

Changing the Norm on Cross-border Enforcement of Tax Debts

by Philip Baker QC

One of the established norms of international tax law is that one State will not assist in the enforcement of tax debts due to another State.¹ The existence of this norm has influenced the development of the principles of international tax law perhaps more than one sometimes appreciates. At present, there are a number of proposals, which have been adopted or are under discussion, to depart from the norm. It is interesting to speculate what impact such a departure might have on the future of international tax law.

Cases on the non-enforcement of tax debts are rather like London buses: one waits five years, and then three cases come along together. Three recent cases in the US have reaffirmed the continuing vitality of what in America is called “the Revenue Rule”. These cases have all arisen out of essentially the same set of circumstances: they are claims by governments outside the US for loss of excise duties and other taxes on cigarettes as a result of the alleged involvement of a number of US cigarette manufacturers in tobacco smuggling. Perhaps the fullest discussion of the Revenue Rule is in the earliest of these cases, Attorney General of Canada v. R J Reynolds Tobacco Holding Inc. and

¹ In the United Kingdom, this rule is known as the rule in the Government of India case [1955] AC 491. For discussion of this rule, and its recognition in other jurisdictions, see Philip Baker, “Transnational Enforcement of Tax Liabilities” in John Dixon ed., *Tolley’s International Tax Planning* (4th Edition, 1999) – a revised edition of this chapter is currently at the printers.

Others.² As its title indicates, that case involved claims by the Canadian Government for lost duties and taxes. Similar claims have been brought by the European Community along with the fifteen Member States of the Community,³ and by the Government of Ecuador⁴. In all three cases the US court struck out the claim by the foreign government on the grounds that it was a claim for the collection of taxes and that this contravened the Revenue Rule.

The underlying rationale for the Revenue Rule has been expressed differently at various times: one is tempted to say that none of the explanations is entirely satisfactory. Earlier cases tended to base the rule on the principle of sovereignty – that the collection of taxes is an act of sovereignty, and (absent agreement) no sovereign allows another State to exercise its sovereignty on its territory. This is probably less of an explanation than simply a description: because the collection of taxes is an act of sovereignty, therefore it is limited to the territory of a state, therefore it is an act of sovereignty.

In the early 20th Century an alternative explanation was put forward for the Rule: that it avoided the danger of the courts of one State having to consider whether the tax laws of another State infringe principles of public policy. This explanation is hardly more satisfying than the sovereignty explanation: when faced with foreign private law, States have no particularly

² United States Court of Appeals for the Second Circuit, 12th October 2001, 268 F.3d 103.

³ The European Community & Others v. Japan Tobacco Inc. and Others, United States District Court for the Eastern District of New York, 19th February 2002, 2002 U.S. Dis. Lexis 2506.

⁴ Republic of Ecuador v. Philip Morris Companies Inc. and Others, United States District Court for the Southern District of Florida, 26th February 2002, 2002 U.S. Dis. Lexis 3423.

difficulty in deciding whether the law in question might infringe its public policy.

The Attorney-General of Canada case is interesting in offering a new explanation for the Revenue Rule; one which has been taken up in the two subsequent cases. The explanation is that the existing network of double taxation conventions has been concluded on the basis that there is a rule of non-enforcement of foreign taxes - hence the reason for exchange of information provisions, and the occasional provisions for assistance in collection of taxes which are included in some tax treaties. Added to this is the particular, US issue of the separation of powers: the Court of Appeals was concerned that if it departed from the Revenue Rule this might interfere with the treaty-making prerogative of the executive under the US Constitution.

Phrased somewhat differently, this new explanation has some strength to it. In effect, our existing body of principles of international tax law has been formulated on the assumption that the Revenue Rule exists; to deny the continued vitality of the Revenue Rule risks undermining our existing framework for international taxation.

This point is particularly interesting because there are proposals currently under discussion, or recently adopted, which threaten exactly this: to undermine or abrogate the Revenue Rule. Two proposals should be mentioned in particular.

The first of these is the adoption in June last year of European Council Directive 2001/44/EC amending the existing Directive on mutual assistance for the recovery, inter alia, of tax claims. This amendment extends the existing Directive to require Member States of the European Union to assist one another in the collection of virtually all forms of taxation, including VAT, excise duties, and taxes on income and capital. (In practice, virtually the only taxes that are not covered are taxes on inheritance and estates and stamp duties.) Member States are required to adopt any changes to their laws to comply with the Directive by the 30th June 2002. From that date, effectively the Revenue Rule will have disappeared as between Member States of the European Union: one Member State will be able to ask another to collect taxes on its behalf.

