Controlling Tax Information: Limits to Record-Keeping and Disclosure Obligations

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PRÉCIS

De récentes modifications apportées à la Loi de l'impôt sur le revenu sur la question de la tenue de registres et la jurisprudence sur le sujet mettent l'accent sur les obligations d'information des contribuables envers Revenu Canada. Ces obligations peuvent s'articuler dans le contexte des exigences de tenue de livres ou dans le cadre de vérifications et d'enquêtes. Les droits d'accès à l'information de Revenu Canada sont peut-être larges, mais ils ne sont pas illimités.

L'auteur souligne l'obligation pour les contribuables de tenir, conserver et produire des registres et documents sur leur situation fiscale, tant sur support papier que sous forme électronique. Ces obligations sont analysées à la lumière de la récente introduction, dans la Loi, d'une définition du terme «registre» et des problèmes de création de documents électroniques et de stockage de la documentation que connaissent les entreprises aujourd'hui.

L'auteur passe en revue la jurisprudence récente sur la communication d'informations et de documents dans le cadre des vérifications et enquêtes civiles et criminelles. Les tribunaux ont confirmé le droit qu'a Revenu Canada d'obtenir une quantité considérable d'informations dans le cadre de l'administration du régime fiscal fédéral, mais l'auteur est d'avis qu'il existe encore des limites importantes.

À cause de l'évolution du droit dans ce domaine, il est essentiel pour les contribuables d'évaluer leurs pratiques de tenue de registres et d'adopter des politiques à jour de conservation de l'information à caractère fiscal.

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ABSTRACT

Recent amendments to the Income Tax Act relating to record keeping and case law have focused on the obligations of taxpayers to provide information to Revenue Canada. These obligations may arise in the context of record keeping and in the course of audits and investigations. While Revenue Canada's rights to access information are broad, they are not unlimited.

The author outlines taxpayers' obligations to maintain, retain, and produce records and documents relating to their tax affairs, in both paper and electronic form. These obligations are considered relative to the recent introduction of a statutory definition of "record" and taking into account issues associated with the electronic creation and storage of documentation that prevails in business today.

The author goes on to review recent jurisprudence relating to the provision of information and documentation in the course of audits and civil and criminal investigations. The courts have confirmed Revenue Canada's entitlement to substantial amounts of information in the course of administering the federal tax system, but the author argues that important limits still remain.

The evolution of the law in this area makes it essential that taxpayers evaluate their record-keeping practices and adopt updated policies for the retention of tax-related information.

INTRODUCTION

Canadian taxpayers are required under the Income Tax Act[1] to maintain and retain records that will enable their tax liabilities to be verified. To facilitate the administration and enforcement of the Act, Revenue Canada is given extensive powers not only to inspect those books and records and other documents in the course of conducting an audit, but also to issue demands for information.

Revenue Canada's powers to require record keeping and the production of information are extensive, and its entitlement to inspect documents in the course of conducting audits or investigations of taxpayers is broad, but in both cases they are not unlimited. There is no general statutory requirement that taxpayers retain *all* documents touching on their tax affairs, including those that are only peripherally related, for extended time periods. Further, the right of Revenue Canada to audit a taxpayer's affairs and demand the production of documents, whether in the context of civil or criminal investigations, is subject to limitations imposed both under the Income Tax Act itself and by decided cases. In addition, taxpayers may continue to resist the production of documents protected by

[1] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

solicitor-client privilege where factual circumstances permit, notwithstanding some judicial refinements to the scope of this entitlement.

This article focuses principally on the extent of taxpayers' obligations to maintain, retain, and produce records and documents relating to their tax affairs. These obligations are examined in the context of the practicalities and limitations of the day-to-day running of a business, against an apparent tendency on the part of tax administrators to require production of increasing volumes of information.[2]

The creation of electronic (computer-based) documents in the ordinary course of business today also raises new challenges in record retention. Accelerating retention costs and the impracticalities of excessive retention and storage of paper-based documentation have become important elements of any record management process. This article will discuss ongoing developments and problems relating to the creation, storage, and production of computer-based records and documents, and the current approach of tax administrators to the emergence of electronic commerce in the context of record keeping and production.

Finally, this article discusses recent judicial developments relating to Revenue Canada's audit powers and its rights to require the production of information, as well as developments relating to the taxpayer's right to silence. While recent decisions have affirmed the powers of Revenue Canada to inspect information either on audit or upon demand, it will be argued that they have not expanded the range of information to which Revenue Canada is entitled.

Canadian tax law in this area continues to evolve. Therefore, taxpayers need to be aware of their statutory obligations and, of equal importance, their rights, if they are not to be compromised in the face of increasingly demanding and intrusive approaches by Revenue Canada to ensuring tax compliance. It is essential that taxpayers review their record-keeping and retention methods and implement updated record management practices to ensure the greatest possible control of tax-related information, whether in paper or electronic form.

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[2] There are a number of papers that have addressed these topics in recent years. See, in particular, Ian H. Pitfield, "Dealing with Revenue Canada: A Lawyer's Perspective," in *Report of Proceedings of the Forty-Fifth Tax Conference*, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 10:1-15; Alain Orvoine, "Dealing with Revenue Canada: An Accountant's Perspective," ibid., 11:1-18; Werner H.G. Heinrich, "Current Administrative and Enforcement Issues: An Update on the Scope of the Audit, Requirements, Penalties, Collection Matters, and the Fairness Package," in *1995 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1995), tab 15; Jack A. Calderwood, "The Art of the Deal, Part 1: Negotiating Settlements—Revenue Canada's Perspective," in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 30:1-8; and Edwin G. Kroft, "Selected Issues in Administration, Appeals and Enforcement," in *Tax Law for Lawyers*, vol. 3 (Ottawa: Canadian Bar Association, 1998), paper 1.

RECORD RETENTION

The Income War Tax Act, 1917,[3] Canada's first federal statute imposing taxes on income, did not contain a record-keeping requirement at the time of its enactment. Within two years, however, the minister was given the power to prescribe that records and accounts be kept by a taxpayer who failed or refused to keep adequate books or accounts for tax purposes.[4] The requirement that taxpayers keep books and records is set out in subsection 230(1) of the Act and has existed in its current form for over 50 years.[5]

Under subsection 230(1),

> [e]very person carrying on business and every person who is required, by or pursuant to this Act, to pay or collect taxes or other amounts shall keep records and books of account (including an annual inventory kept in prescribed manner) at the person's place of business or residence in Canada or at such other place as may be designated by the Minister, in such form and containing such information as will enable the taxes payable under this Act or the taxes or other amounts that should have been deducted, withheld or collected to be determined.

Books and records required to be kept under this provision generally must be preserved until six years have passed from the end of the last taxation year to which the records and books of account relate.[6] Failure to comply may result in prosecution under subsection 238(1) and a fine or imprisonment on conviction.

The obligation of taxpayers to retain books and records under the Act is clear. There is less certainty, however, as to what constitutes a book of account or a record, and also which particular books and records must be kept for the purposes of compliance with subsection 230(1). Subsection 230(3) allows the minister to stipulate that particular persons shall keep such records and books of account as the minister may specify, but this power may be exercised only in circumstances where a person has failed to keep adequate records and books of account for the purposes of the Act.

Historically, Revenue Canada has not specified particular books and records that are to be maintained by taxpayers other than to require that

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[3] SC 1917, c. 28.

[4] SC 1919, c. 55, section 6, later embodied in section 46 of the 1927 consolidation.

[5] See section 114 of the Income Tax Act, SC 1947-48, c. 52, derived from sections 46 and 46a of the Income War Tax Act, supra footnote 3. Similar record-keeping obligations in the context of the goods and services tax are described in section 286 of the Excise Tax Act, RSC 1985, c. E-15, as amended. See also *GST Memorandum* 15.1 (new series), "General Requirements for Books and Records," October 1994, and *GST Memorandum* 15.2 (new series), "Computerized Records," October 1994, regarding record-keeping requirements under the Excise Tax Act.

[6] Subsection 230(4). Subsection 230(4.1), enacted in 1998, now requires persons who keep records in electronic form to retain them in an electronically readable format for the same retention period as is otherwise required for printed documents. For further discussion of issues relating to electronic record keeping, see below under the heading "Requirements and Challenges of Electronic Record Keeping."

the books and records that are maintained must permit a determination to be made of the taxes that are payable or the taxes or other amounts that are to be collected, withheld, or deducted by a person under the Act. These records must also substantiate and allow verification of all deductible, charitable, athletic, and political contributions received. Books and records must, in turn, be supported by vouchers or other source documents to permit verification.[7] Taxpayers with foreign affiliates also have a responsibility to ensure that adequate books and records are maintained in a manner that will enable computations relating to such entities to be substantiated.[8] The Act contains no stipulation of the books or records that must be maintained by taxpayers who are subject to the new foreign investment property reporting rules. One can anticipate, however, that the onerous penalties that may result from non-compliance will serve as an incentive to taxpayers to maintain records that will permit verification of information filed in foreign investment property returns.[9]

Historical Judicial Interpretation of the Meaning of Books and Records

Before 1998, the Act did not contain a definition of "record," and it still does not define what is meant by the expression "book of account." However, as the following discussion shows, other statutes, legal dictionaries, and case law have considered the meaning of these terms.

A record has been defined to mean, among other things, the state of being recorded or preserved in writing; thus, a record would include a piece of recorded evidence or information, an account of a fact preserved in permanent form, a document or monument preserving it, and an object serving as a memorial of something.[10] *Black's Law Dictionary* defines the verb "record" to mean:

> To commit to writing, to printing, to inscription, or the like. To make an official note of; to write, transcribe, or enter in a book, file, docket, register, computer tape or disc, or the like, for the purpose of preserving authentic evidence of. To transcribe a document, or enter the history of an act or series of acts, in an official volume, for the purpose of giving notice of the same, of furnishing authentic evidence, and for preservation.[11]

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[7] See regulation 5800 and newly revised *Information Circular* 78-10R3, "Books and Records Retention/Destruction," October 5, 1998, relating to the retention of books and records generally, the electronic imaging of books of original entry and source documents, and the recognition of electronic records as books and records of account. For further discussion, see below under the heading "Requirements and Challenges of Electronic Record Keeping."

[8] See *Information Circular* 77-9R, "Books, Records and Other Requirements for Taxpayers Having Foreign Affiliates," June 22, 1983.

[9] See sections 233.2 through 233.7.

[10] *The Concise Oxford Dictionary*, 7th ed. (Oxford: Oxford University Press, 1982).

[11] *Black's Law Dictionary*, 6th ed.

In a business context, "records" have been defined to mean "accounts, correspondence, memorandums, tapes, discs, papers, books, and other documents or transcribed information of any type, whether expressed in ordinary or machine language," and "business records" as "[j]ournals, books of account and other records which may be ordered produced as part of discovery in trial or in preparation of a case and generally given a broad interpretation for such purposes."[12] While the Interpretation Act[13] does not contain general-purpose definitions of these terms, "record" is defined in section 30 of the Canada Evidence Act,[14] as it relates to the admissibility into evidence of business records, to include "the whole or any part of any book, document, paper, card, tape or other thing on or in which information is written, recorded, stored, or reproduced."

Jurisprudence imports a requirement into the meaning of "record" that the memorandum of the occurrence of an event be created roughly contemporaneously with the transactions in question, rather than at some later time. In *Setak Computer v. Burroughs*, the court emphasized that

> [a] substantial factor in the reliability of any system of records is the promptness with which transactions are recorded. Unless it appears from the context of the record, or the testimony of the witness introducing the writings or records into evidence, that the act, transaction, occurrence or event described therein occurred within a reasonable time before the making of the writing or record, then such writing or record should not be admitted for the purpose of proving those matters. Where there is evidence of some delay in transcribing, then in each case, it would seem to me, the Court must decide, as a matter of fact, whether the time span between the transaction and the recording thereof was so great as to suggest the danger of inaccuracy by lapse of memory.[15]

There has been relatively little judicial comment in Canada on the meaning of "records and books of account" as that expression has appeared in the successive record-keeping provisions of the Act, but the few cases on point do provide an indication of Parliament's intention in enacting a statutory record-keeping requirement. These cases support the proposition that, at least until the recent enactment of a statutory definition, there were no particular books and records that had to be retained by taxpayers. Rather, it was open to taxpayers to adopt their own accounting

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[12] Ibid.

[13] RSC 1985, c. I-23, as amended.

[14] RSC 1985, c. C-5, as amended.

[15] (1997), 15 OR (2d) 750, at 760-61 (HCJ). See also *Matheson v. Barnes*, [1981] 2 WWR 435, at 438 (BC SC), where a three-week delay in the preparation of the record was held to cause it to be insufficiently contemporaneous. *Setak Computer* is discussed in John Sopinka, Sidney N. Lederman, and Alan W. Bryant, *The Law of Evidence in Canada* (Markham, Ont.: Butterworths, 1992), 203. Similar requirements exist under both British and Australian jurisprudence. See, for example, *H v. Schering Chemicals Ltd.*, [1983] 1 All ER 849, at 852 (QB), per Bingham J; and *Atra v. Farmers & Grazers Co-op Co.* (1986), 5 NSWLR 281, at 285 (Com. L. Div.), per Woods J.

and record-keeping systems, which would be acceptable for tax purposes provided that those systems enabled taxes payable under the Act (or other amounts referred to in subsection 230(1)) to be determined.

In one of the earliest tax cases, *Freitag v. Minister of National Revenue*,[16] the taxpayer was assessed on a "net worth" basis for an amount of additional income based on the theory of the minister's assessors that the taxpayer's income would have been higher had he been charging the "normal mark-up" typical for his business. The minister also contended that the taxpayer had kept inadequate records, rendering it impossible for the assessors to ascertain the total amount of actual sales during the tax year in issue. The court, however, was not prepared to accept the minister's net worth assessment. It observed that the taxpayer had produced a comprehensive financial statement prepared by a well-known firm of chartered accountants and had also maintained three "books" that his accountant testified were "adequate for the purpose, having regard to the nature and size of the business."[17]

Similarly, in *Empire House (London) Ltd. v. The Queen*,[18] the appellant corporation carried on business as a bar selling beer and food in its beverage room. The minister issued a requirement that the taxpayer keep additional books and records under subsection 125(2) of the Act (as it then read) as well as complete cash register tapes filed in date order. When he refused to install and maintain such tapes, the appellant was convicted before the magistrate of an offence under the Act; however, on appeal, Grant J set aside the conviction and directed a verdict of acquittal. The relevant provisions of the Act simply required persons to whom the provisions applied to keep records and books of account in such form and with such information as would enable the taxes payable under the Act or the tax or other amounts that should have been deducted, withheld, or

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[16] 51 DTC 350 (TAB).

