CCH Tax Notes – July

Highway to Hell: The CRA's High Net Worth Initiative

By: David Louis, J.D., C.A., Tax Partner

Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

_____

A CRA initiative - which was virtually unknown only months ago – is dramatically changing the ground rules on how affluent entrepreneurs and their private corporations interact with the CRA. The project is actually part of an international initiative on the part of the European-based OECD. It is known to the CRA as the Related Party Initiative (RPI for short), so-called because the CRA is looking at groups of entities and how they interact in terms of tax planning. However, the focus is definitely on wealthy individuals (net worth of at least $50M according to the CRA), with complex structures (the CRA's recent party line is more than 30 or so entities – but these benchmarks could change).

Basically, groups that are targeted for audit by the CRA will be treated on par with public corporations. For example, senior tax auditors will be sent in on your file. A recent article on the subject suggests that completion of the audit could take up to three years, particularly if technical issues requiring referral to specialists are involved.**[1]** Besides reassessing taxpayers, one of the objectives of the project is to "risk assess" the group. If your group is identified as high risk, you can be sure that you will be audited regularly.

The "Long Questionnaire"

In most cases, the audit process begins with a 20-or-so-page questionnaire. My understanding is that the provision of this questionnaire is now mandatory on the part of the CRA for all audits in the High Net Worth program. I first wrote about the questionnaire in this newsletter last October, before it became generally known that it was part of the initiative. As I indicated, the questionnaire is specific about entities, asking for details of "unlisted" companies, private trusts, partnerships, joint ventures (including names and addresses of other joint venturers), and "further entities". For unlisted corporations for example, information is required if you are a shareholder, director or officer, shares (or an interest or option) are held on your behalf, or you control the company directly or indirectly**[2]**. For further discussion of the content of the questionnaire, see "Tax Grazing: Questionnaires, Wills and Leaky Pipelines". Tax Notes No. 573, October 2010. A recent version of the questionnaire asks for value of assets held by these entities and defines "further entities" to include bare trusts**[3]**. In short, however, the CRA wants to know about all companies and other entities in your group, whether onshore or offshore, and their assets and liabilities, including a corporate chart and financial statements of the entities.

Articles on this initiative advise clients not to panic when they get the questionnaire. A more appropriate reaction would be mobilization, sort of like D-Day. It will probably be advisable to enlist the services of a good tax practitioner: there are some trick questions that can give the CRA the ammo to attack trust structures, and so on. Requested information could be protected by solicitor-client privilege. For larger groups, answering the questionnaire could take weeks – perhaps even months - of intensive work. Some practitioners I have talked to refer to the questionnaire as a "fishing expedition."

If several entities in the group are selected for audit, they will each receive separate CRA letters with requests for audit information (general ledger, journal entries, bank statements, etc., etc.). A typical follow up audit query sheet asks for minute books, a listing of all legal and accounting firms used by the group, including all correspondence files with them, and all tax planning documents.**[4]**

Some Suggestions

The following are some suggestions for coping with the CRA's initiative, or its prospect:

- Consider how you document your company's transactions. Because public company auditors are involved, they are used to seeing lots of paper. Even though case law supports the contention that the requirement for documentation to evidence transactions may not be as stringent in a smaller corporation**[5]**, it may be prudent to prepare contemporaneous documentation of various transactions (such as shareholder loan set-offs or repayments in kind), rather than rely on journal entries. Documentation relating to other entities in the group may also be important, trusts being a good example. For domestic income-splitting family trusts, it is important to have trustee resolutions or other evidence that show that income was legally "payable" to the beneficiaries in the particular year it was allocated (i.e., in accordance with the T3 slips for the year). The documentation relating to Alberta or offshore trusts may be critical, as it may relate to the proper residence of such trusts.

