



Ready, set, audit

A guide to dealing with CRA audits

Understanding the CRA audit process and how to properly prepare for and manage an audit can eliminate most anxieties and reduce business disruptions.



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“Being prepared for a potential CRA audit is generally not a priority for most businesses.”

Is your business ‘audit ready’?

Being prepared for a potential CRA audit is generally not a priority for most businesses. Managing day-to-day business operations and issues tends to leave very little time to think about potential issues should the business be selected for audit. The result is that once a business receives official notification of a pending audit, panic typically sets in.

Every business in Canada has the potential to be selected for an audit. Unless you are prepared for that potential, once the CRA provides notice of a pending audit, you may find yourself with insufficient time or the proper resources to deal with CRA audit queries and requests for information. A tax audit can be very time consuming and costly for the business and have a negative impact on business activities. Therefore, advance preparation for a potential audit can reduce costs and disruptions and generally result in smaller reassessments, if any.

Keeping books and records

While most businesses are aware of the requirement to keep source records and documents such as appointment books, invoices, cancelled cheques, etc., most businesses encounter difficulties during a CRA audit because of improper maintenance of other types of books and records that may be requested by the CRA in the course of the audit such as:

- Minute books for incorporated businesses are not kept up to date regarding share transactions; minutes of Board of Directors meetings; minutes of shareholder meetings; etc.
- Signed copies of final agreements such as Sale and Purchase Agreements; employment contracts; partnership agreements; etc.

Maintaining books and records on a timely and complete basis will generally have a positive impact on the CRA audit. The ease with which the auditor is able to follow and trace through the transactions under review will have a significant impact on the amount of time required to complete the audit and would normally generate few queries or additional information requests. On the other hand, inaccurate books and records may result in the CRA pursuing alternative ways to validate reported revenues and expenses which may create significant delays in completion of the audit as well as creating additional difficulties in challenging the CRA's findings.

Documenting transaction related activities

Proper preparation implies much more than simply having books and records available and organized for the auditor to review. While the books and records may provide the necessary information regarding regular business activities¹, the CRA will also include a review of non-regular business activities² in the course of most audits. Information in respect of non-business activities may not necessarily be included in the books and records of the business.

For non-regular business activities, proper preparation should begin at the time transactions are contemplated. Auditors will often question taxpayers as to the purpose of transactions. It is therefore imperative that adequate documentation be generated, maintained and updated, if necessary, from the time the transaction(s) are contemplated to the time they have been finalized. Given that CRA audits usually occur 1-3 years after the transaction or series of transactions actually took place, it may be difficult to remember important details regarding the rationale guiding the transaction(s) and staff involved in the transaction(s) may no longer be employed by the taxpayer's business.

¹ Normal business activities include sales, expenses, amortization, etc.

² Non-regular business activities refer to transactions such as sale/purchase of assets, reorganization of the business activities, transactions with non-residents, etc.

TIP

Taxpayers need to be mindful of issues or transactions that may come under the scrutiny of the CRA in the course of an audit and develop proper support and documentation to defend what has been done and the results achieved.

TIP

The CRA has recently undertaken reassessments to deny deductions such as capital cost allowance and cumulative eligible capital claimed on the basis that taxpayers were unable to provide requested records to support the amounts included as additions.

Some of these requests were for documents related to additions as far back as 20 years.

Retention period for books and records

The Income Tax Act requires that all books and records must be kept for six years from the end of the tax year to which they relate³. Caution should, however, be exercised in interpreting this general rule, specifically, to the expression “end of the taxation year to which they relate”. For example, in respect of items such as cancelled cheques and invoices, it is reasonable to interpret this rule to mean that these items need only be maintained for six years after the taxation year in which revenues and expenses related to those items have been reported for tax purposes.

However, documents relating to the acquisition of assets must be maintained for six years after the tax year in which the assets have been disposed of, or in the case of depreciable assets, six years after the tax year in which there are no longer any depreciable assets in that particular class.

