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COMMENTARIES

TREATING TAX ISSUES THROUGH TRADE REGIMES

Reuven S. Avi-Yonah[*]

I. INTRODUCTION

Professor Paul R. McDaniel has performed an extremely valuable service in clarifying the relationship between trade and tax law. In particular, he has done so by pointing out that, to a large extent, the two spheres do not overlap, much less clash in their objectives. This makes sense because, fundamentally, the goal of trade law is to facilitate trade, while the goal of tax law is to raise revenue. Thus, for example, an ideal tariff under trade law is set at zero, but an ideal tax under tax law is set at some positive rate. It therefore should not be surprising that there is a large measure of non-overlap between trade and tax law.

This comment will focus on those areas in which tax and trade law do overlap, and explore some of the ways in which this overlap occurs. Professor McDaniel argues that the only areas in which tax and trade law do overlap are in the case of "tax expenditures," *i.e.*, subsidies delivered through the tax law. As we shall see, an examination of the General Agreement on Tariffs and Trade (GATT)[1] suggests that this is in-

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1. The 1994 version of the GATT is part of the Marrakesh Agreement Establishing the World Trade Organization, reached at the conclusion of the Uruguay Round of trade negotiations. *See* Marrakesh Agreement Establishing the World Trade Organization [hereinafter WTO Agreement], Apr. 15, 1994, LEGAL INSTRU-

deed the case, but there also may be some tax-related violations of GATT that are not included in any tax expenditure budget.

This comment is divided into three parts. First, I will summarize the main provisions of trade law that bear on taxation. Second, I will examine the application of trade law to three specific types of tax regimes, identified in my previous work as "production tax havens," "traditional tax havens," and "headquarters tax havens."[2] Finally, I will discuss the general question of whether problems in the tax law, and in particular harmful tax competition, should be addressed through trade law and the World Trade Organization (WTO), or are better left to organizations with less adjudicatory power such as the Organization for Economic Cooperation and Development (OECD).

II. THE GATT AND TAXES

There are two articles of the GATT that bear directly on taxation. Article III of the GATT provides that "internal taxes . . . should not be applied to imported or domestic products so as to afford protection to domestic production."[3] Because of the reference to products, this provision generally has been understood as referring only to indirect taxes (*i.e.*, excise taxes or consumption taxes such as the value added tax (VAT)). However, even if the article is interpreted as referring to direct taxes as well, it seems unlikely that the income tax in particular can be used as an instrument for protecting domestic production because of the difficulty of designing income tax provisions that will apply only to foreign production.[4]

MENTS—RESULTS OF THE URUGUAY ROUND vol. 1 (1994), 33 I.L.M. 1125 (1994) [hereinafter GATT 1994], *available at* http://www.wto.org/english/docs_e/legal_e/final_e.htm.

2. *See generally* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000).

3. *Id.* at art. III.

4. Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131 (2001). Warren has argued that there is significant scope for income tax discrimination against foreign investors which is not the same as discrimination against foreign products or producers. But he is hard pressed to adduce any real life examples of significant discrimination against foreign investors via the tax law. For example, the denial of imputation credits to foreign shareholders, which is his prime example of such discrimination, is only discriminatory if the combined corporate and withholding tax rate in the source

Article XVI of the GATT provides in general for notification procedures in the case of any "subsidy . . . which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, [a contracting party's] territory."[5] In addition, the article expressly prohibits the use of any subsidy "on the export of any product . . . which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market."[6] A note clarifies that the exemption of an exported product from taxes borne by the like product when destined for domestic consumption (such as zero rating exports for VAT) "shall not be deemed to be a subsidy."[7]

