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Special Tax Zones and the World Trade Organization

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Special Tax Zones in the Era of International Tax Coordination

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Chapter 7

Special Tax Zones and the World Trade Organization

Reuven Avi-Yonah* and Martin Vallespinos**

7.1. Tax competition and special tax zones

A special tax zone (STZ) is a preferential tax regime that is ring-fenced. A preferential tax regime is ring-fenced when the sponsoring country effectively protects its domestic economy from the harmful effects of its own tax breaks.[1] The protection of the domestic economy is generally achieved either by excluding the resident taxpayers from taking advantage of the tax benefits or by prohibiting the beneficiaries from operating in the domestic market.[2]

The gist of this practice was well-explained by the OECD in the consolidated application note of the 1998 report, "Harmful Tax Competition: An Emerging Global Issue"[3] (the 1998 Report), as follows:

> Countries may reduce effective tax rates on the income from geographically mobile activities to attract new investment, stimulate particular types of business activity, or maintain existing domestic activity. The hope is that the tax revenue foregone will be compensated by an increase in the desired activity. Despite these objectives, a reduction of the effective tax rate may result in a net revenue loss. Continued reductions of the effective tax rate are even more likely to result in less revenue for the government.
>
> If, however, a country partly or fully ring fences the application of a low effective rate of tax, then the domestic tax base of the country providing the low rate will not be affected. The lower tax rate applied will primarily or only have an impact on the tax bases of foreign countries from which the geographically mobile financial or other service activity is attracted. In this case, ring-fenced regimes will have little or no cost to the country offering the regime and thus

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1. A. Laukkanen, *Special Tax Zones in Developing Countries and Global Tax Policy*, 70 Bull. Intl. Taxn. 3 (2016), Journals IBFD.
2. OECD, *Harmful Tax Competition: An Emerging Global Issue* (OECD 1998).
3. Id.

> there is no inherent limit on their use. This may lead to a proliferation of ring-fenced regimes which in turn might interfere with each country's sovereign right to determine its own tax policy, including the decision to tax such income.[4]

During the last decades, and since the first modern STZ was established in Ireland in 1959,[5] a variety of different zone setups have evolved. The most typical are commonly associated with isolated areas (e.g. industrial parks) offering tax-free treatment for goods that enter the zone, go through a process of assembling or manufacturing and then leave the zone. The spectrum of STZs that are currently available for investors, however, goes a lot further than this classic perception.[6] Many of the current STZs are intended to attract service and banking activities. In addition, ring-fencing is generally achieved through methods other than a separate customs area, such as a private ruling granting the tax benefit to a specific beneficiary or a general exclusion of the tax residents from the sponsoring country's direct or indirect tax benefits.

Essentially, an STZ is a type of preferential tax regime adopted for the purpose of tax competition. This form of tax competition, however, is different than a tax haven. Tax havens traditionally focus on tax planning, financial services, asset holding and other schemes that allow foreign enterprises and wealthy individuals to reduce their taxes in their residence countries.[7] As such, they are generally not oriented towards attracting substantial economic activities. In stark contrast, STZs traditionally focus on direct, indirect and customs duties tax benefits and are intended to develop the internal economy of the sponsoring country by attracting substantial economic activities. The existence of economic substance has protected STZs from the criticism that has typically surrounded tax havens. However, their better reputation does not necessarily mean that STZs are totally innocuous.

The potential harmful effects of preferential tax regimes (including STZs) and tax havens were addressed by the OECD for the first time in 1998

4. OECD, *The OECD Project on Harmful Tax Practices, Consolidated Application Note: Guidance in Applying the 1998 Report to Preferential Tax Regimes* p. 20 (OECD 1998).
5. M. Engman, O. Onodera & E. Pinali, *Export Processing Zones: Past and Future Role in Trade and Development*, OECD Trade Policy, Working Paper No. 53 (OECD 2007), available at http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=td/tc/wp(2006)39/final (accessed 27 Dec. 2017).
6. J. Farrell, *The Interface of International Trade Law and Taxation: Defining the Role of the WTO* (IBFD 2013), Online Books IBFD.
7. R. Palan, R. Murphy & C. Chavagneux, *Tax Havens: How Globalization Really Works* (Cornell U. Press 2010).

with the issuance of the 1998 Report.[8] This report provided an analysis of the phenomenon of harmful tax competition and identified factors that characterize tax havens and harmful preferential tax regimes. It also recommended numerous measures in the areas of domestic legislation, tax treaties and international cooperation that countries may pursue to counter harmful tax competition. Although not legally binding, the recommendations of the 1998 Report were the first attempt to set out international rules regarding preferential tax regimes (including STZs) and tax havens.

The 1998 Report identified two types of harmful tax competition: tax havens and harmful preferential tax regimes. Rather than a theoretical definition, the report provided a number of key factors to identify a tax haven or a harmful preferential tax regime. The key factors to identify a tax haven are (i) a low or no effective tax rate; (ii) no substantial activity; (iii) a lack of transparency; and (iv) a lack of effective exchange of information. In turn, the key factors to identify a harmful preferential tax regime are (i) a low or no effective tax rate; (ii) ring-fencing; (iii) a lack of transparency; and (iv) a lack of effective exchange of information.

In addition to this theoretical framework, the 1998 Report proposed the creation of a Forum on Harmful Tax Practices (FHTP) to review and monitor the preferential tax regimes that existed among the OECD member countries. It also recommended unilateral, bilateral and multilateral measures to counteract harmful tax competition.[9]

Conceptually, STZs are within the scope of the 1998 initiative, as ring-fencing is one of the key factors that should be considered to identify a harmful preferential tax regime. However, the 1998 Report limited itself to preferential tax regimes aimed at attracting geographically mobile activities such as financial and other service activities (e.g. insurance, leasing and banking). This means that STZs intended to attract active investment in plant or manufacturing were excluded from the scope of the OECD anti-harmful tax competition initiative.[10]

The 1998 Report was followed by a progress report in June 2000 entitled "Towards Global Tax Co-Operation: Progress in Identifying and Eliminating Harmful Tax Practices" (the 2000 Report), which summarizes the main findings of the FHTP. The 2000 Report identified 47 potentially

8. OECD, *supra* n. 2, at p. 19.
9. Id.
10. Id.

harmful preferential tax regimes, which were grouped into the following nine categories:

- intellectual property (IP) regimes;
- headquarters regimes;
- financing and leasing regimes;
- banking and insurance regimes;
- distribution centre and service centre regimes;
- shipping regimes;
- holding company regimes;
- fund management regimes; and
- other miscellaneous regimes.

Another progress report from 2006 (the 2006 Report) indicated that of the 47 preferential tax regimes identified as potentially harmful in the 2000 Report, 20 regimes had been abolished, 14 had been amended to remove their potentially harmful features and 13 were found not to be harmful.[11] Only one preferential tax regime, i.e. the Luxembourg 1929 holding company regime, was considered harmful.[12]

The 2006 Report was a self-identified stopping point for the anti-harmful preferential tax regimes initiative. The last paragraph of the 2006 Report indeed explained that "with the abolition or amendment of all the regimes identified as harmful, all the primary mandates of the 1998 report were accomplished". This explanation, however, is misleading for two reasons.

