



What To Do When

CRA CONTACTS YOU

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The Reach of The **Canada Revenue Agency**

The Canada Revenue Agency (CRA) is mandated to apply the Income Tax Act and Excise Tax Act in pursuit of collecting both income taxes and GST/HST. The powers of the CRA include verification or audit activity with an emphasis on businesses that are operated either individually, or through corporations or partnerships.

The CRA is not restricted to simply auditing businesses, and will therefore verify numerous types of income activity. These activities include employment expenses, transactions involving the sale of property that result in capital gains or losses, rental properties, foreign properties, etc.

In addition, the reach of the CRA extends to income earned both within and outside of Canada, particularly involving residents of Canada.

The reach of the CRA is increasing everyday as new sources of information become available to them. This is a result of more and more countries collaborating to share information.



What Does It **Mean To You?**

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The likelihood of CRA contacting individuals and service providers in regards to personal income or the income of clients is greater than it has ever been.

Over the last few years, successive governments have pledged substantial additional funding to the CRA for the hiring of new auditors to increase audit activity.

In the 2017 Federal Budget the government pledged \$523.9M to CRA with the goal of raising an additional \$2.5B in tax revenues. This is in addition to \$444M previously pledged to the CRA with tax revenue projections of \$2.4B.

The CRA employs thousands of auditors with different levels of training and expertise, some of the more common of which include:

- **Desk auditors** who typically verify specific items on individual income tax returns
- **Payroll auditors** who focus their attention on payroll issues such as employee benefits and withholdings like CPP and EI
- **Small and medium size business auditors** who audit businesses of individuals and small private corporations
- **Basic and large case file auditors** who audit larger businesses generally operated through corporations
- **International tax auditors** whose focus is on Canadians operating businesses outside Canada or foreign interests operating within Canada
- **Specialty auditors** audit tax shelters, SR&ED, resource sectors, etc.

The government is committed to a significant increase in audits and audit related activity; CRA has the manpower to easily achieve this objective. The expectations are clear in terms of additional tax revenues and the push is on, which may result in accelerated queries and audits that are somewhat aggressive in nature. CRA communications with the aim of initiating processes will sometimes result in audits that include queries of varying nature such as requests for information and reminder/education letters detailing reporting obligations and advising of potential audits.



What Can You Expect From a **CRA Contact?**

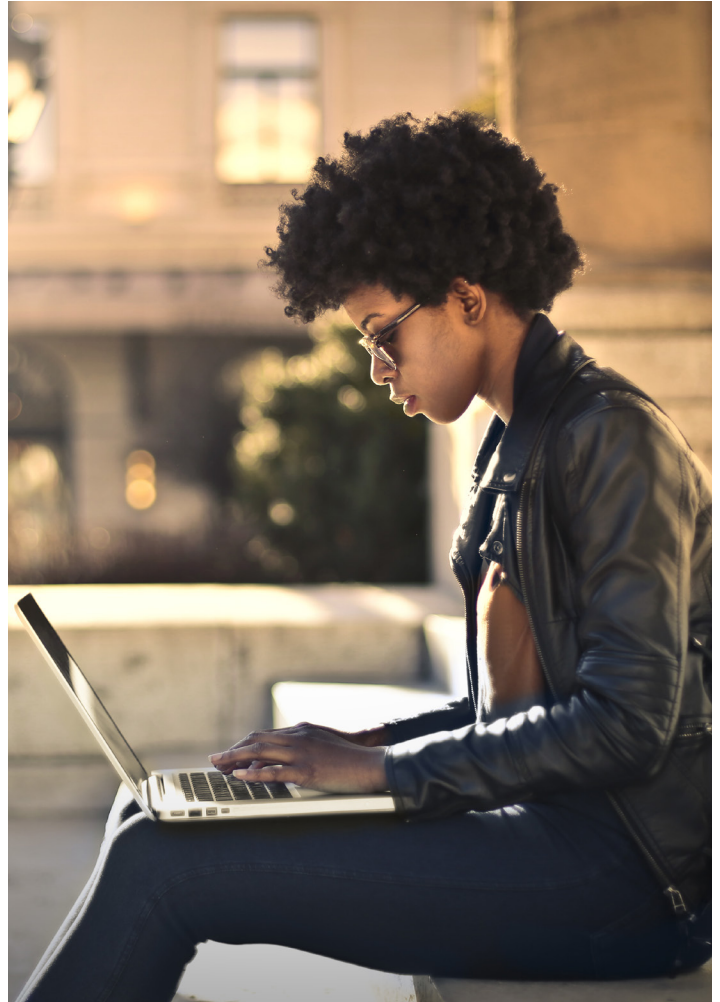
A large portion of correspondence from CRA employs standardized language requesting information, some of which may be applicable and some of which that will not be applicable. You may be surprised by what is requested, such as personal bank statements, credit card statements and other financial information, that at first glance, may appear to have little or no connection to the income activity under examination. Unfortunately, CRA generally has the right to request such information.

