CANADIAN TAX Highlights

US Tax Collection in Canada

How far the US tax authorities' reach extends into Canada in respect of US tax liability and penalty collection depends on the status of the debtor and the nature of the debt or penalty. The following discussion relates to the collection of taxes and associated interest, foreign bank account report (FBAR) penalties, fraud penalties, penalties for failure to pay, and accuracy-related penalties, all of which obligations are imposed under the Internal Revenue Code, except for FBAR penalties, which are imposed by the Bank Secrecy Act.

The general common-law position in respect of collection of foreign tax debts is set out in *United States of America v. Harden* ([1963] SCR 366). The US government attempted to collect a tax debt by registering the debt as a civil debt in a Canadian court. The court concluded that by attempting to collect taxes in this manner, the United States was attempting to enforce its revenue laws in Canada, a violation of the longstanding rule that a sovereign state will not collect taxes for the benefit of a foreign state. Quoting *Peter Buchanan Ld. & Machaig v. McVey*, the SCC adopted the reasoning of the High Court of Ireland that "in no circumstances will the courts directly or indirectly enforce the revenue laws of another country." The court said that "[n]o court ought to undertake an inquiry which it cannot prosecute without determining whether those laws are consonant with its own notions of what is proper." There is no distinction between the underlying claim and the collection of that claim.

That common-law position of non-enforcement is altered by article XXVI A of the Canada-US treaty, which establishes authority for assistance in the collection of tax debts. This assistance is provided in respect of "revenue claims": "all categories of taxes collected" "together with interest, costs, additions to such taxes and civil penalties" and "contributions to social security and employment insurance premiums levied by or on behalf of" the US government, which includes taxes and penalties imposed under the Code. The CRA treats US taxes and penalties that fall within this description in the same way that it treats domestic debts and uses its collection tools to recover the money. Thus, US tax owing, and interest and penalties ancillary thereto, is collectible under those treaty provisions. However, the treaty contains an important exception: assistance is not provided if the individual is a Canadian citizen.

In contrast, FBAR penalties are assessed for failure to report, and they are not connected to an underlying tax debt or to any penalty under the Code. The specific enumeration of social security and employment insurance contributions in the definition of revenue claim in article XXVI A(9) makes it clear that the treaty drafters turned their minds to other types of government debts that do not fit within the general description of "all categories of taxes collected." Thus, FBAR penalties are not collectible under article XXVI A because they are not income or capital taxes or taxes imposed under the Code or related penalties. There is still potential for the competent authorities to agree to extend the meaning of "tax" to include FBAR penalties in accordance with article XXVI A (11).

The United States may pursue recourse in Canadian courts regarding the collection of FBAR penalties. With respect to a foreign penal debt, the rule is clear: Canadian courts will not enforce it (*Pro Swing Inc. v. Elta Golf Inc.*, 2006 SCC 52). The underpinning rationale is that foreign law conflicts with and encroaches on domestic law and thus the sovereignty of the domestic state. "Penal law" is defined in *United States of America v. Ivey* (1995 CanLII 7241 (ONSC), aff'd. 1996 CanLII 991 (ONCA)) as "all suits in favour of the State for the recovery of pecuniary penalties for any violation of statutes for the protection of its revenue or other municipal laws, and . . . all judgments for such penalties." FBAR penalties should not be enforced because they appear prima facie to fall within that description: they serve to punish a US citizen or green-card holder for his or her failure to report to the US government. Furthermore, FBAR penalties are not compensatory and do not affect the disgorgement of profits. (See *Ivey*; *United States Securities and Exchange Commission v. Cosby*, 2000 BCSC 338; and *United States of America (SEC) v. Shull*, 1999 CanLII 6625 (BCSC).

Harden makes it clear that taxes cannot be collected pursuant to registration of a civil judgment in a reciprocal jurisdiction. Although FBAR penalties are not taxes, it is highly likely that they are penal and thus are not enforceable in Canada. However, some uncertainty exists, and it may be possible to collect FBAR penalties in Canada on the principle of comity, discussed in *Morguard Investments Ltd. v. De Savoye* ([1990] 3 SCR 1077): a foreign judgment for a debt may be enforced in Canada if the party brings a separate action in a Canadian court.

In summary, a Canadian citizen need have little concern about the collection of US tax, interest, and ancillary penalties. However, a US taxpayer who is a Canadian resident and not a Canadian citizen and who owes US tax, interest, and penalties may face collection thereof by the CRA pursuant to treaty article XXVI A. It is extremely unlikely that Canadian citizens or residents will have to face collection of FBAR penalties, except in the very unlikely event that those penalties may be characterized as registrable civil judgments.

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