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# Accountants, Privilege, and the Problem of Working Papers

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# Accountants, Privilege, and the Problem of Working Papers

*Full and frank disclosure between corporate issuers and their auditors and accounting advisors is critical for maintaining access to the information required for audits and public confidence in the capital markets. While tax authorities in the United States, Australia, New Zealand and the United Kingdom have the power to make broad requests for working papers, in all four jurisdictions, legislation or administrative practice reflects the determination that the best approach for balancing tax and capital markets requirements is for the revenue authorities to seek working papers only in exceptional circumstances. Additionally, limited forms of privilege for accountants have been recognized in all four jurisdictions. In contrast, Canada Revenue Agency practices require broad disclosure of corporate information and working papers. This paper suggests that the result of CRA practice is to restrict access for auditors to information necessary for the assessment of financial statements and required by capital markets. It argues that by driving corporations to seek tax advice from lawyers rather than accountants, CRA paradoxically is creating an environment where less information, not more, is available for tax authorities. The author proposes that the CRA adopt a policy of requesting working papers and information only in exceptional and well-defined circumstances. Such a policy would accord with recent corporate governance reforms aimed at encouraging more open and transparent financial reporting, and would bring Canadian practice in this area into step with recent international developments.*

*La divulgation complète et franche entre les sociétés émettrices, leurs vérificateurs et leurs conseillers comptables est cruciale pour préserver l'accès à l'information nécessaire aux vérifications et, par conséquent, la confiance du public dans les marchés financiers. Quoique les administrations fiscales aux États-Unis, en Australie, en Nouvelle-Zélande et au Royaume-Uni ont le pouvoir de faire des demandes élargies pour des documents de travail, dans les quatre pays les lois ou les pratiques administratives reflètent la détermination que la meilleure façon de respecter l'équilibre entre les exigences fiscales et celles des marchés financiers est pour les administrations fiscales les pratiques de l'Agence du revenu du Canada (ARC) exigent la divulgation exhaustive des renseignements relatifs à une société et de ses documents de travail. L'auteur conclut que les méthodes absolues pratiquées par l'ARC ont pour résultat un accès limité, pour les vérificateurs, aux renseignements nécessaires à l'examen des états financiers et requis par les marchés financiers. De plus, en forçant les sociétés à demander des conseils d'ordre fiscal à des avocats plutôt qu'à des comptables, l'ARC crée, paradoxalement, un environnement où les administrations fiscales ont accès à moins plutôt qu'à plus de renseignements. L'auteur propose que l'ARC adopte une politique prévoyant qu'il soit permis de demander la communication des documents de travail et de certains renseignements uniquement dans des circonstances exceptionnelles et bien définies. Une telle politique s'accorderait avec les récentes réformes apportées à la régie d'entreprise qui visent à encourager des rapports financiers plus ouverts et plus transparents, et elle adapterait les pratiques canadiennes aux récents développements internationaux.*

*Introduction*

At the Canadian Tax Foundation Tax Conference in Toronto on September 28, 2004, representatives of the Canada Revenue Agency (CRA) stated that CRA would be conducting a broad-based consultation with the tax, accounting, and business communities about clarifications to CRA's policy regarding their access to accountants' and auditors' working papers, particularly those dealing with the analysis of tax provisions or tax liabilities.[1] CRA's announcement came on the heels of anecdotal reports of general requests by certain CRA offices for audit working papers as a matter of routine, an apparent change in CRA administrative practice. While CRA authority to initiate broad requests for information from accountants is clearly authorized under the *Income Tax Act*,[2] the practice has the potential to serve as an impediment to efforts by accountants and auditors to facilitate responsible and legitimate disclosure within the self-reporting tax system.

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1. "Canada Revenue Agency Round Table," in Report of Proceedings of the Fifty-Sixth Tax Conference [2004] (Toronto: Canadian Tax Foundation, 2005) 5A:1 at 5A:5-6.

2. *Income Tax Act*, R.S.C. 1985, c. 1, s. 231 [*Income Tax Act*]. See also the discussion of *Kitsch*, *infra*, 378-382.

Further, by implementing a practice of broad requests for information, CRA has put Canada out of step with recent developments in Australia, the United States, New Zealand and the United Kingdom, all of which have limited the ability of tax authorities to seek disclosure of information from taxpayers except in clear and well-defined special circumstances. Those countries have recognized the integral relationship between tax policy and corporate governance practice, and have arrived at compromise solutions that preserve the ability of auditors to help ensure open and transparent financial reporting. The use by CRA of its broad powers to question auditors and accountants about their clients' subjective intentions and to obtain access to documents and information is in essence creating a paradox: auditors are being held to much higher standards of accountability for the accuracy of financial information being provided to capital markets than ever before, yet, if left unchecked, CRA practices are creating disincentives for clients to be open in speaking with their auditors and non-lawyer advisors.

The paradox is particularly significant in relation to audit working papers. Recent developments in auditing standards require that more information be kept in the working paper files to justify audit opinions for financial reporting purposes in capital markets. If CRA routinely seeks access to accountants' and auditors' working papers, as recent CRA practice and policy suggest, clients will be reluctant to disclose information to auditors for financial reporting purposes that could be exposed in a tax audit. As a result, there will be a negative impact on the quality of information available to conduct the audit, and, in turn, there will be less information available to capital markets. If Australia and the United States, in particular, have found a working balance between capital markets and tax system imperatives, surely Canadian authorities ought to be able to do the same.

The proverbial "elephant in the corner" in this discussion is privilege. Lawyers in Canada have it, accountants do not, and the decision of the Federal Court of Appeal in *Kitsch*[3] has unleashed the threat not only that CRA will be able to engage in expansive documentary requests from taxpayers' accountants, but also to demand responses from accountants about their clients' intentions. If CRA policy continues in its present direction, the inevitable result will be the flight of taxpayers to lawyers rather than accountants for tax advice, ironically resulting in the availability of less information to CRA auditors, not more.

3. *Tower v. M.N.R.*, [2004] 1 F.C.R. 183 (C.A.), overturning *Tower v. M.N.R.*, [2003] 2. F.C 146 (T.D.) (*Kitsch*).

This article sets out current CRA practice on audit working papers and demands for information. It details international developments critically relevant to CRA policy and Canadian competitiveness, and seeks to offer a principled rationale for limiting CRA requests for access to auditor and accountant working papers to exceptional circumstances such as instances of fraud or misrepresentation. In a self-reporting system, it is evident that CRA requires access to source documents related to transactions or events linked to the determination of tax liability. Working papers, however, do not constitute evidence of these transactions and are not directly relevant to the determination of a corporation's tax liability under the *Income Tax Act*. Implementing broad requests for papers will serve as an impediment to efforts by accountants and auditors to facilitate responsible and legitimate disclosure within the self-reporting system and could well lead to the adoption by companies of protocols that would endeavor to cloak with privilege procedures leading to estimates of tax liabilities. The end result would be litigation over those procedures and a less efficient and transparent system, an outcome contrary to the directions of other recent reforms. Further, it will drive Canada away from harmonization of its efforts with Australia, the United States and the United Kingdom. These are countries with which it has announced major initiatives to promote tax integrity and CRA thus far has articulated no rationale for diverging from them.[4]

I. *Background: working papers and CRA policy*

In Canada, "working papers" is a term of art, so some description of them is important for understanding this issue. In the context of an audit, working papers addressing the analysis of the tax provision or tax liabilities are, in essence, those which reflect the estimate of a company's tax provision or liabilities. The papers may be created within the organization, or by an outside auditor or advisor in cooperation with management. Certain elements of the tax provision are readily quantified, while others require judgments estimating the impact of identified or non-identified tax results. Working papers prepared by the auditor reflect the auditor's views in fulfilling its responsibility to probe, question and exercise its professional judgment for the purpose of forming an opinion on the company's financial statements. These papers are not the same as working papers generated in connection with the preparation of the company's annual tax return.

4. For example, the Joint International Tax Shelter Information Centre (JITSIC) in partnership with Australia, the United Kingdom, and the United States, discussed further below and in Canada Revenue Agency, "Aggressive International Tax Planning Centres of Expertise," August 2005, online: <http://www.cra-arc.gc.ca/newsroom/factsheets/2005/aug /050823-e.html>.

In recent U.S. corporate governance reforms, in particular the *Sarbanes-Oxley Act of 2002*[5] and rules promulgated under it by the Securities and Exchange Commission (SEC), "work papers" have been defined as "documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by standards established or adopted by the [SEC] or by the Public Company Accounting Oversight Board."[6] The relevant SEC Final Rule Release notes that section 802 of the *Sarbanes-Oxley Act* was intended to require more than what was traditionally thought of as an auditor's "work papers," and explains that the definition adopted accords with an understanding of the documents required to be retained under Generally Accepted Auditing Standards (GAAS).[7] Different definitions have been applied to delineate different kinds of work papers relevant to tax provisioning in the United States. A 2004 Internal Revenue Service (IRS) document, discussed further below, categorizes work papers typically prepared for publicly traded corporations into three groups and provides detailed definitions of "audit work papers," "tax accrual work papers," and "tax reconciliation work papers."[8] The *Sarbanes-Oxley Act* requirements mandate that auditors of publicly listed companies require appropriate documentation to substantiate a tax provision. Key schedules, reconciliations or similar source documents pertaining to significant issues in the audit need to be retained. That is so even if they are not otherwise necessary for inclusion in the audit file because they constitute financial information received in the course of the audit that is considered relevant to the audit or review of an SEC registrant or its subsidiary. The document retention requirements and the related need to be independently satisfied of material inputs into the financial statements of the company being audited have meant a transformation in approach to the audit and have imposed new and significant obligations.[9]

The Public Company Accounting Oversight Board (PCAOB) is a private, non-profit corporation established in the United States pursuant

5. *Sarbanes-Oxley Act of 2002*, Pub.L. 107-204, 116 Stat. 745 (2002) [*Sarbanes-Oxley Act*].

