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MASTER THESIS

Prohibition of the Discriminatory Income Tax Measures under WTO Law

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Table of Abbreviations

CFC	Controlled foreign company (corporation)
Commentary	Commentary to the OECD Model Convention with Respect to Taxes on Income and on Capital
DISC	Domestic international sales corporation
DSB	Dispute settlement body
DSU	Dispute Settlement Understanding
DTT	Double taxation treaty
EC	European Communities (<i>under which name the European Union is still referred to within the WTO</i>)
ETI	Extraterritorial income
FSC	Foreign sales corporation
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
Member State	WTO Member State
MFN	Most-favored nation treatment
NT	National treatment
OECD	Organisation for Economic Co-Operation and Development
OECD MC	OECD Model Convention with Respect to Taxes on Income and on Capital
OEEC	Organisation for European Economic Co-Operation
SCM Agreement	Agreement on Subsidies and Countervailing Measures
TFEU	Treaty on the Functioning of the European Union
TRIMs Agreement	Agreement on Trade-Related Investment Measures
UN	United Nations
US	United States of America
VCLT	Vienna Convention on the Law of Treaties
WTO	World Trade Organization

Section 1. Introduction

“As trade and investment flows have increased throughout the world, trade negotiators and tax policymakers have become conscious of each other’s presence. They nevertheless have continued to plow their separate furrows. They are, however, plowing the same field, which is getting smaller.”¹

Malcolm Gammie

It was in 1998 that Robert Green asserted that the academic literature largely failed to connect international tax to international trade policy.² Fifteen years and *US—FSC* later, the academic literature boasts significant advances in bridging the two spheres. We shall argue that still neither scholarly writing nor the WTO itself has offered a clear vision of how the WTO law restricts the tax policies.

The line of the WTO rulings in the cases involving the US incentives for exporters contributed towards the consensus that the WTO prohibition of export subsidies extends to income taxation. Rather overlooked decision in *Argentina—Bovine Hides* evidences that the income tax measures are not excluded from the WTO national treatment undertaking either. We are yet to see the WTO MFN obligation to be invoked in a direct tax case.

However, as this paper shall argue, the WTO did not develop a consistent analytical framework for dealing with the income tax cases. This holds true for both subsidy benchmark under the SCM Agreement (‘foregoing of revenue otherwise due’) and connection to products, which a tax measure needs to bear, to fall within the ambit of the GATT NT and MFN obligations (‘internal taxes on products’).

1.1. Problem description

In Yariv Brauner’s words, “[t]he amount and scope of tax provisions and fundamental constructs that are placed at risk under the hypothetical full application of WTO law may seem devastating to any tax expert.”³ Professor Brauner’s uneasiness is symptomatic of how blurred the line dividing WTO-compliant income tax measures from infringements is.

The potential that the WTO law has to undercut the very core of world’s tax systems led some commentators to conclude that international trade and tax regimes must keep the distance.⁴ Yet, the WTO dispute settlement bodies seem not to listen. Conversely, the trend is towards extended applicability of the WTO law in the field of direct taxation. Hence, the need to discard ‘hypothetical full application of WTO law’ in favor of a precise and predictable standard.

The research problem this paper envisages is determination of the limits the WTO law imposes on income tax policies.

¹ Gammie, M., *The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement*, 49 *Tax Law Review* 4 (1994), p. 617

² Green, R. A., *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 *Yale Journal of International Law* 79 (1998), p. 87

³ Brauner, Y., *International Trade and Tax Agreements May Be Coordinated, but Not Reconciled*, 25 *Virginia Tax Review* 251 (2005), p. 288

⁴ E.g. Cockfield, A. J., and Arnold, B. J., *What Can Trade Teach Tax? Examining Reform Options for Art. 24 (Non-Discrimination) of the OECD Model*, *World Tax Journal*, Vol. 2, No. 2 (2010), pp. 139-153

1.2. Purpose

The purpose of this paper is to identify the specific limits on income tax policies imposed by the WTO law. To this end, the paper strives to ascertain, first, the subsidy benchmark under the SCM Agreement (interpretation of the foregoing of ‘revenue otherwise due’) and, second, the nature of connection to products that brings a tax measure under the scope of Articles I:1 (MFN) and III:2 GATT (NT) (interpretation of ‘internal taxes on products’).

1.3. Method

As a starting point for our research, we use the binding instruments adopted under the auspices of the WTO. Wherever the wording of the primary sources is too vague to yield the result, we resort to the case law of the GATT/WTO DSBs. The solutions offered by adjudicators are analyzed independently but with reference to the existing academic literature. The political implications of a particular solution are not a primary concern of this paper, yet we take note of them (in Section 3, mostly) to assess the solutions’ feasibility. Where appropriate, we draw comparisons between the non-discrimination obligations under the WTO law, EU law, and international tax law.

1.4. Delimitations

The paper leaves the GATS non-discrimination commitment outside its scope. This is because the agreement contains a general tax carve-out (see Section 2.1), which renders the agreement inapplicable to the vast majority of income tax measures. Also, we deliberately omit from our research the special non-discrimination regimes of the Agreement on Agriculture and TRIMs, in both instances because of their narrow applicability.

Finally, this paper does not speculate on enforceability of the WTO non-discrimination standard in any domestic legal order. It is essentially a public international law discussion: The WTO law’s main role is to limit the Member States in designing their tax laws. In most jurisdictions, it does not grant remedies to private parties, but is relevant for them nonetheless. The taxpayers can often petition their trade ministry for investigation; it is also them who take an ultimate hit of retaliatory tariffs.

1.5. Outline

The rest of this paper is structured as follows.

Section 2 provides an overview of the anti-discrimination provisions of the WTO Agreement and investigates their relationship with the DTTs.

Section 3 describes the mismatch between the WTO anti-discrimination provisions and traditional principles of the tax law and policy.

Section 4 investigates the manner the WTO DSBs apply the NT obligation to income tax measures, discerns and evaluates their analytical framework.

Section 5 performs the same task in respect to the prohibition of export subsidies.

Section 6 summarizes our research.

Section 2. Overview of the WTO Anti-Discrimination Provisions and Their Relationship to DTTs

The WTO non-discrimination obligation encompasses three standards of treatment: (1) most-favored-nation, (2) national treatment, and (3) prohibition of export subsidies. It is separately spelled out for goods and for services, respectively in the GATT and GATS. The WTO prohibition of subsidies is laid down in the GATT and detailed in the SCM Agreement and only applies to goods.

The special rules apply to agricultural products under the Agreement on Agriculture. Instead of the outright prohibition of subsidies, this instrument contains a commitment for their gradual reduction.⁵

The TRIMs Agreement has limited relevance for income taxation. It bars the Member States from applying any trade-related investment measure inconsistent with NT to the goods⁶ but does not prohibit attaching export performance requirements to tax incentives for investment.⁷

2.1. Most-favored nation and national treatment obligations

The coverage of income tax measures varies across the instruments. As far as goods are concerned, the MFN treatment should be accorded with respect to customs duties and ‘other charges’ imposed on the importation or exportation of products; NT should be accorded with respect to the application of ‘internal taxes on products.’ The MFN obligation is specifically extended to most measures covered by NT (those under Article III:2 GATT).

These GATT provisions were traditionally understood to apply exclusively to indirect tax measures.⁸ However, as we shall see from *Argentina—Bovine Hides*, the expression ‘internal taxes on products’ is not synonymous to ‘indirect taxes’ and may very well cover certain direct tax measures.

As far as services are concerned, the MFN and NT obligations under the GATS extend to direct taxation. However, the GATS carves out measures ‘aimed at ensuring equitable or effective imposition or collection of direct taxes’ from NT and benefits conferred by tax treaties from MFN.

This difference between the GATT and GATS is problematic in two respects. Firstly, income taxes apply to the income rather than goods or services. Even so, they do not typically make a distinction between the income from goods and income from services. Hence, a direct tax measure will be tested against both standards, unless in a rare case where its scope is limited to income from goods only (or services only). This appears justified if one heeds the objective of the GATT, which is to eradicate *border* protectionism.⁹

The second concern is that the absence of a GATS-like carve-out from the GATT can be construed as an indication that the GATT was intended to apply to direct tax measures broadly. Indeed, according to the AB, in the WTO law “omission must have some meaning.”¹⁰ This argument is undermined by the fact that the GATS is a later instrument negotiated with a

⁵ Art. 6(1) of the Agreement on Agriculture

⁶ Art. 2(1) of the TRIMs Agreement

⁷ Daly, M., *The WTO and Direct Taxation*, Discussion Paper No. 9, WTO, Geneva, 2005, p. 6

⁸ Green, R. A., *The Interaction of Tax and Non-Tax Treaties*, Bulletin for International Fiscal Documentation, June 2002, p. 257

⁹ Slemrod, J., and Avi-Yonah, R., *(How) Should Trade Agreements Deal with Income Tax Issues?*, 55 Tax Law Review 533 (2002), p. 541

¹⁰ *Japan—Taxes On Alcoholic Beverages*, AB Report of 4 October 1996, Wt/Ds11/Ab/R, section H, para. 8

supposedly clearer understanding of how tax and trade treaties interact. The carve-out is said to have been imposed by the tax officials on the trade officials during negotiations.¹¹ Still, some commentators opine for inclusion of a tax carve-out into the GATT;¹² an alternative view is that a carve-out would be superfluous, since the GATT has been interpreted to apply to income taxes only in very narrow cases anyway.¹³

2.2. Prohibition of export subsidies

The strongest limit on the discriminatory income tax measures in the WTO law stems from the prohibition of export subsidies under Article XVI GATT and the SCM Agreement (the Uruguay Round subsidies code).

