NOVEMBER 27, 2018

Federal Court's Decision in *Atlas Tube Canada ULC*: Beware, Tax Due Diligence Reports May Not Be Privileged

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In *Canada (National Revenue) v Atlas Tube Canada ULC*, the Federal Court (FC) held that the Canada Revenue Agency (CRA), in the course of an ongoing audit, was entitled to a draft tax due diligence report (Report) prepared by the accounting firm Ernst & Young (EY).

The Report was commissioned, on the advice of legal counsel, by the general counsel of Atlas's U.S. parent, JMC Steel Group Inc. (JMC), in the context of the M&A transaction that led to Atlas's acquisition. At issue was whether the Report was covered by solicitor-client privilege and whether the forced disclosure of the Report violated Atlas's right not to be required to self-audit.

Exception to Disclosure in an Audit

The CRA's power to demand documents and information when auditing a taxpayer is very broad. This power extends to all documents or information that may be required to verify compliance with the *Income Tax Act* (ITA).

Nonetheless, solicitor-client privilege is specifically carved out of reach of CRA auditors in section 232 of the ITA. In *Canada (Attorney General) v Chambre des notaires du Québec*, the Supreme Court of Canada found that the protection of solicitor-client privilege has quasi-constitutional status and must be "as close to absolute as possible." Generally, when documents are created for the principal purpose of providing legal advice, they are covered by solicitor-client privilege.

Background

Atlas, a private Canadian company, is a subsidiary of JMC, a private U.S. company. In 2012, before JMC acquired the shares of Lakeside Steel Inc. (LSI), a public Ontario corporation, its general counsel engaged EY to perform Canadian tax due diligence. In its Report, which was communicated to JMC, EY explained, *inter alia*, (i) the tax profile and tax attributes of LSI and its subsidiary and (ii) LSI's subsidiary's material tax exposures resulting from its Canadian tax filings for the previous four taxation years.

Soon after the transaction was completed, the CRA began its audit of Atlas, in the course of which it requested a copy of the Report.

FC's Decision

Atlas challenged the requirement to disclose the Report on three grounds: first, that the Minister did not establish that the Report was relevant to its audit; second, that the Report was governed by solicitor-client privilege; and third, that disclosing the Report would violate Atlas's right not to conduct a self-audit. All three grounds were dismissed by the FC.

The Court found that the threshold for relevance is low, in that the Minister need only prove that a document may be relevant to its audit in order to request it. Given that the Report was prepared for the purposes of the transaction under audit, this was an easy threshold to meet.

With respect to solicitor-client privilege, the Court dealt principally with the question of whether the Report was obtained for the principal purpose of JMC receiving legal advice. The Minister argued that the principal purpose of the Report was to inform JMC's business decision, whereas Atlas argued that the Report was intended to inform how JMC's counsel structured the acquisition. The Court found it unclear, on the facts, whether the Report was shared with JMC's Canadian counsel. After considering that "Canadian tax diligence was one of several categories of due diligence that JMC was undertaking with the assistance of third parties," the Court found that dominant

purpose of the Report "when commissioned and generated was to inform the decision whether to proceed with the transaction and at what price." Because the purpose of the Report was not to obtain legal advice, solicitor-client privilege was therefore held not to extend to the Report.

Atlas also relied on the recent decision *BP Canada Energy Company v Canada (National Revenue)* (*BP Canada*) to suggest that the disclosure of the Report would violate its right against conducting a self-audit. In *BP Canada*, the Federal Court of Appeal had found that the Minister was not entitled to receive internal tax accrual working papers from taxpayers since such documents are intended to assess the uncertain tax positions taken by public companies in filing their tax returns. The FC distinguished the finding in *BP Canada* on the basis that, in that case, the Minister requested documents for the purpose of facilitating audits that had yet to commence. Given that the request for the Report was made "in the context of an active audit of particular issues," *BP Canada* was found not to apply and the CRA's request was held not to "offend the principle described in *BP* that a taxpayer is not required to self-audit."

Takeaway

The FC's distinction between requests made by the CRA in the context of an active audit and those made to facilitate future audits was not made by the Federal Court of Appeal in *BP Canada*. The FC's narrow reading of the *BP Canada* decision is a reminder that taxpayers must be careful when dealing with accountants or other non-lawyers on sensitive tax matters – in particular in an M&A context – because the CRA may be entitled access to communications and documents produced by non-lawyers. Where there is sensitive information, taxpayers are best advised to first seek advice from their lawyers.

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