6. 17 CFR Part 210, ss210.2-06(1)(b) [Release Nos. 33-8180; 34-47241;.IC-25911;.FR-66; File No. S7-46-02].

7. *Ibid.* at p. 5.

8. US Internal Revenue Service, "IRM Par 4 Examining Process, Chapter 10 Examination of Returns, Section 20 [I.R.M. 4.10.20] Requesting Audit, Tax Accrual, or Tax Reconciliation Workpapers," online: <http://www.irs.gov/pub/irs-utl/tawpirm070904 checked.doc> [I.R.M. 4.10.20] at 4.10.20.2.

9. See, for example, Public Company Accounting Oversight Board, Bylaws and Rules – Standards – AS 3, Auditing Standard No. 3 – Audit Documentation, June 9, 2004, online: <http://www.pcaobus.org/Rules_of_the_Board/Documents/Rules_of_the_Board/AuditingStandard3.pdf>. Note that these obligations have implications beyond U.S. borders.

to the *Sarbanes-Oxley Act*. It has as its mission the oversight of public company audits, the protection of the interests of investors, and the furtherance of "the public interest in the preparation of informative, fair and independent audit reports."[10] As part of its mandate the PCAOB registers and inspects all accounting firms that issue or prepare audit opinions on the financial statements of U.S. companies and, where necessary, investigates and disciplines such firms. Foreign-based firms, including Canadian ones, are affected as the PCAOB has not excluded them from registration or inspection, regardless of whether and how they are registered and inspected under their domestic jurisdictional regimes.[11] PCAOB claims an expansive right to review audit work papers in conducting inspections of audit firms, a critical part of its mandate.[12] Given that audit documentation is required to satisfy PCAOB requirements and to support public interest and trust in audited financial reports (especially post-Enron), the U.S. tax authorities have exercised restraint in seeking access to such documentation for tax purposes. Their position is remarkable yet consistent with the primary purpose of the documentation created: the audit of the company's financial statements.

Traditionally, CRA's policy in respect of working papers was that requests to examine them would not be "routine." Indeed, the following exchange from the Revenue Canada Round Table at the 1979 Canadian Tax Foundation Annual Conference concerning CRA policy is representative:

> Question 34
> Access to Public Accountants' Files
> Some of our correspondents have stated that some assessors have routinely requested the auditors to provide their audit files for inspection. What is the Department's policy on this matter?
>
> Department's Position
> It is not the policy or practice of the Department routinely to request audit files from accountants for inspection. Normally, any such request would result only when the auditor's files form part of the taxpayer's records and a proper examination could not be carried out without access to those

10. Public Company Accounting Oversight Board, "Our Mission", online: <http://www.pcaobus.org> [home page].
11. For a discussion of the PCAOB's view with respect to its regulation of non-U.S. auditors, see Daniel L. Goelzer, "The PCAOB and the Oversight of Non-U.S. Auditors," [Speech text], April 19, 2004, online: <http://www.pcaobus.org/News_and_events/Events/transcripts/2004-04-19_Goelzer.asp>.
12. For a discussion of the PCAOB's approach to inspections, see Daniel L. Goelzer, "The Work of the Public Company Accounting Oversight Board and its Impact on Tax Services," Luncheon Address at the Advanced Forum on Global Transfer Pricing American Conference Institute, November 10, 2004, online: <http://www.pcaobus.org/News_and_Events/Events/transcripts/2004-11-16_Daniel_Goelzer_Speech.asp>. The rules on inspections are online: <http://www.pcaobus.org/Rules_of_the_Board/Documents/Rules_of_the_Board/all.pdf> [Section 4-Inspections, Rules 4000-4012].

> files. The more complete and sophisticated that a taxpayer's records are, the less the necessity for examination of audit files. However, in each case, the decision as to whether or not there is a need to request access to an auditor's records will depend upon the judgment of the assessor and/ or his supervisor. The powers given to the Minister – and through him his employees – under the Income Tax Act encompass and are not abused by such requests. Usually the request will be made by the assessor during his examination without recourse to a formal requirement as provided by subsection 231(3) of the Act.[13]

This issue has arisen on a number of occasions since then with essentially the same response from Canadian tax authorities.[14] The approach that auditor or accountant working papers *not* be routinely requested has been set out in CRA guidelines for obtaining information from accountants. Those guidelines provide that CRA will request the production of specific working papers when necessary to reconcile client records or where they contain closing or balancing adjustments relevant to tax returns. The guidelines also provide, however, that "it is not the policy of the CCRA to request a general access to accountant's working papers for the purpose of scrutinizing them in the course of conducting an audit."[15]

The guideline approach recognized the inherent tension between an auditor's need to access all relevant tax information for the purposes of preparing an audit of the company's financial statements, and the legitimate desire of the company to protect communications with its professional advisors (in particular, its accountants) in addressing its need for tax advice, with the benefit of privilege if possible. Corporate statutes mandating audits also provide the auditor with a statutory right to access information necessary to conduct an effective audit.[16] There is common law precedent

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13. Canadian Tax Foundation, Report of the Proceedings of the Thirty-First Tax Conference, 1979, "Revenue Canada Round Table," 631-632.

14. See Canadian Tax Foundation, Report of the Proceedings of the 42nd Tax Conference, 1990, "Revenue Canada Round Table," 50:32-50:33:

> 1) It is the department's general practice to request that accountants produce specific working papers for examination where those papers can reasonably be considered to be an extension of the client's records. In accordance with section 231.1 of the Act, the department expects accountants to produce these working papers upon request. There has been no change to this practice.
>
> 2) Where there is good reason to believe that additional relevant information, including tax-planning documentation, is in the possession of the accountant, and that information has not been provided in response to informal and formal written requests, a requirement under section 231.2 may be issued. Requests for tax-planning documentation are normally limited to circumstances in which the intention or purpose is crucial. This situation usually arises in the context of possible application of anti-avoidance provisions of the Act.

15. CRA Investigation Manual IM-11 Part-2 Tax, TOM 11.3.6(2) – "Guidelines for Obtaining Information from Accountants."

16. See, for example, the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 170.

from Alberta, recently confirmed in Ontario, for the position that privilege can be maintained over documents disclosed to an auditor to the extent that 1) such disclosure is mandated by statute; 2) the disclosure is for the limited purpose of the audit; and 3) there is no intention on the part of the company making the disclosure to waive privilege over the document being disclosed.[17] The extent of this protection, however, is limited; a corporation can turn over a privileged document to its auditors to comply with its statutory obligations without waiving privilege only over that particular document. The protection applies to a limited number of working papers and does not extend to the broad range of other information or documents a taxpayer might disclose to its auditors that should also remain confidential between accountant and client. Accordingly, if companies fear that better protection over sensitive information or documentation is required, they will be driven towards attempting to limit auditor access to privileged *and* other information. Where auditor access is provided, one response may be to restrict the notes and records that auditors keep from such reviews. Accordingly, where CRA requests and policies generate concern about leaving unprivileged documentation in a file, the practices adopted will make the work of the accountants performing the statutory audits more difficult.

The CRA's position logically will encourage companies to obtain tax advice under the cloak of legal privilege, from their lawyers rather than their accountants.[18] This will have an impact on the auditor oversight function performed by the Canadian Public Accountability Board (CPAB). The creation of CPAB was announced in July 2002 by federal and provincial financial and securities regulators, together with Canada's chartered accountants, as a new independent public oversight system for accountants and accounting firms that audit reporting issues. The federal Department of Finance described CPAB as providing:

> a new, national system of oversight for public accounting firms and their auditors who audit public companies. The CPAB will inspect audit firms and review adherence to standards applicable to public company auditors. It will impose penalties directly on audit firms and refer disciplinary

17. *Interprovincial Pipe Line v. M.N.R.*, [1996] 1 F.C. 367 (T.D.); more recently, see *Philip Services Corp. (Receiver of) v. Ontario Securities Commission*, [2005] O.J. No. 4418, (2005) 77 O.R. (3d) 209 (Ont. S.C.J. – Div. Ct.) overturning *Cineplex Odeon Corp. v. Canada (Minister of National Revenue, Taxation)*, [1994] O.J. No. 628, 114 D.L.R. (4th) 141 (Ont. Gen. Div.) and effectively confirming the *Interprovincial* approach. The *Philip Services* case was decided, though, in a non-tax and Ontario-specific context. See Carman R. McNary, "When Audit Obligations Conflict with Rights to Privilege – Who Wins?" CCH Tax Topics Number 1763-64, December 22, 2005; also Bradley Davis, "Decision explores protection of solicitor-client documents shared with auditors" *The Lawyer's Weekly* (January 27, 2006) at 10.