First, by 2006, the anti-harmful preferential tax regimes initiative had already lost momentum as a result of the discontent and criticism expressed by several OECD member countries, including Luxembourg, Switzerland and the United States. Indeed, through a brief communication signed in July 2001 by then-US Treasury Secretary O'Neill,[13] the United States withdrew support from "any efforts intended to dictate to any country what its own tax rates or tax system should be" and reaffirmed its commitment to participate in any attempt to increase information exchange. The firm opposition of these key OECD member countries impacted the Fiscal Committee's

11. OECD, *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries* pp. 5-6 (OECD 2006).
12. The Luxembourg 1929 holding companies regime, however, was repealed on 19 April 2005. Existing 1929 holding companies were benefitted with a grandfathering clause until the end of 2010. *See* R. Bogaerts, *Luxembourg Adapts 1929 Holding Companies Regime to Comply with EU Code of Conduct*, 45 Eur. Taxn. 8 (2005), Journals IBFD.
13. US Department of the Treasury, *Treasury Secretary O'Neill Statement on OECD Tax Havens* p. 1 (10 May 2001), available at https://www.treasury.gov/press-center/press-releases/Pages/po366.aspx (accessed 27 Dec. 2017).

strategy, which shifted towards a new approach that was less focused on tax policy intervention and more focused on ensuring transparency and tax information exchange.

Second, the 2006 Report did not mention that the 21 regimes listed as harmful in the 2000 Report were abolished as a result of pressure other than the OECD initiative. Indeed, the legislative changes implemented among the European countries within the period were driven mostly by the pressure of the European Union on its Member States, which were required to align their domestic tax systems with the principles of the EU Code of Conduct on Business Taxation, as well as with the State aid rules.

In 2013, the OECD and G20 countries adopted a 15-point Action Plan to address base erosion and profit shifting (BEPS). In BEPS Action 5,[14] the OECD revamped its previous work on harmful tax practices and committed the FHTP to restarting its activities. In addition, BEPS Action 5 was included as one of the four BEPS minimum standards, which means that, although not legally binding, there is a high expectation that the proposed standards will be implemented accordingly by countries that are part of the consensus.

BEPS Action 5 introduced a renewed version of the anti-harmful tax practices initiative, thus reflecting a new approach in terms of priorities, pressing areas, methods and main policy goals. BEPS Action 5 determined two priority areas: (i) improving transparency, including compulsory spontaneous information exchange on rulings related to preferential regimes; and (ii) requiring substantial activity for any preferential regime. The second priority area, however, is mainly focused on IP preferential tax regimes. In addition, under the renovated initiative, ring-fencing remained a "factor" for identifying a preferential harmful tax regime, but is no longer one of the "key factors".[15] Substance, conversely, was elevated in rank from a secondary factor to a key factor.[16]

After the publication of BEPS Action 5, the FHTP reviewed 164 preferential regimes. The results of such review are summarized in the 2017

14. OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report* p. 12 (OECD 2015), International Organizations' Documentation IBFD, available at http://dx.doi.org/10.1787/9789264241190-en (accessed 27 Dec. 2017).
15. Id., at p. 23.
16. Id.

OECD Progress Report on Preferential Tax Regimes (2017 Report).[17] The 2017 Report demonstrates that the OECD has kept its narrow scope in the assessment of preferential tax regimes, as it only addresses regimes oriented towards attracting passive income and investment in financial and service activities. The categories of preferential tax regimes that remain within the scope are similar to the nine categories identified in the 1998 Report listed above. Ring-fencing is still a relevant factor for the analysis (e.g. the Chilean Business Platform Regime), but is no longer an essential factor. Finally, the results of the FHTP review demonstrate that substance is the essential factor, and tax incentives intended to develop a zone through substantial business activities are generally respected or considered out of scope.

In summary, the OECD anti-harmful tax practices initiative only reaches a small portion of the STZs available around the world, namely STZs implemented in the OECD-G20 area and focused on financial and service-related investments. Although countries are showing progress in incorporating the BEPS minimum standards, the proposals of the OECD are not binding and are not intended to restrict STZs oriented towards substantial manufacturing activities. Service and financial STZs, on the other hand, could raise concerns under BEPS Action 5, but the mere presence of ring-fencing may not be conclusive in the assessment, as this factor has been downgraded in importance. As explained above, the main priorities in BEPS Action 5 are transparency, information exchange and substance. This means that a ring-fenced scheme that is compliant with these factors could possibly be respected. The narrowness of the OECD approach leads to the conclusion that the OECD does not provide a legal framework extensive enough to regulate STZs on a global scale. The BEPS Project has ratified the OECD's traditionally narrow approach with respect to STZs. This position may reflect the OECD's intention to not involve itself in matters that would fall under the jurisdiction of the World Trade Organization (WTO), as will be explained later.

17. OECD, *Harmful Tax Practices – 2017 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5*, (OECD 2017), available at http://dx.doi.org/10.1787/9789264283954-en (accessed 27 Dec. 2017).

7.2. The WTO rules and STZs

7.2.1. Overview of the WTO regime

The WTO Agreements do not include specific references to STZs. However, this legal framework has been consistently applied to STZs to the extent that they contravene the basic rules of the international trade system.

The WTO's legal texts are embodied in the Marrakesh Agreement Establishing the World Trade Organization, which acts as an umbrella for another 60 agreements, annexes, decisions and understandings (collectively known as the WTO Agreements). The WTO Agreements cover a broad spectrum of trade issues, but overall, they are aimed at ensuring a transparent, fair and non-discriminatory international trade system. Even though the WTO main agreement includes a broad declaration of principles, its specific policy goals are focused on assuring fairness and non-discrimination in trade and do not give significant weight to other issues, such as preventing harmful tax competition or protecting countries' tax bases.

One of the main instruments created by the WTO to achieve fairness in trade is the Subsidies and Countervailing Measures Agreement (SCM Agreement). This agreement provides substantive rules governing when and under what circumstances a member country may challenge a subsidy imposed by another member country. The agreement provides two avenues for objection: a state may (i) unilaterally impose countervailing duties on subsidized imports; or (ii) file a formal complaint with the WTO Dispute Settlement Body with the possibility of imposing retaliatory sanctions if the complaint is upheld.[18] One important caveat is that the SCM Agreement is limited in scope to the area of goods and does not include rules on subsidies in the area of services.

Article 1 of the SCM Agreement defines a subsidy as a "financial contribution by a government conferring a benefit", which includes the direct transfers of funds, goods or services (other than infrastructure) and the non-collection or forgiveness of taxes otherwise due. Further, the SCM Agreement distinguishes two categories of subsidies: prohibited subsidies and actionable subsidies. The prohibited subsidies, described in article 3 of the SCM Agreement, are disallowed outright, and WTO members are allowed to unilaterally impose countervailing measures against the country sponsoring them. This category includes (i) subsidies that are contingent,

18. M.J. Trebilcock, *Understanding Trade Law* (Edward Elgar 2011).

in law or in fact, upon export performance; and (ii) subsidies that are contingent upon the use of domestic over imported goods.

On the other side of the spectrum, the actionable subsidies category includes any other subsidies that are not considered "prohibited" and that satisfy the following two additional requirements:

- specificity: an actionable subsidy is considered specific when the eligibility to receive the benefits is limited to certain enterprises, industries or areas (article 2 of the SCM Agreement); and
- adverse effect: an actionable subsidy is considered adverse when it produces a serious prejudice to the interests of another member, an injury to its domestic industry or a nullification or impairment of benefits accruing directly or indirectly to other members under General Agreement on Tariffs and Trade (GATT) 1994 (article 5 of the SCM Agreement).

When an actionable subsidy is specific and produces an adverse effect, the affected countries are entitled to file a formal complaint with the WTO Dispute Settlement Body and may impose retaliatory sanctions in the event that the complaint is successful.

