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Tax, Trade, and Harmful Tax Competition: Reflections on the FSC Controversy

by Reuven S. Avi-Yonah

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The current controversy over foreign sales corporations (FSCs) provides a good opportunity to address the broader question of the proper relationship between the international income tax regime and the WTO. In particular, can one identify aspects of international taxation that are subject to the jurisdiction of the WTO, as reflected in the General Agreement on Tariffs and Trade (GATT)? This article will argue that there are certain aspects of current international income tax practice that are subject to the jurisdiction of the WTO. In particular, many of the regimes identified by the OECD as constituting harmful tax competition should also be considered export subsidies under article XVI of the GATT, and, therefore, as being subject to challenge under WTO procedures, just as the FSCs were challenged by the EU.

The article is divided into three parts. Part I is a general description of those parts of the GATT that relate to taxation. Part II concludes that most production tax havens, and some traditional and headquarters tax havens, constitute export subsidies under the GATT. Finally, Part III asks whether harmful tax competition is better addressed by the WTO or by organizations with less binding adjudicatory power, such as the OECD. It concludes that, while in the short term the OECD has the advantage, the WTO may provide a better forum in the longer term.

I. The GATT and Taxes

There are two articles of the General Agreement on Tariffs and Trade 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." Because of the reference to products, this provision has generally been understood as referring only to indirect taxes (i.e., excise taxes or consumption taxes such as 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.

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." 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." 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." Article XVI was significantly expanded by the Subsidies Code included in the 1994 version of the GATT. The Subsidies Code defines "subsidy" as including cases where "government revenue that is otherwise due is foregone or not collected." 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 "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). Because services frequently involve 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."14 In addition, most favored nation (MFN) treatment can be avoided if the difference in treatment follows from a tax treaty.15

II. Application of GATT Rules to Tax Havens

In previous work, I have identified three types of tax havens: (a) "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; (b) "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 (c) "headquarters tax havens," i.e., regimes designed to attract multinational enterprises to locate their headquarters in a jurisdiction by promising no taxation (or no current taxation) of income derived from foreign subsidiaries.16 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 generally "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 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).17

It would seem that such production tax havens constitute prohibited export subsidies under the GATT. They generally involve foregone revenue (i.e., are tax expenditures), are specific to certain taxpayers (in fact they are frequently negotiated deals), and are "in fact" contingent on export performance, because the products or services 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 that 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 financial services, such as brokerage or insurance, targeted entirely at foreigners (and frequently ring fenced as well). Thus, arguably, traditional tax havens, or at least that part of their activities that is more than...
pure passive investment, fall within the prohibition on export subsidies as well. Moreover, since they are generally not party to tax treaties, the exclusion of treaty matters from GATS does not cover them.

The toughest cases are headquarters tax havens. This covers specific regimes designed to attract foreign multinational enterprises (MNEs), which are akin to production tax havens. Those are presumably export subsidies for the reasons stated above. 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. But usually there is also the provision of services and/or transfer of intangibles, and frequently also the sale of goods to the foreign subsidiaries. In these cases there is trade, and the provision could be an export subsidy.

The ultimate question in this regard is whether deferral or exemption is a tax expenditure, because foregone revenue is a precondition to finding a subsidy under the GATT. In a worldwide regime such as the United States, the answer is clearly yes (and deferral is in the tax expenditure budget). What about an exemption regime? The Europeans have argued 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 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 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.

In the short run, the OECD is clearly the superior forum to address the problem of harmful tax competition because of the progress it has already made on this issue.

III. Should Harmful Tax Competition Be Addressed Through the WTO?

I have argued elsewhere that the problem of harmful tax competition cannot be adequately addressed by the current international tax regime based on bilateral treaties. 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.

The OECD is clearly the superior forum in the short run because of the progress it has already made on the issue. However, in the long run, relying on the OECD to restrict harmful tax competition suffers from three significant drawbacks. First, the OECD only has 29 members, and it is not clear that it can effectively enforce its anti-tax competition rules on non-member countries. For example, solutions that rely on where the parents of MNEs are located assume that no significant growth in MNEs will take place outside the OECD, and solutions that rely on the OECD as the market assume no significant markets outside the OECD. Either assumption may become wrong, and 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 joined the OECD recently (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 harmful 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

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18 That is why the new U.S. exclusion for "qualifying foreign trade income" (new code section 114) seems unlikely to pass W TO muster, since it operates in the context of a worldwide tax regime.

19 Note, however, that the FSC report does seem to approve of "territorial tax systems." But this is dicta; if the case ever came before the WTO, the U.S. seems to have a stronger argument for complaining about the European exemption systems than most tax experts assume.

20 See Avi-Yonah, Globalization, supra.

21 The EU effort is even more limited in scope, and has run into significant problems because of this, as the recent developments on taxation of savings make clear (the U.K. and Luxembourg will cooperate only if Switzerland and the U.S. do).
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 does so.

Third, the OECD effort is limited so far 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 has only 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 the WTO, as well as by events at Seattle). Moreover, as indicated above, the WTO rules already cover and prohibit most 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. 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. Green argues that the need for the WTO to resolve trade disputes legally 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. In an assurance (stag hunt) game, both players cooperate if they can be assured of the other player’s cooperation. In the first case, an organizational setting is needed to manage retaliatory strategies while, in the second, it is needed to provide the information required 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 re-impose its tax without adequate assurance that other countries will follow. Similarly, for direct investment, countries have adopted tax incentives or have adopted deferral and exemption rules for their resident MNEs in response to the actions of other countries and fear of 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 effectively resolve.

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, 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, at the last minute, on excluding direct taxes from the purview of the GATS. Green argues that if the WTO dispute resolution mechanism were given authority over tax issues, this may lead to widespread noncompliance, espe-

25 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 “Antilegalistic Approaches,” supra.
26 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 cooperate 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.
27 See “Antilegalistic Approaches,” supra.
cially given the perception that the WTO is non-transparent and that it lacks democratic legitimacy. Green may be wrong about this estimate, especially since the analysis above has shown that the WTO already has jurisdiction on most forms of harmful tax competition, so that further extension of its powers would be unnecessary. 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 DISC case in the GATT and the adoption of the tax competition report by the OECD show, a country will typically reserve its veto power only to those cases in which the adverse result is truly perceived as a severe limit on its sovereignty. In other cases, the stigma of disapproval is sufficient to ensure cooperation.

IV. Conclusion

The OECD's effort to combat harmful tax competition has so far been a remarkable success, achieving much more progress in a short time frame than most observers would have predicted when it started in 1998. However, the hard part is yet to be tackled: will countries actually give up their preferential tax regimes under the timetable devised by the OECD? In addition, the OECD has not yet addressed the problem of preferential regimes for real investments, and it is unclear whether it can achieve progress on preferential regimes in non-member countries.

From this perspective, I believe that it is helpful and not harmful to the OECD effort (which I wholeheartedly support) to point out that most of the preferential tax regimes identified by the OECD may also be export subsidies, and therefore subject to attack under current WTO rules. The prospect of repeating the FSC struggle over and over again on a worldwide basis may indeed be a powerful impetus for inducing both member and non-member countries to cooperate with the less coercive and less costly OECD effort. But should the OECD effort fail, then serious consideration should be given to pursuing the goal of limiting harmful tax competition through the WTO, in the ways outlined above.

28 See id.; see also Joel P. Trachtman, “The Domain of WTO Dispute Resolution,” 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.

29 Of course, this assumes that some forms of tax competition should be limited. For the normative argument as to why they should, as well as an attempt to distinguish, on a principled basis, harmful from beneficial tax competition, see Avi-Yonah, supra.