18. The issue of privilege is discussed further below.

> matters relating to individual auditors to the relevant provincial institute or association of professional accountants. The Board will also make recommendations on accounting standards, assurance standards, rules of professional conduct, and governance practices to the relevant professional institutes or standard-setting bodies.[19]

CPAB's stated purpose is to promote high quality external audits of public companies in Canada, and its establishment was important to ensure the confidence of the Canadian public and international investors in the functioning of Canadian capital markets.[20] Indeed, in March 2004 the Canadian Securities Administrators approved National Instrument 52-108 (Auditor Oversight) which contained a rule requiring auditors of reporting issuers to be CPAB members in good standing.[21] If an auditor has required that a client disclose a legal opinion pursuant to its statutory authority and the client seeks to maintain privilege, disclosure by the auditor to a third party such as CPAB could possibly negate that privilege. As CPAB and its auditor oversight function are new, there is as yet no guidance on this issue of privilege in the auditor oversight context. In its October 6, 2004 report on Initial Quality Inspections of the Four Largest Accounting Firms, CPAB complained about the restriction on its access to information because of claims of legal privilege, and further noted that it was seeking statutory authority to obtain access to privileged information in the context of its auditor oversight function "without the privilege attaching to that information being negated."[22]

Accordingly, any CRA policy regarding access to working papers must not be considered in isolation. As the CPAB statement indicates, the potential impact on the audit function of an increased resort to privilege is not simply theoretical musing. International experience indicates that policies about tax authorities' access to working papers need to be assessed in light of any impact that they will have on the ability of auditors to access information relevant to the financial statements of a company. A diminished audit function will have a negative effect on the proper functioning of the

19. See Department of Finance (Canada), "Fostering Investor Confidence in Canadian Capital Markets," September 10, 2003, online: <http://www.fin.gc.ca/toce/2003/fostering_e.html>.
20. See the CPAB website: <http://www.cpab-ccrc.ca>.
21. On June 27, 2003, the Canadian Securities Administrators released a draft rule that would require auditors of reporting issuers to be members in good standing of CPAB. National Instrument 52-108 (Auditor Oversight) implementing such a rule was approved on March 9, 2004 in Ontario and came into force on March 30, 2004. See online: <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040326_52-108-aud-oversight.jsp>.
22. Canadian Public Accountability Board, "Public Report on Initial Quality Inspections of the Four Largest Accounting Firms," October 6, 2004, paragraph 16, online: <http://www.cpab-ccrc.ca/dbdocs/41636b335f6cc.pdf>.

Canadian capital markets and both domestic and international investor confidence.

CRA officials also have not articulated a coherent rationale for maintaining a policy inconsistent both with developments internationally, and with its previous restraint in accessing working papers. A retreat by CRA officials into a posture of unfettered, broad access by tax auditors to all working papers would be inconsistent with domestic and international efforts to encourage accountability and transparency in both the tax system and the capital markets. The guidance from recent international efforts in Australia, the United States, New Zealand and the United Kingdom points towards a compromise that CRA officials should formally adopt.

II. *International perspectives*

Corporate governance reform and the efficient functioning of the tax system are matters of international concern. Canada has recognized this, and has participated formally with tax authorities in the United States, Australia and the United Kingdom in international efforts to share best practices and to encourage collaboration and the coordination of information. Indeed, at the same September 28, 2004 Canadian Tax Foundation Roundtable at which the question of a review of the audit working papers policy was raised, CRA representatives spoke of Canada's formal involvement in an international joint task force on tax shelters. They referred to a formal Memorandum of Understanding signed in April 2004 with Australia, the United States and the United Kingdom establishing the Joint International Tax Shelter Information Centre in Washington, D.C. They also refered to a task force goal of increased cooperation on tax transactions "perceived as abusive."[23] Accordingly, international developments dealing with auditors' and accountants' working papers are relevant and instructive for Canadian policymakers.

In particular, the approaches adopted by the IRS in the United States and by the Australian Taxation Office (ATO) to the classification of working papers, and their policies of self-imposed restraint in seeking access to working papers only in very limited circumstances provide an appropriate balance between relevant disclosure and the preservation of the need for open communication between client and accountant or auditor. The principles underlying these Australian and American approaches similarly

23. "Canada Revenue Agency Round Table," in Report of Proceedings of the Fifty-Sixth Tax Conference [2004] (Toronto: Canadian Tax Foundation, 2005), *supra* note 1, 5A:1 at 5A:7-8; the Joint International Tax Shelter Information Centre (JITSIC) is discussed further in Canada Revenue Agency, Income Tax – Technical News No 32., July 29, 2005, online: <http://www.cra-arc.gc.ca/E/pub/tp/itnews-32/itnews-32-e.html#P117_16255>; and in Canada Revenue Agency, "Aggressive International Tax Planning Centres of Expertise," *supra* note 4.

inform the steps taken in the United Kingdom as well as in New Zealand. In June 2005, New Zealand formally recognized a form of statutory privilege for accountants in order to assist taxpayers to obtain candid and independent advice and to promote voluntary compliance.[24] Developments in the United States, Australia, the United Kingdom and New Zealand are each considered in the next section.

1. *United States*

The approach of the IRS to the disclosure of work papers has generally been one of voluntary "self-restraint." Concerns about tax shelter activity have led to the development in the United States of special protocols in respect of "listed transactions," clearly identified by the IRS and publicized as being transactions in that exceptional category. The exercise of voluntary restraint regarding documentary demands and production is suspended for those transactions; this is consistent with the additional scrutiny with which the IRS views such transactions. The IRS also requires specific identification and filings regarding them. In contrast to the present Canadian approach, the general standard pertaining to requests in the United States for audit or tax accrual work papers is that such papers will be sought only in "unusual circumstances." It is noteworthy that the IRS has a broad authority to examine all working papers as a result of prior U.S. jurisprudence.[25]

On July 9, 2004, Internal Revenue Service Large and Mid-Sized Business (LMSB) Commissioner Deborah M. Nolan released new Internal Revenue Manual (IRM) guidance on requesting tax accrual work papers, with changes designed to address particular concerns about tax shelter abuse in the United States.[26] IRM Section 4.10.20 divides work papers typically prepared for publicly traded corporations and other large collectively owned entities into three categories:

24. The New Zealand Parliament passed the *Taxation (Base Maintenance and Miscellaneous Provisions) Act* 2005 [2005 No. 79] on 15 June 2005, and the Act received Royal Assent 21 June 2005 [*NZ Act*]. See the discussion *infra*, 376-378. The limited forms of privilege in the United States and the United Kingdom are discussed on pages 366-367 and 374-376 respectively. For detail on its introduction and background, see *Taxation (Base Maintenance and Miscellaneous Provisions) Bill*, 16 November 2004, online: <http://www.taxpolicy.ird.govt.nz/publications/files/bills/231bar1.pdf>; see also Hon Dr. Michael Cullen, Minister of Finance, Minister of Revenue (NZ), *Taxation (Base Maintenance and Miscellaneous Provisions) Bill, Commentary on the Bill*, 16 November 2004, online: <http://www.taxpolicy.ird.govt.nz/publications/files/novbill04comm.pdf>.

25. *U.S. v. Arthur Young & Co.*, 465 U.S. 805 (1984).

26. Deborah M. Nolan, Commissioner, Large and Mid-Size Business Division, Department of the Treasury, Internal Revenue Service "Memorandum for Large and Mid-Size Business Division," July 9, 2004, online: <http://www.irs.gov/pub/irs-utl/memo1.pdf>.

1. Tax reconciliation accounts in the work papers;
2. Audit working papers (defined in IRM 4.10.20.2), created by or for the independent auditor, providing support for the fairness opinion;
3. "Tax accrual workpapers," defined in the IRM to include "those audit workpapers, whether prepared by the taxpayer, the taxpayer's accountant or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities"; more simply put, those working papers containing details of reserves and deferred tax calculations.

With respect to the first category, disclosure is the norm. Tax reconciliation work papers are to be requested as a "routine" matter at the beginning of an examination and ordinarily come from the taxpayer, though access may be sought from the taxpayer's accountants.

For the other two categories, IRS requests for audit work papers and tax accrual work papers are rare and are to be made under the "unusual circumstances standard." "Unusual circumstances" exist when a specific issue is identified by an IRS examiner in an audit for which additional facts are needed; the examiner has sought from the taxpayer and available third parties all the facts known to them relating to the identified issue; and the examiner has sought some supplementary analysis of the issue, not necessarily contained in the work papers of facts relating to the identified issue.[27] In 2004 guidance about the "unusual circumstances standard," the IRS noted:

> Examiners should keep in mind that the taxpayer's records are the primary source of factual data to support the tax return. Audit or tax accrual workpapers should normally be sought only when such factual data cannot be obtained from the taxpayer's records or from available third parties, and then only as a collateral source for factual data. Audit or tax accrual workpapers should be requested with discretion and not as a matter of standard examining procedure.... The request should be limited to the portion of the workpapers that is material and relevant to the examination. Whether an item is considered to be material is based upon the examiner's judgment and an evaluation of the facts and circumstances of the case.[28]

The 2004 guidance is consistent with the IRS approach for about the previous twenty years. Although the United States Supreme Court

27. Defined in I.R.M. 4.10.20.3.1(2) ("Unusual Circumstances Standard"). For further discussion of the Unusual Circumstances Standard and its application, see Internal Revenue Service, "Tax Accural Workpapers Frequently Asked Questions – July 28, 2005," online: <http://www.irs.gov/businesses/corporations/article/0,,id=146242,00.html>.
28. *Ibid.*

recognized the right of the IRS to obtain tax accrual work papers in its 1984 decision in *United States v. Arthur Young*,[29] the IRS announced at the time that it would continue a policy of "restraint" and would not request such work papers as part of a standard review. The exception to the standard came about with respect to tax shelter activity. The IRS policy approach was modified in 2002[30] to direct IRS agents to exercise less restraint and routinely request tax accrual work papers in connection with tax shelter activity—in the case of "listed" or substantially similar transactions.[31]

A "listed transaction" is defined as "a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."[32] A subsequent section in the regulation provides:

> A taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction under paragraph (b)(2) of this section. A taxpayer also has participated in a listed transaction if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction under paragraph (b)(2) of this section. Published guidance may identify other types or classes of persons that will be treated as participants in a listed transaction.[33]

Listed transactions are one of six categories identified as "reportable transactions" requiring a taxpayer to attach to its return for the taxation year a disclosure statement in the prescribed form, in essence highlighting the transaction to tax authorities and signaling that it might merit additional scrutiny.