[17] Ibid., at 351. More recently, in *Hildebrandt v. The Queen*, 98 DTC 1013 (TCC), a farmer who carried on a substantial farming operation with annual revenues of approximately $500,000 was subjected to penalties for gross negligence for failing to maintain any record books relating to the farm operations. Having heard the evidence of the minister's assessor that the appellant did not maintain a record book, and that she was not able to determine his income by matching his revenues and expenses, Mogan J concluded that the appellant should be penalized for having failed to meet the record-keeping standard of care required to be met by every person carrying on a business, as prescribed in subsection 230(1). In *Ozawa v. The Queen*, 97 DTC 1500 (TCC), the taxpayer advanced the novel argument that his lack of expertise in keeping records should exonerate him from his record-keeping obligation. Not surprisingly, Sarchuk J found this position to be untenable. See also *Zalzalah v. The Queen*, 95 DTC 5498 (FCTD); *Hilscher v. The Queen*, 95 DTC 6 (TCC); and *Kay v. The Queen*, 95 DTC 1 (TCC)—all recent examples of cases where proper books and records were not maintained and the taxpayer's appeal consequently failed. In the context of the Excise Tax Act, see, for example, *Trudeau v. The Queen*, [1997] GSTC 36 (TCC); *Helsi Construction Inc. v. The Queen*, [1997] GSTC 104 (TCC); and *Automobiles Dieudonné Inc. v. The Queen*, [1996] GSTC 82 (TCC).

[18] 66 DTC 5410 (Ont. SC).

collected to be determined. Consequently, the right of the minister to require that a person keep particular records and books of account must be conditional on that person's having previously failed to keep adequate records and books of account for purposes of the Act. However, witnesses called on behalf of the Crown indicated in cross-examination that the information that was available to them was sufficient for them to determine the tax payable. None of these witnesses indicated that they were unable to determine the tax liability of the taxpayer from the available information. Faced with these facts, the court found no basis on which to uphold the taxpayer's conviction.[19]

One interesting discussion of "records" or "books of account" in a tax context emanated from an unreported judgment of the Ontario Court—Provincial Division rendered in a criminal case a number of years ago, in which a chartered accountant was one of two co-accused charged with offences under the Act.[20] His client was charged with tax evasion, but it was alleged, on the basis of some calculations and items mentioned in the accountant's working papers, that the accountant had participated in the making of false or deceptive entries in the client's records or books of account. The court granted a dismissal of charges against the client on the basis of insufficient evidence. However, the Crown proceeded against the accountant and advanced a broad definition of a taxpayer's records and books of account as including both books of original entry and the auditor's working papers generated in the course of an annual audit. Two chartered accountants gave conflicting expert evidence on the point, but the court concluded that the term "books of account" as used in the Act was wide enough to embrace both the books of account and books of original entry as those terms are defined in the Canadian Institute of Chartered Accountants' *Terminology for Accountants*.[21] "Book of account" is defined there

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[19] In *MNR v. Furnasman Ltd. et al.*, 73 DTC 5599 (FCTD), in the context of the Canada Evidence Act, RSC 1970, c. E-10, and having regard to the very broad definition given to the word "record" in section 30 as including "documents" or papers, Addy J was of the view that records would include credit reports that might emanate between one department of a financial institution and another, as well as interoffice memorandums and similar types of documentation, provided that these records were made "in the usual and ordinary course of business" (ibid., at 5603). In *R v. Schmidt*, 93 DTC 5319 (BC CA), in upholding the taxpayer's conviction for wilful evasion of taxes, destruction of documents, and falsification of records, the court concluded that while a statutory declaration itself might not constitute a "book and record" of a corporation, certain listed invoices that were attached to the statutory declaration in question did constitute "records" of the corporation's alleged expenditures on scientific research and, as such, constituted its "books and records" for purposes of subsection 230(1). See further Sopinka, Lederman, and Bryant, supra footnote 15, at 187-216, regarding the business records exception to the hearsay rule and what constitutes a business record as an evidentiary matter.

[20] *Regina v. Cooper*, file no. 005189/82 (Ont. Prov. Ct.) [unreported]. For a thorough discussion of the facts of this unreported case, see E.A. Avey and M.G. Quigley, "A Case of Tax Evasion: An Accountant's Day in Court" (September 1984), 117 *CA Magazine* 58-66.

[21] Canadian Institute of Chartered Accountants, *Terminology for Accountants*, 3d ed. (Toronto: CICA, 1983), 23.

as "[a]ny book or record in which the operations and transactions of an organization are recorded in terms of money or some other unit of measurement and which constitutes part of the accounting system," and "book of original entry" as "[a] book of account in which individual operations and transactions are recorded preparatory to summarization and/or posting to ledger accounts."

In the court's view, the term "records" as used in the Act was wide enough to embrace the expression "accounting records" as defined in *Terminology for Accountants*.[22] Ultimately, the accountant was acquitted on the charges, his conduct amounting to mere window dressing for purposes totally unrelated to the Act; but on the definitional point, the court concluded:

> It is therefore obvious that the expression "records" is broad enough to include books of account as well as other documents. Those other documents would be documents which would . . . include "business papers such as invoices, credit memorandums, (sic) bank cheques, insurance policies, freight bills and promissory notes. These furnish detailed information about business transactions, state the terms of contracts, and serve as evidence of the propriety of accounting entries." Also embraced within the term "records" would be "working papers in which information for the periodic statements is assembled." I would not purport however to include all working papers prepared by auditors within the expression working papers.[23]

In summary, accounting terminology and decided case law suggest that the terms "record" and "book of account" have relatively precise meanings in the business world. Further, recent decisions of the Supreme Court of Canada confirm that the ordinary business meaning of words and phrases should be respected in tax matters. In *2747-3174 Québec Inc. v. RPAQ*, L'Heureux-Dubé J said:

> It is evident from this analysis that terms generally used in the business world, including taxation terms, have a meaning unique to the business world. Since the business world occupies such an important place and has such profound ramifications in our society, there are a great many terms of business language that have already been precisely defined by those working in the field. In fact, taxation terms often have definitions that have been clearly established through empirical means, that are generally recognized and accepted or that have been standardized by various bodies: see, for example, the dozens of specialized dictionaries and glossaries in taxation, accounting and management. . . .
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> Thus, the "plain meaning" used by this Court in the taxation field is actually the "plain meaning as already defined by the business world." But there is more, not only have the terms already been defined by the business community, but terminological and lexico-graphic research is being done in that field and published in specialized literature. . . .

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[22] "Accounting records" means the formal books of accounts and supporting documentary evidence: ibid., at 4.

[23] Supra footnote 20.

> It is thus the business world itself that develops its own contextualized definitions based on what is here being called the "modern" method. This Court then uses those definitions as what it views as the "plain meaning" generally accepted in the business world.[24]

Regardless of the business world's understanding of "records," the recent enactment of a statutory definition that includes a broad range of items raises new issues relating to taxpayers' record-keeping obligations under the Act. These issues are further complicated by increasing electronic and computer generation and storage of information.

The 1998 Amendments: A New Statutory Definition of "Record"

The new definition of "record" is included in subsection 248(1) for purposes of the Act as a whole and became effective on June 18, 1998. The definition includes

> an account, an agreement, a book, a chart or table, a diagram, a form, an image, an invoice, a letter, a map, a memorandum, a plan, a return, a statement, a telegram, a voucher, and any other thing containing information, whether in writing or in any other form.

As a consequence of this amendment, the definition of "document" in section 231 has been contracted to refer only to "money, a security *and a record* [emphasis added]." Previously, it included "money" and "securities" as well as "books, records, letters, telegrams, vouchers, invoices, accounts and statements (financial or otherwise), whether computerized or not."

The technical notes accompanying the definition of "record" state that it encompasses "a variety of items, whether they are in writing or in any other form,"[25] but it is unclear whether the new definition has been enacted merely for greater certainty or to encompass previously unincluded items. The breadth of the new definition, and in particular its inclusion of "any other thing containing information, whether in writing or in any other form," suggests that the historical concept of a "record" has been expanded for purposes of the Act.

The enactment of this definition has raised a concern among some in the tax community that it will result in new obligations to keep significant

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[24] [1996] 3 SCR 919, at 1014-15, as referred to in François Barette, "Interest: Where Are We Now?" in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 8:1-34, at 8:31-34. See also *Canderel Limited v. The Queen*, 98 DTC 6100 (SCC), on the importance of business practice and commercial principles. Most recently, in *Upper Lakes Shipping Ltd. v. Minister of Revenue for Ontario*, [1998] OJ no. 115 (CA), Carthy JA observed that in the absence of a statutory definition for a term, resort should be had to ordinary commercial principles to attribute meaning to a business phrase.

[25] Canada, Department of Finance, *Explanatory Notes Relating to Income Tax* (Ottawa: the department, December 1997), clause 239.

amounts of documentation.[26] A December 1997 submission to the Department of Finance by the Tax Executives Institute (TEI) voiced fears that the scope of the definition is so "amorphous" that it will require taxpayers to retain a substantial volume of new "records" and, as a result, will significantly increase taxpayer compliance costs.[27] A submission to the Department of Finance by the Canadian Chamber of Commerce in 1997 outlined the potential extent of this problem:

> Conceivably, every draft of a document which is finally executed, together with all marginal notes of every recipient of each of those drafts, might be considered to fall within the proposed definition of record, so its destruction would be an offence under the ITA. Similarly, innumerable documents or notes that contain numbers will potentially fall within the definition of "record." Conscientious taxpayers will err on the side of caution and most will be faced with an enormous and costly archival problem; of course, this will also create an additional auditing burden for Revenue Canada.[28]

The Tax Determination Standard: Subsection 230(1)

Although the definition of "record" is broad, it should not be construed in the context of subsection 230(1) either as requiring taxpayers to keep *every* document that comes into existence or as subjecting them to a new positive obligation to create records that is not present in the existing language of the subsection. While the definition enumerates specific items as being "included" within its ambit, extending so far as "any other thing containing information, whether in writing or in any other form," taxpayers are still required under the language of subsection 230(1) only to keep records and books of account "in such form and containing such information as will enable the taxes payable under this Act . . . to be determined." It is not an unlimited requirement. Support for this construction can be found in a comparison of the wording of subsections 230(1) and (4), since subsection 230(4) does not require the retention of *all* books and records, but rather only those referred to in "this section"—

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[26] See, for example, Paul J. Gibney, "For the Record" (January 20, 1998), 6 *Canadian Tax Highlights* 1-2, where it is suggested that a taxpayer's record retention duty will be more onerous. The author noted that while Revenue Canada has taken a broad view as to the documents and records to be retained, particularly internal memorandums and correspondence relating to transactions, this view was not supported previously under the Act given the absence of a statutory definition of "record." The author expresses a concern that the new definition of "record" may require *all* internal memorandums and correspondence to be retained in order to comply with the Act.

[27] Tax Executives Institute, "Comments on Pending Canadian Income Tax Issues Submitted to the Department of Finance, December 10, 1997" (November-December 1997), 49 *The Tax Executive* 520-25.

[28] Canadian Chamber of Commerce, "Positions on Selected National and International Issues," 1997, Finance and Taxation, 30. Note, however, that the decision of the British Columbia Supreme Court in *Southern Railway of British Columbia Limited et al. v. Dep. MNR et al.*, 91 DTC 5081, may permit marginal notes on draft documents to be excised from the documents as constituting privileged communication.

that is, section 230. On the other hand, subsection 230(4) imposes the additional requirement that a taxpayer retain "every account and voucher" necessary to verify the information contained in the books or records that are kept for purposes of section 230.

Revenue Canada undoubtedly has broad inspection powers under section 231.1 to inspect any book, record, or document that relates to a tax matter. However, there is no requirement under the Act that taxpayers "keep," in the sense of "retain," all books and records that may come into existence including, for example, all information that might in any way be relevant to the taxes payable by a third party. Thus, the scope of the minister's inspection power under section 231.1, which includes not only the taxpayer, but any other person, should not be construed as imposing a further record retention requirement. In addition, it seems reasonable to conclude from the wording of the legislation that a document need not be retained if the proper tax (or any other amounts referred to in subsection 230(1)) can be determined from other books and records that are retained.[29] By extension, while documents can be inspected if retained, those that are not "records" that are required to fulfil the prescribed tax determination purpose may be destroyed. The Tax Court held in *Husky Oil*[30] that no adverse inference concerning a taxpayer's conduct is to be drawn from the culling and destruction of internal non-required records.

The interpretation that a taxpayer is not required to keep all records, but rather only such records as will enable the taxpayer's own income tax liability to be determined, seems to be supported by Revenue Canada itself in its newly revised *Information Circular* 78-10R3.[31] Revenue Canada does not specify records that taxpayers must keep but merely outlines the

[29] Nevertheless, subsection 230(1) also deals with the books and records that a taxpayer must "keep" in the sense of "maintaining," and subsection 230(4) deals with the period for which such books and records need to be "retained." On this interpretation, if the books and records that a taxpayer "kept" for the purposes of complying with subsection 230(1) were inadequate to enable taxes payable to be determined, subsection 230(1) may require that books and records be created or "kept" to meet this requirement, in the absence of which the minister could require that specific books and records be retained under subsection 230(3).

[30] *Husky Oil Limited v. The Queen*, 95 DTC 316, at 326 (TCC). The decision of Kempo J was affirmed by the Federal Court of Appeal, 95 DTC 5244. While it is understood that some advisers are concerned that the apparent rejection of "relevancy" in the *AGT Limited* case, infra footnote 56, as a basis on which to refuse production of particular documents demanded under section 231.2 may actually result in the imposition of a new, more stringent record-keeping requirement under section 230, in this writer's view, such a conclusion is unwarranted. It does not seem reasonable to conclude that the tax determination purpose test embodied in subsection 230(1) has been judicially amended by a decision primarily related to another provision of the Act. Arguably, there is a fundamental difference between being required to keep, in the sense of retain, all documents and other business information regardless of relevancy and being required to produce those records and documents that have actually been retained once Revenue Canada has made a section 231.2 demand. The latter proposition, it is suggested, cannot logically support the former.

[31] Supra footnote 7.

verification results that must be possible on the basis of the particular books of account and records that the taxpayer does maintain. Further, the new circular, which was released in October 1998 after the enactment of the new definition of "record," does not on its face reflect any substantive change in Revenue Canada's position regarding record keeping generally, although it does elaborate in some detail on the department's position with respect to the keeping of electronic records.[32]

Thus, taxpayers appear to still be at liberty to determine on their own what books and records they will keep, but the books and records that are created, maintained, and retained must meet a prescribed information threshold. They must contain enough information in sufficient detail to permit the tax determination standard to be met.