Article XVI was expanded significantly by the Subsidies Code included in the 1994 version of the GATT.[8] The Subsidies Code defines "subsidy" as including cases where "government revenue that is otherwise due is foregone or not collected."[9] To be actionable under the GATT, a subsidy must be "specific to an enterprise or industry or group of enterprises or industries."[10] In addition, a specific subsidy is prohibited only if it is "contingent, in law or in fact, . . . upon export performance" or "upon the use of domestic over imported goods."[11] Annex I to the Subsidies Code includes an "illustrative list of export subsidies" which includes "[t]he full or partial exemption remission, or deferral specifically related to exports of direct taxes . . . paid or payable by industrial or commercial enterprises."[12] However, a footnote clarifies that this language

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country exceed the individual tax rate on domestic shareholders, which is unlikely in OECD members. Even if it exists, such discrimination is not covered by the current GATT, which does not directly address investment issues. *See generally* Joel Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 INT'L TAX & PUB. FIN. 471 (1995) (while theoretically it is possible to design tax rules that have the same effect as tariffs, in practice that this is difficult to achieve).

5. GATT 1994, at art. XVI.

6. *Id.*

7. *Id.*

8. Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, WTO Agreement, Annex 1A, LEGAL INSTRUMENTS—RESULTS OF THE URUGUAY ROUND vol. 1, 33 I.L.M. 229 (1994) [hereinafter Subsidies and Countervailing Measures], *available at* http://www.wto.org/english/docs_e/legal_e/final_e.htm. This agreement only applies to products; services are covered by the General Agreement on Trade in Services (GATS), which does not yet address subsidies.

9. *Id.* at art. 1.

10. *Id.* at art. 2.

11. *Id.* at art. 3.

12. *Id.* at Annex I. The list also includes a provision for exemption or remis-

"is not intended to limit a Member from taking measures to avoid the double taxation of foreign source income earned by its enterprises."[13]

The other agreement included in the 1994 version of the GATT that bears on taxation is the General Agreement on Trade in Services (GATS).[14] Because services frequently involve foreign direct investment (FDI), in this case the line between trade and investment is particularly blurred. Therefore, the United States inserted provisions in the GATS that prevent it from overriding domestic tax legislation and income tax treaties applicable to FDI. In particular, the provision of national treatment for service providers can be avoided if "the difference in treatment is aimed at ensuring the equitable and effective imposition or collection of direct taxes."[15] In addition, most favored nation (MFN) treatment can be avoided if the difference in treatment follows from a tax treaty.[16]

III. APPLICATION OF GATT RULES TO TAX HAVENS.

In a previous work, I have identified three types of tax havens: (1) "production tax havens," in which there is a specific tax holiday or other type of tax benefit designed to attract foreign investors to set up production facilities in a host country; (2) "Traditional tax havens," *i.e.*, jurisdictions with little or no income tax that seek to attract foreign investors and financial service providers through the promise of no taxation and bank secrecy; and, (3) "headquarters tax havens," *i.e.*, regimes designed to attract multinational enterprises (MNE) to locate their headquarters in a jurisdiction by promising no taxation (or no current taxation) of income derived from foreign subsidiaries.[17]

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sion of indirect taxes in excess of those levied on products for domestic consumption, and defines direct and indirect taxes to include income tax and VAT, respectively. *See id.* at n.58. Deferral is allowed if accompanied by an interest charge. *Id.*

13. *Id.* at n.59.

14. General Agreement on Trade in Services, Apr. 15, 1994, WTO Agreement, Annex 1B, LEGAL INSTRUMENTS–RESULTS OF THE URUGUAY ROUND vol. 31 (1994), 33 I.L.M. 1168 (1994) [hereinafter GATS], *available at* http://www.wto.org/english/docs_e/legal_e/final_e.htm.

15. *Id.* at art. XIV.

16. *See id. See also id.* at art. XXIII (no arbitration in the case of existing tax treaties).