The SCM Agreement bars the Member States from providing subsidies contingent, in law or in fact, on export performance.

In assessing the WTO-compatibility of a Member State's measure, a DSB shall first establish if it constitutes a subsidy under Article 1 of the SCM Agreement, *i.e.* (1) whether there is a financial contribution by a government or any public body within the territory of a Member, and (2) whether a benefit is thereby confirmed.

The adjudicators shall then rule whether a subsidy is contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance. The subsidies related to export performance are by extension specific.¹⁴ There is consequently no need for separate specificity analysis.

Income tax measures fall under the purview of the SCM Agreement. In respect to the first test (whether a measure is a subsidy), the agreement lists 'government revenue that is otherwise due is foregone or not collected' among the forms a financial contribution can take. The item is exemplified by tax credits. In respect to the second test (whether a subsidy is an export subsidy), the illustrative list of export subsidies includes the 'full or partial exemption, remission, or deferral specifically related to exports, of direct taxes' and the 'allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged.'

The SCM Agreement also obliges the Member States to ensure arm's-length pricing in the transactions between their exporting enterprises and foreign buyers,¹⁵ since a tolerated underpricing can have an effect equivalent to that of an export subsidy.

Finally, income tax measures aimed at avoiding the double taxation of foreign-source income are specifically excluded from the illustrative list of export subsidies.¹⁶

2.3. The relationship between WTO law and DTTs

It is well known that the WTO law non-discrimination standard is not the only one applicable to income tax measures. International tax law has developed its own non-discrimination obligation embodied in Article 24 OECD MC. The question arises whether Article 24 OECD MC prevails over the WTO obligations, provides context for their interpretation, or lacks any relevance.

¹¹ Ault, H. J., and Sasseville, J., *Taxation and Non-Discrimination: A Reconsideration*, World Tax Journal, Vol. 2, No. 2 (2010), p. 110

¹² *Supra* note 4, p. 142

¹³ International Fiscal Association, *Reports on 60th Amsterdam Congress Proceedings*, in IFA Yearbook 2006, p. 50

¹⁴ Art. 2.3 of the SCM Agreement

¹⁵ Footnote 59 to the SCM Agreement

¹⁶ *Ibid.*

In the case of services, the solution is clear. As noted before, the GATS contains the general tax carve-out, according to which a Member State may not invoke the NT provisions “with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation.”¹⁷ Accordingly, a DTT non-discrimination clause generally prevails over the GATS NT obligation with respect to disputes involving taxation of services and service suppliers.¹⁸ While the quoted language does not address the MFN treatment, it is not guaranteed by Article 24 OECD MC, so the conflict is likewise avoided.

As far as goods are concerned, the WTO Agreement (of which the SCM Agreement is a part) and DTTs confer international obligations, which ought to be performed concomitantly under the *pacta sunt servanda* principle.¹⁹

An argument can be made that bilateral tax treaties constitute *inter se* modifications of the multilateral treaty—the WTO Agreement—within the meaning of Article 41 VCLT. Public international law permits such modifications as long as they do not affect the enjoyment of other parties’ rights and do not frustrate the object and purpose of the multilateral treaty (*i.e.* the WTO Agreement) as a whole.²⁰

While these conditions are capable of being met even by the treaties that deviate from the WTO rules,²¹ the conflict of norms is not apparent.

We shall see in Sections 3.2 and 3.3 that Article 24 OECD MC enshrines a looser non-discrimination obligation. Not only DTTs have distinct subject matter but also they are never notified to other Member States as modifications (a procedural requirement under Article 41(2) VCLT).

There is a stronger case to assert that DTTs provide context in the light of which the WTO Agreement should be interpreted in tax cases (or, rather, DTTs “shall be taken into account together with context”²² in the international law parlance). In that, DTTs fall under the residual category of ‘other rules of international law applicable in relations between the parties.’²³

In conclusion, DTTs cannot be said to override or modify the WTO Agreement. The international obligations arising from the two shall be performed concomitantly.

The WTO non-discrimination standard encompasses the NT and MFN obligations and prohibition of export subsidies. The NT and MFN obligations share the scope and apply to ‘internal taxes on products.’ The scope of the prohibition of export subsidies was specified as foregoing of ‘revenue otherwise due’ at the Uruguay Round when the SCM Agreement had been adopted. The WTO non-discrimination standard is not overridden by DTTs and applies simultaneously with it.

¹⁷ Art. XXII:3 GATS

¹⁸ *Supra* note 4, p. 144

¹⁹ Art. 26 VCLT

²⁰ Art. 41(1)(b) VCLT

²¹ Pauwelyn, J., *Conflict of Norms in Public International Law, How WTO Law Relates to Other Rules of International Law*, Cambridge, 2003, p. 318

²² Art. 31(3)(c) VCLT

²³ *The Vienna Conventions on the Law of Treaties: A Commentary*, Oxford, 2011, p. 433

Section 3. Problems in Application of the WTO Anti-Discrimination Provisions to Income Tax Measures

The WTO anti-discriminatory provisions were outlined immediately above. This section demonstrates that their application in the field of income taxation is complicated by an array of special considerations.

First of all, the governments admittedly wish to keep the income taxation as a policy tool free of the WTO's close supervision. Secondly, tax law should be permitted to discriminate on the basis of residence, since it imposes different tax consequences depending on a person's status as a resident or non-resident. Thirdly, the benefits granted under tax treaties are by and large bilaterally negotiated—and are not intended to 'multilateralize' under MFN. Finally, different adjudicators are in charge of the WTO Agreement and DTTs, which feature creates opportunities for forum shopping.

Back in 1994 J. P. Steins, Jr., hinted at the controversy caused by “the divergent views on tax measures that are justified in terms of traditional international tax policy but that reasonably may be said to impede international investment.”²⁴

“Should the free trade movement necessarily trump traditional international tax principles?”—Professor Steins inquired.²⁵ Now that the SCM Agreement and Article III GATT were ruled applicable to direct taxation, the issue is topical as never before.

In this section, we strive to identify where and why could the traditional principles of tax law run counter to the trade obligations.

3.1. Governments' willingness to preserve the tax policy within their sovereign domains

The expansion of the WTO rules has increased the potential for conflict between these rules and the domestic tax laws,²⁶ while there are strong indications that the states do not wish to cede their sovereignty over direct taxation.

No global tax organization was ever set up. The OECD and UN, which both maintain bodies entrusted with guiding the development of international tax law, only serve as think tanks and negotiations forums. Their documents are soft law limited in its scope to elimination of double taxation and countering tax avoidance and evasion. This is in sharp contrast with the WTO, which operates on the basis of the multilateral trade rules vested with the power to adopt the decisions binding upon Member States concerned.

Even in the existing institutional framework, the governments never appeared preoccupied with tax discrimination. As Lara Friedlander points out,²⁷ even Article 24 OECD MC—international tax law's own non-discrimination obligation—looks amiss in the OECD MC: It applies to all taxes (not only those listed in Article 2), places an obligation on the source state alone (the residence state is free to discriminate as between income earned in different source countries²⁸) and looks at nationality rather than residence. In the same vein, the OECD (then OEEC) Fiscal

²⁴ Steins, J. P. Jr., *Income Tax Implications of Free Trade*, 49 *Tax Law Review* 675 (1993-1994), p. 675

²⁵ *Ibid.*

²⁶ *Supra* note 7, p. 2

²⁷ Friedlander, L., *The Role of Non-Discrimination Clauses in Bilateral Income Tax Treaties after GATT 1994*, *British Tax Review*, No. 2, 2002, pp. 74-75

²⁸ Arnold, B. J., *Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities: Canada, Australia, New Zealand, the United Kingdom, and the US*, Canadian Tax Paper No. 90, Canadian Tax Foundation, Toronto, 1991, p. 27

Committee is known to have remarked that tax discrimination “has no connection with problems of double taxation.”²⁹

The narrow scope of Article 24 OECD MC is claimed to be the broadest appropriate in the field of direct taxation.³⁰ Indeed, this non-discrimination provision originates from early non-tax agreements (e.g. treaties of friendship, commerce and navigation) and, as the OECD Commentary observes, “[t]he fact that such clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope.”³¹

Article 24 OECD MC does not provide for MFN³² and limits access to NT by singling out an unusual discrimination criterion. Thus, the clause prohibits taxing a foreign *national* more harshly than a domestic national in the same circumstances ‘in particular with respect to residence.’ This stipulation means that a resident national (i.e. national of State A resident in State A) can only be compared to a foreigner who is a local resident too (i.e. national of State B resident in State A). Hence, the OECD MC does not forbid the discrimination based on residence,³³ which is much more frequent in tax law than the nationality-based.

This holds true even for situations where “a State bases a favourable tax position on a criterion or a combination of several criteria which practically can be fulfilled as a rule only by nationals of that State, as long as nothing refers directly to nationality.”³⁴ In other words, Article 24 OECD MC does not prohibit indirect discrimination.³⁵

Finally, the governments regard direct taxation as a crucial policy tool used to redistribute wealth and promote development of particular industries or geographical areas. In fact, as the governments saw their powers over border tariffs and indirect taxes curtailed under the WTO agreements, direct taxation can be viewed as ever more important an economic tool.³⁶

3.2. Widely accepted differentiation of tax treatment of residents and non-residents

The WTO NT obligation is difficult to reconcile with the commonly accepted practice of making legitimate distinctions between resident and non-resident taxpayers.³⁷ Most tax systems assess residents on their worldwide income and non-residents, only on their domestic income;³⁸ exclusively payments to non-residents sustain withholding taxes.

As shown above, the differential tax treatment based on residence does not fall foul of Article 24 OECD MC because the latter bans discrimination based on nationality *and* does not cover indirect discrimination.