For the first 5 years after its entry into force, the SCM Agreement contained a third category of subsidies, i.e. the non-actionable subsidies. The non-actionable subsidy provisions, as defined in articles 8 and 9 of the SCM Agreement, were narrowly-defined specific subsidies for research and development, the adaptation of existing facilities to new environmental regulations and assistance for disadvantaged regions. These subsidies were selected for non-actionable status on the basis that they furthered important policy goals and were unlikely to have harmful effects on trade. The provisions on non-actionable subsidies applied provisionally for a period of 5 years and expired at the end of 1999.

The SCM Agreement contains no specific rules concerning STZs. However, an STZ scheme can be considered as conferring a prohibited or actionable subsidy if certain requirements are satisfied. The first requirement is that the tax benefit granted by the STZ must fall within the definition of a subsidy provided by article 1 of the agreement. In this respect, reductions, remissions or deferrals of direct taxes normally qualify as subsidies under the agreement because they are treated as "financial contributions that result in a benefit" (article 1.1(a), appendix I, paragraph E). In an attempt to coordinate this general rule with the double tax treaty network, footnote 59 of annex I to the agreement introduces an exception for cases of direct tax reductions,

remissions or exemptions that are created for the purpose of avoiding double taxation of foreign-source income.

On the other side, tax benefits limited to duty drawback and/or indirect tax exemption, remission or deferral systems for exports (e.g. VAT refunds) are normally not considered subsidies under article 1.1 (and its footnote 1), except for the case of capital goods imported for trade or business.[19]

Once demonstrated that the tax preferences granted by the STZs are subsidies under article 1 of the SCM Agreement, the next step consists of determining whether those subsidies are considered prohibited, actionable or non-actionable. For these purposes, this chapter distinguishes (i) "red-light STZs", which are those that qualify as prohibited subsidies under article 3 of the SCM Agreement; (ii) "yellow-light STZs", which are those that qualify as actionable subsidies under article 2 of the SCM Agreement; and (iii) "green-light STZs," which are those that are outside the purview of the WTO.

7.2.2. Red-light STZs

Red-light STZs are prohibited under article 3 of the SCM Agreement. This category includes STZs granting tax benefits that qualify as prohibited subsidies under the agreement. An STZ grants a prohibited subsidy when the tax benefits are contingent upon export performance or the use of domestic over imported goods. Specifically, annex 1 of the agreement provides a list of the prohibited export subsidies, which includes (in paragraph E) income tax reductions, remissions, deferrals and special exceptions, to the extent that they are specifically related to exports. With regard to indirect taxes and customs duties, an exemption, remission or deferral is considered a prohibited subsidy only if it is in excess of those levied with respect to the production and distribution of like products when sold for domestic consumption.

The language of article 3 and the guidelines provided in annex 1 of the agreement treat as a prohibited subsidy any ring-fencing scheme based on prohibiting the introduction of goods manufactured within the STZ into the domestic market of the sponsoring country. When an STZ qualifies as

19. Footnote 1 of the WTO Subsidies and Countervailing Measures (SCM) Agreement provides that "the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy".

a red-light STZ, any WTO member may request the establishment of a dispute settlement procedure in order to obtain a ruling recommending that the offending subsidies must be withdrawn without delay. The requesting member does not need to demonstrate that the subsidy is specific to a certain industry or sector or that the subsidy is producing an adverse effect on the economy of the other WTO member. Further, if the member found to be in violation does not comply with the recommendation, the complaining party may eventually receive authorization from the Dispute Settlement Body to take appropriate countermeasures.

The entry into force of the SCM Agreement was a hard blow for many countries, especially developing countries with long-established manufacturing STZs treated as separate areas outside their borders or "national customs territory" and with tax benefits conditional on export performance. In the years that followed the introduction of the agreement, indeed, several developing countries expressed concern that some of their internal tax and import duty exemption programmes that would be covered by the prohibition were still of crucial importance for achieving their development objectives. Besides, developing countries argued that export subsidies are superior to tariffs to protect their infant industries because the latter also negatively affect consumers in the domestic markets.[20]

In response to these concerns, the SCM Agreement affords an exemption under article 27.2(a) and annex VII for less-developed countries that have not reached a GNP per capita of USD 1,000. For the purposes of this exception, Annex VII of the agreement includes a list with all the countries with per capita income below the USD 1,000 threshold. The list, created during the Uruguay round, originally included 20 countries (e.g. Bolivia, Cameroon, Kenya, Honduras and Pakistan), and none of the acceding countries were superadded afterwards (e.g. Vietnam).[21] Once countries reach and establish a GNP per capita of USD 1,000, they are removed from the exemption. As of today, countries such as the Dominican Republic, Egypt, Guatemala, Morocco and the Philippines have been removed from the list.

20. Commission on Growth and Development, *The Growth Report: Strategies for Sustained Growth and Inclusive Development* (World Bank 2008), https://openknowledge.worldbank.org/bitstream/handle/10986/6507/449860PUB0Box3101OFFICIAL0USE0ONLY1.pdf (accessed 27 Dec. 2017).

21. D. Coppens, *How Special is the Special and Differential Treatment under the SCM Agreement? A Legal and Normative Analysis of WTO Subsidy Disciplines on Developing Countries*, 12 World Trade Review 1, p. 79 (2013).

In addition to this exemption, articles 27.2(b) and 27.4 affords, to all developing countries not included on the list, an 8-year transition period to eliminate incompatible subsidies. This transition period expired for all countries at the end of 2002, but they are entitled to request an extension by the SCM Committee in light of their development needs under article 27.4. The SCM Committee annually reviewed the necessity thereof. If a negative determination was made, the export subsidy had to be phased out within 2 years from the end of the last authorized period.[22] Finally, the flexibility to offer export subsidies for both groups of developing countries was extinguished for products that had reached export competitiveness. According to article 27.6, export competitiveness of a product exists "if a developing country Member's exports of that product have reached a share of at least 3.25% in world trade of that product for two consecutive calendar years". This limitation excludes the main activities of all the large industrialized developing countries (e.g. Indian textiles) without regard to their economic performance.

To summarize, since the SCM Agreement entered into force, the number of red-light STZs around the globe has dropped, mainly after the end of the last transition period. As of today, only a reduced number of small trading developing countries maintain red-light STZs.

7.2.3. Yellow-light STZs

Yellow-light STZs qualify as actionable subsidies under the SCM Agreement. The yellow-light category includes STZs granting benefits that are actionable subsidies, that satisfy the specificity requirement of article 2 of the agreement and that satisfy the adverse effect requirement of article 6 of the agreement. If these three requirements are satisfied, the affected WTO member is entitled to file a formal complaint with the WTO Dispute Settlement Body, with the possibility for the imposition of retaliatory sanctions in the event that the complaint is successful.

The tax benefits provided by an STZ would normally satisfy the "specificity" requirement because ring-fencing, by definition, is based on restricting the tax benefits to a separate area, sector, group or enterprise in order to protect the domestic tax base. Based on this reasoning, an STZ that excludes the tax residents of the sponsoring country from the tax benefits would potentially qualify as an actionable and specific subsidy if the industry sector is

22. Id.

included within the scope of the SCM Agreement. As explained before, the SCM agreement is limited in scope to trade in goods and excludes trade in services.

