HIGHLIGHTS

NEWS ANALYSIS

FATCA: Vulnerable to a Canadian Constitutional Challenge?

by Kristen A. Parillo

It may seem unthinkable to some that Canada — the U.S.'s largest trading partner — wouldn't enter into an intergovernmental agreement with the United States to implement the U.S. Foreign Account Tax Compliance Act. However, a letter from Canada's leading constitutional scholar to the Canadian Department of Finance questioning the constitutionality of a possible IGA has given hope to some Canadian anti-FATCA crusaders that such a scenario could happen.

The U.S. government's recent crackdown on offshore tax evasion has unsettled many Canadians, particularly the dual Canadian-U.S. citizens residing in Canada (estimated at about 1 million) who didn't realize they still had to file U.S. tax returns and foreign bank account reports. Following the 2010 enactment of FATCA and subsequent dialogue between the U.S. Treasury Department, the IRS, and stakeholders on the best way to implement the new reporting and withholding rules, many Canadian individuals and financial institutions expressed concerns about FATCA's extraterritorial reach and the enormous costs of enforcing the new rules.

In September 2011 Canadian Finance Minister Jim Flaherty sent a letter to major U.S. newspapers in which he said that while the Canadian government supports U.S. efforts to curb tax evasion, it did not believe that imposing FATCA on Canadian citizens and financial institutions would achieve that objective and would instead ''waste resources on all sides.'' Asserting that FATCA would raise significant privacy concerns and effectively turn Canadian banks into extensions of the IRS, Flaherty noted that the U.S. and Canada already have procedures in place to address suspected tax evasion — the information exchange provisions of the Canada-U.S. tax treaty.

In an effort to reduce financial institutions' compliance costs and resolve local law conflicts that would otherwise prevent banks from complying with FATCA's reporting requirements, Treasury in February 2012 unveiled the IGA framework as an alternative means for financial institutions to comply with FATCA. On November 8, 2012, Treasury announced that it was in IGA negotiations with more than 50 jurisdictions, including Canada. That same day, the Canadian Department of Finance released a statement inviting stakeholders to submit comments and concerns about the ongoing Canada-U.S. IGA negotiations.

In response to that invitation, Peter W. Hogg, one of Canada's leading constitutional experts, in December 2012 sent a five-page letter to the Department of Finance in which he contended that an IGA negotiated under the terms of the model IGA would likely violate section 15(1) of Canada's Charter of Rights and Freedoms, which prohibits discrimination based on several criteria, including ''national or ethnic origin.''

Elizabeth May, an American-born member of the Canadian Parliament for Saanich-Gulf Islands and leader of the Green Party of Canada, obtained Hogg's letter through an Access to Information Act request and on March 13 posted it on the Green Party's website. May, who has been strongly critical of FATCA and has urged the Canadian government to stand guard against the ''extraterritorial demands'' of the United States, said Hogg's letter ''should provide some cause for hope to the one million Canadians, including hundreds of my constituents in Saanich-Gulf Islands, who have been threatened by this financial witch-hunt.''

May's publication of Hogg's letter was picked up by mainstream Canadian media outlets as well as various websites and blogs, including Maple Sandbox (which calls itself ''a gathering place for people fighting FATCA, FBAR and U.S. citizenship-based taxation''), the Isaac Brock Society (a forum for ''individuals who are concerned about the treatment by the United States government of U.S. persons who live in Canada and abroad''), and U.S. Citizens in Canada InfoShop (a website dedicated to documenting the historical circumstances following the IRS's 2011 offshore voluntary disclosure initiative and the implementation of FATCA).

Nigel Green, CEO of the DeVere Group, a financial consulting company that advises expats and international investors, on March 14 posted a statement on the company's website in which he proclaimed that Hogg's letter ''could provide another nail in the coffin for FATCA.'' A person named Blaze commented on Green's statement:

> If Canadian government sells out Canadian citizens on FATCA, many of us are prepared to come together to launch legal action to protect our rights as Canadian citizens and residents. A consultation with another leading constitutional lawyer took place almost a year ago. Groundwork is laid if either banks or the government tries to violate our fundamental rights.

While Hogg's letter has generated some excitement and hope among anti-FATCA advocates that it will give the Canadian IGA negotiators second thoughts — or will somehow throw a legal wrench in Canada's implementation of FATCA — the online chatter has largely overlooked a fundamental question: Does Hogg make a strong constitutional argument? The answer appears to be no, at least on his section 15(1) point.

Hogg declined to be interviewed by Tax Analysts, saying he would prefer not to publicly discuss his letter while IGA negotiations between the Canadian and U.S. governments are ongoing.