Electronic images of paper documents can be accepted as the original record provided that reproductions of books of original entry and source documents have been produced, controlled and maintained according to the latest standards set by the Canadian General Standards Board. Information on these standards can be found on the Public Works and Government Services Canada web page on imaging standards. Those standards include, for example, ensuring that all data on the original document is readable in the same way as if the CRA was reviewing the original document.

³ Subsection 230(4) of the *Income Tax Act*



CRA and the audit process

Self-assessing tax system

The Canadian tax system is one based on self-assessment which means that taxpayers must register their businesses, if applicable, calculate their own taxes at the end of the year or at the end of the reporting period and submit a tax return to the CRA along with any required payments.

Once a tax return is filed, it goes through an initial processing that checks basic information and calculations. At the completion of this initial processing, the CRA will issue a Notice of Assessment. This Notice of Assessment generally starts the clock on the amount of time the CRA can make any revisions to amounts assessed. Revisions may be the result of tax audits.

Types of CRA Audits

Notwithstanding the fact that the Canadian tax system is based on self-assessment, Canadians have generally shown a high compliance with Canadian tax laws. The auditing process is meant to maintain public confidence in the fairness and integrity of Canada's tax system.

The CRA undertakes numerous types of audits in regards to reported activities, including:

- **Personal and corporate tax** – review of reported activities for individuals and trusts as well as small, medium and large businesses;
- **International audits** – includes transfer pricing audits, residency issues, Regulation 102 and 105 issues and offshore compliance audits;
- **Aggressive Tax Planning** – includes the review of tax shelters and other files where specific or general anti-avoidance rules may apply;
- **GST/HST** – review of GST/HST remittances or requests for input tax credits (except for residents of Quebec which is administered by Revenue Quebec);
- **Scientific Research and Experimental Development** – review of SR&ED credits and activities;
- **Employer compliance** – includes review of payroll withholding requirements and taxable benefits;
- **Charities** – determine whether charities meet eligibility requirements in order to be authorized to issue charitable receipts; and
- **Registered plans** – includes review of whether pension or investment arrangements meet the requirements of the Income Tax Act.

Your rights as a taxpayer

The CRA's Taxpayer Bill of Rights builds on the CRA's commitment to serve taxpayers with a high degree of accuracy, professionalism, courteousness and fairness. Taxpayers can expect to be treated fairly under clear and established rules and can expect high standards of service each time they deal with the CRA.

In the course of a CRA audit, the most notable taxpayer rights are the right to have the law applied consistently; the right to have costs of compliance taken into account; the right to complete, accurate, clear and timely information; and the right to a formal review of your file and a subsequent appeal.

The CRA Audit Process

There are two general audit approaches used by the CRA – desk audits or field audits.

In the course of undertaking a desk audit, the CRA will normally issue a written request that specific books and records be sent to the local tax services office. Generally, desk audits are intended to verify specific items in the tax returns filed and can be conducted either pre-assessment or post-assessment. The process that will be followed in the course of a desk audit will generally be the same as the process described below starting at step three.

In the case of a field audit, the following describes the general process steps for the conduct of the audit:

1. **Notification of pending audit** – the CRA will inform you of a pending audit either by telephone or by way of a letter requesting that a convenient date and time be arranged to start the audit at your place of business. The letter will also provide details as to the books and records that will be required for the auditor's review;
2. **Initial interview** – the auditor will explain the audit process, seek to learn about your business and tour the business premises in order to gain a better understanding of your business. The auditor will generally review the books and records at your place of business. If there is insufficient space at your place of business, the auditor may borrow your books and records in order to conduct the audit at the CRA local office. A detailed receipt for the borrowed documents will be provided at the time the books and records are borrowed and they will be returned to you when the audit is complete;
3. **Review of books and records** – The general process followed by the CRA in reviewing books and records include:
 - Reconciling the financial statements to the trial balance and adjusting entries;
 - Reconciling the trial balance to the general ledger;
 - Review of supporting documents (including invoices, cancelled cheques, etc.) for amounts recorded in specific general ledger accounts.
4. **Requests for clarification or additional documents** – throughout the audit the auditor may request additional information or request that you clarify information already provided. This also provides you with the opportunity to discuss with the auditor issues that have been identified in order to ensure that information being provided or clarified will respond to the auditor's concerns or questions;
5. **Completing the audit** – the auditor will prepare a schedule of any proposed adjustments to your previous tax assessment with detailed calculations and explanations and should discuss these further with you;
6. **Representations to proposed adjustments** – you will be provided with a reasonable period, normally 30 days, to respond to the auditor's proposed adjustments. Representations should be provided in writing within the allocated or agreed upon period of time;
7. **Closing the file** – once the auditor has considered all representations, you will receive a final letter that explains the results of the audit and should detail the consideration given to your representations; and
8. **Notice of Reassessment** – if the audit results in a net change to your taxes, either a refund or an amount due, the CRA will mail you a Notice of Reassessment in due course.

How does the CRA select files for audit?

There are a number of ways the CRA selects files for an audit. Smaller files are normally selected based on processes put in place by the CRA including:

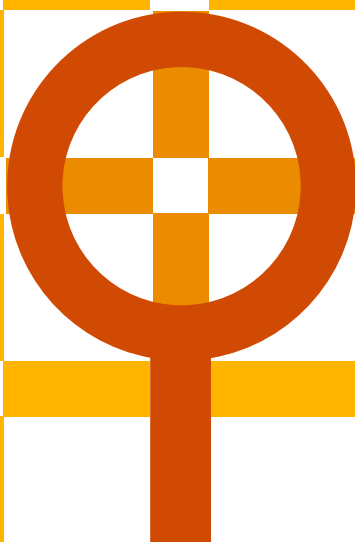
- **Electronic selection** – all information included in the tax return you file with the CRA is recorded on the CRA's computer system which allows the CRA to select returns based on various selection criteria – for example, comparing gross profit margin of your business with other businesses in the same industry; significant changes in various categories of income or expenses; etc.
- **Projects** – the CRA does projects in which it selects a group of similar types of businesses and compares them – for example, real estate brokers; taxi drivers; restaurants and bars; industries where significant compliance issues may have been uncovered in the past; etc.
- **Leads** – leads can be information that the CRA has received from other CRA audits and may also come from outside sources such as taxpayers, business associates, disgruntled employees, etc.
- **Secondary files** – the CRA may select files because of their association with other previously selected files – for example, if you are in a partnership with another taxpayer that is currently under audit, it is usually more convenient to examine all of the records at the same time.

For medium and large files, the CRA has recently begun to make use of risk assessment models whereby each taxpayer would be reviewed on an annual basis and assigned a risk ranking based on specific risk factors. These files will be ranked as either high risk, medium risk or low risk.

High risk files would generally be subjected to full compliance audits. Medium risk files would generally be audited on a limited scope basis where the audit would target only certain items. Low risk files would generally not be subjected to any compliance action but would still be monitored on a yearly basis.

Some of the important risk factors that would be used to determine the individual risk rankings would include:

- Past compliance issues;
- Level of difficulty in obtaining books, records and responses to CRA queries;
- Complexity of business structure;
- Overall industry risk associated with the industry in which the business operates; and
- Level of confidence in the internal controls of the business.



TIP

During the course of the audit, maintaining regular discussions with the auditor in regards to issues identified or under review should significantly reduce the risk of large unexpected proposed adjustments. Regular weekly/monthly progress meetings should be established at the onset of the audit to assist with the progress of the audit.

Managing a CRA audit

What if you've been selected for a CRA audit?