- Complying with the CRA's initiative probably means hiring a good tax advisor – perhaps even a team of legal and accounting advisors - and the fees that go with them. Basically, you are paying to keep the CRA from dipping into your pocket. Trying to short circuit this process when dealing with the CRA's questions could be very costly in terms of potential tax exposure. For example, decisions must be made about what information and documentation to give to the CRA, which requires an understanding of the significance of the information.

- Beware of unreported income. One of the main objectives of the audit questionnaire is to ferret out unreported offshore income. If the CRA unearths unreported income (offshore or otherwise) under its audit initiative, things can get scary. Over the years, I have found that many people are motivated to put assets offshore not so much to reduce taxes, but for such objectives as to have a safety net in the event of difficulties with judgment creditors – others fear the prospect of religious persecution, or even political upheaval. If there is a possibility that the High Net Worth initiative could be applied to you and your family, I strongly suggest that you make a voluntary disclosure of the offshore income - before you get the CRA questionnaire.**[6]**

- Consider carefully what goes in your corporation's minute books. The CRA will no doubt review them as part of the audit process. For example, section 140 of the Ontario Business Corporations Act requires a corporation to maintain minutes of meetings and resolutions of shareholders and directors. Consider whether these resolutions are necessary under corporate law, especially if the items to which the resolutions relate may be tax-sensitive or otherwise privileged.

- As I said earlier, a follow-up question typically posed by the CRA asks for a listing of correspondence with legal and accounting firms used by the group and all tax planning documents. Thus, privilege becomes important, as it can prevent having to hand over these potentially-prejudicial documents to the CRA. If you or your family could be subject to the High Net Worth initiative, I suggest that tax planning documents which are sensitive should be prepared such that they are subject to solicitor-client privilege.

- Tax advisors should consider their exposure in the event of an adverse reassessment. Consider whether a tax opinion is appropriate or will lead to legal actions by a disgruntled client. Before undertaking a transaction, the risks should be explained to the client.

It is thought that there are about fifty of these audits currently in progress. If you have any information or views you wish to share with readers pertaining to the CRA initiative, please send them to me; I may pass them along in a follow-up article.

David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide. David's practice focuses on tax and estate planning for entrepreneurs and their corporations (dlouis@mindengross.com).

---

[1] See “High Net Worth Individuals Facing Increased Scrutiny”, Heather Evans, J. J. Lefebvre, and James MacGowan, *STEP Inside*, May 2011.

[2] The concept of control is defined extremely broadly in the questionnaire, e.g., whether your “suggestions” would be followed in various contexts. An affirmative answer may raise a number of potentially-prejudicial tax issues.

[3] An “entity” is defined in the questionnaire to mean “any company, trust, establishment, foundation, anstalt, partnership, society, association, any charitable body or fund, and any other body or organisation of any kind, whether incorporated or not.”

A “further entity” is defined to mean “any entity, whether inside or outside of Canada (other than an unlisted company, a trust, a partnership or a joint venture as outlined in the questions 1 through 4 of the questionnaire). For greater certainty, the term ‘further entity’ includes a bare trust.”

[4] One audit question I am aware of asked for the verification of a calculation which was done in the mid-90’s.

[5] In Massey-Ferguson Ltd. v. The Queen, 77 DTC 5013 (FCA), it was stated that:

The whole development of commercial law over the centuries is replete with examples of the Courts recognizing that business men do not always depend on expert documentation to prove the true characterization of their transactions. Rather, they tend to achieve their desired ends, particularly when the relationships between them are close, in informal and expeditious ways which perhaps are abhorrent to lawyers. In doing so they ran [run] the risks inherent in such a practice of determining their respective rights. Frequently no difficulties ensue, but if they do, *in the absence of contracts or other documents, Courts must determine the intention of the parties and the nature of the obligations imposed on them by reference to credible evidence of another kind.* ... [page 5017]

[6] At least one tax litigation lawyer has suggested making a voluntary disclosure if you are not the actual addressee of the CRA questionnaire. There may not be much to lose by trying this, but whether this strategy will be successful remains to be seen.