Due Diligence in the Tax Practice

What You Need To Do To Protect Yourself and Your Client

2012 Ontario Tax Conference

First published by the Canadian Tax Foundation - 2012 Ontario Tax Conference (Toronto, October 29-30, 2012)

Steven Hurowitz
KPMG
Partner, M&A Tax Services
(416) 777-8050
shurowitz@kpmg.ca

Joan E. Jung
Minden Gross LLP
Partner, Tax
(416) 369-4306
jjung@mindengross.com

Due diligence in tax practice means more than the steps taken, both from a legal perspective and accounting/financial perspective, to identify issues on a purchaser's behalf in an acquisition transaction. Due diligence is what you need to do to protect yourself and your client. The concept of necessary or prudent steps by the advisor relates not only to acquisition transactions, but should inform his or her practice generally. Tax considerations are ubiquitous.

Over thirty years ago, a paper written for the 1978 Annual Conference on "The Liabilities of Tax Advisers" [1] commented that there was only one case [2] in which faulty tax advice was the basis of a cause of action. There are more reported cases today, both against lawyers and accountants, but thankfully, the number of reported cases does not seem significant.

This paper will discuss the professional obligations of tax advisors (limited to lawyers and chartered accountants ("CA's") and certified general accountants ("CGA's") practicing in Ontario) to their respective self-regulatory bodies and the standard of care to avoid civil liability. This can be contrasted with the "culpable conduct" standard set out in the third party civil penalty in section 163.2 [3], tempered by the recent Tax Court of Canada decision in *Julie Guindon v. The Queen* [4] ("*Guindon*").

We will also discuss how a tax advisor can exercise due diligence in completing a due diligence assignment for a client.

Introduction

The Lawyers' Professional Indemnity Company (referred to as "LawPro") provides errors and omissions insurance to lawyers in Ontario. Statistics and information from LawPro [5] show that over the 1998-2011 period:

(a) the average tax claim had a greater cost ($60,000) than the average claim in other law fields ($31,000);

(b) the predominant cause of a claim in the tax field was "failure to know the law" (being the identified cause in 46% of claims in the subject period); and

(c) most tax claims (81%) related to a loss of less than $100,000 with a small percentage of claims (12%) that related to a loss of over $250,000.

As indicated above, the primary cause of claim in the tax field in the above period was "failure to know the law". In contrast, this was not the primary cause in other practice areas (but typically ranked third after poor client communication and time management). Presumably this is a reflection of the complexity and challenge of tax law. Nine percent (9%) of tax claims were attributed to "inadequate investigation". The words "inadequate investigation" might suggest some lack of or insufficient due diligence on the part of the lawyer. On its face, the words "inadequate investigation" could speak to investigating facts or identifying issues but the latter might also be considered to fall with "failure to know the law". There is likely some overlap in these categories. As we understand that the choice of category is a matter of judgement and discretion of the claims examiners, it is difficult to conclude from the available statistics whether claims might derive from an advisor's lack of due diligence regarding client representations. Initially we intended to focus on exactly the foregoing, i.e., the necessary or prudent due diligence that an advisor should undertake before relying on client representations for the purpose of giving tax advice. However, because client representations essentially are the facts and assumptions upon which a structure is proposed or advice given, it seemed appropriate to broaden the discussion to the standard of care expected of a tax advisor.

For chartered accountants, on a Canada-wide basis as of June 30, 2012, 56% of claims arose from the tax area. [6]

Sources of Liability

The source of liability for the tax advisor can be civil, ethical or arise from the third party civil penalty provision in the ITA. Civil liability (or what is commonly referred to as "professional malpractice" or "professional liability") can derive from (a) breach of contractual duties (i.e., the retainer) whether express or more typically implied; or (b) concurrent liability in tort (to both client and third parties in a relationship of sufficient proximity and who rely on the lawyer's or accountant's expertise). A breach of ethical codes of conduct can result in action taken by a self-regulatory body, being the Law Society of Upper Canada ("LSUC") for lawyers, the Institute of Chartered Accountants of Ontario ("ICAO") for CA's and the Certified General Accountants of Ontario ("CGAO") for CGA's, practicing in Ontario.

Professional Conduct Rules for Lawyers

In Ontario, lawyers are governed by the *Law Society Act* [7] which sets out a self-regulatory scheme. Under this statute, it is the function of the LSUC to ensure that all persons who practise law in Ontario meet standards of learning, professional competence and professional conduct that are appropriate for the legal services they provide. The statute provides that a licensee (i.e., a lawyer) is considered to fail to meet the standards of professional competence if, among other things, there are deficiencies in knowledge, skill or judgement and the deficiencies give rise to a reasonable apprehension that the quality of service to clients may be adversely affected. [8] The LSUC has enacted a Code of Professional Conduct which are the ethical obligations to be observed by all lawyers. Failure to comply may lead to a conduct review and disciplinary proceedings. Typically, these involve cases of fraud or misappropriation or trust account deficiencies rather than negligence.

Rule 2 of the Rules of Professional Conduct deals with competence and contains a definition of "competent lawyer". Key provisions of Rule 2 follow:

> "A lawyer shall perform any legal services undertaken on a client's behalf to the standard of a competent lawyer."
>
> "competent lawyer" means a lawyer who has and applies relevant skills, attributes, and values in a manner appropriate to each matter undertaken on behalf of a client including

(a) knowing general legal principles and procedures and the substantive law and procedure for the areas of law in which the lawyer practises,

(b) investigating facts, identifying issues, ascertaining client objectives, considering possible options, and developing and advising the client on appropriate courses of action,

(c) implementing, as each matter requires, the chosen course of action through the application of appropriate skills, including,

(i) legal research,

(ii) analysis,

(iii) application of the law to the relevant facts,

(iv) writing and drafting,

(v) negotiation,

(vi) alternative dispute resolution,

(vii) advocacy, and

(viii) problem-solving ability,

(d) communicating at all stages of a matter in a timely and effective manner that is appropriate to the age and abilities of the client,

(e) performing all functions conscientiously, diligently, and in a timely and cost-effective manner,

(f) applying intellectual capacity, judgment, and deliberation to all functions,

(g) complying in letter and in spirit with the Rules of Professional Conduct,

(h) recognizing limitations in one's ability to handle a matter or some aspect of it, and taking steps accordingly to ensure the client is appropriately served,

(i) managing one's practice effectively,

(j) pursuing appropriate professional development to maintain and enhance legal knowledge and skills, and

(k) adapting to changing professional requirements, standards, techniques, and practices."

The official commentary to Rule 2.01 expressly states that the above is not a standard of perfection.

"This rule does not require a standard of perfection. An error or omission, even though it might be actionable for damages in negligence or contract, will not necessarily constitute a failure to maintain the standard of professional competence described by the rule."

While failure to comply with the Rules of Professional Conduct might be taken into account by a court in a civil action against the lawyer for negligence, the failure, in and of itself, may not constitute basis for a civil action. Further, the fact that a lawyer is found liable for negligence in a civil action does not usually render him/her subject to disciplinary action. [9] For example, in *Quinney v. Orr* [10] ("*Quinney*"), the court held that breach of professional conduct by a chartered accountant, did not provide a basis for an action in negligence against the accountant. The plaintiffs sued their chartered accountants for damages as a result of a reassessment by Canada Revenue Agency ("CRA") of their personal income tax returns. The plaintiffs claimed that the accountant, Orr, was negligent in setting up their new international structure as a corporation rather than a partnership. In the course of audit, the chartered accountant advocated to CRA that the structure was indeed a partnership which he knew was a false position. In the civil action, the plaintiff asserted that this false assertion was a breach of the accountant's governing rules of professional conduct. While the court acknowledged same and heard expert evidence to this effect, in this particular case, if the accountant's false statement had been accepted by CRA, the plaintiff's tax liability would have been eliminated and therefore, the chartered accountant's breach of rules of professional conduct did not adversely affect the plaintiff. Accordingly, the court held that such breach did not support a negligence action.

Professional Conduct Standards for Accountants

Professional conduct for accountants is governed by various provincial institutes and/or associations.

The profession of Chartered Accountancy in Ontario is governed by the Chartered Accountants Act, 2010 [11]. Public standards of practice for Ontario CA's are enforced by ICAO's Rules of Professional Conduct and bylaws("ICAO Rules"). [12]

Ontario CA's who do not abide by the ICAO Rules are subject to disciplinary action.

Rule 202.1 "Integrity and due care" appears to be the rule applicable to reliance on client representations regarding tax matters. It reads "A member, student or firm shall perform professional services with integrity and due care."

The ICAO Rules do not provide further guidance on how to apply this rule in practice other the following general comment (our emphasis in italics):

> "Members are expected to be straightforward, honest and fair dealing in all professional relationships. They are also expected to act diligently and in accordance with applicable technical and professional standards when providing professional services. *Diligence includes the responsibility to act, in respect of an engagement, carefully, thoroughly, and on a timely basis.* Members are required to ensure that those performing professional services under their authority have adequate training and supervision. [13]"

This guidance suggests that a member who does not act diligently with respect to client representations could potentially be subject to disciplinary action.