Upon establishing specificity, the tax break must result in "adverse effects" for another WTO member. The SCM Agreement provides for three types of adverse effects: (i) injury to a domestic industry; (ii) nullification or impairment of benefits accruing directly or indirectly to other members under the GATT 1994; or (iii) serious prejudice to the interests of another member.

Article 6 of the SCM Agreement provides complex rules to determine whether an actionable subsidy produces a serious prejudice. A subsidy is generally deemed to produce a serious prejudice under these rules if (i) the total value of the subsidization represents more than 5% of the value of the product or more than the amount of net operating losses sustained by an industry (with the exception of one-time measures); or (ii) the subsidy consists of a direct forgiveness of debt.

To summarize, the tax benefits granted by an STZ to a specific industry, sector or taxpayer are, by definition, treated as specific subsidies under the SCM Agreement. Therefore, it would be necessary to test whether the "adverse effect" requirement of article 6 of the SCM Agreement is satisfied. In this regard, for example, if the lower corporate income tax rate is found to subsidize the production costs by 5% or more, the STZ would be deemed to cause serious prejudice and adverse effects on the interests of other members. If that is the case, the STZ will be obliged to withdraw the subsidy or remove its adverse effects. However, the sponsoring country could bring the regime into conformity with the subsidy rules by only increasing the low corporate income tax rate to the extent necessary or lowering the mainstream rate to match the level offered within the STZ. Alternatively, the sponsoring country could remove the specificity of the STZ by opening up the tax benefit to all industry sectors, both domestic and foreign. However, this, in effect, may negate the purpose of the STZ. As a consequence, under the "actionable subsidies" criteria, the legality of STZs is still very risky.[23]

7.2.4. Green-light STZs

Green-light STZs are outside the scope of the WTO Agreements. This category includes:

23. Farrell, *supra* n. 4.

- non-harmful STZs: STZs with tax benefits that are actionable and specific subsidies but do not satisfy the "adverse effects" requirement. This category would include, for example, STZs in which the benefit does not exceed the 5% threshold described in article 6 of the SCM Agreement (*see* section 7.2.3.);
- service-oriented STZs: subsidies promoting the provision or exportation of services;
- STZs granting benefits protected by the Agreement on Agriculture; and
- article 8 STZs (until 1999). While SCM article 8 was in effect (through 31 December 1999), STZs intended to promote certain research activities, assistance for disadvantaged regions or the adaptation of existing facilities to new environmental requirements were not considered unfair or distortive by the WTO. Since this provision was eliminated, the tax policies underlying the subsidization are no longer relevant for the WTO legal analysis. The main factors to determine whether a subsidy is permitted under the WTO rules (specificity, adverse effects, etc.) are fact-specific and do not rely on tax policy considerations.

Although unlikely, a green-light STZ could still be in violation of other WTO Agreements, such as the GATT, the General Agreement on Trade on Services (GATS) or the Trade-Related Investment Measures (TRIMS) Agreement.

An STZ could contravene the non-discrimination principle established in the GATT/GATS. This principle, which is one of the cornerstones of the WTO legal framework, is embodied in two obligations: the most-favoured-nation (MFN) treatment obligation and the national treatment obligation. In simple terms, the MFN treatment obligation prohibits discrimination among goods, services or service suppliers of different origins (or with different foreign destinations).[24] The national treatment obligation, in turn, prohibits discrimination between foreign goods, services and service suppliers and domestic goods, services and service suppliers.[25]

The most relevant non-discrimination provisions are included in articles I and III of the GATT for the case of goods and in articles II and XVII of the GATS for the case of services.

In the case of a goods-oriented STZs, articles I and III of the GATT would apply if the STZ provides preferential treatment to certain companies based

24. P. van den Bossche & D. Prevost, *Essentials of WTO Law* p. 13 (Cambridge University Press 2016).
25. Id.

on their nationality. This exposure is low because it is commonly accepted that the non-discrimination rules of the GATT only apply to trade tax and internal indirect tax benefits and exclude income tax benefits.[26] In this regard, 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". The reference to "products" in article III suggests that the GATT only applies to indirect taxes. A systematic interpretation of the agreement, however, shows a fair amount of ambiguity to the point that there are no final positions or conclusive answers to this issue.[27] However, even if the GATT were applicable to direct taxes, the "national treatment" obligation is unlikely to pose significant challenges for an STZ. This is first because the national treatment obligation of the GATT is intended to protect foreign investors at a disadvantage with respect to the local investors but does not work the other way around (protecting local investors from their foreign competitors), and second because an income tax limited in scope to foreign activities would be almost impossible to enforce.[28]

Service-oriented STZs, in turn, could potentially be restricted by articles II and XVII of the GATS. This agreement, however, allows WTO members to maintain specific exceptions to the application of the MFN provision (article II:2)[29] and includes a general exception to the national treatment rule for the case of measures implemented for the purpose of ensuring the "equitable or effective imposition or collection of direct taxes" (article XIV (d)).[30]

These two groups of exceptions narrow the potential applicability of the GATS to service-oriented STZs. However, a service-oriented STZ that provides preferential tax treatment to a subset of companies based on their nationality could still be considered contrary to the MFN principle (article II of the GATS) to the extent that it is not protected by a specific exception.[31] With respect to the national treatment rule, the considerations provided for

26. Id., at p. 31. *See* also M. Matsushita, T. Schoenbaum & P. Mavroidis, *The World Trade Organization: Law, Practice and Policy*, 2nd edn., p. 168 (Oxford International Law Library 2006): "So-called direct taxes (i.e., those not imposed on products but on income or producers) fall outside the scope of article III:2. Article III: 2 applies to taxes only on products (e.g., sales taxes, excise taxes, value-added taxes)."
27. Farrell, *supra* n. 4, at p. 79.
28. R. Avi-Yonah, *Passport to Toledo: CUNO, the WTO and the ECJ*, 109 Tax Notes, pp. 1661-1668 (2005).
29. Currently, more than 400 measures have been exempt from the most-favoured-nation clause, and many of those exceptions include direct taxes.
30. Farrell, *supra* n. 4, at p. 92.
31. Engman et al., *supra* n. 3.

the case of the GATT are applicable to the GATS. To summarize, the overall exposure of STZs to the GATT/GATS non-discrimination provisions is low.

Finally, an STZ can fall within the scope of the TRIMS Agreement because the typical tax incentives provided by these schemes would normally qualify as a "trade-related investment measure."

The annex of the TRIMS Agreement provides an illustrative list of the investment measures that are in violation of the agreement. The list includes trade-related investment measures that (i) require "the purchase or use by an enterprise of products of domestic origin or from any domestic source" (commonly called "local-content requirements"); (ii) require "that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports" ("trade-balancing requirements"); or (iii) "restricts the importation by an enterprise" by "restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise" ("foreign exchange restrictions"). As a result, any STZ that has a local-content requirement, a trade-balancing requirement or a foreign exchange restriction could be considered in violation of the TRIMS Agreement. However, it should be noted that the TRIMS Agreement only applies to investment measures related to trade in goods, excluding services. In addition, the TRIMS Agreement is focused on indirect taxes and customs duties rather than direct taxes. In this respect, article II of the agreement states that the prohibitions are intended to reinforce the obligation of national treatment (paragraph 4 of article III of the GATT) and the obligation of the general elimination of quantitative restrictions (paragraph 1 of article XI of the GATT). These obligations, as explained, do not apply to direct taxes.