Hogg's Letter

Hogg wrote that while FATCA and any related IGA could run afoul of some Canadian privacy, human rights, and federal and provincial laws, and could also violate other sections of the charter, his analysis focused only on section 15(1), which states:

> Every individual is equal before and under the law and has the right to the equal protection and equal benefit of the law without discrimination and, in particular, without discrimination based on race, national or ethnic origin, colour, religion, sex, age or mental or physical disability.

Hogg noted that the Canadian Supreme Court has held that citizenship is an ''analogous ground'' to national or ethnic origin, so that discrimination based on citizenship is prohibited by section 15(1). He argued that if the Canadian government were to sign an IGA and enact legislation giving effect to the IGA provisions, the due diligence requirements in Annex I of the IGA would violate section 15 to the extent they follow those found in the model IGA.

The problem, he explained, is that the due diligence provisions require financial institutions to treat people differently based on innate characteristics such as place of birth or citizenship. As an example, he pointed to Section II.B of the model IGA's Annex I, which sets out the procedures for reviewing preexisting individual accounts with a balance or value as of December 31, 2013, that exceeds $50,000 ($250,000 for a cash value insurance contract or annuity contract) but does not exceed $1 million. Under that section, financial institutions must review their records to see if any of their account holders show certain U.S. indicia:

- identification as a U.S. citizen;
- unambiguous indication of a U.S. place of birth;
- a current U.S. mailing or residence address;
- a current U.S. telephone number;
- standing instructions to transfer funds to an account maintained in the United States;
- currently effective power of attorney or signatory authority granted to a person with a U.S. address; or
- an ''in care of'' or ''hold mail'' address that is the sole address the financial institution has on file for the account holder.

Hogg noted that if the financial institution finds U.S. indicia in an account holder's file, it must treat that account as a U.S. reportable account and report it as such to the Canada Revenue Agency, which will then automatically forward the account information (including the account holder's name, address, date of birth, account balance, and interest accrued on the account) to the IRS. Regardless of a finding of U.S. indicia, a financial institution may elect to apply the provisions of Section II.B(4) of Annex I, under which a financial institution is not required to treat an account as a U.S. reportable account if the account holder provides documentation such as an IRS Form W-8, a non-U.S. passport, or a Certificate of Loss of Nationality of the United States, or a ''reasonable explanation'' of the account holder's renunciation of U.S. citizenship or why he did not obtain U.S. citizenship at birth.

Hogg also pointed to Section III of Annex I, which sets out the rules for opening new individual accounts. Financial institutions must review depository accounts with an account balance exceeding $50,000 and cash value insurance contracts with a cash value exceeding $50,000 to determine if the account holder is resident in the United States for tax purposes. The rules state that for this purpose, ''a U.S. citizen is considered to be resident in the United States for tax purposes, even if the account holder is also a tax resident of another jurisdiction.'' Account holders who qualify as U.S. resident for tax purposes must be treated as U.S. reportable accounts, and the financial institution must report the account holders' information to the CRA, which will then automatically forward it to the IRS.

Hogg said that when the IRS obtains information on U.S. reportable accounts, it is reasonable to expect that the IRS will pursue some account holders for taxes and penalties or seek criminal prosecution when it believes individuals have evaded their U.S. citizenship-based tax obligations. ''Many of these people are Canadian residents and Canadian citizens, often with no economic connection to the United States, no knowledge that they had tax obligations to the U.S., and no knowledge of retroactive changes to U.S. citizenship law that may have bestowed an unwanted citizenship on them,'' he wrote.

The IGA provides no mechanism whereby individuals suspected of being U.S. citizens would even know that their personal information was provided to the

IRS, Hogg pointed out. Those individuals would therefore have no opportunity to provide additional information or take other steps to prevent the transmission of their personal information outside Canada, he added.

Hogg concluded that the due diligence procedures mandated by the IGA ''are discriminatory in a way that would not withstand Charter scrutiny'' because they effectively treat individuals differently, and adversely, based on an immutable personal characteristic — namely, citizenship or place of birth. If the Canadian Parliament were to enact legislation permitting such differential and adverse treatment, the legislation would contravene the equality protections of section 15(1), Hogg said.

Given that the Canadian Supreme Court has interpreted discrimination based on national or ethnic origin as prohibiting discrimination based on citizenship, ''to impose on financial institutions the duty to report to CRA (en route to the IRS) the names, addresses, place of birth and date of birth and details of the bank accounts of account-holders identified only by their place of birth in or citizenship of the United States, and all under the implicit threat of taxes, penalties or prosecutions by the IRS, seems to me to be a clear case of discrimination in contravention of s. 15,'' he wrote.