²⁹ OEEC Report 1958, para. 31-33, as cited in van Raad, K., *Nondiscrimination in International Tax Law*, Kluwer, Deventer, 1986, p. 31

³⁰ *Supra* note 11, p. 114

³¹ Commentary to the OECD MC, Commentary to Article 24, para. 3

³² *Ibid.*, Commentary to Article 24, para. 2

³³ Bennett, M. C., *Nondiscrimination in International Tax Law: A Concept in Search of a Principle*, 59 *Tax Law Review* 439 (2006), pp. 444-445

³⁴ Vogel, K., *Klaus Vogel on Double Taxation Conventions*, 3rd ed., Kluwer, London, 1997, p. 1290

³⁵ Friedlander, L., *The Role of Non-Discrimination Clauses in Bilateral Income Tax Treaties after GATT 1994*, *British Tax Review*, No. 2, 2002, p. 80

³⁶ *Supra* note 4, p. 147

³⁷ *Supra* note 11, p. 116

³⁸ Vann, R. J., *International Aspects of Income Tax*, in Thuronyi, V. (ed.), *Tax Law Design and Drafting*, IMF, 1998, Vol. 2, p. 4

Unlike OECD MC, WTO law does prohibit indirect discrimination.³⁹ Since differential treatment is typically based on residence and residence is typically defined by reference to nationality, this differentiation can in many instances amount to discrimination indirectly based on nationality.

What keeps the WTO law from undermining the distinction between residents and non-residents—is its limited reach into direct taxation. As demonstrated in Section 2.1, the NT and MFN obligations only extend to ‘internal taxes on products.’

This means that the WTO law does not require the Member States to abolish the differentiation, but also that if a particular income tax measure is ruled to constitute an internal tax on a product, this differentiation will not be accepted as a justification ground.

3.3. Bilateralism of the tax treaties

One notable difference between international trade and tax regimes is that while the former is based on multilateral instruments, the latter is largely bilateralistic.

In the WTO law, any concession made to a Member State should be extended to all other Member States under the MFN principle of Article I:1 GATT (Article II:1 GATS). If certain Member States wish to further liberalize trade within a narrower club, the only WTO-compliant option is to form a free trade area or customs union within the meaning of Article XXIV GATT.

Conversely, concessions in international tax are normally made on a bilateral basis, with each side bargaining for reciprocal benefits that could have either beneficial or adverse effect on its economy depending on the balance of trade between the treaty partners.⁴⁰ This bilateralism provides the rationale for general rejection of the MFN principle in tax treaties.

As Yariv Brauner notes, there is no expectation for global convergence of tax treatment since each DTT should produce a different negotiated outcome that presumably maximized the benefits to the particular Contracting States in the particular situation.⁴¹

To the best of author’s knowledge, the WTO MFN clause was never invoked in a direct tax case. Albert J. Rädler reports the German Federal Tax Court’s stance on a claim of the MFN under a German-American Friendship and Trade Agreement:⁴² The court ruled that to extend the treaty benefits to residents of a third state based on the MFN principle would “in principle [be] foreign to international tax law.”⁴³

An extensive MFN undertaking would put an end to bilateralism of tax treaties. In that, it has a potential of being farther-reaching than an extensive NT: Nationality-based NT falls short of countering residence-based distinctions, unless a resident status is only available for domestic nationals (the case of indirect nationality-based discrimination). By contrast, MFN ensures equal treatment of different non-residents who can find themselves in the same circumstances. The most immediate consequence of a hypothetical comprehensive MFN would be a universal zero rate of withholding taxes (for each state having a single zero-percent WHT treaty).

Yet, the WTO MFN is not just such a comprehensive standard. Its application in the field of direct taxation is limited in the same way NT’s application is.

³⁹ Cottier, T., and Oesch, M., *Direct and Indirect Discrimination in WTO Law and EU Law*, Working Paper No. 2011/16, Swiss National Centre of Competence in Research, 2011, p. 14

⁴⁰ Chisik, R., and Davies, R. B., *Asymmetric FDI and Tax-Treaty Bargaining: Theory and Evidence*, *Journal of Public Economics*, Volume 88, Issue 6, June 2004, pp. 1119-1148

⁴¹ Brauner, Y., *International Trade and Tax Agreements May Be Coordinated, but Not Reconciled*, 25 *Virginia Tax Review* 251 (2005), p. 266

⁴² German-American Friendship, Trade and Navigation Agreement of 29 October 1954, Art. XI(1)(3)

⁴³ Rädler, A. J., *Most-Favoured-Nation Concept in Tax Treaties*, in Lang, M., (ed.), *Multilateral Tax Treaties, New Developments in International Tax Law*, Vienna, 1998, p. 4

The considerations set out in this section are important in that they inform WTO's understanding of how broad an interpretation of 'internal taxes on products' would be appropriate in international tax. It may be tempting for the adjudicators to stretch the concept to engulf all taxes that add to the cost of a product (that is to say, all taxes). It is not impossible to find textual support for such an expansionist interpretation in GATT, which refers to internal taxes levied 'directly or indirectly' on products. That is where the above reasoning comes into play, mandating narrower interpretation.

3.4. Opportunities for forum shopping

International trade and tax regimes provide for different dispute resolution mechanisms and remedies. If in a dispute regarding application of a DTT, a violation of the WTO Agreement is also claimed, the forum shopping emerges as a concern.

The WTO relies on the dispute settlement system set up in accordance to the DSU (Panels and the Appellate Body).⁴⁴ If a violation is found, the WTO DSBs would recommend bringing the measure in conformity with the WTO law and, if the recommendation is not implemented within a reasonable period of time, would mandate compensation and the suspension of concessions.⁴⁵ In legal orders of the vast majority of the Member States, the WTO law is not directly applicable.⁴⁶

By contrast, the vertical (*i.e.* taxpayer-government) disputes arising from DTTs are heard by the domestic courts and the horizontal (*i.e.* intergovernmental) disagreement is resolved in the mutual agreement procedure or, if a DTT so provides, through arbitration.

The forum-shopping argument was raised in *US—FSC*: The US claimed that the EC could not refer the dispute to a WTO Panel before the remedies available under the DTT have been exhausted.⁴⁷ The Panel rejected the argument noting that the DSU does not provide a legal basis for this claim.⁴⁸

The OECD deals with the forum-shopping concerns (in respect to the GATS only) its Commentary to Article 25 OECD MC. Normally, measures stemming from a DTT would fall under the GATS' general tax carve-out (see Section 2.1 above). However, to provide greater certainty, the OECD suggests that the Contracting States insert in their DTTs a provision whereby any disputes concerning application of a DTT must be resolved by the competent authorities under the mutual agreement procedure and such disputes cannot be brought before the GATS dispute resolution bodies unless both Contracting State consent.⁴⁹

We shall return to the finding of this section further down the line to see if they are taken into account by the DSBs when ruling in income tax cases. What appears clear from the wording of the GATT is that they were not in the drafters' mind. This conclusion is reinforced by the later adoption of the GATS, whose more tax-aware draftsmen inserted the general tax carve-out.

⁴⁴ Art. 19(1) DSU

⁴⁵ Art. 22(2) DSU

⁴⁶ *E.g.* Lester, S., and Mercurio, B., *World Trade Law: Text, Materials and Commentary*, Oxford, 2008, p. 130

⁴⁷ *United States—Tax Treatment for "Foreign Sales Corporations"*, Panel Report of 8 October 1999, WT/DS108R, para. 4.89

⁴⁸ *Ibid.*, paras. 7.16 and 7.22

⁴⁹ *Supra* note 31, Commentary to Article 25, para. 93

Section 4. The WTO's Application of the National Treatment Obligation in Income Tax Cases; Projected Extension to the MFN Obligation

As Section 2 illustrated, Article III:2 GATT prohibits discrimination against imported goods by means of internal taxes and requires the NT to be accorded in respect to the 'internal taxes on products.'

Traditionally, this was viewed as circumscribing Article III:2 GATT to indirect taxes.⁵⁰ However, there is sparse case law that extends the applicability of this provision to income tax measures, provided they bear sufficient link to 'products.'

This section examines the Panel report in *Argentina—Bovine Hides* and describes the implications this decision has for the NT and MFN obligations.

4.1. Application of the NT to income tax measures in *Argentina—Bovine Hides*

4.1.1. Background to the case

The Panel in *Argentina—Bovine Hides* was called upon to examine the set of contested tax measures being applied to the importation and exportation of bovine hides by Argentina.

The majority of the contested measures were made up of the non-tariff indirect taxes, such as 'additional' VAT of nine percent and the advance turnover tax raised by Argentina on the import of products into its territory. A direct tax measure at issue was the obligation to pay in the income tax 'prepayments' upon importation.

In Argentina, the income tax (*Impuesto a las Ganancias*) is indiscriminately levied on profits from the sale of domestic and imported goods. Normally, it must be paid on an annual basis.⁵¹

However, the circulars from the Argentine tax authorities provided for the collection at source of the income tax on the importation of goods and the withholding at source of the income tax on certain internal sales of goods.⁵²

When the goods were definitively imported into Argentina, the customs authority collected a prepayment of income tax from importers, which was calculated on the gross basis at the rate of 3 percent (11 percent in the case of personal consumption) and could then be credited against the annual income tax liability. This treatment was applied to a broad range of imported goods.⁵³

Similarly, as regards internal sales, the law required most corporate taxpayers to withhold the prepayment of income tax when making payments for certain categories of goods. The prepayments on internal sales were withheld at 2 percent for sales by registered taxable persons and 4 percent by non-registered taxable persons.⁵⁴

It was this fact pattern that was subject to judicial review in *Argentina—Bovine Hides*.