In some respects, this change is not unduly surprising. Within most federal states, agreement is reached for mutual assistance in collecting taxes and duties. In the US, for example, judgments for tax debts due to other States of the Union are entitled to the full faith and credit clause of the Constitution. Similarly, within the Swiss Confederation a concordat was reached for mutual assistance in the collection of Cantonal taxes. Even so, the effective abandonment of the Revenue Rule by the fifteen European Union countries for claims inter se is of some significance both for the development of EC tax law and of international tax law.

The other proposal has a potentially wider audience and a wider impact. In the draft of the 2002 update to the OECD Model, the Committee on Fiscal

Affairs has proposed the insertion of a new Article 27 of the OECD Model (with the subsequent articles being renumbered) providing for co-operation in the enforcement of tax debts.⁵ Assuming this proposal is adopted, OECD member countries are not obliged to conclude conventions containing an equivalent provision, but it is much more likely that they will do so. At present, there are some 200 double taxation conventions which contain some form of provision for mutual assistance in the collection of taxes.⁶ In the future, there may be many more.

It is interesting to speculate what this gradual abrogation of the Revenue Rule may lead to. Here are a few suggestions.

It is perhaps not overstating matters to say that the normal basis for tax jurisdiction claimed by States owes much to the existence of the Revenue Rule. Most States tax their residents on their worldwide income and non-residents on income having its source in their country. A simple explanation for this principle is that these are the taxes that a State can collect: they can enforce claims against their residents, and they can enforce claims where the source of income is in the country. What they cannot do is tax non-residents on income having a source outside the country, even though it might have some other link to the country which might justify a tax claim. This is, one might speculate, one of the reasons why taxation on basis of citizenship is not particularly popular -

⁵ For discussion of this proposal, see Dr. F. Prats, "Mutual Assistance in Collection of Tax Debts" (2002) 30 *Intertax* 56 – 78.

⁶ *Ibid*, page 58.

other than for countries like the US - because non-resident citizens who have their income outside the country present a real problem of enforcement.

In a world where the Revenue Rule has been supplanted by a general principle of mutual assistance in tax collection, the established bases for tax jurisdiction may change.

This is not to suggest that more countries will start to tax on the basis of citizenship, though that is one possible conclusion. With greater mobility of persons, and the increased possibility for individuals not to be resident in any jurisdiction, taxation on the basis of citizenship may look more attractive, if it represents a viable – and enforceable – option. In a sense, the taxation of companies on their worldwide income in their state of incorporation is akin to the taxation of individuals on the basis of nationality: as that approach gathers adherents, cross-border enforcement of taxes against a company (whose only link with a territory is that it is incorporated under the law of that territory) may be more attractive.

It seems unlikely that States would universally abandon tax jurisdiction based upon residence or situs/source. However, one may see more claims to extended jurisdiction to tax. Two examples might illustrate this.

First, taxation of capital gains by individuals who have left the country and have disposed of assets after giving up residence. Arguably, an asset

acquired while they were resident has increased in value during that period of residence, and the State from which they have departed should be entitled to claim at least some of that gain as its own for tax purposes. At present, States may approach this by having a departure tax, but this is unattractive since it may require the departing taxpayer to pay tax on unrealised gains (or provide security for future payment of the tax), and potentially interferes with the freedom of persons to move from country to country. If, however, tax can be collected in the country of new residence – and there is agreement as to the allocation of taxing rights over the gain that has accrued over a number of years – then countries have an incentive to adopt legislation to tax the gains of former residents.

A similar situation arises with regard to stock options which might have been granted while an employee was working in one country, but are exercised when the individual has moved to another country. Under the Revenue Rule, it would not be possible for this first country to collect tax in the other country when the option is exercised: under a new norm of cross-border assistance in collection, this possibility becomes realistic.

Another example might be the recovery of deductions made by a former resident. Let us suppose that an individual makes tax-deductible contributions to a pension scheme while he is resident in State A. He subsequently moves to State B, and the pension arrangements are moved with him. Once the individual starts to draw down on his pension, State A - under the norm of the

Revenue Rule - would have no way of recapturing the benefit given by the deduction of the contributions: under a norm of cross-border assistance, State A would be able to do just this.

No doubt there are many other examples of changes to the basic jurisdiction to tax which readers of this article might care to think about. In a sense, the Revenue Rule has forced States to adopt a basis for tax jurisdiction that was never wholly satisfactory but which at least met the requirement of enforceability. Residence taxation allowed the state of residence – if it had all the information available – to tax on the basis of the ability to pay: source-based taxation lacked that feature and so relied upon the potentially-inequitable use of flat-rate withholding taxes. In a brave new world where the Revenue Rule no longer constrains States, it may be possible to allocate tax jurisdiction between States on a basis that is more equitable and more rational, while remaining enforceable.