

Best Practices for Canadian Tax Audit Management

***Financial Executives International (FEI)
Canada***

March 27, 2014

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AGENDA

- Managing audits and assessments
- Income tax best practices
- SR&ED best practices
- Payroll tax best practices
- Customs best practices
- Sales tax best practices
 - Canada Revenue Agency
 - Revenue Quebec



Managing Audits and Assessments

Jeffrey Shaw, CPA, CMA, Senior Manager, Client Support Services

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MANAGING AUDITS AND ASSESSMENTS

Minimize audit impact

- Due to uncertain outcome and possible financial consequences
- Preparation is key
- Audit goal - complete as efficiently as possible
- Three phases
 - Planning, management, review

Develop an audit strategy

- Keep audit under control
 - Initial effort may be significant
 - Less effort required subsequently
 - Improves compliance

A collage of business-related images at the top of the slide. On the left, a person's hands are shown writing on a document with a pen. In the center, there is a close-up of a document with numbers like 121, 120, 119, 118, and 117, and some arrows. On the right, there is a large blue and yellow arrow pointing to the right.

MANAGING AUDITS AND ASSESSMENTS

Audit planning

- Pre-audit preparation
 - Review previous returns
 - Assign a liaison
 - Must understand the business
 - Person aware of audit issues
 - Find a suitable work area for auditor
 - Close to liaison
 - Not too comfortable or unpleasant

A collage of business-related images at the top of the slide. On the left, a person's hands are shown writing on a document with a pen. In the center, there is a close-up of a document with numbers (121, 120, 119, 118, 117) and arrows pointing downwards. On the right, a large blue and yellow arrow points to the right, matching the Ryan logo's design.

MANAGING AUDITS AND ASSESSMENTS

Audit planning

- Pre-audit preparation
 - Be aware of common audit issues
 - Assemble audit documents
 - Helps audit start smoothly
 - Takes time to prepare
 - May require other resources

MANAGING AUDITS AND ASSESSMENTS

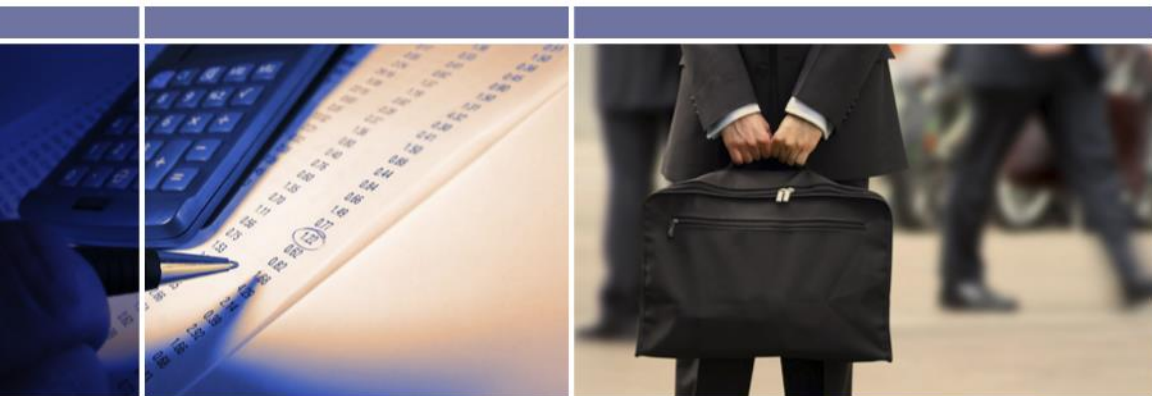
Audit management

- Requests for information
 - Committed response time
 - Should be in writing
 - Track information provided
 - Never offer unsolicited information
- Hold regular meetings

MANAGING AUDITS AND ASSESSMENTS

Audit review

- Notice of assessment
 - New issues
 - Statute barred items
- Post audit analysis
- Identify issues
- Make changes to eliminate issues
 - Penalties for negligence



Income Tax Best Practices for Audit Management

Clyde Seymour, CPA, CA, MACC, Principal, Income Tax

PREPARING FOR A FEDERAL TAX AUDIT

- Understand your Federal audit risk by type of audit.
- Various types of Federal tax audits:
 - Minute Book
 - Federal Income Tax
 - International – Transfer Pricing
- It is best to be prepared in advance for each type of audit by understanding and mapping the potential risks and CRA focus areas.
- Consider a Voluntary Disclosure where compliance failure exists.
- New VDA process and management. VDA can go back 10 years.