The IRS administrative direction as of July 19, 2004[34] followed Announcement 2002-63 directing an agent to make a mandatory Information Document Request (IDR) for tax accrual work papers "when a taxpayer claims the benefit of a listed transaction for a return filed on or after July 1, 2002, and for some returns filed before that date."[35] IDRs are

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29. *Supra* note 25.

30. Announcement 2002-63, online: <http://www.irs.gov/pub/irs-utl/announcement_2002-63.pdf>. See also Larry R. Langdon, Commissioner, Large and Mid-Size Business Division, and Joseph G. Kehoe, Commissioner, Small Business/Self-Employed Division, "Obtaining Tax Accrual Workpapers Related to Abusive Tax Avoidance Transactions," undated (2002), online: <http://www.irs.gov/pub/irs-utl/lmsb_sbse_memorandum.pdf>.

31. (defined in Treas. Reg. ss 1.6011-4).

32. Treas. Reg. Ss. 1-6011-4, section b(2).

33. Treas. Reg. Ss 1-6011-4, section c(3)(1)(A).

34. IRM 4.10.20, *supra* note 8.

35. *Supra* note 26.

subject to review within the IRS, so some internal standard applies across examination offices and ensures a level of consistency in interpretation and application.

IRS Chief Counsel Donald Korb commented during a July 16, 2004 roundtable discussion in Washington that the policy is designed to curb tax shelter abuse by providing greater transparency to the tax return in which benefits arising from the shelter transaction are reported, and that "the policy makes taxpayers think twice before choosing to use a tax shelter."[36] Korb also commented that all attorney-client privilege defenses to summonses for tax accrual work papers will be "flushed out" and that the marketplace will react by avoiding abusive shelters which would attract difficulties.[37] The common practice is to negotiate audit work paper access at the start of the audit, but, as noted above, IRS agents have little room for discretion under the rules when it comes to tax accrual work papers. At the roundtable, IRS Chief Counsel Korb confirmed that "in virtually every instance in which a request for tax accrual work papers is allowed, it is mandatory that the agent make one." The panel agreed, though, that the IRS "weapon" of summonses would only work effectively as a disincentive to future shelter activity if the IRS continued its "policy of restraint."[38]

Finally, the consensus of the panel at the roundtable regarding the use of attorney-client privilege claims to resist disclosure was that work-product doctrine may protect work papers from summons enforcement and that litigation over the issue would centre around the remoteness of any connection between the preparation of the work papers and possible litigation.[39] This remains relevant in the consideration of the practical impact of any Canadian efforts to minimize restraint in seeking disclosure from accountants and auditors. It signals the legitimacy of the concern that clients will turn to lawyers and the cloak of privilege unavailable to accountants in Canada to address concerns about CRA's ability to penetrate the accountant-client relationship.

It is important in this regard to note the differences between Canada and the United States when it comes to privilege in respect of tax working papers. There is no common law privilege for accountants in the United States. A limited form of statutory privilege was extended in 1998 to communications between taxpayers and "federally authorized tax

36. George Jones, "IRS Chief Counsels Debate Interim Guidance on Tax Accrual Workpapers; Shakeout of Rules Anticipated," CCH News – News-Federal, 2004 TaxDAY (July 19, 2004).

37. *Ibid.*

38. *Ibid.*

39. *Ibid.*

practitioners" (FATPs).[40] It applies to communications that would have been privileged had they been between taxpayer and attorney. In *United States v. Frederick*,[41] the court held that the scope of the tax practitioner-client privilege depends on the scope of the common law protections of confidential attorney-client communications and can be no broader than it. The FATP privilege is limited to IRS matters, and does not apply in cases of fraud or criminal activity. Accordingly, determination of work product privilege for attorneys has a bearing on the ability of accountants and auditors to claim protection over communications with clients in the audit context for IRS purposes. Given the IRS position of "self-restraint," with respect to work papers, however, it appears the extent of the FATP privilege will not need to be tested in the near term.[42]

In the end, the U.S. policy of self-restraint and the 2004 and 2005 clarification and confirmation of the policy that IRS examiners should only request audit or tax accrual work papers in "unusual circumstances"[43] provides a model worthy of adoption by CRA. American approaches to both capital markets reform and the operation of the tax system mirror Canadian concerns for the efficient functioning of both. Concerns about tax shelter abuse are dealt with through the implementation of a separate regime of "listed transactions." The IRS approach strikes an appropriate balance between disclosure and the need to encourage open communication between clients and the professional advisors who play such an integral part in the self-reporting system.[44]

2. *Australia*

Australia recognizes that the balance between disclosure and the free flow of information between client and accountant or auditor needs to be maintained with a view to encouraging full and frank disclosure. The

40. 26 U.S.C.A. ss. 7525.
41. 182 F. 3d 496 (7th Cir. 1999).
42. The wisdom of privilege for both attorneys and accountants is being questioned in particular with respect to claims made in the tax shelter context: see Richard Lavoie, "Making a List and Checking It Twice: Must Tax Attorneys Divulge Who's Naughty and Nice?" (2004) 38 U.C. Davis L. Rev. 141 (arguing that on policy grounds, attorney-client privilege should be limited in the context of tax planning). For a contrary view arguing for an extension, rather than contraction, of privilege in the tax context, see William R. Lawlor, "Extending Privilege to Accountants: Should We Follow the American Lead?" 4:1 *Report of Proceedings of the Fiftieth Tax Conference*, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999). For consideration of privilege and government authorities in the US more generally: Lance Cole, "Revoking Our Privileges: Federal Law Enforcement's Multi-Front Assault on the Attorney-Client Privilege (And Why It Is Misguided)" (2003) 48 Vill. L. Rev. 469; Bruce A. Green and David C. Clifton, "Feeling a Chill," ABA Journal (December 2005) at 61.
43. *Supra* note 27.
44. For additional discussion of legislative and administrative efforts to curtail tax shelter abuse in the United States, see Marvin A. Chirelstein and Lawrence A. Zelenak, "Tax Shelters and the Search for A Silver Bullet" (2005) 105(6) Colum. L. Rev. 1939.

Australian Taxation Office (ATO) has articulated a "concession" to the accounting profession that has the effect of circumscribing what the ATO claims would otherwise be its relatively unfettered access to documents of the client of an accounting firm. In a September 2003 speech, a senior ATO official said that the "concession" did not have "the same standing as a fundamental common law right or privilege as does legal professional privilege" and that in certain situations, "the Commissioner will [nonetheless] authorize tax officers to obtain access to relevant documents."[45] The rationale for the concession he articulated is critical. The overall approach reflects the

> Commissioner's acceptance that there is a certain class of document which should remain confidential in all but the most exceptional of circumstances. It is an acknowledgement that taxpayers should be able to discuss their various financial options in a full and frank manner with professional accounting advisors – thereby assisting those in need of independent and professional advice to cope with the demands and intricacies of their rights and obligations under the tax system.[46]

The ATO's official statement of the "accountant's concession" is set out in a March 2005 document entitled "Guidelines to Accessing Professional Accounting Advisor's Papers."[47] The Introduction to those Guidelines formally incorporates the rationale described above:

> While recognizing that the Commissioner has the legislative power to request access to most documents, it is accepted that there is a class of documents which should, in all but exceptional circumstances, remain within the confidence of taxpayers and their professional accounting advisors. In respect of such documents the ATO acknowledges that taxpayers should be able to consult with their professional accounting advisors on a confidential basis in respect of their rights and obligations under taxation laws to enable full and frank discussion to take place and for advice to be communicated on that basis.
>
> These guidelines describe how that acknowledgement applies in practice. They are an administrative concession and will be adhered to by ATO offices provided that taxpayers and their professional accounting advisors use these guidelines in the spirit in which they were formulated.[48]

45. Michael D'Ascenzo, Second Commissioner of Taxation, "Balancing Individual Interests and Community Needs – A Focus on Legal Professional Privilege," Address to the Australian Italian Lawyers Association Tax Seminar, Melbourne, Australia, 18 September 2003, online: <http://www.ato.gov.au/print.asp?doc+/content/37818.htm>.
46. *Ibid.*
47. Online: <http://www.ato.gov.au/corporate/content.asp?doc=/content/51665.htm>.
48. *Ibid.*

The concession is exercised according to the administrative directions contained in the ATO Access Manual, revised as of March 14, 2005 and now publicly available.[49] The guidelines define three categories of documents. These are:

(1) Source documents, such as ledgers, journals, balance sheets and profit and loss accounts and tax working papers. The ATO claims full and free access to all of these documents.

