

# The Problem of Reciprocity in Transnational Enforcement of Tax Judgments

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A critical impediment to transnational collection of taxes is an old common law rule: the courts of one nation will not enforce the tax laws of another.<sup>1</sup> When first articulated over two hundred years ago,<sup>2</sup> the rule was rational. Countries were engaged in great commercial rivalries and did not wish to assist their international competitors in the collection of revenues.

The rule is an unacceptable burden on the modern community of nations.<sup>3</sup> International tax evasion now threatens the integrity of every national taxing system.<sup>4</sup> Judicial reluctance to assist transnational tax collection has become a legal anomaly; international cooperation in other areas of the law (such as enforcement of private law judgments<sup>5</sup> and extradition of accused criminals<sup>6</sup>) is now more the rule than the exception. Despite the many writers who have criticized the rule's effects<sup>7</sup> and who have made alternative proposals<sup>8</sup> there has been no judicial or legislative movement to abandon the established practice of non-enforcement of foreign tax judgments.<sup>9</sup>

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1. See, e.g., *Government of India v. Taylor*, 1955 A.C. 503, [1955] 1 All E.R. 292 (former English corporation nationalized by Indian government; Indian tax on capital gain not enforced in English court). See Note, *International Enforcement of Tax Claims*, 50 COLUM. L. REV. 490 (1950) for a thorough critique of the common law rule.

2. The rule can be traced to two English cases decided in 1775. *Holman v. Johnson*, 1 Cowp. 341, 343, 98 Eng. Rep. 1120, 1121 (K.B. 1775); *Planche v. Fletcher*, 1 Doug. 251, 253, 99 Eng. Rep. 164, 165 (K.B. 1775).

3. See, e.g., Note, *International Enforcement of Tax Claims*, 50 COLUM. L. REV. 490 (1950).

4. SUIT, *INTERTAX: Intergovernmental Cooperation in Taxation*, 7 HARV. INT'L L. CLUB J. 179, 179-81 (1966).

5. See 47 AM. JUR. 2D *Judgments* § 1215 (1969) (recognition under comity—judgments of foreign nations).

6. See generally I. SHEARER, *EXTRADITION IN INTERNATIONAL LAW* (1971); 31 AM. JUR. 2D *Extradition* §§ 7-13 (1967).

7. See Johnson, *Reciprocal Enforcement of Tax Claims Through Tax Treaties*, 33 TAX LAWYER 469 (1980) ("A foreign government has never attempted to enforce a tax claim in United States courts.") See also Robertson, *Extraterritorial Enforcement of Tax Obligations*, 7 ARIZ. L. REV. 219, 234 n.66 (1966) (no cases upholding enforcement of foreign tax judgments have arisen in federal court).

8. See Johnson, *supra* note 7, at 470.

9. See *id.*

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This comment argues that the common law rule of non-enforcement of tax judgments is not desirable, and that published alternative proposals are fundamentally flawed because they apply a formal concept of reciprocity. This comment proposes a refined concept of reciprocity—"structural reflection"—and an accompanying series of tests that will resolve the shortcomings of previous proposals. This concept minimizes the undesirable effects of formal reciprocity and presents a more satisfactory legal approach to transnational tax enforcement.

Discussion will be confined to the enforcement of tax *judgments*, that is, final decrees issued after the completion of formal legal proceedings. Tax judgments must be distinguished from tax claims, which are the assessments claimed by a taxing authority, but not subjected to contest and proof.<sup>10</sup> The terms "judgment state" and "enforcing state" will be used throughout. The judgment state is the state which imposes the tax and which has obtained a tax judgment through its own courts. The enforcing state is the state where the taxpayer or his assets can be found and which is asked to give effect to the tax judgment.

### The Common Law Rule

The common law rule that the courts of one nation will not enforce the tax laws of another nation arose during the mid-eighteenth century, a period of intense commercial rivalries among nations.<sup>11</sup> The origins of the rule have been traced to a famous dictum by Lord Mansfield that "no country ever takes notice of the revenue laws of another."<sup>12</sup> The rule itself was announced a few years later in *Planche v. Fletcher*.<sup>13</sup> Although these early rulings involved export restrictions, the term "revenue laws" came to encompass the various tax statutes of other nations.<sup>14</sup>

The British House of Lords firmly established the rule's applicability to modern income taxes in the case of *Government of India v. Taylor*.<sup>15</sup> In *Taylor*, India (judgment state) attempted to compel Britain (enforcing state) to enforce a capital gains tax against a company that had

10. See Note, *supra* note 3, at 496-98. If nations were to afford legal process to tax claims it would place upon courts the difficult task of trying foreign tax cases. The day may come when nations will wish to undertake such obligations, but that date must surely follow experience with enforcement of tax judgments obtained in the taxing nation's courts.

11. See E. WEBER, *A MODERN HISTORY OF EUROPE* 450-59 (1971).

12. *Holman v. Johnson*, 1 Cowp. 341, 343, 98 Eng. Rep. 1120, 1121 (K.B. 1775).