17. For further elaboration, see Avi-Yonah, *supra* note 2.

How do the GATT rules previously described apply to these three types of tax haven? The clearest application is in the case of production tax havens. These regimes are invariably "ring fenced," *i.e.*, they are designed to foster exports and, therefore, are separated from the domestic economy (and sometimes also not available to domestic investors). The regimes are ring fenced precisely because they are set up by countries with a real domestic tax base that do not wish to see that base eroded by the tax concessions granted within the preferential regimes. The European Union (EU) and OECD reports on harmful tax competition cite dozens of such regimes, even though they limit themselves only to regimes of member countries and (in the case of the OECD) exclude "real" investments (*i.e.*, manufacturing).[18]

There seems to be little doubt that such production tax havens constitute prohibited export subsidies under the GATT. They invariably involve foregone revenue (*i.e.*, tax expenditures in McDaniel's sense), are specific to certain taxpayers (in fact they are frequently negotiated deals), and are, in fact, contingent on export performance because the products they involve cannot be targeted at the domestic market.

The case of traditional tax havens is harder. Since there is no income tax, they do not involve "foregone revenue" or a tax expenditure in the traditional sense. However, traditional tax havens frequently grant exemptions to the offshore sector from those taxes they do collect (*e.g.*, VAT). Moreover, they frequently involve not just pure investments (which are presumably not covered by the current GATT), but in particular the provision of intangibles (such as the know how built into financial services), targeted entirely at foreigners (and frequently ring fenced as well). Thus, arguably traditional tax havens, or at least that part of their activities that are more than pure passive investment, fall within the prohibition on export subsidies as well. Moreover, since they generally are not party to tax treaties, the exclusion of treaty matters from GATS does not cover them.

The toughest cases are headquarters tax havens. This

18. *See OECD Announces Release of Harmful Tax Competition Report*, 2000 WTD 124-10 (June 26, 2000); *Primarolo Group's EU Harmful Tax Competition Report Identifies 66 Violative Regimes*, 2000 WTD 50-1 (March 10, 2000).

covers specific regimes designed to attract foreign MNEs, which are akin to production tax havens. Those presumably are export subsidies for the reasons above stated. However, they also cover things like the U.S. deferral regime and the European exemption for foreign source income of domestic MNEs. Are these export subsidies under the GATT? If the only activity involved is pure investment (*e.g.*, the acquisition of a foreign target), then the regime is not covered. However, usually there also is the transfer of intangibles, and, frequently, the sale of goods to the foreign subsidiaries. In these cases there is trade in goods, and the provision could be an export subsidy.

The ultimate question is thus the one identified by Professor McDaniel: Is deferral or exemption a tax expenditure? In a worldwide regime such as the U.S., the answer is clearly yes (and deferral is in the tax expenditure budget).[19] What about an exemption regime? Professor McDaniel argues that the exemption of foreign source income in Europe is part of the normative baseline. But defining the baseline for the European regimes is hard, since they contain many worldwide features (such as controlled foreign corporation (CFC) regimes). Thus, I think that it is possible to argue that there is "foregone revenue" here as well, even if it is not reflected in the tax expenditure budget.

But what about the footnote that specifically excludes regimes designed to avoid double taxation? While the intent of this footnote was to exclude the European regimes, query whether an exemption regime that does not take into account whether the income was subject to tax at the source qualifies as a "measure to avoid double taxation." Fundamentally, a general exemption regime distinguishes between domestic and foreign source activities in a way that frequently subsidizes exports, not just investments, and therefore can be construed as an export subsidy if the income is not taxed at source.[20]

19. Note, however, that to the extent the transfer of tangible or intangible goods to foreign subsidiaries is covered by sections 367 or 482, there is no subsidy involved, since pure investment activity is not a subsidy.

20. Note, however, that the Foreign Sales Corporation (FSC) report (cited by Professor McDaniel) does seem to approve of "territorial tax systems." But this is dicta: If the case ever came before the WTO again, as seems likely, the U.S. seems to have a stronger argument for complaining about the European exemption systems than most tax experts assume.