The first thing you need to do is to comply with the request to the best of your ability.

Oftentimes a CRA contact will be added to the correspondence who may be in a position to provide additional information.

Keep in mind that once the process has been initiated, the CRA will not relent until the nature of the correspondence has been resolved.

It is also important to remember that a seemingly innocent query can sometimes develop into something much more significant. For example a query about a specific expense claimed may, depending on the findings, expand to other expenses or income and become a full or general audit.



You Have Been Selected For a CRA Audit - **What to Expect**



You may have initially received written communication by mail or have been contacted by phone with a follow-up letter by the CRA advising that you have been selected for an audit. In either case, you will have a name and contact number of the CRA auditor and often their manager which, CRA refers to as the “Team Leader”.

It is important to first determine the nature or scope of the audit, which will let you approximate the intensity of the audit including how much documentation and other information you will be asked to provide and the length of time the audit will take.

While the initial correspondence may reveal the scope to some degree, it is suggested that you ask why the file was screened; this question relates to how files are selected. The CRA employs many “screeners” whose job it is to scan through filed tax information including financial statements and other data to determine whether there are any risk factors that should be investigated. If there are only a few, the audit may fall under the “restricted audit” category. The CRA auditor’s duties involve clearing the screeners’ comments as quickly as possible and moving on. If, in the course of the restricted audit, the CRA auditor uncovers other “areas of interest”, the audit may result in a full-blown unrestricted or general audit. CRA auditors are advised to always be on the lookout for additional points of interest that could lead to reassessments. This is often the reason why many professional advisers caution against providing too much information or documentation at the start – providing documentation or information not specifically requested may, unbeknownst to you, cause the CRA auditor to believe there are further matters worth investigating, thereby prolonging the audit and increasing the costs and likelihood of a reassessment.

In many instances, a file is screened on an open-ended basis, meaning a full scale general audit. Such cases often require auditors to apply a lengthy list of standard audit tests to a multitude of items which may require substantial documentation. For example, some of these standardized audit tests referred to as “IVI” techniques (“indirect verification of income”) are often employed when auditing small to

medium sized private corporations. Their objective is to determine the potential for unreported income. When interpreted by the CRA, these tests may result in a net worth audit. Net worth audits often result in outlandish reassessments which are difficult and costly to defend. Notorious gangster Al Capone was imprisoned based on these types of audit tests.

At the end of the day, the information you will be required to provide and questions you will be required to answer will ultimately depend on the nature and scope of the audit.

Note that neither the CRA auditor nor their Team Leader are obligated to tell you whether the audit is restricted or not, but in our experience many will disclose the information in the interest of resolving the file in the most timely manner.

If the audit is unrestricted, you should expect to be asked to provide considerable information including, but not limited to, in the case of private companies, organizational charts, minute books, all accounting records, ledgers and journals, invoices, contracts, and bank statements. In addition, the documentation you may be required to provide may extend to shareholders and family members of shareholders involved with the company during the fiscal year under review. Information and documentation pertaining to partnerships and trusts will also be requested, if applicable.

In terms of private corporations, CRA auditors typically focus on shareholder benefits, shareholder loans, and shareholder expenses (i.e. travel costs, entertainment and home office expenditures). When these expenses are considered as personal, the discrepancies are treated as a combination of unreported income and shareholder benefits. This means, that the amount will be taxed twice and interest will be charged. As well, there is potential for penalties to be charged of up to 50% of the additional tax.

CRA audits can take a considerable period of time. A “no change” audit in which no reassessment is issued generally takes no more than a few months from start to finish, whereas more extensive general audits can take as long as one year or more. Once you factor in reassessments and any disagreements that lead to notices of objection, you can easily double that time.



Tips to ensure **the audit proceeds as smoothly and as quickly as possible.**



- Be professional and respectful
- Be courteous
- Avoid putting up roadblocks or fuelling the perception that you are unwilling to provide everything requested within specific timeframes, unless of course you are dealing with solicitor-client privilege
- Try to develop a professional rapport with the CRA auditor early on that leads to open discussion and understanding if there are expected delays in providing necessary documents. Keep in mind that CRA auditors, by nature, are suspicious and are looking for indicators that support that suspicion. If the relationship begins on a good foundation, disagreements that arise may be dealt with much more effectively than in the absence of that foundation.