Whether this is the first time you have been selected for a CRA audit or you have been subjected to previous CRA audits, the key to minimizing the potential for a reassessment is to take the CRA audit very seriously and to exercise some control over the conduct of the audit. This can be achieved in the following ways:

- **Relationship with the CRA auditor** – working cooperatively with the auditor to expedite the audit process may provide the auditor with an enhanced willingness to resolve the issues at the audit stage rather than through a contested reassessment, especially in gray areas of the audit;
- **Request for information should be in writing** – requests for additional information by the auditor may sometimes be received orally during the course of your discussions with the auditor. Auditors should be requested to provide their request in writing in order to ensure that there are no misunderstandings as to what specific information or documents you are being asked to provide;
- **Respond to queries on timely basis** – responses to the auditor's queries should be provided within the deadlines set by the auditor. If additional time may be required to obtain some of the requested documents or information, this should be discussed with the auditor at the earliest possible time and not once the deadline has passed. Any extensions should be documented to prevent subsequent disputes. Information that is available should be provided within the previously set deadline;
- **Responses should be in writing** – when documentation or information are provided to the auditor, they should be included in a formal written response with specific reference to the auditor's written request for the documentation or information;
- **Discussions with the auditor** – you should never appear evasive in the course of discussions with the auditor as this may be interpreted as a failure to comply with their requests for information or that you may have something to hide from the CRA.
- **Anticipate issues/concerns** – in the course of regular discussions with the auditor, you may be able to get a general sense of the issues upon which the auditor is focusing their attention and may provide you with some insight as to what the general results may be and thus avoiding surprises in the future. Understanding where the auditor has concerns early on may provide an opportunity to target responses to ensure those concerns are effectively addressed;
- **Keep the audit on track** – while taxpayers are expected to respect timelines established by the CRA it is not uncommon for long delays to occur in the course of the audit due to CRA internal procedures and/or the auditor's commitments in other audits. In some cases, delays caused by the CRA may result in the CRA requesting that you provide a waiver in respect of the normal reassessment period in order to complete the audit. It is therefore crucial that the auditor be held accountable for the resulting CRA delays. Where there appears to be little or no audit activity on-going over time, you should communicate with the auditor to establish the reasons for the delays and to establish a timeline for the completion of the audit;
- **Document all discussions with the CRA** – auditors are required to document all interactions with taxpayers for the purposes of their files. This includes a summary of all discussions held with the taxpayer and/or other persons in the course of the audit. This information may be used during the objection or appeal process as indicative of the discussions that were held with the taxpayer if there are disagreements as to whether a taxpayer was informed of particular issues in the file. It is therefore imperative that you also document all discussions with the CRA including summaries of discussions, whether in person or by telephone. These summaries would include the date and time the discussions took place;
- **Request copy of audit file** – once the auditor has issued a proposal letter you have the right, pursuant to CRA policy, to request a copy of the audit file. Information contained in the audit file may be of assistance in preparing any representations to proposed reassessments; and
- **Consistent representations** – final representations to a proposal letter should always be made in writing. Statements made in the final representations should be consistent with the positions taken during the course of the audit and great care should be taken to ensure that they do not conflict with positions taken in regards to other issues or transactions.

TIP

There is a correlation between the amount of time spent by the auditor in conducting the audit and the reassessments arising as a result of the audit. A cooperative approach in dealing with the auditor may reduce the number of hours and, correspondingly, the size of the reassessment.

Purpose of a waiver (Form T2029)

During the course of an audit, a waiver can be used by a taxpayer to waive the normal reassessment period⁴ in respect of a taxation year, or the additional three year period⁵ within which the Minister may assess, reassess or make additional assessments⁶. The intended purpose of a waiver is to allow taxpayers with additional time to make representations in respect of any adjustments that have been proposed, by way of a proposal letter, by the CRA. The intended purpose of a waiver is not to provide more time for the CRA auditor to conduct the audit.

