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Analyzing US Court ruling quashing treaty information request

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The effort to develop a global consensus towards co-operation in exchange of information between tax administrations has increased tremendously. In effect, the tax administrations have taken an aggressive stance for obtaining tax information. Under the current standards regarding exchange of information, the requested authority can refuse cooperation if the tax administration of the requesting country fails to demonstrate that the information sought is relevant for the administration or enforcement of its domestic laws.

In most cases, several inevitable questions arise regarding whether the information request is valid under both the relevant tax treaty and domestic law. In response, taxpayers have moved to block such information requests, especially when the nature of the request appears to be more of a ‘fishing expedition’ having no nexus with the taxability of the transaction.

Recently, the U.S. District Court of Illinois (“Court”) in Bikramjit Singh Kalra v. United States of America1 quashed summons that were issued by the U.S. Internal Revenue Service (“IRS”) pursuant to a request made by the Indian tax authorities concerning the tax liability of Bikramjit Singh Kalra (the “taxpayer”), on grounds of lack of statutory procedure and purpose.

BACKGROUND

The taxpayer is a US tax resident individual filing US tax returns and has disclosed that he has no tax liability in India. The Indian tax authorities proceeded with investigation concerning his tax liability in India and requested co-operation from the IRS in obtaining financial information under Article 28 of the India-USA tax treaty pertaining to exchange of information.

Pursuant to this request, the IRS officials served administrative summons on Bank of America (“BOA”) for financial information relating to the taxpayer’s bank accounts in the US. An undated and unsigned notice of the summons was mailed to the taxpayer on his Indian address. The taxpayer claimed that he was not in receipt of any notice other than the copy of the summons received from BOA. The taxpayer filed a petition to quash the IRS summons. In response, the IRS moved to dismiss this petition filed by taxpayer on grounds of lack of subject matter jurisdiction and failure to state a claim.

JUDGMENT

The motion of the IRS to dismiss the taxpayer's petition was denied by the Court on the following grounds:

Maintainability: The IRS contended that the taxpayer's petition should be dismissed on the grounds of lack of subject matter jurisdiction of the Court. Elaborating further, it was argued that the doctrine of sovereign immunity provides that IRS cannot be sued unless a waiver has been obtained. To this argument, the Court held that there were specific statutory provisions which gave a right to the taxpayer to proceed against the IRS to quash the summons.

Failure to follow statutory steps: While considering the issue of whether the petition is time barred or not, the taxpayer argued that the time limitation has not triggered in the present case as the notice of summons was not in proper form.

The taxpayer argued the various ways in which the IRS failed to fulfill statutory notice requirements, including-

1. Failure to provide a notice in the prescribed form containing a copy of the summons and explanation of the taxpayer's right to sue to quash the summons.
2. The summons certificate issued to BOA was defective on account of being unsigned and undated.
3. There was no mail receipt to show that summons was in fact mailed to the taxpayer.
4. The affidavit sent to the taxpayer was defective as the same was not certified by a public notary and did not contain a specific date.

The Court accepted the taxpayer's reasoning that the petition was filed as soon as possible after the taxpayer's receipt of notice from BOA directly and that the IRS failed to follow the statutory notification procedure, in absence of which there should be no time restrictions.

Accordingly, on the grounds that IRS was non-compliant with statutory notice requirements, the petition of the taxpayer was accepted.

Failure to prove that the information sought is relevant to a specified purpose: To enforce a tax summons, the IRS must make a prima facie case showing that the summons was issued in good faith. In doing so, the IRS must meet its minimal burden to show compliance under the test laid down in United States v. Powell2, which is as follows:

1. the investigation has a legitimate purpose;
2. the information sought may be relevant to that purpose;
3. the information sought is not in the IRS's possession; and
4. the IRS has followed the statutory steps for issuing a summons.

The IRS failed to demonstrate the purpose and relevancy of the information sought. The

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Court held that the fact that the request for information was pursuant to a treaty between India and USA is only evident from the memorandum, and there is no other competent evidence to show that the summons was issued in good faith.

ANALYSIS

The power of the IRS to issue summons is very broad and may only be defeated if the Powell tests are not satisfied. Under the Powell tests, a summons is valid if the investigation is being conducted for a legitimate purpose, the material sought is relevant to that purpose, the material sought is not already in the possession of the IRS, and proper administrative procedures have been followed. The instant judgment emphasized the importance of procedural and statutory compliance in the issuance of summons.

The Indian authorities' request for information was made under Article 28 of the India-USA tax treaty3, which deals with the exchange of information and administrative assistance. Under this Article, India and the US can exchange information, including financial information for carrying out the provisions of the country's domestic law as well as the treaty provisions. Article 28(3) provides that US tax authorities shall not be obligated to obtain information or carry out administrative measures at variance from the laws of the US. This means that a non-compliance of domestic laws by US tax authorities would violate this provision of the treaty. Thus, the position taken in the judgment is also in line with Article 28(3). This shows the clear congruence between the US domestic law and treaty provisions on this aspect.

Another key point to note is that tax treaties generally have a clearly defined qualification. This is clear from the Commentary on Article 26 of the OECD Model Tax Convention on Income and Capital which provides that the information sought has to be 'foreseeably relevant' for the information seeking state's tax authorities. This precludes the information seeking state from going on 'fishing expeditions' and restricts the information to that which is relevant for determining the tax liability of the targeted taxpayer. Since this addition to the OECD model tax treaty is relatively recent, the India-USA tax treaty lacks such a provision. However, since the US courts have adopted the Powell tests, to a certain extent the same is now considered to be incorporated as a requirement under US domestic law. Further, even the technical explanation to the India-USA tax treaty explains that only that information which is 'necessary' could be exchanged under the treaty.

This case reiterates the importance of proper procedure while issuing summons and seeks to avoid unnecessary examination of taxpayer's accounts. From a taxpayer's perspective, the case highlights the taxpayer's right to quash summons issued even to third parties if statutory procedures have not been duly complied with, or if the tax authorities fail to show a legitimate purpose for obtaining the information, or such information is not relevant to that purpose, but rather, a 'fishing expedition'. On the other hand, taxpayers must also keep in

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mind that the burden to prove such non-compliance lies on them.