⁵⁰ Horn, H., and Mavrodís, P. C., *Still Hazy after All These Years: The Interpretation of National Treatment in the GATT/WTO Case-Law on Tax Discrimination*, European Journal of International Law (2004), Vol. 15, No. 1, p. 40; Working Party Report on Border Tax Adjustments, adopted on 2 December 1970, BISD 18S/97, para. 14

⁵¹ *Argentina—Measures Affecting the Export of Bovine Hides and the Import of Finished Leather*, Panel Report of 19 December 2000, WT/DS155/R, para. 11.117

⁵² *Ibid.*, para. 11.119

⁵³ *Ibid.*, para. 11.120

⁵⁴ *Ibid.*, paras. 11.123-11.127

4.1.2. Key arguments of the parties

Before the Panel, the EC argued that the income tax prepayments levied on importation were ‘internal taxes on products’ that are applied to imported goods in excess of those applied to like domestic products.⁵⁵ To support this claim, the EC drew a comparison between the amounts of prepayments due on importation and on internal sale.

The EC maintained that the income tax prepayments constituted a tax on products and not on income, since those payments must be made whether or not the underlying import transactions generate any profit and computed on the customs value but not a profit margin.⁵⁶

According to Argentina, the measures at issue fell outside the scope of Article III:2 GATT on two grounds: first, they did not create additional taxes but rather provided for the method of collection and, second, the income tax was not a tax on products.⁵⁷

4.1.3. Key findings of the Panel

The Panel agreed with Argentina’s characterization of the measures at issue as a mechanism for the collection of taxes.

This did not, however, preclude the Panel from ruling that Article III:2 GATT applied to these measures, because they presupposed the imposition of charges and so fell under the ‘charges of any kind’ language of the provision.

Further, while the Panel agreed that income taxes normally are not taxes on products within the meaning of the provision, this does not, according to the Panel, affect characterization of a specific measure related to them (*e.g.* prepayment) as falling within the article’s scope.⁵⁸

4.2. Implications for income taxation

The major implication of the decision in *Argentina—Bovine Hides* for income taxation is that the direct tax measures are not automatically, by virtue of characterization, excluded from the purview of Article III:2 GATT. Rather, each measure should be examined on its own merits.

However, the concerns voiced by the tax community over the perils of the NT obligation in income taxation (and reported in Section 3) are overstated. The GATT NT obligation is designed to counter border protectionism and spelled out with appropriately restrictive language.

As a result, Article III:2 GATT mandates the comparison of fiscal treatment of *products* and not taxpayers.

One rather disturbing consequence of that is that DSBs should not be expected to take account of the qualities of a taxpayer in the examination of the NT claims. Thus, the prepayment obligation in *Argentina—Bovine Hides* applied to residents and non-residents alike. However, if it had been based on residence, the Panel would have no legal grounds to take this distinction into account, since any comparability analysis is limited to that of likeness of underlying products under the GATT.

Another important finding of *Argentina—Bovine Hides* is that each tax measure will be examined separately. That is, the administrative and collection measures do not derive their nature (*i.e.* of a tax on income) from the nature of a tax, which they enforce.

⁵⁵ *Ibid.*, para. 11.129

⁵⁶ *Ibid.*, para. 11.156

⁵⁷ *Ibid.*, paras. 11.130 and 11.157

⁵⁸ *Ibid.*, para. 11.159

4.3. Relevance for the MFN obligation

The author is unaware of any GATT/WTO case in which a breach of the MFN obligation under Article I:1 GATT was claimed in the income tax measures.

However, the applicability findings made in *Argentina—Bovine Hides* should hold true for the MFN obligation. This is because Article I:1 extends to ‘all matters referred to in paragraphs 2 and 4 of Article III’ and the finding in the cited case was made under Article III:2 GATT.

The MFN obligation also encompasses Article I:1’s own scope, which is, in relevant part, ‘charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation.’

Hence, Article I:1 extends to (1) internal taxes on products; and (2) charges of any kind imposed in connection with importation or exportation, the method of levying and all attached formalities. The decision in *Argentina—Bovine Hides* and any forthcoming rulings under Article III:2 are relevant for the purposes of Article I:1 GATT in the part they deal with applicability to certain income tax measures.

To date, the NT has been rarely (and the MFN, never) invoked in relation to income tax measures. One possible explanation is that the Member States do not see such claims as sufficiently strong for costly WTO litigation; another is perhaps their unwillingness to set themselves on a slippery slope putting their own measures in jeopardy.

The crucial takeaway of *Argentina—Bovine Hides* is that income tax measures are not immune from the NT and MFN obligations of the GATT. True, income tax is not among ‘internal taxes on products,’ but certain administration and collection measures can fall under this category. Each will be examined on its own merits.

The measures most likely to attract scrutiny under the NT and MFN undertaking are price-based prepayments and alternative minimum taxes.

Section 5. The WTO's Application of the Prohibition of Export Subsidies in Income Tax Cases

This section deals with the approaches the DSBs have developed to identify the prohibited export subsidies provided through the tax system.

Subsection 5.1 analyzes the rulings in which the DSBs have revealed their approach to this category of cases. Subsection 5.2 proceeds synthesizing the findings so to construct the comprehensive analytical framework behind the judgments. Subsection 5.3 concludes by testing the adequacy of the DSBs' analytical framework in the light of special consideration relevant to income taxation (Section 3 above) and with reference to academic literature.

5.1. Summary of jurisprudence

The body of WTO jurisprudence on the income tax subsidies consists of two subsets. The first is the line of cases on the preferential treatment of income from export-related activity by the United States, consisting of the DISC case, the six-stage FSC case (in whose course three different income tax regimes were examined, each by a panel and the Appellate Body), and *US—Aircraft*.

The second subset is commonly referred to as the cases on European territorial tax systems (which name is not fully accurate given that the Dutch and Belgian tax systems at issue were indeed worldwide systems with broad exemption of foreign-source income).

The DISC case and the cases on the income tax practices of France, the Netherlands and Belgium were examined under the prohibition of export subsidies as per Article XVI:4 GATT (other claims had been brought forward, too, in particular as regards non-notification of a subsidy under Article XVI:1 GATT and nullification or impairment of benefits under Article XXIII:2 GATT).

In 1995, the SCM Agreement entered into force. In the FSC case and *US—Aircraft* the claims were made under the renegotiated prohibition of export subsidies enshrined in this instrument.

More WTO disputes on the subsidies in income taxation are likely to arise in the future. Subsequent challenges may be anticipated to the following income tax measures, in respect to which the infringement of the SCM Agreement was alleged and the consultation requested:

1. Belgium's index-linked tax exemption for recruiting a departmental head for exports;⁵⁹
2. The Netherlands's special 'export reserve' for income derived from export sales;⁶⁰
3. Greece's special annual tax deduction calculated as a percentage of export income;⁶¹
4. Ireland's special tax rate in respect of trading income from the export sale of Irish-manufactured goods ('special trading houses' regime);⁶²
5. France's deduction of foreign start-up expenses through a tax-deductible reserve amount;⁶³ and

⁵⁹ *Belgium—Certain Income Tax Measures Constituting Subsidies*, Request for consultations by the United States, 11 May 1998, WT/DS127/1 G/SCM/D21/1 G/L/237

⁶⁰ *The Netherlands—Certain Income Tax Measures Constituting Subsidies*, Request for consultations by the United States, 11 May 1998, WT/DS128/1 G/SCM/D22/1 G/L/240

⁶¹ *Greece—Certain Income Tax Measures Constituting Subsidies*, Request for consultations by the United States, 11 May 1998, WT/DS129/1 G/SCM/D23/1 G/L/238

⁶² *Ireland—Certain Income Tax Measures Constituting Subsidies*, Request for consultations by the United States, 11 May 1998, WT/DS130/1 G/SCM/D24/1 G/L/239

⁶³ *France—Certain Income Tax Measures Constituting Subsidies*, Request for consultations by the United States, 11 May 1998, WT/DS131/1 G/SCM/D25/1 G/L/241

6. China's income tax refund and tax credits for the purchase of domestically manufactured equipment.⁶⁴

5.1.1. US—DISC case

In 1962, the United States enacted Subpart F of the Internal Revenue Code whereby foreign base company income (*i.e.* foreign-source income of foreign CFCs) was rendered taxable in the US.⁶⁵

In 1971, in order to offset the disadvantages stemming from the 1962 amendment and also the absence of the border tax adjustment mechanism from the US Goods and Services Tax, the US set up a special tax regime for the “domestic international sales corporations” (DISCs). One of the qualification requirements was that no less than 95 percent of the gross receipts of a company had consisted of qualified export receipts. The DISCs enjoyed indefinite and interest-free deferral of tax on their worldwide until the income is repatriated or the DISC liquidated or stripped of the status. A DISC's income was determined on the basis of administrative pricing rules that fell foul of the arm's-length principle.

The European Communities alleged that the DISC regime constituted a prohibited export subsidy within the meaning of Article XVI:4 GATT and requested consultations. As the consultations failed, a GATT Panel was established.

Before the Panel, the EC pointed at the illustrative list of export subsidies⁶⁶ and in particular to items (c) and (d) of that list, which refer to, respectively, “the remission, calculated in relation to exports, of direct taxes [...] on industrial or commercial enterprises,” and “the exemption, in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption.”⁶⁷ The US retaliated that the benefits of the DISC legislation were sufficiently uncertain as to duration and amount to negate any analogy to remission or exemption of taxes.⁶⁸

Neither disputant suggested an analytical framework, or a benchmark, for assessment whether a measure at issue constituted a subsidy and, if so, a prohibited export subsidy. Instead, the arguments focused on whether the DISC regime falls under the quoted items of the illustrative list of export subsidies.

