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Case Digest

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CASE DIGEST

This CASE DIGEST provides brief analyses of cases that represent current aspects of transnational law. The Digest includes cases that establish legal principles and cases that apply established legal principles to new factual situations. The cases are grouped in topical categories and references are given for further research.

TABLE OF CONTENTS

I.	TAXATION	469
II.	AIR CARRIER LIABILITY	472
III.	JURISDICTION	474
IV.	SETTLEMENTS	475

I. TAXATION

UNITED STATES TAX PRINCIPLES GOVERN DETERMINATION OF ACCUMULATED PROFITS UNDER FOREIGN TAX CREDIT SECTION OF INTERNAL REVENUE CODE, *United States v. Goodyear Tire & Rubber Co.*, 110 S. Ct. 1172 (1990).

Goodyear Tyre and Rubber Company Limited (Goodyear G.B.), a British corporation and wholly owned subsidiary of Goodyear Tire and Rubber Company (Goodyear), a United States corporation, paid income taxes to the United Kingdom and the Republic of Ireland in 1970 and 1971. In addition, Goodyear G.B., paid dividends for 1970 and 1971 to Goodyear, its sole shareholder, which Goodyear reported on its federal income tax return. Goodyear then sought credit for part of the foreign taxes paid by Goodyear G.B., as allowed in section 902 of the Internal Revenue Code. Under section 902, the parent of a foreign subsidiary is allowed an indirect credit for foreign taxes paid by that subsidiary. When a subsidiary, however, distributes dividends to its United States parent, and distributes only part of its available profits, the amount of the credit allowed is limited to the amount of tax the subsidiary paid based on the dividends issued. The foreign tax credit available to the United States parent may be represented algebraically as follows: Credit

= Foreign Taxes Paid x (Dividends÷(Accumulated Profits minus Foreign Taxes))

In 1973, British taxing authorities recalculated Goodyear G.B.'s income and tax liability for 1970 and 1971 and refunded a substantial amount of Goodyear G.B.'s tax payments for those years. Under section 905(c), the foreign tax credit may be recalculated when "any tax paid is refunded in whole or in part." The United States Commissioner of Internal Revenue therefore recalculated the foreign tax credit available to Goodyear for the years 1970 and 1971. The Commissioner lowered the amount of taxes paid by Goodyear G.B., but did not lower accumulated profits to take into consideration the lowering of Goodyear G.B.'s income liability for 1970 and 1971 because the loss allowed under British law for those years would not have been allowed under United States tax law. As a result, Goodyear paid tax deficiencies assessed by the Commissioner for 1970 and 1971. Goodyear then brought suit for a refund in the United States Claims Court, claiming that foreign tax principles should determine the meaning of accumulated profits in the section 902 formula.

The Claims Court rejected Goodyear's claim, stating that the purposes of section 902 indicate that accumulated profits should be determined by United States tax principles. The Court of Appeals for the Federal Circuit *reversed*, holding that the plain meaning of section 902 requires that accumulated profits be calculated in accordance with foreign law. The Federal Circuit found that this interpretation furthered the underlying purpose of section 902: avoiding international double taxation.

The United States Supreme Court *Held: Reversed.* The Court held that accumulated profits within the meaning of section 902 of the Code must be determined according to United States tax principles. According to the Court, the issue whether accumulated profits should be determined under foreign or United States tax principles could not be resolved from the language of section 902 because the statutory language relates accumulated profits to the foreign tax paid as determined by foreign laws and to the dividend issued as determined by United States law.

The Court stated that the legislative history of the foreign tax credit indicates that the two purposes underlying the credit were: first, to protect United States companies from double income taxation; and second, to insure that United States corporations operating foreign subsidiaries and those operating unincorporated foreign branches are treated equally. The Court noted that the risk of double taxation is less than the risk of unequal treatment when accumulated profits are defined by United States tax principles. Goodyear claimed that if "accumulated profits" were defined by United States tax principles, "double taxation [would

result] only when a dividend is sourced to a year in which [United States] tax concepts recognize little or no income and yet a subsidiary pays substantial foreign tax." Goodyear had not shown that this frequently occurs. The Court also stated that Goodyear's approach of defining accumulated profits in terms of foreign tax principles would lead to unequal tax treatment between United States companies operating through subsidiaries and those operating through unincorporated companies whenever the calculation of income tax by foreign tax officials differs from the United States calculation.