What "Records" and "Documents" Enable Taxes To Be Determined Under the Tax Determination Standard?

What documents are necessary to enable taxes payable under the Act to be determined? Does the new definition of "record" impose a positive obligation to create new documentation? Does the enactment of the new definition now require that all tax-planning analysis or memorandums be retained? Finally, are items such as working papers or tax provisions that come into existence in the ordinary course of conducting financial audits or preparing shareholder reports, "records" that must be retained and, if retained, produced in response to Revenue Canada demands?

A record or document does not need to be retained if the proper tax payable by the taxpayer can be determined from other books and records that are retained. This appears to be a reasonable interpretation of subsection 230(1), there being no cumulative record creation or retention requirement, to the point of redundancy, evident on the face of the provision. For example, arguably taxpayers need not keep duplicates of information that is in the books and records that are kept, or summaries of financial information and analysis derived from business books and records when the source information itself is contained in those books and records. On this theory, management information summaries need not be retained to the extent that they merely summarize or interpret source financial information to assist management and do not themselves enable taxes payable under the Act to be determined. While working papers and tax provision calculations seem to constitute records, at least under the new definition, they may not need to be retained if they do not meet the tax determination purpose, and usually they will not. The proper amount of tax payable, for example, is determinable from the records, documents, and books of account that record the business transactions that are undertaken and the facts relating to those transactions. It is not determined by reference to the analytical "second guessing" that underlies any business taxpayer's tax

[32] For further discussion, see "Requirements and Challenges of Electronic Record Keeping," below.

provision calculations undertaken in the course of financial statement preparation, or to management information summaries prepared to measure, or justify compensation for, the achievement of management objectives.

In the past, many tax advisers advised their clients that tax-planning memorandums need not be retained. It was reasonable for advisers to have reached this conclusion, on the basis either that they were not books and records in the accounting sense, or that the necessary facts from which tax liability could be determined were obtainable from other books and records kept by the taxpayer.

The application of the Act in any particular case and the proper determination of the tax payable may depend, however, on facts that are not reflected in invoices, agreements, or the formal books of account and supporting documents that were traditionally considered to be the taxpayer's "books and records." For example, entitlement to a particular tax result may be available only where the parties deal at arm's length or some other factual situation exists. Apart from cases in which satisfaction of the arm's-length requirement will depend on whether the parties are related, an arm's-length relationship between particular persons is usually determined by reference to all the facts and circumstances underlying the status of those persons relative both to each other and to the particular matter. This is also true in situations where the taxpayer's entitlement to a tax result is dependent on the existence of a subjective element. Subjective element requirements can be found in the numerous provisions of the Act that require a "purpose" or a "reason" to be established in relation to transactions or occurrences in order that a particular tax result may be claimed.[33] Examples are paragraphs 20(1)(c) and 18(1)(a), which require an income-earning purpose to be met as a condition of the tax result, or numerous avoidance provisions, such as subsection 256(2.1), which deems corporations to be associated if a "main reason" for their separate existence was tax reduction. Similar requirements are also found in the general anti-avoidance rule. Therefore, books of account and records that enable "purpose" or any other constituent subjective element to be determined as a fact must be retained, but other items not directly tied to the tax determination process need not be. Such records will need to be retained where one of the facts that underlies the availability of the tax treatment, and therefore enables the tax payable to be determined, is the "purpose" or the "reason" for the transaction in question.

Thus, subsection 230(4), in conjunction with subsection 230(1), may now require a taxpayer to retain a document that falls within the ambit of

[33] There are many instances in the Act where the existence of such subjective elements is critical to entitlement to the tax result. For example, in the Act, the word "purpose" appears 853 times; the phrase "for the purpose of gaining or producing income," 44 times; the phrase "primarily for the purpose [or purposes] of," 18 times; the phrase "main purpose," 6 times; the phrase "one of the purposes of which," 4 times; the word "reason," 229 times; and the phrase "principal reason," once, in section 103.

the new definition of "record" if that document outlines facts and circumstances that go to the tax determination purpose and are not contained in other books and records that are being retained. For example, if a taxpayer has a tax-planning memorandum on a particular transaction that purports to set out the "purpose" or reasons for which the transaction is being undertaken, arguably the memorandum should be retained if this information is not contained in any other book or record that is being retained, and the information is relevant in determining the tax consequences—that is, it is relevant to the tax determination purpose inherent in subsection 230(1).

The problem with this assertion is that the memorandum probably does not contain anything other than the writer's *opinion* on the subjective element of purpose, and the writer's opinion of purpose or motive may not only be irrelevant when tested against the tax determination standard, but may simply be wrong. Whose view of "purpose" should prevail? Is the real purpose of a transaction the one reflected, say, in directors' minutes authorizing a transaction to be undertaken, or is it to be found in the in-house memorandum of the tax manager that reviews the tax results that are expected to flow from the transaction that the directors have approved, or in the economic analysis or recording of those results by the company's accounting staff? While these kinds of uncertainties existed before the enactment of the new definition, they may come into sharper focus under the new expansive meaning of "record."

It should not be forgotten, however, that subsection 230(1) is not being amended to eliminate the tax determination standard. The definition of "record" does not substantively change the statutory record-keeping requirement since taxpayers are still required to keep "records," albeit in an exceedingly broad range of enumerated forms, only to the extent that they contain such information as enables taxes payable under the Act (or other amounts) to be determined.

The corollary issue is whether taxpayers have a positive obligation under section 230 to create a documented record of matters that might be relevant, including facts or circumstances that bear on the taxpayer's entitlement to the tax result claimed, but which are not addressed in other books and records that are retained. While this interpretation may be supportable on the words, arguably it must be qualified as impractical and unreasonable. An interpretation that would *require* tax-planning documentation to be created and, once created, retained is not entirely clear if only because a statement of facts in a tax-planning memorandum does not establish the existence of those facts, any more than an opinion of purpose in a memorandum should be taken as determinative of that issue.[34] If the intention is that a taxpayer be required to create documents to comply literally with subsection 230(1), the legislation should be substantially

[34] Under the business records evidentiary rule, such memorandums, if retained, would be producible in evidence. See Sopinka, Lederman, and Bryant, supra footnote 15, at 187-216.

more specific, as in the case of the contemporaneous documentation provisions included in the new transfer-pricing rules.[35]

The answer to these questions must surely lie in subsection 230(1) itself rather than in the definition of "record." If it is accepted that subsection 230(1) contains within it a tax determination standard against which the sufficiency of a taxpayer's record-keeping obligations is to be tested, then arguably any and all records, either under the old common law interpretation or under the new statutory definition, need to be retained for the retention periods contemplated in subsection 230(4) only where such records are tested against that standard and are determined to be necessary to meet that statutory purpose. On this construction, however, arguably the concerns raised by the Canadian Chamber of Commerce, among others, go too far. Rather than requiring *all* drafts of documents and *all* notes on drafts to be retained out of concern that they evidence a "purpose" or a "reason" for an action, and requiring all tax memorandums to be retained on the same basis, such items would need to be retained only if there were a demonstrable and direct link between the item in question and the establishment of the fact that goes to the existence of the "purpose" or the "reason," and not merely a peripheral or incidental connection.

It is suggested, however, that taxpayers should be advised that the requirement does not even go this far. On this more restrictive interpretation of the implications of the new definition, it seems reasonable to view many tax-planning memorandums as containing little more than the opinions of employees of the enterprise or their advisers as to the facts relevant to particular transactions, or their opinion of the purposes sought to be achieved by those transactions or the reasons why they were undertaken. On this interpretation, these items may not be the best or even very good evidence of "purpose" or "intention," much less of what actually may have happened or have been the facts relating to transactions that occurred. On this basis, arguably such documents would not be of assistance in the determination of taxes (or other amounts referred to in subsection 230(1)) and thus need not be "kept" or "retained."

While the new definition of "record" should not prevent taxpayers from undertaking record retention management and the destruction of documents that are not necessary to the determination of their tax liability, it is equally clear that a much broader range of materials and forms of information will need to be tested against the tax determination standard before final decisions are made not to retain particular documents. It will be imperative to go through this evaluative process, even if it will now be a more onerous task, if the taxpayer does not wish to have extraneous or

[35] Subsection 247(4) imposes a positive obligation on taxpayers to document transactions governed by the transfer-pricing rules. It actually lists the precise records or documents that are required to be made or obtained and stipulates the content of those records or documents.

irrelevant documents requested on audit under section 231.1, or required to be produced under section 231.2 or as part of "full disclosure" during the course of litigation.

Practical Problems with the New Definition

One can easily contemplate scenarios that will raise questions over the requirement to retain records and documents and force taxpayers and their advisers to evaluate whether a document, memorandum, or opinion obtained in the course of business planning or the implementation of transactions must be retained or may be destroyed.

Suppose a taxpayer obtains a tax opinion from an accounting firm on some current tax management issue or relating to a transaction and then obtains a second opinion from a law firm. Must these opinions be retained? Would the answer differ if these two opinions reached differing conclusions? Does it make any difference if the opinions are obtained after the transactions are completed? Does it matter whether the opinions relate to a provision such as the interest deduction rule in paragraph 20(1)(c) as compared to a "strict liability" type of provision, such as withholding obligations under subsection 212(1)?

While both a "letter" and a "memorandum" are now included in the definition of "record," raising at least a threshold concern that the opinions must be kept, the better test is whether the documents in question enable taxes to be determined. As a mere opinion of a professional adviser, it seems reasonable to conclude that neither needs to be retained, since it seems probable that neither opinion, strictly speaking, enables the tax payable by the taxpayer (or other amount) to be determined. An opinion simply records the results of the interpretive analysis undertaken by the adviser. This answer should not change whether the opinions were obtained before or after the transaction, or whether it was the legal opinion that was obtained first—although in the former case the legal opinion is probably privileged, and in the latter case, depending on how the retainers of the professional advisers were arranged, both opinions may be exempt from production as documents protected by solicitor-client privilege.

Even where it is the professional advisers who have designed the business or tax plan, it should be reasonable to conclude that the outline by professional advisers of the benefits that may be achieved through the implementation of some series of transactions is not determinative of the taxpayer's ultimate purpose in later implementing those transactions or some variation thereon. Caution dictates, however, that a taxpayer should make use of its entitlement to solicitor-client privilege in such cases by arranging for the advice to be provided in a manner whereby not only the legal advice, but also the accounting advice, will be cloaked in privilege. While the subject of solicitor-client privilege is beyond the scope of this article, taxpayers and their advisers must remember that particular steps must be taken to obtain the protection of privilege, such as ensuring that the advice of the chartered accountant is requested by the solicitor, rather than the client, and is provided directly to the solicitor at the client's

request, rather than being obtained directly by the client from the accountant (in which case no privilege would be applicable).[36]

The more difficult scenario may be the creation within a business enterprise of an internal memo to file that contains information that is clearly relevant, on any fair assessment, to the computation of the tax payable by the business, where such information arguably cannot be obtained from any other source. In such a case, it seems clear that the memo to file would need to be retained, and it would be a document that Revenue Canada would be entitled to review on audit, assuming that Revenue Canada requested the disclosure of such items. A variation on this scenario is the situation where the information that relates to the computation of tax is contained in a separate schedule attached to the memo to file. There is some debate whether the taxpayer would be entitled in this scenario to destroy the memo to file but retain the schedule, since the latter enables taxes to be determined while the former does not. What if the memo to file contains information that is relevant to the computation of tax but that information can be obtained from other documents? Can the taxpayer destroy the memo to file after the fact, and does it matter whether Revenue Canada has commenced an audit of the taxpayer?

It will always be preferable to undertake a purge of non-essential documents immediately after the implementation of a transaction as part of the normal post-closing agenda, or on a regular ongoing basis. Any document that is not essential to the determination of taxes payable (or other amounts) can be culled from the taxpayer's records, assuming that no audit has yet commenced and no request for documents or information has been made by the tax authorities. In the situation outlined above, there seems to be no need to retain the memo to file, even if it is relevant to the computation of tax, if the information contained in that memo can be obtained from other documents that are retained.

Even in circumstances where an audit has commenced, it is understood that some professional advisers take the view that until a particular document has actually been requested by the auditors, a taxpayer is at liberty to eliminate documents considered irrelevant to the tax determination purpose. However, there is debate on this point: other advisers consider it

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[36] For a recent review of rules relating to solicitor-client privilege, see Al Meghji and Steven Sieker, "A Contest of Unequals: Recent Developments in Tax Litigation," in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 11:1-35, at 11:9-17. See also M.G. Quigley, "Disclosure of Sensitive Information—Are There Limits to Record-Keeping Obligations and Revenue Canada's Investigative Powers?" paper presented at the Dealing with Revenue Canada Conference, Toronto, June 17, 1998, and cases cited therein; and Gregory J. Gartner and Ken S. Skingle, "A Potpourri (Tossed Salad?) of Current Issues in Tax Litigation," in *1997 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1997), tab 8. On the subject of solicitor-client privilege generally, see Ronald D. Manes and Michael P. Silver, *Solicitor-Client Privilege in Canadian Law* (Toronto: Butterworths, 1993); and Sopinka, Lederman, and Bryant, supra footnote 15, at 623-772.

improper for the taxpayer to purge documentation once a Revenue Canada audit has commenced. The best solution is to avoid this interpretive and ethical dilemma by purging unnecessary documentation immediately after transactions have been undertaken, while the circumstances of the situation are fresh in the mind of all persons concerned and an objective evaluation can be undertaken of the relevance of the document in question. Objectivity may be more difficult to attain when a Revenue Canada audit is imminent or already under way.

Consequences of Failure To Keep Adequate Records: Is Due Diligence a Defence?

As a practical matter, the issue that may be of most concern to taxpayers in this area is how to avoid the risk of being charged with an offence under the Act for failure to comply with the record-keeping obligations imposed by section 230. As the Canadian Chamber of Commerce noted in its brief to the Department of Finance, most taxpayers are conscientious in meeting their statutory duties and may choose to err on the side of keeping more rather than less in order to avoid this exposure.

While this is probably a realistic view of a practical compliance concern, it may be that taxpayers and their advisers are unduly worried. It should be remembered that under section 238 of the Act, a conviction for failure to comply with the statutory record-keeping obligations requires a criminal prosecution, and the accused must be found guilty beyond a reasonable doubt. Section 34(2) of the Interpretation Act makes it clear that the Criminal Code[37] provisions apply to charges brought under sections 238 and 239 of the Income Tax Act for offences under the Act. Presumably, mens rea—that is having the "guilty mind" or "intention" to commit an offence—is a normal prerequisite to a conviction. *Lack* of intention is normally a defence to a criminal prosecution.