7.3. Inconsistencies in the current WTO regime

7.3.1. Good intentions, but unfair outcomes

In the last 2 decades, the WTO has become the global leader in the regulation of STZs. The rules of the SCM Agreement filled a regulatory vacuum that the OECD left when its members decided to withdraw the organization from any initiative intended to regulate tax incentives and countries' tax policies.

The shift of global leadership from the OECD to the WTO could be seen as a positive change in terms of legitimacy because the WTO is a truly global

organization with 164 members (as of 29 July 2016), representing 92% of the world's population and 95% of world trade. In addition, this change could be seen as legal progress because the WTO can create "hard international law" enforced by quasi-judicial global institutions. The main benefit of creating hard international law is the breakdown of the "Westphalian dilemma" and all the collective action problems of the current international tax regime.

Overall, however, the current WTO legal framework of STZs appears to be unfair and inconsistent with the underlying policy goals of this organization. This is because service STZs generally remain free from legal challenges (because there are no formal subsidy rules concerning services), whereas manufacturing STZs (with substantial activities) are significantly curtailed. The disparity in treatment between goods-oriented STZs and service-oriented STZs has produced a negative impact on developing countries, as they tend to rely more on manufacturing STZs to achieve economic growth. At the same time, the disparity in legal treatment benefits developed countries, which tend to rely more on offshore banking, technology and financial services STZs to attract investment.

The current WTO system restricts developing countries from exploiting their competitive advantages in the manufacturing of goods. At the same time, the current system incentivizes developed countries to implement STZs in areas where they have comparative advantages, such as financial services, telecommunications and banking. The WTO records of requests for consultations provide factual support of this conclusion: from a total of 115 cases based on the SCM Agreement, only 32 were initiated by developing countries.[32] In addition, most of the export-contingent STZs created in the developing world were significantly restricted during the early 2000s by the operation of the SCM Agreement. The technical reason for this disparity is that the SCM Agreement did not include services within its scope, and the GATS has not included subsidy rules to fill that gap. As a result, international financial service zones or international business centres that offer offshore banking are generally free from challenges under current WTO law, although they could be challenged at the regional level (e.g. under EU law). The fairness and distributional concerns raised by this disparity have not been sufficiently addressed by the WTO leadership, on the grounds that the main objectives of the WTO are limited to market access, freedom and non-discrimination in trade.

32. World Trade Organization (WTO), *Disputes by Agreement*, available at https://www.wto.org/english/tratop_e/dispu_e/dispu_agreements_index_e.htm?id=A20# (accessed 27 Feb. 2017).

In sections 7.3.2.-7.3.4., this article will analyse three case studies that demonstrate the disparity of treatment explained above: (i) The Costa Rica Duty-Free regime; (ii) The US Foreign Sales Corporation (FSC) regime (and the *Boeing* case); and (iii) the portfolio participation exemption.

7.3.2. Case study 1: Manufacturing STZs in the developing world: The Costa Rica Duty-Free Zone

Costa Rica's Duty-Free Zone regime, created by Law No. 7210 of 23 November 1990, is a set of incentives and benefits offered to enterprises making new investments in Costa Rica. The incentives granted by this regime are as follows:

- inward clearance into the duty-free zone of goods required for the operations of the enterprise, including supplies, accessories, machinery and equipment, fuel and transportation;
- exemption from all taxes relating to the exportation or re-exportation of goods;
- exemption from payment of taxes on capital and net assets, payment of land tax and payment of tax on the transfer of real estate;
- exemption from sales and consumption taxes on purchases of goods and services;
- exemption from all taxes on remittances abroad;
- exemption from all taxes on profits and any other taxes for which the tax base is calculated in relation to gross or net earnings, dividends paid to shareholders or revenue or sales; and
- exemption from all municipal or business taxes.

At the time of its creation, the Duty-Free Zone was ring-fenced by requiring that at least 75% of an enterprise's production was exported. This requirement was clearly intended to protect the domestic market from the subsidized goods manufactured in the STZ. The beneficiaries of the Duty-Free Zone were export-processing industries, export-trading enterprises, service industries and enterprises that export services to natural or legal persons domiciled abroad and enterprises or other entities engaged in scientific research. Banking, financial and insurance entities based in duty-free zones did not qualify for the benefits of this regime.

In 2010, Costa Rica reported 246 enterprises receiving the benefits of Duty-Free Zone status, which represented 54.2% of Costa Rica's total exports

and approximately 58,000 new jobs directly associated with the STZ.[33] In addition, Costa Rica reported that the Duty-Free Zone had a favourable socio-economic impact, with the installation of high-technology enterprises (including the famous settlement of Intel) and the development of a significant knowledge-based industry in the domestic market, plus a specialized and highly competitive labour force.

However, since the SCM Agreement entered into force in 1995, the Costa Rican Duty-Free Zone became a prohibited subsidy subject to the 8-year transition period of article 27.4. In 2001, during the Doha negotiations, the Committee on Subsidies and Countervailing Measures of the WTO decided that the transition period, ending in 2002, should be extended to the end of 2007, subject to annual review.[34] In 2007, the WTO again extended the exemptions for 22 countries (including Costa Rica) for an additional 8 years (until 2015).[35] During the third transition period, Costa Rica implemented deep changes in the Duty-Free Zone in order to comply with the provisions of the SCM Agreement. The new tax regime,[36] as amended in 2010, incorporated a new category of processing enterprises that does not require the exportation of a percentage of production in order to be eligible for the Duty-Free Zone regime. The amendments to the law specify that the exemptions and benefits applicable to enterprises classified under the new article 17(f) of the law shall not be contingent in fact or in law upon export performance. In addition, such enterprises are allowed to introduce their production into the domestic market without losing the benefits, but in such cases, all import taxes and customs procedures will apply.

Despite these profound reforms, the Costa Rican Duty-Free Zone continued to produce a favourable socio-economic impact, and remained an attractive hub for foreign investment. In fact, a recent study issued by a Costa Rican governmental agency (*Promotora de Comercio Exterior de Costa Rica*, or PROCOMER) indicates that the Duty-Free Zone has always been socially

33. PROCOMER, *Promotora de Comercio Exterior de Costa Rica, Balance de las Zonas Francas: Beneficio Neto del Régimen para Costa Rica, 2006-2010* (PROCOMER 2011).
34. WTO, *Procedures for extensions under Article 27.4 for certain developing country members* para. 1.(e) (WTO 2001).
35. WTO, Committee on Subsidies and Countervailing Measures, Decision of the Committee of 13 July 2007, G/SCM/120, appendix 1 (WTO 2007).
36. The draft was approved by the Legislative Assembly on 17 December 2009 and signed by the Executive on 12 January 2010. Accordingly, Law No. 8794 of 12 January 2010 (CR: Amendments to the Duty-Free Zone Regime Law, No. 7210 of 23 November 1990) came into effect on 22 January 2010 when it was published in the Official Journal *La Gaceta* No. 15 of 22 January 2010.

and economically sustainable, both before and after the 2010 reform.[37] As of 2016, for every 1 tax dollar forgone, companies in the Costa Rican STZ generated 6.2 dollars in value. In addition, the STZ generated, in 2015, social security tax revenues in the amount of USD 515 million, 82,086 jobs and average salaries 1.8 times higher than in the rest of the country.