The Court relied on administrative interpretations of section 902 and on the principle of construction that tax provisions should be interpreted by United States tax principles absent a clear congressional intent that foreign tax concepts be used. *Significance*—For the purpose of obtaining foreign tax credits, United States corporations operating through foreign subsidiaries cannot take advantage of foreign tax principles in determining accumulated profits. Although this holding is disadvantageous to United States corporations operating through foreign subsidiaries, it insures that such corporations and other United States corporations operating through foreign unincorporated branches shall be treated equally.

TAX INJUNCTION ACT BARS FOREIGN PARENT OF SUBSIDIARY DOING BUSINESS IN CALIFORNIA FROM RAISING FOREIGN COMMERCE OBJECTIONS TO TAX BOARDS'S FORMULA, *Franchise Tax Board of California v. Alcan Aluminium Ltd.*, 110 S. Ct. 661 (1990).

Alcan Aluminum Ltd. (Alcan), a Canadian company, is the sole shareholder of Alcan Aluminum Corp. (Alcancorp), an Ohio corporation. Imperial Chemical Industries PLC (ICI), a British company, is the sole shareholder of ICI Americas, Inc., a Delaware corporation. Both Alcancorp and ICI Americas do business in California. Alcan and ICI brought two separate lawsuits in the District Court of the Northern District of Illinois against the Franchise Tax Board of California and some of its employees located in Chicago, Illinois. Alcan and ICI sought declaratory and injunctive relief from the use by the Board of the unitary business/formula apportionment method to determine how much of the taxable income of Alcancorp and ICI Americas should be allocated to California. Under the formula, the Board first determines the total earnings of the "unitary business" of the company doing business in California. The Board then calculates an allocation fraction by taking an "unweighted average of three ratios: California payroll to the total payroll, California property value to total property value, and California sales to total sales." Finally, the Board multiplies the allocation fraction by the total income of the unitary business to compute the amount of income

taxable by California. The district court dismissed the suit.

The Court of Appeals for the Seventh Circuit *reversed.* The court held that Alcan and ICI had article III standing to challenge the taxes imposed on Alcancorp and ICI Americas by California. The court reasoned that if the California taxes assessed were higher than allowed by United States law, such tax would cause financial injury to Alcan and ICI through an illegal reduction in the return on their investments in their subsidiaries and a decrease in value of their stockholdings. The Seventh Circuit also held that Alcan and ICI had stockholder standing and that their suits were not barred by the Tax Injunction Act, 28 U.S.C. § 1341 (1982).

The United States Supreme Court *Held*: *Reversed.* The Court held that Alcan and ICI had article III standing as stockholders, yet concluded that the suits were barred by the Tax Injunction Act.

Under the Tax Injunction Act, "[t]he district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State." The Court held that Alcancorp and ICI Americas could obtain a plain, speedy, and efficient remedy through California's refund procedures. Because Alcan and ICI had total control over their subsidiaries, they therefore also had a plain, speedy, and efficient remedy.

Alcan and ICI disagreed that they had a remedy, arguing that their subsidiaries could not challenge California's unitary tax under the foreign commerce clause or on the basis of foreign commerce injuries to their parent corporations. The Franchise Tax Board objected, arguing that California courts could entertain and decide foreign commerce claims. The Court concluded that Alcan and ICI had not shown that California state courts would not entertain foreign commerce claims. The Tax Injunction Act thus applied. *Significance*—The Tax Injunction Act bars foreign parent corporations of wholly owned subsidiaries doing business in California from bringing actions in federal court against the Franchise Tax Board of California. Claims of foreign commerce injuries must be raised by the taxpayer subsidiary.

II. AIR CARRIER LIABILITY

PUNITIVE DAMAGES RECOVERABLE UNDER WARSAW CONVENTION FOR AIR CARRIER WILLFUL MISCONDUCT, *In re Hijacking of Pan American World Airways, Inc. Aircraft at Karachi Int'l Airport, Pakistan on Sept. 5, 1986,* 729 F. Supp. 17 (S.D.N.Y. 1990).

This action arose out of the brutal hijacking of a flight from Bombay,

India to New York's Kennedy Airport in which twenty people were murdered. Parties injured as a result of the hijacking filed suit against Pan American World Airways (Pan Am) in the United States District Court for the Southern District of New York. Plaintiffs brought suit under the Warsaw Convention as amended by the Montreal Agreement. Pan Am moved for partial summary judgment on the issue of punitive damages, arguing that article 17's compensatory damages limitation of $75,000 pre-empted any possible recovery of punitive damages under the Warsaw Convention.