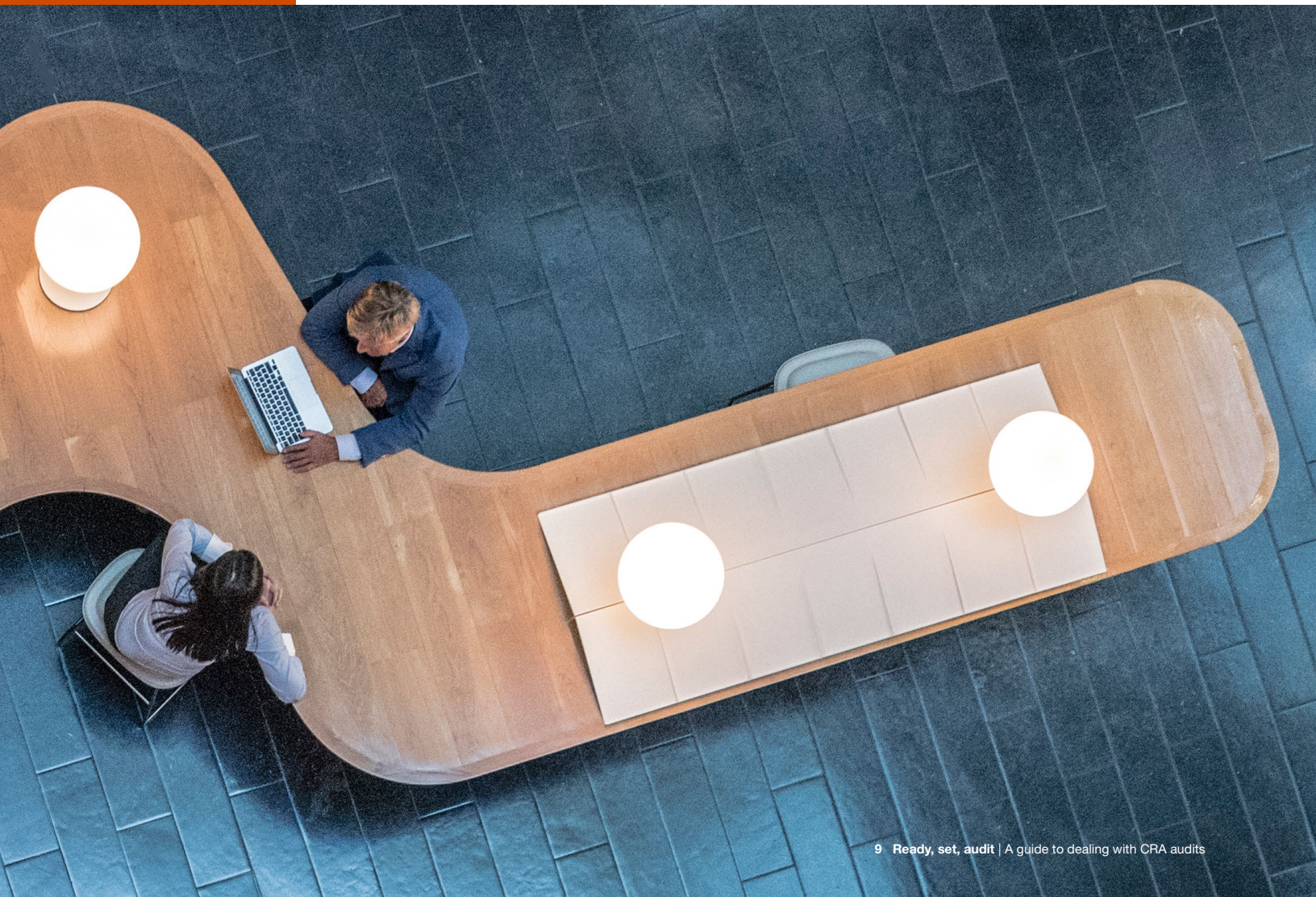
Should you sign a waiver to extend the normal reassessment period?

We recommend that any request by the CRA to provide a waiver should be discussed with your tax advisor who can provide a recommendation as to whether to provide, or not to provide a waiver.

