The procedural link between healthcare policy and tax policy is uniquely strong in the United States because of the budget reconciliation process, which requires repeal of the ACA taxes as a precondition for achieving broader tax reform goals that have nothing to do with healthcare.

Polls suggest that the middle believes, at least for now, that the more tax-financed ACA system is preferable to the more privately financed AHCA. The patients, rather than the taxpayers, seem to be winning this tug of war. ■

NEWS ANALYSIS

Canadian Appeals Court Denies CRA Demand for Taxpayer's UTP List

by Steve Suarez

The power of tax authorities to obtain information is extensive and ever-expanding. In self-assessment systems such as those in Canada, taxpayers calculate and report their income and taxes, and the government audits them to verify that those amounts are correct. The audit function is a necessary element to ensure compliance and establish the necessary degree of trust in the tax system required for it to operate effectively.

Effective audits in turn require that tax authorities be able to obtain information. Taxpayers that are the subject of information demands sometimes feel that what is demanded is excessive, unfair, or unreasonable.

In *BP Canada Energy Co. v. Minister of National Revenue*, 2017 FCA 61 (2017), *rev'g* 2015 FC 714 (2015), the Canada Revenue Agency demanded materials considered among the most sensitive information a taxpayer possesses: tax accrual working papers (TAWPs), which outline areas a taxpayer thinks might be successfully challenged and quantify any possible exposure. The Federal Court of Appeal (FCA) found in favor of the taxpayer, overturning a decision by a judge of the Federal Court (Trial Division) ordering the taxpayer to provide the CRA with a list of its uncertain tax positions.

Facts

In preparing its financial statements, BP Canada Energy Co., a Canadian subsidiary of a public European company, internally analyzed potential exposures in Canadian tax positions it had taken and identified UTPs. That analysis, which was highly confidential and potentially prejudicial, was incorporated into the financial statement process in the form of reserves representing potential taxes and interest if the CRA successfully challenged the company's positions.

During its audit of the taxpayer's 2005 tax year, the CRA became aware of the TAWPs containing that analysis. As the audit progressed over the next two years, the CRA repeatedly

asked the taxpayer to turn over the TAWPs, initially in connection with a concern over some accounting entries that were eventually resolved. BP Canada provided the CRA with redacted TAWPs, which sufficed to address the original issue for which the CRA's demand arose.

By that point, however, the CRA had decided that a list of items identified by the company as having a material risk of being challenged would be a terrific head start for future audits. It continued to demand full disclosure of the unredacted TAWPs — particularly the issues list. The audit of BP Canada's 2006 and 2007 tax years had begun, and the CRA demanded the TAWPs for those years as well. The taxpayer continued to resist full disclosure of the issues list, which the CRA itself described as a "roadmap" for focusing its audit resources. The CRA made formal demands for the list under sub-section 231.1(1) of the Income Tax Act (Canada), but BP Canada didn't comply. The CRA then applied to the Federal Court for an order under ITA section 231.7 to force BP Canada to turn over the list.

The Lower Court's Decision

The Federal Court granted the CRA its compliance order to compel BP Canada to disclose its issues list to help expedite future CRA audits.[1] In a meandering judgment that essentially rejected all the taxpayer's arguments regarding the interpretation of ITA sub-section 231.1(1), the court found the CRA was still entitled to have the list if it didn't need it to complete its audit — even if the purpose of the demand was simply to expedite future audits and the materials sought consisted exclusively of subjective analysis rather than objective facts. The issues list involved taxes, and the CRA wanted to see it to make audits easier. As far as the court was concerned, that was enough to come within the scope of the relevant statutory provision authorizing the CRA to demand access.

The taxpayer also raised several arguments regarding why — even if the issues list was compellable under ITA sub-section 231.1(1) — the court should nonetheless refuse to exercise its discretion to issue a compliance order under sub-section 231.7(1):

- the CRA had not acted in good faith because it had allegedly misled the taxpayer regarding its purpose for wanting to see the list;
- disclosure of the issues list was not necessary for the CRA to conduct a full and fair audit;
- the CRA's pursuit of the issues list to use it as an audit roadmap amounted to an "unauthorized fishing expedition";
- pursuit of the issues list was contrary to the CRA's published administrative policy on when it would seek access to TAWPs;
- forcing the disclosure of TAWPs discriminates against corporations required to prepare financial statements that include reserves for UTPs because it puts them in a worse position relative to other taxpayers; and
- forced disclosure of TAWPs would produce adverse public policy consequences because it would be likely to result in lower-quality financial statements of taxpayers who would be less inclined to undertake sensitive (and potentially prejudicial) analyses of their UTPs if the CRA were able to demand access to and use them against those taxpayers.