13. 1 Doug. 251, 253, 99 Eng. Rep. 164, 165 (K.B. 1779).

14. See, e.g., *Municipal Council of Sidney v. Bull*, [1909] 1 K.B. 7; *In re Visser*, [1928] 1 Ch. 877.

15. 1955 A.C. 503, [1955] 1 A11 E. R. 292.

previously operated in India. The tax was based on gains recognized when the company's assets were nationalized by the Indian government.<sup>16</sup> The House of Lords held that the Indian government could not use an English court to enforce such a tax liability.<sup>17</sup>

The severity of the common law rule is exemplified by a Supreme Court of Canada case, *United States v. Harden*.<sup>18</sup> In *Harden*, the United States had obtained a judgment in federal court against Mrs. Harden for \$640,000, representing taxes due and interest. To escape this judgment, Mrs. Harden moved to Canada, taking with her all her assets.<sup>19</sup> The Canadian supreme court cited the line of common law authority in refusing to enforce the American judgment.<sup>20</sup>

In the United States, the common law rule was at one time generally adopted among the individual states, each refusing to enforce tax judgments of sister states.<sup>21</sup> The United States Supreme Court declared this practice unconstitutional in *Milwaukee County v. M.E. White Co.*,<sup>22</sup> holding that "full faith and credit" requires recognition of tax judgments on the same basis as private law judgments.<sup>23</sup> The Supreme Court did not decide whether "full faith and credit" also required the prosecution of a sister state's tax *claims*,<sup>24</sup> but some state courts have independently permitted actions on tax assessments imposed by other states.<sup>25</sup>

In the international field, however, an American court would probably follow the common law rule and refuse to enforce a foreign tax judgment in the absence of a treaty obligation.<sup>26</sup> While there are no

16. *Id.* at 503, 1 A11 E. R. at 292.

17. *Id.*

18. 41 D.L.R. 2d 721, 63-2 U.S. Tax Cas. (CCH) ¶ 9768 (1963).

19. *Id.* at 721-23, 63-2 U.S. Tax Cas. (CCH) ¶ 9768.

20. *Id.* at 724-27, 63-2 U.S. Tax Cas. (CCH) ¶ 9768. For a critical discussion of the opinion see Recent Cases, 77 HARV. L. REV. 1327 (1964).

21. See Robertson, *Extraterritorial Enforcement of Tax Obligations*, 7 ARIZ. L. REV. 219, 225-34 (1966).

22. 296 U.S. 268 (1935).

23. *Id.* at 279.

24. *Id.*

25. See, e.g., *Ohio v. Arnett*, 314 Ky. 403, 234 S.W.2d 722 (1950) (Kentucky court allowed action by Ohio for collection of workmen's compensation premiums); *State v. Rodgers*, 197 Mo. App. 217, 193 S.W.2d 919 (1946) (Missouri court allowed action by Oklahoma for collection of taxes incurred when defendants resided in Oklahoma).

The gradual waning of the common law rule, at least in the sister state context, is indicated by the American Law Institute, which, after incorporating the common law rule in its 1934 Restatement of Conflicts, deleted the rule from the 1969 Restatement Second. RESTATEMENT OF CONFLICT OF LAWS § 443 (1934) provided that "[a] valid foreign judgment for the payment of money, which has been obtained in favor of a state, a state agency, or a private person, on a cause of action created by the law of the foreign state as a method of furthering its own governmental interests will not be enforced." *Id.*

26. See Robertson, *supra* note 21, at 234.

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court decisions based on a foreign government's attempt to enforce its tax judgment in an American court,<sup>27</sup> support for the common law rule can be inferred from judicial pronouncements in related areas. New York courts, for example, have frequently applied the rule in cases involving exchange control restrictions of a foreign nation,<sup>28</sup> and foreign death taxes.<sup>29</sup>

The common law rule has been criticized on several grounds. It has been said to represent a "gap" in the international legal enforcement scheme.<sup>30</sup> Criminal laws are given extraterritorial reach by means of bilateral extradition agreements.<sup>31</sup> Foreign private law judgments are customarily enforced pursuant to the comity principle.<sup>32</sup>

Other critics point to the seriousness of international tax evasion.<sup>33</sup> Every taxing body is vulnerable to loss of tax revenues if taxpayers can simply remove themselves from the taxing jurisdiction and thereby avoid payment of taxes.<sup>34</sup> As governments attempt to tax more private wealth, international cooperation is necessary to ensure the effective collection of taxes. The common law rule fosters a jungle environment where every country is expected to "go it alone" in tax collection. Critics point out that greater total revenues could be realized through international cooperation in the enforcement of tax judgments.<sup>35</sup>

27. See Robertson, *supra* note 21.

28. Banco do Brasil v. Israel Co., 12 N.Y.2d 371, 239 N.Y.S.2d 872, 190 N.E.2d 235 (1963).

29. See, e.g., *In re Matthew's Trust*, 21 Misc. 2d 356, 358, 191 N.Y.S.2d 994, 996 (N.Y. Sup. Ct. 1959) where a New York court states that ". . . the courts of this state will not enforce the revenue laws nor aid in the collection of taxes of another state or nation, absent reciprocal agreements." *Id.* See also *In re Bliss' Trust*, 26 Misc. 2d 969, 208 N.Y.S.2d 725 (N.Y. Sup. Ct. 1960); *Estate of Robinson*, 25 Misc. 2d 9, 206 N.Y.S.2d 459 (N.Y. Sur. Ct. 1960); *Estate of Lamar*, 15 Misc. 2d 544, 182 N.Y.S.2d 512 (N.Y. Sur. Ct. 1958); *McNell's Estate*, 10 Misc. 2d 359, 170 N.Y.S.2d 893 (N.Y. Sur. Ct. 1957).