In respect to existence of a subsidy, the Panel did not go any further than stating that the DISC regime “conferred a tax benefit,”⁶⁹ admittedly in comparison with taxation of worldwide income of the DISCs in absence of the DISC regime. The Panel ruled that this subsidy was export-related, since “if the corporation income tax was reduced with respect to export related activities and was unchanged with respect to domestic activities for the internal market this would tend to lead to an expansion of export activity.”⁷⁰

The violation of Article XVI:4 GATT was therefore established.

⁶⁴ *China—Certain Measures Granting Refunds, Reductions or Exemptions From Taxes and Other Payments*, Request for consultations by the United States, 7 February 2007, WT/DS3581 G/L/813 G/SCM/D74/1 G/TRIMS/D/25

⁶⁵ Hufbauer, J. C., *The FSC Case: Background and Implications*, Peterson Institute for International Economics, 2002, available from: <http://www.iie.com/publications/papers/paper.cfm?ResearchID=451>

⁶⁶ Declaration of 19 November 1960 Giving Effect to the Provisions of Article XVI:4, BISD 9S/32

⁶⁷ *United States Tax Legislation (DISC)*, Panel Report of 2 November 1976, L/4422-23S/98, para. 28

⁶⁸ *Ibid.*, para. 33

⁶⁹ *Ibid.*, para. 67

⁷⁰ *Ibid.*

5.1.2. Cases on the income tax practices of France, the Netherlands and Belgium

In a tit-for-tat to the EC's action in the DISC case, the US lodged complaints against the income tax practices of France, the Netherlands and Belgium.

The tax systems at issue were as follows. France maintained a strict territorial system based on the source principle with the result that foreign income of residents was untaxed.⁷¹ The Netherlands formally taxed worldwide income of its residents but exempted income subject to tax abroad, as a unilateral double tax relief, what assimilated the Dutch worldwide system to a territorial one.⁷² Finally, Belgium's worldwide system allowed the tax paid or due abroad as a deduction from the tax base, to which the reduced income tax rate (1/4 the normal rate) was then applied.⁷³

Each of these systems was pronounced to infringe Article XVI:4 GATT.

In the proceeding before the Panels, the US attacked each of the tax systems stating that they involved giving up countries' taxing rights over foreign income and therefore subsidizing of exporters.⁷⁴

The defendants cited the fiscal sovereignty and the need to avoid international double taxation.⁷⁵ Also, it was in these cases that the distinction between general and special tax rules was suggested. Thus, the French representative claimed that the territoriality principle "was in no case a special rule intended to promote exports."⁷⁶ The Panel agreed with the US that solely the effect and not the intent behind the measures mattered.⁷⁷

In the French case, the Panel concluded that France "allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of French taxes."⁷⁸ By doing so, France "has foregone revenue from this source and created a possibility of a pecuniary benefit to exports" (emphasis added).⁷⁹

It is notable how the adjudicators had employed the language that was later used in the SCM Agreement. It is equally notable that, in determining whether a revenue was forgone, the Panel compared the revenue due under the French territorial system and the revenue that would be due if France had levied tax on the basis of residence. This is at odds with how the later Panels approached the 'revenue otherwise due' proviso of the SCM Agreement (as we shall see, they took domestic tax system, absent a contested measure, as a comparison pair).

The Panels' findings declaring the contested tax systems the export subsidies are not likely to be valid under the SCM Agreement, which has introduced a selectivity criterion. As to the characterization of the tax systems in question as *export* subsidies, it can be explained by the fact the exemption systems were applied to transactions that originated in the residence countries, not just to transactions that took place wholly outside the countries of residence; thus, the exemption

⁷¹ *Income Tax Practices Maintained by France*, Panel Report of 2 November 1976, L/4423-23S/114, para. 8

⁷² *Income Tax Practices Maintained by the Netherlands*, Panel Report of 2 November 1976, L/4425-23S/137, para. 8

⁷³ *Income Tax Practices Maintained by Belgium*, Panel Report of 2 November 1976, L/4424-23S/127, para. 11

⁷⁴ *E.g. Income Tax Practices Maintained by France*, Panel Report of 2 November 1976, L/4423-23S/114, para. 19

⁷⁵ *E.g. Ibid.*, para. 20

⁷⁶ *Ibid.*, para. 20

⁷⁷ *Ibid.*, paras. 25, 48

⁷⁸ *Ibid.*, para. 47

⁷⁹ *Ibid.*

provided a benefit for export sales not available to domestic sales and, hence, constituted a partial exemption from taxes for export income in violation of GATT.⁸⁰

Therefore, the rulings in the cases on the European income tax practices are not to be understood as concluding that a territorial system as such, properly operated to apply exclusively to transactions taking place outside the country of residence, is a prohibited export subsidy.⁸¹

5.1.3. US—FSC case

a) Background to the case

In 1981, the GATT council adopted the Panel reports in the DISC and European income tax practices cases. The understanding was accompanied by a Chairman's Note observing that "[t]he Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country and should not be regarded as export activities in terms of Article XVI:4. It is further understood that Article XVI:4 requires that arm's-length pricing be observed. [...] Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income."⁸²

In 1984, following the understanding, the US Congress repealed the DISC legislation and phased in the substitute Foreign Sales Corporation (FSC) regime. This replacement law was designed in a different fashion. First, only the corporations managed outside the US could qualify as FSCs. Second, the tax exemption operated through a presumption that foreign trade income of the FSCs is not effectively connected with a conduct of trade or business within the US (which is a condition attracting taxation under the US laws). In addition, the FSCs were shielded from the application of the domestic CFC rules under which a share of a foreign subsidiary's undistributed income was taxable in the hands of the US parent. As in the case of the DISCs, the FSCs' income was based on the administrative pricing rules not in line with the arm's-length principle.

The FSC regime was challenged by the EC in 1999. By that time, the GATT was converted into the WTO and the SCM Agreement adopted at the Uruguay Round.

The new subsidies code spelled out the definition of a subsidy (see Section 2.2 above). Among the forms a subsidy can take the SCM Agreement listed 'government revenue that is otherwise due is foregone or not collected.' It was this wording that the adjudicative bodies in the FSC case were called upon to interpret.

b) Key arguments of the parties

The EC claimed that the FSC regime involves two subsidies. First, certain exemptions from income taxes for FSCs and their parent companies and, second, the administrative pricing rules that increase the amount of income shielded from taxation by the FSC exemptions.⁸³

The US responded by stating that footnote 59 to item (e) of the Illustrative List of export subsidies contains the 'controlling legal standard' applicable to ECs' claim. Further, the US brought the Panel's attention to the 1981 Understanding, which the US read to mean that the

⁸⁰ McDaniel, P. R., *Trade and Taxation*, 26 Brooklyn Journal of International Law 1621 (2001), p. 1628

⁸¹ *Ibid.*

⁸² GATT Council Understanding on Tax Legislation (1981), BISD 28S/114, 7-8 December 1981

⁸³ *United States—Tax Treatment for "Foreign Sales Corporations"*, Panel Report of 8 October 1999, WT/DS108R, para. 7.35

exemption from tax of income attributable to foreign economic processes does not constitute the foregoing of revenue that is ‘otherwise due.’⁸⁴

c) Key findings of the Panel

Unlike the previous panels, the FSC Panel clearly outlined the analytical framework that guided it towards the conclusions. Unsurprisingly, the Panel followed the structure of the SCM Agreement starting with establishment of a subsidy and proceeding with an analysis of whether the subsidy is contingent upon export performance.

As regards the comparison pair in the interpretation of the ‘revenue otherwise due,’ the Panel noted that as the WTO does not oblige to maintain any particular tax system, it does not provide a “theoretical ‘correct’ benchmark for taxes that would represent the norm for taxes and duties ‘otherwise due’ [and] [a]ccordingly, the determination whether revenue foregone is ‘otherwise due’ must involve a comparison between the fiscal treatment being provided by a Member in a particular situation and the tax regime otherwise applied by that Member.”⁸⁵

This led the Panel to adopt the ‘but for’ case: it took the term ‘otherwise due’ to refer to the situation “that would prevail *but for* the measures in question” (emphasis added).⁸⁶ Therefore, a comparison was made between taxation of the FSCs’ foreign income under the FSC regime and taxation of FSCs’ foreign income in its absence.

The Panel rejected the test suggested by the EC, which was to assess whether there is a “deviation from or exemption to the generally applied rate or basis for collection,” that is, to draw comparison with the ‘generally applicable’ tax regime.⁸⁷ The EC argued that there would only be foregoing of revenue if the exemption or exclusion from taxation were “not based on neutral and objective criteria” being “special and programmatic.”⁸⁸

d) Key findings of the Appellate Body

On appeal, the Appellate Body rejected the ‘but for’ test as a general jurisprudential standard but upheld its application in the specific circumstance of the case *a propos*.⁸⁹ The ‘but for’ test was discarded as susceptible to circumvention: If a Member State designed a tax regime under which there was no general rule applied, formally, to the revenues in question, the test will never be satisfied.⁹⁰

The AB did not offer any alternative standard, as the US did not appeal against the ‘but for’ test.

e) Key findings made in the compliance proceedings (review of the ETI regime)

Following the AB report in the FSC case, the US substituted the FSC regime for the ETI legislation. Instead of exempting ‘extraterritorial income’ from tax, the ETI excluded it from the definition of gross income (*i.e.* from the tax base) altogether.

The US was once again taken to the WTO dispute settlement system by the EC over the ETI in the compliance proceedings under.