The court rejected all those arguments on sparse and often unconvincing grounds. It said it believed fairness required the CRA to have access to the taxpayer's UTP analysis, adding that taxpayers' recourse is to expend the effort and expense of litigating whatever the government (with its limitless resources) decides to challenge. The court said the real question was "fairness to whom," quoting (and effectively adopting) arguments made by the CRA:

> If the CRA does not discover the transactions within the normal reassessment period, there is no scrutiny of the tax compliance with respect to these positions. There is no verification by the CRA, and there is no review by the Tax Court of Canada. If the CRA does not uncover the tax positions in time, the shareholders of BP win, and the taxpayers

[1] For an analysis of the lower court's judgment, see Steve Suarez, "Canada Revenue Agency Declares Open Season on Taxpayer Information," *Tax Notes Int'l*, July 13, 2015, p. 143.

> of Canada lose. If the tax position is discovered and challenged by the CRA, the matter can ultimately be resolved by the Tax Court of Canada as to the propriety.
>
> I submit these are cases that should be reviewed by the CRA and ultimately by the Tax Court of Canada. Where large corporations are taking positions that are on the line, that they are not black and white, these are precisely the types of cases that should ultimately be resolved before the courts.

Whatever the right answer is on the facts of this case, the lower court's legal reasoning in reaching the conclusion it did was profoundly unpersuasive on many of the issues and quite dissatisfying overall, given the importance of the case. It was unsurprising that the taxpayer appealed.

The FCA's Decision

A three-member panel of the FCA rendered a unanimous judgment in favor of BP Canada, overturning the compliance order issued by the lower court. The FCA concluded that while TAWPs *could* come within ITA sub-section 231.1(1) in some circumstances, that provision did not authorize the sort of unrestricted, routine access the CRA was seeking.

The FCA's conclusion on the scope of ITA sub-section 231.1(1) made it unnecessary to address the secondary question of whether the lower court should have exercised its discretion to grant the compliance order. However, the FCA pointed out that seeking the compliance order effectively constituted CRA contravention of its own administrative policy on accessing TAWPs, and that the lower court judge shouldn't have exercised his discretion in issuing the order.

The FCA took a practical approach to both the relevant interpretational questions and the application of the law (as properly interpreted) to the specific facts under litigation. It went beyond a simplistic, literal reading of the words to examine them "in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act and the intention of Parliament."

After examining the facts and the parties' positions (including that of Chartered Professional Accountants of Canada, which the FCA granted intervenor status over the CRA's objections), the FCA reviewed the type of information typically found in TAWPs:

> The expression "tax accrual working papers" generally refers to papers created by or for independent auditors in order to assist in the process leading to the certification of financial statements in accordance with [generally accepted accounting principles]. In Canada, the obligation to issue financial statements that are certified by independent auditors is imposed under provincial securities legislation (Appeal Book, vol. IV, p. 440, para. 5). TAWPs can be created internally or by the independent auditors but in both cases, their purpose is to identify uncertain tax positions and provide for reserves which will allow the independent auditors to certify that the financial statements fairly and accurately reflect the financial situation of the corporation under audit.
>
> Given the reason for which they are prepared, TAWPs typically identify tax positions capable of being challenged successfully by the Minister, an opinion as to the likely outcome in the event that they are, and a reserve intended to neutralize the financial distortion which would result. To the extent that an uncertain tax position endures from one year to the next, the reserve associated with the position is re-evaluated each year.

Against that backdrop, the FCA agreed with the lower court that ITA sub-section 231.1(1) could not have been drafted more broadly, and articulated when the prerequisites of that provision have been satisfied. If the CRA has shown it is acting for an authorized purpose,[2] it must show that all or part of the document sought:

[2]The FCA stated that on a literal reading, using the taxpayer's UTPs as a roadmap to facilitate audits appears to be an authorized purpose.

- is part of or is in the taxpayer's books and records;
- relates or may relate to information that is or should be in the taxpayer's books and records; or
- relates or may relate to any amount the taxpayer must pay under the ITA.

The FCA then considered BP Canada's interpretational argument that the term "information" as used in ITA section 231.1(1), when read in context with related statutory provisions, should be interpreted as limited to objective facts relevant in determining a taxpayer's tax liability. The FCA wasn't convinced by that approach, but didn't seem to find it necessary to come to a conclusion on that point to dispose of the case:

> [67] The issue in this case is not whether the information revealed by BP Canada's Tax Reserve Papers could be accessible under the Act. After all, everyone is agreed that it is, if required, in order to respond to a specific inquiry made in the context of an audit. The disclosure of the redacted version of BP Canada's Tax Reserve Papers in response to the query made about the accounting entries attests to this (see paragraphs 11 and 12 above). The real issue is whether subsection 231.1(1) allows general and unrestricted access to this information, if this is indeed what was sought and authorized in this case.