(2) Restricted source documents, which are advice papers created prior to or contemporaneously with a transaction or arrangement. The ATO states in its guidelines that it will only seek access to these documents in exceptional circumstances, such as:
   - Suspicion of fraud, evasion or other offences
   - The taxpayer's source documents have been lost or destroyed, or are otherwise unavailable or are not made available, and the ATO cannot otherwise obtain sufficient information
   - The source documents do not provide sufficient information for the ATO to properly evaluate a taxpayer's arrangements

(3) Non-source documents. These may include advice provided after a transaction had been completed which does not affect the recording of the transaction in the accounts or tax return.

A taxpayer must make a claim for the concession to apply with respect to restricted source and non-source documents.[50] The ATO has stated publicly that it has only applied the "exceptional circumstances" criteria to override the concession on four occasions.

Chapter 07 of the ATO Access Manual, entitled "Access to Professional Accounting Advisor's Papers," details and references the guidelines under which ATO officials may seek access to "restricted source" documents (which are described as "advice documents shedding light on transactions") and "non-source documents." The chapter reiterates the overarching policy direction quoted in the first paragraph of the Guidelines above. It also notes that the Guidelines also apply "only to documents prepared by external accounting advisors who are independent of the taxpayer." This is to be distinguished from a situation where advice documents are created by officers within an organization.

However, even those documents may merit considerable protection from disclosure to ATO officials. Chapter 7.15 signals that the ATO clearly

49. Online: <http://www.ato.gov.au/corporate/content.asp?doc=content/51010.htm> [Guidelines].
50. *Ibid.*

understands the link between corporate governance priorities and tax disclosure:

> The Tax Office recognizes the benefits of increased involvement by company boards in assessments of tax risk, particularly when it occurs in an environment of candour and open discussion among directors and their advisors. Company board involvement on that basis is expected to promote rigour in tax assessments. For this reason, in 2004 the ATO is developing a practice statement on access to documents of companies' boards concerning tax risk assessments of the company's systems, processes or major transactions or arrangements. Tax officers should have regard to this statement once published in deciding how to deal with access to such board tax risk documents.[51]

The Guidelines reiterate that access by ATO officials to the restricted classes of documents from a company's external accounting advisors is only in exceptional circumstances; further, access is only available when written approval is sought from and granted by designated ATO (SES) officials, building in review, management supervision, procedural fairness and national consistency. Australian courts have confirmed that the application of the guidelines to the accountants' "concession" gives rise to an entitlement of procedural fairness or natural justice in their application.[52]

The ATO Commissioner has taken a pragmatic view of the application of the concession, honouring the spirit of the statement that taxpayers need to consult with their accounting advisors on a confidential basis, while at the same time ensuring that the ATO has sufficient access to the requisite documents it needs to permit its tax audit work to continue:

> In those cases where the Accounting Advisors' concession is claimed and we are unable to ascertain from the documents which have been provided the facts necessary to determine the taxation consequences of the particular transactions or arrangements then this will be considered 'exceptional circumstances' resulting in the removal of the concession. Likewise, where the law requires a determination of the purpose for which a transaction or arrangement is entered into and this cannot be ascertained from the documents provided, then this would amount to 'exceptional circumstances' allowing the lifting of the concession. I am prepared to consider appropriate and timely arrangements for segregating any advice component from the factual information we are seeking.[53]

51. *Ibid.*, s. 7.5. Note: At time of writing, this statement is not yet publicly available.
52. See *Deloitte Touche Tomhatsu v. Deputy Commissioner of Taxtion* (1998), 98 A.T.C. 5192; (1998), 40 ATR 435; and *ONE.TEL Ltd. v. Deputy Commissioner of Taxation* (2001), 101 F.C.R. 548; [2000] ATC 4,229.
53. Guidelines, *supra* note 49, Chapter 7.10, quoting from " A Question of Balance," address by Michael Carmody, Australian Commissioner of Taxation, to the American Club, Sydney, NSW, Australia, 17 September 1999.

The Australian Federal Court has also considered the issue of the privilege to be accorded third party advice. In *Pratt Holdings and Anor v. FCT* [54] it extended privilege to accountants' documents even where the accountant was not directly acting as the taxpayer's agent in dealing with the taxpayer's lawyers. In that case, the taxpayer had requested advice from its accountants which it required in order to provide instructions to its lawyers. The lawyers had suggested that the taxpayer obtain a valuation of assets and other independent accounting advice in relation to the quantification of particular losses.

During the course of an audit, the ATO wrote to the taxpayer's accountants seeking access to certain documents over which the accountants claimed privilege as they had been prepared in relation to the request from the lawyers. At first instance the trial judge rejected the claim of privilege over the accountants' advice because the accountants were not the agent of the taxpayer in making the communication to the taxpayer's lawyers.

On appeal, the Court focused on the function performed by the accountants rather than the formalities of the legal relationship. The Court recognized the need for taxpayers to rely on experts to assist in instructing legal counsel where commercial arrangements are complex. It held that the function performed by the accountants in creating the documents for the taxpayer was to enable the taxpayer to make the necessary communication with its lawyers to obtain legal advice. Accordingly, the Court found, legal professional privilege extended over the documents the accountants had created.[55] Even though not akin to the FATP privilege in the United States, the decision constitutes an important recognition of the need for further protection of the confidential relationship between accountant and client in the advisory context. It emphasized the functionality of the linkage and the need for professional advice rather than the strict form by which that advice was provided.[56]

Thus, Australia also provides an important model for Canadian consideration in its categorization of working papers. Further, the model recognizes that self-restraint on the part of taxation authorities is required to sustain an atmosphere conducive to disclosure and confidentiality which is required for capital markets to function. Clearly, the concession itself and the administrative guidelines under which it will be extended

54. [2004] FCAFC 122, reversing *Commissioner of Taxation v Pratt Holdings*, [2003] FCA 6.

55. See also the discussion of the decision and the difficulties in respect of the privilege determination in both Canada and Australia in Susan Van Der Hout, "Third-Party Privilege," 13(5) *Canadian Tax Highlights* (May 2005) at 1-2.

56. For a further discussion of legal professional privilege and the disparity in treatment between legal and non-legal advisors in the provision of tax advice, see Rodney Fisher, "Confidential tax communication: A right or a privilege?" (2005) 20(4) Australian Tax Forum 555.

and preserved, highlight that the concession is extended in a spirit of cooperation that needs to be honored by both taxation officials and by taxpayers (and their advisors) themselves. Self-restraint is extended on those conditions. Unlike in Canada, Australian officials have seen the wisdom, in the broader context, of such treatment.

3. *United Kingdom*

The situation in the United Kingdom parallels that in the United States and in Australia: tax authorities have broad authority to access working paper documents, but have chosen to exercise that authority in limited circumstances. Sections 20A and 20B of the *Taxes Management Act 1970*[57] provide authority for the United Kingdom Inland Revenue (IR) to require access to documents that contain or which may contain information relevant to tax liability. There is an exception to the requirement regarding a tax advisor's documents where the documents relate to a pending appeal,[58] or where the documents are the advisor's own property and consist of communications for the purpose of giving or receiving tax advice.[59] This exception can be circumvented, however, where the client has a copy of the tax advisor's document and the request is made to the client rather than the advisor.

Should a taxpayer or its advisors object to an IR request and a "compromise" cannot be reached, the IR can ask tax commissioners to rule on whether the request is reasonable and whether the taxpayer should comply. The IR exercises its power to obtain documents and records from third parties "relatively sparingly." Where the IR chooses to exercise its ultimate power to seize documents it must follow strict procedures in doing so, including the procurement of a warrant from the appropriate judicial authority.

Historically, IR rarely sought access to accountants' working papers for large corporate taxpayers, even though under the powers described above IR arguably has authority to seek relevant information from third parties. In Statement of Practice 5/90, Inland Revenue confirmed this restraint:

> Accountants' working papers will not be called for on a routine basis. The Revenue will normally do so in connection with enquiries into a client's tax affairs only where they have been unable to satisfy themselves otherwise that the client's accounts or returns are complete or correct. Although the new provisions give the Revenue formal powers to require access to accountants' working papers, this has been given in the past

57. *Taxes Management Act 1970* (U.K.) c. 9, Pt III (Other Returns and Information, Production of Accounts, Books and Other Information) [*TMA*].
58. *Ibid.*, s. 20B(2).
59. *Ibid.*, s. 20B(9(b)).

> on a voluntary basis where appropriate. The Revenue will continue their general policy of seeking access on a voluntary basis and will use their formal powers only where they consider it absolutely necessary.[60]

In practice, then, Inland Revenue does not seek access to auditor or accountant working papers.[61] Reforms in 2004 aimed at curbing tax shelter abuse have instead focused on pre-implementation disclosure. The United Kingdom has recently addressed concerns of abuse through means other than working paper disclosure, although attorney-client privilege remains a particular concern even with the new rules.

