# Managing the Cross-Border Flow of Information

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## 1. Legislative Context for the Provision of Information

a) U.S. Rules

- Revenue agents are authorized to examine books and records, and to examine persons. I.R.C. Section 7602(a)(1).
  - Agents ask for information using Form 4564, Information Document Requests (IDRs).
- The Internal Revenue Service's examination power is extremely broad. I.R.C. § 7602.
  - Most information is considered "relevant or material."
  - The Service can issue a summons to any person it "may deem proper."
  - The Service can obtain documents, and take testimony under oath.
- Potential defenses against production:
  - Attorney-client privilege
  - Work product protection
  - The section 7525 tax practitioner-client privilege
  - These defenses cannot be asserted broadly, but must be asserted and established on a document-by-document basis.



## 1. Legislative Context for the Provision of Information

a) U.S. Rules (cont'd)

- Foreign-based documents
  - If the IRS determines that books and records necessary to substantiate income and/or deductions are located outside the United States, the IRS will first seek voluntary cooperation from the taxpayer by requesting that such documents be made available for examination in the United States if the taxpayer has possession, custody or control over the specific books and records sought.
  - Under section 982, if a taxpayer fails to substantially comply with any formal document request arising out of the examination of any item, a court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is at issue must prohibit the introduction by the taxpayer of any foreign–based documentation covered by the formal document request.
  - As a general rule, any persons or entity subject to the jurisdiction of a U.S. court can be compelled to produce such records and documents in their custody and control, regardless of whether such records and documents are located outside of the United States.
    - When it is determined during the course of an IRS examination that books and records located outside of the United States are necessary to substantiate income and/or deductions of a taxpayer, an IRS revenue agent will request that the taxpayer make them available for examination in the United States if the taxpayer has custody or control over the specific books and records sought.

## 1. Legislative Context for the Provision of Information

### b) Canada

- ITA s. 231.1 – CRA's general audit power – taxpayer is obliged to provide "all reasonable assistance" and answer "all proper questions"
- ITA s. 231.2 – Domestic requirements: provides CRA broad powers to require the production of documents or information – *ebay* decision: may cover documents available electronically to a Canadian recipient of a requirement, even if no hard copy files or servers in Canada
- Enforceable by CRA through seeking compliance order from court or prosecution
- Defences – relevance and privilege



## 1. Legislative Context for the Provision of Information

### b) Canada (cont'd)

- ITA s. 231.6 – Foreign-based requirements: CRA may demand that a resident or non-resident carrying on business in Canada produce any document or information available or located outside of Canada that may be relevant to the administration or enforcement of the Act
- s. 231.6 provides that the requirement may be varied if appropriate or even set aside if it is found to be unreasonable, but on the decided cases taxpayers have not found much success
- Enforceable by CRA through an order generally prohibiting the taxpayer from relying on the information or documents sought, or by prosecution

## 2. New U.S. Disclosure Rules Governing Uncertain Tax Positions

a) Overview of U.S. rules

- Beginning in 2010, certain business taxpayers are required to report uncertain tax positions on Schedule UTP.
- Generally, a corporation must report a tax position on its Schedule UTP when:
  (1) it has taken the position on its federal income tax return for the current tax year or a prior tax year, and
  (2) the corporation or a related party issues audited financial statements for all or a portion of the corporation's tax year and those financial statements either record a reserve with respect to that position for federal income tax or those financial statements do not record a reserve because the taxpayer expects to litigate the position.
- The Schedule UTP instructions require a corporation to rank all of the reported tax positions (including transfer pricing and other valuation positions) based on the United States federal income tax reserve (including interest and penalties) recorded for the position taken on the return, and to designate those tax positions for which the reserve exceeds 10 percent of the aggregate amount of the reserves for all of the tax positions reported on the schedule.



