Tax Notes

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TAXPAYERS OBLIGED TO PROVIDE TAX ACCRUAL WORKING PAPERS DURING AN AUDIT

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Wolters Kluwer regularly features Dentons Canada LLP articles examining cases and topics of special interest.

Tax Accrual Working Papers Explained

Taxpayers undergoing financial statement audits are generally required to prepare tax accruals, also known as uncertain tax positions, to account for and disclose material items where the tax treatment is either unclear or the subject of dispute with the tax authorities. Frequently, the taxpayer's own employees prepare the tax accrual working papers which, for instance, under the United States Generally Accepted Accounting Principles ("US GAAP") and International Financial Reporting Standards ("IFRS"), require significant analysis of all tax positions that are less than certain. The tax accrual working papers are then provided to the financial statement auditors to establish a value for the contingency that is recorded as a liability on the financial statements. Since tax accrual working papers are created to outline all material tax positions where uncertainty exists, they could provide a road map to tax auditors outlining where the risks lie and can be used by tax auditors to establish reassessment positions that the tax auditors may not have otherwise identified. Furthermore, even where a taxpayer takes a reasonable filing position, the tax accrual working papers may outline less favourable alternative filing positions. For this reason, taxpayers would generally not want to provide their tax accrual working papers to the tax authorities.

Moreover, while it is understood that taxpayers are required to maintain these documents for accounting and securities law purposes, it is unlikely that taxpayers need to maintain tax accrual working papers pursuant to the *Income Tax Act* (Canada) (the "ITA") or the *Excise Tax Act* (Canada) (the "ETA"). Specifically, section 230 of the ITA and subsection 286(1) of the ETA only require the maintenance of such books and records as will enable the taxes payable or the amounts that should have been collected, withheld, or deducted to be determined. Since tax accrual working papers are not required to determine any of these amounts, but are prepared only to outline the risks associated with the tax positions taken for financial accounting purposes, it is certainly arguable that they do not fall within the scope of these statutory requirements.

CRA's Published Policy on Tax Accrual Working Papers

The Canada Revenue Agency ("CRA") takes the position that tax accrual working papers "relate" to the books and records of taxpayers. Accordingly, the CRA may inspect tax accrual working papers during the course of a tax audit pursuant to subsection 231.1(1)

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of the ITA or subsection 288(1) of the ETA, which provide the CRA the right to inspect, audit, or examine the books and records of a taxpayer or any document that relates or may relate to the information that is, or should be, in the books and records of the taxpayer. However, in a published policy, the CRA stated that information from third parties will be sought when the taxpayer cannot or will not provide information. The CRA also provided that tax accrual working papers will not be routinely required.

The *BP Canada* Case

Whether or not a taxpayer is required to provide the CRA with an issues list from its tax accrual working papers during the course of a tax audit was the subject of an application brought before the Federal Court of Canada by the Minister of National Revenue in *BP Canada Energy Company v. Minister of National Revenue*, 2015 DTC 5077 (F.C.), seeking a compliance order requiring BP to produce its tax accrual working papers.

In *BP Canada*, the Minister candidly argued that it sought to obtain BP's tax accrual working papers to assist the CRA in expediting its audit not only for the years for which the tax accrual working papers were prepared but also for subsequent tax years — thus implying that the documents were not required for the audit but were simply helpful as a matter of convenience for the auditor. The Minister presented herself as being in an inherently disadvantaged position in Canada's self-reporting tax system. In requesting the tax accrual working papers, the Minister argued that she was merely performing her obligation to verify the accuracy of BP's tax return.

BP argued that the Minister may have broad authority in her audit powers, but the provision of the issues list is not required to fulfill her duty to administer the ITA. Moreover, the issues list reflected BP's subjective opinion regarding potential tax risks and, in this case, related to statute-barred taxation years. Accordingly, BP's position was that these documents could not be viewed as relating to the determination of taxable income under the ITA. BP also argued that even if the statutory test is met, the Federal Court would be required to justify the exercise of its discretion and would not be able to do so in this case. BP provided a number of reasons why the Federal Court should not exercise its discretion, including that the disclosure of the issues list amounted to a compulsory "self-audit", that the Minister's own policy and practice demonstrated that the issues list is not required to complete the audit, and that disclosure of tax accrual working papers would be contrary to public interest in the full and frank disclosure of tax risks for financial reporting purposes.