On March 17, 2004, the Chancellor of the Exchequer announced new rules to require promoters and users of certain tax arrangements to disclose details of those arrangements to Inland Revenue. In addition to legislative provisions contained in a finance bill, on May 17, Inland Revenue published for consultation three draft regulations. The consultation period ended on June 30 and the final text of the regulations was published on July 9. The rules thereafter became law and, by early October 2004, the scheme was fully in place.[62]

The rules are designed to alert Inland Revenue to certain types of tax planning strategies at an early stage. The "Promoter" – the person who markets or designs a "notifiable" arrangement – is responsible at first instance for making the notification but, if there is no U.K. promoter, the taxpayer is required to make the disclosure. To be "notifiable" the arrangements must enable a person to obtain a tax advantage by saving or deferring U.K. corporation tax, income tax or capital gains tax, and obtaining such a tax advantage must be one of the main benefits expected to arise from the arrangements. The "disclosure information" is made on a standard Inland Revenue form, requires no client specific identification,

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60. Statement of Practice 5/90 (Accountants' Working Papers), in Inland Revenue (U.K.), Statements of Practice (issued up to August 31, 2004), online: <http://www.hmrc.gov. uk/practitioners/sop.pdf>.

61. See *TMA*, *supra* note 57, s. 20B(9)(a), setting out that a notice to provide documents under Section 20(3) or (8A) "does not oblige a person who has been appointed as an auditor for the purposes of any enactment to deliver or make available documents which are his property and were created by him or on his behalf for or in connection with the performance of his functions under that enactment."

62. See *Finance Act 2004* (U.K.) c. 12, Pt 7, ss. 306-317 [Disclosure of Tax Avoidance Schemes]; see also *The Tax Avoidance Schemes (Promoters and Prescribed Circumstances) Regulations 2004*, SI 2004-1865, online: <http://www.hmrc.gov.uk /si/2004-1865.pdf>; *The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2004*, SI 2004-1863, online: <http://www. hmrc.gov. uk/si/2004-1863.pdf>; *The Tax Avoidance Schemes (Information) Regulations 2004*, SI 2004-1864 online: <http://www.hmrc.gov.uk/si/2004-1865.pdf>; all in force August 1, 2004; and *The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) (Amendment) Regulations*, SI2004-2429 online: <http://www.hmrc.gov.uk/aiu/prescribed-arrangements-amemt.pdf> in force 30 September 2004; and *The Tax Avoidance Schemes (Promoters Prescribed Circumstances and Information) (Amendment) Regulations*, SI 2004-2613, online: <http://www.hmrc.gov.uk/si/2004-2613.pdf>, in force 14 October 2004.

and should be sufficient to enable Inland Revenue to understand how the arrangement is intended to operate. Once disclosed, the arrangement is given a reference number and clients will be required to reference the number on their tax returns for the first relevant return period and those thereafter in which the tax advantage arises.

The scheme caused grave concerns for lawyers who believed that the requirement to make disclosure in the form proposed would violate privilege. The initial position of Inland Revenue was that there would be no exemption for legal professionals. However, by late September, the Law Society of England and Wales advised its members that they were protected by legal professional privilege from reporting their clients' tax affairs. On September 30, 2004, Inland Revenue agreed. On October 1, 2004, the Financial Times of London reported that Inland Revenue and the Law Society of England and Wales had hammered out a concession to the regulatory reporting requirements.[63] The concession agreement would require changes to the legislation and would make clients, rather than their lawyers, responsible for reporting their tax plans. The Association of Chartered Certified Accountants and the Consultative Committee of Accountancy Bodies claimed that the concession could undermine the disclosure regime and would provide lawyers with an unfair advantage in seeking and obtaining tax planning work from clients, particularly as the accountant's privilege would not similarly exempt accountants.

In 1989, Parliament had extended a limited form of privilege to accountants, acting upon recommendations arising from the 1983 Keith Committee's wide-ranging review of the enforcement powers of both Inland Revenue and HM Customs & Excise. Amendments to the *Taxes Management Act 1970*[64] attempted to ensure that Inland Revenue would not be able to obtain from the tax agent details of tax advice which had been given by the agent to the taxpayer. The Keith Committee had commented on the difficulty of affording different treatment to the advice given by solicitors on tax matters as opposed to advice given by other tax agents (including accountants); these amendments were an effort to "level the playing field."

For lawyers, section 20B(8) of the *TMA* provides that a demand by Inland Revenue under the Act "does not oblige a barrister, advocate or a solicitor to deliver or make available, without his client's consent, any

63. Vanessa Houlder, "Accountants critical of Revenue deal with lawyers", *Financial Times of London*, 1 October 2004, p. 2; see also *Financial Adviser*, "Solicitors under no obligation to reveal advice to Revenue," 30 September 2004; Roland Gribben, "Brown 'will not delay' on tax laws," *The Daily Telegraph*, 30 September 2004, p. 1; and Asset Finance International, "UK law firms object to new disclosure regime," 2 October 2004.
64. *Supra* note 57, s. 20B(9)-(11).

document with respect to which a claim to professional privilege could be maintained" [the "lawyer's privilege"]. Section 20B(9), [the "accountant's privilege"], provides that such an Inland Revenue demand

> (a) does not oblige a person who has been appointed as an auditor for the purposes of any enactment to deliver or make available documents which are his property and were created by him or on his behalf for or in connection with the performance of his functions under that enactment, and
>
> (b) does not oblige a tax adviser to deliver or make available documents which are his property and consist of relevant communications.

"Relevant communications" are defined in section 20B(10) as:

> communications between the tax adviser and –
>
> a. a person in relation to whose tax affairs he has been appointed, or
>
> b. any other tax adviser of such a person,
>
> the purpose of which is the giving or obtaining of advice about any of those tax affairs

The precise ambit of the privilege afforded by the Act is still subject to some uncertainty. In 2003, the House of Lords rejected an effort by Inland Revenue to obtain from a client's legal advisors documents that Inland Revenue had been unable to obtain from the client directly.[65] Inland Revenue had argued that its information powers overrode the protection afforded by the common law principle of legal professional privilege. The House of Lords rejected this view, holding that privilege could only be trumped by clearly stated statutory provisions or by necessary implication, after construing the statute as a whole. Audit working papers may become part of this debate as the impact of the decision is felt but, as a practical matter, IR does not often seek to review all audit working papers and judicial guidance in this respect is unlikely.

In summary, the situation in the United Kingdom in essence parallels that in the United States; there is statutory authority permitting wide-ranging inquiries for working papers, and a well developed policy of "self-restraint" in exercising that authority only in unusual circumstances. Further, akin to the United States situation, a limited form of statutory privilege for accountants exists, and the extent of common law privilege for lawyers needs to be considered in the context of any reform. Concerns

65. *R. (Morgan Grenfell & Co. Ltd.) v. Special Commissioner of Income Tax*, [2003] 1 A.C. 563.

over the disclosure of possible abuse of the tax system have been addressed in 2004 not through administrative changes to this approach, but rather via an open and transparent regulatory effort to require disclosure about client tax plans in advance of their implementation. This has itself presented concerns about the ability to circumvent the regulatory intention through the use of lawyers rather than accountants as tax advisors.

4. *New Zealand*

On November 16, 2004, New Zealand Finance Minister Michael Cullen introduced legislation extending to tax advisors, such as chartered accountants, the statutory privilege currently protecting the advice lawyers give their clients.[66] The proposed changes had been announced on September 14, 2004 and followed a lengthy period of consultation.[67] Under the amendments, passed on June 15, 2005,[68] a new section 20B of the *Tax Administration Act 1994* introduces a non-disclosure right for certain communications between tax advisors and their clients. To qualify for the right, the taxpayer's advisor needs to be a member of an advisor group approved by New Zealand Inland Revenue.[69] Documentary communication between tax advisors and their clients will be protected if the "main purpose" for the creation of the document is to give or receive tax advice on tax laws, but a claim of non-disclosure on the grounds that a document is a "tax advice document" must be asserted under the rules governing the claims process. The non-disclosure right is subject to exclusions "relating to information of a factual nature, accounting and tax work papers, non-tax advice such as valuation and investment advice, matters relating to debt recovery and matters concerning illegal or wrongful acts."[70] "Tax work papers" are not defined in the legislation; rather, the scheme differentiates between "tax advice," which is protected,

66. Taxation (Base Maintenance and Miscellaneous Provisions) Bill, 16 November 2004, online: <http://www.taxpolicy.ird.govt.nz/publications/files/bills/231bar1.pdf> [NZ Bill]; see also Hon Dr. Michael Cullen, Minister of Finance, Minister of Revenue (NZ), Taxation (Base Maintenance and Miscellaneous Provisions) Bill, Commentary on the Bill, 16 November 2004, online: <http://www.taxpolicy.ird.govt.nz/publications/files/novbill04comm.pdf> [NZ Bill Commentary].

67. See Hon Dr. Michael Cullen, "Statutory privilege for legal advice extended," Media Statement, 14 September 2004, Inland Revenue Department, New Zealand, Policy Advice Division, online: <http://www.taxpolicy.ird.govt.nz/index.php?view=320>; also Hon. Dr. Michael Cullen, "Address to ICANZ 2004," Speech Notes, 15 October 2004, Inland Revenue Department, New Zealand, Policy Advice Division, online: <http://www.taxpolicy.ird.govt.nz/index.php?view=320>; see also Annabel Young, "Operational and Policy Issues," 83(9) Chartered Accountants Journal of New Zealand, 1 October 2004.

