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When is information on foreign income relevant to a tax investigation?

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Tuesday, February 9th, 2021

HMRC v Embiricos [2020] UKUT 370 (TC) reflects a common issue that arises in connection with tax investigations or audits of internationally mobile individuals. Mr Embiricos filed his tax returns on the basis that he was resident, but not domiciled in the UK. On that basis, he was entitled to the remittance basis of taxation. That meant that his foreign income and gains would only be taxed when they were remitted to the UK.

Relevance of foreign income

HMRC opened an enquiry (audit) into his returns, but only in relation to his claim that he was domiciled outside the UK. HMRC decided, on the basis of information provided, that he was domiciled in the UK, which Mr Embiricos disputed. He applied to the Tax Tribunal for a direction that this aspect of the enquiry be closed (a partial closure notice).

UK tax law permits a partial closure notice so as to complete an enquiry into a particular aspect of the enquiry. A taxpayer may then dispute the issue in an appeal to the Tax Tribunal against such a notice. This is in contrast to a final closure notice that finalises all aspects of an enquiry.

HMRC also issued to Mr Embiricos a statutory notice to produce information to fully conclude their enquiry. This required the information HMRC thought they would need in order to calculate the tax due on the basis that he was domiciled in the UK – in other words, details of his worldwide income and gains. Mr Embiricos also argued that the notice should not be approved by the Tax Tribunal.

Underlying the application to close the enquiry and against the information notice, was the proposition that, if the taxpayer is not domiciled in the UK, then information on his foreign income and gains that are unremmited, is irrelevant to his tax return in the particular years. The same issue arises where the residence of an individual is in dispute. At what point does foreign income and gains become relevant? At what point is the taxpayer able to ask a tribunal or court to determine the precondition to his liability to tax on foreign income and gains?

The First-tier Tribunal directed that the partial closure notice should be issued and that the information demanded on foreign income and gains was accordingly not required pending determination of domicile (*Embiricos v HMRC* [2019] UKFTT 236 (TC)).

On appeal, the Upper Tribunal reversed that decision based on a narrow interpretation of the

closure notice legislation.[1]

Treaty context

The same issue arises in treaty-based international exchange of information. This is illustrated by the US District Court decision in *Hanse v USA*, Case No. 17-cv-4573 (US District Court, 5 March 2018), discussed in my blog on information powers: Http://kluwertaxblog.com/2018/03/21/exchange-information-bumps-road/ In that case, the IRS sought to obtain information from a lawyer in New York pursuant to a request from the French Tax Administration under France-US tax treaty. In that case, Mr Hanse argued that that he was not a resident France (but resident in Switzerland), and, as a non-resident French citizen, not liable to French income tax on income earned outside of France. Accordingly, his French residence should be resolved first, before obtaining information on the basis that he was resident in France.

Civil and Human Rights

In my view, the starting point for thinking about these issues is the basic right to privacy enshrined, for example, in the European context, in article 8 of the European Convention on Human Rights (ECHR) and, in the United States in the Fourth Amendment to the US Constitution.

Article 8(1) establishes privacy as a fundamental right. No public authority may interfere with this right except as provided in article 8(2). In the tax context, such interference can only be "in accordance with the law and is necessary in a democratic society in the interests of … the economic well-being of the country". The European Court of Human Rights has said that these article 8(2) exceptions must "be interpreted narrowly, and the need for them in a given case must be convincingly established" *(K.S. and M.S. v. Germany*, (Application no. 33696/11) 6 October 2018 at [42]).

Any demand for information by a tax authority is, of its nature, an interference with this right. The central issue is whether the interference is justified. That analysis includes whther the interference is in pursuit of a legitimate aim, and whether it is necessary in a democratic society. Proper administration of the tax law is, in general terms, a legitimate aim.

In order to be necessary, the interference must be proportionate to the aim pursued and go no further than is needed. These cases raise the question whether requiring information that only becomes necessary if it is determined that the taxpayer is indeed resident (or domicled in the *Embiricos* case). Where that status is genuinely in dispute, then it would appear not.

The current international legal context of automatic exchange of information under the CRS and FATCA supports this conclusion. The purpose of both automatic exchange regimes are to support compliance in taxpayers' residence states, and is predicated on the source state supplying information to the residence state.

The *Hanse* case highlights another connected difficulty where this issue arises in exchange of information cases. The US District Court considered Fourth Amendment rights but only in judging the actions of the IRS in gathering the information. Unless the requesting state notifies the person who is the subject of the information request, there is no other opportunity to challenge the validity of the request. This itself raises questions around due process and ECHR, Article 6. Mr Hanse however presented no evidence to support his contentions on French residence. The court declined to evaluate the legitimacy of the French request, in line with existing US case law. A dispute about

residence was also rejected as a ground for refusing exchanging information by the US District Court in *Puri v. United States*, NO. CV 20-7270-RGK (AGRx) (January 12, 2021).

Article 26(1) of the OECD Model

A solution may be found by the court in the requested state examining the validity of the request by reference to the relevant treaty provisions. Although, in its current form, Article 26(1) of the OECD Model is not restricted to exchanges of information relating to residents of a contracting state, it is more doubtful whether information relating to a person whose residence is in dispute is "foreseeably relevant" until that issue is resolved. In addition, if it is the case that such information does not meet the standards for compliance with ECHR, Article 8, then it would not be obtainable by the requesting state within article 26(3)(b) (If that state is a party to the ECHR or similar instrument). Disclosure of such information would also not be permitted under article 26(3)(c) as contrary to contrary to public policy (ordre public).

The question of public policy also appears to be raised by the *Puri* case. There,a request of information from the Indian Revenue to the IRS was opposed for, among other reasons, that the purpose of the request was improper as 16 years of bank account information was sought because of her family member who was in the Indian political opposition. Whether the US good faith requirement was met by the the Indian Revenue was not considered relevant.

[1] Mr Embiricos has been granted permission to appeal to the Court of Appeal.

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