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Newsletter

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Offshore Bank Accounts: the Tax Authorities' Audit Powers

The Conduct of the Tax Audit

Pursuant to the Canadian tax system, Canadian residents must pay taxes on their worldwide income.

In return, the legislator has conferred broad powers upon the tax authorities to ensure that taxpayers have properly determined their payable taxes.

These powers include the power to request the examination of books and records, to require the production of documents or information located in Canada or abroad.

❖ Informal Requests for Information and Requirements

When Canadian tax authorities wish to inspect, audit or examine a taxpayer's books and records, they send an "informal" request for information.

This allows Canadian tax authorities to have access to accounts, agreements, books, charts or tables, diagrams, forms, images, invoices, letters, maps, memorandums, plans, returns, statements, telegrams, vouchers, and any other things containing information, whether in writing or in any other form.

Tax authorities may also send a so-called requirement, which is more restrictive than the "informal" request.

Requirements are used to require a person (whether the taxpayer or a third party) to provide any information, including an income tax return, or to produce documents. The provision of information or the production of documents must be done for the purposes of the application or the enforcement of the Act¹, an international agreement or a tax treaty with another country.

It is important to note that failure to comply with a requirement can lead to serious consequences for taxpayers. Indeed, in addition to the fact that the tax authorities may request an order from the court to provide or produce the requested information, the law also provides that penalties or imprisonment may possibly be imposed.

The more restrictive nature of requirements is illustrated in particular by the fact that the legislator has expressly provided that certain formalities must be met for requirements to be valid. Requirements must first be sent by personally served notice or by registered or certified mail. Moreover, the taxpayer must be given a reasonable period of time to respond to the requirement.

Interestingly, the tax authorities cannot however require a taxpayer to file a document in a specific format. Canadian courts have recently had to rule on this issue and have held that the Canada Revenue Agency cannot require the taxpayer to change the format of a document already filed in order to make the use of same easier for the tax authorities.

The legislation accordingly gives Canadian tax authorities very broad powers in order to obtain information or documents located in Canada.

❖ Requirements Addressed to Third Parties

The tax authorities may also contact third parties, through requirements, to obtain the required documents and information. Such requests are usually addressed to the financial institutions where taxpayers have their bank accounts.

The fact that Canadian courts have been called to intervene on numerous occasions in respect of the foregoing is undoubtedly explained by the fact that the information usually sought by the tax authorities is

sensitive in nature and that sending such requests is a process that is undertaken without the knowledge of the taxpayer concerned.

Overview of the Case Law

One of the first concrete interventions by our courts in this area dates back to the early 1960s, in a decision involving a requirement sent to a financial institution that was likely to reveal the identity of the taxpayer's clients, both resident and non-resident. In its decision, the Supreme Court of Canada dismissed the taxpayer's appeal and determined that the criteria for assessing the validity of a requirement was whether same was made for any purpose related to the administration or enforcement of the Act; a condition that was met to the extent that there was a genuine and serious inquiry into the tax liability of a specific person or persons.²

This decision of the Supreme Court, confirming of the power to issue requirements to third parties, has provided a sufficient level of comfort to the tax authorities in order to enable them to issue requirements of a very broad scope, without being unduly concerned by the infringement of the rights of persons not named in the requirements.

Thereafter, in the mid-1980s, the Supreme Court of Canada had the opportunity to put an end to certain practices of the tax authorities. The objective was to prevent cases of abuse and to circumscribe the scope of requirements addressed to third parties. More specifically, the Court had to consider situations where a requirement was made to verify the accuracy of the tax returns of a specific category of the taxpayer's clients.³ Based on the understanding that there was no inquiry being conducted into the tax liability of the clients not named in the requirement, the Court found that the requirement made to the third party constituted a "fishing expedition", which was not permitted under the Act.

At that time, the Supreme Court of Canada made it clear that there must be a serious and genuine inquiry into the tax liability of a specific person in order for the requirement to be valid.

However, developments in respect of the foregoing did not stop there.

Indeed, in the mid-2000s, a new criteria was introduced, namely that a tax audit be conducted in good faith with a genuine factual basis. The Federal Court of Appeal therefore departed from the criteria previously established by the Supreme Court by stating that it was not necessary for a person to be subjected to a serious and genuine inquiry into his or her tax liability.⁴

The power to issue requirements to third parties had once again been broadened to some extent in favour of the tax authorities.

Recently, in June 2018, the Federal Court was called upon to intervene again in respect of a requirement addressed to a third party, where the tax authorities wanted to obtain a list of the commercial clients of a Crown corporation, Hydro-Québec.⁵

In the *Hydro-Québec* decision, the Court noted at the outset that the possibility afforded to tax authorities to request information from third parties is not unlimited given that they cannot require third parties to provide information or produce documents concerning one or more unnamed persons without the prior authorization of a judge. The judge will only grant this request to the extent that (i) the person or group is identifiable and (ii) the provision of the information is required to verify whether the person or group has fulfilled any duty or obligation under the law.