30. See Leflar, *Extrastate Enforcement of Penal Claims and Governmental Claims*, 96 HARV. L. REV. 193 (1932). Leflar asserts that

[t]he intervention of state boundary lines enables such persons to avoid their liabilities altogether. They take advantage of a little area of incomplete development in the law, carelessly left lying in between two large areas whose development has been along different lines. On the one side lies the great body of law enforcing civil liabilities as such. . . . On the other side the criminal law seeks to exert itself by the device of extradition and interstate rendition. The neglected middle ground was at one time unimportant, an area within which there arose little litigation. That is no longer true. Attempts to evade taxation alone have become so important within this area that some equivalent device for protection against them is becoming a practical necessity.

*Id.* at 220.

31. See *supra* note 6.

32. See *supra* note 5.

33. "International tax evasion . . . [is] a recognized evil from both a moral and economic viewpoint. . . ." Note, *supra* note 3, at 490.

34. See Surr, *supra* note 4, at 179-82.

35. *Id.* at 182-84.

Perhaps the most appealing argument against the common law rule is that it promotes the evil known as "tax immorality."<sup>36</sup> Taxes have become commonplace in the modern world, and are, in the words of Justice Holmes, "what we pay for civilized society."<sup>37</sup> Governments are constrained in the amount of wealth they can subject to tax. Wealth or income which escapes taxation often cannot be made up, except at the cost of increasing levels of hardship for other taxpayers.<sup>38</sup> These "honest" taxpayers, who do not take advantage of the common law rule, consequently bear a greater share in supporting the state.<sup>39</sup> The effect of legal evasion through the common law rule is loss of revenue, loss of tax-producing capital, and increased taxation of the unfortunates who are within the reach of the taxing authorities and who compose the tax base.<sup>40</sup>

### The Limitations of Unilateral Enforcement

International non-cooperation in the enforcement and collection of tax judgments effectively limits national taxing power to the unilateral situations where the taxing state has access to (1) a person, (2) an income-generating item of wealth, or (3) some other asset or item of wealth. These three classes of tax "reach" are analogous to the traditional jurisdictional categories: in personam,<sup>41</sup> in rem,<sup>42</sup> and quasi in

36. Leflar, *supra* note 30, at 216. "[T]here is currently developing public morality which considers the obligation to pay taxes validly imposed to be as binding as the obligation to pay a private debt voluntarily undertaken." *Id.*

37. *Compania General de Tabacos v. Collector*, 275 U.S. 87, 100 (1927) (Holmes, J. dissenting).

38. *See Surr*, *supra* note 4, at 180.

39. Leflar, *supra* note 30, at 216. Leflar asserts that "[t]he tax burden is a tolerable thing only as it is fairly distributed. Complete evasion by some inevitably increases the burdens of others." *Id.*

40. *See supra* note 38.

41. A nation has "in personam" tax reach when it can exact a tax by virtue of its legal powers over the taxpayer's person, even if the wealth or income on which the tax is determined is located outside that taxing nation's boundaries. "In personam" tax reach usually occurs when the taxpayer is physically present within the taxing jurisdiction. For example, the American taxing authorities can require U.S. resident aliens to pay an income tax based on their worldwide income since American courts can reach these taxpayers and their wealth by proceeding against them personally.

42. A nation has "in rem" tax reach when an income-producing element is present (physically or constructively) within the taxing jurisdiction, even if its owner is abroad (i.e., not subject to personal reach). For example, the United States can tax rental income from real estate property located within the U.S.—even if owned by a non-resident alien—because the property itself is within the reach of the U.S. courts.

It could not, however, reach rental income from property situated abroad, unless it could reach either the owner (in personam) or one of his unrelated assets located within the U.S. (quasi in rem).

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rem.<sup>43</sup> The concepts of reach and jurisdiction should not be confused. Reach must include effective enforcement power while jurisdiction may be asserted even where it cannot effectively be enforced.<sup>44</sup> Many countries do not impose taxes on wealth that is likely to be outside of their tax reach.<sup>45</sup> The United States, on the other hand, asserts a taxing jurisdiction that far exceeds its reach, i.e. its ability to collect through unilateral legal means. Indeed, sections 1 and 61 of the Internal Revenue Code<sup>46</sup> seem to impose a tax on all persons on their total worldwide income.<sup>47</sup> Transnational enforcement of tax judgments would give nations a much longer tax reach. Such a change in international law might influence changes in the kinds and scopes of taxes nations impose.