IV. SHOULD HARMFUL TAX COMPETITION BE ADDRESSED THROUGH THE WTO?

Many of the contributors to this symposium have pointed out that the problem of harmful tax competition cannot be adequately addressed by the current international tax regime based on bilateral treaties.[21] A multilateral effort clearly is needed, and the question is whether the proper forum for it is the WTO or an organization such as the OECD, with a more restricted membership and fewer adjudicatory powers.

Reliance upon the OECD to restrict tax competition suffers from three significant drawbacks. First, the OECD only has 29 members, and it is unclear whether it effectively can enforce its anti-tax competition rules on non-member countries.[22] For example, solutions that rely on where the parents of MNEs are located assume that no significant growth in MNEs will take place outside of the OECD, and solutions that rely on the OECD as the market assume no significant markets outside the OECD. Either assumption may become wrong. When that happens, solutions that rely on OECD enforcement will lose their effectiveness unless those emerging markets were to join the OECD. While several developing countries have recently joined the OECD (*e.g.*, South Korea and Mexico), it is hard to imagine China or India doing so in the near future.

Second, relying on the OECD to implement solutions to the tax competition problem, even if those solutions are tailored to benefit developing countries, may not be acceptable to those countries. Even though the OECD has made a huge effort to include non-OECD members in the tax competition project, it is still identified as the rich countries' club. Thus, it is hard to believe that developing countries will be able to shed their suspicions that the OECD will not act in their interests even if it actually can be made to do so. In fact, the effort by

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21. *See* Vito Tanzi, *Globalization, Technological Developments, and the Work of Fiscal Termites*, 26 BROOK. J. INT'L L. 1261 (2001); Jack M. Mintz, *National Tax Policy and Global Competition*, 26 BROOK. J. INT'L L. 1285 (2001); Peggy B. Musgrave, *Sovereignty, Entitlement and Cooperation in International Taxation*, 26 BROOK. J. INT'L L. 1335 (2001); Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, 26 BROOK. J. INT'L L. 1641 (2001). *See also* Avi-Yonah, *supra* note 2.

22. The EU effort is even more limited in scope, and has run into significant problems for this reason, as the recent developments on taxation of savings show (the UK and Luxembourg will cooperate only if the U.S. and Switzerland do).

the OECD to develop a multilateral agreement on investments (MAI) foundered precisely because developing countries and left-leaning non-governmental organizations coordinated a campaign against it as representing the interests of the rich countries and "their" MNEs.

Third, the OECD effort has thus far been limited to geographically mobile financial services, and excludes real investments, although these constitute a significant part of the problem. In addition, even for the areas it does cover, the OECD only has the power to persuade, not to adjudicate.

From these perspectives, the WTO is a more attractive candidate for "world tax organization." It has a much broader membership than the OECD, and developing countries are much better represented (and have real clout, as shown by the recent struggle over choosing the Director General of WTO). Moreover, as indicated above, the WTO rules already cover and prohibit many forms of harmful tax competition identified by the OECD.

But there are several serious objections to including tax matters in the jurisdiction of the WTO. First, it has been argued that the WTO lacks sufficient tax expertise.[23] However, that problem can be remedied by hiring a sufficient number of tax experts to sit on the WTO's panels. In fact, as the WTO has expanded its jurisdiction to non-tariff matters, its staff already includes tax experts who also understand trade issues.

Robert Green has advanced a more serious objection arguing that the costs of imposing the WTO's legalistic dispute-resolution mechanism outweigh any benefits.[24] Green argues that the need for the WTO to resolve trade disputes legalistically is based on two features that are typically lacking in the tax context: retaliation and lack of transparency. Retaliation is a feature of repeated prisoners' dilemma type games and insures that players have an incentive to cooperate.[25] In an assurance (stag hunt) game, both players cooperate if they can be

23. *See* Robert E. Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN. L. REV. 1443 (1988); William M. Considine, *The DISC Legislation: An Evaluation*, 7 N.Y.U. J. INT'L. L. & POL. 217 (1974).

24. *See* Robert M. Green, *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 YALE J. INT'L L. 79 (1995).