MINUTE BOOK AUDIT

- Minute Book audits generally cover corporate reorganizations:
 - Tax elections
 - Treaty Positions
 - Taxable Canadian Property
 - Surplus & Safe Income
- CRA is validating if elections are “on-side” by verifying if cash or liabilities assumed “boot” exceeded elected amounts/fair values.
- International restructuring is complicated combining treaty application (limitation of benefit) and exempt surplus regime.
- Restructuring costs scrutinized (e.g. legal) for deductibility vs. ECE.
- **Best Practice** – Maintain appropriate final closing books, reporting memorandums, and calculations especially if reorganization is managed offshore. Once the lawyers and accountants have executed the transaction, the explanation to CRA rests with management.

FEDERAL INCOME TAX AUDIT

- Normally commences with a letter requesting information.
- Consider meeting with auditor to discuss contents of information request which may be voluminous to scale down to sample sizes.
- Meeting also important to set proper time-lines and develop a relationship with the auditor.
- “Communication is Key” to avoid arbitrary assessments as its easier to deal with issues currently to remove from a proposed assessment than after assessment through appeals.
- Common areas of domestic audit focus:
 - Legal fees
 - Withholding taxes on cross-border distributions
 - Thin Capitalization
 - Provincial income allocation factors (schedule 5)

INTERNATIONAL AUDIT – TRANSFER PRICING

- Contemporaneous documentation (functional & economic analysis) due at tax return date with yearly update.
- The CRA “90 Day Letter” – Remember the necessity to be “contemporaneous”.
- Has your TP documentation been properly updated with supporting documentation? Have your international functions changed due to reorganizations?
- Are you covering all reportable non-arm’s transactions:
 - Goods
 - Services
 - Management Fees
 - Intercompany Debt
 - Intangibles
- Beware impact of marketing function. Marketing efforts could increase or decrease charge for such services and/or decrease the value/charge for intangible brand rights.
- **Best Practice** – Verify that annual T106 reporting matches Transfer Pricing Documentation.



INTERNATIONAL AUDIT – CASH SWEEPS

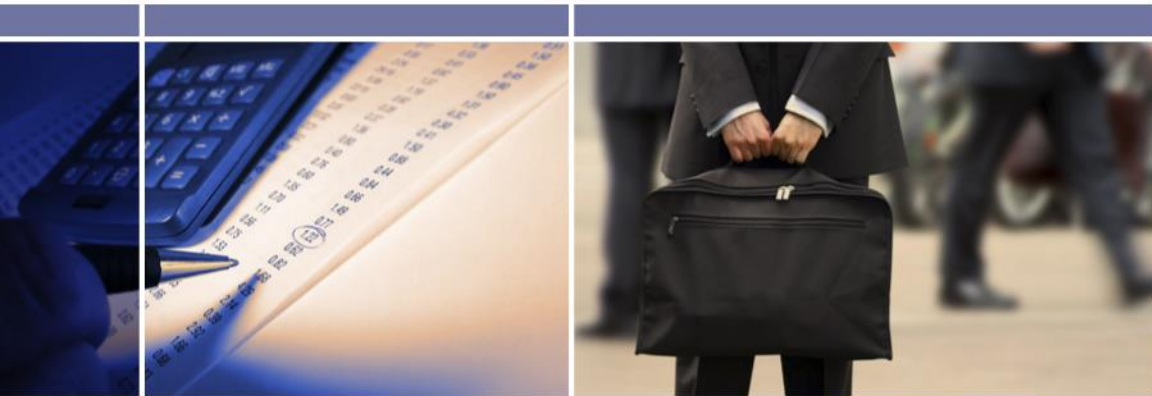
- Common practice for parent to extract cash from Canadian subsidiary by drawing against an intercompany receivable.
- Where cash is swept from Canadian subsidiary as an “undocumented advance” and above basis (debt and equity), if outstanding greater than one year, loan is deemed income to parent, deemed as dividend, and subject to withholding tax.
- **Beware** – “Right of Offset” – Many companies maintain separate intercompany AR and AP and CRA may challenge if right of offset exists.
- **Best Practice** – Tax reconciliation of intercompany accounts. Document any excess cash sweep above intercompany as payment of debt or return of capital or a dividend. Document right of offset policy.

INTERNATIONAL – MANAGEMENT SERVICES FOREIGN COUNTRY

- Increased audit focus on management services provided abroad.
- Audits are targeting where documentation is traditionally weaker – e.g. Management Fees not supported by proper service description and/or support for costs charged/allocated to Canada.
- Unsupported management fees can be assessed “unreasonable” with the following implications:
 - **Denial of deduction;**
 - **Assessment as dividend subject to withholding tax; and**
 - **Penalties & Interest.**
- **Best Practice** – Maintain supporting invoice with detail costing from parent company for management fees charged and ensure pricing is aligned with transfer pricing study.