### The Grounds for Judgment Recognition

At least two legal bases might justify the enforcement of foreign tax judgments. The first basis is an explicit obligation found in a treaty. The second is the independent discretion of a court to apply the “comity” principle.

The use of tax treaties as basic structures for the enforcement of tax judgments has been extensively discussed in the literature.<sup>48</sup> Typically, Country A agrees to open its courts to Country B for B’s use in executing tax judgments against taxpayers and their assets located in Country A. Likewise, B’s courts would be open to A’s use. Tax treaties have existed for a relatively long time, and several have contained mutual

43. A nation has “quasi in rem” tax reach whenever there is an item of wealth within its jurisdiction belonging to the taxpayer, even though both the taxpayer and the income-producing element on which the tax is based are abroad. Thus, the U.S. may effectively tax a foreign corporation on its U.S.-source income—even if that income is received or recognized abroad—if that corporation has other assets located within the United States.

44. I.R.C. §§ 1, 61 (CCH 1981). See *infra* note 47.

45. For example, the United Kingdom does not seek to tax its nationals when they reside abroad. See generally WORLD TAX SERIES, TAXATION IN THE UNITED KINGDOM 13/4 (1957).

46. I.R.C. § 1 imposes a tax on the “taxable income of every individual.” I.R.C. § 1 (CCH 1981). “Taxable income” in turn is derived from the section 61 definition of gross income as “all income from whatever source derived.” I.R.C. § 61 (CCH 1981). See MCDANIEL & AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 36 (1977). See also OWENS, INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION § II, 3-4 (1980).

47. The broad tax imposition is circumscribed by other sections of the Code (I.R.C. §§ 871 and 872 exempt certain foreign individuals from U.S. tax; §§ 881 and 882 exempt foreign corporations). Case law suggests, however, that should Congress wish to do so, it could constitutionally impose a universal income tax. Cook v. Tait, 265 U.S. 47, 54 (1924). See Choate, Hurok & Klein, *Federal Tax Policy for Foreign Income and Foreign Taxpayers—History, Analysis and Prospects*, 44 TEMPLE L.Q. 441, 444 (1970-71).

48. See generally Johnson, *supra* note 7.

enforcement provisions.<sup>49</sup>

Mutual enforcement treaty provisions, in many instances, have critical weaknesses. First, treaties often have not allowed the judgment state to proceed against a citizen of the enforcing state.<sup>50</sup> Therefore, Country A could use the courts of Country B only against those who are not citizens of Country B. In one writer's assessment, much of the tax evasion due to the lack of transnational enforcement involves citizens of the enforcing nation returning home with income earned in the judgment nation.<sup>51</sup> Judgments against these taxpayers cannot be enforced under the present-day treaty provisions. Second, mutual enforcement treaties have been unpopular because governments are reluctant to subject their residents to legal obligations that may be unacceptably foreign to their own national legal culture.<sup>52</sup> For example, the United States Congress has shown a consistent hostility to limited mutual enforcement provisions, based on a concern that American-style "due process" or "tax equity" may not exist in foreign tax schemes.<sup>53</sup>

The problem of enforcing judgments which are offensive to a state has been solved normally by inserting a "public policy" clause in the treaties: the courts of the enforcing nation need not enforce judgments that are against its public policy.<sup>54</sup> The public policy clause presents two major dangers. At one extreme, litigants will argue that the clause should prevent enforcement, asserting an expansive meaning of "against the public policy."<sup>55</sup> A broad conception of the public policy exception would preclude enforcement in many cases. At the other extreme, a court which is overly concerned with international goodwill

49. United States treaties include those with Denmark (Convention, Dec. 1, 1948, United States-Denmark, art. XVIII, 62 Stat. 1730, 1736, T.I.A.S. No. 1354); France (Convention, Aug. 11, 1968, United States-France, art. 27, 19 U.S.T. 5280, 5314-15, T.I.A.S. No. 6518); The Netherlands (Convention, Apr. 29, 1948, United States-Netherlands, art. XXII, sec. 1, 62 Stat. 1757, 1766, T.I.A.S. No. 1855); and Sweden (Convention, Nov. 14, 1939, United States-Sweden, art. XVII, 54 Stat. 1759, 1770-71, T.S. 958). For a discussion of the current operation of enforcement through tax treaties, see Johnson, *supra* note 7.

50. See Johnson, *supra* note 7, at 474. United States treaties concluded with France, Denmark, and the Netherlands do not permit enforcing such judgments. The treaty with Sweden allows enforcement only against nationals of the judgment state. *Id.* See also *supra* note 50.

51. See Johnson, *supra* note 7, at 474.

52. See *id.* at 471.

53. JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, MEMORANDUM, S. EXEC. REP. NO. 5, 90th Cong., 2d Sess. 40 (1968), reprinted in 1 TAX TREATIES (CCH) ¶ 2838, at 2819. See Johnson, *supra* note 7.