The court denied Pan Am's motion. *Held: Partial summary judgment denied.* The Warsaw Convention does not provide the exclusive remedy. The Convention therefore does not preempt the right to recover punitive damages in cases involving willful misconduct. The court noted that the Warsaw Convention creates a right of action independent of the actions possible under the internal law of the signatory state, so that the state remedies are not abolished under the Convention unless specifically preempted. Preemption may be implied if supported by the statute itself or it's legislative history. The Convention, however, leaves many issues to the internal law of the parties, including the issue of damages. The court quoted article 25(1) in response to Pan Am's claim that other provisions of the Convention bar or limit punitive damages:

> The carrier shall not be entitled to avail himself of the provisions of this convention which exclude or limit his liability, if the damage is caused by his willful misconduct or by such default on his part as, in accordance with the law of the Court to which the case is submitted, is considered to be equivalent to willful misconduct.

The court therefore concluded that article 17, which limits recoveries to $75,000, is a limiting provision within the meaning of article 25 only, and that such claims would not be barred in cases involving willful misconduct.

The court departed from the reasoning of the United States Court of Appeals for the Eleventh Circuit in *Floyd v. Eastern Airlines*, 872 F.2d 1462 (11th Cir. 1989), *cited in In re Air Disaster in Lockerbie, Scotland on Dec. 21, 1988*, 709 F. Supp. 231 (E.D.N.Y. 1990). The courts in both of these cases sought to construe the Convention in accordance with the intent of the contracting parties. The court stated that its interpretation of *Chan v. Korean Airlines*, 109 S. Ct. 1676 (1989), would not permit it to construe the Convention to effect what was intended by the contracting parties, because under *Chan* preemption of punitive damages claims should not be implied in the absence of clear language in the Convention or the legislative history supporting the implication. *Significance*—There is an apparent split developing in the courts over

whether punitive damages are recoverable under the Warsaw Convention as interpreted by the United States Supreme Court in *Chan v. Korean Airlines.*

III. JURISDICTION

CORRESPONDENCE BANK ACCOUNT WITH UNITED STATES TRUST COMPANY HELD INSUFFICIENT CONTACT WITH UNITED STATES TO ESTABLISH SUBJECT MATTER JURISDICTION UNDER THE FSIA—*International Housing Ltd. v. Rafidain Bank Iraq*, 893 F.2d 8 (2d Cir. 1989).

Plaintiff International Housing Limited (IHL) is a corporation organized in the Cayman Islands with its principal place of business in the Bahamas. Defendant Rafidain Bank Iraq is a banking corporation wholly owned by the Iraqi Government; it maintains no office in the United States, owns no real property in the United States, has no employees in the United States, and it is not licensed to do business in the United States. Rafidain's sole contact with the United States is a correspondence bank account—used for deposit and payment of funds—with the Irving Trust Company in New York City.

In 1975, IHL entered into a contract with a division of the Iraqi Government to construct 740 housing units in Iraq. IHL used the Royal Bank of Canada as its commercial bank; the Iraqi Government used Rafidain. Rafidain issued "overdraft facility" credit to IHL, and IHL guaranteed any indebtedness to Rafidain through Royal Bank, with which IHL had an indemnity agreement. When a contract dispute arose and the overdraft credit was exhausted, Rafidain sought to obtain its guarantees on the overdraft through Royal Bank. IHL sued the defendant in the Bahamas. The Bahamian court eventually allowed the payment of the overdraft guarantees, and IHL was forced to indemnify Royal Bank for $850,000. Rafidain never appeared in the action, and IHL obtained a judgment against Rafidain for $850,000.

IHL subsequently brought an action in the United States District Court for the Southern District of New York to enforce the judgment. Rafidain failed to appear, and the court ordered that Rafidain's account at the Irving Trust Company be garnished to satisfy the judgment. Rafidain moved to vacate the judgment on the grounds that the court lacked subject matter jurisdiction. The district court held that there was subject matter jurisdiction, but that Rafidain lacked the minimum contacts necessary for a finding of personal jurisdiction.

The United States Court of Appeals for the Second Circuit *Held: Reversed.* A finding of subject matter jurisdiction was not proper under the

Foreign Sovereign Immunities Act (FSIA) when the defendant's only contact with the forum was a correspondence bank account that served as a conduit for funds and when no loss occurred in the United States.