## 2. New U.S. Disclosure Rules Governing Uncertain Tax Positions

b) Canadian Implications

- Obvious concern is whether information collected through Schedule UTP would be provided to CRA
- IRS has undertaken to "generally refrain" from providing such information to other governments unless that government can provide reciprocal information
- Consider, however, Article XXVII(1) of the *Canada-U.S. Tax Treaty*—imposes an obligation to share certain tax information unless one of the exceptions in Article XXVII(3) applies; it appears the IRS could rely upon the exception in paragraph 3(b), on the basis that this information is not obtainable under the laws of Canada or in the normal course of administration of the laws of Canada

## 2. New U.S. Disclosure Rules Governing Uncertain Tax Positions

b) Canadian Implications (cont'd)

- Broader concern is whether the Canadian government may legislate similar disclosure requirements. This seems premature as the CRA policy on access to tax reserve information, entitled "Acquiring Information from Taxpayers, Registrants and Third Parties", was finalized and released in the summer of 2010 after a broad-based consultation process that took several years
- It makes sense to wait to see how the new CRA policy is applied and is working in practice, before moving to a new approach that was not discussed in the consultation process



## 3. Privilege

a) U.S. Developments – Tax Accrual Workpapers

- In 1984, the Supreme Court held in *United States v. Arthur Young & Co*. that tax accrual workpapers enjoy no special protection against disclosure to the Service.
- Nevertheless, later that same year, in Announcement 84-46, the Service stated that it would demonstrate "administrative sensitivity" and generally would not request tax accrual workpapers (the "policy of restraint").
- In 2002, responding to tax shelter developments, the Service adopted a new policy under which workpapers will be requested from taxpayers that engage in "listed transactions."
- In September 2010, the IRS announced that, if a document is otherwise privileged under the attorney-client privilege, the section 7525 tax practitioner privilege, or the work product doctrine and the document is provided to an independent auditor as part of an audit of the taxpayer's financial statements, the IRS will not assert during an examination that the privilege has been waived by such disclosure.
  - Taxpayers may redact certain information related to the preparation of Schedule UTP from any tax reconciliation work papers provided to the IRS.

# 3. Privilege

a) U.S. Developments – Tax Accrual Workpapers (cont'd)

- In its 2009 decision in *Textron*, the first reported case involving tax accrual workpapers since *United States v. Arthur Young & Co*., the First Circuit held that the workpapers at issue in that case were not protected by the work product doctrine because they were not prepared "in anticipation of litigation."
- According to the majority, "the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements. Textron's workpapers were prepared to support financial filings and gain auditor approval; the compulsion of the securities laws and auditing requirements assure that they will be carefully prepared, in their present form, even though not protected; and IRS access serves the legitimate, and important, function of detecting and disallowing abusive tax shelters."
- Although prepared by attorneys, the work papers were not privileged because they were shared with Textron's accounting firm
- Scope of *Textron* substantially narrowed by the subsequent 2010 decision in *Deloitte*



# 3. Privilege

b) Canadian Developments

- Main new development is the release of the new CRA policy on its right to acquire information, released in the summer of 2010.
- Policy contains some helpful comments, including that CRA will "always attempt to collect information from the most direct source in the least intrusive manner", and that access to tax reserve working papers will not be "routinely required". However, CRA does appear to believe it is entitled to pursue these materials in an appropriate case, notwithstanding that one of the CRA's governing principles is that it "will not be influenced by any subjective analysis".

## 3. Privilege

b) Canadian Developments (cont'd)

- If CRA insists on pursuing tax reserve working papers and an administrative resolution cannot be found, then the taxpayer may have several possible grounds of legal challenge:
  - CRA abused its discretion in a particular case
  - Relevance
  - Solicitor-client or litigation privilege (note that Canadian law on waiver of privilege more favourable than in the U.S.)
  - Administrative law (CRA not following its new policies)
  - Constitutional argument: unreasonable search or seizure contrary to s. 8 of *Canada's Charter of Rights and Freedoms*



## 3. Privilege

b) Canadian Developments (cont'd)

- Canadian case law on CRA access to tax reserve working papers is not as well developed as in the U.S.
- *PwC-Ford* was a Canadian case in which CRA sought to obtain the tax reserve working papers relating to Ford Canada from PwC. The CRA requirement was challenged by PwC in Federal Court. The CRA's actions seemed to be more aggressive than contemplated by its own policy (e.g., seeking the working papers from PwC without seeking the information first from Ford Canada through less intrusive means) and thus the case was resolved out of court in August, 2010.
- *Textron* and *Deloitte* may be relevant to Canadian legal analysis of litigation privilege in this context.