It is of the utmost importance to maintain a cordial relationship whenever possible to ensure the audit is completed as efficiently as possible.

We have seen CRA audits begin with friction and distrust that devolves into aggressive audit positions, which cannot be resolved during the audit stage forcing a costly continuation through to CRA Appeals and sometimes the courts.

How Can Welch **Help?**

It is important that you do not feel powerless and at the mercy of CRA in these interactions. Our goal is to be proactive, informative, and to provide our income tax and GST/HST experience and expertise with respect to dealings of any kind with CRA.

We possess the skills of an experienced tax team that includes ex-CRA resources responsible for both training and working extensively with CRA auditors of all levels.

We have a long history of providing our services to clients who have been the subject of CRA queries, investigations, and restricted and full scale audits. Our results have ultimately led to the elimination of penalties and interest, as well as a significant reduction (if not entire elimination) of the proposed increase in taxes.

We understand that unprompted communications by the CRA create a level of anxiety. We appreciate that the income tax and GST/HST systems provide a high level of complexity that few Canadians are versed in and that oftentimes CRA correspondence may seem incomprehensible. We are here to assist you with any CRA contacts or correspondence to ensure you the most favourable outcome.



Case Studies

Case 1 – The IT Consulting Business:

A long running incorporated IT consulting business had multiple clients under contract. Expenses incurred for cell phone, meals and entertainment, advertising and promotion, automobile, parking and travel were disallowed by CRA auditor for each of the 2011, 2012 and 2013 years. The expenses disallowed as a deduction for the company were also reassessed to the shareholders as fully taxable benefits. In addition, the 2011 year was statute-barred. We successfully represented the shareholders and the company to (1) eliminate the statute-barred year and (2) reduce all reassessments by 80% to 90% on average, saving our client tens of thousands in assessed taxes. Note: This audit was initially screened as a restricted audit

Case 2 – The Management Consulting Business:

A wholly-owned corporation carried on a management consulting business with multiple contracts fulfilled by the sole shareholder. The corporate office was situated in the residence of the sole shareholder. A CRA audit for 2012, 2013 and 2014 resulted in the disallowance of office expenses including cell phone, internet, supplies, and expenses for automobile, parking and travel. Golf club membership expenses incurred that generate contracts were added as shareholder benefits along with all disallowed expenses. In addition, shareholder loan adjustments were added to the shareholder's income. Finally, penalties were applied and the statute-barred limitations were ignored for the 2012 year. Two levels of complaints were filed against the CRA auditor based on the aggressive nature of the audit. The outcome resulted in the reversal of all penalties, the reversal of the statute-barred year reassessment, and the reduction of all audit adjustments by at least 90%.

Case 3 – The Restaurant Business:

In this file the client, a Canadian subsidiary of a foreign parent company, was audited by the CRA. The client operated a large restaurant and adjoining bar. The auditor disallowed certain professional fees and royalty and interest expenses in connection with contractual arrangements with the Parent including financing. CRA also proposed adjustments for Part XIII tax and foreign tax credits. Finally CRA employed a projection method to estimate revenues from the sale of alcoholic beverages and reassessed the discrepancy as unreported income. Penalties were not applied nor were there any statute-barred years involved. During the proposal stage we convinced CRA that the financing expenses were fully deductible, which accounted for half of the reassessments. Our intervention and involvement saved the company \$100,000 to date. An objection has been filed for the remaining issues. In addition, a service complaint was filed in regard to the inexperience of the CRA auditor and the use of audit techniques that were not warranted. We are still awaiting contact by CRA Appeals.





About The Author: Gary Donell



Gary began working with the CRA in 1985 after working in the private sector for eleven years and stayed in various roles at CRA for nearly thirty years. He regularly consults with numerous CRA auditors on a variety of domestic and international issues.

In his roles with the CRA, Gary participated as a guest speaker in CRA sponsored tax events for some of Canada's largest companies, provided a special tax event to the Department of Justice and the Department of Finance policy section, and was the CRA guest speaker for over 10 years in the advanced tax program.

Gary joined the Welch LLP tax group in 2016 giving Welch LLP a valuable advantage for our clients in dealings with the CRA to obtain fair, reasonable and appropriate results.

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