⁴As defined in subsection 152(3.1) of the Income Tax Act

⁵As defined in subsection 152(4)(b) of the Income Tax Act

⁶Under subsection 152(4) of the Income Tax Act



Resolving post-audit issues

Definition of a large corporation for audit purposes:

The definition of a large corporation for purposes of the Income Tax Act is different than the CRA's classification of large file corporations for audit purposes. Although files considered large file corporations for audit purposes (that is, gross revenues greater than \$250 million) would also be considered large corporations for purposes of the Act, smaller corporations may also qualify as large corporations for purposes of the Act where the taxable capital employed in Canada exceeds \$10 million.⁷

What if I disagree with a CRA reassessment?

If you disagree with the notice of reassessment, you can file a notice of objection with the Appeals division of the CRA within 90 days from the date of the notice of reassessment. The notice of objection should provide explanations as to why you disagree with the reassessment and include all relevant facts and documents.

Where a corporation is a large corporation, the notice of objection must:

- Reasonably describe each issue to be decided;
- In respect of each issue, specify the relief sought expressed as the amount of change in a balance of unclaimed outlays or expenses or other amounts of the corporation; and
- Provide facts and reasons relied on by the corporation in respect of each issue.

Following a review of the notice of objection, the CRA Appeals division may either vacate (i.e., cancel), confirm or amend the notice of reassessment. If the CRA confirms or varies the reassessment and you still do not agree or, if 90 days has elapsed after the filing of a notice of objection and the Minister has not notified you that it has vacated or confirmed the reassessment, you may file an appeal of the reassessment to the Tax Court of Canada. Decisions of the Tax Court of Canada may be appealed to the Federal Court of Appeal and ultimately, leave may be sought to have the issue considered by the Supreme Court of Canada. It should be noted, however, that the Supreme Court of Canada allows very few tax cases to be heard before the Court.

What about the tax liability during an objection or appeal?

As a general rule, where a taxpayer has served a notice of objection or an appeal to the Tax Court, the CRA is not permitted to take any collection actions in respect of the amount in dispute. Where, however, the Tax Court of Canada confirms the CRA reassessment, the CRA may then take any appropriate collection action with respect to the amount owed regardless of whether an appeal is filed with the Federal Court of Appeal. While the ability of the CRA to undertake collection actions may be limited during the course of an objection or appeal, interest charges continue to accrue on all unpaid amounts in dispute.

The general rule does not apply in regards to amounts required to be deducted or withheld and required to be remitted or paid to the CRA. Examples include payroll taxes, withholdings pursuant to Part XIII of the Act, HST/GST, etc. These amounts are due and payable as provided in the Act.

Large corporations, as so defined in the Act, must pay 50% of the outstanding tax liability despite the filing of a notice of objection with the CRA.

⁷ Subsection 225.1(8) of the Income Tax Act

TIP

During the course of the audit, maintaining regular discussions with the auditor in regards to issues identified or under review should significantly reduce the risk of large unexpected proposed adjustments.

Correcting past omissions

If you wish to correct inaccurate or incomplete information, or to disclose information not previously reported to the CRA, you may qualify for relief of penalties or prosecution under the CRA's *Voluntary Disclosure Program* ("VDP"). The CRA revised their VDP program effective March 1, 2018. There are now two "tracks". A Limited Program when there is intentional conduct to be non-compliant or generally for corporations with gross revenue exceeding \$250 million in at least two of the past five taxation years and any related entities. Relief under the Limited Program is significantly curtailed. While relief from criminal prosecution is available, interest relief is not, nor is relief from penalties other than gross negligence penalties. Where the Limited Program is not applicable the General Program provides much broader relief. In addition to not being referred for criminal prosecution, penalties will not be charged (subject to a limitation period) and partial interest relief may be granted.