INTERNATIONAL – SERVICES PROVIDED IN CANADA

- Audit risk to both domestic & parent company for any services in Canada.
- Deemed “Permanent Establishment” risk to parent for services through Fifth Protocol to Canada U.S. Treaty.
- Regulation 105 15% withholding applies to payments made by a Canadian corporation to a non-resident individual or corporation for services provided by the non-resident in Canada (applies to both non-arms and arm’s length)
- Where a Canadian non-resident corporation pays remuneration to a non-resident employee, the corporation must withhold employment taxes pursuant to Regulation 102 where such employee reports for work in Canada.
- Penalties and interest apply for Regulation 105 and 102 failure to withhold and remit.
- **Best Practice** – Prepare for withholding requirements or consider tax waiver to negate withholding.



SR&ED Best Practices for Audit Management

*Danny Ladouceur, CPA, CA, Principal & Practice Leader,
SR&ED*

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SR&ED ENVIRONMENT

New phase of change

- 2009
 - Simplified form with word limits
 - Name of advisors/consultants becomes mandatory disclosure
 - CRA granted substantial budget to hire more auditors
 - Prescribed list of supporting documents provided by CRA
- Guides to Conducting Reviews/Audits issued by CRA
- Evolution of CRA Risk Matrix
- Greater emphasis on documentation

PREPARING FOR AN SR&ED AUDIT

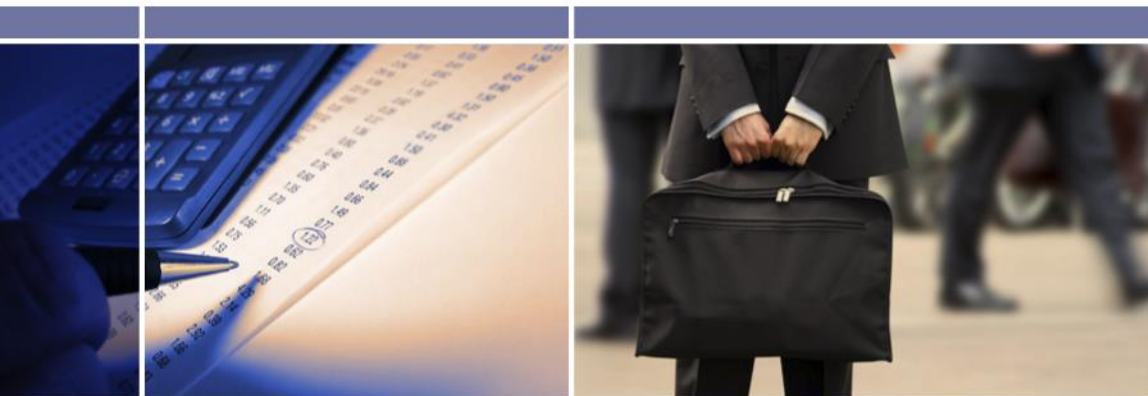
Pre-audit preparation

- Re-familiarization with details of the claim
- Awareness of CRA's Guide to Conducting Reviews as well as CRA's new consolidated policy document (5 Eligibility Questions) released October 2013
- Preparation of a presentation emphasizing obstacles and advancements in new knowledge
- Organization of all contemporaneous supporting documentation
- Layout all physical evidence (i.e. pictures, prototypes, failed parts, wasted materials)

SR&ED AUDIT

Emphasis during audit

- Convince CRA's RTA of the eligibility of Technological Obstacles
- Convey scientific method used; awareness of CRA's new 5 Eligibility Questions
- Documentation
- Link Expenses/Resource Utilization to Experimentation described in technical reports originally submitted to CRA
- Highlight the excluded activities and expenses



Payroll Tax Best Practices for Audit Management

Kerry Thomas, CPA, CGA , Director, Payroll Tax Services

CANADIAN PAYROLL TAXES

- Federal
 - Canada Pension Plan (“CPP”) contributions
 - Employment Insurance (“EI”) premiums
 - Income Tax on employment earnings
- Provincial
 - Workers’ compensation premiums (WSIB/WCB/CSST)
 - Health taxes
 - Employer contributions to work-related funds (Quebec)

PAYROLL TAX AUDITS

- Purpose
 - Enforcement action, to determine employer's compliance with its payroll tax obligations
- Auditor's authority
 - Examination of employer's records
 - Inspection of employer's premises
 - Discretion to assess employer for non-compliance