During the last decade, many other countries have also trimmed down incentives to permitted exemptions or have made such exemptions WTO-consistent by relaxing the export requirement. Thus, the requirement that all or a certain percentage of production must be exported, such as under the old Costa Rican Duty-Free Zone regime, has become increasingly rare.[38]

The success of the Costa Rican STZ experience, however, cannot be easily replicated under the current WTO legal framework. In actuality, if a developing country wishes to pursue an export promotion policy, it will find that most of the STZ schemes that countries such as Costa Rica, Korea (Rep.), Panama or Taiwan utilized in the past to create export-led economic growth are no longer allowed under the current WTO system.[39]

The WTO restrictions on export-related subsidies have a significant impact on big industrialized developing countries with diversified local economies (e.g. Argentina, Brazil, Colombia or Turkey). Indeed, if a big industrialized developing country introduces an STZ without an export requirement, that would likely result in the destruction of their incipient domestic industries rather than the promotion of export-led economic growth. In addition, the Costa Rican example demonstrates that countries can implement export-related subsidies for a transitional period and then repeal those restrictions without losing the foreign investment and the associated export-related growth.

Overall, this case study shows that the SCM Agreement has significantly reduced the ability of developing countries to use export promotion policies to foster the manufacturing activities for which they have competitive advantages.

37. PROCOMER, *Promotora del Comercio Exterior de Costa Rica, Balance de las Zonas Francas: Beneficio Neto del Régimen para Costa Rica 2011-2015* (PROCOMER 2011), available at https://procomer.com/downloads/zonas-francas/balance_zf_2011_2015.pdf (accessed 27 Dec. 2017).
38. Engman et al., *supra* n. 3.
39. J. Mah, *Special and Differential Treatment of Developing Countries and Export Promotion Policies under the WTO*, 34 The World Economy 12 (2012).

7.3.3. Case study 2: Manufacturing STZs in the developed world: The US DISC-FSC disputes

In 1972, the United States passed the Domestic Sales Corporation (DISC) legislation as part of a raft of protectionist measures introduced to lessen a persistent balance-of-payment deficit. In addition, the DISC legislation was created to balance the disadvantage that US companies face in comparison with their counterparts in countries practicing territorial tax methods and benefiting from "discriminatory" border tax adjustments. The DISC legislation created an onshore method of tax sheltering that allowed a US parent company to set up a wholly-owned subsidiary for the purpose of deferring US income taxation on profits arising from export activities. Typically, a DISC was a "fictitious" company that operated as an export agent for the parent. The tax break offered three advantages. First, 50% of the DISC's "export sales income" was sheltered from federal income tax until actual distribution. Second, "inter-company" pricing rules enabled the parent company to channel more income to the DISC than would have normally been the case under the Internal Revenue Code's standard arm's length pricing method. These rules resulted in up to a 25% indefinite tax deferral on the parent's total combined income. Third, sheltered income could be shifted back to the parent company in the form of producer loans, thus creating a means of "bailing out" tax-deferred income.

In 1974, the European Community initiated an official complaint against the DISC regime. The European Community argued that the DISC regime was an export subsidy that fit in the list of subsidies provided by annex I, item (c). The WTO Panel found the DISC deferral to be a legal export subsidy in violation of the GATT 1947, as it did not attract the interest component of the tax that would normally be levied for late or deferred payment of tax. The WTO Panel found that the forgiveness interest constituted a "partial exemption" under both items (c) and (d) of the Illustrative List.

To bring the DISC regime in conformity with the WTO resolution, the United States enacted the FSC regime. FSCs remained functionally equivalent to their predecessors, the DISCs, but shifted the tax break to qualified offshore locations (e.g. Barbados and the US Virgin Islands). The FSC corporate requirements were flexible enough for the US parent to maintain little more than a fictitious company. The FSC regime offered three tax advantages. First, the FSC obtained a corporate income tax exemption on a portion of "foreign trade income" (at least 30%) deemed to be "foreign source income not effectively connected with a trade or business within the United States". Second, the tax exemption circumvented the

US controlled-foreign-corporation rules (Internal Revenue Code Subpart F income). Third, the distribution of dividends, whether deriving from the exempt or non-exempt FSC income, normally qualified for a 100% deduction. Like the DISC, the tax break was magnified by the availability of special transfer pricing methods.

Technically, the FSC regime is clearly a ring-fenced preferential tax regime. The restriction of the benefits for the so-called "foreign trade income" isolates the domestic market from the activities of the beneficiaries. In addition, the tax break is an export subsidy under article 3 of the SCM Agreement. In 1999, the WTO Panel found that the FSC regime constituted a prohibited subsidy pursuant to article 3.1(a) of the SCM Agreement. In 2000, the Appellate Body report upheld the Panel's ruling.

To summarize, the WTO has clearly identified both the DISC and FSC regimes as red-light STZs. This case study shows that the restrictions imposed by the WTO on STZs have impacted developed countries as well. However, the difference in this scenario is that developed countries generally have competitive and long-established industries that are generally not impacted by competing foreign investment once the export requirements are removed.

7.3.4. Case study 3: Service/financial STZs in the developed world: The interest portfolio exemption

In 1984, Congress repealed the US withholding tax on portfolio interest income earned by foreigners.[40] "Portfolio interest" was defined as including interest on US government bonds, on bonds issued by US corporations (unless the bondholder held 10% or more of the shares of the corporation) and on US bank accounts and certificates of deposit. In the short run, the portfolio interest exemption was motivated by the immediate desire of both the US government and US multinationals to borrow abroad without having to bear the cost of any withholding tax. In the long run, however, other policy arguments were weighed. The reform was intended to bring back to the United States some of the financing activity that shifted to London in the 1970s and 1980s and recapture the related employment and tax receipts from this sector of the economy.[41] Indeed, an estimate discussed in the con-

40. US: Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127(a), 98 Stat. 494, 648-50 (codified as amended at I.R.C. § 871(h) (1994)).
41. US: 1983-84 Misc. Tax Bills VI: S. 1066, S. 1550, S. 1557 and S. 1666: Joint Hearings before the Subcommittee on Savings, Pension, & Investment Policy and Subcommittee

gressional debates forecasted the creation of 250,000 new jobs as a result of the tax reform.[42]

The United States' enactment of the portfolio interest exemption has resulted in a classic race to the bottom because most developed countries followed the United States and eliminated their withholding tax on interest paid to non-residents on bank deposits and on government and corporate bonds to protect their banking and financial activities.[43] In addition, some developed countries went further and included exemptions of dividend payments limited to non-residents (e.g. the Netherlands).

From a technical perspective, the portfolio interest exemption is a preferential tax regime because its beneficiaries do not have to pay taxes for the receipt of interest that qualifies as "portfolio." In addition, this preferential tax regime is ring-fenced because the tax residents of the sponsoring country are excluded from the tax benefits offered by the regime. For example, in the case of the United States, the tax residents must include the portfolio interest received in their gross income and pay taxes accordingly, while the non-residents (with no trade or business in the United States) are not required to pay any income tax on this type of interest.

If the SCM Agreement were applicable to services, the portfolio interest exemption could be considered a yellow-light STZ regime because the subsidy is specifically oriented towards a service sector (banking and financing activities). From a technical standpoint, the subsidy benefits the foreign creditor and not the bank of the sponsoring country because the former is the technical taxpayer of the withholding tax. From an economic perspective, however, the subsidies benefit the banks, which increase their international competitiveness (due to the reduction of the borrowing cost) and attract more portfolio investment from other countries. Finally, these subsidies produce a serious prejudice to other WTO members. Latin American countries provide a prime example: after the enactment of the portfolio interest exemption, about USD 300 billion fled from Latin American countries to bank accounts and other forms of portfolio investment in the United States. Most of these funds were channeled through tax haven corporations and therefore escaped taxation in the country of residence. Estimates of

on Taxation & Debt Management of the Senate Committee on Finance, 98th Cong., 1st Sess. 30-31 (1983), p. 244 (statement of John Evans of Morgan Stanley & Co.).