It is hard to see how a taxpayer who exercised diligence in testing tax-planning memorandums or other internal corporate documentation against the tax determination standard in subsection 230(1), and who reasonably concluded that an item need not be retained, could be convicted of an offence in the absence of evidence of an intention to evade tax, or carelessness, or neglect in the performance of the statutory record-keeping obligations under the Act. Not only will such due diligence serve to evidence the absence of the requisite intention in the case of offences that are criminal in the true sense, but it may be a defence to the administrative penalties imposed under the Act, even where they purport to apply automatically.

In *Pillar Oil Field Projects Ltd. v. The Queen*,[38] the court concluded that there was no reason for not extending an analysis respecting penalties in

[37] RSC 1985, c. C-46, as amended.

[38] [1993] GSTC 49 (TCC).

criminal law matters to administratively imposed penalties under the Act and emphasized that the principles established by the Supreme Court of Canada in *The Queen v. Sault Ste. Marie*[39] were relevant. Bowman J stated:

> [T]he Crown would need to demonstrate a compelling reason for treating the imposition of the numerous penalties provided for in our fiscal statutes as incapable of being challenged by a taxpayer who could establish that he or she was without fault and acted with due diligence. To infer a legislative intent that such penalties were unassailable on any ground would be contrary to the principle enunciated by Dickson, J. in the *Sault Ste. Marie* case that: . . . punishment should in general not be inflicted on those without fault.[40]

This analysis has recently been adopted and explored more fully by the Federal Court of Appeal in *Consolidated Cdn. Contractors v. The Queen*.[41] In an important and thoughtful decision, Robertson J thoroughly reviewed the principles established by Dickson J in *Sault Ste. Marie* in considering the availability of a due diligence defence to the automatic penalty provisions of section 280 of the Excise Tax Act, which apply where there is an underpayment of goods and services tax. The court held that there could be no valid basis for maintaining absolute liability for all administrative penalties. While patent unfairness alone was not sufficient reason to import a due diligence defence into the penalty provision in issue, the principle that there should be no punishment without fault translated into a presumption that absolute liability was not intended. This presumption would be rebuttable where the statutory language was unequivocal in intending absolute liability, where the penalty led to trivial consequences, and where due diligence was incompatible with the legislative scheme and would frustrate the purpose of the penalty. Section 280 was not such a provision, and thus the defence was available.

In the case of the record-keeping obligations under the Act, it is clear that it is the higher standard of criminal intent that is applicable, since section 238 provides penalties not for mere administrative "wrongdoing," but for offences, including failure to keep adequate books and records, that require a finding of intent beyond a reasonable doubt.

Regrettably, the invitation of the Canadian Chamber of Commerce to the Department of Finance to eliminate the ambiguities of the new definition of "record" was not taken up.[42] While it remains to be determined how broadly Revenue Canada will interpret the new definition, it is hoped

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[39] [1978] 2 SCR 1299.

[40] Supra footnote 38, at 49-4. See also *Feuiltault v. The Queen*, 94 DTC 1653 (TCC); *Ford v. The Queen*, 95 DTC 848 (TCC); and *Bennett v. The Queen*, 96 DTC 1630 (TCC)—all income tax cases that followed the principle in *Pillar Oil Field*.

[41] [1998] GSTC 91 (FCA).

[42] The Chamber of Commerce, supra footnote 28, at 30, recommended that the definition be amended to exclude the words "and any other thing containing information, whether in writing or in any other form" and instead include the words "regardless of the medium in which it is produced, but does not include any such document or thing unless it is specifically needed to determine the nature or conclusion of any transaction, arrangement or event."

that a reasonable and practical approach will be followed. In fairness to the tax authorities, there is nothing in IC 78-10R3, nor have there been any recent pronouncements, that indicate a sea change in Revenue Canada's prior administrative practices. While the uncertainty of the new definition remains, taxpayers can take comfort that the exercise of thoughtful and practical due diligence will serve to provide protection from prosecution for alleged failure to keep adequate records.

Requirements and Challenges of Electronic Record Keeping

Electronic commerce and the record retention powers of computer systems that most businesses use today raise serious record retention issues. Today most computer systems undertake an automatic backup of word processed documentation and spread sheet type analyses on a daily basis, if not more frequently. Thus, how are taxpayers' electronic records to be "controlled" and "managed"?

The Department of Finance has recognized the implications of electronic commerce for taxpayers' record-keeping obligations under the Act, announcing in 1995 its intention to prepare draft legislation to address the issue of maintenance and retention of electronic books and records in order to clarify the law with respect to issues of retention, access, and maintenance. Revenue Canada took the position that electronic records must be accessible to authorized persons no matter what paper documentation may exist. Just as in the case of paper documentation, failure to maintain adequate electronic records or to grant access to those records to authorized persons might result in taxpayers being subjected to penalties under the Act.[43]

New legislation was enacted in 1998 relating to electronic records. New subsection 230(4.1) requires persons who keep records electronically to retain them in an electronically readable format for the same retention periods as are stipulated in subsection 230(4), unless the minister exempts such persons from the obligation under new subsection 230(4.2).[44]

Recently, the Minister's Advisory Committee on Electronic Commerce[45] considered whether existing record-keeping standards under the Act, which

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[43] See *Window on Canadian Tax* (North York, Ont.: CCH Canadian) (looseleaf), paragraph 3705. In *Information Circular* 78-10R2, Special Release, February 10, 1985, Revenue Canada recognized electronic images of books of original entry and source documents as books and records of account but prescribed the manner in which such images were to be produced, controlled, and maintained.

[44] Subsection 230(4.2) provides that the minister may exempt a person or class of persons from the obligation to retain electronic records on such terms and conditions as the minister considers to be acceptable.

[45] Canada, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce* (Ottawa: Revenue Canada, April 1998). The committee is herein referred to as "the e-comm committee."

were generally designed to ensure that tax authorities have the information available to verify the propriety of transactions that have an impact on the tax system, are adequate to reflect electronic transactions. Observing that it is the responsibility of taxpayers to maintain books and records in a manner that conforms with industry standards, the e-comm committee expressed its belief that the reference in the new statutory definition of "record" to "any other thing containing information, whether in writing or in any other form" would include information contained in permitted electronic format and impose similar record maintenance and retention obligations with respect to electronic records as are applicable to paper documentation and records.

Anticipating conversions of books and records from paper to electronic format, the e-comm committee stressed the responsibility of taxpayers to ensure that converted records are accurate and readable. While Revenue Canada will accept records that are converted from one electronic format to another, provided that there is no loss, destruction, or alteration of information and data relevant to the determination of taxes, it will require that records be retained in paper form if a proposed conversion would not ensure the preservation of the records.[46]

The e-comm committee concluded that it would not likely be difficult for Revenue Canada to audit records for certain aspects of electronic commerce because the failure of a taxpayer to adequately support entitlement to a deduction or expense, whether in paper or electronic format, would preclude the tax recognition of the item unless proper proof of payment were provided. The same rule would be applicable whether the record of the expense was in paper or electronic form. The committee did express concern, however, that taxpayers might maintain detailed records of costs and expenses to ensure deductions but keep less detailed records on the revenue side.

The e-comm committee further observed:

> In a non-electronic environment, all documents can be examined for their attributes of authenticity and integrity—that is, in original form, containing original signatures, and with signed original back-up documents such as order, shipping, and receiving documents and logs. In an electronic world, these types of documents do not exist in the same form, which in certain cases raises concerns about their authenticity and integrity. Accounting

[46] See IC 78-10R3, supra footnote 7. Similar developments are occurring in US tax practice. The Internal Revenue Service established record-keeping requirements in Rev. proc. 91-59, 1991-2 CB 841, which specifies the basic requirements to be met where taxpayer records are maintained within an automatic data processing system. That procedure was updated with the issuance of Rev. proc. 97-22, 1997-1 CB 652. For further discussion, see J. Maida and R. Rubenstein, "Record Retention Rules of the Electronic Highway" (January 1997), 28 *The Tax Advisor* 43-44; N. Allen, "New Revenue Procedure Outlines Electronic Record Retention Rules and Allows for Destruction of Originals" (July 1997), 28 *The Tax Advisor* 456-57; and T. Coppinger et al., "IRS Permits Electronic Imaging in Rev. Proc. 97-22" (March 1998), 29 *The Tax Advisor* 157-58.

> software may or may not contain measures to prevent or identify alterations and erasures. It becomes much more difficult to rely on these records without resorting to additional auditing procedures that may not be feasible or timely to conduct.[47]

In the result, while current and proposed (subsequently enacted) record retention provisions of the Act were considered adequate to deal with electronic commerce, the e-comm committee made a number of recommendations relating to electronic record keeping, including the recommendation that existing record-keeping legislation be reviewed to assess the impact of new technologies on the law.[48]

Since the e-comm committee's report was released, the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants has provided its comments,[49] as have groups such as the TEI.[50] The minister of national revenue also has issued a detailed response to the report after consulting with numerous interested groups.[51]

The focus of the joint committee's comments was the fear of additional burdens and costs to business flowing from implementation of the e-comm committee's recommendations. The joint committee stressed that from a compliance perspective, the government should resist imposing onerous new obligations on business, because if they made doing business in Canada more costly or inefficient, the competitive position of Canadian businesses would be jeopardized. The joint committee also indicated, however, as did other public interest and industry groups, that it would be eager to participate in developments in the area of record retention, data storage, evidence, and similar issues.

The minister indicated in his response that Revenue Canada agrees with and will implement recommendations 50 to 54 of the e-comm committee

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[47] Supra footnote 45, at section 4.5.2.

[48] Other recommendations were (1) that Canada's existing treaty network be amended through negotiation to add new exchange-of-information and enforcement rules comparable to those in the Canada-US tax treaty; (2) that Revenue Canada work with accounting bodies in the development of auditing standards with respect to electronic record keeping and participate in the development of standards to establish verifiable data storage formats; and (3) that the Department of Justice work with provincial counterparts to prepare legislation governing the admissibility of electronic records as evidence. All of these suggested changes are contained in recommendations 50 to 54 of the e-comm committee report.

[49] Letter from the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants to Rob Weil, Manager, Electronic Commerce Group, Audit Directorate, Revenue Canada, September 10, 1998, containing the joint committee's comments on the report of the e-comm committee.

[50] Tax Executives Institute, "Electronic Commerce and Canada's Tax Administration, September 17, 1998" (September-October 1998), 50 *The Tax Executive* 390-402.

[51] Revenue Canada, *Electronic Commerce and Canada's Tax Administration: A Response by the Minister of National Revenue to His Advisory Committee's Report on Electronic Commerce* (Ottawa: Revenue Canada, September 1998) (herein referred to as "the minister's response").

report concerning the maintenance of books and records,[52] and will work closely with the Electronic Commerce Technical Advisory Group on compliance and administration in those matters. Preliminary discussions have been held about seeking the amendment of existing tax treaties to include new provisions comparable to the exchange-of-information and enforcement rules recently added to the Canada-US tax treaty.

Interestingly, the minister's response, released before revisions to IC 78-10R2, evidences Revenue Canada's agreement with the e-comm committee's view that the current record retention provisions of the Act are adequate to deal with electronic commerce, and as previously discussed, the revised circular is consistent with that response. The minister has provided assurances that Revenue Canada will continue to consult with the private sector, other government departments, accounting organizations, and standard-setting bodies to ensure that the law continues to be adequate to deal with changing technology. At the same time, Revenue Canada will try to ensure that the development of standards and audit practices applicable to electronic commerce will not obstruct the adoption of new technology.

Finally, the minister's response affirms that Revenue Canada's initiatives will be coordinated with proposals to amend the Canada Evidence Act to incorporate the substance of the Uniform Electronic Evidence Act, approved in principle by the Uniform Law Conference of Canada in August 1997. It is understood that the minister of justice has been working with her provincial counterparts through that conference with the objective of amending legal frameworks to accommodate electronic commerce.

While Revenue Canada seems to be content that it has sufficient tools under the present law to conduct audits of electronic transactions, including dealing with encryption technology, it has voiced concern that the development of ever more sophisticated encryption technology could prevent the department from accessing information relevant to the determination of a person's tax liability. Revenue Canada intends to continue to monitor and assess the impact of such new technology and business methods to ensure its continuing ability to maintain compliance with Canada's tax laws.[53]

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[52] The TEI also agreed with the implementation of recommendations 50 to 54, although it expressed concern relating to the location of records and the potential for increasing audits by foreign jurisdictions if treaty provisions are renegotiated to permit rights of inspection for records located in other countries. Instead, the TEI recommended that Revenue Canada consider permitting foreign-based information to be considered to be books and records maintained in Canada if it is readily accessible online from a location in Canada. See Tax Executives Institute, supra footnote 50.

[53] With respect to third parties, such as transaction managers, the e-comm committee had recommended that such persons be required to provide Revenue Canada with electronic records or a copy of the records of any client taxpayers being audited. The minister noted that recent amendments to the Criminal Code with respect to computer searches allow

(The footnote is continued on the next page.)

Following the release of the minister's response, Revenue Canada issued IC 78-10R3 on October 5, 1998. As in earlier iterations, the revised circular does not specify particular records and books that have to be kept, other than setting out the tax verification objective that must be capable of being met on the basis of the records that are maintained. The new definition of "record" is included, but there is no indication in the content of the revised circular that Revenue Canada plans to take a more aggressive position on documents and records that need to be retained, having regard to that definition. Accordingly, it seems probable that Revenue Canada is content, as a practical matter, to allow taxpayers to continue to undertake their own evaluations of books and records to decide whether or not they need to be retained for tax determination purposes. The revised circular continues to indicate inferentially, as did earlier versions, that Revenue Canada itself continues to believe that non-essential records, books, and documents—that is, those that do not meet the tax determination standard in subsection 230(1)—may be destroyed.

Revenue Canada cautions in paragraph 12 of the circular that all records and books of account (including source documents) that originate in paper format must be kept, except where an acceptable imaging or microfilming program is in place. Paragraphs 15 through 18 of the circular describe what Revenue Canada regards as the essential elements of an acceptable imaging program. However, the records and books of account contemplated in these paragraphs must be those that meet the tax determination standard in subsection 230(1), since non-essential records that do not meet that standard do not need to be retained, regardless of format. Thus, it seems clear from the circular that essential records do not need to be retained in both paper and electronic format. Where an acceptable electronic imaging program is in place and a taxpayer keeps records in electronically readable format, hard paper copies of the same material may be disposed of.