# 3. Privilege

## c) Conflict of Law Rules

- Where a cross-border communication is made and is sought by the tax authorities, what country's law determines which rules of privilege apply?
- U.S. courts defer to the law of the country that has the "predominant" or the "most direct and compelling" interest on whether those communications should remain confidential
- This determination may be very important as there can be significant differences in the law of privilege as between different countries. For example:
  - in Canada and the U.S., privilege applies to advice from in-house lawyers, but this is not the case for in-house counsel in the European Union
  - Canada has a doctrine of limited waiver to protect solicitor-client privilege where privileged material is required by external auditors for financial statement purposes, whereas no such doctrine exists in the U.S.



# 3. Privilege

## c) Practical Implications – Example

- Assume:
  - Simultaneous audits of the same transaction in Canada and the US.
  - Advice provided by both US and Canadian advisors
  - Advice provided by both lawyers and accountants
  - Advice on both discrete issues and overall subject matter
  - Advice both before and after the transaction is completed (so some advice is only relevant to tax return and financial statement reporting, not structuring)
  - Documents containing the advice are physically located in both Canada and the U.S.
  - In-house personnel are both lawyers and non-lawyers
- What is privileged and what is not?
- If obtainable by one tax authority, under what circumstances may it be disclosed to the other?

# 4. Voluntary Disclosures

a) U.S. Experience – 2009 Program

- The 2009 voluntary disclosure program generally permitted taxpayers to avoid criminal prosecution if they disclosed all of their previously undisclosed foreign financial accounts and agreed to:
  (1) pay all unpaid taxes (and interest) for the past six years;
  (2) pay an accuracy or delinquency penalty on the overdue tax for each of the six years; and
  (3) in lieu of all other penalties that may apply, pay a penalty equal to 20% of the highest aggregate balance held in the account during the six-year period.
- The 2009 program resulted in more than 15,000 voluntary disclosures. Since then, more than 3,000 additional taxpayers have made disclosures to the IRS.
  - According to the IRS: "The objective [was] to bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws. Additionally, the information gathered from taxpayers making voluntary disclosures under this practice will be used to further the IRS's understanding of how foreign accounts and foreign entities are promoted to United States taxpayers as ways to avoid or evade tax."



# 4. Voluntary Disclosures

a) U.S. Experience – New 2011 Program

- On February 8, 2011, the IRS announced another voluntary disclosure initiative.
- The 2011 voluntary disclosure initiative has the following general components:
  - A penalty equal to 25 percent of the amount held in foreign accounts/entities or value of foreign assets in the year with the highest aggregate asset value covering the periods 2003 through 2010;
  - A reduced penalty of 12.5 percent for those situations where the taxpayer's foreign assets did not exceed $75,000 in any calendar year covered by the program;
  - A 5-percent penalty for taxpayers who did not open the foreign account and for foreign residents who were unaware they were U.S. citizens; and
  - The filing of original and amended tax returns and the payment of taxes, interest and an accuracy-related penalty no later than August 31, 2011.

