CRA's Power to Compel Taxpayers to Disclose Uncertain Tax Positions Affirmed

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*Canada (National Revenue) v Atlas Tube Canada ULC*1 is the latest in a series of cases considering the ability of the Canada Revenue Agency (CRA) to compel corporate disclosure of confidential reports analyzing the tax positions of a company. In *Atlas Tube*, the Federal Court held that CRA could compel taxpayers to disclose sensitive accounting reports in the context of an active audit under sections 231.1 and 231.7 of the *Income Tax Act.*2 Taxpayers engaging in transactional due diligence should carefully consider the source and content of reports acquired for planning purposes.

Background

In 2012, Atlas Tube Canada ULC (Atlas), a private Alberta company, was a subsidiary of a private U.S. company called JMC Steel Group Inc. (JMC). On March 30, 2012, JMC acquired the shares of a public Ontario corporation, Lakeside Steel Inc. (LSI), for $148 million, by way of a plan of arrangement approved by the Ontario Superior Court of Justice. LSI was a holding company which owned two subsidiaries: Lakeside Steel Corporation (LSC), an Ontario company, and Lakeside Steel Holdings USA Inc. (LSU). The purchase transaction included the following pre- and post-acquisition steps:

1. Another amalgamation of LSI to form a new LSI;
2. Transfer of LSU shares by the new LSI to JMC for a stated value of $57 million;
3. Transfer of new LSI shares and debt of $32 million to 6582125 Canada Inc. (658) resulting in a $90 million debt owing by 658 to JMC; and
4. Atlas acquiring the $32 million debt and new LSI shares from 658, and consequently owing $90 million to 658.

CRA audited Atlas for its taxation year ended April 21, 2012, and reviewed the steps in the purchase transaction above as part of that audit. In particular, CRA was considering the issues of whether:

1. The $57 million of stated value for LSU shares was fair market value; and
2. The rate employed in Atlas's interest expense deduction for the debt owed to 658 was reasonable.

In preparing for the transaction, a due diligence process was conducted by JMC. As part of the due diligence process, Ernst & Young LLP (Canada) (EY) was engaged to

conduct Canadian tax diligence upon the recommendation of JMC's Canadian legal counsel, Stikeman Elliott (Stikeman). EY prepared a draft due diligence report (the Report), the information in which was shared with Stikeman. CRA requested a copy of the Report in its audit of Atlas, which refused, citing solicitor-client privilege.

The Federal Court Decision

The Federal Court was asked to consider two major issues:

1. Was the Report relevant to the audit under section 231.1 of the ITA? If so, was it protected by solicitor-client privilege?
2. Would compelling the Report impose an obligation to self-audit on Atlas, which would be prohibited by case law?

With respect to the first issue, the Court held that relevancy has a low threshold under section 231.1 of the ITA. Citing jurisprudence from the Federal Court of Appeal, the Court noted that seeking to obtain information relevant to the tax liability of a person whose liability is under investigation is a purpose related to the administration or enforcement of the ITA, even if much of the information requested turns out to be irrelevant. Ultimately, it is CRA's prerogative as to whether it will conduct an audit and what form that audit will take. The taxpayer's books and records are relevant, even if simply to verify that they have no impact on a taxpayer's tax liability. A record does not have to be relevant to a particular issue under audit in order to be compelled; it simply has to be relevant in determining a taxpayer's tax liability. Consequently, even though the Court agreed with Atlas that the CRA's specific reasoning behind requesting the Report was flawed, the Report was compellable because it may shed light on the general tax attributes of Atlas.

The Court also considered the issue of solicitor-client privilege. The Report itself was not a direct communication between solicitor and client prepared for the purpose of providing legal advice, and as such, was not automatically protected by privilege. The Court nevertheless considered whether solicitor-client privilege could apply to the Report. It concluded that the dominant purpose of the Report when commissioned was to inform the decision about whether to proceed with the transaction, and at what price, rather than the purpose of obtaining legal advice on the structure of the transaction. Thus, the Court held that solicitor-client privilege did not apply. To the extent that the Report or information in it also informed Stikeman's ability to give legal advice, that purpose was ancillary to the business rationale, and thus Atlas failed to meet its burden of establishing that the Report was protected by privilege.

Finally, the Court held that Atlas was not protected by the principle that a taxpayer is not compelled to self-audit. This principle was established recently by the Federal Court of Appeal in *BP Canada Energy Company v Minister of National Revenue*.3 Atlas argued that the Report revealed LSI's and LSC's uncertain tax positions regarding prior tax years, which did not relate to the taxation year of Atlas under audit, and objected to producing a roadmap of uncertain tax issues for the two related companies. The Court recognized that the decision in *BP* precluded general and unrestricted access to tax accrual working papers on a prospective basis, outside of the context of an audit of particular issues. In the case at hand, however, the Court took a narrower view of the decision in *BP*, holding that there was an active audit and thus, any of Atlas's working papers could thus be compelled.

Takeaways

While the taxpayer was unsuccessful in resisting production of its due diligence reports in this case, significantly, the Court recognized that such reports, even if prepared by non-lawyers, can be protected by solicitor-client privilege in certain circumstances. Should a taxpayer wish to have the option of resisting production of due diligence reports, legal advice should be sought as to how to structure the engagement of the preparer of such reports – here, EY – from the outset in order to be best positioned to claim privilege over due diligence reports when CRA seeks to compel their production.

1 2018 FC 1086 [*Atlas Tube*].

2 RSC 1985, c 1 (5th Supp) [ITA].

3 2017 FCA 61.

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