68. The *Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005* [2005 No. 79], *supra* note 4, passed through Parliament on 15 June 2005 and received Royal Assent on June 21, 2005. See ss. 119-122.

69. *Ibid.*, s. 122 (inserting 20B(4)&(5)). Chartered Accountants are such an advisor group.

70. NZ Bill, supra note 59, Explanatory note, p. 10; see also NZ Act, *supra* note 24, ss. 20B(2) and 20D.

and "tax contextual information," which must be disclosed.[71] Under the new scheme, the right of non-disclosure must be claimed in writing, and factual information (such as a brief description of the document, the name of the author and the date the document was created) will need to be provided to the New Zealand Inland Revenue Department (IRD) by way of a statutory declaration, either by the taxpayer or by the tax advisor on the taxpayer's behalf.[72]

In introducing the proposals in a 2002 discussion document, the New Zealand government noted that the existing lawyer-client privilege, as the main exception to the IRD's information-gathering powers, had been identified in a number of reports as "causing difficulties in the administration of the tax system."[73] In implementing the new rules, which would apply to both lawyers and other tax practitioners, including chartered accountants, the document noted:

> The new rules should improve Inland Revenue's access to factual information and, therefore, assist the enforcement of the Inland Revenue Acts. At the same time, the new rules should promote the efficient conduct of compliance with the tax laws by allowing or continuing to allow tax practitioners to have a candid relationship with their clients.[74]

Further, the document provided:

> Voluntary compliance with the tax system could suffer if there is a perception that some taxpayers are able to use the current privilege system to conceal details of their true income and therefore avoid or evade payment of tax. A reduction in voluntary compliance increases the tax burden for those taxpayers who continue to comply with the law.
>
> Another disadvantage of the current privilege system is that it provides lawyers with a competitive advantage over other tax advisers. Privilege may be claimed for tax advice from a lawyer when advice of exactly the same nature provided by a chartered accountant is not privileged.[75]

In introducing the reforms that implement a new privilege scheme, the New Zealand government similarly recognizes that candour between client and professional advisor, including accountants and auditors, is critical to the integrity of the tax system. The commentary to the bill introducing the

71. NZ Act, *supra* note 24, s. 20F(3).
72. NZ Act, *supra* note 24, s. 20D.
73. Hon Dr. Michael Cullen, Minister of Finance, Minister of Revenue, "Tax and privilege: a proposed new structure," Policy Advice Division, New Zealand Inland Revenue Department, May 2002, para. 1.2, online: <http://www.taxpolicy.ird.govt.nz/publications/files/taxprivdd.pdf> [NZ Discussion Document].
74. *Ibid.* at para. 1.3.
75. *Ibid.* at paras. 2.14, 2.15.

reforms noted that accountants are central to the administration of the tax system and, while a blanket extension of legal professional privilege to accountants was not warranted:

> Accountants should, however, also be able to give candid and independent advice to their clients, as lawyers do, without the need to disclose that advice to Inland Revenue. The benefit of enabling this to occur is that the advice can promote voluntary compliance by taxpayers with the tax system and give rise to a consequent reduction in compliance and administrative costs.[76]

The New Zealand extension of a form of statutory privilege to afford protection to the advice passing between accountant and client on tax matters is clearly designed to facilitate the effective functioning of a self-reporting tax system and to narrow the gap in treatment between accountants and lawyers. This is consistent with steps taken in the United States, Australia and the United Kingdom. It reinforces the merit of the policy goal of "efficient conduct of compliance with the tax laws by allowing or continuing to allow tax practitioners to have a candid relationship with their clients."[77]

### III. *The Canadian context:* Kitsch *and the problem of privilege*

In considering the appropriate response to the problem of recasting access to working papers by CRA officials in an era of transparency in financial reporting and corporate governance, consideration needs to be given to privilege. Here, too, Canada's response is out of step with developments in the United States, Australia, the United Kingdom and New Zealand. Apart from the absence of even a limited form of statutory privilege for accountants in the tax system, a July 2003 decision of the Federal Court of Appeal interpreted the ability of CRA, under section 231.2 of the *Income Tax Act*, to question accountants in an extraordinarily intrusive way about their clients' subjective intentions. Without a form of voluntary self-restraint by CRA along the lines exhibited by IRS officials in the United States after the decision in *Arthur Young*,[78] the end result from a client perspective will

76. NZ Bill Commentary, *supra* note 66 at 44. Note that the New Zealand law on legal professional privilege protects from disclosure facts about a transaction that are referred to in communications between a lawyer and a client. As originally proposed, the new structure would have changed this – no facts contained in communications between a lawyer and a client on tax matters, including facts referred to in a lawyer's advice given on a transaction, would be privileged outside litigation. The NZ Bill as introduced backed away from this position and the amendments thus do not affect legal professional privilege and communications between lawyers and clients on tax matters – both the advice and the factual underpinnings thereof – are protected from disclosure. The contours of solicitor-client privilege in Canada with respect to facts are not as broad as the legal professional privilege is conceived in New Zealand.

77. NZ Discussion Document, *supra* note 73 at para. 1.3.

78. *Young*, *supra* note 25.

be a race to privilege – to lawyers – and a reluctance by clients to disclose information to their auditors and accountants, with a consequent impact on the availability of information to the capital markets.

There are two critical components of the decision in *Kitsch*.[79] The first is the interpretation of the scope of the powers granted to CRA in section 231.2 of the *Income Tax Act* permitting comprehensive demands for documentary disclosure and interrogatories of accountants. The second is the Court's finding that there is no policy rationale supporting privilege for communications between clients and their tax accountants who provide them with advice in the course of a professional relationship. This is even after the court reviewed the United States extension of the FATP privilege to accountants for IRS purposes. The signal from the Court is that legislative intervention, rather than an extension of the common law, is necessary to extend privilege categories to accountants. As a result, the onus falls back upon CRA (or indeed the Department of Finance) to consider the change both for purposes of the tax system, and for the broader relationship to corporate governance reform.

Section 231.2 of the *Income Tax Act* provides the government with broad powers to require "any person" to provide information or documents "for any purpose related to the administration or enforcement" of the Act.[80] *Kitsch* put the breadth of the power under section 231.2 squarely in issue. In particular, the question was whether the language of section 231.2 mandated that taxpayers' accountants provide answers to written questions from the Minister of National Revenue (MNR) about the subjective intention and purposes of transactions into which the taxpayers had entered. Three taxpayers (Kitsch, Tower, and Tower) were moving from Canada, and BDO Dunwoody, a firm of chartered accountants, provided them with advice about transactions into which they could enter in order to create interest deductions to offset the effect of the departure tax. The exact nature of the transactions was not discussed in the judgment. The taxpayers implemented the transactions and the initial assessment of their returns allowed the interest deductions they had claimed. The MNR subsequently requested information regarding the deductions; BDO

79. *Kitsch*, *supra* note 3.

80. Section 231.2 (1) reads:

Notwithstanding any other provision of this Act, the Minister may, subject to subsection (2), for any purpose related to the administration or enforcement of this Act, including the collection of any amount payable under this Act by any person, by notice served personally or by registered or certified mail, require that any person provide, within such reasonable time as is stipulated in the notice,

a) any information or additional information, including a return of income or a supplementary return; or

b) any document.

Dunwoody responded but did not provide all the information sought. The taxpayers were reassessed, and the interest deductions were disallowed.

The MNR then served Requirements under section 231.2(1) of the *Income Tax Act* on BDO Dunwoody. The Requirements were comprehensive and demanded "production of numerous documents, including all tax files, planning documents, working paper files, permanent files, records, minutes or note of all conversations or meetings, detailed billings, detailed telephone records, promotional material, and correspondence relating to the taxpayers." In addition, the Requirements demanded that two BDO accountants answer a number of questions designed to elicit facts within the accountants' knowledge about the taxpayers' subjective intentions in entering into the transactions that gave rise to the interest deduction that the MNR had disallowed for the taxpayers' 1997 and 1998 returns. The taxpayers and BDO Dunwoody challenged the Requirements, arguing that the statute did not permit such an expansive set of demands by the tax authorities.

At trial, the Court found that section 231.2 of the Act gave the MNR the right to demand the documents but not the answers to the interrogatories. The Federal Court of Appeal said the trial judge erred in doing so, and that section 231.2 is framed sufficiently broadly to permit interrogatories of accountants. It held that the requirement to provide "any information" in section 231.2(1)(a) means that the MNR is entitled both to documents and to ask questions of the taxpayers and their accountants to elicit knowledge or facts about the transactions, including the purpose or intention behind them. No appeal was taken to the Supreme Court of Canada.

In addition to the obvious ramifications for the relationship between accountants and their clients, and the difficulties the decision poses for taxpayers' privacy interests and their choice in professional advisors, the real import of the decision is on the question of privilege. As a practical matter, the shield against the legislative power in section 231 of the Act lies in privilege, something, as yet, unavailable to clients of accountants in Canada. While a 1982 decision of the Supreme Court of Canada made it clear that in Canadian law privilege, in addition to being an evidentiary rule, is a "substantive rule of law"[81] that permanently privileges tax planning documents if the documents are within the scope and extent of privilege established according to common law principles.