As a systems matter, however, in contrast to paper documents, which can simply be shredded, it may be substantially more difficult, if not effectively impossible, for businesses to purge electronic records that do not meet the tax determination standard and consequently do not need to be retained. This reality will create document management problems, since any document that is retained, in paper or electronic form, may be subject to production on audit under section 231.1 or may be the subject of a requirement under section 231.2. One can envisage circumstances where

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[53] Continued . . .
Revenue Canada to take copies of electronic files, but the minister's response to the report suggests that this power will not necessarily be used. Rather, decisions on whether to take copies or to seize the hard drive or the computer itself will be made on the basis of the facts in each case having regard to the best evidence rule. Provided that an investigation will not be jeopardized, Revenue Canada will endeavour to take copies of computer files rather than actually seize a computer.

a taxpayer has culled paper records but has been insufficiently attentive to ensure that archived electronic versions of the same documents and records also have been eliminated, or indeed that e-mail has not been archived[54] and has been fully purged from the company's records. In such a case, while no paper version may be available to be produced once an audit has commenced, Revenue Canada will likely be quite content to have the electronic version that has not been purged.

The scope of this problem is easy to understand in the context of ordinary word processing software used by most businesses today. Take, for example, the simple case of a tax-planning memorandum prepared by an in-house tax manager in electronic format using ordinary word processing software. Typically, after the document has been created, it will be printed out and it may well be included in a file. Thereafter, in the course of purging non-essential documents as part of the company's regular record retention review function, a decision may be made that the particular memorandum does not need to be retained and typically the paper version would be discarded. But what of the electronic version contained within the company's computer archives? Unless specific and careful steps have been taken to purge the electronic version of the document as well, it will in all likelihood have been retained and will be able to be reviewed by Revenue Canada on audit or upon the issuance of a section 231.2 requirement, when Revenue Canada obtains access to the company's computer-based document archives.

Not only is this a problem with the simple tax-planning or other type of file memorandum, but earlier drafts of agreements relevant to transactions undertaken also may be available for review within the company's computer archives if care has not been taken to purge them. The deletion of a particular document by its creator from his or her own computer will not delete a copy of the document that has been automatically backed up into the computer archive system of the business, which—regrettably from a tax point of view—was probably designed specifically to ensure that such documents would not be mistakenly erased.

While it is far beyond my own technical computer knowledge, as well as the scope of this article, to discuss procedures for purging computer-based documentation, my understanding is that this process can be quite

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[54] Newspapers and periodicals have attested recently to the potential significance of this problem. As correspondents Marcia Stepanek and Steve Hamm noted last year in *Business Week*, e-mail messages can prove to be an evidentiary nightmare. In the Microsoft anti-trust case in the United States, it appears that e-mail messages dashed off years before by Microsoft chair Bill Gates and his senior staff may prove to be the "smoking guns" that show that Microsoft sought to crush competitors and monopolize access to the Internet. See "Office E-Mail: It Can Zap You—in Court," *Business Week*, June 8, 1998, 72; T. Bridis, "E-Mail Can Come Back To Haunt You," *Winnipeg Free Press*, June 27, 1998, and by the same correspondent, "Old E-Mail Rising Up To Haunt Microsoft: Gates Considered a Message Deletion Policy but Never Moved To Create One, Court Told," *The Globe and Mail*, November 11, 1998.

complicated. Further, there is probably an unavoidable conflict between the tax manager's goal of eliminating records and documentation not required to be retained under section 230 of the Act and the prime objective of information technology professionals with respect to record retention and computer archive management, which is to save rather than destroy old documentation.

Clearly, there is a dilemma here for taxpayers seeking to responsibly manage and restrict the retention of books and records, and there are probably only two alternative courses of action available to reconcile these conflicting objectives. The ideal approach is to consider at the time a document is created whether it is one that must be retained. Regardless of the motive behind the document's initial creation, one needs to assess carefully whether it is likely to create more problems than it solves if at some future time Revenue Canada becomes aware of the document or demands its production. Where there is no need to create documents, prudence demands that taxpayers resist the temptation to do so.

Alternatively, taxpayers may implement record management programs that eliminate existing documentation that is not strictly required to be retained under the provisions of the Act. In this case, it will be necessary to consult with information technology advisers and take concrete steps soon after a transaction is completed, or regularly as part of an ongoing record management process, to ensure that redundant documentation, such as earlier drafts of commercial agreements, or potentially embarrassing or damaging e-mail messages, is in fact fully purged from the computer archives of the business.

There can be little doubt that electronic record retention systems will be more difficult to manage and control than traditional paper-based systems, at least from a tax point of view. It may be more difficult to ensure in an electronic environment that only the desired and necessary records are being retained. Even where records or documents in electronic format are deleted, it may be possible with existing and developing technology to "recreate" computer files that the taxpayer may believe to have been destroyed. Consequently, it may never be possible to be fully satisfied that any electronic record that comes into existence may not be available for use as evidence in the context of some future assessment or proceeding. In light of this reality of modern business life, taxpayers must take a more proactive role to manage record retention and creation. It will be increasingly important to ensure that the records that are available to be reviewed in future establish only those facts that need to be established and are free, to the maximum extent possible, of extraneous or irrelevant information, and particularly of items that may give rise to future audit queries or that would compromise a taxpayer's claim of a particular tax result.

AUDITS AND INFORMATION DEMANDS

Tax advisers are frequently asked to advise clients concerning their legal obligation to allow Revenue Canada to inspect their books, records, and

other documents. Not only does Revenue Canada have the power to inspect these items in connection with the conduct of an audit, but it is also empowered to serve a requirement on the taxpayer or third persons compelling the production of requested information if it is not provided willingly. Neither of these powers is unlimited, however, since both are exercisable only for purposes related to the administration or enforcement of the Act. Nevertheless, developments in recent cases seem to indicate an increased willingness of Canadian courts to grant Revenue Canada broader access to information in the course of discharging that administration and enforcement mandate.

Sections 231.1 and 231.2: Scope of the Minister's Right To Inspect and Demand Production of Books, Records, and Other Documents[55]

Section 231.1 of the Act allows a person authorized by the minister, for any purpose related to the administration or enforcement of the Act,[56] to inspect, audit, or examine "the books and records" of a taxpayer or "any document," either of the taxpayer or of any other person, that relates or may relate to the information that is or should be in the books and records of the taxpayer, or that relates to any amount payable by the taxpayer under the Act. For the purposes of carrying out an inspection, audit, or examination, section 231.1 permits Revenue Canada personnel to enter premises or places where any business is carried on, where any property is kept, where anything is done in connection with any business, or where any books or records are or should be kept.[57] Further, the owner or manager

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[55] For another recent discussion of these requirements, see Mary Messih, "Revenue Canada's Requirement To Provide Documents or Information," *Tax Topics*, no. 1358 (North York, Ont.: CCH Canadian, March 19, 1998).

[56] The meaning of this expression has been considered in a number of cases: see *Canadian Bank of Commerce v. Attorney General of Canada*, 62 DTC 1236 (SCC); *James Richardson & Sons, Limited v. MNR*, 82 DTC 6204 (FCA); *McKinlay Transport Limited et al. v. The Queen*, 90 DTC 6243 (SCC); *Canadian Forest Products Ltd. et al. v. MNR*, 96 DTC 6506 (FCTD); and *AGT Limited v. AG of Canada*, 96 DTC 6388 (FCTD), aff'd. 97 DTC 5189 (FCA). These cases establish that for the minister's inquiry to be for a purpose related to the administration or enforcement of the Act, the minister must be capable of showing that there is an inquiry being made to determine the tax liability of specific persons or to verify compliance by identifiable persons. More broadly based inquiries about unnamed persons or even specific classes of unidentified persons will not meet this requirement.

[57] Note that this apparently open-ended authorization to inspect books and records extends only to business premises. Where Revenue Canada officials seek to enter a person's dwelling-house, either the consent of the occupant must have been obtained or Revenue Canada must have obtained the authorization of a search warrant granted under subsection 231.1(3). An application for such a warrant is brought on ex parte application. The warrant may be issued when a judge is satisfied (1) that there are reasonable grounds to believe that a dwelling-house is a place where any business is carried on, any property is kept, anything is done in connection with any business, or any records or books of account are or should be kept; (2) that entry is necessary for purposes relating to the administration or enforcement of the Act; and (3) that either entry has been refused by the occupant or there are reasonable grounds for believing that entry will be refused.

of the property or business being inspected is required to give all reasonable assistance[58] and to answer all proper questions that relate to the administration or enforcement of the Act.[59]

Section 231.2 of the Act entitles the minister, "[n]otwithstanding any other provision of this Act," for any purpose related to the administration or enforcement of the Act, to serve notice on a taxpayer requiring that the taxpayer provide "any information" or "any document" within a reasonable time period stipulated in the notice.

The language of section 231.1 suggests that Revenue Canada is not empowered to have access to all books, records, and documents, but rather the minister's authorized representative must be able to satisfy a relevancy requirement as a precondition to carrying out an inspection, audit, or examination. In particular, the books, records, and documents in question must (or may) relate to information that is or should be in the taxpayer's books or records or to "any amount payable by the taxpayer" under the Act. In contrast, where the minister issues a demand under section 231.2, the person to whom notice is served may be required to provide "any information" or "any document" without restriction.

As discussed earlier, with the introduction of the new definition of "record," the definition of "document" in section 231 was amended. The latter applies for purposes of sections 231.1 to 231.6. The fact that the definition of "document" is inclusory and not exclusive means that all items that are considered documents under general legal principles and decided case law will fall within the ambit of the term.[60] Thus, the former

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[58] In the context of old paragraph 231(1)(c), one author noted that providing "reasonable assistance" did not mean preparing new documents or doing the tax auditors' job for them. See Richard W. Pound, "Audit, Inquiry, Search and Seizure," in *Report of Proceedings of the Thirty-Seventh Tax Conference*, 1985 Conference Report (Toronto: Canadian Tax Foundation, 1986), 27:1-75, at 27:22-24.

[59] The meaning of "proper questions" was considered in *R v. Marcoux et al.*, 85 DTC 5453 (Alta. Prov. Ct.). In that case, Revenue Canada auditors seemed to ask questions intended to trick the taxpayers and did not advise the taxpayers of all information that was in Revenue Canada's possession at the time the questions were being asked, apparently with an intention to mislead the taxpayers. In such circumstances, where the court noted a wide gap between the manner in which the special investigators had conducted themselves and Revenue Canada's guidelines on that subject, notes taken by the Revenue Canada special investigators were held to be inadmissible in criminal proceedings later brought against the taxpayers.

[60] As discussed above, the common law establishes that "document" is a word having a very broad meaning. Sopinka, Lederman, and Bryant, supra footnote 15, at 927 et seq., state on the authority of *Fox v. Sleeman* (1897), 17 PR 492, that a document is "any writing or printing capable of being made evidence, no matter on what material it may be inscribed." The current legislative and judicial trend is to include modern methods of communicating and storing information. In *Tide Shore Logging Ltd. v. Commonwealth Ins. Co.* (1979), 100 DLR (3d) 112 (BC SC), it was held that the word "document" also includes a tape recording, provided that what is recorded is indeed information—that is, relevant sounds of some description. Videotapes, microfiche, and computer records have also been admitted as documentary evidence in civil and criminal proceedings.

definition in section 231 merely expanded the class of items that might otherwise be considered to be documents to include the specific items listed in the definition. The same might have been said of the expansion that results from the importation of the term "record"; however, a comparison of the new and former definitions of "document" indicates that the scope of information now capable of being inspected by Revenue Canada pursuant to section 231.1 and demanded under section 231.2 has been expanded by reason of the new definition of "record."

These changes have not, however, affected the relevancy requirement in section 231.1, as described above. It is against this criterion of relevancy that requests by Revenue Canada to inspect or audit particular documents should be tested, although as seen in recent cases, courts are demonstrating an increasing reluctance to limit Revenue Canada's powers of inquiry only to documents that meet the conditions specified in section 231.1.

The Legacy of the McKinlay Transport Decision

The seminal decision of the Supreme Court of Canada in *McKinlay Transport Limited et al. v. The Queen*[61] supported Revenue Canada's right to inspect the books, records, and documents of a taxpayer. It also held that the requirement to produce documents does not violate the Canadian Charter of Rights and Freedoms[62] as an unreasonable search and seizure. While that case did not address specifically the requirement to produce particular books and records of a taxpayer, but rather considered the Charter implications of a demand for information under old subsection 231(3) of the Act (the predecessor to section 231.2 dealing with demands for information), it is clear that Revenue Canada has over the years come to rely on this decision as supportive of its right of access to any documents it may request from taxpayers.

Wilson J in her reasons for judgment argued that the privacy right of most corporations was lower than that which might apply in the case of an individual taxpayer. It was the court's theory that corporations are already required to accept significant intrusions into their privacy as a result of their obligations to comply with statutory filing requirements. Notwithstanding the broad interpretation of this decision advanced by Revenue Canada, it is noteworthy that it was only in respect of business records that relate to the taxpayer's tax liability that Wilson J indicated a taxpayer's privacy interest in business records is low: "a taxpayer may have little expectation of privacy in relation to his *business records relevant to the determination of his tax liability* [emphasis added]."[63]

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[61] Supra footnote 56.

[62] Part I of the Constitution Act, 1982, being schedule B of the Canada Act 1982 (UK), 1982, c. 11.

[63] *McKinlay Transport*, supra footnote 56, at 6251.

Despite the arguably limiting effect of Wilson J's comment, Revenue Canada considers that its requests to corporate taxpayers to produce documents do not further intrude upon a corporation's right to privacy; that, accordingly, such information ought to be provided; and that it is the minister who will determine relevancy. Revenue Canada no doubt finds support for its approach in the following words of Wilson J:

> It [the predecessor to section 231.2] simply calls for the production of records which may be relevant to the filing of an income tax return. A taxpayer's privacy interest with regard to these documents *vis-à-vis* the Minister is relatively low. The Minister has no way of knowing whether certain records are relevant until he has had an opportunity to examine them.[64]

Over the years since *McKinlay Transport* was decided, many taxpayers have disagreed with the broad reading by which Revenue Canada has sought to extend this principle. They have argued that the mere fact that a corporation's privacy has already been "invaded" as a result of the obligation to file documents with regulators cannot alter the requirement in section 231.1 that the documents sought by Revenue Canada must be directly relevant to Revenue Canada's audit inquiry and the taxpayer's liability for taxes.

