IRS SUMMONS ISSUED AT CANADA'S REQUEST ENFORCEABLE EVEN THOUGH INFORMATION WOULD ALSO BE USED FOR CRIMINAL PROSECUTION PURPOSES IN CANADA

I. INTRODUCTION

The United States-Canada Tax Convention of 1942[1] requires each contracting state to furnish the other with information obtainable under the former's revenue laws insofar as the information may be of use to the requesting state in the assessment of taxes.[2] This Recent Development analyzes the Second Circuit Court of Appeals' decision in *United States v. Manufacturers and Traders Trust Co.*,[3] in which the Tax Convention of 1942 was held to permit the transfer of information despite the fact that such information would also be used for criminal prosecution in the requesting nation.

II. THE DISTRICT COURT DECISION

In the *Manufacturers and Traders Trust* decision below, the Tax Convention was applied to the following facts:[4] Robert Jane, a Canadian citizen, and his wife were residents of Canada until 1978. The Canadian Department of National Revenue (CDNR) was investigating their Canadian income tax liabilities for 1976-1978, and in the course of that inquiry, the Canadian authorities made a jeopardy assessment[5] against Robert Jane on the theory that he was transferring assets out of Canada. Jane then commenced bankruptcy proceedings in Canada. The Royal Canadian Mounted

1. United States-Canada Tax Convention of 1942, in force June 15, 1942, United States-Canada, 56 STAT. 1399, T.S. No. 983, 124 U.N.T.S. 271 [hereinafter cited as the "Tax Convention"].

2. *Id.* at art. XIX. Article XIX further provides: "The information to be furnished under the first paragraph of this Article, whether in the ordinary course or on request, may be exchanged directly between the competent authorities of the two contracting States."

3. 703 F.2d 47 (2d Cir. 1983).

4. Statement of facts found by the District Court for the Western District of New York, reported at 703 F.2d 47, 49.

5. "Jeopardy Assessment" is defined as follows:

> If the collection of a tax appears in question, the IRS may assess and collect the tax immediately without the usual formalities. Also, the IRS has the power to terminate a taxpayer's taxable year before the usual date if it feels that the collection of the tax may be in peril because the taxpayer plans to leave the country.

BLACK'S LAW DICTIONARY 749 (rev. 5th ed. 1979).

Police (RCMP), charged with investigating criminal matters concerned with bankruptcy, became involved. There was a continuing, close working relationship between the officials of CDNR, responsible for inquiring into the Janes' tax liability, and the RCMP, responsible for criminal aspects of Robert Jane's bankruptcy. The CDNR's working papers were turned over to the RCMP, and the agent working on the civil tax case was ordered to respond to the RCMP agent's questions. CDNR subsequently requested information from the Internal Revenue Service (IRS) under the Tax Convention, and the IRS, pursuant to the request, issued summonses to obtain such information. The district court, however, refused to enforce them.

In the past, case law has interpreted the Tax Convention to mean that if Canada is investigating the liability of a potentially delinquent taxpayer, the United States may utilize the same investigative techniques that it would employ if that person were under IRS investigation for domestic tax liability.[6] Moreover, if a person is under IRS investigation for a domestic tax liability, the investigator must show that such investigation is being conducted for a legitimate purpose.[7] If the sole objective of the investigation were to obtain evidence for use in a criminal prosecution, the purpose would not be considered a legitimate one, and enforcement would be denied.[8]

The district court, in *Manufacturers and Traders Trust*, found such an illegitimate purpose because there was an agreement, express or implied, that if the CDNR obtained enforcement of the summons against Jane, the information procured would be made available to the RCMP for its criminal investigation. The court concluded that the material sought by the CDNR was intended, at least in part, for the use of the RCMP.[9] The district court then applied the criteria, established by the Supreme Court, for the enforcement of IRS summonses in domestic cases and ordered that enforcement be denied because of "bad faith."[10]

---

6. United States v. A. L. Burbank & Co., Ltd., 525 F.2d 9, 13 (2d Cir. 1975), *cert. denied*, 426 U.S. 934 (1976).

7. United States v. Powell, 379 U.S. 48, 57 (1964). The IRS must "show that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed—in particular, that the" Secretary or his delegate, "after investigation, has determined the further examination to be necessary and has notified the taxpayer in writing to that effect." *Id.* at 57-58.