25. *See id. See also* ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984).

assured of the other player's cooperation.[26] In the first case, an organizational setting is needed to manage retaliatory strategies while in the second it is needed to provide the information needed for the assurance to exist.

However, in the context of tax competition, it would seem that both retaliation and lack of information are serious problems. For example, in the case of portfolio investment, the U.S. began a race to the bottom by abolishing its withholding tax and other countries responded (*i.e.*, retaliated) by abolishing their own taxes. In the current situation, no country dare reimpose its tax without adequate assurance that other countries will follow. Similarly, for direct investment, countries have adopted tax incentives or adopted deferral and exemption rules for their resident MNEs, in response to the actions of other countries, and fear changing such policies without assurance that others will follow suit. Thus, whether these developments are characterized as prisoners' dilemma or assurance games, they seem to present precisely the kind of problem that only a multilateral organization with rule-making power can resolve effectively.[27]

However, Green also raises another objection to giving the WTO authority over taxes which in practice is likely to be far more potent: The problem of sovereignty. Countries are wary of giving up their sovereignty over tax matters, a fact which lies at the heart of their ability to exercise national power. This concern is particularly acute in the U.S. and almost led to the failure of the entire Uruguay Round as the U.S. insisted upon, at the last minute, excluding direct taxes from the purview of the GATS.[28] Green argues that if the WTO dispute resolution mechanism were given authority over tax issues it may lead to widespread non-compliance; especially given the perception that the WTO is non-transparent and lacks democratic legitimacy.[29]

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26. The assurance game has a payoff structure in which the best outcome is if both countries cooperate while in the prisoner's dilemma the best outcome is if you defect and the other side cooperates. *See* Green, *supra* note 24.

27. The race to the bottom in international taxation in the 1980s resembled a prisoners' dilemma, in which one country (the U.S.) preferred to defect while others cooperated in order to draw investment to it. But the current situation is more like an assurance game, in which the U.S. and other OECD members would prefer cooperation above all other outcomes.

28. *See* Green, *supra* note 24.

29. *See id. See also* Joel P. Trachtman, *The Domain of WTO Dispute Resolu-*

Green may be wrong about this estimate, especially since the analysis above has shown that the WTO already has jurisdiction on many forms of harmful tax competition, so that no further extension of its powers is necessary. But even if Green is right, and sovereignty poses a real problem, there may be a solution to this as well. Under the GATT regime, all decisions had to be reached by consensus, *i.e.*, with the agreement of the party whose regime is at stake. Under the WTO rules, on the other hand, all dispute settlement rulings are binding unless there is a consensus not to implement them, *i.e.*, when even the complaining party agrees to refrain from action. Perhaps the former rule is more appropriate for tax matters than the latter because it gives the loser a veto if it feels that its sovereignty is truly at stake. Similar rules exist for tax matters in both the EU and the OECD. But, as the Domestic International Sales Corporation (DISC) case in the GATT and the adoption of the tax competition report by the OECD show, a country typically will reserve its veto power only to those cases in which the adverse result truly is perceived as a severe limit on its sovereignty. In other cases, the stigma of disapproval is sufficient to ensure cooperation.

Professor McDaniel is right in pointing out that there exists a very significant degree of non-overlap between tax and trade law. However, he also correctly points out that there also exists some area of overlap, which can be defined as tax expenditures. The question is how important is this area of overlap. I would argue that it is extremely important, and that in the international arena the expenditures threaten to undermine countries' ability to collect income taxes on cross-border income.[30] If that is the case, then perhaps the WTO is the most promising forum for finding a solution.

tion, 40 HARV. INT'L L.J. 333 (1999) (describing factors to be weighed in choosing between rules and standards in the WTO context). But it should be noted that the WTO already has exercised jurisdiction over matters such as food safety, intellectual property, and similar issues that also involve sensitive sovereignty issues.

30. *See* Avi-Yonah, *supra* note 2.