Although a request to obtain documents concerning unnamed persons by its nature leads to some form of fishing expedition, the Court specified, in the *Hydro-Québec* decision, that the legislator's intention is to protect unnamed persons.

As such, the following principles were identified in the Federal Court's decision in *Hydro-Québec*:

- Full-scale fishing expeditions are not permitted;
- The requirement under the Act to turn to the courts to authorize a request for information pertaining to unnamed persons is a clear illustration of the concern that there may be abuse in the use of such requests by tax authorities;
- A group is not "identifiable" to the extent that said group has no basis in the application or enforcement of the Act;
- To the extent that the tax authorities have not identified the taxpayers who may be included in a "bona fide tax audit", then a group is not "identifiable" within the meaning of the Act;
- A tax audit is not in good faith when taxpayers have been identified as a result of a search based on parameters not related to the Act;
- The fact that a requirement is made by the tax authorities does not necessarily mean that said requirement is made to verify compliance with the Act.

The Federal Court's decision to refuse to extend the scope of a requirement to a third party was favourably received by practitioners and their clients in that it confirms the need for a strong link to the Act, both in terms of the "identifiable group" criteria and the quality of the information sought.

❖ Foreign-Based Information or Document

The powers of the tax authorities to issue requests for information pursuant to the preceding sections extend to information or documents located in Canada. However, what about documents or information located abroad?

Whether through requests to taxpayers or third parties, tax authorities may require a person resident in Canada or a person not resident in Canada but carrying on a business in Canada to provide information or documents located outside Canada.

From the outset, the question arises as to what constitutes a “foreign-based information or document” within the meaning of the Act. This definition is very broad and provides that a foreign information or document is “any information or document that is available or located outside Canada and that may be relevant to the administration or enforcement of this Act”.

The appropriate criteria to apply is not whether the information requested is useful in determining a person's Canadian liability for tax, but rather whether the information is useful for the purposes of the Act.⁶

Requests for foreign documents must be sent by personally served notice or by registered or certified mail. In addition, the notice must (i) set out a reasonable period of time (at least 90 days) within which the taxpayer must respond to the request, (ii) describe the foreign information/documents sought and (iii) specify the consequences of failing to comply with the request.

Above all, the Act provides that the person on whom the notice is served may contest it by motion before a judge, who may confirm, vary or set it aside if satisfied that it is unreasonable.

In view of the above, however, an important distinction is made in the legislative provisions governing requirements (re: documents located in Canada) as compared to those relating to foreign documents.

With respect to the regime of requirements (re: Canadian documents), only requests for information about unnamed persons are subject to judicial authorization, while conversely, when foreign information or documents are required, all requests are subject to judicial authorization. Tax authorities will therefore prefer to operate under the general regime of requirements.

The Federal Court of Appeal was called upon to rule on this distinction in the specific context in which the tax authorities were seeking information stored on servers located abroad⁷. The Court relied on the definition of “foreign intelligence or document” to rule that because information stored on servers located abroad was regularly accessed from Canada (and not from abroad), the information was not foreign intelligence. As a result, tax authorities could proceed by transmitting a request under the general regime of formal requests (re: Canadian documents).

Conclusion

It appears from the above that tax authorities have a wide range of options available to them to obtain information or documents to ensure that their tax base is adequately protected.

Whether through “informal” requests for information or requirements, however, the powers of tax authorities are subject to limits, which have frequently been brought to the forefront by our courts.

Since the information obtained during a tax audit will have a significant influence on subsequent steps taken by the tax authorities, it is important to ensure that the conditions for the validity of requirements are fully respected.

1. *Income Tax Act*, R.S.C., 1985, ch. 1 (5th Supp.) and *Taxation Act*, CQLR, c. I-3.
2. *Canadian Bank of Commerce v. Canada*, [1962] S.C.R. 729.
3. *James Richardson & Sons Ltd. v. Canada*, [1984] 1 S.C.R. 614.
4. *Canada (National Revenue) v. The Greater Montréal Real Estate Board*, 2006 FC 1069.
5. *Canada (National Revenue) v. Hydro-Québec*, 2018 FC 622.
6. *European Marine Contractors Ltd. v. Canada (Customs and Revenue Agency)*, 2004 FC 114.
7. *eBay Canada Ltd. v. M.N.R.*, [2010] 1 FCR 145, 2008 FCA 348.

The content of this newsletter is intended to provide general commentary only and should not be relied upon as legal advice.

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