8. *See* Reisman v. Caplin, 375 U.S. 440, 449 (1964).

9. United States v. Manufacturers and Traders Trust Co., 703 F.2d 47, 49 (2d Cir. 1983).

10. *Id.; see infra* notes 30-32 and accompanying text.

III. THE COURT OF APPEALS DECISION

Applying an expansive approach to the Tax Convention,[10a] the United States court of appeals reversed the district court in *United States v. Manufacturers and Traders Trust Co.*[11] The court conceded that if this were a wholly domestic matter, the ruling below might have been sustained.[12] The court however, held that "the requirements for summons-enforcement are not in all respects precisely the same [for international cases as they are] for domestic cases" and in this case, the "Government satisfied all the standards applicable under the Convention."[13]

The first prerequisite in obtaining enforcement of a summons under the Convention, said the court, is that the CDNR must be considering the income tax liability of a person under the revenue laws of Canada.[14]

Next, it must be determined whether there is any prohibition either on obtaining the information for partly criminal investigatory purposes, or against the interchange of information between the Canadian officials interested in civil liability and those concerned with criminal prosecution. There are no such prohibitions under Canadian or international law. United States law must then be considered.[15]

Article XXI, section 1 of the Tax Convention empowers the Commissioner to furnish such information "as the Commissioner is entitled to obtain under the revenue laws of the United States of America."[16] One interpretation of this phrase is that it incor-

---

10a. *See, e.g.*, United States v. A.L. Burbank, 525 F.2d at 13.

11. 703 F.2d at 47.

12. *Id.* at 50. On the other hand, the ruling might not have been sustained in an analagous domestic case. For example, in United States v. Chemical Bank, 593 F.2d 451, 456 (2d Cir. 1979), a summons was enforced even though there was considerable interaction between the IRS and the Strike Force coordinated by the Department of Justice. In United States v. Scholbe, 664 F.2d 1163, 1167 (10th Cir. 1981), a summons was enforced where the IRS had not recommended criminal prosecution, but an ongoing criminal non-tax investigation was under way and the IRS had agreed to provide the other agency with information secured by the tax investigation. Again, in United States v. Stuckey, 646 F.2d 1369, 1376-77 (9th Cir. 1981), a summons was enforced where the taxpayer was also under investigation for drug offenses and the IRS was willing to share information with the Drug Enforcement Administration. *See also* 26 U.S.C. § 6103(i) (1976 & Supp. V 1981), a statute authorizing disclosures by the IRS to federal agents administering non-tax laws in certain defined circumstances.

13. 703 F.2d at 50-51.

14. *Id.*

15. *Id.*

16. Tax Convention, *supra* note 1, at art. XXI.

porates all domestic laws, including the full judicial gloss governing IRS summonses and their enforcement. This is the interpretation that the district court followed. The court of appeals, on the other hand, took the more liberal approach that the judicial gloss need not be the same for an international case as for a wholly domestic one. The court held that the Commissioner can have different "entitlements" under "the revenue laws of the United States of America" in the two separate kinds of cases.[17] Neither Article XIX, nor Article XXI of the Tax Convention state that the IRS should have exactly the same authority in both areas, or that the Commissioner shall have only those powers under the treaty as he has in the wholly domestic sphere.[18]

Aside from this question of authority, the policies behind the revenue laws of the United States wherein the enforcement of an IRS summons is restricted to cases in which there is a legitimate purpose, are "wholly internal."[19] Federal criminal prosecutions in this country are the responsibility of the Department of Justice, not the IRS. Second, discovery in American criminal cases is restricted to the grand jury.[20] These policies are not applicable to Canada which does not have such "marked separations, and does not normally use the grand jury."[20a] Moreover, there is no reason to apply these policies to a case under this treaty. The United States has no interest in thrusting these policies into Canadian prosecutions. Likewise, Canada has no interest in having these policies applied to its taxpayers.[21]