54. See 47 AM. JUR. 2D *Judgments* § 1245 (1962).

55. "Against public policy" can conceptually be expanded to preclude all foreign judgments, except those emerging from a legal culture identical to that of the enforcing state.

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may conclude that use of the public policy clause should be confined. Whether a judicial forum will accommodate competing considerations to generate an appropriate level of enforcement is not assured.

The second legal basis for enforcement of foreign tax judgments is the unilateral, discretionary court application of the comity principle. This principle already is a common basis for the enforcement of foreign private law judgments.<sup>56</sup> Comity parallels the notion of “full faith and credit” in interstate enforcement. The comity principle is usually premised on two requirements: reciprocity of enforcement<sup>57</sup> and an adequate degree of compatibility between two legal systems.<sup>58</sup>

Previous proposals for transnational tax judgment enforcement have focused on the formal reciprocity aspect of comity, without fully considering a compatibility analysis. As shown below, formal reciprocity, while workable in the private judgment field, is not appropriate in the tax area. The test proposed in this comment, structural reflection, is based on a refined concept of comity, providing an answer that takes into account the compatibility aspects of the principle.

### Formal Reciprocity

Proposals for transnational enforcement of tax judgments have been based on some principle of reciprocity.<sup>59</sup> An analogous requirement exists for the enforcement of private law judgments.<sup>60</sup> Formal reciprocity means strict mutual enforcement. Country A enforces Country B’s judgments only if Country B enforces those of Country A.

In the tax area, a formal principle of reciprocity that does not allow for exceptions may be too sweeping to be accepted by the courts. Tax systems differ. Some countries tax their citizens even when they reside abroad;<sup>61</sup> others do not.<sup>62</sup> An English court might be reluctant to enforce a U.S. judgment against a U.S. citizen residing in Britain, finding

56. See *supra* note 5.

57. See 47 AM. JUR. 2D Judgments § 1249 (1962). See also *Ritchie v. McMullen*, 159 U.S. 235 (1895) (judgment entered by a U.S. court will be enforced in Canada if a Canadian judgment has been enforced under similar circumstances in the U.S.). But see *Coulbourn v. Joseph*, 195 Ga. 723, 25 S.E.2d 576 (1943) (judgment of a foreign court will be enforced only if the legal system of the country of judgment is compatible with the legal system of the U.S.).

58. See *infra* notes 63-72 and accompanying text.

59. See, e.g., *Robertson*, *supra* note 21, and Note, *supra* note 3.

60. *Hilton v. Guyot*, 159 U.S. 113 (1895) (“The general comity, utility, and convenience of nations have . . . established a usage among most civilized states, by which the final judgments of foreign courts of competent jurisdiction are reciprocally carried into execution,” quoting *Wheat*, Int. Law § 147 (8th ed. 1866)).

61. The United States taxes its citizens worldwide. I.R.C. §§ 1, 61 (CCH 1981).

62. See *supra* note 46.

such a tax to be irrational, oppressive, or onerous when viewed from the standpoint of English legal culture. Yet formal reciprocity would require enforcement, unless the English court could invoke the public policy exception.

### Structural Reflection: A Proposal

Structural reflection, like formal reciprocity, is based on principles of comity. Unlike formal reciprocity it embodies elements of compatibility. Additionally, it refines the concept of reciprocity. These two elements combine to make it an appropriate test for the enforcement of tax judgments.

#### A. *Compatibility and the "Public Policy Exception"*

The most often invoked exception to enforcement of private law judgments is the public policy exception, based on the underlying requirement of legal compatibility.<sup>63</sup> The requirement of legal compatibility is often expressed as follows: the foreign law does (or does not) offend this State's public policy.<sup>64</sup> The declaration of offense to public policy results from a contextually incongruous placement of foreign law into the enforcing court's legal culture.<sup>65</sup>

The public policy exception from comity enforcement and the "public policy clause" in treaty enforcement both serve the same function: to screen out judgments according to their legal compatibility. The comity principle, however, allows greater discretion to the court than does treaty enforcement. A treaty is a "law of the land" obligation, to which the "public policy exception" may be applied only in unusual circumstances.<sup>66</sup>

Finding that a foreign judgment offends the enforcing nation's public policy may be based on either substantive or procedural grounds. It must include certain "due process" notions, such as notice, opportunity

63. See *supra* notes 55-56 and accompanying text.

64. *Id.*

65. See Smit, *International Res Judicata and Collateral Estoppel in the United States*, 9 U.C.L.A. L. REV. 44 (1962) ("The [public policy exception] has afforded escape from recognition in cases ranging from situations in which the foreign judgment did indeed appear to be incompatible with local notions of fundamental justice and decency, to situations in which the foreign substantive law applied in the constitution of the foreign judgment was merely different from that prevailing at the local forum"; *id.* at 52).