81. *Descoteaux v. Mierzwinski*, [1982] 1 S.C.R. 860; see also *Lavallee, Rackel & Heintz v. Canada (Attorney General),* [2002] 3 S.C.R. 209 (describing privilege as " a principle of fundamental justice" and "a civil right of supreme importance in Canadian law"); see also Mahmud Jamal and Brian Morgan, "The Constitutionalization of Solicitor-Client Privilege" (2003) 20 Sup. Ct. L. Rev. (2d) 213.

What this means for practical purposes is that privilege does not solely arise when CRA is seeking documents or information in the context of judicial proceedings, but at all times (including an investigative stage such as an audit). Accordingly, the impact on accountants acting as tax advisors and auditors will be significant. It thus begs the question, as New Zealand authorities posed, whether differential treatment of accountants and lawyers is warranted.

A senior partner from KPMG made this point to the Canadian Tax Foundation in 1998:

> It is completely illogical that a taxpayer who seeks tax advice from two widely recognized and competent tax advisers should have privileged communications with one, but not the other, solely because one is a lawyer and the other is not. Surely taxpayers' rights and the requirement of a fair justice system dictate that privilege over tax advice should not be governed by the profession to which the tax adviser belongs.[82]

The Federal Court of Appeal in *Kitsch* was, however, unmoved by arguments about the role accountants play in the tax system, or by the existence of the FATP privilege for accountants in the United States. Writing for the full panel, Mr. Justice Malone concluded that "no overriding policy consideration exists so as to elevate the advice given by tax accountants to the level of solicitor-client privilege."[83] The Court rejected both a class privilege for accountants and a "case-by-case" privilege recognized by the application of the Wigmore principles to determine whether communications ought to be privileged in the circumstances before the court.[84] The relationship of accountants and clients was not, the court held, one which needed to be "sedulously fostered." In the Court's words, "[w]hile confidentiality may be preferred, the tax accountant-client relationship is in no way as fundamental to society and the administration of justice as the solicitor-client relationship."[85]

Acknowledging the 1998 United States legislation creating the FATP privilege as a "matter of policy interest," the Court concluded that "it is of no consequence to the task at hand," and "[in] addition, a review of the content of that legislation undoubtedly reveals that enactment of the

82. Lawlor, *supra* note 42 at 4:1.
83. *Kitsch, supra* note 3 at para. 38.
84. See *R. v. Gruenke*, [1991] 3 S.C.R. 263 at 289-290 for discussion of the case-by-case approach. The Federal Court of Appeal had held previously in *Baron v. Canada*, [1991] 1 F.C. 668 that an accountant-client privilege did not exist in relation to advice given by an accountant in respect of search and seizure provisions in the *Income Tax Act*, and the court in *Kitsch* considered both whether a class privilege ought to be recognized (contra *Baron*) or whether the case-by-case assessment would result in privilege being acknowledged in the circumstances before it.
85. *Kitsch, supra* note 3 at para. 43.

class privilege for accountants is better left with Parliament."[86] Though the Supreme Court of Canada in *R. v. Gruenke*[87] had written that nothing "precludes the identification of a new class on a principled basis" and that the law of privilege "may evolve to reflect the social and legal realities of our time," the Federal Court of Appeal clearly signaled that any such move would be the prerogative of the legislature rather than the Court. This was in spite of (and without comment upon) the argument of counsel for the taxpayers that:

> the social and legal reality in Canada today is that professional tax accountants provide the bulk of tax advice to Canadians. They do so in the expectation that their communications with their clients will be confidential. They provide the same tax advice on the same law concerning the same issues that tax lawyers provide and perform the same legal analysis to the same facts that tax lawyers do. In determining whether a communication should be subject to a class privilege, the focus should be on the type of advice given and the context in which it is given, and not on the name of the degree held by the person giving the advice.[88]

The New Zealand legislation of June 2005 was crafted in the context of corporate governance reform post-Enron. Together with the United States and Australian approaches, this should signal to Parliament that reconsideration of the extension of a form of privilege to accountants is warranted.[89]

*Conclusion*

In its 1997 decision in *Hercules Managements Ltd.*[90] the Supreme Court of Canada quoted with approval a passage from its earlier decision in *Haig v. Bamford*[91]about the importance of the work of the accounting profession in corporate governance:

86. *Kitsch, supra* note 3 at para. 48.
87. *Gruenke, supra* note 84 at 289-290.
88. *Kitsch, supra* note 3 (Joel Nitikman, Factum of the Appellants).
89. *Kitsch, supra* note 3 at para. 48: "enactment of the class privilege for accountants is better left with Parliament."
90. [1997] 2 S.C.R. 165 at para. 32.
91. *Haig v. Bamford,* [1977] 1 S.C.R. 466. Though the Supreme Court found that auditors owed a prima facie duty of care in tort to shareholders of the corporation who claimed to have suffered losses in reliance on faulty audited financial statements, it held that those prima facie duties were negated by policy considerations and in particular a concern about exposing auditors of public companies to "the possibility of indeterminate liability, since such a finding would imply that auditors owe a duty of care to any known class of potential plaintiffs regardless of the purpose to which they put the auditors' reports." *Hercules, supra* note 90 at para. 64.

> The increasing growth and changing role of corporations in modern society has been attended by a new perception of the societal role of the profession of accounting. The day when the accountant served only the owner-manager of a company and was answerable to him alone has passed. The complexities of modern industry combined with the effects of specialization, the impact of taxation, urbanization, the separation of ownership from management, the rise of professional corporate managers, and a host of other factors, have led to marked changes in the role and responsibilities of the accountant, and in the reliance which the public must place upon his work. The financial statements of the corporations upon which he reports can affect the economic interests of the general public as well as of shareholders and potential shareholders.

This role has been amplified in the post-Enron environment and in investor confidence reforms.[92] CRA's current policy regarding the disclosure of working papers, however, pits the tax system and capital markets obligations of accountants against one another, to the detriment of both. CRA's broad powers to question auditors and professional advisors about their clients' subjective intentions and its ability to obtain access to audit working papers are in essence creating a paradox; rather than accessing more information, the consequence of CRA actions will be less information for both capital markets and tax system purposes.

The issue is particularly significant in relation to audit working papers. Recent developments in auditing standards require that more information be kept in the working papers to justify audit opinions for financial reporting purposes in capital markets. If CRA routinely seeks access to accountants' and auditors' working papers, or there is the policy and legislative opportunity for it to do so, clients will understandably be reluctant to disclose information to their accounting and auditing advisors, or to create a paper trail backing up assessments and judgments; that will

92. As a result, I have questioned whether the policy considerations relied upon by the Supreme Court in *Hercules* might be revisited: see Paul D. Paton, "Rethinking the Role of the Auditor," in Paul D. Paton, ed., *Challenge and Change in Securities Regulation – 12th Queen's Annual Business Law Symposium Proceedings* (2005)[forthcoming, 2006]. Anita Anand has argued a similar position: discussing the *Hercules* decision and *Kripps v. Touche Ross* (1997), 33 B.C.L.R. (3d) 254 (C.A.): "... an authoritative judicial attempt to reconcile the two decisions would certainly be useful. The post-Enron regulatory disposition towards heightened accountability of auditors will inevitably colour such an analysis and leads one to question whether *Hercules* would be decided differently today." Anita I. Anand, "The Regulation of Auditors After Enron," in Anita I. Anand & William F. Flanagan, eds., *Conflict of Interest in Capital Markets Structures, Queen's Annual Business Law Symposium 2003* (Queen's Annual Business Law Symposium, 2004) 197 at 213. See also J. Blackier and M. Paskell-Mede, "Auditor Liability in Canada: The Past, Present and Future" (1999) 48 U.N.B.L.J. 65; Poonam Puri and Stephanie Ben-Ishai, "Proportionate Liability Under the CBCA in the Context of Recent Corporate Governance Reform: Canadian Auditors in the Wrong Place at the Wrong Time?" in Poonam Puri and Jeffrey Larsen, eds., *Corporate Governance and Securities Regulation in the 21st Century* (Toronto: Butterworths, 2004) at 127; see also Brian Cheffins, "Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow" (1991) 18 C.B.L.J. 118.

have a direct and negative impact on the quality of the information available to conduct the audit and hence on the information available to the capital markets. Tax authorities in other countries have crafted a balance between the various concerns of capital markets and tax authorities which CRA officials would be wise to replicate, particularly as Canadian authorities officially participate in efforts to cooperate with those authorities. CRA has never provided justification for deviating from what appears to be the development of an effective international standard for addressing the issue of working papers.

As the international examples provided amply illustrate, a CRA policy statement limiting requests for working papers to "unusual circumstances" and otherwise confirming a policy of self-imposed restraint in the manner articulated by the IRS in the United States would achieve a proper balance between candour and confidentiality. Beyond a mere CRA administrative pronouncement, however, international developments and the potential ramifications of the decision in *Kitsch* warrant rethinking the current Canadian approach to privilege for tax matters. By following the lead of New Zealand, the United States and the United Kingdom in creating legislation that recognizes a limited form of privilege for accountants, Canada would bring its practice in line with the "social and legal reality" of the role and relationships of chartered accountants. As a package, both sets of reforms would accord with international developments and the underlying logic animating them. Notwithstanding the fact that tax authorities have the power to seek documents and information, a policy of self-restraint can go a long way towards encouraging the open and frank communication between auditors, accountants and their clients so critical to the proper functioning of both the capital markets and the tax system as a whole.