In addition, BP specifically argued that the issues list should not be compelled because doing so would fundamentally offend the principles of the self-reporting tax system that the Minister administers as a matter of law and would single out a certain class of taxpayers who are required to prepare tax accrual working papers for non-tax purposes. In making this argument, counsel for BP described in vivid detail how allowing the CRA to request tax accrual working papers effectively shifts the audit work from the Minister to the taxpayer.

The Federal Court Decision

In granting the compliance order requiring BP to provide the requested tax accrual working papers, the Federal Court found that while the Minister may not need the tax accrual working papers to complete an audit, if the Minister wants them, she should have them. The Federal Court did not accept BP's "road map" argument or its "self-audit" argument and put weight on the fact that the issues list was already prepared and, thus, no additional work would be required by the taxpayer. Instead, the Federal Court endorsed the Minister's audit approach in this case, stating that the Minister's request for tax accrual working papers is not part of a fishing expedition if the Minister knows that she wants a clear road map to be used for current and future audits.

The Federal Court also provided a broad interpretation of the types of documents that may be requested by the Minister pursuant to subsection 231.1(1) of the ITA, stating that they relate to the taxpayer's records. The Federal Court found that while the ITA may not require that these types of documents be retained, if they are retained for another reason, the documents can be requested by the Minister. This was held to be the case by the Federal Court despite BP's argument that in doing so the Minister unfairly prejudices a certain subset of taxpayers who are required to prepare tax accrual working papers for non-tax reasons. Here, the Federal Court found the Minister's argument more compelling. The Minister provided that tax accrual working papers allow the Minister to identify and audit additional

items where taxpayers take positions "that are on the line" which may be disputed by the taxpayer and, ultimately, decided upon by the Tax Court of Canada.

Caution Required by Taxpayers

The decision in *BP Canada* clearly outlines the Federal Court's opinion that tax accrual working papers need to be produced when requested pursuant to section 231.1 of the ITA. It also supports the Minister's policy argument that using tax accrual working papers allows the CRA to challenge more tax positions before the Tax Court of Canada. Accordingly, despite arguments to the contrary made by BP, this decision condones a shift in the burden and cost of the tax audit function from the CRA to taxpayers in cases where tax accrual working papers are prepared.

While BP will likely file an appeal, this Federal Court decision nevertheless serves as an important reminder that the CRA is becoming increasingly aggressive in its audit practices and the legislation affords the CRA extremely broad powers to obtain a wide array of information from taxpayers. As such, taxpayers as well as tax advisers should be cognizant of the potential disclosure obligations when preparing and maintaining tax accrual working papers.

A number of tax lawyers from Dentons Canada LLP write commentary for Wolters Kluwer's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for Wolters Kluwer's* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for Wolters Kluwer's* Federal Tax Practice *reporter and the summaries for Wolters Kluwer's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by Wolters Kluwer:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Dentons Canada LLP and a member of the Editorial Board of Wolters Kluwer's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

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2015 RRIF WITHDRAWAL CHANGES — QUESTIONS AND ANSWERS

The Canada Revenue Agency ("CRA") recently released a technical interpretation in which it responded to a series of questions relating to the reduction of the registered retirement income fund ("RRIF") minimum withdrawal amounts announced in the 2015 federal Budget. The new rules allow a RRIF annuitant to re-contribute the difference between a withdrawal calculated using the old (pre-Budget) minimum and the new minimum. This difference is referred to as the "eligible RRIF withdrawal amount". To be deductible, the re-contribution must be made by February 29, 2016.

The questions deal largely with administrative matters.

Q1: Can a RRIF annuitant choose to withdraw the old RRIF minimum amount for 2015 and, if so, is the excess over the new minimum an excess amount?

A1: Yes to both questions. Although the RRIF carrier is normally required to withhold tax from an excess amount, for 2015 only, no withholding is required if the annuitant withdraws a minimum amount calculated under the old rules.

Q2: Must the annuitant re-contribute the eligible withdrawal amount to the same RRIF carrier or to the same type of plan?

A2: No. The re-contribution can be made to any RRIF with any carrier. Technically, the re-contribution can also be made to a pooled registered pension plan or it can be used to acquire an annuity, although it is likely impractical to do so.

Q3: Is it the RRIF annuitant or the RRIF carrier that determines the eligible RRIF withdrawal amount?