In determination of a subsidy, the Panel made a far-reaching conclusion that distinguishes the ETI regime from the European territorial systems. The Panel noted that ‘extraterritorial income’ was qualified by several stringently selective criteria, including a requirement relating to use

⁸⁴ *Ibid.*, para. 7.36

⁸⁵ *Ibid.*, para. 7.43

⁸⁶ *Ibid.*, para. 7.45

⁸⁷ *Ibid.*, paras. 4.526 and 7.46

⁸⁸ *Ibid.*,

⁸⁹ *United States—Tax Treatment for “Foreign Sales Corporations”*, AB Report of 24 February 2000, WT/DS108/AB/R, para. 91

⁹⁰ *Ibid.*

outside the US and an exclusion of income from certain property from the benefits of the ETI, namely oil and gas and timber.⁹¹ The ETI was also elective. Non-taxation of foreign income was therefore not a part of the ‘prevailing domestic standard.’⁹²

In appealing against the Panel’s finding in the compliance proceedings, the US explicitly denounced the comparison pair the Panel employed.⁹³ The US asserted that the ETI measure established a general rule of the US taxation whereby the ETI-covered income is ‘outside U.S. taxing jurisdiction.’⁹⁴ Also, the US described its ‘prevailing domestic standard’ as using the ‘gross income’ concept merely as a starting point and then allowing deductions from the taxable gross income, of which the ETI is just one example.⁹⁵

It was for the analysis of these arguments that the Appellate Body developed a so-called ‘comparability test.’ First, the AB carved out the income covered by the ETI measure. After that, both ETI rules and rules applicable to the taxpayers in comparable situations (*viz.* US residents deriving foreign income and crediting the foreign tax in the US) were applied to the said items of income. Since taxation under the ETI rules was more beneficial, the foregoing of revenue was established.⁹⁶ Finally, the AB observed that the elective nature of the ETI regime ensured that if taxation under the general rules proved laxer, the taxpayer could simply drop out of the regime.⁹⁷ Such consideration led the AB to dismiss the appeal.

Later on, the EC had to resort to the compliance proceeding to challenge yet another iteration of the FSC, the Jobs Creation Act, which grandfathered the ETI measure in respect to certain transactions and provided for a transitional period for others.

In the second compliance proceedings, new questions of law relevant to our discussion were not raised.

5.1.4. US—Aircraft case (Boeing case)

In the aftermath of *US—FSC*, the US state and local authorities introduced or kept the tax incentives for the aerospace industry. The measures that were at stake in the *US—Aircraft* include the income (business and occupation) tax rate reduction by the State of Washington and city of Everett, as well as industrial revenue bonds provided by the city of Wichita.

Non-tax subsidies were also alleged that are outside the scope of this paper.

US—Aircraft is notable for the clear articulation of the DSBs’ analytical framework. The AB suggested a three-step analysis in determination of a subsidy: As a first step, a DSB should identify the tax treatment that applies to the income of the alleged recipients. Then, as a second step, a DSB should identify a benchmark for comparison—that is, the tax treatment of comparable income of comparably situated taxpayers. Finally, as a third step, a DSB should compare the reasons for the challenged tax treatment with the benchmark tax treatment it has identified after scrutinizing a Member's tax regime.⁹⁸

⁹¹ *United States—Tax Treatment for “Foreign Sales Corporations” (Recourse to Article 21.5 of the DSU by the EC)*, Panel Report of 20 August 2001, WT/DS108/RW, para. 8.21

⁹² *Ibid.*, para. 8.25

⁹³ *United States—Tax Treatment for “Foreign Sales Corporations” (Recourse to Article 21.5 of the DSU by the EC)*, AB Report of 14 January 2002, WT/DS108/AB/RW, para. 82

⁹⁴ *Ibid.*

⁹⁵ *United States—Tax Treatment for “Foreign Sales Corporations” (Recourse to Article 21.5 of the DSU by the EC)*, AB Report of 14 January 2002, WT/DS108/AB/RW, para 84

⁹⁶ *Ibid.*, para. 98

⁹⁷ *Ibid.*, para. 103

⁹⁸ *United States—Measures Affecting Trade in Large Civil Aircraft (Second Complaint)*, AB Report of 12 March 2012, WT/DS353/AB/R, paras. 812-814

On the merits of the case, the AB upheld the Panel's conclusion that contested state and local measures constituted the prohibited export subsidies.⁹⁹

5.2. Determination of the jurisprudential standard

As a preliminary matter, this section uses the term 'jurisprudential standard' to refer to the analytical approach the DSB took in handling the claims of a prohibited export subsidy under Article XVI:4 GATT and the SCM Agreement. Specifically, we refer to a comparison pair used to determine if the 'revenue otherwise due' was foregone.

The jurisprudential standard has three dimensions to it. First, whether an intent to subsidize is essential, or is an analysis purely consequential.

Second, whether the comparison should be made with some other regime in the Member State's own system (in the following, internal comparison) or against some objective standard (external comparison).

Third, what is the specific benchmark to be used. In the case of an internal comparison, such benchmark would be a 'general' non-subsidizing tax treatment. If we were to make an external comparison, a benchmark could be derived from either a foreign tax system or the theory of tax law (or possibly public finance).

5.2.1. Intent-based or consequential test

As early as in the European income tax practices cases of 1981 the Panels ruled that "however much the practices may have been an incidental consequence of [...] taxation principles rather than a specific policy intention," they nonetheless constituted a subsidy.¹⁰⁰

Throughout the three iterations of *US—FSC*, the DSBs have shown little interest in the intent, except in their analysis of justification under Footnote 59 to the SCM Agreement (which indicates that the agreement was 'not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member'). On this point, the Panel observed that the variations between different tax systems make it 'probably impossible' to avoid double taxation entirely, exclusively or precisely.¹⁰¹ From this the Panel inferred that it was sufficient to establish a 'reasonably discernable' relationship between the measure and its asserted purpose (*i.e.* intent) of avoiding double taxation.¹⁰²

For the determination of a subsidy, however, relevance of the intent was not apparent before the AB report in *US—Aircraft*, which remarked that "the panel should compare *the reasons* for the challenged tax treatment with the benchmark tax treatment it has identified after scrutinizing a Member's tax regime"¹⁰³ (emphasis added). In the AB's view, such a comparison it needed to determine whether, in the light of the treatment of the comparable income of comparably situated taxpayers, the government is foregoing revenue that is otherwise due in relation to the income of the alleged recipients.¹⁰⁴

⁹⁹ *Ibid.*, paras. 1350(b)(iv)(A) and 1350(c)(ii)

¹⁰⁰ *E.g. Income Tax Practices Maintained by France*, Panel Report of 2 November 1976, L/4423-23S/114, para. 48

¹⁰¹ *United States—Tax Treatment for "Foreign Sales Corporations" (Recourse to Article 21.5 of the DSU by the EC)*, Panel Report of 20 August 2001, WT/DS108/RW., para. 8.95

¹⁰² *Ibid.*

¹⁰³ *United States—Measures Affecting Trade in Large Civil Aircraft (Second Complaint)*, AB Report of 12 March 2012, WT/DS353/AB/R, para. 814

¹⁰⁴ *Ibid.*

It is noteworthy that the WTO jurisprudence clearly prefers the so-called objective intent to subjective. That is, the intent of the measure will be determined by reference to the ‘general structure and design’ of the measure itself rather than parliamentary documents.¹⁰⁵

5.2.2. *Internal or external comparison*

The Panel in *US—FSC* found—and the later panels reiterated—that the tax system of a Member State concerned represents a proper benchmark for assessment.¹⁰⁶ This conclusion was drawn from *Indonesia—Automobiles*. The Panel in this latter case dealt with exemptions from a luxury tax on imported cars and found that the Member State is free not to levy any luxury tax but, once it introduces the tax, it thereby sets a benchmark against which the foregoing of ‘revenue otherwise due’ is to be measured.¹⁰⁷

5.2.3. *Benchmarking*

It is not enough to conclude that the comparison should be made within the Member State’s own tax system. As the AB in *US—FSC* pointed out, “the word ‘foregone’ suggests that the government has given up an entitlement to raise revenue that it could ‘otherwise’ have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised ‘otherwise.’”¹⁰⁸

Therefore, the term ‘otherwise due’ implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation,¹⁰⁹ to which comparison this paper refers as ‘benchmarking.’

The DSBs demonstrated their divergent views on benchmarking. Initially, the Panel in *US—FSC* offered the ‘but for’ test, which presupposed a comparison of taxation under the contested measure and in its absence. This test was criticized by the AB in *US—FSC* for being easy to circumvent and rejected in favor of the “prevailing domestic standard” test by the Panel in *US—ETI*. In turn, the AB in *US—ETI* opined that, absent a clear distinction between the general rule and exceptions to it, the “prevailing domestic standard” test was unworkable. The comparability test was developed instead, under which taxation in accordance with the contested measure should be compared with taxation of the “legitimately comparable” non-qualifying income.

The evolution of the DSBs’ approaches to the benchmarking is illustrated in the table below.