Another element in the court of appeals' decision was that the need for the summons was Canada's alone, and information sought would be used there only. If the U.S. did not comply with the summons request, Canada might consider it a failure to comply with the Tax Convention. Canada might indeed wonder what interest or right the United States has in applying its internal policies to a case in which only Canada is involved. Moreover, our international relations with Canada might well be strained, and the executives of both countries might be embarrassed if a valid request was denied.[22]

17. 703 F.2d at 51.
18. *Id.; see also* United States v. A.L. Burbank & Co., Ltd., 525 F.2d 9, 13 (2d Cir. 1975).
19. 703 F.2d at 52.
20. *Id.; see also* United States v. LaSalle National Bank, 437 U.S. 298 (1978).
20a. 703 F.2d at 52.
21. *Id.*
22. *Id.* at 52-53.

Additionally, IRC section 7852(d),[23] dictates that no provision of the Code "shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment" of the Code.[24]

The court of appeals concluded from this analysis that it was not "bad faith" for Canadian tax officials to intend to share information, obtained from the IRS, with other officials investigating and prosecuting a Canadian criminal case.[25]

IV. ANALYSIS

The Second Circuit's decision in *Manufacturers and Traders Trust* cannot be viewed in a legal vacuum. The applicable provisions of the Internal Revenue Code, and several decisions of the Supreme Court, suggest that in cases where the IRS attempts to obtain information from Canada for possible domestic criminal prosecutions, such information may not be transferred to U.S. officials.

As noted above, the 1942 Tax Convention provides for the transfer of information between the U.S. and Canadian revenue departments, where that information would prove useful in the assessment of tax liability.[26] The Convention further provides that if the CDNR deems it necessary to secure the cooperation of the IRS in determining tax liability, the IRS may furnish the CDNR such information as is obtainable under the revenue laws of the United States.[27] The Internal Revenue Code authorizes the Secretary of the Treasury to examine any books, papers, records, or other data which may be relevant or material to an inquiry concerning a taxpayer's return. Summonses may also be issued to persons in possession of account books that relate to the targeted taxpayer's business.[28] Not all such summonses, however, will be enforced.

---

23. 26 U.S.C. § 7852(d) (1976 & Supp. V 1981).

24. *Id.*

25. 703 F.2d at 53.

26. Tax Convention, *supra* note 1, at art. XIX.

27. *Id.* at art. XXI. Article XXI further provides:

> 2. If the Commissioner in the determination of the income tax liability of any person under any of the revenue laws of the United States of America deems it necessary to secure the cooperation of the Minister, the Minister may, upon request, furnish the Commissioner such information bearing upon the matter as the Minister is entitled to obtain under the revenue laws of Canada.

28. 26 U.S.C. § 7602 (1976 & Supp. V 1981). If the summoned person refuses or fails to comply, the district courts have jurisdiction to enforce the summons. 26 U.S.C. §§ 7402(b), 7604.

In *United States v. LaSalle National Bank*,[29] the Supreme Court found that two requirements emerge for the enforcement of an IRS summons. First, the summons must be issued before the Service recommends to the Department of Justice that a criminal prosecution reasonably related to the subject matter of the summons be undertaken. Second, the Service must use the summons authority in good faith pursuit of the congressionally authorized purposes of 26 U.S.C. § 7602.[30]

The meaning of "good faith" was explained in *United States v. Powell*,[31] as follows: (1) the investigation must be conducted for a legitimate purpose (i.e., the IRS must retain an interest in civil tax collection); (2) the material sought must be relevant to the legitimate purpose of the investigation; (3) the information must not yet be in the possession of the IRS; and (4) the proper administrative steps must be followed.[31a]

In *United States v. Garden State National Bank*,[32] the Third Circuit explained that the IRS has the power to issue summonses in the course of its investigation of civil tax liability even if evidence thereby uncovered might subsequently serve as the basis for a criminal prosecution of the taxpayer. The IRS may not, however, use its power to issue administrative summonses for the sole purpose of conducting or furthering a criminal investigation on its own behalf, or on behalf of the Justice Department.[33]

Furthermore, a taxpayer can be summoned, as well as be required to produce books and records, and to testify concerning income tax liability where the purpose is to ascertain the correct-

---

29. 437 U.S. 298 (1978).