In order to qualify for a disclosure under the VDP, the disclosure must be (1) voluntary (i.e., you are not aware of any enforcement action initiated by the CRA in respect of the issues being disclosed); (2) complete (i.e., full and accurate facts and documentation for all taxation years covered by the disclosure); and (3) in respect of the application, or potential application of a penalty (i.e., the penalty may be a late filing penalty, a failure to remit penalty, or a discretionary penalty); (4) payment (you must include payment of the estimated tax owing with the VDP application).

In order to determine whether your attempts to correct inaccurate or incomplete information or to disclose information not previously reported to the CRA would qualify under the VDP, you may review the CRA's Information Circular – IC00-1R6 *Voluntary Disclosures Program* or alternatively, a member of our Tax Dispute Resolution team would be pleased to assist you.

Relief from penalties and interest

The Act gives the CRA the ability to administer the income tax system fairly and reasonably by helping taxpayers to resolve issues that arise through no fault of their own, and to allow for a common-sense approach in dealing with taxpayers who, because of personal misfortune or circumstances beyond their control, could not comply with a statutory requirement for income tax purposes⁸. The Act provides the Minister with the discretion to:

- Waive or cancel penalties and interest;
- Extend the filing deadline for making certain elections;
- Grant permission to amend or revoke certain elections;
- Authorize refunds to individuals (other than trusts) even if an income tax return is filed outside the normal three-year period; or
- Authorize a reassessment or redetermination for an individual (other than trusts) or a testamentary trust beyond the normal reassessment period where the adjustment would result in a refund or a reduction in an amount payable.

If your request for relief under the Taxpayer Relief program is initially denied, you may request that the CRA undertake a second independent review of the Minister's decision. If your request is still denied after a second level review, you may seek judicial review before the Federal Court of Canada. The Federal Court will review the reasonableness of the process followed by the CRA in rendering its decision. While the Federal Court may return the issue to the CRA for reconsideration, it does not have any judicial powers to obligate the Minister to exercise her discretion but the Federal Court's comments may be persuasive in the Minister's reconsideration of the issue.

⁸ see subsections 220(2.1) to 220(3.2) of the Income Tax Act as well as Information Circular IC07-1 *Taxpayer Relief Provisions*

How we can help

We assist clients in each phase of the tax audit to help minimize the impact it has on your business. Our Tax Dispute Resolution (“TDR”) team includes former officials with the CRA and Revenu Québec as well as former litigators with the Department of Justice and also work with our affiliated law firm, PwC Law LLP. As a team, we bring deep technical expertise, local knowledge, strong government relations, tax litigation experience and global perspective.

Our team helps clients:

- Adopt defensible tax filing positions while maintaining effective and efficient global business operations;
- Resolve audit conflict in the least disruptive manner possible; and
- When necessary, litigate to achieve a favourable outcome.

Are you audit ready?

We can:

- Build “defence strategies” into the structuring and operations of the business;
- Obtain advance rulings;
- Coordinate “course of conduct” reviews to ensure that post-structuring operations align with the initial implementation plan;
- Identify tax audit and controversy risks and exposures;
- Develop and implement alternatives to the current business model to mitigate the company’s risk profile.
- Conduct E-discovery, transaction documentation review

Managing an audit

We can:

- Assist clients in managing and responding to audits and examinations;
- Assist in audit level presentations, negotiations, and settlement discussions to resolve disputes efficiently and favourably at the examination level; and
- Help clients determine whether a waiver of the normal reassessment period should be provided when requested by the CRA.

Post-audit settlement/resolution

We can:

- Present and negotiate during the administrative appeals process;
- Assist in preparing a Notice of Objection which properly addresses the issues under appeal and provides detailed arguments to support the request to vacate a CRA reassessment;
- Assist with Advance Pricing Agreement negotiations using “rollback” features to resolve pre-existing disputes;
- Competent Authority and Mutual Agreement Proceedings and negotiations;
- Litigation and litigation support at the Tax Court of Canada; the Federal Court of Appeal; and/or the Supreme Court of Canada.

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