Hogg acknowledged that section 15 is subject to the charter's general saving clause, set out in section 1, under which charter guarantees are subject to ''such reasonable limits prescribed by law as can be demonstrably justified in a free and democratic society.'' However, Hogg said any argument attempting to use section 1 to justify the IGA's due diligence requirements would be ''extremely weak.''

''The objective of ensuring compliance with U.S. tax laws is probably not important enough to justify breaches of the Canadian Charter, and even if it was important enough, the measures contemplated are grossly disproportionate to the objective, affecting, as they would do, as many as perhaps a million law-abiding Canadian citizens or residents who have a place of birth or citizenship in the U.S.,'' he wrote.

''Canada is not a tax haven, and these people are here for reasons that have nothing to do with reducing the taxes they have to pay,'' he continued. ''If some of them are found to have been avoiding U.S. taxes, that could hardly justify a Canadian law imposing such intrusive measures affecting so many people distinguished only by place of birth or citizenship.''

Hogg therefore urged the Canadian government — assuming it intends to sign an IGA — not to negotiate an agreement based on the measures contained in the model IGA. He suggested that the Canadian government seek to limit Canadian financial institutions' collection of information to what is already collected and provided under the existing Canada-U.S. tax treaty. In other words, financial institutions should focus their review of records for evidence of U.S. residence, not U.S. citizenship.

Hogg recommended that the Canadian government modify the due diligence procedures specified in the model IGA by stipulating that any account held by a person who is a resident of Canada for Canadian tax purposes would not be treated as a U.S. reportable account. Thus, only accounts held by U.S. residents would be identified as U.S. reportable accounts.

''Any legislation enacting an IGA with this more limited focus would be more consistent with existing data collection practices of Canadian financial institutions, less disruptive of existing practices, and more protective of equality rights,'' Hogg concluded. ''Section 15 does not prohibit discrimination based on place of residence, and legislation based on existing practices would be much less likely to be vulnerable to a Charter challenge.''

Incomplete Analysis?

Canadian practitioners who specialize in privacy and security matters told Tax Analysts that Hogg's constitutional analysis is incomplete. ''Certainly a FATCA IGA would require banks to single out one fact about a person — citizenship — which Professor Hogg is correct in saying is a protected ground from discrimination under section 15,'' said Timothy M. Banks of the Toronto office of Dentons.

''But the Supreme Court has said that not every distinction or differentiation based on those prohibited grounds is discrimination,'' Banks said. ''There has to be some disadvantage that's imposed on that person that's linked to or perpetuates some prejudice or some kind of stereotype.''

''It's not clear how that requirement would be satisfied if the Court were to say that's the test,'' he continued. ''What prejudice or stereotype do we have about persons with dual citizenship, who may be residents of Canada, that is linked to this tax reporting structure? That would be a question that the Court would want to hear something about. And that is not discussed in Professor Hogg's letter.''

Michael H. Lubetsky of the Montreal office of Davies Ward Phillips & Vineberg LLP agreed that Hogg's analysis is missing a critical point — that not all distinctions constitute a violation of section 15(1) — and he said Hogg oversimplified the issues. ''Many laws make distinctions based on immutable personal characteristics that result in adverse treatment,'' he said. ''For example, in Canada persons over age 65 get a special tax credit. For those under age 65, that's adverse treatment. I'm under 65 and don't get this special tax credit — I'm being treated adversely based on a personal immutable characteristic, my age.''

''If I went to court and said I should be entitled to the age tax credit because I'm being discriminated against under section 15, I would be laughed out of

court, and rightfully so,'' he continued. ''The reason I'd be laughed at is two things. First, section 1 of the Charter says the government may violate the constitution if the measure can be demonstrably justifiable in a free and democratic society. So you can make an argument that the protection of the elderly is important — that they have particular problems and concerns and need this tax credit. That would be a section 1 answer.''

''A second, more important answer is the dignity answer,'' Lubetsky said. ''The Supreme Court has held that section 15 does not apply to every distinction under the sun — it applies only to distinctions that relate to the dignity and the worth of the individual, and that send a message that members of this disadvantaged group are somehow not as worthy of protection as other people.''

Lubetsky said he finds it highly unlikely that the Court would accept an argument that requiring financial institutions to flag accounts showing indicia of U.S. citizenship is discrimination in violation of section 15(1). ''I don't think one could argue that legislation adopting the IGA's due diligence requirements is sending a message that American citizens, or people born in the States, are somehow less worthy, or that this is an attack on the dignity of U.S. citizens,'' he said. ''We don't tax our expatriates like America does, but I don't think we regard taxation of expatriate citizens as necessarily something that's morally reprehensible.''