The court distinguished *Texas Trading & Milling Corp. v. Nigeria*, 647 F.2d 300 (2d Cir. 1981), *cert. denied*, 454 U.S. 1148 (1982), finding that the trust company in *Texas Trading* was an active participant in the deal, and that the contract breach and resulting financial loss actually occurred in the United States. *Texas Trading* is the principal decision of the Second Circuit concerning the direct effects clause of the FSIA. In *Texas Trading*, a New York corporation sustained losses when the Nigerian Government prevented the Morgan Trust Company from making payments due under a contract between Nigeria and the New York corporation. The court in *Texas Trading* held that the direct effects need not be substantial and foreseeable and that the contacts in that case were enough to establish subject matter jurisdiction. *Texas Trading* has, however, been rejected by the Fifth, Sixth, Seventh, Ninth, and District of Columbia Circuits, all of which follow the substantial and foreseeable effects standard.

In the instant case, the court did not address the issue whether "payment to a United States branch office of a foreign sovereign's bank would involve a 'direct effect in the United States.'" *Significance*—The Second Circuit refused to expand further its interpretation of the direct effects clause of the FSIA to include a correspondence bank account that passively transfers money as directed and plays no other role in the transaction.

IV. Settlements

SUCCESSFUL CLAIMANTS BEFORE UNITED STATES CLAIMS TRIBUNAL MAY BE ASSESSED REASONABLE USER FEE, *United States v. Sperry Corp.*, 110 S. Ct. 387 (1989).

Sperry Corp. and Sperry World Trade (Sperry), United States corporations, filed suit in the United States Claims Court claiming that a two percent charge deducted pursuant to a Directive License of the United States Department of Treasury from a settlement award granted to Sperry by the Iran-United States Claims Tribunal was unconstitutional and was not authorized by the Independent Offices Appropriation Act of 1952 (IOAA), 31 U.S.C. § 483a (1976).

The Claims Court held that the Directive License violated IOAA. Congress then enacted section 502 of the Foreign Relations Authorization Act. This provision requires United States claimants who receive settlements before the claims Tribunal to pay a charge from their award

to the United States government as reimbursement to the Government for expenses incurred in connection with the operation of the Tribunal. Congress made section 502 effective retroactively. Sperry then brought suit again in the Claims Court arguing that the charge authorized by section 502 was unconstitutional. The Claims Court rejected the claim and dismissed the suit. The Court of Appeals for the Federal Circuit *reversed*, holding that section 502 was unconstitutional because it authorized a taking of Sperry's property without just compensation.

The Supreme Court *Held*: *Reversed.* The Court stated that Sperry had not suffered an improper taking of its property. Sperry argued that the section 502 deduction could not be characterized as a user fee because the United States had not shown that the amount of the deduction approximates the costs of the Tribunal or the use of its services. The Court disagreed, noting that section 502(a) specifically states that the deductions are for reimbursement for expenses incurred by the United States; Sperry therefore had the burden of showing that section 502 deduction was inaccurate. The Court then pointed out that it had never held that a user fee must be precisely calibrated to the use of government services, and that the deductions under section 502 are not clearly excessive.

Sperry claimed that the United States took its property by charging Sperry for the use of procedures it preferred not to use. The Court disagreed, stating that the user fee is not a taking but a reimbursement for government services from which Sperry benefited. The Court pointed out that because Sperry's settlement was entered as a formal award by the Tribunal, Sperry was assured that the judgment would be readily collected. According to the Court, it was not dispositive that private negotiations rather than the Tribunal's procedures were more influential in enabling Sperry to receive its award. The Court concluded that a reasonable user fee was justified by the availability of such benefits as hearing rooms, translation facilities, and facilities for service of documents—regardless of whether they were actually used.

Sperry also claimed that section 502 violates the fourteenth amendment's due process clause because it imposes a deduction on Sperry's award through retroactive application. The Court held that retroactive application of section 502 is justified by the rational legislative purpose of ensuring that all claimants successful before the Tribunal would be treated alike. The Court held that section 502 does not violate the equal protection component of the due process clause by requiring only successful claimants to pay a user fee. The Court stated that Congress could have reasoned that successful claimants receive a benefit from the Tribunal sufficient to justify paying the user fee, and that requiring all claim-

ants to pay a user fee might deter small and uncertain claims. *Significance*—United States citizens required to settle claims against a foreign state through a claims tribunal established by the United States may be assessed a reasonable user fee if successful.