How the FCA framed what the CRA was seeking — and thus the question before the court — is fundamental to understanding the decision's scope and precedential value. Fundamentally, the CRA sought a declaration that TAWPs can be obtained at any time without restriction. The FCA understood the implications of that demand and readily concluded that the statutory provision simply could not be interpreted to authorize that result. The FCA said the lower court's judgment gave the CRA unfettered discretion to require taxpayers to produce TAWPs as a routine matter, without restriction and without the need to advance any particular justification, and that Parliament clearly meant for the broad power in ITA section 231.1 to be used with restraint for those kinds of documents.

The FCA made two important points in concluding that the CRA's interpretation of ITA sub-section 231.1(1) shouldn't be accepted.

First, the court acknowledged that the ITA requires taxpayers to self-assess, but said it can't be interpreted to allow the CRA "to compel a taxpayer to self-audit on an ongoing basis." When faced with questions that are "reasonably open to debate," taxpayers can file their returns on the basis most favorable to them. While the statute says CRA auditors "are entitled to be provided with 'all reasonable assistance' in performing their audits . . . they cannot compel taxpayers to reveal their 'soft spots,'" the FCA said. Given that BP Canada had to document its UTPs annually, the lower court's decision allowed the CRA to compel BP Canada to self-audit.[3] The FCA found that result unacceptable, saying unrestricted access to a taxpayer's UTPs would essentially allow the CRA to "enlist taxpayers who maintain TAWPs to perform the core aspect of audits conducted" under the ITA.

Second, the FCA considered the public policy argument made by both the taxpayer and the intervenor regarding the inevitable effect the CRA's position would have on taxpayers. Corporations required to prepare TAWPs that the CRA could freely use against them without restriction would be less likely to analyze and document potential exposures for (and disclose those risks to) their external accounting auditors, which would in turn result in financial statements of decreased reliability. Shareholders, creditors, regulators, and others who rely on those financial statements would therefore be prejudiced. The court clearly accepted that as the logical and predictable consequence of the unrestricted access the CRA was demanding. It concluded that Parliament couldn't have intended that the CRA's power to obtain documents "be used to imperil the integrity of the financial reporting system put in place by the provinces" under their corporate/securities laws, and that ITA sub-section 231.1(1) should not be interpreted in such a manner as to "ride roughshod over provincial laws." That section should be interpreted not in isolation but

[3] In that regard, the FCA found it irrelevant that the CRA sought disclosure of documents already prepared by the taxpayer, as opposed to demanding that the taxpayer create new documents.

rather within the relevant legal context, which includes other statutes and the laws of other levels of government. The FCA also rejected the CRA's use of U.S. jurisprudence on the public policy matter (accepted by the lower court), saying, "If anything, the U.S. experience which can be gleaned from [the *Textron* and *Arthur Young*] cases confirms that general and unrestricted access to TAWPs would have a negative impact on financial reporting and impose on taxpayers an obligation which they do not have."

Thus, the court rejected the government's interpretation of ITA sub-section 231.1(1) and found that the CRA cannot invoke that section to obtain "general and unrestricted access" to the parts of BP Canada's TAWPs that revealed its UTPs.

The FCA's conclusion regarding the proper scope of ITA sub-section 231.1(1) made it unnecessary to consider whether the lower court had correctly exercised its discretion in granting the compliance order under sub-section 231.7(1). Even so, the FCA commented that the lower court's reasoning for granting the compliance order misstated the CRA's stated administrative policy on seeking access to TAWPs as being that TAWPs are compellable under the ITA without restriction.

In fact, the relevant CRA policy statement does reserve the right to demand TAWPs but clearly states that they are not routinely required and that CRA officials should not be influenced by any subjective analyses, comments, or opinions in any documentation demanded[4] — which of course is entirely what TAWPs consist of. Having correctly framed the question in the context of the aggressive nature of the CRA's "without restriction" demand, the FCA made clear that the order being sought was outside the bounds of the CRA's own policy, which the lower court had incorrectly interpreted. As such, the lower court should not have exercised its discretion to grant the compliance order.

Analysis

The CRA was aggressive in seeking a compliance order for TAWPs solely for use as an audit roadmap and essentially without restrictions. Had it been successful, it would have moved the goalposts dramatically in its favor in terms of the permissible use of its statutory powers to obtain confidential taxpayer information. That result would not have been appropriate or fair, and the FCA's decision is a welcome development in making clear that the government's authority to compel disclosure from taxpayers is extensive but not unlimited.