A3: The CRA expects the RRIF carrier to provide the information the annuitant requires. The CRA will require a letter confirming the eligible RRIF withdrawal amount and a receipt for the re-contribution.

Q4: Will the CRA follow the previously issued guidance on the re-contribution process or will new guidance be issued?

A4: The annuitant should claim a deduction for the re-contribution on line 232 of the T1. A separate re-contribution receipt will be required, showing the amount, the name of the carrier, the contract number, the annuitant's name and social insurance number, the amount received, and the date of receipt.

Q5: What income attribution rules apply where an excess arises under the new rules and the RRIF is a spousal/partner plan?

A5: The spousal attribution rules use the old withdrawal minimums for 2015.

Q6: What changes are to be made to the 2015 XML schema?

A6: None.

Q7: Will the CRA issue an FAQ, as in 2008?

A7: Yes. It is being developed.

Q8: How are RRIF carriers to report the old and new minimum withdrawal amounts?

A8: The excess amount reported on box 24 of the T4RIF should be based on the old, unreduced, minimum amounts for 2015. As noted in Questions 3 and 10, the carrier will be required to provide additional information to the annuitant. (Editorial Note: This reporting is consistent with the system that was used in 2008. The excess amount reported in 2015 is to be based on the old rules, with a letter provided to any annuitant for whom the new minimum is relevant.)

Q9: On transfers between carriers, the transferor is required to pay the minimum amount before effecting the transfer. Does the carrier use the old or the new minimums?

A9: If the transfer occurs before Bill C-59 receives royal assent (Editorial Note: royal assent was received on June 24, 2015), the old minimum should be used. Thereafter, use the new minimum.

Q10: Should the carrier use the old or the new minimum in calculating the eligible designated benefit for a RRIF being distributed in 2015 due to the passing of the annuitant?

A10: As the new minimum applies for 2015, it should be used. The carrier is required to use the new minimum once Bill C-59 receives royal assent (Editorial Note: i.e., after June 24, 2015). The CRA will require a letter confirming that the new limit has been used to support the deduction claimed by the qualifying beneficiary. (Editorial Note: The new minimum is used in calculating the eligible designated benefit to ensure that the qualifying beneficiary is able to roll over the maximum amount passing from a deceased's RRIF.)

Q11: Can a RRIF carrier use its existing systems to issue a receipt for a re-contribution or will systems have to be updated to comply with a new XML schema?

A11: The CRA will not create a new XML schema. As noted in the response to Question 4, a receipt will be required for the re-contribution.

CURRENT ITEMS OF INTEREST

Economic Action Plan (Bill C-59) Receives Royal Assent

On June 24, 2015, Finance Minister Joe Oliver welcomed the royal assent of the *Economic Action Plan 2015 Act, No. 1*, which puts into effect many of the key legislative elements of the Economic Action Plan 2015.

Taxpayers Affected by Wildfires Granted Relief

On July 21, 2015, the Canada Revenue Agency ("CRA") announced that taxpayer relief is available to individuals and corporations affected by the wildfires in British Columbia, the prairie provinces, and Ontario if they are unable to meet their filing obligations. Individuals and businesses unable to file or pay taxes on time because of the wildfires can make a request to the CRA to have interest and/or penalties waived or cancelled, using Form RC4288, *Request for Taxpayer Relief*. The CRA will assess each case on an individual basis and they stress that returns still need to be filed.

CRA Introduces New Folio S4-F2-C1, Deductibility of Fines and Penalties

On July 9, 2015, the Canada Revenue Agency released a new Income Tax Folio, S4-F2-C1, Deductibility of Fines and Penalties. This Folio replaces Interpretation Bulletin IT-104R3 and discusses the various factors that must be considered in determining the deductibility of fines and penalties for tax purposes.

Private Member's Bill C-377, *An Act To Amend the Income Tax Act* (requirements for labour organizations)

On June 30, 2015, Bill C-377, which requires labour unions in Canada to file a standard set of financial statements each year for public disclosure, received royal assent and was passed into law.

FOCUS ON CURRENT CASES

This is a regular feature examining recent cases of special interest, coordinated by *John C. Yuan* and *Christopher L.T. Falk* of McCarthy Tétrault LLP. The contributors to this feature are from McCarthy Tétrault LLP, Montreal, Toronto, Calgary, and Vancouver.