30. *Id.* at 311-12. While the *LaSalle* court was unanimous in imposing an absolute ban on enforcement of IRS summonses issued after the case has been referred to the Justice Department, it was divided on the question of the validity of summonses issued before that referral. Four Justices would have held any summons issued before the cutoff to be conclusively valid. *Id.* at 319-21 (Stewart, J., dissenting). The majority, however, left open the possibility that such a pre-referral summons could be challenged by the taxpayer if the Service as an institution had not issued the summons in "good faith." *Id.* at 313-18 (Blackmun, J.). The congressionally authorized purposes include: "ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability . . . ." 26 U.S.C. § 7602.

31. 379 U.S. 48, 57-58.

31a. *Id.* at 58.

32. 607 F.2d 61 (3d Cir. 1979).

33. *Id.* at 66.

ness of the taxpayer's return. The fact that there may also be other purposes in particular cases is irrelevant.[34] In other words, if the sole objective of a domestic tax investigation is to obtain evidence for use in a criminal prosecution, the purpose is not legitimate, and enforcement of an IRS summons should be denied.[35] If the investigation will be conducted for a legitimate purpose, however, the summons will be enforced.[36] This is not, however, necessarily the case under the Tax Convention.

Judicial interpretation of the Tax Convention has yielded a different result. In *United States v. A.L. Burbank & Co., Ltd.*,[37] the Second Circuit found that one purpose of the Tax Convention was to provide a means of cooperation between the contracting states whereby information could be exchanged through the administrative processes provided by the statutory laws of each nation.[38] Generally, treaties must be broadly construed if their intent is to be given effect.[39] When a provision of a treaty fairly admits of two constructions, one restricting, the other enlarging rights which may be claimed under it, the more liberal interpretation is to be preferred.[40] The latter construction is adopted because diplomatic and good faith considerations require that treaty obligations should be liberally construed so as to secure equality and reciprocity between the contracting states.[41]

Aside from general principles of construction, section 7852(d) of the 1954 Code,[42] which was enacted after the Tax Convention, provides that no provision of the Code shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the Code.[43] Thus, while the Second Circuit's decision in *Manufacturers and Traders Trust Co.* is seemingly consistent with the U.S. Obligations under the 1942 Tax Convention, it must, of course, await future development in the area.

---

34. Lash v. Nighosian, 273 F.2d 185 (1st Cir. 1959), *cert. denied*, 362 U.S. 904 (1959).
35. Wild v. United States, 362 F.2d 206 (9th Cir. 1966).
36. *Id.*
37. 525 F.2d 9 (2d Cir. 1975).
38. *Id.* at 13.
39. *Id.* at 14.
40. Bacardi Corp. v. Domenech, 311 U.S. 150, 163 (1940).
41. Factor v. Laubenheimer, 290 U.S. 276, 293-94 (1933).
42. 26 U.S.C. § 7852(d) (1976 & Supp. 1981).
43. *Id.*

V. CONCLUSION

The United States Court of Appeals for the Second Circuit has determined that under the Tax Convention, the IRS can obtain information requested by Canada to help determine a Canadian taxpayer's liability, despite the fact that a primary purpose of the request may be to further a Canadian criminal prosecution, and even though such request may have been denied if it had been made in the course of a domestic IRS investigation. The requirements for enforcement of an IRS summons are not the same under the Convention as they are for wholly domestic cases. The policies behind the revenue laws of the United States that cause summons enforcement to be restricted do not apply to Canada, and therefore the judicial gloss of our laws should not apply to a case under the Tax Convention. The decision implies that Canada may obtain information from the United States that may be used for criminal prosecutions, whereas under the same circumstances, in a wholly domestic case, such information would not be obtainable by the IRS.

Ami Setright