42. M. Doskey Franson, *Repeal of the Thirty Percent Withholding Tax on Portfolio Interest Paid to Foreign Investors*, 6 Nw J. Int'l L. & Bus., p. 930 (1984-1985).

43. R. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 7, pp. 1573-1676 (2000).

the capital flight from all developing countries to the United States in the 1980s reached as high as USD 148 billion in a single year.[44] In this regard, the domestic economy of the sponsoring country is not affected by the tax break because the benefits are ring-fenced to non-residents. However, as explained, the SCM Agreement does not impose limitations on this practice because it is not oriented towards promoting trade in goods.

This situation unveils a clear disparity in treatment between developed and developing countries. Developed countries have had leeway to use ring-fenced schemes as a tool to perpetuate their competitive advantages in the field of banking and financial activities and to enlarge the development gap with developing countries. This form of tax competition, tolerated by the OECD and the WTO, has fueled the process of capital flight in developing countries, destroyed their currencies and weakened their sovereignty.

7.4. EU State aid rules and STZs

7.4.1. Overview of the EU State aid rules

The European Union has also developed a legal framework for state-provided tax incentives, including STZs. These rules, generally known as "State aid rules," differ from the WTO rules with respect to their underlying goals, enforcement procedures and scope.

With respect to the underlying goals, the WTO's foundational principles are market access, non-discrimination and fairness in trade. These policy goals, embedded in the WTO legal framework, are primarily related to the operation of the private economy[45] and generally do not address, at least directly, pathologies affecting the public economy, such as harmful tax competition, base erosion or profit shifting. In contrast, the EU legal framework is grounded on much further-reaching policy objectives such as, inter alia, the creation of an internal integrated market and even a political union among the EU Member States.[46] In that respect, the EU rules on State aid have been systematically used since the late 1990s as an instrument to tackle

44. Id.

45. C. Micheau, *State Aid, Subsidy and Tax Incentives under EU and WTO Law* (Wolters Kluwers 2014).

46. M.M. Slotboom, *Subsidies in WTO Law and in EC Law: Broad and Narrow Definitions*, 36 Journal of World Trade 3, pp. 517-542 (2002).

harmful tax competition within the European Union,[47] on the assumption that harmful tax competition is incompatible with the internal market.[48]

With respect to the general content, the WTO system includes subsidies that are forbidden in any case (red-light subsidies), subsidies that are forbidden only if they result in measurable adverse effects (yellow-light subsidies) and other subsidies that are allowed (green-light subsidies). These rules are not applicable in the field of services. The State aid rules, on the contrary, apply to any type of business, including services, and were designed as a bipolar legal system in which the government aid is treated as either compatible or incompatible with the internal market. There is not a third category subject to different requirements like in the WTO system. However, the line between compatible and incompatible aid is more blurred in the EU system than in the WTO system because certain State aid could be subject to a discretionary assessment and considered compatible by the European Commission (e.g. situations involving the development of economically depressed areas and certain economic activities).

Before assessing the specific application of the State aid rules to STZs, it is useful to outline, in a brief summary, the main features of the State aid legal framework as reflected in EU law, Commission pronouncements[49] and court decisions.

7.4.2. Incompatible State aid

The Treaty on the Functioning of the European Union[50] (TFEU) defines State aid in article 107(1), which reads:

> Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distort competition

47. Commission Communication to the European Parliament and the Council, First annual report on the implementation of the Code of Conduct on Business Taxation and fiscal State aid – Progress report on the work concerning the taxation of income from savings and a common system of taxation for interest and royalty payments between associated companies, COM (1998) 595 final (25 Nov. 1998).
48. Commission Communication, *Towards tax co-ordination in the European Union – A package to tackle harmful tax competition*, COM (97) 495 final (1 Nov. 1997). *See also* Resolution of the Council and the representatives of the Governments of the Member States meeting with the Council of 1 December 1997 on a Code of Conduct for Business Taxation, OJ C2/6.
49. The Commission issued in 2016 a Notice on the notion of State Aid as referred to in Article 107(1) TFEU, C/2016/2946, OJ C 262, 19 Jul. 2016.
50. Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, OJ C 326 (2012).

> by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

Based on this definition, the Court of Justice of the European Union (ECJ) has held that State aid exists when a national measure (i) is financed by the state through state resources; (ii) provides an advantage for an undertaking; (iii) is selective; and (iv) affects trade between Member States and is incompatible with the internal market.[51]

The definition provided by article 107(1) and its reference to "any aid granted by a member State or through State resources in any form whatsoever" clearly supports the idea that a direct or indirect tax incentive granted by a Member State would constitute State aid if it results in a selective advantage that is incompatible with the internal market. Under EU law, a tax incentive includes an advantage in the calculation of the tax base, applicable tax rate, assessment of the tax liability or enforcement of a tax claim. In recent investigations, the European Commission also included transfer pricing rulings in contradiction with the arm's length principle.[52]

The tax incentive must provide a selective advantage. This requirement is satisfied when the tax burden of certain undertakings is reduced with respect to the normal tax regime generally imposed by the Member State, which is intended to be the general framework within which the effects of a measure are to be analysed.[53] For the purpose of this analysis, the EU courts have elaborated the following three-step test:
- step 1: identification of the system of reference;
- step 2: assessment of whether the measure at issue constitutes a derogation from the identified system in that it differentiates between economic operators that are, in the context of the economic system in question, in a comparable situation (derogation test); and
- step 3: evaluation of the possible justification of the measure by the nature of the general scheme of the system itself (justification test).

Based on this three-step test, the ECJ's case law and the Commission's practice have outlined different types of tax selectivity. For example, tax

51. BE: ECJ, 15 June 2006, Joined Cases C-393/04 and C-41/05, *Air liquid Industries Belgium SA v. Vile de Seraing a.o.*
52. N. Robins & S. Shamsi, *The European Commission's State Aid Clampdown: The End of "Selective" Tax Rulings?*, 18 Derivs. and Fin. Instrums. 1 (2016), Journals IBFD.
53. R. Cisotta, *Criterion of Selectivity*, in *State Aid Law of the European Union* p. 133 (H. Hofmann & C. Micheau eds., Oxford U. Press 2016).

selectivity can be based on the taxpayer's structure (e.g. considering its size, public or private status or legal entity form) or on its activities (e.g. tax benefits for textile activities or car manufacturers). It can also be based on national criteria (e.g. tax benefits on national products), on a territorial basis (e.g. tax benefits limited to a certain territory) or on other factors (e.g. employment considerations or environmental or economic impact). The Commission has also considered certain tax benefits as de facto selective when the measure was formally available for all the taxpayers but, in practice, only benefitted certain specific companies or businesses.

Finally, a selective tax incentive would constitute State aid if it is deemed incompatible with the internal market. The ECJ case law generally does not require an actual analysis of these criteria,[54] and there is no indication that the distortion of competition has to be significant or substantial.[55] In that respect, it seems that the Commission and the ECJ generally presume that this requirement is satisfied when the other conditions are met.

7.4.3. Compatible State aid

The general concept of State aid provided by article 107(1) recognizes several exceptions under article 107(2) and (3) of the TFEU.

Under article 107(2) of the TFEU, the following types of aid are regarded as being compatible with the internal market:
- aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned (article 107(2)(a));
- aid to compensate for damage caused by natural disasters or exceptional occurrences (article 107(2)(b)); and
- aid granted to the economy of certain areas of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division.