On this basis, in the face of an inspection under section 231.1, a taxpayer should be entitled to maintain as confidential documentation prepared for its own internal purposes, and even certain documents prepared for external reporting purposes, which it would not be required to disclose absent a clear relevancy connection to the purposes for which section 231.1 was enacted. The principles in *McKinlay Transport* arguably established that the minister did not have an unfettered right to access all books, records, and documents of a taxpayer, either by reason of a demand for production under section 231.2 or, by extension, under the minister's inspection rights in section 231.1. Rather, the minister's request for information or demand for production of documents and records had to meet the relevancy test contained in sections 231.1 and 231.2. It was thus open to a taxpayer to challenge the relevance of, and hence the obligation to produce, certain books and records, and in particular other documents, for any of the reasons outlined by the lower courts in *McKinlay Transport*[65] (which reasons were not overruled by Wilson J in the Supreme Court of Canada).

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[64] Ibid.

[65] In the Ontario High Court, 87 DTC 5051, Trainor J, on the basis of *James Richardson & Sons, Limited v. MNR*, 84 DTC 6325 (SCC), held that the document production requirement under the predecessor to section 231.2 could not be construed as a seizure that might violate the Charter of Rights and Freedoms. The essence of Trainor J's reasons was that the recipient of such a demand could successfully attack it on a number of grounds—for example, that a reasonable time was not allowed for the production of the material, that the minister was engaging in a fishing expedition and not a genuine and serious inquiry into a particular taxpayer's liability, that the documents were not germane or relevant to

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Since the Supreme Court of Canada's decision, *McKinlay Transport* has been considered and discussed in numerous Canadian tax cases[66] and at least one Privy Council decision.[67]

Technically, at least until the 1998 amendments, "records" arguably referred only to original source documents, and not to later analyses of those documents. Thus, it might have been supposed that it was only with respect to "records" in that narrower sense that Wilson J was suggesting that a taxpayer's privacy interests are low. In this limited context, this conclusion would be sensible since books of account and accounting records are required to be produced in any event for other purposes, such as financial reporting. A taxpayer might therefore have argued that Wilson J's reasons in *McKinlay Transport* did not extend to all documents, but merely to "books and *records*," as a technical matter, and thus that the low privacy expectation threshold did not apply to all business documents, but

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[65] Continued . . .
the issues between the parties, or that the documents were privileged. Trainor J suggested that it might well be incumbent on the minister to set out grounds for a demand in order that relevance could be ascertained. At the Ontario Court of Appeal, 88 DTC 6314, Grange J adopted Trainor J's analysis and concluded that the fact that taxpayers could challenge the requirement to produce information was sufficient to dispel the notion that a requirement to produce was an unauthorized search or seizure. He concurred in Trainor J's view that the relevant provisions of the Act were not unqualified or unlimited, but rather were subject to judicial review "wherein the requirement will be tested objectively to determine whether it is authorized by the section and whether it is relevant to the tax liability of a specific person" (supra, at 6315). He concluded on the authority of *Canadian Bank of Commerce*, supra footnote 56, and *James Richardson & Sons*, supra, that fishing expeditions would not be permitted.

[66] See *Zeppetelli et al. v. The Queen et al.*, 90 DTC 6461 (Que. CA); *Tyler v. MNR*, 91 DTC 5022 (FCA); *Merko v. MNR*, 90 DTC 6643 (FCTD); *Morena et al. v. The Queen et al.*, 90 DTC 6685 (FCTD); *Baron et al. v. The Queen*, 91 DTC 5055 (FCA); *Montreal Aluminium Processing Inc. et al. v. The Queen*, 91 DTC 5424 (FCTD); *Gregory v. MNR*, 92 DTC 6518 (FCTD); *The Queen v. Cappell*, 92 DTC 6591 (Ont. CA); *Ludmer et al. v. MNR*, 93 DTC 1351 (TCC); *The Queen v. Transgas Limited et al.*, 93 DTC 5391 (Sask. CA); *Kourtessis et al. v. MNR*, 93 DTC 5137 (SCC); *Gray et al. v. AG of Canada et al.*, 93 DTC 5518 (Ont. Gen. Div.); *The Queen v. Norway Insulation Inc. et al.*, 95 DTC 5328 (Ont. Gen. Div.); *R v. Harris*, 95 DTC 5653 (BC SC); *Del Zotto v. The Queen et al.*, 95 DTC 5518 (FCTD), 97 DTC 5145 (FCTD), rev'd. 97 DTC 5328 (FCA); *Djokich v. AG of Canada*, 95 DTC 5623 (FCTD), 96 DTC 6214 (FCTD); *AGT Limited*, supra footnote 56; and *Deloitte & Touche Inc. v. AG of Canada*, 97 DTC 5520 (FCTD).

[67] In *NZ Stock Exchange v. Comr of Inland Revenue*, [1991] STC 511 (PC), the Judicial Committee held that a request for information by the commissioner of inland revenue did not offend against the applicants' rights under the New Zealand Bill of Rights Act, 1990, which guaranteed them the right to be secure against unreasonable search or seizure. The commissioner was charged with ensuring that the assessable income of every taxpayer is assessed and the tax paid in the interests of the community at large. Consequently, the requirement by the commissioner that information be produced by the stock brokers and banks in respect of unidentified taxpayers could not be considered to be unreasonable. The Judicial Committee concluded that the powers conferred on the commissioner were not unreasonable, and it felt no need to engage in an "elaborate consideration of different expectations of privacy in different contexts" (ibid., at 515) as the Supreme Court of Canada did in *McKinlay Transport*.

only to records.[68] Whatever the validity of this nuance may have been before the 1998 amendments, it is now likely to be lost with the statutory expansion of the meaning of "records" to include virtually all recorded information.

Has the Relevancy of Documents Become Irrelevant?

Regrettably, more recent decisions suggest that a taxpayer who resists a Revenue Canada requirement to produce documentation on the basis of its alleged "irrelevance" may not find success in the courts. Directly on point is the recent decision of Rothstein J of the Federal Court—Trial Division in *AGT Limited v. AG of Canada*.[69] At issue in that case was the minister's entitlement under section 231.2 to require production by AGT of certain confidential information it had prepared in connection with rate hearings being held before the Canadian Radio-television and Telecommunications Commission (CRTC).

After being privatized in 1990, AGT (formerly the Alberta Government Telephone Commission) came under the jurisdiction of the CRTC and became obliged to apply to the CRTC for a variety of regulatory approvals. The rates at which AGT would be allowed to charge for its services were subject to CRTC approval and depended on AGT's revenue requirements. Typically, the CRTC would set AGT's rates at a level that would permit AGT to cover its expenses, including its anticipated income tax liabilities; to meet its cost of capital, including interest on debt; and to earn a return on equity.

AGT took a more conservative approach to projecting its income tax liability for CRTC purposes than it had in filing its federal income tax returns, but the CRTC did not accept all of the components submitted by AGT in support of the establishment of its revenue requirements. AGT then became concerned that its CRTC submissions might prejudice it in any subsequent dealings with the tax department, given that the content of its tax returns and its CRTC submissions were not entirely consistent. Consequently, it sought a confidentiality order from the CRTC for those submissions that, if discovered by the minister of national revenue, might undermine AGT's ability to negotiate with the minister[70] on any proposed reassessments.

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[68] In justifying the existence of former subsection 231(3) (and by extension current section 231.2), Wilson J referred on four separate occasions to "records" and the need to produce "records" as opposed to documents. There is no indication that Wilson J ever contemplated that a taxpayer would have a low privacy interest in records as now defined, given that many of these items are arguably not "relevant to the determination of his tax liability."

[69] *AGT Limited*, supra footnote 56 (FCTD).

[70] In this sense, AGT's position was not unlike that of any corporation forced to disclose to Revenue Canada the elements that might constitute its tax cushion analysis or provision for taxes prepared for shareholder financial reporting purposes.

The CRTC allowed some of AGT's confidentiality requests, but Revenue Canada then sought access to those documents by issuing a requirement under section 231.2 of the Act. AGT applied to the Federal Court for judicial review, advancing a variety of arguments in support of its position. Ultimately, each of these submissions failed, its application was dismissed, and Revenue Canada was held to be entitled to obtain production of the sensitive documents. The Federal Court of Appeal later agreed with this result when it dismissed AGT's further appeal.[71]

In the course of denying AGT's request for judicial review, Rothstein J reviewed the Supreme Court of Canada's decisions in *James Richardson & Sons*[72] and *McKinlay Transport*. In his view, *McKinlay Transport* had established five distinct principles:

1) that the expectation of privacy of a taxpayer in relation to business records is relatively low;

2) that relevance of the material requested to a particular issue is not a prerequisite to a requirements notice by the minister of national revenue under subsection 231.2(1), so long as the minister's purpose in issuing the requirement is related generally to the administration or enforcement of the Act;

3) that the production of documents may be compelled even if the documents are not required to be prepared or kept under the Act;

4) that there is no requirement under the Act that a requirements notice set out the grounds or particulars in respect of which the documents sought are required; and

5) that so long as the documents pertain to a genuine inquiry into the tax liability of a person, they may be the subject of a requirements notice under subsection 231.2(1).

In concluding that Revenue Canada was entitled to the documents requested, and that there need be no preliminary determination of relevance, the court stated:

> There is no doubt that the subject matter of the documents which the Minister sought pertains to AGT's tax liability. The Minister is entitled to business records, which these are, whether relevant or irrelevant to any specific issue. The fact that the documents may not have been prepared for purposes of the *Income Tax Act* is of no consequence.
>
> *I do not see any general condition precedent to the Minister invoking subsection 231.2(1) that he first attempt to obtain the documents voluntarily or that he limit his requirements by some preliminary determination of likely relevance*. Certainly the Minister may not invoke subsection 231.2(1) in bad

[71] *AGT Limited*, supra footnote 56 (FCA).

[72] Supra footnote 65.

> faith. However, the fact that he acknowledges that some of the information he seeks is not relevant, is not fatal to the Minister [emphasis added].[73]

The Federal Court of Appeal acknowledged on appeal that taxpayers have an interest in having their business strategies kept in confidence, but it concluded that when balanced against the interests of the state, the latter's interests must be favoured. Desjardins JA said that in light of the *McKinlay Transport* decision, the only analysis required in considering the minister's right to require documents under section 231.2 related to relevancy and reasonableness. All that was required was that the information sought by the minister be relevant to the tax liability of one or more specific persons, and that the tax liability of those persons be the subject of a genuine inquiry.[74]

AGT Limited is an important case for its specific affirmation of the scope of the minister's authority to require document production under section 231.2, in the wake of the *McKinlay Transport* decision and cases that followed it. Happily, the Federal Court of Appeal continues to affirm the importance of relevance, in its observation that courts will continue to test that the information required is relevant to a specific person's tax liability, and of the reasonableness of the minister's actions. It is also clear, however, that the courts view this provision as a necessary tool in the minister's arsenal to ensure compliance, and that they are not prepared to debate relevance of particular items requested to be produced. Once the minister invokes the specific authority vested in him under the Act to require the production of information, or to inspect information, he is entitled to receive the information or to review it, provided only that the tests of reasonableness and taxpayer-specific relevance described by Desjardins JA are met.[75] Further, this conclusion seems to be consistent

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[73] *AGT Limited*, supra footnote 56 (FCTD), at 6392-93. The remainder of Rothstein J's judgment related to the application of common law privilege to the confidential documents requested by Revenue Canada and the interaction of the minister's power to require the production of documents under the Act in the face of confidentiality provisions in proceedings before other federal tribunals.

[74] See also *Maple Lodge Farms Limited v. The Queen*, 97 DTC 5226 (FCTD), and a comment on both that and the *AGT Limited* decision by R. Jarman, "Can Ministerial Requirements for the Production of Documents Be Successfully Opposed?" *Dominion Tax Cases* (North York, Ont.: CCH Canadian, May 12, 1997).

[75] More recently, the relevancy of documentation has been further considered in the context of a tax appeal in *SmithKline Beecham Animal Health Inc. v. The Queen*, 98 DTC 1929 (TCC). At issue was whether the corporate taxpayer was required to produce an expert's report that had been produced for use in prior constitutional litigation, and whether that report was relevant to the taxpayer's income tax appeal. The taxpayer resisted production of the document on the basis that the tax assessment in the current appeal was not related to that constitutional issue and the parties to that issue were not the same. However, the Crown's motion to require the production of the document was granted by the Tax Court of Canada. In reaching this conclusion, Hamlyn TCCJ referred to decisions of the Federal Court of Appeal in *Owen Holdings Ltd. v. The Queen*, 97 DTC 5401, and *AGT Limited*, supra footnote 56, concluding that in relation to the production of documents and

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with the direction evident in the very recent decisions of the Supreme Court of Canada in *Schreiber v. Canada (Attorney General)*[76] and *The Queen et al. v. Del Zotto et al.*[77] One can detect a growing reluctance on the part of the higher Canadian courts to permit resistance to the production of information based on alleged violations of privacy rights, in the face of what are perceived to be legitimate requests for information by the state made in the course of administering Canadian law.

Information Demands Relating to Unidentified Persons

Arguably, in the wake of the *AGT Limited* decision, the main circumstance where a taxpayer is likely to succeed in resisting a demand by the minister for information under section 231.2 is where the information sought cannot be shown to relate to the particular taxpayer who is being investigated or whose liability is being considered, but relates instead to unidentified persons. This was the situation in *Canadian Forest Products Ltd. et al. v. MNR*.[78] There, the applicants were companies active in the forest industry. Revenue Canada sought to obtain information from them in the course of auditing four or five other companies in the same industry.

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[75] Continued . . .
the particular document in question, the scope of the document production requirement is very broad and the relevancy threshold quite low. From a reading of the pleading, the evidence filed on the motion, and the reported decisions in the constitutional litigation, the documents requested did relate to the matters in issue in the tax appeal. The fact that the parties to the prior litigation were different from the parties to the tax appeal did not prevent the minister of national revenue from having access to the particular documents, since they related to the potential tax liability as pleaded in the proceedings. See also *Fletcher Challenge Investments Inc. v. The Queen*, 98 DTC 1721, where the Tax Court extended an equally broad approach to the question of relevance of documentation for the purposes of examination for discovery, concluding on the basis of the decision in *Algonquin Mercantile Corp. v. Dart Industries Canada* (1984), 79 CPR (2d) 140 (FCTD), that it is wiser to err on the side of requiring extensive production of documents than to adopt an overly restrictive approach.

[76] (1998), 158 DLR (4th) 577 (SCC). In this case, the government of Canada sought information from the government of Switzerland relating to Canada's criminal investigation of activities of the plaintiff. The court found that while international criminal investigations might have implications for rights and freedoms such as those enumerated in the Charter, this did not mean that the Charter was engaged. Although the information request came from the government of Canada, any intrusion into the plaintiff's privacy rights resulted from actions of the Swiss government, and these were not subject to Charter scrutiny, even though they might have been undertaken by the Canadian government.