However, we identified only 9 disciplinary cases under Rule 201.1 that involved tax matters. Of these cases only one seems to involve a situation where an accountant did not adequately investigate a client's representations regarding tax matters. [14].

The dearth of tax cases in respect of due care with respect to client representations likely results from two factors:

1. The disciplinary system is complaints driven. We surmise that clients rarely complain about an accountant if the accountant prepared a return or provided advice based on false information provided by the client.

2. Disciplinary action can also arise out of a practice inspection. However, the ICAO does not carry out an inspections focused on a firm/practitioner's tax practice.

Certified General Accountants of Ontario are subject to the Code of Ethical Principles and Rules of Conduct (CGAO Code) [15].

The CGAO Code sets out certain fundamental principles including a principle regarding deceptive information being: "Members shall not be associated with any information that the member knows, or ought to know, to be false or misleading, whether by statement or omission."

The CGAO Code then sets out certain specific rules of conduct. These rules include:

- R401 Communication Issued in Connection with Financial Information: "A member shall not issue a communication on any financial information, whether for publication or not, when the information is prepared in a manner that may have a tendency to be misleading."
- R402 Association with Financial Information: "A member shall not be associated with any letter, report, statement, representation, financial statement or tax filing, whether written or oral, which the member knows, or ought to know, is false or misleading, regardless of any disclaimer of responsibility. It is recognized that compliance with this Rule may place a member in a difficult position vis-à-vis the member's employer or client. Nevertheless, the member has an obligation to comply with this Rule."

Ontario CGA's who do not abide by the CGAO Code are subject to disciplinary action by the CGAO.

We did not identify any disciplinary cases under Rules 401 and 402 involving a CGA who did not adequately investigate a client's representations regarding tax matters.

Given the lack of detailed rules and disciplinary cases, the ICAO Rules and CGAO Code do not on their own provide significant guidance on the specific due diligence a tax practitioner should take in respect of taxpayer representations.

Civil Liability

The retainer is the obvious basis of a lawyer's obligations and duty to his client. Whether a written retainer agreement is entered into or not, an implied term of the relationship is that the lawyer agrees to provide legal services with reasonable competence and diligence. This is the standard of care used to judge negligence.

For many years, there was a debate about whether a solicitor could also be sued in tort for negligence. Although no longer the case in Ontario, this was sometimes relevant to the time when a limitation period started to run. However, the Supreme Court of Canada held in *Central Trust Co. v. Rafuse* [16] ("*Central Trust*") that there is concurrent liability in contract and tort for negligence arising by virtue of the solicitor-client relationship. The duty of care in contract and tort is the same and the Supreme Court of Canada agreed that a plaintiff has the right to assert the cause of action (i.e., in contract or tort) that would be the most advantageous to him. However, the concurrent liability in tort is limited to the extent of a contractual exclusion or limitation on liability. An example of this might be a limited scope retainer.

Although the discussion below specifically refers to lawyers, the same concepts apply to accountants.

The Standard of Care

An action against a lawyer for negligence is a claim that the lawyer did not meet the standard of care. A lawyer owes a duty of care to his client to carry out his services with reasonable skill, care and diligence. Sometimes the standard of care is referred to as that of the reasonably competent solicitor or the ordinary competent solicitor or the ordinary prudent solicitor. The claim of negligence is based on the implied duty to take reasonable care that is part of the retainer between lawyer and client. The same duty arises in tort.

A lawyer may make an error in judgement. This may, but need not, constitute negligence. The question is whether a reasonably prudent lawyer in the same circumstances would have made the same error. The reasonableness of the error is usually assessed by the court on the basis of expert evidence. As standards may evolve, it is the standard at the time the error was made which is relevant for this purpose.

J.F. Newton Ltd. v. Thorne Riddell [17] ("*JF Newton*") illustrates the manner in which a court investigates and determines whether an act or omission has breached the standard of care. The case involved tax planning in advance of a share sale and specifically a safe income strip at or around the time that what is now subsection 55(2) was enacted into law. The share purchase agreement, which contained provision for a strip by means of redemption of shares pre-closing, was executed ten days after the amendments to section 55 were introduced in the House of Commons, although draft legislation had first been published four or five months previously. The court noted that there were no decided cases and little other material to assist in advising on the probable interpretation of the amendments. All of this pre-dated the 1981 Annual Conference at which the "Robertson Rules" were announced [18]. As a result of the share redemption, J.F. Newton Ltd. (the plaintiff) was deemed to receive a dividend of $5.25 million. Its tax return was filed on the basis that the entire deemed dividend was a taxable dividend. CRA reassessed. CRA disputed the safe income calculation on the basis that a lease cancellation payment should not have been included; the safe income should have been pro-rated over the shares; and took the position that a paragraph 55(5)(f) designation could not be late filed. The plaintiff ultimately settled with CRA but sued the accountants for negligence on the grounds that the accountants were negligent in including the lease cancellation payment in the computation of safe income; failing to pro-rate safe income over all the shares; and failing to make a designation under paragraph 55(5)(f) .

The court noted the lack of written documentation regarding the defendant's advice to the plaintiff but found that in the long professional relationship between the parties, oral advice had become the norm. The court considered Mr. Newton (the principal of the plaintiff) to be a knowledgeable and sophisticated business person. It was expressly noted that he was an accountant by profession who had at one time worked with CRA. The court said: "[H]e was a knowledgeable and tax conscious client. He was able to understand the tax advice given, and was able to ask pertinent questions with respect to the advice." [19] The court found that it was probable that the plaintiff was advised of the risk of reassessment on the inclusion of the lease cancellation payment in the computation of safe income. The court also found it probable that the plaintiff was advised of the "all or nothing" effect of the safe income calculation under section 55 . Presumably this finding was intended to refer to the effect of a redemption, absent a paragraph 55(5)(f) designation. The court inferred (presumably from testimony) that the plaintiff was advised that it would be able to negotiate out of a complete disallowance by CRA. Given the above findings, it would seem that the only question to be considered with reference to the standard of care should have been the issue of pro-rating safe income. The court found that the defendants did not perceive this to be a risk and therefore did not communicate same to the plaintiff. The issue was framed thus: "The question is whether a reasonably competent tax advisor would have perceived and advised upon this risk in December 1980 or January 1981."

The court heard expert evidence. The expert evidence referred to "information available to the tax community at the time" with respect to the manner in which safe income should be computed and the action "most practitioners ... would have done" with reference to the pro-rating of safe income. The court found that the defendants' advice met the standard to be expected of "reasonably competent tax specialists" at the time the advice was given. The tax return of the plaintiff was filed in April 1982 after the "Robertson Rules" were announced and the expert evidence was that "all members of the tax community would have been aware of this provision", i.e., paragraph 55(5)(f) . The court however accepted the statements in the expert evidence that it was not reasonable to make such a designation in order to minimize risk of examination of the transaction and in any event, the plaintiff had settled with CRA as if such a designation had been made. In other words, the defendant's failure to recommend a paragraph 55(5)(f) designation did not result in additional tax to the plaintiff. The court concluded that the plaintiff failed to prove negligence on the defendant's part and failed to prove any loss from relying on the defendant's advice.

The time period in issue in the above case obviously preceded the technological tools, search engines and commercial databases available today which are part of a tax specialist's toolbox. One would hope that an advisor today with access to such tools would be able to discern, for example, CRA's administrative positions on the calculation of safe income, and therefore perceive issues and alert a client of risks. It may be that literacy and ability in search techniques have become a component of the reasonably competent solicitor.

In *Quinney* [20], the plaintiffs sought tax advice from Orr, a chartered accountant about the structure for their new business as distributor of Unilever products in Romania. The plaintiffs sued Orr and claimed he breached the standard of care in not recommending a partnership structure. Rather, a corporate structure was implemented. Romanian law apparently required that the business be operated through a corporation, although such a corporation could have been agent for a partnership. The plaintiffs had advised that they expected to make a considerable profit and to do so quickly and provided documentation to Orr to this effect. The documentation came from a meeting of the plaintiffs with Unilever projecting $40 million USD gross sales in the first year. The court found that the plaintiffs had to prove that they had communicated an expectation of significant business losses over a period of time in order to succeed in their claim that Orr had breached his standard of care in not recommending a partnership structure. But that was not consistent with their testimony. The expert evidence which the court accepted was that a competent tax advisor would discuss a client's business objectives and once these are defined, propose the appropriate business structure. The inference is that Orr was entitled to rely upon the information or projections provided to him in formulating his advice regarding structure. It is also noteworthy that the structuring was implemented in considerable haste which was noted in the decision. The plaintiffs met with Orr on their way to the airport for a flight to Romania in November and Unilever expected that the plaintiffs' distribution business to be operational by January of the following year. Prior to meeting with Orr, the plaintiffs had commenced investigating the business opportunity some months earlier including retaining a business consultant and had already retained Romanian lawyers and accountants and leased a warehouse in Romania.