Measure subject to review		Comparison made in determination of a subsidy
1981	Panel in <i>US—DISC</i>	Taxation of worldwide income of qualifying companies <i>compared to</i> taxation of worldwide income of the same companies in absence of the DISC regime ¹¹⁰
1981	Panel in French	Taxation of export-related activities <i>compared to</i> taxation of

¹⁰⁵ *United States—Import Prohibition of Shrimp and Shrimp Products*, AB Report of 6 November 1998, WT/DS58/AB/R, para. 137, see also *Japan—Taxes on Alcoholic Beverages*, AB Report of 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, pp. 29-30

¹⁰⁶ *United States—Tax Treatment for “Foreign Sales Corporations”*, Panel Report of 8 October 1999, WT/DS108R, paras. 7.41 and 7.44

¹⁰⁷ *Indonesia—Certain Measures Affecting the Automobile Industry*, Panel Report of 8 July 1998, WT/DS54/R-WT/DS55/R-WT/DS59/R-WT/DS64/R, para. 14.155

¹⁰⁸ *United States—Tax Treatment for “Foreign Sales Corporations”*, AB Report of 24 February 2000, WT/DS108/AB/R, para. 90

¹⁰⁹ *Ibid.*

¹¹⁰ *United States Tax Legislation (DISC)*, Panel Report of 2 November 1976, L/4422-23S/98, para. 67

	income tax practices	domestic activities for the internal market ¹¹¹ (determination of a subsidy and an export subsidy is syncretic)
1981	Panel in Dutch income tax practices	Similar ¹¹²
1981	Panel in Belgian income tax practices	Similar ¹¹³
1999	Panel in <i>US—FSC</i>	‘But for’ test Taxation of qualifying companies’ foreign income under the FSC regime <i>compared to</i> taxation of foreign income of the same companies in absence of the FSC regime ¹¹⁴
2000	AB in <i>US—FSC</i>	‘But for’ rejected as a general standard but upheld on the facts of the case; no alternative test offered (outside the scope of appeal) ¹¹⁵
2001	Panel in <i>US—ETI</i>	‘Prevailing domestic standard’ test Taxation of foreign income under the ETI regime <i>compared to</i> taxation of foreign income under the prevailing domestic standard ¹¹⁶
2002	AB in <i>US—ETI</i>	Comparability test Taxation of foreign income under the ETI regime <i>compared to</i> taxation of similar foreign income in the hands of other taxpayers in ‘comparable situations’ (US residents crediting foreign tax in the US) ¹¹⁷
2005	Panel in <i>US—Jobs Creation Act</i>	Beyond the terms of reference of the compliance proceedings
2006	AB in <i>US—Jobs Creation Act</i>	
2011	Panel in <i>US—Aircraft</i>	‘But for’ test Taxation under the contested measures <i>compared to</i> taxation under the general rule ¹¹⁸
2012	AB in <i>US—Aircraft</i>	Comparability test Taxation of the beneficiaries of the contested measures <i>compared to</i> taxation of comparable income of comparably situated taxpayers ¹¹⁹

¹¹¹ *Income Tax Practices Maintained by France*, Panel Report of 2 November 1976, L/4423-23S/114, para. 47

¹¹² *Income Tax Practices Maintained by the Netherlands*, Panel Report of 2 November 1976, L/4425-23S/137, para. 34

¹¹³ *Income Tax Practices Maintained by Belgium*, Panel Report of 2 November 1976, L/4424-23S/127, para. 34

¹¹⁴ *United States—Tax Treatment for “Foreign Sales Corporations”*, Panel Report of 8 October 1999, WT/DS108R, para. 7.45

¹¹⁵ *United States—Tax Treatment for “Foreign Sales Corporations”*, AB Report of 24 February 2000, WT/DS108/AB/R, para. 91

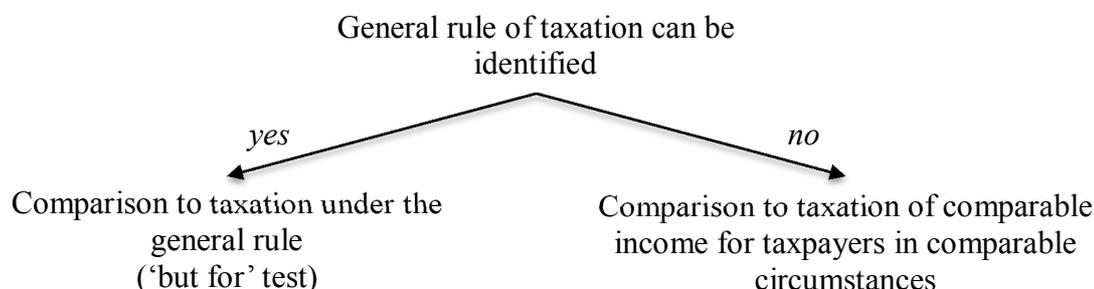
¹¹⁶ *United States—Tax Treatment for “Foreign Sales Corporations” (Recourse to Article 21.5 of the DSU by the EC)*, Panel Report of 20 August 2001, WT/DS108/RW, para. 8.37

¹¹⁷ *United States—Tax Treatment for “Foreign Sales Corporations” (Recourse to Article 21.5 of the DSU by the EC)*, AB of 14 January 2002, WT/DS108/AB/RW, para. 98

¹¹⁸ *United States—Measures Affecting Trade in Large Civil Aircraft (Second Complaint)*, Panel Report of 31 March 2011, WT/DS353/R, para. 8.133

The best attempt so far at reconciliation of the diverging jurisprudential standards was undertaken by the Panel in *US—Aircraft*: “[T]he Appellate Body’s analysis suggests that where it is possible to identify a general rule of taxation applied by the Member in question, a ‘but for’ test can be applied. In other situations, the challenged taxation measure should be compared to the treatment applied to comparable income, for taxpayers in comparable circumstances in the jurisdiction in issue.”¹²⁰

We can illustrate this reasoning as follows:



The AB admonished the shortcut for excessive simplicity but did not reject it.¹²¹

At least two crucial issues are still left without a definitive answer. First, what is a general rule for the ‘but for’ test? On different occasions, the DSBs have inferred this status from: (1) design of the statute; (2) chronological order in which the provisions were introduced; and (3) volume of income they cover.

Second, what is the comparable income of the comparably situated taxpayers? So far, the AB has resorted to the express tautology “the like will be compared to the like” and provided an example that it would not be appropriate to compare the income from sales transactions to the earned income, which is hardly helpful.¹²²

5.3. Adequacy of the jurisprudential standard

Section 5.2 has extracted the jurisprudential standard, which the DSBs use for handling the income tax cases under the SCM Agreement, from their previous rulings. We now move to analyze whether the standard is adequate.

By an adequate jurisprudential standard this paper means the one that is:

1. Capable of being reconciled with the principles of income taxation and international tax regime, as outlined in Section 3 above;
2. Derived from the wording of the SCM Agreement and aligned with its purpose;
3. Universal and comprehensive;
4. Difficult to circumvent; and
5. Predictable in application.

¹¹⁹ *United States—Measures Affecting Trade in Large Civil Aircraft (Second Complaint)*, AB Report of 12 March 2012, WT/DS353/AB/R, para. 812

¹²⁰ *United States—Measures Affecting Trade in Large Civil Aircraft (Second Complaint)*, Panel Report of 31 March 2011, WT/DS353/R, para. 7.120

¹²¹ *United States—Measures Affecting Trade in Large Civil Aircraft (Second Complaint)*, AB Report of 12 March 2012, WT/DS353/AB/R, para. 818

¹²² *United States—Tax Treatment for “Foreign Sales Corporations” (Recourse to Article 21.5 of the DSU by the EC)*, AB Report of 14 January 2002, WT/DS108/AB/RW, para. 90

5.3.1. *Internal or external comparison*

The use of an internal comparison is an accurate inference from the wording used in the SCM Agreement ('foregoing of the revenue that is otherwise due'). It acknowledges that WTO law was not intended to harmonize the systems of income taxation.

With some degree of simplification, the use of an internal comparison, taken together with a selectivity requirement, can be viewed as a trade-off between free trade and tax sovereignty: WTO law does not bar a Member State from levying very low or no income taxes, as long as such tax broadly available. What ensures the reasonable level of taxation is not WTO law but the need to raise revenue.

An external comparison, *i.e.* the use of an objective definition of income as a benchmark, can be desirable in the case of states with hardly any domestic tax base. This is largely the case of offshore tax havens.

While purportedly desirable in some cases, the use of an external benchmark would depart from the wording of the SCM Agreement and go beyond what the Member States have agreed to.

5.3.2. *'General rule' and 'prevailing domestic standard' approaches*

As described in Section 5.2.3 above, the first question a DSB will face is whether it is possible to establish a general rule, from which a contested measure is a deviation.

The determination of a general rule requires guidance, which the previous jurisprudence fails to provide. At a minimum, there are three methods of selecting a tax regime as a baseline 'general rule': (1) based on the design of a statute; (2) by order of introduction; and (3) by volume of transactions covered.

Assume a Member State maintains the following provisions on taxation of foreign income:

Provision 1	A resident shall be subject to income tax on its domestic income.	Long-standing provision of the income tax act	Covers 70 percent of the volume of income declared by the residents of the country concerned
Provision 2	If a resident derives foreign income that is not subject to tax at source or taxed at a rate lower than 15 percent, such income shall be deemed the domestic income.	Introduced by the amending act	Covers 5 percent of the volume of income declared by the residents of the country concerned
Provision 3	The domestic income taxable under Provision 2 shall be exempt from tax if a resident demonstrates that it has effective business operations in a source state.	Introduced by the same amending act	Covers 25 percent of the volume of income declared by the residents of the country concerned

Assume further that Provision 3 is to be examined under Article 1 of the SCM Agreement as the foregoing of revenue.

One approach is to characterize Provision 2 as a general rule with a result that Provision 3 involves the foregoing of revenue.

Another approach is to characterize Provision 1 as a general rule, from which both Provision 2 and Provision 3 deviate. (Yet another approach would be to regard Provisions 2 and 3 as a composite tax measure.)