Creditor Allowed a Terminal Loss on Sale of Property Received Through Foreclosure

***568864 BC Ltd. v. The Queen*, 2015 DTC 1042 (Tax Court of Canada)**

The issue in this case was whether the taxpayer was entitled to claim a terminal loss on the disposition of property that was security for loans the taxpayer made to a supplier of the taxpayer's group of companies and that the taxpayer acquired through foreclosure. The Tax Court held that, in the circumstances, the taxpayer was entitled to the terminal loss even though the economic result was similar to allowing the taxpayer (who was not in the money lending business) to claim a deduction for the unpaid principal amount of its loan to the defaulting supplier.

The taxpayer was part of a group of companies that supplied the construction industry with wooden fascia/gutter boards used in residential homes. The taxpayer's role in the corporate group was to provide management services and to own certain higher risk assets that management chose to hold separately from the manufacturing operations to avoid distorting the bonus pools for employees of the manufacturing entity.

The manufacturing entity in the taxpayer's group used a specialized type of engineered wooden board that was produced by an arm's length vendor using patented processes. The vendor was in financial difficulty and needed to both refinance existing high-yield debt and secure additional funds to properly operate its business. Jim Young, the principal shareholder of the taxpayer's group of companies, was impressed with the vendor's product and wanted to ensure that his companies would have continued access to those products. Ultimately, it was agreed that the taxpayer would make a number of advances to the vendor and approximately $3,500,000 was loaned to the vendor pursuant to that commitment. Various forms of security were provided for the loans including, in particular, the patents for the underlying technology which were owned and pledged by the vendor's principal shareholder.

Despite the taxpayer's financial assistance, the vendor continued to have difficulties and both the vendor and its principal shareholder eventually fell into bankruptcy. While the vendor was in bankruptcy, unsuccessful efforts were

made to find a buyer for the vendor's business and the patents. The patents were eventually released to the taxpayer in the course of the bankruptcy proceedings and, thereafter, the taxpayer's group of companies made efforts to find a joint venture partner to try to exploit the patented technology. A suitable partner was not found after almost two years of trying and, by the end of the that period, it was clear that the residential construction industry was in sharp decline such that the prospects for exploiting the patented technology for profit were greatly diminished. It was then decided that the taxpayer would terminate its attempts to try to exploit the patents and the taxpayer transferred the patents to a corporation controlled by Mr. Young's son, Christopher Young, for nominal consideration.

In its tax return for the year that the taxpayer disposed of the patents, the taxpayer claimed a terminal loss on the basis that the patents were depreciable property in the hands of the taxpayer at the time of the disposition. The size of the terminal loss in connection with disposition was the difference between (i) the taxpayer's cost of the patents, starting with its acquisition cost as determined by subsection 79.1(6) of the *Income Tax Act* to be the taxpayer's $3,500,000 adjusted cost base of the loan receivable from the vendor, plus approximately $70,000 of legal costs to secure or defend the patents, and (ii) the nominal consideration of one dollar received on the transfer of the patents to the corporation controlled by Christopher Young.

The Minister reassessed to disallow the terminal loss and took the position that the patents were not actually acquired in the transaction whereby the trustee in bankruptcy released the patents to the taxpayer. The Minister also asserted that the patents were not acquired for the purpose of gaining or producing income, as required by paragraph 1102(1)(*c*) of the *Income Tax Regulations* and, therefore, the patents were not depreciable property.

The Minister's factual basis for concluding that the taxpayer did not acquire the patents when the trustee in bankruptcy gave its release was the fact that the language used in the release provided that it was given "subject to an ultimate accounting for the proceeds of disposition" in the unlikely event that the taxpayer was able to find a buyer for the patents willing to pay a price in excess of the $3,500,000 the bankrupt borrower owed to the taxpayer. The Minister also considered it relevant that legal title to the patents (as shown in the U.S. Patent Office) remained in the name of the principal shareholder of the bankrupt until it was transferred to the trustee in bankruptcy in 2010. It was the Minister's view that beneficial ownership of the patents remained with the original owner until that time. The Tax Court rejected the Minister's position on this issue, as it was clear on the evidence that all relevant parties fully intended for the taxpayer to have beneficial ownership of the patents as a consequence of the release. The transfer of legal ownership many years later was irrelevant to the only meaningful question: i.e., when did beneficial ownership pass to the taxpayer?