Orr had proposed a Cayman finance structure. The court also found that Orr would have breached the standard of care of a tax advisor if this structure had been implemented. The experts agreed that an international finance company would not be cost effective given the low range of financing needed for the venture. But as the finance company was proposed to be established in a country with which Canada had no tax treaty and because of a nuance in the definition of "exempt earnings", there would have been additional tax cost to such structure. There was no discussion in the decision of Orr's familiarity with the foreign affiliate rules in the ITA. While it was unclear whether Orr was a tax specialist, he was held to that standard of care.

The standard of care does not require a lawyer to know all the law, but rather to have a good working knowledge of the law including statutes that are relevant to his work. *Central Trust*is the seminal case in Canada on the standard of care required of a solicitor. The alleged negligence in this case was the failure of the solicitors to know or learn of a provision in the provincial corporate statute which caused an issue with respect to the validity of a proposed mortgage. The standard of care was explained in the following words of the Supreme Court of Canada [21]:

> "A solicitor is not required to know all the law applicable to the performance of a particular legal service, in the sense that he must carry it around with him as part of his "working knowledge", without the need of further research, but he must have a sufficient knowledge of the fundamental issues or principles of law applicable to the particular work he has undertaken to enable him to perceive the need to ascertain the law on relevant points. The duty in respect of knowledge is stated in 7 *AmJur*2d, Attorneys at Law § 200, in a passage that was quoted by Jones J.A. in the Appeal Division, as follows: "An attorney is expected to possess knowledge of those plain and elementary principles of law which are commonly known by well-informed attorneys, and to discover those additional rules of law which, although not commonly known, may readily be found by standard research

> techniques." See Charlesworth and Percy on *Negligence* (7th ed. 1983), pp. 577-78 to similar effect, where it is said: "Although a solicitor is not bound to know the contents of every statute of the realm, there are some statutes, about which it is his duty to know. The test for deciding what he ought to know is to apply the standard of knowledge of a reasonably competent solicitor." The duty or requirement of professional competence in respect of knowledge is put by Jackson and Powell, *Professional Negligence* (1982), at pp. 145-46 as follows: "Although a solicitor is not `bound to know all the law,' he ought generally to know where and how to find out the law in so far as it affects matters within his field of practice. However, before the solicitor is held liable for failing to look a point up, circumstances must be shown which would have alerted the reasonably prudent solicitor to the point which ought to be researched" ..."

Factors considered by the courts in reviewing the standard of care include the sophistication- of the client, the limits of the retainer, and the form and nature of the client's instructions. [22]

Does the retainer include tax advice?

This question was considered in Silver v. Morris [23]. Silver retained a lawyer, Morris, regarding the sale of her sole proprietorship business, an H&R Block Tax business. Morris expressly advised Silver that he was not a tax specialist and had "absolutely no knowledge of tax matters". Silver later brought an action against Morris, claiming that she had lost an opportunity for substantial tax savings. She could have incorporated her business and relied upon subsection 110.6(14) to claim the benefit of the enhanced capital gains deduction. Silver had operated an H&R Block Tax business for over 10 years. She had taken all the prescribed H&R Block courses and in fact, had trained others. Silver testified that she had asked Morris if she would save tax by incorporating. The court considered whether the lawyer was under a duty to refer Silver to a tax specialist.

The majority of the appellate court held that in the ordinary case, a solicitor retained by a client on the sale of a business should be alert to and give competent advice with respect to the tax implications arising on the sale and if not knowledgeable, he should advise his client to seek advice from someone with expertise. On the particular facts of the case, the appellate court agreed with the trial court that Morris had no such duty. The Court found that Silver was not unsophisticated; had access through the H&R Block network to tax advice and most importantly, was not relying on Morris to provide tax advice.

The fact which blurred the analysis was Morris' offer to make a call to an accountant. He relayed that telephone call to Silver. Morris asked the accountant a general question which was presumably his interpretation of Silver's question _ would a purchaser of a business pay more for shares or assets of a business? There was no reference to the capital gains deduction. It is unclear whether the accountant was expressly retained by Morris or if this was simply a call to a professional acquaintance. There was a dissenting judgement in the Court of Appeal which focused on the information gleaned from the accountant and relayed to Silver. The dissenting judgement noted that the information obtained by Morris, "if he had given it any thought" would have led to the realization that she was not getting much information of utility and therefore, he should have directed her to a tax specialist.

The statement in *Silver v. Morris* of the "ordinary case", i.e., tax implications are included in the retainer, is important. The same was found in *Baniuk v. Filliter* [24], in obiter.

Baniuk v. Filliter was a case involving the settlement of a lengthy shareholder dispute and oppression action. The matter was settled on consent among the parties that Baniuk's shares would be purchased by the corporation. Baniuk later brought an action against the solicitors for failing to communicate offers of settlement and failing to properly advise on tax matters.

Baniuk had become dissatisfied with his then counsel during the lengthy litigation process. He interviewed other law firms to find new counsel. Baniuk was introduced to Mockler (one of the defendants) after he advised that he wanted a lawyer with experience in dealing with shareholder buy-outs and tax matters. Mr. Mockler had a graduate degree in tax and had worked as a researcher on the Royal Commission on Taxation. He had a commercial law practice and conducted tax litigation at all levels of court.

The shareholder dispute was settled on the basis that Baniuk's shares would be purchased by the corporation. Baniuk asserted that he suffered greater tax liability than he would have if his shares had been purchased by the other shareholder. The difference obviously derives from deemed dividend treatment in the former case compared to a capital gain in the latter case. It is unknown whether the enhanced capital gains deduction would have been available to Baniuk.

The trial court found that there was an oral retainer concluded between Baniuk and the defendant that the defendant's law firm would advise him with respect to the manner in which Baniuk's shares would be bought out, including the structuring of same to take tax consequences into account. In this regard, the trial judge noted testimony of Baniuk and Mockler in which both acknowledged early interviews where Mockler gave details of his tax experience. Also, the trial judge noted materials filed by Mockler on behalf of the plaintiff during the course of the shareholder litigation which made reference to the plaintiff's tax liability. This was considered persuasive evidence that the retainer explicitly included tax advice.

However, the trial judge carried on to state that he would, in any event, have found the proffering of income tax advice as an implied term of the retainer. The trial judge heard and accepted the testimony of a number of experts in commercial transactions who stated that when clients are involved in corporate transactions or reorganizations, the lawyer would and should confirm that the client knows the tax implications.

The above findings were accepted by the appellate court.

Based on the above cases, the duty to advise of tax implications seems to be an implied term of a retainer involving commercial matters. As one of the above cases involved a general practitioner who expressly disavowed tax knowledge and the other involved a practitioner with tax knowledge who was seemingly retained to deal with the commercial aspect of the matter, it appears that the implied term is not limited to a tax specialist. This principle can also be discerned from *Confederation Life Insurance Company v. Shepherd, Mckenzie, Plaxton, Little & Jenkins* [25] ("*Confederation Life*"), a case involving a law firm retained to act on a mortgage financing. The lender/plaintiff asked the solicitors to ensure that a clause consenting to the registration of the project as a condominium would not adversely affect the terms of the mortgage. It seemed that the solicitors looked at the inclusion of such a clause only from a drafting perspective. The solicitors did not turn their minds to certain provisions of the Condominium Act which would enable the mortgagor to prepay the mortgage upon registration of the project. The court held:

> "Where ... a solicitor undertakes to provide advice and legal services in respect of a transaction which is governed or affected, in whole or in part, by a public stature such as the Condominium Act, the solicitor bears the burden of exercising reasonable care and skill to ascertain by an examination of the relevant legislation and the manner in which that legislation may impact upon the transaction. The solicitor is obliged to advise his client of any risks or concerns which such legislation may give rise to."

It goes without saying that many commercial transactions are governed or affected in whole or part by federal or provincial tax statutes, among other statutes. Applying the above statement, a solicitor who undertakes to provide legal services in respect of a commercial transaction must advise of risks and concerns that federal and provincial statutes, including the tax statutes, may give rise to. Because of this implied term of the retainer, the advisor should expressly limit his retainer and disavow tax advice, where appropriate.

The Rules of Professional Conduct define a "limited scope retainer" as "the provision of legal services by a lawyer for part, but not all, of a client's legal matter by agreement between the lawyer and the client" and sets out procedures to be followed. [26] Not surprisingly, the procedures may be distilled to "reduce it to writing" and "provide a copy to the client".

Where both accountants and lawyers are involved in a matter, it is important that responsibility for tax advice be delineated and agreed with the client. [27] The identity of the advisor upon whom the client is relying for tax advice should be clear. This may involve a limited scope retainer. One set of advisors may be responsible for tax advice to the knowledge, reliance and agreement of the client, but the actions of the other advisors could affect the tax advice. For example, tax advice may be provided by lawyers but the reporting and/or filing of elections may be neglected or done erroneously by the accountants. In the alternative, tax advice may be provided by accountants, but legal documentation to implement the proposed structure may be drafted by lawyers in which case, the role of review and approval should be delineated. The challenge is "retainer creep" as a matter or relationship progresses. Sometimes the demarcation line between the roles of the tax accountant and tax lawyer may be crisp at the outset but blur as a matter or transaction progresses so that tax advice may be coming from both. In this case, a quarterback role is important and best practice would dictate the amendment of any engagement letter/agreement.