PAYROLL TAX OBLIGATIONS

- Registration
 - “Employer” (statutory definition)
- Reporting
 - Annual returns
- Remittance (withholdings and self-assessments)
 - Penalties for non-payment

PAYROLL TAX AUDIT RISKS

- Reporting risks
 - Material change in circumstances
 - Understated remuneration

COMMON AUDIT ISSUES (QUEBEC)

- Health tax (HSF)
 - Tax rate determined by global payroll (all affiliated companies)
 - Maximum rate of 4.26% can be applied retroactively (four years)
- Private health insurance benefits
 - Taxable benefit for Quebec employees

COMMON AUDIT ISSUES (ONTARIO)

- WSIB
 - Payroll service provider prepares annual return, but, is unaware of certain information regarding earnings to be included or excluded
- Employer Health Tax (EHT)
 - Out-of-province earnings
 - » If employee works in a province other than Ontario, but does not report to the employer's "permanent establishment" outside Ontario and is paid from Ontario, then EHT is payable on his/her earnings

COMMON AUDIT ISSUES (CRA)

- Payments through accounts payable for personal services not reported on T4s or T4As
- Misreported taxable benefits: potential 100% cost



Customs Best Practices for Audit Management

David Reilly, Manager, Customs Duty Recovery

CUSTOMS AND DUTY REVIEWS

Ryan helps navigate complex Customs and Foreign Trade laws and regulations by accurately identifying duty, tax, and fee requirements, ensuring:

- The proper classification of goods under the Harmonized System tariff
- The preferential trade agreements, preferential tariff treatments, and respective rates of duty have been applied to your goods
- Your goods have been correctly valued in accordance with the Customs Valuation regulations

In complex situations, Ryan will prepare and secure favorable Customs rulings prior to submitting refund requests, thus ensuring proper tariff classification, protecting your compliance with the Canada Border Service Agency (“CBSA”), and helping you keep more of what’s yours in the future.

TRADE COMPLIANCE VERIFICATIONS

The CBSA manages compliance with the Tariff Classification, Tariff Treatment, Valuation, and Origin programs using the following two post-release verification processes:

1. Random verifications
2. Targeted priorities

RANDOM VERIFICATIONS

Random verifications are designed to measure compliance rates and revenue loss and the results may be used for many purposes, including:

- Risk assessment;
- Establishing client service activities;
- Revenue assessment; and
- Promoting voluntary compliance.

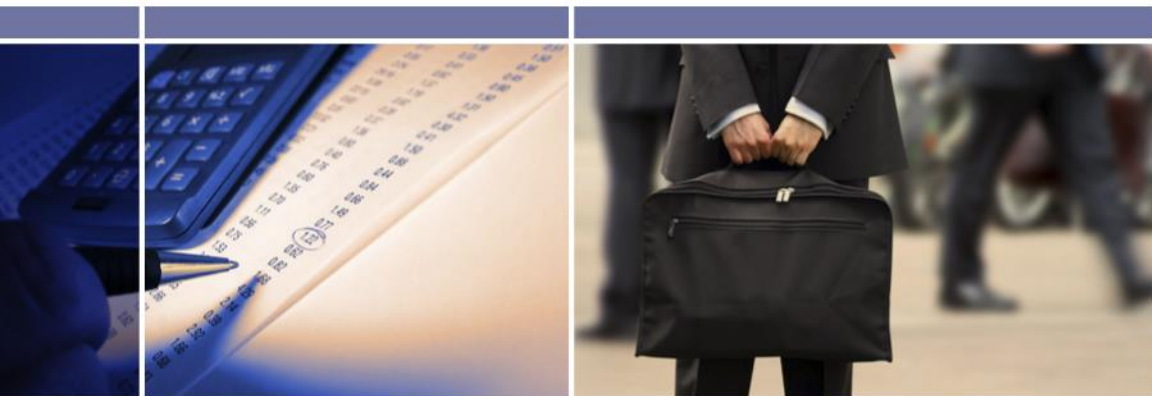
TARGETED PRIORITIES

Targeted priorities are determined through a risk-based, evergreen process, meaning that new targets are added throughout the fiscal year. Targeted priorities may also be carried over from previous years.

- See attached list of targeted items

HOW TO DEVELOP AND IMPLEMENT A COMPLIANCE PLAN

- Are we compliant? How do I check?
 - Sampling
 - Reconciliation (purchase order, invoice, waybill, receiving report, general ledger, payment received)
 - Determine your level of compliance
- Have the Executives buy-in
- Cross-departmental co-operation
- Develop a compliance statement
- Put procedures in place (notify CBSA/broker of errors within 90 days)



Sales Tax Audit Trends

Jeffrey Shaw, CPA, CMA, Senior Manager, Client Support Services



CANADA REVENUE AGENCY (“CRA”)

A collage of three images: on the left, hands pointing at a document with a circular diagram; in the center, a close-up of a document with numbers (121, 120, 119, 118, 117) and arrows; on the right, a large blue and yellow arrow pointing right.

