



TAX NOTES

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CRA SUCCESSFULLY COMPELS DISCLOSURE OF TAX DUE DILIGENCE REPORT OF TARGET - NO SOLICITOR-CLIENT PRIVILEGE

On November 5, 2018, the Federal Court in *MNR v. Atlas Tube Canada ULC*, 2018 FC 1086, granted an application by the Minister of National Revenue (“**Minister**”) to compel disclosure of a tax due diligence report prepared by an accounting firm in connection with an acquisition transaction. This decision is a useful reminder for purchasers engaged in acquisition transactions that solicitor-client privilege only extends to documents prepared by third parties in certain specific circumstances, and that the Minister has the ability to compel disclosure of such documents if they are relevant to an audit and not privileged.

Background and Decision

The parent company of Atlas Tube Canada ULC (“**Atlas**”) directly engaged an accounting firm to prepare a tax due diligence report for a potential target. The target was acquired and, after some post-closing transactions, became a subsidiary of Atlas. In the course of an audit of Atlas, the Canada Revenue Agency (“**CRA**”) requested the tax due diligence report be provided. Atlas refused to provide the report and the Minister brought an application under section 237.1 of the *Income Tax Act* (Canada) to obtain an order compelling Atlas to disclose the report. Atlas opposed the application, arguing the report should not be provided as (1) it was irrelevant to the audit of Atlas; (2) it was protected by solicitor-client privilege; and (3) compelling production would impose an obligation to self-audit.

Atlas was unsuccessful on all three arguments, and the order was granted. As of the date of writing, the decision has not been appealed.

Implications and Takeaways

A tax due diligence report of a recently acquired target can be extremely revealing. It often details the quality of a target’s existing tax attributes and outlines any material tax exposures, including any uncertain tax positions taken by the target in historical tax filings. For obvious reasons, it is preferable not to be required to disclose such a report to the CRA. Even though disclosure was compelled in the *Atlas* decision, the case still provides two useful takeaways for purchasers looking to have such reports remain confidential.

First, it may be advisable for tax or commercial counsel advising on the transaction to engage the accounting firm (or other non-legal service provider) directly to prepare the tax due diligence report to assist counsel in advising on the structure and terms of the acquisition transaction. If

the dominant purpose of the creation of the report is the giving of legal advice by transaction or tax counsel to the purchaser, rather than to enable the purchaser to make a business decision as to whether or not to complete the transaction, then the tax due diligence report generally should be protected by solicitor-client privilege. Indeed, in our experience, most tax risks identified through due diligence impact legal matters such as deal structuring, indemnities, and holdbacks, and do not often become a determining factor in deciding whether to proceed with an offer. Therefore, in many circumstances it should be possible to arrange for services relating to tax due diligence reports to be provided directly to transaction or tax counsel to assist counsel in providing legal advice, such that the reports generally are subject to solicitor-client privilege. In that case, care must also be taken to avoid inadvertently waiving such privilege, which could occur if a report is shared with investment advisors or (subject to “common-interest privilege”) the other party to the transaction.

Having said that, if the transaction entails an acquisition of widely held shares it may not be commercially feasible to resolve tax risks with indemnities and holdbacks. In other words, the nature of some transactions is such that there is little scope to mitigate risks through structuring. In those circumstances it may be more difficult for due diligence to be said to be provided to assist in the provision of legal advice and not primarily for business purposes.

The other important point to keep in mind from the *Atlas* decision is that the report was sought in connection with an audit of Atlas. In other words, the initial request was made in the course of an existing audit and was not made prior to the commencement of the audit. If a CRA request for information is made prior to the commencement of an audit, even if an existing tax due diligence report is not privileged and potentially falls under the umbrella of the information request, consideration should be given as to whether the report is required to be disclosed at that stage. It may be that, based on existing case law, the report does not need to be disclosed until an actual audit is commenced and it is reasonably determined that the report has some potential relevance to the audit.