Besides aid that is de jure consistent with the internal market, certain State aid could be subject to discretionary assessment and considered compatible by the Commission in situations involving the development of economically depressed areas, certain economic activities, cultural and heritage

54. IT: Court of First Instance), 4 Apr. 2001, Case T-288/97, *Regione Friuli Venezia Giulia v. Commission of the European Communities*.
55. BE: ECJ, 21 Mar. 1990, Case C-142/87, *Kingdom of Belgium v. Commission of the European Communities*.

conservation and other categories specified by the decision of the Council in a proposal from the Commission. A tax incentive found to constitute illegal State aid would automatically be abolished or altered, and the European Commission can recover the aid from the taxpayer, together with interest, over a period of up to 10 years.

7.4.4. State aid and STZs

The tax benefits provided by STZs generally qualify under the definition of State aid provided by article 107(1) of the TFEU. Moreover, the Commission and the European courts have considered that a tax incentive is selective in nature when the state ring-fences the benefit on a geographical or sectoral basis. In its 2016 Notice,[56] the Commission stated that any measure of which the scope does not extend to the entire territory of the state should be considered selective. In the *Azores* decision, however, the ECJ clarified this interpretation for the case of a tax incentive provided by a regional or local government.[57] In this regard, the Court acknowledged that an intra-state entity can enjoy sufficiently autonomous status so that the territory of the intra-state entity may be the relevant framework for assessing the selectivity of the measure.[58] The Court also stated that an intra-state entity is deemed to have sufficient autonomous status when (i) it has political and administrative status separate from the central government; (ii) the financial repercussion of the tax incentive is not compensated by the central government; and (iii) the measure can be adopted without the central government having the ability to interfere with its substance.

Based on the aforementioned interpretations, STZs appear to be incompatible with the internal market by nature. This conclusion, however, can certainly be questionable when the exceptions provided for in article 107(2) and 107(3) of the TFEU are included in the equation. Indeed, the State aid rules provide that a selective tax incentive can still be considered compatible with the internal market if the policy objective of such an incentive falls within the specific categories of article 107(2). Under article 107(2), the following aid is considered compatible with the internal market: (i) aid with a social character that is granted to individual consumers; (ii) aid granted in case of damages caused by natural disasters or exceptional occurrences; and (iii) aid granted to the economy of certain areas affected by the division

56. Commission Notice on the notion of State Aid, *supra* n. 49.
57. PT: Grand Chamber, 6 Sept. 2006., Case C-88/03, *Portuguese Republic v. Commission of the European Communities*, Action for annulment – State aid decision 2003/442/EC-.
58. Micheau, *supra* n. 41.

of Germany. In addition, under article 107(3), the Commission has discretion to consider whether the following aid is compatible with the internal market: (i) regional aid; (ii) aid promoting an important project of common European interest; (iii) aid granted to remedy a serious economic disturbance; and (iv) aid supporting culture and heritage conservation.

In addition, when the State aid fits within any of the categories of article 107(3), the European Commission has exclusive competence to declare such State aid as compatible with the internal market. With respect to regional aid, the Commission has laid down a comprehensive set of guidelines describing specific regions where State aid would be judged as "good aid." In general, these are the regions where the standard of living is abnormally low or where there is serious underemployment. The guidelines also describe the type of aid that is admitted and the type of investments that are eligible.

In summary, the application of the EU State aid rules may require additional judgement on the policy reasons underlying the creation of an STZ. This additional judgement results in certain STZs being treated as good aid and others being treated as incompatible aid. For example, the Shannon STZ in Ireland was rejected for State aid approval and is no longer eligible under the regional aid exceptions. Since 2003, the Shannon STZ has been exposed to Ireland's mainstream corporate tax rate of 12.5%. On the other hand, the Madeira Free Zone (MFZ) in Portugal has been respected and considered good aid by the European Commission under article 107(3) of the TFEU. The MFZ was created in Portugal on the island of Madeira and currently operates an industrial free zone, an international services centre, an international shipping registry and, beginning in 2015, an air transport register.

The current MFZ is the third subsequent aid scheme implemented by Portugal and approved by the Commission in the exercise of the discretionary powers granted by article 107(3). The first regime was authorized in 1987, and companies were able to benefit from it until 31 December 2011.[59] The second regime was authorized by the Commission in 2002, with the same end date as the first. Starting on 1 January 2012, the companies registered under the second regime can only benefit from the provisions of the third regime.[60] The third regime, which is the current regime, offers

59. Commission decision SG(87) D/6736 of 27 May 1987 in Case N 204/86, prolonged by Commission decision SG(92) D/1118 of 27 January 1992 in Case E13/91 and again prolonged by Commission decision SG(95) D/1287 of 3 November 1995.
60. Bras et. al, *The Madeira Free Zone and Its Standpoint within the European Union*, 13 EC Tax Review 3, p. 124 (2004).

considerably reduced rates for income and withholding taxes on revenue generated within the zone. All of these regimes have been subject to the scrutiny of EU State aid rules and deemed permissible within the meaning of regional development aid. The Commission determined that the tax incentives granted by the MFZ constitutes State aid within the meaning of article 107(1) of the TFEU. The Commission relied on the fact that the aid granted by the MFZ is directed towards an outermost region and is intended to offset the additional costs arising in the economy of Madeira as a result of its remoteness, insularity, small size, difficult topography and climate, economic dependence of a few products, etc. Based on those policy goals, the Commission found the scheme to be compatible with the internal market pursuant to article 107(3)(a), as it was targeted to address the specific handicaps of Madeira, as an outermost region, and was proportional, since its conditions had the result of it not leading to overcompensation of the additional costs of the aid beneficiaries.

Decisions such as those regarding the MFZ demonstrate that the EU legal framework provides a degree of flexibility that is not present in the WTO system, which does not consider the objectives and policies pursued by the states when they create an STZ. On the flipside, the inclusion of policy considerations in the equation raises a higher level of legal uncertainty that generally is not present in the WTO legal framework.

7.5. Conclusion

Since the SCM Agreement was enacted in 1995, global leadership in the field of STZs has shifted from the OECD to the WTO. The general WTO Agreement includes a broad set of policy goals that goes beyond trade relationships, but its legal framework has been systematically narrowed down to the task of assuring market access, non-discrimination and fairness in trade. Other relevant issues that impact trade, such as harmful tax competition or tax base erosion, have been treated as secondary agenda items and are insufficiently weighted.

As of today, more than 20 years since the enactment of the first WTO Agreements, the WTO's overall treatment of STZs appears to be inconsistent with the general policy goals of the organization. While service-oriented STZs generally remain free from challenges because there are no formal subsidy rules concerning services, manufacturing-oriented STZs with substantial activities have been significantly curtailed by the SCM Agreement. The disparity in the treatment of goods and services has produced a negative

impact on developing countries, as they tend to rely more on manufacturing STZs to achieve economic growth, while it has benefitted developed countries, which rely more on offshore banking, technology and financial service STZs in order to attract investment.

The fairness and distributional concerns raised by this disparity in treatment have also been overlooked, on the ground that the objectives of the WTO are limited to market access, freedom and non-discrimination in trade. This perspective, however, is inconsistent with the rationale and general policy goals of the organization, as provided by the main WTO Agreement. The WTO would do well to examine its differential treatment of service versus manufacturing STZs in light of this disparate treatment of regimes in developing versus developed countries.