CRA SALES TAX AUDIT TRENDS

GST/HST desk audits

- Much more frequent
- Limited to one “Reporting Period”
- Standard information request
- Desk auditors not as knowledgeable, leading to misunderstandings, possibly triggering a full audit

CRA SALES TAX AUDIT TRENDS

Recovery of GST/HST

- Documentary requirements
 - Must be obtained prior to claiming an ITC
 - Prescribed information required
- Common exposures
 - Use of a factor to claim ITCs
 - Closely-related "recipient"
 - Non-resident vendors

CRA SALES TAX AUDIT TRENDS

Regular historical issues

- Failure to collect GST/HST
 - Substantiating a zero-rated supply
 - Substantiating exempt supplies
 - Misinterpreted legislation

CRA SALES TAX AUDIT TRENDS

Regular historical issues - continued

- Failure to collect GST/HST
 - Failing to recognize a supply was made
 - Supplies made in Canada
- Failure to remit GST/HST collected
- Not adjusting for 50% M&E restriction

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CRA SALES TAX AUDIT TRENDS

More recent issues

- Determination that person is a FI or SLFI
- Request to file GST111 and Form 494

CRA SALES TAX AUDIT TRENDS

Pension plans and deemed supplies

- Standard query on audit letters
 - Do you have a pension?
 - What type?
 - Do you incur costs internally or externally for a pension?
 - Do you make actual supplies to pension?
- Enforcement of the 2 year rebate limitation
- System generated denials of rebate claims
- Due to misinterpretation of filing deadline



REVENUE QUEBEC

REVENUE QUEBEC AUDIT TRENDS

Recent Quebec Budget announcements

- Quebec Budget announcements
 - Improving enforcement and compliance
 - Ambitious tax recovery targets
 - Aggressive assessments
 - \$3.5 billion in tax recoveries in fiscal 2012-2013
- Lost recent court decision
 - Abusive assessment and collection action
 - Fictitious work papers
 - Evidence of performance (revenue) targets and bonus payments

REVENUE QUEBEC AUDIT TRENDS

Quebec audit tactics - recipient of the supply

- Adequate information to support that a person is a recipient
- Legislation allows the name on invoice to be registered name or trade name
- Legal name of business - Able Manufacturing Canada Limited and invoices may state the name as follows:
 - Able
 - Able Manufacturing
 - Able Manufacturing Canada
 - Able Manufacturing Canada Inc.
- QST auditor only accepts ITRs on invoices in name of Able Manufacturing Canada Limited
- Be proactive in your invoice review

REVENUE QUEBEC AUDIT TRENDS

Quebec audit tactics – documentary requirements

- Auditor claims invoices are false
 - Acquiring non-specialized labour or temporary staff from temporary help agencies
 - Phony invoices were being issued to cover up under-the-table payments
 - Construction and employment agencies are under scrutiny
 - Organizations dealing with these business could also be scrutinized

REVENUE QUEBEC AUDIT TRENDS

Quebec audit tactics – Documentary requirements – continued

- ITRs denied for various reasons
- Temp. help agency may provide services but not remit the QST
 - Auditors claiming that validating the QST numbers is not sufficient
 - Taxpayer must take an active role in defending against fraud
 - Legislation on ITR entitlement does not require the registrant verify that the supplier has remitted the QST

REVENUE QUEBEC AUDIT TRENDS

Quebec audit tactics – Agency

- Principal can claim ITRs on expenses incurred by agent on principal's behalf
- Assessments may occur where there is no agency agreement in place
 - Agency agreement is not required
 - Issue raised on transactions between related parties

REVENUE QUEBEC AUDIT TRENDS

Quebec audit tactics – large business restrictions

- Use of 5% LB simplified method
 - Personal vs. non-personal expense
 - ITRs on directly paid expenses associated with expense on business trip
 - Method replaced with method consistent with the GST/HST simplified factor method on January 1, 2014
- Energy used for manufacturing
 - Challenging the analysis of manufacturing

REVENUE QUEBEC AUDIT TRENDS

Quebec audit tactics - arbitrary assessment

- QST audit for full four-year period
- Auditor requests waiver
- If taxpayer refuses to sign waiver, may issue arbitrary assessment
 - Arbitrary assessment is valid like any other assessment
 - Objection must be filed with 90 days
 - May be better to sign waiver



Questions ?