The Sophisticated Client versus other

In some instances, the duty to warn a client of potential risks as part of the standard of care has been held to apply only to the unsophisticated client. [28]

In *285614 Alberta Ltd. v. Burnet Duckworth & Palmer* [29] ("*285614 Alberta*"), a shareholder loan transaction resulted in an adverse tax assessment of the shareholder and his wife. The tax issue was whether a demand promissory note constituted a bona fide arrangement for repayment within the meaning of subsection 15(2) as it read in 1985. It appears that the defendant lawyer, Sprackman, was not a tax specialist. The evidence was that he did not discuss subsection 15(2)15(2) with either the shareholder or his wife. The judgement states that he was aware of the requirements of subsection 15(2) and was confident that a promissory note would satisfy these requirements. There is no detail in the judgement regarding the basis of Sprackman's knowledge or confidence. But the judgement does expressly state that he did not conduct any research into this point. Expert testimony was provided by one corporate commercial lawyer (based on authorities provided by plaintiff's counsel) and one tax specialist. Both agreed that the law was unsettled regarding the requirements of subsection 15(2) . Although they disagreed on whether a promissory note was sufficient, they agreed that a lawyer who was aware of the uncertainty should advise his client about the uncertainty. The court held that the defendant lawyer was not required to advise the shareholder of the risk of tax consequences. The court noted that the shareholder was experienced in business and tax matters and had testified of an intention to repay the loan within one year which the court interpreted as familiarity with the statutory requirements. However, the court held that the defendant lawyer did have a duty to warn the shareholder's wife, who was not a sophisticated business person, of the tax consequences. In this regard, the court expressly stated that the defendant lawyer breached the standard of care both in failing to advise the shareholder's wife of the potential for tax consequences and failing to "adequately consider or research the requirements of the legislation" [30].

The failure to "adequately consider or research" is thought provoking, if not alarming. The extract from the judgement in *Confederation Life* above referred to a solicitor exercising reasonable care by "an examination of relevant legislation". The extract from the Supreme Court of Canada judgement in *Central Trust* above referred to discovering additional rules of law which "may be readily found by standard research techniques". In *285614 Alberta*, the judge accepted that the authorities referred to by the plaintiff "were all found in major reporting services and tax bulletins which would be easily accessible to any lawyer" [31]. The scope of legal research necessary to ascertain the manner in which legislation (and in particular, tax legislation) may impact upon a client's transaction is not clear, especially as technological research tools advance and databases (often by subscription only) proliferate.

It has however been held that in the case of a sophisticated client, a tax advisor need not expressly state that his advice may be incorrect. [32]

Third Party Civil Penalty, s. 163.2, ITA

Overview

The objective of the third-party civil penalty regime is to deter third parties from making or acquiescing in the making of false statements or omissions in relation to income tax or goods and services tax/harmonized sales tax (GST/HST) matters [33]. Amongst other things, the penalties are intended to penalize tax preparers who turn a blind eye to false information provided by their clients [34]. The third party penalty provisions apply to statements made after June 29, 2000.

CRA has provided administrative guidance on the application of these penalties in *Information Circular* 01-1 [35] ("IC 01-1 ") and in various presentations by CRA officials [36].

Guindon is the first reported case involving s.163.2.

The following discussion focuses on the penalties applicable under section 163.2 of the ITA. Similar penalties apply under the Excise Tax Act [37].

The ITA provides two third party civil penalties, sometimes referred to as the "tax planner penalty" in subsection 163.2(2) and the "tax preparer penalty" in subsection 163.2(4) . These short-form names may be misleading as the categorization of the advisor does not determine the applicable subsection. There are some subtle distinctions in the wording of the two subsections and the penalty calculation is different but fundamentally, the prerequisites to both provisions are (a) a "false statement"; (b) actual knowledge that the statement is a "false statement" or "culpable conduct".

The so-called "tax planner penalty" applies to a person who makes, furnishes, participates in the making of, or causes another person to make or furnish a statement that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by another person for a purpose of the ITA [38]. The person who could use the false statement does not need to be identified in order to apply this penalty.

When a false statement is made in the course of a planning activity or a valuation activity, the tax planner penalty is the greater of $1,000 or the total of the tax planner's gross entitlements for the planning or valuation activity (calculated at the time at which the Notice of Assessment of the penalty is sent to the tax planner) [39].

The so-called "tax preparer" penalty applies to a person who makes, or participates in, assents to, or acquiesces in the making of a statement to, by or on behalf of another person that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by or on behalf of the other person for a purpose of the ITA [40]. Although this penalty is commonly referred to as the "tax preparer" penalty, it has a much broader application and can also apply to a person providing tax advice to a specific taxpayer; and an appraiser or valuator preparing a report for a specific taxpayer or a number of persons who can be identified.

The "preparer penalty" is the greater of:

(a) $1,000, and

(b) the lesser of:

(i) the penalty to which the other person (i.e., the person who could use the false statement for a purpose of the ITA) would be liable under subsection 163(2) if the other person made the statement in a return filed for the purposes of the ITA and knew that the statement was false; and

(i) the total of $100,000 and the person's gross compensation, at the time at which the Notice of Assessment of the penalty is sent to the person, for the false statement that could be used by or on behalf of the other person [41].

"Culpable conduct" is defined as conduct, whether as an act or a failure to act that:

- is tantamount to intentional conduct, or
- shows an indifference as to whether the ITA is complied with, or
- shows a willful, a reckless or a wanton disregard of the law [42].

Based on the above definition, CRA accepts that "[C]ulpable conduct refers to conduct that is not simply an honest error of judgement or failure to exercise reasonable care (i.e., ordinary negligence) [43].

The background to the third party civil penalty and in particular the use of the words "culpable conduct" was explained in the Explanatory Notes to section 163.2 : [44]

> During the post-budget consultation period, concerns were expressed by professional bodies on behalf of their membership that the proposed civil penalty provisions could apply in cases where a tax professional makes an honest error of judgement, or where there is an honest difference of opinion. These concerns reflected a concern about the proposed gross negligence standard rather than the other test for liability that is based on a knowledge standard.
>
> The gross negligence standard has been used elsewhere in the tax law and has been judicially interpreted in a number of cases. In the government's view there is a great deal of difference between "ordinary" negligence and "gross" negligence. It is not the government's policy intent to apply a third party penalty under new section 163.2 in cases of conduct that is an honest error of judgement, or an honest difference of opinion. Rather the gross negligence standard was selected because it addresses this legitimate concern while ensuring that participants in otherwise culpable activity do not escape liability.
>
> Nevertheless, in response to representations of professional bodies, section 163.2 substitutes for "gross negligence" the concept "culpable conduct" which is defined with reference to the types of conduct to which the courts have, in the past, applied a civil penalty under the tax law.

Paragraphs 16 and 17 of IC 01-1 expanded upon the above to give general parameters where the section is not intended to apply and factors considered in determining culpable conduct. Based on paragraph 16, the third party civil penalty will not apply to:

- Tax planning arrangements that comply with the law

- Honest mistakes or oversights
- Differences of opinion where there is bona fide uncertainty
- Activities that are administratively accepted by CRA.

The list of factors considered in determining culpable conduct were listed in paragraph 17 as:

- Whether the position taken is obviously wrong, unreasonable and/or contrary to well established case law.
- Considering the advisor's experience with the relevant subject matter and knowledge of the taxpayer's specific circumstances, the extent of knowing or deliberate participation in false statements
- The degree to which the culpable conduct represents the most aggressive and blatantly abusive behaviour
- The extent to which there is a pattern of repeated abuse
- Whether the reduction of taxes is significant

IC 01-1 also states that action that may result in sanction by the advisor's professional body or a negligence or malpractice action by a client would not necessarily result in the application of the third party civil penalties. [45]An advisor may fail to meet the standard of care and as a result, be liable for damages to the client. While failure to meet the standard of care may involve a false statement used for purposes of the ITA, this does not automatically mean actual knowledge of the advisor that the statement was false or culpable conduct. There is surely a distinction between negligence without any modifier and gross negligence as used in subsection 163(2) and therefore culpable conduct. [46]

CRA assessment practices

Prior to the introduction of the legislative provisions, the Department of Finance (Finance) indicated that these penalties were intended to apply to "egregious" situations [47]. In the spirit of this guidance, the CRA has indicated that it intends to strictly control the application of third party penalties [48]. Further CRA has indicated that the penalties are to be applied in only the most flagrant situations, that is, those that demonstrate abusive behavior or widespread impact [49].

