds of contentious issues can generally appear. First, some of your claims might be inadequately supported and thus disallowed by the auditor. In this case you can discuss with the auditor what other supporting evidence would satisfy him or her and provide it.

Second, some of your claims might be only partially accepted by the auditor. For example, the business use of your car might be questioned when you do not provide an accurate log book. In such case you may want to try to reach a negotiated settlement with the auditor. The two considerations that heavily influence an outcome of negotiations with the CCRA's auditor are your negotiating skills and your credibility in the auditor's mind.

Third, some of the facts can support different legal interpretations. You and your accountant should work together to develop strongest possible case. If the strength of your case does not persuade the auditor, you may have to "agree to disagree" and use your interpretation of facts and circumstances during the appeal process or in the courts.

STAGE 4: RESOLUTION STAGE

During the resolution stage

the auditor issues a so-called "30-day letter" proposing the adjustments to be made. This letter allows the taxpayer to react to the proposed adjustments, discuss the proposal with the auditor, and supply new evidence if necessary. At the end of the audit the taxpayer will receive a Notice of Reassessment specifying the adjustments and taxes payable.

The 30-day letter gives you the last chance to alter the reassessment at the audit level. There are three major decisions to be made. First, you should decide which issues you still want to fight during the audit stage and which ones you will take to the appeals stage. Although it is usually preferable to fight as many issues as possible during the audit stage, in some cases you might be able to negotiate a better settlement at the appeals stage and, therefore, you might want to refrain from further discussion of these issues with the auditor.

Second, the resolution stage

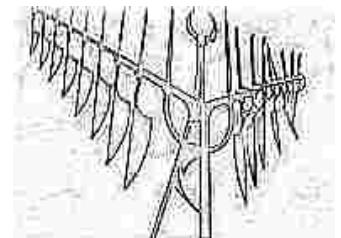
gives you the last chance to go directly to the auditor's supervisor. This is an appropriate course of action in all cases where the auditor appears not to have the training, experience or knowledge of the specific industry issues, or where he or she is proposing to reassess contrary to either the law or the CCRA's administrative rules. In addition, you may also try to circumvent the auditor when the auditor is difficult to deal with or has preconceived biases against you. Obviously, it is often best to try to circumvent (and upset) the auditor only after you have his proposal in hand.

Third, you should calculate the amount of tax, penalties and interest payable and compare it to the cost of fighting the reassessment at the appeals level and in the courts. This will allow you to either take the issues to the next level, or to come back to the auditor and attempt to reach a settlement with him or her. We have experienced some willingness to lower the assessment if the taxpayer agrees not to take the case to

the appeals level.

In summary, while this article attempted to provide some insight into the somewhat mysterious tax audit, the typical taxpayer will still probably perceive the tax audit as a frightening and confusing experience. This perception is probably the same regardless whether the taxpayer tried to fully comply with the law or whether the taxpayer took some liberties with the interpretation of the Income Tax Act. Perhaps judge Lord Denning M.R. explained the source of this feeling best when he stated that "[t]he trouble is that the [tax] legislation is drawn so widely that in some hands it might be an instrument of oppression.... Once great power is granted, there is a danger of it being abused." Hopefully, the suggestions supplied in this article will at least reduce your fear of the tax audit and provide some guidance for what to do when you get that letter or call saying "Congratulations, you're being audited!"

-ph-



Bird. Barrie, Ontario

"The trouble is that the tax legislation is drawn so widely that in some hands it might be an instrument of oppression.... Once great power is granted, there is a danger of it being abused."

MEET OUR PARTNERS:

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