Banks questioned Hogg's assertion that any argument based on the ''reasonable limits'' clause of section 1 to justify the due diligence requirements would be ''extremely weak.'' Following its decision in *R. v. Oakes,* [1986] 1 S.C.R. 103, the Supreme Court has developed a four-step test to determine whether limits placed on charter-guaranteed rights and freedoms are ''demonstrably justified in a free and democratic society'':

- Is the government's objective in limiting the right a pressing and substantial objective according to the values of a free and democratic society?
- Does the legislation's limitation of a charter right have a rational connection to Parliament's objective?
- Do the means used to achieve the objective impair the right as little as possible?
- Are the means used to achieve the objective proportional to the effects of the legislation?

''Many Charter cases are won and lost, and hard-fought, over this section 1 point,'' Banks said. ''The Court requires real evidence, and it's difficult to predict in advance how the Court would go. I think some of the issues the Court would be interested in are the importance — given international mobility and international commerce — of being able to engage in cooperation agreements in order to facilitate tax compliance and tax collection. That's important not only from the U.S. perspective but also Canada's perspective.''

Banks said that if there were a constitutional challenge of the IGA, the Court would have to be mindful that the issue isn't the reasonableness of the U.S. citizenship-based tax regime vis-à-vis the Canadian residence-based tax regime. ''If the case were to be argued, that's going to be something that's difficult to keep at the forefront — the fact that it's not about whether it's reasonable for the U.S. to have a tax system based around citizenship,'' he said. ''The parties really have to be focused on the information-sharing and whether that complies with the Charter.''

Other Legal Challenges?

Lubetsky said it's possible that a better argument for challenging the constitutionality of a FATCA IGA could be made under sections 7 and 8 of the charter. Section 7 protects an individual's autonomy and personal legal rights from governmental actions (''everyone has the right to life, liberty and security of the person and the right not to be deprived thereof except in accordance with the principles of fundamental justice''). Section 8 protects an individual's right to privacy (''everyone has the right to be secure against unreasonable search or seizure'').

''The question could be framed as: Does a systematic, widespread gathering of information and turning it over to a foreign government in a way that a person in Canada doesn't have any way of knowing specifically that he's being targeted, and has no opportunity to challenge the turning over of that information, violate the Charter?'' Lubetsky said.

''That's where I think a constitutional challenge may lie — and I emphasize may,'' he added.

Other possible legal challenges could be made on federalist grounds. Lubetsky noted that in Canada, if the federal government enacts a treaty on a subject that is within the exclusive jurisdiction of the provinces, the provinces must enact those treaty provisions. ''Some financial institutions, such as credit unions, are regulated provincially, and there will be a constitutional question about whether the Parliament of Canada can regulate them,'' he explained.

''There's a big question whether the federal government is constitutionally competent to enact some of the FATCA provisions,'' Lubetsky continued. ''Generally speaking, the division of power between what is a matter of federal jurisdiction and what is a matter of provincial jurisdiction historically is sharper in Canada than it is in the United States.''

As for whether the Department of Finance is considering the constitutional implications of a FATCA IGA, Banks said that all legislation in Canada has at least some level of review for compliance with the

charter. ''And I think when you have someone of Professor Hogg's stature sending you a letter like this, you will put it on your radar,'' he said.

Moreover, given that FATCA has attracted the mainstream media's attention — which could increase the appetite for public interest advocacy and charter litigation — the Department of Finance is likely aware that any legislation implementing a FATCA IGA could be the subject of a constitutional challenge, Banks said.

If Canada did sign an IGA under the terms of the model IGA, it's possible the implementing legislation could be tied up for years in the Canadian courts, Banks said. ''This is going to be important to a significant number of people who are resident in Canada, and one could easily imagine that there would be Charter litigation,'' he said. ''And that could take years to unfold.''

An interesting issue, Banks said, is whether a constitutional challenge would be brought by an individual or by a group via public interest litigation. ''Whether a court would give the group standing to do that is a big question,'' he said. ''You can imagine that U.S. citizens living in Canada who might be the subject of this litigation may be reluctant to bring a claim in their own name. So we'd have to wait and see whether a court would grant a public interest group standing to bring the claim instead.''

If a legal challenge were brought, Banks said, another interesting issue would be whether the individual or group that brings the claim seeks a stay of the application of the IGA implementing legislation until the case is fully heard. ''That would be very much an uphill battle, but they could seek a stay,'' he said.