Statistics made available by CRA [50] as of August 30, 3012 indicate:

- A total of 185 cases have been reviewed for potential application of the penalty;
- In 71 cases (33 promoters and 38 tax preparers), an aggregate third party penalty in excess of $79 million has been assessed;
- In 64 cases (35 tax preparers and 39 valuators), the third party penalty audit is still in process; and
- 50 cases were rejected or otherwise determined that the penalty should not apply.

Given that the rules have been in place for about 13 years, the above statistics appear to be consistent with the CRA only applying the penalty in flagrant situations.

Court Cases

Earlier in this conference the *Guindon* decision was discussed. It is the first reported case involving section 163.2 . In summary, the Tax Court of Canada held that the section163.2 penalty constitutes a criminal offence and entitles a taxpayer to the benefit of Charter protections, including the requirement of proof beyond a reasonable doubt, rather than the normal burden of balance of probabilities applicable in civil matters. Although Bedard, J. found that a third party penalty imposed under section163.2 is by its nature a criminal offence, he also made a determination of whether Guindon knew or would reasonably have been expected to know but for circumstances amounting to culpable conduct that the timeshare units and trust did not exist when she signed charitable donation receipts. As the case had been decided by the finding that the penalty was a criminal offence such that, among other things, the Tax Court did not have jurisdiction to deal with the matter, Bedard. J.'s comments regarding culpable conduct were *obiter*. Guindon wore two hats. She was the lawyer (with no expertise in tax law) who wrote an opinion that she knew would be used by the promoter to attract potential participants in the donation program. She was also the president of the charity to which the timeshare units were donated by participants and who signed the donation receipts, or was present when another officer signed.

The parties agreed that by issuing the donation receipts, Guindon made a false statement. Neither party argued that Guindon's legal opinion was the false statement.

With respect to the culpable conduct prerequisite and notwithstanding the Explanatory Notes to section 163.2 (a portion of which was reproduced earlier in this discussion), the court disagreed with the Crown's assertion that culpable conduct should not be differentiated from gross negligence and noted that this would render Parliament's choice of a different term if the two were considered to be the same. The court found that culpable conduct must refer to conduct in the "strongest" cases of gross negligence and further, required evidence of mens rea or intention and "conclusive proof of culpable conduct".

It is not entirely clear what the requirement of mens rea adds given that jurisprudence under subsection 163(2) has equated gross negligence to "intentional acting" [51] or a "deliberate and intentional consciousness". [52]

In the case at hand, the court held that Guindon, as an officer of the charity, knew that she could not rely on her own legal opinion which was incomplete and knew also that she could not rely on the principals who were in turn relying on her legal opinion.

Third party penalties in the context of taxpayer representations

Third party penalties can potentially apply in a number of circumstances. We will focus in this paper on the potential application of the penalties to a tax preparer or tax advisor's reliance on client representations.

In this context, culpable conduct could arise where a tax advisor shows indifference as to whether the ITA is complied with.

CRA has commented that the "indifference" test:

> "describes the passive aspect of culpable conduct. The expression means that the person's actions or failure to act indicate that the person was wilfully blind regarding the facts or the application of the tax legislation. The person suspects that the situation demands that certain questions be asked. However, inquiries are not made because the person would then possess the knowledge of the false statement. This behavior was addressed in Sirois c. R., 1995 CarswellNat 555 (T.C.C.) [1995] 2 C.T.C. 2648, which relates to subsection 163(2) of the ITA, gross negligence on the part of the taxpayer. The court described the taxpayer's behaviour as 'He buried his head in the sand.' [53]"

The Sirois case above involved a lawyer with the Department of Justice who deducted the professional dues paid to his Quebec regulatory body. For the first few years of his employment, he did not do so. The dues were paid by his employer; the taxpayer simply passed the statement of account to his manager for payment. The court found that the taxpayer "took a chance" and deducted the dues because he heard that co-workers were doing so. He made no inquiry whether the amount was included as a taxable benefit on his T4. The court noted his professional training and noted that he could have checked to learn if the amount was included on his T4 but did not do so because he did not want to know. This was indifference as to whether the ITA was complied with. While the result of this case may seem rather obvious given the facts, the need for inquiry as opposed to intentional non-inquiry is evident.

A "good faith" exception to the "tax planner" and "tax preparer" penalties is available where the taxpayer relied, in good faith, on information provided to the advisor by or on behalf of the other person, or because of such reliance, failed to verify, investigate or correct the information (i.e., did not look into the accuracy of the information). [54]

CRA has interpreted this to mean (our emphasis in italics):

> "*the exception will apply where the information used by the tax advisor is not on its face, clearly false, or obviously unreasonable to a prudent person or does not raise obvious questions in the mind of the tax advisor.* Good faith is described as "honesty of intention, and freedom from knowledge of circumstances which ought to put the holder on inquiry." *In other words, a person may rely on information in good faith in the absence of a reason that could cause a reasonable and prudent person to believe that the information could be incorrect.* [55]"

CRA has provided an example (see Example 1 in Appendix I) of a situation where the "good faith" exception would apply. In this example a new client brings to his accountant a listing of his business expenses and revenue. The accountant has a quick look at the expenses. The expenses seem to be related to the type of business of the client and nothing stands out as obviously unreasonable. On audit CRA determines that a large proportion of the expenses claimed cannot be substantiated and the reported revenue is significantly underreported. Although CRA accepts that the "good faith" exception would apply in this hypothetical situation, in a real situation, it may not be clear cut that a client representation is not "clearly false" or "obviously unreasonable".

CRA has recognized that this situation could exist. It has commented:

> "There may be situations when additional questions will have to be asked before the person can satisfy himself or herself that the information is credible (i.e., consistent with the person's knowledge). A person may wish to document this supplementary information if it needs to be referred to at a later date. [56]"

CRA has provided two examples (see Example 1 and Example 12 in Appendix I) of situations where further questioning is warranted. In each example there is significant incongruence between the client's reported income and certain expenditures. In Example 1 the tax preparer questions his client and receives a response that is not implausible. As a result CRA would not apply a third party penalty. In Example 12, CRA indicates it would apply the penalty if the tax preparer proceeded without questioning his client.

These two examples illustrate extreme cases where we would ordinarily expect a tax preparer's "alarm bells" would be set off. However, most real life situations will be much more subtle and prudence suggests that some investigation may be required by a tax advisor before the he can conclude a taxpayer representation is not "clearly false" or "obviously unreasonable". In this respect CRA has provided the following guidance to tax practitioners on best practices to minimize the risk of a penalty being applied [57]:

- Record any information supplied by the client.
- Document any concerns about the truthfulness, accuracy, or inconsistency in the information supplied.
- Record questions asked about those concerns.
- Record the client's responses.
- Record any further discussions to clarify inconsistencies or contradictions.
- Document any research conducted and the results of such research.
- Record any assumptions made.
- Question the reasonableness of statements and assumptions.
- Record why the assumptions are reasonable.

Due Diligence in an Acquisition Transaction

In the context of an acquisition, due diligence is an investigation to determine values and risks of an investment in a target business or entity ("Target"). The purpose of due diligence is to: (a) assist in negotiation of the purchase price and transaction documents; (b) manage obstacles and prevent surprises in the transaction process; (c) provide information to assist in structuring; and (d) assist in verifying, defining and structuring representations and warranties, indemnities and other terms in the agreement of purchase and sale. Due diligence can be critical in identifying tax issues that may affect the transaction. There is a fair amount of writing on this topic [58] and this is intended to provide some limited commentary.

The scope of a due diligence investigation will vary depending on the nature of Target, the extent of the investment and the needs of the buyer. Typical areas of investigation include the financial, tax, legal, commercial, IT, and HR, position of Target.

A due diligence investigation is not the same as an audit, examination or review in accordance with standards established by the Canadian Institute of Chartered Accountants ("CICA"). Accordingly, it should not be expected that the investigator would plan the work and undertake procedures in a manner that would allow him to express an opinion on the financial position of Target.

Often a tax advisor is asked by a client to assist with tax due diligence in respect of a proposed investment. The objectives of a tax due diligence often include:

- Identifying historic tax exposures (hidden liabilities) of Target. Following the identification process, the investigation can focus on quantifying the potential exposures (or a dollar range for each exposure) and the likelihood that a tax authority will successfully challenge the exposure item. This risk evaluation is typically a subjective assessment involving professional judgement. The tax advisor will usually have to consider the nature of the tax exposure, the technical merit of Target's tax filing position, and his/her own professional experience;
- Uncovering weaknesses in the tax function of Target;
- Assessing whether there are any tax "deal breakers";
- Identifying potential quality of earnings adjustments involving tax items.
- Identifying aspects that impact acquisition structuring:
- Providing possible mitigation strategies for tax exposures, including:
- Representation, warranties and indemnities;
- Escrow arrangements;
- Purchase price reduction;
- Post-closing process changes and/or restructuring;

Due diligence should be a joint effort of the accountants and lawyers. Each professional is better tasked with certain analysis. The accountants would be better in analyzing the tax exposures while the lawyers would be better in determining whether risks can be appropriately protected by representations and warranties or require specific tax indemnity provisions and/or a holdback. This is best as a joint work project.