66. U.S. CONST. art. VI, § 2 ("[A]ll Treaties made, or which shall be made under the Authority of the United States, shall be the supreme Law of the Land . . ."). See TRIBE, *AMERICAN CONSTITUTIONAL LAW* 167-68 (1978) ("Under the supremacy clause, it is indisputable that a valid treaty overrides any conflicting state law, even on matters otherwise within state control.").

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to be heard, etc.<sup>67</sup> A public policy test gives courts the ability to enforce foreign judgments on a selective basis. The same exception could be applied to the transnational enforcement of tax judgments.

Public policy tests, as a general solution to the transnational enforcement of tax judgments, have been criticized because of their potential abuse in application. Proponents of enforcement worry that courts may misuse the public policy tests by applying subjective or political concepts of “public policy.”<sup>68</sup> Application of the public policy exception in an ostensibly arbitrary manner might offend foreign nations and could hamper international relations.<sup>69</sup>

The public policy exception is essential to safeguard due process. Without its protection, an oppressive nation might convert its distaste for one of its citizens into a “tax obligation,” obtain a *pro forma* judgment, and then use transnational enforcement to reach him.<sup>70</sup> To protect against such abuse, some might argue that considerable scrutiny should be applied to all requests for enforcement, even if the result is that many judgments go unenforced.

The problem with “public policy” is that the term is seldom precisely defined and therefore does not provide a manageable standard for judicial decisions. Clearly, the public policy exception should be preserved to block enforcement against someone who has been denied an opportunity to be heard.<sup>71</sup> It should also be used to block an act of individualized political oppression.<sup>72</sup> The concept, however, provides little guidance when applied to judgments based on taxes, which though fairly imposed, are foreign to the particular legal culture.

Aggressive invocation of an undefined public policy exception could make enforcement so infrequent and irregular as to be little improvement over the present absence of enforcement. If a notion of legal compatibility (at least as to taxes) were accurately defined, the public

67. For a discussion of the effect of due process concerns on the enforcement of foreign judgments, see Smit, *supra* note 66, at 46-47 (“[A] due process question might be raised if either a federal or a state tribunal proposed to give cognizance to, and clothe with domestic sanctions, a foreign judgment that was obtained in utter disaccord with domestic notions of fairness.”).

68. See *supra* note 66 (public policy can be applied in cases where there is a mere difference in substantive law between judgment and enforcing states).

69. *But see* Leflar, *supra* note 5, at 217 (arguing that refusal to enforce based on public policy would be less offensive than general non-enforcement).

70. One can imagine the scenario where a government enacts a “tax” aimed at recovering wealth from certain easily identified individuals. For example, the present Iranian government might impose a “tax” on the wealth accumulated by members of the former Pahlavi regime.

71. See *supra* note 68.

72. See *supra* note 71.

policy tests could be used with greater precision. Both the courts and potential taxpayers would know the meaning of "public policy," and would adjust their expectations accordingly.

Structural reflection, as described below offers a flexible yet clear framework for courts to rule on the transnational enforcement of tax judgments. It replaces the vague generalities of the public policy exception to offer meaningful criteria for judicial decisions.

### B. *The Test for Structural Reflection*

"Structural reflection" is distinguishable from the formal reciprocity of automatic enforcement and is based on a systematic matching of the kind and scope of taxes imposed in two or more legal systems. Under the principles of structural reflection, for every tax to be enforced in the enforcing state, there must exist an analogous tax in the judgment state. Returning to the case where the U.S. seeks to enforce a judgment against a U.S. citizen residing in Britain, the result would differ from that obtained by applying formal reciprocity. In this case, there would be no structural reflection because the U.K. would *not* tax a U.K. subject residing in the U.S., as the U.K. does not tax its subjects when they are resident abroad. What the U.S. seeks and what formal reciprocity would require is a one-sided obligation on the part of the enforcing state.

A test for structural reflection will eliminate such instances of one-sidedness required by formal reciprocity, which would be commonplace given the great variety of taxes. Structural reflection, as a test in transnational enforcement, has a simple premise: no nation should be asked to enforce a tax which it would not itself impose. Formal reciprocity necessarily violates this principle.

The test for structural reflection is a two-step mode of analysis: first, a comparison between the "kind" of tax imposed by the judgment state and the taxing scheme of the enforcing state; second, a comparison of the "scope" of the taxes of the two systems.<sup>73</sup> A four-part classification of "kinds" of taxes can serve for the first comparison test for structural reflection. Three kinds of taxes are based on items of wealth. These are taxes imposed at the time of (1) acquisition (e.g. income taxes), (2) continued possession (e.g. property taxes), or (3) disposal (death or gift taxes).<sup>74</sup> A fourth kind of tax is based on a privilege, such as im-

73. See *infra* notes 78-80 and accompanying text.

74. In the United States, the federal government imposes income (I.R.C. § 1) and estate (I.R.C. § 2001) taxes. Individual states impose income taxes, death taxes, and property taxes.