The FCA's decision in *BP Canada* will serve as an important precedent on the scope of ITA sub-section 231.1(1) and the circumstances under which a court should grant compliance orders under sub-section 231.7(1). It establishes several important propositions:

- the scope of sub-section 231.1(1) is not as broad as a literal reading of the text would suggest;
- in interpreting the ITA, it should be presumed as a general matter that it is intended to be read to function harmoniously with other statutes (including provincial ones), not to work at cross-purposes with them;
- the CRA is legally obligated to exercise restraint in seeking access to TAWPs — its administrative policy on that is not a concession, but a statutory requirement that taxpayers can assert in court;
- there is nothing illegitimate or inappropriate in a taxpayer adopting a *reasonable* position on its tax return that is most favorable to it;
- a taxpayer's obligation to render assistance to CRA auditors does not extend to the point that the taxpayer is effectively being asked to self-audit or reveal its soft spots, and taxpayers can't be compelled to undertake what are essentially core audit functions; and
- if the CRA asks a court to exercise its discretion and produce a result contrary to the CRA's own administrative policy, the court generally should not do so.

[4] CRA, "Acquiring Information From Taxpayers, Registrants and Third Parties." For a review of the CRA's policy statement, see Suarez, *supra* note 1, at 145-146.

There is much in *BP Canada* that taxpayers will take comfort in, and rightfully so. Many people in the tax community viewed the CRA's request for a compliance order to obtain TAWPs solely for use as an audit roadmap as an extreme and unfair position, and it is not inappropriate that the resulting judgment includes conclusions that the CRA might have preferred not be reached. Effectively, the government chose to advance an immoderate proposition that invited judicial rejection, and that was just what happened.

The FCA's judgment is also important in terms of displacing the precedent that might otherwise have been established by the lower court's decision, the reasoning of which was disappointing. Had the original judgment been allowed to stand, the legal landscape in this area would be quite different. That said, the FCA confirmed that the CRA can obtain TAWPs in appropriate circumstances. It did not define those circumstances, but made clear that the right answer is not "without restriction," that taxpayers generally cannot be compelled to self-audit, and that both the law and the CRA's administrative policy require that restraint be used when seeking to access TAWPs. The likely result of a CRA demand for TAWPs should be measured against those benchmarks.

The FCA found problems with BP Canada's argument that ITA sub-section 231.1(1) should be read as limited to objective information, as opposed to subjective opinions. Therefore, it would appear that the provision isn't necessarily limited to objective facts and that subjective analysis could also be within its scope. That said, given the FCA's conclusion that CRA auditors generally cannot compel taxpayers to self-audit or reveal their soft spots, the CRA may have a difficult time convincing a court to grant a compliance order for purely subjective analysis other than in exceptional circumstances. For example, if the taxpayer's purpose or intent is relevant to the substantive question of whether tax was due, or if the taxpayer's position fails to meet the "reasonableness" standard, a court might be more willing to compel disclosure. It is possible that if the CRA has identified a specific contentious topic for review based on its own work, a court might be more likely to order TAWP-related disclosure. Those, however, are questions for another day, and future cases will further define the circumstances in which the CRA can compel disclosure of TAWPs.

Another question is whether the principles established in *BP Canada* extend to materials other than TAWPs. While the fact that these materials were created in compliance with and to further the objectives of other statutes was clearly important to the FCA's conclusion, the court's statement that CRA auditors cannot compel taxpayers to reveal their soft spots could extend to materials not specifically created to comply with some applicable law. Moreover, many kinds of materials other than TAWPs that a taxpayer might prepare to meet legal obligations could also be of interest to a CRA auditor. It is not obvious why the same conclusion shouldn't also apply to those kinds of documents.

While *BP Canada* is a positive result for taxpayers, it is not the last word in defining the scope of the CRA's powers to obtain information. Until remaining questions are resolved, taxpayers should exercise prudence in preparing and handling information and analyses that could be prejudicial if compellable on audit. The CRA will continue to routinely seek planning memoranda, opinions, and similar tax-sensitive analyses for use in audit. Therefore, taxpayers should always consider what documents truly need to be created and whether they can reasonably be prepared within the scope of lawyer-client privilege so as to be protected from disclosure.[5]

[5]For a review of the scope and importance of lawyer-client privilege in Canada, see Suarez, "Canada Revenue Agency Forces Taxpayer to Disclose Discussions With Accountant," *Tax Notes Int'l*, May 11, 2015, p. 553.