A tax advisor can exercise due diligence in completing a due diligence assignment for a client. This involves taking a systematic approach in order to minimize the risk of failing to identify a significant tax exposure that should be identified within the scope of the work performed. A systematic approach can also assist a tax advisor with enhancing value to his/ her client. This is because a systematic approach should aid the tax advisor in better evaluating the issues identified and can assist in avoiding client disappointment where expectations are not met.

A systematic approach can involve the following four elements:

1. Planning
2. Scoping
3. Execution
4. Reporting

A systematic approach involving effective risk management procedures can also assist a tax advisor in (i) meeting his/her professional obligations with respect to due care; avoiding claims of negligence and (iii) avoiding third party civil penalties.

Planning and scope

It is good risk management practice for the tax advisor to agree on a scope of work (or a work plan) with his client. The agreed work plan can include in an engagement letter that sets out other terms and conditions of the engagement. There is no standard scope of work that can be applied to each investigation. Rather, the scope should be modified to reflect the specific needs of the client and the specific circumstances of Target.

The specific needs of the client will depend on various factors including the client's ability to complete certain aspects of the tax due diligence in-house, the stage of the transaction, and the amount of time available to complete the work, access to tax information of Target, the client's tolerance for tax risk, and the client's budget for the work.

The stage of the transaction can be a factor as investors often want to take a high level "deal breakers only" approach at an earlier stage when there exist multiple bidders and/or the investor is not yet deeply committed to the investment.

In order to develop the work plan that is tailored to Target's situation it is important for the tax advisor to a gain a general understanding of Target. The tax advisor can undertake this by reading information available at the planning stage including:

- The Confidential Information Memorandum (CIM) and Management Presentation;
- Publicly available information such as Annual Reports and Annual Information Forms for a public target and company website for a private target;
- Organization chart; and
- Recent financial statements and tax returns.

It is also important to recommend a tailored work plan that takes into account industry specific issues. For instance, in general the risk of sales tax exposures is higher for a retailer than for a manufacturer. Accordingly, we would generally recommend that the scope for a retail target include sales tax procedures.

Another example is the software development and information systems service provider sectors. It is common for companies in these sectors to hire individual independent contractors on a long term basis. Accordingly, we would generally recommend that the work plan for a target in these sectors cover the extent of use of such individual independent contractors and the risk of payroll tax exposures if these individuals are in fact employees.

In certain instances the tax due diligence will be undertaken by both tax accountants and tax lawyers. Therefore, it is important at the planning stage to allocate procedures to avoid duplication of efforts. In these situations the tax accountants typically focus on tax returns, tax working papers and tax correspondence while the tax lawyers typically focus on legal documents relevant to the tax investigation. The lawyers generally review corporate records (minute books and other statutory filings) including share terms, major contracts, documented arrangements amongst shareholders (whether in the form of a shareholders' agreement or not), option arrangements and historic reorganization transaction documents. For instance, the tax lawyers may read the board minutes of Target as these may highlight tax risks that Target's board has considered related to a particular transaction.

Notwithstanding the above, the scope of work will often include certain key procedures including:

- Interviewing management of Target and their tax advisor regarding their knowledge of:
- structuring of significant transactions in open tax years and the tax treatment thereof;
- tax planning arrangements implemented;
- nature of tax advice provided by external and internal tax advisors;
- historical tax positions taken including the quantum of tax reserves included in the financial statements and the basis for those reserves;
- results of tax audits and status of current/pending tax audits;
- related party transactions and transfer pricing matters; and
- nature of systems to ensure compliance with various tax laws.
- Reading tax returns for open taxation years and supporting work papers and financial statements.
- Reading copies of correspondence received from tax authorities.
- Reading tax provision work papers.

A more comprehensive due diligence may include:

- Reading correspondence provided by external and internal tax advisors.
- Reading transfer pricing studies.
- Reading R&D claims.
- Reading legal documents including corporate minutes and resolutions, purchase agreements, tax indemnity agreements, rollover agreements and related party agreements.
- Detailed sales tax, payroll tax and/or customs procedures.

The following items also reflect best practices for a work plan:

- Agreement on the period the due diligence will cover, e.g. three years vs. all open years;
- Agreement on the form of reporting, e.g. key findings only vs. a more comprehensive detailed report.
- Agreement on a materiality level. The materiality level may vary at each phase of due diligence.

For example, a phase 1 "deal brokers only" approach could cover only the most recent three years and require key findings reporting on tax exposures identified of at least $250,000. However, a Phase 2 detailed due diligence could cover all open years, require detailed reporting and reduce the materiality level to tax exposures identified of at least $100,000.

Reporting will be discussed in a later section.

Execution

The execution of the tax due diligence work plan is not just an exercise of tying in Target's corporate tax return to its financial statements or checking that Target's Schedule 1 adjustments seem reasonable. It should be a broader consideration of Target's potential tax risks based on factors observed including:

- The nature of the business activities of Target and how these can create tax exposures:
- The types of transactions undertaken by Target and how these can create tax exposures; and
- Management's attitude towards tax compliance and tax risk.

As well, it is important to be duly diligent in asking questions based on the information provided. That is, turn this information into value by asking "so what?

The following is a set of observations regarding potential tax exposures identified based on hypothetical management representations and documents provided by a hypothetical target.

- The financial statements disclose large bonuses to the shareholders but management told us some of the shareholders are not active. Is there an exposure for non-deductible bonuses to inactive shareholders?
- The statement of cash flows indicates capital asset additions of $10 million, but Schedule 8 shows additions of $2 million and Schedule 1 shows a repairs and maintenance deduction of $8 million. Does this mean Target has taken an aggressive position on deducting refurbishment costs?
- There are large addbacks on Schedule 1 for non-deductible interest and penalties? Does this mean that management is cavalier towards its tax compliance requirements?
- The CIM states there is a sales office is in Quebec, but no gross revenue is allocated to Quebec on Schedule 5. Is there an exposure for taxes payable to Quebec and/or QST?
- The financial statements disclose intercompany payments to foreign subsidiaries but Target has not provided any T1134s or T106s. Is there an exposure for penalties for not filing required returns?
- Management told us intangibles were moved to the US as part of a North American restructuring. Management stated that the value of the intangibles was nil, but Canadian taxable income post-restructuring decreased significantly. Is

there an exposure for the transfer of value intangibles to a related bon-resident at less than fair market value proceeds?

- Target is a limited risk a distributor in Canada of its foreign parent's products but it is incurring losses? Does the transfer pricing policy reflect the arm's length standard?
- The financial statements disclose a capitalization of the underwater debt into equity but the tax returns do not report a reduction of non-capital losses due to debt forgiveness. Are the non-capital losses of Target overstated?
- Earnings are repatriated out of Canada by way of dividends but the T106s do not report the filing of NR4 returns? Is there an exposure for unremitted withholding tax?

Quality of earnings

In many cases a business is valued based on a multiple of its forecasted earnings before interest, taxes, depreciation and amortization (EBITDA). Certain tax exposures can potentially involve not only an historic liability, but also potentially have a future impact on EBITDA. Accordingly, these types of tax exposure items can have s significant impact on the value of the deal. The following are examples of exposures that can create negative EBITDA adjustments:

- Additional payroll taxes such as employer CPP, EI and health tax premiums for employees being treated as contractors,
- Excessive R&D, training and energy claims;
- Additional customs duties that cannot be passed onto to end users; and
- Unrecoverable payments of GST, HST, PST and QST.

Alternatively, the due diligence may identify opportunities to increase EBITDA such as additional R&D, training and/or energy credits.

A tax due diligence that only focuses on historic tax exposures may miss the impact of these type of tax items on deal value.

Recent trends

A well planned tax due diligence will also consider recent business and tax trends. The following is a potpourri of tax issues that have been particularly relevant in recent years.

Cross-border tax issues

Canadian companies have increasingly expanded their global reach. This has led to increasing tax exposures in the following areas.

- Transfer Pricing and inter-company transactions;
- Activities in foreign jurisdictions creating exposures of permanent establishments in those foreign jurisdictions; and
- Complex offshore planning (e.g., financing structures) creating exposures for mind and management of foreign corporations residing in Canada, foreign accrual

property income, non-deductible interest, foreign withholding taxes and foreign exchange gains and losses.

Tax issues arising because of current economic climate

A number of tax issues have arisen as a result of the general economic downturn commencing in 2008 including:

- Business consolidations and the use of restricted tax losses;
- Synthetic tax consolidation strategies; and
- Debt restructurings and planning to mitigate the impact of the debt forgiveness rules.

Planning to retain Canadian-controlled private corporation (CCPC) status

Certain private companies that are economically controlled by non-Canadians have undertaken planning to retain CCPC status in order to retain favorable SR&ED investment tax credits.

Reporting: what does the client want to know?