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port, employment, business, or excise taxes.<sup>75</sup> In cases of transnational enforcement, some taxes are more clearly analogous than others, with income and estate taxes being the easiest to classify in homologous categories. Most nations today impose all four kinds of taxes, although there is great variance as to the relative mix utilized in providing a revenue base.<sup>76</sup>

Once two taxes are found alike in kind, it is appropriate to turn to the second prong of the test for structural reflection. It requires a comparison of the "scope" of taxes imposed by the two nations. Nations differ greatly as to the scope of power they extend to their taxing authorities. A nation's tax scope may far exceed the boundaries of its effective power to tax, its unilateral tax "reach."<sup>77</sup>

To analyze national tax scopes, it is helpful to isolate the component tax "theories" on which authority to tax is based. A "theory" of taxation identifies the feature which subjects the person or wealth to tax.<sup>78</sup> A national taxing scheme may be based on one such theory, or, as in the United States, on an intersecting amalgam of such theories.<sup>79</sup>

75. For example, federal Social Security taxes are exacted from all employers for the "privilege" of hiring workers.

76. The United States relies heavily on income taxes to raise revenues. There is no federal U.S. property tax. In France, however, property taxes are much more important for providing national revenues.

77. *See supra* notes 45-48 and accompanying text. Scope is a different concept from tax "reach." Given the present rule of international non-enforcement, all nations are effectively limited to collecting only those taxes within their tax "reach" (be it in personam, in rem or quasi in rem "reach"). The American notion of scope (or legitimate authority to tax) is perhaps the broadest in the world. The U.S. seeks to impose certain taxes, such as income taxes, on a broader class of persons (its own citizens wherever resident) than do most other nations.

78. The notion of "theory of taxation" has been taken from lectures by Professor Boris I. Bittker delivered in the fall of 1981 at Yale Law School. Any errors in the analysis presented here originate with the author.

79. The American system of taxation is defined in scope by the conjunction of three fundamental theories of taxation, which are the benefit theory, the "ability-to-pay" theory, and the public duty theory. The benefit theory imposes a tax on those who extract protection and support from the American government and American institutions. The tax is the price due for benefits received from the government. For example, a U.S. resident alien is asked to pay a tax based on his worldwide income in exchange for the benefits and rights he receives from U.S. residency. I.R.C. §§ 1, 61 (CCH 1981). A non-resident alien who operates a U.S. trade or business is expected to pay tax on his U.S.-source income, to compensate for his taking advantage of the U.S. market. I.R.C. §§ 871, 872. A non-resident alien who is present in the U.S. for more than six months of the year is asked to pay a tax on his capital gains, premised on the benefits received from such a long transiency. I.R.C. § 871(a)(2).

The second type of tax theory upon which the U.S. taxing scheme is based is the ability-to-pay theory. Although this theory is similar to the benefit theory, it differs in that the amount of accessible wealth determines the tax, even if the taxpayer receives little or no corresponding benefit. For example, a non-resident alien who receives dividends from a U.S. corporation operating exclusively abroad faces a 30 percent tax on those dividends, even though he may not receive commensurate benefits from the U.S. government. I.R.C. §§ 871(a), 881(a) & 1441. The rationale is that the wealth is where the U.S. government can

While seldom explicitly discussed, tax "theories" are useful analytical tools for understanding a nation's authority to impose taxes, and can serve in the comparison of taxes imposed by different nations.

The test for structural reflection requires comparing the taxes imposed by two different legal systems. Whereas the two taxes alike in kind may not exactly correspond in limits, if their scope is based on a similar tax "theory," the reciprocity of structural reflection is satisfied, and enforcement can follow.

### C. *An Example of Structural Reflection*

The operation of the test for structural reflection can be seen in an example analyzed under the U.S. and French tax systems. Both countries have experienced difficulties in controlling foreign corporations located in offshore "tax haven" jurisdictions, where wealth is allowed to accumulate yet not be subject to tax until and unless it is returned home to its U.S. or French owner.

The United States pioneered a solution to the problem of offshore tax deferral by implementing a series of provisions popularly known as Subpart F.<sup>80</sup> Subpart F operates by imposing a tax on the U.S. *owner* based on the present income of its "controlled foreign corporation [CFC]." The tax is imposed whenever certain U.S. ownership<sup>81</sup> and type of income<sup>82</sup> requirements are met. In general, a sole U.S. shareholder who owns a CFC that receives all of its income from passive sources (dividends, interest, royalties, etc.) will be subject to tax on the income that the corporation earns.<sup>83</sup>

More recently, the French Government amended its tax code to deal with the problem of foreign corporations and tax deferral.<sup>84</sup> As does

easily get hold of it, and for that reason it should be taxed. Note that the ability-to-pay theory by itself suggests a taxing scope co-extensive with unilateral tax "reach." It would limit taxing authority to the reach of effective power.

The third tax theory characteristic of the U.S. taxing scheme is the "public duty" theory. It is the obligation of every U.S. citizen, resident or non-resident, to pay a tax based on worldwide income (that is, both U.S.-source and foreign income). I.R.C. §§ 1, 61(a). Clearly, this obligation exceeds the notion of benefits received and requires the submission to tax of sums which the government could not expect to reach unilaterally, even in cases where there is no ability-to-pay, such as double taxation.