Battle of Wills

Since the U.S. and Canadian governments' November 2012 announcements that they are negotiating an IGA, neither side has made a public statement on the status of those negotiations. Asked whether the Canadian government is reviewing the IGA framework for possible constitutional violations, a Canadian Department of Finance official told Tax Analysts on May 24 that the department continues to work with its U.S. counterpart to develop an approach that both countries will find agreeable and hopes to conclude an agreement soon.

The official said the department does not comment on the substance of ongoing negotiations.

What if Canadian officials follow Hogg's advice and demand that the due diligence procedures be narrowed to focus only on U.S. residents, rather than U.S. citizens? In short, a battle of wills. Treasury officials have repeatedly said that the model IGAs are just that — a model — and that the U.S. will not negotiate customized IGAs to address a jurisdiction's particular concerns.

''The really hard case would be if Canada were to conclude that it constitutionally cannot give this information, in which case the U.S. would be faced with a very hard choice as to whether or not it agrees to a significant departure from the due diligence procedures, or it simply says, 'We just cannot have an IGA with Canada,''' said John L. Harrington, a former Treasury international tax counsel now with Dentons. He stressed that he has no personal knowledge of the Canada-U.S. IGA negotiations and is only speculating.

''Only Treasury can make that call, but my view is that Treasury would have to be extremely reluctant to depart from the due diligence requirements,'' Harrington said. ''They've made it clear they want the IGA due diligence provisions to generally follow the regulations, so just as a matter of policy I don't think they'd want to depart too much from the regulatory framework.''

Moreover, accepting a demand from one jurisdiction to depart from the IGA would create an unwelcome precedent, Harrington said. He added that permitting Canada to modify the due diligence requirements could prompt countries that have a loose definition of residence to demand a similar concession to protect account holders in those countries' financial institutions.

''If the jurisdiction is low- or no-tax, then there's no cost to the account holder being considered a resident,'' Harrington said. ''This wouldn't describe Canada, but I would be worried about the precedent if I were Treasury.''

Harrington said he doesn't see how the due diligence provisions are fundamentally different from other limitations, such as domestic tax interest or bank secrecy, that countries have had to abandon to be considered engaged in a full exchange of information.

''I don't mean to be dismissive at all of Canadian concerns,'' he said. ''But a lot of countries have had to give up on traditional and deeply held positions in recent years to be considered fully compliant on exchange of information, and it has been a painful and disruptive process for many of them. I do think this is U.S.-specific, however, since most countries would not seek to tax such nonresidents with so limited links to the 'home' country.''

''So, I think the real question is how much latitude Canada has on this issue,'' Harrington said.

Or alternatively, an acknowledgment by both sides that FATCA offers benefits and drawbacks.

Candice Turner of the New York office of Davies Ward Phillips & Vineberg LLP pointed out that while FATCA could be described as an incremental step in the existing Canada-U.S. information exchange regime on bank account data (that is, the automatic exchange of bank deposit interest payment information under Treas. reg. section 1.6049-8), FATCA's imposition of a 30 percent withholding tax on U.S.-source payments is a high price to pay if a financial institution cannot provide the required information on an account holder.

''A key tension here is that FATCA is meant to apply across the world, but in doing so it affects the many U.S. citizens who live in Canada,'' Turner said. ''People aren't hiding their money in Canadian banks. U.S. citizens who are resident in Canada, if they're paying their Canadian tax, probably don't owe any U.S. tax because of the foreign tax credit. So there isn't a real drain on the U.S. fisc from Americans living in Canada.''

Turner said that while there may be a significant number of U.S. citizens residing in Canada who, intentionally or not, haven't been complying with their U.S. reporting obligations, ''those are just reporting requirements; it's not that they're escaping U.S. tax or trying to hide their assets.''

''From the Canadian perspective, the argument has been, 'We should be treated differently because we have a close relationship, we're border countries, we have tons of people that this affects and they're not hiding assets,''' Turner continued. ''But the U.S. perspective has been very much, 'Everyone's getting the same deal, you can take it or leave it.'''

Turner said many governments have come around from their earlier stance that they would reject FATCA and simply not have U.S. account holders in their financial institutions, and now recognize that they need U.S. investments and must continue to engage with the United States. ''So at the end of the day, those countries have decided it's in their best interest to sign an IGA, and with Canada being so economically and geographically close to the U.S., it's going to be necessary,'' she said.

Those governments have also realized that an IGA can be mutually beneficial (assuming the IGA is the reciprocal version), Turner said. ''Instead of having this 'You can't do this to us' attitude they had in the beginning, these countries are starting to say, 'Wait a minute, this may be to our benefit. Maybe we should do this so we can get information on our own citizens,''' she said.

''So at the end of the day, I suspect Canada will sign a Model 1 reciprocal agreement,'' Turner said.

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