In the instant case, the first approach is supported by the way in which the income tax act is designed and by the fact Provisions 2 and 3 were enacted with the same bill. However, it can be difficult to argue that a purported exception covering five times as much income is not a general rule. It can be well argued that the ‘prevailing standard’ in the jurisdiction concerned is exemption of foreign income under Provision 3 and that Provision 2 is an attached anti-avoidance rule. Therefore, the characterization is not just problematic but indeed reversible.

The main conclusion, however, is that the variation of factors such as legislative design, timing of enactment and volume of covered transactions can lead a DSB to characterize substantively similar measures in different ways. This is the approach’s main drawback.

5.3.3. Comparability approach

Since identification of a general rule can prove impossible, DSBs will often find themselves compelled to use the comparability approach instead.

Yet, the existing case law does not provide sufficient guidance for the comparability analysis. We know from the AB report in *US—ETI* that there are to aspects of comparability. First, the fiscal treatment of ‘legitimately comparable income’ should be compared, second, the comparison is confined to such income earned by the taxpayers ‘in comparable situations.’¹²³ There also must be ‘a rational basis’ for comparing the fiscal treatment of the income subject to the contested measure and the fiscal treatment of certain other income.¹²⁴

We can suggest that in schedular systems the income from within the same schedule is legitimately comparable, unless introduction of a new schedule is itself a contested measure.

In global and schedular systems alike, comparability should be determined on the basis of the tax system’s own principles. We assert that the WTO case law can be used only as long as the underlying principles of tax systems at issue are analogous (the use a substantially different was system as a guideline will be effectively an external benchmark).

5.3.4. Tax expenditure approach

The tax expenditure approach was proposed by Paul. R. McDaniel in reaction to *US—FSC* and may be said to have influenced the AB in *US—Aircraft*.

This approach presupposes a distinction between the normative features of the systems and tax expenditure.

The normative features are the provisions necessary to set up any system of income taxation. They address the following questions: (1) What is the tax base? (2) What are the tax rates? (3) Who is to pay the tax (the taxable unit)? (4) When is the tax to be paid (accounting rules)? (5) How is the tax to be applied in cross-border transactions? and (6) How is the tax to be administered?¹²⁵

According to Professor McDaniel, all other provisions found in a tax statute are not the ‘pure’ tax rules and pursue other objectives, e.g. spending and regulation.¹²⁶

The normative features, the argument goes, constitute a suitable benchmark to assess the foregoing of revenue.¹²⁷

¹²³ *United States—Tax Treatment for “Foreign Sales Corporations” (Recourse to Article 21.5 of the DSU by the EC)*, AB Report of 14 January 2002, WT/DS108/AB/RW, paras. 91 and 92

¹²⁴ *Ibid.*, para. 90

¹²⁵ McDaniel, P. R., *Trade and Taxation*, 26 *Brooklyn Journal of International Law* 1621 (2001), p. 1622

¹²⁶ *Ibid.*, p. 1623

Indeed, they have always served as a benchmark for the tax expenditure accounts (the documents compiled normally in a budget process to measure the public expenditure through taxes, also known as tax expenditure budgets).

However, Professor McDaniel himself acknowledges that the tax expenditure accounts have a degree of subjectivity and occasionally change. By way of example, the US tax expenditure accounts had been based on the objective definition of income until the Reagan administration switched to the reference tax structure approach.¹²⁸ The accelerated depreciation was characterized as a part of the reference tax structure and ceased to be regarded as a tax expenditure measure.

Therefore, defining tax expenditure is problematic because some measures may not be easily characterized as a part of a benchmark or an exception to it.¹²⁹

Apart from the difficulty of agreeing on characterization, the tax expenditure approach is also faulted for creating incentives for tampering with the actual tax expenditure accounts.¹³⁰

5.3.5. Comparison with the EU state aids standard

The TFEU provides that any “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, insofar as it affects trade between member states, be incompatible with the common market.”¹³¹

The European Commission has developed an approach under which the specific tax benefits fall within the language of Article 107(1) TFEU.¹³² Specifically, for a tax measure to qualify as prohibited state aid: (1) it must confer on recipients an advantage which relieves them of charges normally borne from their budget; (2) the advantage must be granted by the state or through state resources; (3) the measure must affect competition and trade between the EU Member States; and (4) the measure must be specific or selective in that it favors ‘certain undertakings or production of certain goods.’¹³³

The benchmarking issue is taken care of in a different way than in the context of the SCM Agreement. While selectivity criterion is akin to that under the WTO law, subsequent analysis is unlike.

Thus, according to the ECJ, the selective nature of a measure may be justified by ‘the nature or general scheme of the system.’¹³⁴

The process of identification of the EU state aid involves following steps: first, identification of a country’s ‘common system’ (a process similar to that followed in the WTO disputes); second, examination of exceptions or deviations from the system to assess if they are justified by the nature or scheme of the tax system (*i.e.* whether they derive directly from the basic or guiding principle of the tax system of the country).¹³⁵

¹²⁷ McDaniel, P. R., *Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions*, 57 *Tax Law Review* 275 (2004), pp. 275-276 [275-300]

¹²⁸ *Ibid.*, pp. 291-292

¹²⁹ *Tax Expenditure in OECD Countries*, OECD, 2010, p. 12

¹³⁰ Brauner, Y., *International Trade and Tax Agreements May Be Coordinated, but Not Reconciled*, 25 *Virginia Tax Review* 251 (2005), pp. 298-299

¹³¹ Art. 107(1) TFEU

¹³² European Commission, *Commission Notice on the Application of State Aid Rules Relating to Direct Business Taxation*, 1998, O.J. (C 384)

¹³³ *Ibid.*, para. 9-12

¹³⁴ Case 173/73 *Italy v. Commission* (1974) ECR 709

¹³⁵ *Supra* note 125, p. 1635

Interpretation of the selectivity criterion is noteworthy. It was construed to exclude the measures pursuing general economic policy objectives through a reduction of the tax burden related to certain production costs (*e.g.* R&D),¹³⁶ yet to encompass the measures targeting, say, all the sectors that are “subject to international competition”¹³⁷ or the entire manufacturing sector.¹³⁸

Crucially, the EU state aid analysis is based on the wording of the TFEU and EU law principles, which are different from those found in the WTO Agreement.

As a result, the ECJ jurisprudence cannot guide the WTO DSBs in handling the disputes under the SCM Agreement.

The WTO case law on prohibition of export subsidies in the form of foregoing of revenue otherwise due has not yet developed a uniform approach to benchmarking. As a shortcut, the ‘but for’ test is adopted, which presupposes a comparison between the tax burden under the contested measure and in its absence.

However, it is acknowledged by the AB that the ‘but for’ test can be easily circumvented by the governments. It is perfectly possible to design a subsidizing tax measure disguised as a general rule or to design a tax system with no general rule.

In response to such considerations, the AB has suggested a comparability approach, which mandates the comparison to the treatment of comparable income of comparable taxpayers.

This approach appears to be deliberately vague, which ensures flexibility but also compromises legal certainty.

¹³⁶ European Commission, *Commission Notice on the Application of State Aid Rules Relating to Direct Business Taxation*, 1998, O.J. (C 384), para. 13

¹³⁷ Commission Decision 97/239/EC of 4 December 1996 in the ‘Maribel bis/ter’ case

¹³⁸ Commission Decision of 22 July 1998 in the ‘Irish corporation tax’ case (SG(98) D/7209)

Section 6. Summary and Conclusions

6.1. Summary of findings

The findings of this paper can be summarized as follows.

In respect to the national treatment and most-favored nation obligations:

- The tax measures are not immune from the scrutiny under the GATT simply because of their characterization as income tax measures.
- The expression ‘internal taxes on products’ does not cover the income tax itself but extends to administration and collection measures applied on the basis of price or value.
- It is each income tax measures (rather than the income tax as a whole) that should be tested against the NT and MFN standards of the GATT.

In respect to the prohibition of export subsidies:

- The comparability approach developed by the AB appears to be a deliberate trade-off between legal certainty and flexibility.
- In that, the comparability approach is preferable over the ‘but for’ test, because the latter can be easily circumvented by way of careful tax law design and drafting.
- The DSBs’ approach to benchmarking is essentially a tax expenditure analysis with internal comparison. However, the DSBs never addressed the considerations of relativity of an internal baseline voiced by the tax and public finance communities.

In respect to the influence of specific income tax considerations:

- The application of the WTO law to the field of direct taxation is not likely to jeopardize the widely accepted principles of the tax law.
- This is not because the limited reach of the WTO law into direct taxation rather than the DSBs paying attention to the income tax’s specificity.
- If a tax measure is ruled to fall within the ambit of the WTO Agreement, there would be no legal support to take account of the tax law theory.

6.2. Conclusions

We have asserted in the beginning of this paper that the WTO jurisprudential standard for dealing with the income tax measures is constructible and well equipped to resolve the conflict between international tax and trade regimes. From this, we inferred that the careful application of the WTO non-discrimination obligation would serve the interest of free trade without jeopardizing the principles of the tax law.

This paper concludes that, in respect to the prohibition of export subsidies, the WTO jurisprudential standard is fairly developed but still lacks guidance on determination of the benchmark tax regime. This is particularly true of the identification of a general rule, as opposed to exceptions, which is necessary to apply the ‘but for’ test, and the comparability analysis, to which a DSB should resort when a general rule is not identifiable.

As regards the NT and MFN obligations, while the jurisprudential standard is still nascent, it is already clear that these obligations restrict the tax sovereignty in introducing the tax measures that apply to products rather than income.

Finally, this paper concludes that application of WTO law to income tax measures can be reconciled with international tax regime. Out of the concerns outlined in Section 3, it is sovereignty that is truly at stake. The Member States have agreed to curtail their sovereignty in the WTO Agreement in order to promote free trade and, from the trade regime’s perspective, tax sovereignty is no different.

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