Exercising due diligence in reporting includes telling a client not just what you have found but what it means to the client. This means incorporating the following best practices:

- Describe each significant tax exposure identified.
- Quantify the amount of each significant tax exposure identified and assess its level of risk.
- Make recommendations to mitigate the tax exposures such as obtaining comprehensive representations, warranties and indemnities and/or what practices can be changed on a go forward basis.
- Identify opportunities to reduce future cash taxes.

The nature of the report can depend on various factors including:

- Time available to complete the report: Often with a tight reporting deadline there is insufficient time to complete a detailed report.
- The tax literacy of the reader of the report: Non-tax readers such as the deal team may only value key findings that briefly outline the tax issue, the likely dollar amount of the tax exposure and the tax advisor's risk assessment. It is important when reporting to the deal team to describe the issue briefly and in non-technical language (i.e., avoid the use of tax section/code references).

On the other hand, the tax director of the investor may value a comprehensive analysis that sets out in detail the tax issues identified so that they can make their own assessment of the level of risk. As well, tax directors often need further detail so that they can assess the accounting implications of the tax issues identified such as the current vs. deferred tax implications for the post-closing balance sheet and whether a reserve will need to be booked for the tax exposures.

In situations where the requirements of both the deal team and the tax director need to be met, the agreed work plan can provide that reporting will involve both key finding and detailed reporting sections.

Following the delivery of the report it is recommended to discuss the report with the client to assess whether they understand the issues identified d and have any follow-up questions. Following this stage the tax practitioner should agree with the client on the scope of any further work. It is best practice to document the agreed expansion in scope in an addendum to the engagement letter.

Conclusion

In this paper, we have approached due diligence from the perspective of both the advisor and the client.

In our view, due diligence from the perspective of the advisor means adequate and prudent review and investigation of client representations and other information provided before providing advice and dealing with tax compliance. It also means understanding client objectives and appropriate research to properly formulate advice. Although we found no cases of sanction by a self-regulatory body for lawyers, CA's or CGA's for inadequate investigation in a tax matter, the link to potential civil liability for professional liability where the advisor does not exercise due diligence can mean failure to meet the standard of care. It is always important to establish scope of work and client expectations. Although the spectre of the third party civil penalty in section 163.2 , ITA looms over advisors, appropriate due diligence on the part of advisors should protect against an assertion of culpable conduct.

We have also discussed due diligence from the perspective of the client with reference to tax due diligence in an acquisition transaction. We have suggested a systematic approach to the project involving planning, establishing scope, execution and reporting and set out suggested best practices.

Appendix I - (Examples from IC 01-1)

CRA has provided a number of examples to illustrate circumstances where it would or would not assess third party penalties. The following examples are applicable to a tax advisor's dealings with client representations.

Example 1: Good Faith Reliance on Client's Information

A newly acquired client, who is self-employed, brings to his accountant a listing of his business expenses. The client also provides the accountant with a figure for his total revenue. He instructs his accountant to prepare an income statement and his tax return based on this information. The accountant has a quick look at the expenses. The expenses seem to be related to the type of business of the client and nothing stands out as obviously unreasonable. After the client's income statement is prepared, it reflects $80,000 of revenue and $55,000 of expenses and the income tax return is filed on that basis.

Upon audit, the CCRA finds a large proportion of the expenses claimed cannot be substantiated by adequate documentation and may not have been incurred. Furthermore, the reported revenue is only half of actual revenue.

CRA Comments

In view of the business that the taxpayer is in, there was nothing in the income statement that would have made the accountant question the validity of the information provided to him. Therefore, he could rely on the good faith reliance exception and would not be subject to the preparer penalty.

Example 4: Reconciling Inconsistent Information

An accountant who lives in an expensive neighbourhood notices that the house next door has just been sold. It was listed for $1 million. The accountant introduces himself to the new neighbour and they become friends. At tax time the friend hires the accountant to prepare his return. The accountant is given a T4 with $25,000 in income reported. Thinking that the gross income is on the low side, the accountant asks if this is all the income he has and the friend replies that it is so. The accountant is still not satisfied with the answer as the income seems to be out of proportion with the living standard of the friend, so he then asks him if he has received money from any source other than his employment and the friend replies that he received an inheritance from his mother last year. The accountant does not ask any further questions but prepares and files the return. When the taxpayer is audited it is discovered that he has over $200,000 in income.

Comments

The accountant would not be subject to the penalties for participating or acquiescing in the understatement of a tax liability. The facts were highly suspect until the accountant asked questions to clear up the doubt in his mind that the client was not presenting him with implausible information. The response addressed the concern and was not inconsistent with the knowledge he possessed.

Example 6: Making Sufficient Inquiries

A tax advisor is a partner in a firm that has a particular corporate client. The client has recently increased the royalty payments to its non-resident parent company as instructed by its parent company. The tax advisor suspects that the deduction of royalties might be unreasonable because of the large increase over the previous year. The advisor reviews the client's records and discusses the issue with the client. Based on the review and the discussion, the advisor is satisfied that the deduction is reasonable and files the corporate tax return on that basis.

Subsequently, an audit of the corporation determines that the company did not satisfy the requirements of subsection 247(4) of the ITA, as it failed to establish that reasonable efforts were made to determine and use arm's length transfer prices on the royalties. The royalty adjustments for the year are in excess of 10% of the company's gross revenues.

Comments

The tax advisor was suspicious of the information provided by the client. Therefore, he reviewed the client's records and had a discussion with the client. The advisor was satisfied with the inquiries. Although the CCRA came to a different conclusion in a subsequent audit, it was satisfied that the false statement was not made knowingly or in circumstances amounting to culpable conduct. The tax advisor had made sufficient enquiries. Furthermore, his response to the answers provided by the corporate client did not show an indifference to compliance with the ITA.

The corporate client may be subject to the transfer-pricing penalty under subsection 247(3) , since he failed to make reasonable efforts to determine and use arm's length transfer prices on the royalties. Before the transfer-pricing penalty can be proposed, the matter must be approved by the Transfer Pricing Review Committee.

Example 12: Indifference When There Is a Lack of Information Submitted

A taxpayer approaches a tax return preparer to prepare and e-file his tax return. Prior to this, the tax return preparer and his firm did not provide any services to the taxpayer and they did not know each other.

The taxpayer provides the tax return preparer with a T4 slip indicating that the taxpayer has $32,000 of employment income, which represents his sole source of income.

The taxpayer tells the tax return preparer that he made a charitable donation of $20,000 but forgot the receipt at home. The taxpayer asks that the tax return preparer immediately prepare and e-file the tax return without obtaining the receipt.

Comments

On these facts, if the tax return preparer were to prepare and e-file the taxpayer's return without obtaining the charitable donation receipt, the CCRA would consider assessing the tax return preparer with the preparer penalty. Given that the quantum of the deduction is so disproportionate to the taxpayer's apparent resources as to defy credibility, to proceed unquestioningly in this situation would show willful blindness and thus an indifference as to whether the ITA is complied with.

Example 16: Indifference Regarding Personal Expenses Claimed as Business Expenses

An accountant receives a box of personal and business receipts from his client and agrees to prepare a business expense statement for him. The accountant includes the $10,000 cost of the client's family vacation (which he knew to be a non-deductible personal expense) as a business expense in the client's tax return.

The accountant prepares and finalizes the client's tax return and advises the client that he will be receiving a $5,000 tax refund. The client signs and files the tax return.

The CCRA conducts an audit and discovers the $10,000 of personal expenses deducted in the client's tax return. The auditor also discovers that the families of the accountant and the client vacationed together. Therefore, the accountant knew the expense was personal at the time he included it in the business expenses.

Comments

The CCRA would consider assessing the accountant with the preparer penalty because the return was prepared and filed despite his knowledge of the false statement. Also, the CCRA would consider applying the gross negligence penalty (subsection 163(2) of the ITA) to the client in whose tax return the false statement was made.

[1] Sherbaniuk, D.J., "The Liabilities of Tax Advisers", 1978 Conference Report 96-131 at p.97. There have been a number of excellent papers on professional responsibility and tax practice in earlier Canadian Tax Foundation conferences. For example, see McDonnell, T. E., "Professional Responsibility and Tax Practice", 1975 Conference Report 953-968; Snider, K., "Errors & Omissions in Tax Practice", 1993 Ontario Conference 11A; Bowman, F.E.P., "Defensive Measures _ The Litigation Perspective", 1994 Ontario Conference 17A; Wilson, B.J., "Defensive Tax Practice". 1997 Ontario Conference 14.

[2] *Farish v. National Trust Co.* (1975), 54 DLR (3d) 426.

[3] R.S.C. 1985, c.1 (5th supp.), as amended (herein referred to as "ITA). Unless otherwise stated, statutory references in this paper are to the ITA.

[4] 2012 TCC 287.

[5] Thank you to Tim Lemieux, practicePro Co-ordinator, Lawyers' Professional Indemnity Company for his assistance in providing statistical information regarding claims.

[6] 2012 CICA National Conference on Income Taxes, "Tax Practice Operations and Risk Management _ Best Practices", a presentation by Gabe Hayos and Brian Wilson.