[77] 99 DTC 5029 (SCC). At issue in this case was the constitutionality of an inquiry undertaken into the taxpayer's affairs under section 231.4 of the Act, and whether such an inquiry constituted an unreasonable search and seizure contrary to section 8 of the Charter. The majority of the Federal Court of Appeal, *Del Zotto*, supra footnote 66, held such an inquiry to be unconstitutional, but the Supreme Court reversed that decision on the basis of the dissenting reasons of Strayer JA, who regarded the section 231.4 inquiry as a tool of limited intrusiveness on individual privacy rights, as compared to a search. Theoretical and potentially invalid uses of information obtained through such an inquiry did not justify a declaration as to its invalidity.

[78] Supra footnote 56.

In effect, Revenue Canada was asking the applicant companies to provide it with information that could be used as a check against prices reported by other companies that were under audit, so that a determination could then be made as to whether the latter companies had accurately reported their income.

The applicants asserted that the minister was not acting for a purpose related to the administration or enforcement of the Act, and that since the requirement related to unnamed persons, the minister first had to obtain the authorization of a judge as contemplated under subsections 231.2(2) through (6). Jerome ACJ agreed with the applicants' submissions. He noted not only that the Supreme Court of Canada's decision in *James Richardson & Sons* had cautioned against interpreting section 231.2 too liberally, even though it was very broad on its face, but also that Wilson J had adopted and affirmed the restrictions enunciated in the *Canadian Bank of Commerce* case.[79] The principles adopted in that case entitle the court to test, objectively, whether the minister is acting for a purpose specified in the Act and whether the information requested relates to the tax liability of a specific person who is under investigation. If so, the objective test of purpose will be met. Prior decisions had confirmed that the courts will require that the minister name particular taxpayers under investigation where he issues a requirement for information. Most important was the court's observation that failure to name the taxpayers under investigation effectively amounted to a "fishing expedition" and that it was exactly this kind of situation, and the desire to protect against it, that had prompted Parliament to enact subsection 231.2(2) in the first place. Jerome ACJ stated:

> The conditions set out at subsection 231.2(3) are designed to guard against abusive investigations by the Department of National Revenue. If the respondent is not prepared to name those taxpayers under investigation, she must proceed by way of subsection 231.2(3).[80]

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[79] Supra footnote 56.

[80] *Canadian Forest Products Ltd.*, supra footnote 56, at 6508, on the authority of *Paquette v. MNR*, 92 DTC 6394 (FCTD), and *Andison v. MNR*, 95 DTC 5058 (FCTD). But compare this decision with those of Rothstein J in *MNR v. Sand Exploration Limited et al.*, 95 DTC 5358 (FCTD) and 95 DTC 5469 (FCTD). In those cases, the minister did obtain an order under the judicial authorization provisions in subsection 231.2(3) of the Act, allowing him to require the corporate respondents to provide a list of persons who had been sold interests in certain seismic data. It was believed that the purchasers of these data had paid an inflated price solely for the purpose of obtaining an excessive tax deduction. Thus, the issue was whether section 231.2(3) entitles the minister to obtain a court authorization to require third parties to provide the names of taxpayers whom the minister believes to be not complying with the Act, and if so, whether the evidence before the court in that case was sufficient to justify the issuance of an authorization. Rothstein J concluded that the group of unnamed investors was ascertainable and that there was a real concern regarding the use being made of the data in question. The information being sought by the minister was not more readily available; therefore, the minister could not be considered to have been conducting a fishing expedition. He had complied with the requirements of subsection 231.2(3), and the authorizations were entitled to stand.

While Jerome ACJ seemed to believe that the correct approach in the circumstances before him was to require that the procedure in subsection 231.2(3) be adopted, there is another alternative under which the minister could have obtained the information he sought. The applicants in *Canadian Forest Products* had maintained that public disclosure of the information requested by the minister was against their business interests, and that the minister was not justified in telling certain taxpayers to turn over information that could be prejudicial to their interests where the information did not have a bearing on their own tax liability. They argued that if the minister needs such information, the release of which could be prejudicial to them, then all companies in the particular industry must be required to supply such information, as would be the case if a regulation to that effect were to be issued under paragraph 221(1)(d) of the Act. In the Supreme Court's decision in *James Richardson & Sons*, Wilson J specifically sanctions this approach in her concluding remarks:

> If the Minister seriously thinks that traders in the commodities futures market generally are not reporting their transactions properly for income tax purposes, then he has s. 221(1)(d) available to him. He can obtain a regulation under that subsection requiring all such traders to file returns of their transactions in the commodities futures markets. Having obtained such a regulation, he is then in a position to demand such returns at large without regard to whether or not any specific person or persons are currently under investigation. The very presence of those provisions in the Act serves, in my view, to support the approach taken in the *Canadian Bank of Commerce* case that s. 231(3) is only available to the Minister to obtain information relevant to the tax liability of some specific person or persons if the tax liability of such person or persons is the subject of a genuine and serious inquiry.
>
> It seems to me that if the Minister wishes to conduct the kind of survey he clearly had in mind in this case, it is right and proper that he obtain a regulation authorizing it. The business implications for the appellant are serious. It agreed to cooperate on the basis that the Minister was conducting a test and that other commodity brokers would also be participating. If its customers were less than happy with their broker's role as conduit to the tax department, its competitors would be in the same position. It now finds that this is not the case. If the tax liability of its customers or one or more of them were the subject of a genuine inquiry, then the Minister would clearly be entitled under s. 231(3) to single out the appellant even though innocent taxpayers' trading activities were disclosed in the process. But it cannot, in my opinion, be singled out otherwise. It cannot be compelled under s. 231(3) to provide the random sample for a check on general compliance by the entire class. This is the purpose of sections 221(1)(d) and 233.[81]

The Crown appealed the decision in *Canadian Forest Products*, but before the appeal could be heard, the information that the Crown had demanded under section 231.2 became redundant. The Crown nevertheless pursued the appeal to displace what it regarded as an unfavourable

[81] *James Richardson & Sons*, supra footnote 65, at 6330-31.

precedent. However, certain of the forest companies (Kruger Inc., Avenor Inc., and Tembec Inc.) were successful in quashing the appeal on grounds that the proceedings were moot.[82] Marceau J decided, on the basis of principles established by the Supreme Court of Canada as set out in *Borowski v. Canada (Attorney General)*,[83] that it is the court's role to arbitrate only in live controversies and not on questions that have become hypothetical by reason of changes in factual circumstances. The Federal Court of Appeal did not expressly address the taxpayers' argument that the information sought by the minister should be obtained under other provisions of the Act.

Taxpayers can rely in future on the decision in *Canadian Forest Products*, which will continue as precedent in the case of third-party information demands, at least until a future appeal in another similar case.[84]

The Right to Silence

There is no doubt that the Act grants broad powers to Revenue Canada to monitor compliance with the Act. Revenue Canada may inspect taxpayers' books and records, conduct audits, and require answers to questions relating to the administration or enforcement of the Act; but Revenue Canada may also obtain from any person, for any purpose relating to the administration or enforcement of the Act, any document and any information. It may also obtain relevant information from a taxpayer, as well as banks and third parties with whom a taxpayer has dealings, in order to verify a taxpayer's taxable income for a particular year.

Notwithstanding these powers, in recent years courts have differentiated between audits or examinations of taxpayers carried out for civil purposes, and "special" investigations of alleged offences under the Act, the goal of which is not to verify compliance, but rather to obtain evidence that would support a prosecution and conviction. In recent years, the courts have held that the audit powers of Revenue Canada cannot be used to investigate suspected tax evasion cases or other income tax offences without violating rights guaranteed in the Canadian Charter of Rights and Freedoms. On this basis, as discussed below, the use of the audit provisions of the Act by Revenue Canada personnel engaged in the investigation of tax offences has been struck down.

The "right to silence" is the ultimate recourse available to a taxpayer who seeks to avoid producing documentation in response to Revenue Canada demands. In circumstances where an audit is suddenly converted into a criminal investigation (sometimes, as the cases have shown, without

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[82] *MNR v. Kruger Inc., Avenor Inc. and Tembec Inc.*, court file no. A-693—96, order of Marceau J, October 9, 1998, Décarie and Robertson JJA concurring.

[83] [1989] 1 SCR 342.

[84] See Tom Clearwater, "One That Got Away" (December 22, 1998), 6 *Canadian Tax Highlights* 93, for a brief discussion of these points and other interesting aspects of the decision on the *Kruger* motion from a procedural perspective.

the taxpayer's knowledge that the nature of the investigation has changed), the taxpayer's obligation to provide reasonable assistance to Revenue Canada's officers is curtailed, and the taxpayer's right to maintain silence and not to incriminate himself or herself becomes paramount.[85]

The principle of a taxpayer's right to silence in such cases is a developing legal trend. The most important decision supporting a taxpayer's right to maintain silence is that of the Ontario Court, General Division in the case of *The Queen v. Norway Insulation Inc. et al.*[86] In that case, LaForme J held that once an auditor conducting an audit under section 231.1 of the Act suspects tax evasion, and in particular once the Special Investigations Branch of Revenue Canada is consulted by an auditor and thereafter "directs the audit" to attempt to uncover suspected tax evasion, the audit power of Revenue Canada will have been misused. Revenue Canada will not be permitted to use section 231.1 of the Act to obtain information and documents, once the audit has been turned into an investigation of criminal wrongdoing, but instead, it must gather evidence by applying for and executing search warrants.

In *Norway Insulation*, the facts were relatively straightforward. In the course of an ordinary audit undertaken under section 231.1, Revenue Canada's auditor formed the view that Norway Insulation may have received unreported income. The file was referred to the Special Investigations group within Revenue Canada, and the auditor ceased working on the audit. After reviewing the auditor's work, Special Investigations agreed with his conclusions. The file was sent back to the audit group with a request that other specific matters be investigated to enable Revenue Canada to establish that reasonable and probable grounds existed to obtain a search warrant.

These further areas were investigated by another Revenue Canada staff person, Mr. Chow. It was on his information that search warrants were later obtained and executed, resulting in charges being laid for offences under the Act. At trial, the court concluded that Charter violations had been committed by Mr. Chow in the course of gathering evidence to support his request for search warrants; accordingly, the warrants were quashed and the accused was acquitted. The Crown appealed the acquittals.

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[85] For a more detailed discussion of the right to silence and its implications, see Craig C. Sturrock, "Taxpayer Relief from Revenue Canada Representations and Abuses," in *Report of Proceedings of the Fiftieth Tax Conference*, 1998 Conference Report (Toronto: Canadian Tax Foundation, forthcoming); Craig C. Sturrock, "Income Tax Audits and Investigations: The Right To Remain Silent and the Right Against Self-Incrimination," in *1997 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1997), tab 17; and David M. Porter, "The Use of Audit Powers by Revenue Canada in Criminal Investigations: Developments Under the Charter of Rights and Freedoms," in *1997 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 1997), tab 16.

[86] Supra footnote 66.

Once again, consistent with the Supreme Court of Canada's decision in *McKinlay Transport*, it was held that audits and investigations undertaken under section 231.1 do not violate citizens' rights to be free from unreasonable search and seizure under section 8 of the Charter, provided that the audit powers are being exercised merely for regulatory or administrative purposes. Involvement of Revenue Canada's Special Investigations group, however, had elevated the "audit" to an "investigation" for offences under the Act that could result in fines and imprisonment. In such a case, the higher privacy expectations that Wilson J had discussed in *McKinlay Transport* became relevant. LaForme J observed that Revenue Canada's staff were not merely determining tax compliance in the course of undertaking this audit. Rather,

> [t]he provisions of section 231.1(1) were, in the case at bar, being relied upon and employed by Revenue Canada as *quasi*-criminal legislation thus requiring greater safeguards to the individual. Section 231.1(1) is designed as a regular audit tool to ensure compliance with the Act. It is not designed to gather evidence for the purpose of a criminal prosecution. It should not be used to bootstrap the ministry investigators into a position where they can obtain a warrant which would otherwise be unattainable.[87]

Since Mr. Chow had been instructed to investigate for information that might be uncovered and since the primary object of continuing to undertake the audit was the possibility of finding evidence, the auditor was no longer merely auditing the taxpayer. He had instead commenced a criminal investigation directed toward ultimately laying charges against the taxpayer.

In concluding that the trial judge had correctly determined that the search was unreasonable, and that the taxpayer's section 8 Charter rights had been violated, LaForme J observed that Revenue Canada Special Investigations ought to have known better. While the particular auditor had acted in good faith, in the judge's view, Special Investigations had embarked upon a course of investigation through the auditor which it knew or ought to have known was beyond the scope of section 231.1. LaForme J concluded by emphasizing the views of the trial judge that

> [i]n addition, there appears to be a public interest to be served in ensuring that public officials who possess the ability to lay charges in *quasi*-criminal matters not be allowed unfettered powers of collecting evidence beyond the point where they have turned their minds from mere administration or regulation to prosecution.[88]

This principle has been upheld more recently in *R v. Jarvis*,[89] a decision of the Alberta Provincial Court. In that case, the chief of audit of Revenue Canada had received an anonymous tip alleging that the taxpayer

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[87] Ibid., at 5330.

[88] Ibid., at 5334.

[89] 97 DTC 5444 (Alta. Prov. Ct.).

had failed to report certain sales income in his tax returns. Contrary to Revenue Canada's internal policies, which required that such tips be investigated by Special Investigations, the tip was referred to the Business Audit Section, resulting in the commencement of an audit to investigate for alleged tax evasion. In the course of the investigation into the alleged tax evasion, one of the members of Revenue Canada's audit team interviewed the taxpayer but without cautioning him that anything he said, or any documents he produced, could be used in evidence against him in relation to a prosecution for tax evasion. Special Investigations used this information and the audit material to obtain a search warrant. The evidence later established that the taxpayer had made statements to the auditors and provided documentary information, oblivious to the fact that he was under a criminal investigation, but rather on the understanding that he was simply the subject of an audit and was therefore required to cooperate under section 231.1 of the Act.

At trial, the accused argued that his section 7 Charter rights had been violated by Revenue Canada's investigators as a result of their failure to caution him at the time of his interview that the statements that he might give could be used in evidence against him. He also argued that his section 8 Charter rights had been violated when Revenue Canada had obtained a search warrant based on information obtained through the misuse of its audit power under section 231.1.

The trial judge concluded that when Revenue Canada's investigator met with the taxpayer, supposedly in the course of carrying on an ordinary audit, she did so for the purpose of confirming her opinion that this matter involved serious underreporting of income, which should be prosecuted. She was conducting an investigation and not a compliance audit. She was seeking information to support her conclusion that tax evasion had occurred. On this basis, the taxpayer's motion to exclude evidence obtained by Revenue Canada through this interview was granted.