The more interesting issue was whether the facts supported the conclusion that the taxpayer acquired the patents for the purpose of gaining or producing income. The nature of the Minister's principal complaint appears to be that the taxpayer was not the legal entity in the taxpayer's group of companies that carried on the manufacturing operations that would have used the engineered wood boards associated with the patents. However, the Tax Court took a more comprehensive view of the evidence and considered the corporate structure and the efforts of the taxpayer's group of companies to try to exploit the patents by way of a joint venture. This led the Tax Court to conclude that "[o]ne way or the other, by licensing the Patents to [its manufacturing affiliate], in partnership or joint venture, and, in addition to earning management fees, would the appellant gain income from the Patents."

In the result, the Tax Court allowed the taxpayer's appeal and restored the terminal loss that the taxpayer claimed in its return for the taxation year in which it disposed of the patents. It was fortunate that the principal of the taxpayer groups of companies took an active interest in the patented technology and its potential impacts on the taxpayer's group of companies. Had there been no demonstrated effort by the taxpayer's group of companies towards exploiting the patents, either within its own group or among a broader group through a joint venture, the taxpayer's economic loss on the loan transaction would have likely remained a capital loss.

— *John Yuan*

RECENT CASES

Gift of ecologically sensitive land to city was not part of business, and taxable capital gain deemed to be zero

The taxpayer was appealing a reassessment which treated a gift of land to the city of Ottawa as a disposition of investment property and included the value of the land, less the original cost, as income from business. The taxpayer was a chartered accountant who had been engaged in commercial real estate as an employee and as the owner of a commercial real estate brokerage firm since 1996. In 1983, the taxpayer's father purchased rural land which he sold to the taxpayer in 2000 for $70,000. When informed in 2003 that the land might be subject to development restrictions, the taxpayer hired a consultant to research subdivision and rezoning possibilities. That was abandoned when the taxpayer was informed of the possibility of donating the land to the city of Ottawa in return for a charitable donation. The land was appraised at $1,935,000 and the taxpayer received a charitable donation receipt in that amount when it was donated in 2009. As the land was considered ecologically sensitive land and the city of Ottawa was a qualified donee, the taxpayer argued that the taxable half of the capital gain was deemed to be zero.

The appeal was allowed. The taxpayer was a credible witness. He bought the property from his father as his father was in need of funds at the time. There was no evidence of any intent by the taxpayer to conduct business with respect to the property. When the taxpayer was investigating the possibility of re-zoning or subdividing the land, a gravel road was built to free a truck that got stuck in peat. There was no intent to carry on a business. The taxpayer was taking steps to preserve the value of the land and the re-zoning and subdivision possibilities were abandoned once the option to donate the land became available. He testified that one of the reasons for gifting the land was to offset large gains but there was no suggestion that the gains were connected to a business. Even if there had been a secondary intention to develop the parcel of land, nothing was carried out and there was no adventure in the nature of trade. The donation to the city was a *bona fide* gift and not the culmination of an adventure in the nature of trade. The nature of a gift does not change because there are favourable tax consequences. The gift yielded a capital gain, the taxable half of which was deemed to be zero, as the land was certified as ecologically sensitive land.

Staltari, 2015 DTC 1130

Summary conviction for tax evasion resulted in fine and conditional sentence

The accused was charged with wilful evasion or attempt to evade compliance with the *Income Tax Act* and the failure to remit goods and services tax. The Crown proceeded summarily and the accused pled guilty. The question for determination by the Court was the appropriate penalty to be imposed.

The accused was required to pay a fine and serve a conditional sentence. The Court noted that in arriving at an appropriate sentence it was required to consider the three objectives of deterrence, denunciation, and rehabilitation. As well, the existence of aggravating or mitigating factors would affect the sentence to be imposed. There were two such aggravating factors, being the significant amount of taxes evaded and goods and services tax not remitted, and the breach of trust committed by not fulfilling the obligation to honestly and accurately report income. However, the accused had no criminal record, had pled guilty to the charges, and had recently experienced both the loss of his spouse and health problems, all of which were mitigating factors. A joint submission with respect to sentencing had been put forward, which called for a fine equal to 75% of the taxes evaded and a 20-month conditional sentence. The Court concluded that the sentence jointly proposed was well within the range of an appropriate sentence for the charges and accepted the joint submission.

Leung, 2015 DTC 5059

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