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The Proposed Enhancement of CRA's Audit Powers, Part Two: Unpacking the New Non-Compliance Regime

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In part one of this series, we discussed how Budget 2024 marks a significant turning point for the Canada Revenue Agency (CRA), introducing measures that substantially bolster its audit powers.

In this part, we discuss the proposed "compliance order penalty," applicable when the CRA obtains a compliance order from the Federal Court to compel a taxpayer to fulfill an outstanding audit request. We also discuss the proposed new non-compliance regime, which would enable the CRA to issue a "notice of non-compliance" and impose penalties on any person who fails to satisfy an audit request or demand, either partially or entirely.

Compliance Orders – The New Penalty

Currently, taxpayers who are under audit are required to provide responses to the CRA's questions as well as its requests or demands for information and records. If a taxpayer repeatedly fails to respond to these requests or fails to respond satisfactorily, the CRA may seek to enforce compliance by filing an application with the Federal Court for a compliance order. (Note: Budget 2024 also proposes to broaden the scope of a compliance order by including foreign-based information requirements pursuant to s. 231.6 of the *Income Tax Act*.) A taxpayer who fails to comply with a court-issued compliance order could face contempt proceedings, which may result in fines or even imprisonment.

Budget 2024 increases the consequences of non-compliance by introducing a compliance order penalty. In proposing the new penalty, Finance commented that "the use of compliance orders has generally not been effective in compelling compliance" because the primary consequence of noncompliance is a contempt order, which Finance feels is "time-consuming" and "does not generally impose a material financial cost on the taxpayer." (Budget 2024, Tax Measures: Supplementary Information, page 32.)

Under the proposed penalty, taxpayers who have been issued a compliance order are liable to pay 10 per cent of the "aggregate amount of tax payable" for the taxation years to which the compliance order relates. This penalty applies only if the tax owed for at least one of the taxation years subject to the compliance order exceeds $50,000.

Potentially Significant Monetary Penalties

The "aggregate tax payable" for a given taxation year, on which the penalty is calculated, may be indeterminate when a compliance order is granted and could remain uncertain for many years.

Moreover, the penalty is calculated as 10 per cent of the aggregate amount of tax payable for the years subject to the compliance order, not just of the tax in controversy. This could result in taxpayers paying a penalty on amounts that were never in dispute or outside the scope of the compliance order.

Consider a scenario involving a large corporate taxpayer that files its tax return on the basis that it is required to pay $10 million in tax. The taxpayer is selected for audit. The CRA accepts the taxpayer's position with respect to the $10 million in tax but takes the position that there are other amounts that were not included in income that result in additional taxes of $1 million. The taxpayer is noncompliant with the

CRA's demands for information, and the CRA successfully obtains a compliance order from the court. The CRA reassesses the taxpayer for the additional $1 million in tax.

Under the proposed framework, the corporation would face a penalty of $1.1 million, which is 10 per cent of the entire $11 million tax payable. This occurs despite the fact that the compliance order pertains solely to the contested $1 million. There is no principled reason why the penalty should be based on amounts that were not in dispute or were entirely unrelated to the subject matter of the compliance order. Finance appears to justify the computation of the penalty because it would "create an incentive for taxpayers to comply with the original request for information or assistance."

Further, it is unclear what would happen if a taxpayer is successful (or partially successful) in appealing the additional tax imposed on the audit, yet there is still an undisputed amount of tax payable for the years subject to the compliance order. Referring to the example above, if the taxpayer successfully reversed the reassessment of the additional $1 million in tax, would the taxpayer still be required to pay the 10 per cent penalty on the amount that is not in dispute (i.e., a $1 million penalty)? This would seem like an unfair result — the taxpayer would be heavily penalized for its conduct during the audit despite the fact that it ultimately prevailed in reversing the amounts that were reassessed based on this same audit.

The harshness of the above result is exacerbated by the fact that the amount of the penalty is nondiscretionary. The penalty does not consider the extent of the taxpayer's compliance, the usefulness of the information obtained or the result of the taxpayer's objection and appeal, if any, to any reassessments. This may lead to disproportionate penalties that do not reflect the taxpayer's compliance efforts or the actual result of the audit. Although the penalty is intended to encourage prompt and full compliance with audit requests, it is hoped that Finance will reconsider the computation of the penalty to avoid overly harsh results.

The Introduction of a 'Notice of Non-Compliance'

Budget 2024 also introduced a "notice of non-compliance." Under this measure, the CRA may send a notice of non-compliance at any time to a person who the CRA determines has not complied in full or in part with a request for information. The consequences of a notice of non-compliance are severe and include:

1. a daily penalty of $50, capped at $25,000 while the notice of non-compliance is outstanding; and
2. a suspension of the limitation period for the CRA to reassess the taxpayer.

A person who has been served with the notice of non-compliance may request that the notice be reviewed. If this second review confirms the CRA's original decision, the person can file an application to the Federal Court for judicial review. Notably, the daily penalty continues to accrue during any CRA or Federal Court review.

Determination of Non-Compliance is at the CRA's Discretion

Whether a person has been compliant with a request for information is entirely at the discretion of the CRA. Even partial non-compliance is sufficient to trigger the notice, so it is possible that a person could be issued a notice despite substantial compliance. In many cases, what is considered "compliant" may well be up for debate — for instance, the CRA may consider a response that is merely unsatisfactory to be non-compliant, even though best efforts were used by the person in providing the response. Leaving the determination of what is compliant entirely in the CRA's hands risks unfairly subjecting taxpayers to financial penalties.

Any Person May Be Subject to a Notice of Non-Compliance

Under the current rules, the CRA has broad powers to request information from "any person" or compel "any person" to attend interviews, not just the taxpayer who is under audit. The term "person" can range from employees, directors and shareholders to professional advisers, such as accountants or lawyers. The new notice of non compliance can also be issued to "any person," which could be problematic for professional advisers attempting to balance their responsibilities to their clients with their obligation to comply with CRA requests.

Limitation Periods May Be Suspended by the Actions (or Inaction) of Others

In general, there is a limitation period within which the CRA may reassess a taxpayer for a particular taxation year. Limitation periods serve to provide taxpayers with some certainty and finality about their tax affairs.

The issuance of a notice of non-compliance suspends the limitation period while the notice remains outstanding. (Revenu Québec has a similar ability to suspend the limitation period until a taxpayer complies with a compliance order (see s. 25.1.2 of the *Tax Administration Act*, RLRQ, A-6.002 for a compliance order issued under s. 39 of the same Act.)) Whether a notice remains outstanding is based on whether a person has complied with or demonstrated that they have done everything reasonably necessary to comply with each requirement of the notice of non-compliance. This seems premised on objective and subjective factors which may be difficult to assess and may result in an unfair suspension of the limitation period.

More worrying is that a notice of non-compliance may suspend the limitation period for a taxpayer even if the notice is sent to a person who does not deal at arm's length with the taxpayer. There could be situations where the parties are legally considered to be dealing at non-arm's-length (e.g., sister companies under control of a common parent) but are not aware that the other party is being audited. It would seem contrary to the principles of certainty and predictability underlying limitation periods if the actions of the related party could suspend the limitation period of the taxpayer.

Conclusion

As the saying goes, "If all you have is a hammer, everything looks like a nail." The level of noncompliance (real or perceived) necessary for the application of the new rules appears to be low. Without guidance from the CRA on the intended scope and application of these new rules, there is a concern that auditors will deploy these new tools frequently and capriciously. Clear guidelines from the CRA will serve to limit their potentially arbitrary and inconsistent application and to build trust with taxpayers to promote collaborative, rather than combative, relationships.

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