In addition to its support for the *Norway Insulation* decision, this case establishes several important principles. First, an "investigation" after a tip has been received alleging failure to report income is properly characterized as an investigation into an "offence" under the Act and cannot be conducted using the section 231.1 audit powers. Where Revenue Canada chooses to simply proceed with an audit, taxpayers will likely succeed in excluding evidence obtained in the course of such an audit on the basis that their rights under sections 7 and 8 of the Charter have been violated. Of equal importance, however, is the proposition established by these cases that as soon as Revenue Canada officials effectively convert their audit into an investigation of a taxpayer in relation to a suspected offence, the taxpayer has a right to be cautioned, and the failure to so caution the taxpayer may make any evidence subsequently obtained inadmissible as a result of Charter violations. Further, where Revenue Canada is investigating suspected tax offences, it cannot gather evidence by using its power to make "third-party demands" under section 231.2 of the Act. Rather, Revenue Canada must obtain a search warrant (under either the Act or the

Criminal Code), and if it does not have reasonable and probable grounds to believe that an offence has been committed, it will not be able to obtain a warrant.[90]

The recent decision of the Federal Court of Appeal in *O'Neill Motors Limited v. The Queen*[91] makes a further important contribution to this developing area of the law. In that case, the Federal Court of Appeal upheld the decision of the Tax Court of Canada that reassessments made against the taxpayer must be vacated where the minister's reassessments had been based on material obtained through an unconstitutional search and seizure. The case was decided on the basis of the remedial provision found in section 24(2) of the Canadian Charter of Rights and Freedoms. Section 24 of the Charter provides as follows:

> (1) Anyone whose rights or freedoms, as guaranteed by this Charter, have been infringed or denied may apply to a court of competent jurisdiction to obtain such remedy as the court considers appropriate and just in the circumstances.
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> (2) Where, in proceedings under subsection (1), a court concludes that evidence was obtained in a manner that infringed or denied any rights or freedoms guaranteed by this Charter, the evidence shall be excluded if it is established that, having regard to all the circumstances, the admission of it in the proceedings would bring the administration of justice into disrepute.

Bowman J of the Tax Court had excluded the illegally obtained evidence when the matter came before him on the basis that Revenue Canada officials, in undertaking the initial seizure and the subsequent reseizure under section 487 of the Criminal Code, had flagrantly and egregiously violated the appellant's Charter rights. The Federal Court of Appeal found that Bowman J had the discretion to make the order he had made and that there was no reason to interfere with his findings. Linden JA held that it was not "appropriate and just" within the meaning of the Charter provision to force the taxpayer, whose constitutional rights had been violated, to defend itself against the reassessments raised by the minister when

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[90] The *Jarvis* case also affirms that banking records cannot be obtained by Revenue Canada under section 231.2 of the Act once it has commenced a criminal investigation. At that time, the audit tools provided to Revenue Canada under the Act must be abandoned and it must instead use search warrants when seizing documents. Note that a new trial has now been ordered in *Jarvis*, but on grounds other than the applicability of the *Norway Insulation* principle. See *R v. Jarvis* (1998), 37 WCB (2d) 501 (Alta. QB), per Lutz J. For other recent cases where the right to silence has been considered, see *R v. Yang* (1997), 35 OR (3d) 109 (Gen. Div.) (Tobacco Tax Act); *R v. Soviak*, [1997] OJ no. 1215 (Prov. Div.) (Retail Sales Tax Act); *R v. Gaudet*, 1997 (NB Prov. Ct.) [unreported] (Income Tax Act); *R v. Warawa*, [1997] AJ no. 989 (QB) (Income Tax Act); *R v. Kloster*, 1997 (BC Prov. Ct.) [unreported] (Income Tax Act); *R v. Leung*, 1997 (BC Prov. Ct.) [unreported] (Income Tax Act); *R v. Lin*, [1997] BCJ no. 1277 (SC) (Income Tax Act); *R v. Chambers*, [1997] 10 WWR 176 (Man. QB) (Narcotic Control Act); *R v. Docouto et al.*, 1998 (Ont. Gen. Div.) [unreported] (Mortgage Brokers Act); and *Donovan v. The Queen*, 98 DTC 2140 (TCC) (Income Tax Act).

[91] 98 DTC 6424 (FCA).

they were based on evidence that had been obtained in a manner that violated the taxpayer's Charter rights.

The *O'Neill* decision seems to mark an important development, demonstrating that there may well be very serious repercussions to the Crown, not only in a criminal context, but indeed on matters of civil reassessment, where Charter rights are not observed in the gathering of evidence that will later be used as the foundation for civil assessments. Nevertheless, the Federal Court of Appeal did underscore certain comments of the Tax Court judge to the effect that the extreme remedy of vacating reassessments that turn out to have been based on unconstitutionally obtained evidence should be reserved only for cases of serious violations where other remedies would be insufficient.[92] Linden JA adopted the comments of Bowman J on this point where he stated:

> I would not want my conclusion in this case to be taken as a wholesale sanctioning of the vacating of all assessments where some component of the Minister's basis of assessment was unconstitutionally obtained information. Other cases may arise in which a simple exclusion of evidence is sufficient, others in which the evidence is of little or no significance in the making of the assessments or where its introduction would not bring the administration of justice into disrepute. . . . In the exercise of the discretion vested in the court under section 24 of the Charter one must be vigilant in balancing, on the one hand, the rights of the subject that are protected under the Charter, and on the other, the importance of maintaining the integrity of the self-assessing system. As each case arises these and, no doubt, other factors will play a role and all factors must be assigned their relative weight. In the circumstances of this case I have concluded that the most appropriate exercise in my discretion is to vacate the assessments.[93]

While it is obviously hoped that very few taxpayers will ever find themselves in the position of being subjected to investigation for alleged criminal offences under the Act, it is important to be mindful of the limits to Revenue Canada's investigatory power under sections 231.1 and 231.2 of the Act. These powers may be exercised only for regulatory or administrative purposes and not to conduct secret criminal investigations.

It should serve as some comfort to taxpayers to know that the courts have been vigilant, at least in recent cases, to protect against unconstitutional searches and seizures. The courts also appear willing, not only to prevent tax authorities from exercising their powers beyond the intended limits if the safeguards established by Parliament and the courts for

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[92] But compare *Donovan v. The Queen*, supra footnote 90, where Lamarre Proulx TCCJ refused to exclude evidence and vacate a civil assessment in circumstances where a Revenue Canada Special Investigations officer attended at the taxpayer's premises along with the auditor, even though the fact that one of the Revenue Canada personnel was from Special Investigations was not disclosed. While the Tax Court judge concurred that such conduct might prejudice criminal proceedings, she concluded that the inappropriate conduct of Revenue Canada should not affect the validity of civil proceedings against the taxpayer.

[93] Supra footnote 91, at 6428.

taxpayers' rights have not been adhered to, but indeed in particularly offensive circumstances to preclude the minister from proceeding with any tax assessment where it is founded on illegally obtained evidence.

MANAGING RECORD RETENTION AND PRODUCTION OBLIGATIONS

There are a number of basic record management and protection principles that should be evident from developments in the law in this area over the past few years. First, it seems clear that amendments to the Act relating to record keeping are designed to increase the volume of information that will be available to Revenue Canada in the course of auditing tax compliance. Further, increasing willingness of the courts to allow a broader scope of documentation to be inspected in the course of audits likely means that audits will be more time consuming, involve greater amounts of documentation, and demand more time and effort on the part of taxpayers. These points should serve as a strong incentive to taxpayers to better manage the records that they maintain and retain, not only by exerting more control over the creation of business documentation, but—perhaps even more important—by thinking ahead as to what the reaction may be to documentation that may have been innocuous at the time of its creation but could later become a focal point for a more vigorous audit by Revenue Canada. Any effort by corporate or business taxpayers, as well as individuals, to protect sensitive information from future disclosure to tax auditors must, of necessity, contain two distinct elements, one prospective and one retrospective.

At the commencement of undertaking any transaction that will have tax implications, and in the ordinary day-to-day running of the business where the manner in which the business is conducted will have tax implications, thoughtful contemporaneous analysis of record-keeping obligations may reduce the audit workload later on. Any transaction that is intended to enable a tax result to be achieved should be considered at the outset with respect to not only the steps necessary to undertake the transaction itself, but also the documentation that will be necessary to prove entitlement to the intended tax result.

Early consideration of these issues has numerous advantages. It avoids future memory lapses on the part of the personnel involved, and perhaps the expense of tracking down former staff and trying to obtain their cooperation and assistance in resolving the tax dispute of a former employer, of whom they may or may not have fond memories. It anticipates not only the tax result sought to be achieved and plans for the creation of records and documentation that will, from the outset, support entitlement to that tax result, but also issues that are likely to be focused on by Revenue Canada auditors. Such an approach enables those issues to be addressed contemporaneously, in the ordinary course of conducting business or of completing transactions.

Concerns about a future audit should also cause taxpayers and their advisers to undertake a thorough review of their existing record retention

policies and to take steps to control the tax authorities' access to sensitive documents. There appear to be a number of common-sense steps that taxpayers can take to gain greater control over this area of business management.

1) Formal record retention policies should be established. If such policies already exist, they should be reviewed carefully against the new statutory definition of "record," and the application of those policies should be controlled centrally. The corporate and tax-related purposes of record retention should be considered and an evaluation made of whether existing record retention policies meet these purposes. While taxpayers have an obligation to ensure that the records necessary to the determination of tax are retained, record retention policies should involve a practice and a methodology that can be easily followed by all relevant personnel as part of the ordinary running of the business. As far as is practically possible, the number of people in the organization who have copies of potentially sensitive memorandums or documents should be limited. One of the biggest problems in any organization of significant size is the natural tendency of individuals who receive memorandums and other documentation to make a copy for themselves and pass it on. As the size of a group receiving or creating documentation in an organization continues to expand, there is increased risk of loss of control.

2) Formal documentation that evidences agreements or implements transactions must be retained. However, there are good arguments to support the destruction of progressive drafts of documents, in spite of concerns voiced by the Canadian Chamber of Commerce. These items need not be retained and may merely provide a basis for unnecessary audit queries. For example, frequently in the course of generating documents for transactions, a corporate lawyer, or the business persons involved in those transactions, will mark the word "tax" in the margin of some document. Such a notation may be a mere reminder that a particular clause should be reviewed from a tax perspective. The presence of the word "tax" on a draft later reviewed by Revenue Canada auditors may, however, be perceived entirely differently and may cause them to become concerned about matters that are in fact inconsequential. Drafts of documents could also serve merely to provide an inaccurate or misleading road-map to Revenue Canada. The best way to avoid this problem is to eliminate draft documentation to the greatest extent possible soon after a transaction is completed. If draft documentation has been culled from files and purged from computer archives, it will not be available to be inspected, nor can a demand be made for its production. If drafts are retained, at a minimum special attention should be paid to protecting them from production under solicitor-client privilege where the drafts came into existence in the course of obtaining legal advice.

3) Generally, it will be the final form of documents, agreements, and contracts for a transaction that will show what was done by the corporation or the taxpayer and will enable the amount of tax owing to be determined. Following the implementation of transactions or legal arrangements, businesses should undertake a formal post-closing record retention

review with their professional advisers, having regard to the new definition of "record." Careful consideration should be given to *all* documents, including memorandums, but there are strong arguments that those items that have been tested against and are not needed to meet the tax determination purpose can and should be discarded. This action should be undertaken as a regular post-closing occurrence, just as, for example, election forms are filed to effect rollover transactions after the transactions are completed or other filings are undertaken. Such a process may ensure that documents show only what was done and what is necessary to evidence entitlement to a particular tax result claim, and not all the machinations and politics of getting to the final result.

4) As discussed above, internal tax analysis memorandums must be tested and purged against the tax determination purpose. Tax results will stand or fall on what was done—not on what someone may have thought was done, or his or her opinion or analysis of what the tax result should be, or his or her particular interpretation of the Act. There are good arguments that record retention obligations do not extend to doing the work of Revenue Canada's auditors for them or letting Revenue Canada know what, if any, may be the strong and weak points of any plan or transaction. It must be remembered, however, that retained records, even those that may not legally be required to be retained, will be compellable on production both under demands for information issued by Revenue Canada and in the course of litigation, subject only to possible non-disclosure on the basis of claims of solicitor-client privilege. The fact that this documentation can be compelled must be a strong incentive to approach record retention from a different perspective.

5) It should be determined from the outset of a transaction what documentation and memorandums will be necessary to support entitlement to the tax result that will be claimed. The entire conduct of the transaction and the preparation of documents and memorandums should be geared toward documenting that entitlement, bearing in mind as well the subjective elements that may need to be established or refuted in order to achieve that result.

6) If internal memorandums contain information that is retained in order to meet the tax determination purpose, but also contain information that may be misleading, irrelevant, or not tax-related, and thus arguably unnecessary in the context of the tax determination purpose that underlies subsection 230(1), it may be possible to create new memorandums containing only the required information, rather than delete portions of the existing documents. An even better approach, however, is to consider at the outset what records will need to be retained and create specific items that will both meet record retention obligations and demonstrate entitlement to the particular tax consequences.

It is important that taxpayers recognize that their ability to purge files of non-essential records will cease once Revenue Canada makes any request for particular information in the course of an audit or issues a demand for production of any document.

7) Business people should work with their lawyers and accountants, to the extent possible, so as to seek or receive advice in such a manner as to avoid compellability and protect information through solicitor-client privilege, given that privilege cannot be obtained after the fact. The creation of documents that reflect advice received should be structured to ensure the protection of privilege. Advice should be obtained regarding specific procedures to follow to ensure that privileged documents will remain confidential, including in the context of annual audits of financial statements. Finally, for documents and records that are subject to privilege, accountants and lawyers should work together to protect the client's entitlement to confidentiality by ensuring that documentation likely to be embraced within the privilege, whether in the client's files or those of its accountants or lawyers, is segregated and held for safekeeping by legal counsel.

There is no question that Revenue Canada's appetite for information is increasing. The new definition of "record," in the context of record retention obligations, seems to evidence this. Further, in the course of conducting audits of taxpayers' affairs, Revenue Canada is requesting access to an ever broader spectrum of documentation and records, in both paper and electronic form. Against this background, taxpayers may be able to achieve substantial cost savings by taking steps at the outset of transactions either to circumscribe the documentation that will come into existence or to control the amount of documentation retained in the context of relevant statutory obligations, and by ensuring, where lawyers are involved, that the benefits of solicitor-client privilege will be available.