[7] R.S.O. 1990, c. L-8.

[8] See section 41, *Law Society Act*:A licensee fails to meet standards of professional competence for the purposes of this Act if,

(a) there are deficiencies in,

(i) the licensee's knowledge, skill or judgment,

(ii) the licensee's attention to the interests of clients,

(iii) the records, systems or procedures of the licensee's professional business, or

(iv) other aspects of the licensee's professional business; and

(b) the deficiencies give rise to a reasonable apprehension that the quality of service to clients may be adversely affected

[9] Grant, Stephen M. and Rothstein, Linda R., "Lawyers' Professional Liability", 2nd ed. (Toronto: Butterworths, 1998), p.9. See also Campion and Dimmer, "Professional Liability In Canada, looseleaf service (Toronto: Carswell), p.7-10.

[10] 2010 DTC 5134 (Sask QB), paragraph 119.

[11] S.O. 2010, c.6, Schedule C.

[12] The Institute Of Chartered Accountants Of Ontario Rules Of Professional Conduct Adopted or continued under the authority of Section 63 and Section 65 of the *Chartered Accountants Act, 2010*, S.O. 2010, c. 6, Schedule C and the bylaws of the Institute as amended from time to time.

[13] ICAO Rules —Forward page 6.

[14] Matter of Kathryn A. Cook dated November 28, 2005. Unfortunately, the facts of this case are not altogether clear as they are set out in exhibits that are not available to the public. The case states that she "lent her name and designation to approximately ninety letters confirming her opinion that named investments were qualified investments for RRSPs in accordance with the Income Tax Act and Regulations when she knew or should have known that she did not have sufficient information or

technical knowledge to provide the opinion" and that she "was not an active participant in the investment scheme and that, through ignorance, had no idea it was a scheme." This appears to imply that the accountant was in part disciplined because she did not adequately question certain information provided by her clients.

15 Schedule A to the Association Bylaws: The Code of Ethical Principles and Rules of Conduct

16 [1986] 2 SCR 147.

17 [1991] 2 CTC 91 (BC SC).

18 Robertson, J.R., "Capital Gains Strips: A Revenue Canada Perspective on the Provisions of Section 55", 1981 Conference Report p.81.

19 Supra, footnote 17, paragraph 49.

20 Supra, footnote 10.

21 Supra, footnote 16, paragraph 67

22 See Campion & Dimmer, supra footnote 9 at p. 7-26.

23 1995 CarswellNS 385 (NS CA).

24 2010 CarswellNB 460 (NB QB) affirmed 2011 CarswellNB 755 (NB CA).

25 1992 CarswellOnt 635 (Ont CJ), paragraph 101.

26 Definition may be found in s.1.03 of Rule 1. Procedures may be found in s.2.20(6.1)-(6.3) of Rule 2.

27 *Brown and Argali Holdings Inc. v. Shortreed* 1987 CarswellAlta 140 (Alta QB). In this case, the plaintiff stated that he was not relying on the defendant lawyers for tax advice and had no discussions with them on tax matters. He also stated that he was looking to the defendant accountants for tax advice. The plaintiff discontinued his action against the accountants for unspecified reasons.

28 This statement might be challenged based on the *Confederation Life* case, supra footnote 25. Confederation Life itself would surely have been considered a sophisticated client, yet the defendant lawyer was held liable for breach of the implied duty to warn. However, the evidence was that the plaintiff expressly asked if the requested consent would adversely affect the mortgage. The implied duty to warn accordingly seemed to have a stronger nexus to the terms of retainer.

29 1993 CarswellAlta 297 (Alta QB).

30 Supra, at paragraph 41.

31 Supra, at paragraph 26.

32 *Arkelian v. Daley* 1992 CanLIl 1302 (BC SC); *Ormindale Holdings Ltd. v. Ray, Wolfe, Connell, Lightbody & Reynolds* 1982 Can LIl 445 (BC CA).

33 IC 01-1 paragraph 3.

34 IC 01-1 Foreword. See the third of eight principles stated by Bill Baker (Assistant Commissioner, Compliance Programs Branch), CRA at the 2000 Annual Conference in "Civil Penalties: Case Studies": "The third principle, which is straightforward, is that the legislation is intended to address those advisers who counsel and assist others in making false statements on filing their returns. This includes tax preparers and others who provide advice to taxpayers in the preparation and filing of their tax returns as well as those preparers and advisers who are wilfully blind to obvious errors in preparing or filing a return or assisting a taxpayer in preparing or filing a return." The eight principles were included in the draft *Information Circular* released by CRA for comment and mostly incorporated in the final version. See Blom, D.C. and MacKnight, R.J., "Third Party Civil Penalties", 2001 Conference Report p38:1 at 38:2 for discussion of same.

35 Third Party Civil Penalties", September 18, 2001.

36 For instance, presentation at Annual Seminar for Ottawa Region Tax Practitioners on January 19, 2005 presentation by Shawna O'Brian of CRA dated May 23, 2007. See also "Civil Penalties: Case Studies", 2000 Conference Report.

37 Section 285.1 of the Excise Tax Act.

38 Subsection 163.2(2)

39 Subsection 163.2(3)

40 Subsection 163.2(4)

[41] Subsection 163.2(5)

[42] Subsection 163.2(1)

[43] IC 01-1 paragraph 24

[44] Explanatory Notes to S.C. 2000, c.19, s.50.

[45] IC 01-1 paragraph 63. This was said somewhat more expansively as the last of the eight principles by Bill Baker at the 2000 Annual Conference, supra footnote 34:"The final principle is that this legislation does not seek to impose a standard of conduct that is beyond what is expected by a professional's governing body. I have taken the time to look at the standards of conduct that guide all of you, and there is quite a bit of complementarity between what we are trying to accomplish here through this legislation and what you set out as a code of conduct for yourselves. The fact is, professionals and non-professionals alike are expected to act in a professional manner. This legislation is designed to deter inappropriate behaviour, and these principles of application will be the gauge by which behaviour will be considered. The law is intended to apply to the bad guys and not to those advisers and planners who act honestly in discharging their professional responsibilities. Our view is that substantially all professionals act responsibly, and we don't expect that most professionals will ever be faced with a penalty consideration. It is in the interest of the government and the tax professionals that the behaviour this legislation addresses is not condoned."

[46] Rather alarming, the CRA Audit Manual at paragraph 28.4.6 in the discussion of a subsection 163(2) gross negligence penalty of a taxpayer states: "When a representative was clearly negligent in preparing the taxpayer/registrant's return, Third-Party Civil Penalties should be considered and the taxpayer/registrant should be informed of the situation to ensure that it does not recur."Query the meaning of "clearly negligent".

[47] IC 01-1 Foreword.

[48] IC 01-1 paragraph 79.

[49] Supra, footnote 34.

[50] Thank you to Wayne Adams for his assistance in obtaining CRA statistics.

[51] *Venne v. The Queen*[1984] C.T.C. 223 (FCTD), paragraph 37.

[52] *Udell v. Minister of National Revenue* 1969 C.T.C. 704 (Excheq. Ct.), paragraph 50.

[53] IC 01-1 paragraph 24.

[54] The "good faith" exception in subsection 163.2(6) does not apply to a statement made by an advisor in the course of an "excluded activity". The latter is defined in subsection 163.2(1) and includes a tax shelter and what is referred to in IC 01-1 as a "tax shelter-like arrangement", i.e., an arrangement one of the main purposes for a person's participation in the arrangement is to obtain a tax benefit". Concerns had been expressed by commentators whether this could include innovative tax ideas developed for one client and then also used for the benefit of others.

[55] IC 01-1 paragraph 35.

[56] Ibid.

[57] IC 01-1 paragraph 65.

[58] For example, see Turner, Graham, "Tax Clauses in Acquisition Agreements" 1996 Corporate Management Tax Conference 8; Kemp, Nita and Leung, Kay, "The Representations, Warranties and Covenants in a Share Purchase Acquisition Agreement: Protecting the Acquirer" in Tax Issues in Acquisition Transactions — A Practical Review (March 27, 2008 Ontario Bar Association); Kroft, Ed and Marchand, Elaine, Tax Issues in Corporate Transactions (February 11, 2011 Canadian Bar Association); Cornell, Megan and Nathans, Lara, Due Diligence Fundamentals (April 6, 2011, Canadian Bar Association).

Author Information:
Steven Hurowitz, CA - KPMG LLP Joan E. Jung - Minden Gross LLP

2012 Ontario Tax Conference, (Toronto: Canadian Tax Foundation, 2012), 13: 1-34.

Bibliography Information:
Steven Hurowitz, CA, and Joan E. Jung, "Due Diligence in the Tax Practice—What You Need To Do To Protect Yourself and Your Client," 2012 Ontario Tax Conference, (Toronto: Canadian Tax Foundation, 2012), 13: 1-34. WHAT YOU NEED TO DO TO PROTECT YOURSELF AND YOUR CLIENT