80. I.R.C. §§ 951-64 (CCH 1981).

81. I.R.C. § 951.

82. I.R.C. § 952.

83. See B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 68.3 (1981). The precise mechanism of Subpart F is quite complicated.

84. Art. 70, Loi no. 80-10 du 18 janvier 1980. (French Finance Act of 1980), Dalloz, Code Générale des Impôts (Suppl. 1980) (on file with the *Yale Journal of World Public Order*). For a discussion of art. 70, see Kaplan & Ault, *International Developments—Another View, Subpart F à la Française*, 8 J. CORP. TAX. 68, 68-70 (1981).

## Tax Judgments

the U.S. Subpart F, the French "Article 70" has an ownership requirement.<sup>85</sup> Unlike Subpart F, however, it only applies to *corporate* owners,<sup>86</sup> and only applies to those foreign subsidiaries located within certain "privileged" tax systems.<sup>87</sup> Therefore, it is not the type of income which the foreign corporation earns but its place of operation which triggers the French tax. These "privileged" jurisdictions are included in a *liste noire* issued by the French Government.<sup>88</sup>

Both the U.S. Subpart F and the French Article 70 are intended to solve the same problem: to prevent abuse of tax deferral privileges granted to foreign subsidiaries. They diverge in their technical operation, however. Assume a U.S. corporation owns a Netherlands subsidiary which holds many of its worldwide patents and receives income from its patent royalties. Subpart F would impose a tax on this income to the U.S. parent.<sup>89</sup> A French parent which holds an analogous Netherlands subsidiary would not be subject to tax under Article 70 because the Netherlands is not a "tax haven" on the *liste noire*.<sup>90</sup> Similarly, if a French company operates an active Netherlands Antilles subsidiary it would be subject to tax under Article 70 because the Netherlands Antilles is on the *liste noire*.<sup>91</sup> A U.S. parent that owned an analogous subsidiary would not be taxed by Subpart F.<sup>92</sup> Thus the two provisions, while intended to solve the same problems, produce different outcomes in their practical operation.

The issue posed, therefore, is twofold: first, whether a French court should enforce a U.S. Subpart F judgment in a situation where Article 70 would not apply; and conversely, whether a U.S. court should enforce a French Article 70 judgment where Subpart F would be inapplicable. In both cases, even with technical divergences, enforcement should follow. This is because both the kind and scope of the taxes are similar. Both nations tax the parents of foreign subsidiaries on income earned by those subsidiaries which otherwise would be deferred. Both extend jurisdiction into the foreign tax haven. Both are based on a

85. Article 70 reads, "a corporation subject to corporation taxation and holding directly or indirectly at least 25 percent of the shares of a corporation registered in a foreign country . . . ." Art. 70-1, *supra* note 85.

86. *See* Art. 70, *supra* note 85.

87. *Id.*

88. A copy of a *liste noire* of "privileged" tax jurisdictions, issued by the French government on October 9, 1975, is on file with the *Yale Journal of World Public Order*.

89. I.R.C. §§ 951-64 (CCH 1981).

90. The Netherlands' absence on the *liste noire* is due more to its status as an E.E.C. member than to an estimation of its tax policies.

91. *See liste noire, supra* note 89.

92. I.R.C. § 952. Income from the active conduct of business is not Subpart F income.

similar tax *theory* (defeat of abusive tax deferral—an ability-to-pay notion). For purposes of structural reflection, Subpart F and Article 70 are the same tax.

A thorough analysis of kind and scope of taxes, including inquiry into the underlying tax “theory,” should clearly indicate which tax judgments should be enforced as between two countries. The goal is to satisfy the demand that no nation be asked to enforce a tax it would not itself impose.

### Summary

The rule that the courts of one nation will not enforce the tax laws of another, though often criticized, continues to be enforced.<sup>93</sup> In the author’s view, the rule continues because of the failure of previous reform proposals to resolve the problem of reciprocity. These proposals have utilized a formal concept of reciprocity (mutual enforcement) that would require courts to enforce taxes incongruous with their own legal cultures.<sup>94</sup> A preferable concept of reciprocity is “structural reflection,” which requires comparison of the structures of tax systems. This requirement is based on the proposition that no nation be asked to enforce a tax it would not itself impose.<sup>95</sup> A nation may decline to impose a certain *kind* of tax for policy reasons, or it may not assert the same *scope* of taxing authority, based on a more limited tax theory. An analysis of kind and scope will determine whether structural reflection is satisfied. If the test for structural reflection is met, enforcement should be required, unless the traditional public policy exception is applied because of failure of due process or fair-play. When applying structural reflection to the tax to be enforced, the traditional public policy exception will rarely need to be invoked, because analysis of the compatibility of a foreign tax with a legal culture is an integral part of the structural reflection test. The application of the structural reflection test should replace non-enforcement as the norm in the transnational tax judgment area.

93. See *supra* notes 30-41 and accompanying text.

94. See *supra* notes 60-63 and accompanying text.

95. See *supra* notes 64-73 and accompanying text.