# 4. Voluntary Disclosures

## b) Canadian Experience

- Canadian voluntary disclosure program has not had quite the impact of the U.S. programs covered above. Some of the issues relating to the Canadian program are summarized below:
  - There has been some uncertainty about the extent of the circumstances in which a disclosure would be considered to be "voluntary" and case law on this issue
  - Practitioners have encountered uncertainty as to how many years back CRA will go
  - If the CRA chooses to go back more than 10 years, it may not be able to waive penalties and interest
  - Practitioners have encountered difficulty in obtaining consistent voluntary disclosure treatment as between the federal level and provincial voluntary disclosure programs not administered by the CRA
  - Hopefully, these issues can be addressed to make the Canadian voluntary disclosure program more effective in encouraging compliance



# 5. Current Trends

## a) U.S. Initiatives

- In March 2010, the *Foreign Account Tax Compliance Act* ("FATCA") became law.
- Effective January 1, 2013, FATCA will require foreign financial institutions (which is broadly defined) to identify and report to the IRS U.S. accountholders or face 30% withholding on U.S. investments, including U.S. source interest, dividends, and gross proceeds.
  - If an account holder refuses to provide information to allow the foreign financial institution to determine whether the account holder is a U.S. person, the account holder will be treated as "recalcitrant" and the foreign financial institution must withhold 30% on "passthru" payments made to that account holder.
  - The Treasury Department and IRS have released two notices (Notice 2010-60 and Notice 2011-34) providing initial guidance on priority FATCA implementation issues, including the procedures under which foreign financial institutions must identify their U.S. account holders.
  - FATCA is likely to result in conflicts of law. For example, Canadian foreign financial institutions must comply with certain "access to basic banking services" and privacy rules that may, respectively, prevent them from closing accounts if information required by FATCA is not provided and providing information required by FATCA to the IRS.

# 5. Current Trends

## b) Canadian Initiatives

- Canada has participated in various international initiatives (see (c) below)
- Canada has increased use of legislative requirements to report more extensive information as part of tax filings (e.g., transfer pricing reporting requirements, tax shelter requirements, foreign affiliate reporting, proposed new GAAR disclosure rules)
- Canada has revamped the criteria for assessing risk in selecting audit targets to include past participation in aggressive transactions, governance structure and the openness and transparency of the taxpayer
- Canada has used the leverage of extending the benefit of its exempt surplus system to expand its network of Tax Information Exchange Agreements—these require agreeing parties to share information relevant to tax, including bank records and entity ownership information
- New audit project on high net-worth individuals and use of extensive questionnaire to seek information early in the audit



# 5. Current Trends

## c) International Initiatives

- Joint audits (e.g., Canada-U.K., U.S.-Australia)
- Joint International Tax Shelter Information Centre ("JITSIC") – several countries created JITSIC to identify and exchange information on abusive tax avoidance arrangements. JITSIC mandate since expanded to address other issues (e.g., tax administrative issues, offshore arrangements, high net-worth taxpayers and transfer pricing compliance)
- Leeds Castle Group – formed in 2006 by ten countries, including U.S. and Canada – formal and regular tax information exchange discussions

# 5. Current Trends

c) International Initiatives (cont'd)

- OECD Forum on Tax Administration – established in 2002 to discuss tax administrative practice and promote tax enforcement; led to the OECD's Tax Intermediaries Project completed in 2008
- Seven Country Working Group on Tax Havens – includes U.S. and Canada; issues international alerts on tax-motivated transactions and tax havens, promotes exchange of information and conducts joint training
- OECD Report dated February 2011 – "Tackling Aggressive Tax Planning Through Improved Transparency and Disclosure" – focuses on the importance of properly targeted disclosure initiatives



# 5. Current Trends

d) Implications for Taxpayers

- The United States and Canada are requiring more information from taxpayers:
  - Schedule UTP
  - FATCA
  - U.S. litigation over workpapers
  - Increased Canadian information reporting requirements
- At the same time, tax administrators are increasingly sharing information
  - About taxpayers
  - About tax administrative practice / enforcement methods

# 5. Current Trends

## d) Implications for Taxpayers

- The stakes may be raised
  - In addition to consequences that may result under local law from information reporting/disclosures, taxpayers must anticipate their information being provided to other tax administrators
  - Taxpayers should evaluate their compliance/information reporting functions to ensure satisfaction of relevant requirements
  - Taxpayers should be aware of current developments with respect to privilege and work product and evaluate whether their current systems/practices are consistent the maintenance of privilege
  - Taxpayers should seek to maintain a strong relationship with tax administrators