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# Trade and Taxation

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# PANEL IV: THE PURSUIT OF NATIONAL TAX POLICIES IN A GLOBALIZED ENVIRONMENT

# PRINCIPAL PAPERS

## TRADE AND TAXATION

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### I. INTRODUCTION

The interaction of trade and taxation has been tense for the past quarter century. Those responsible for government tax policy, particularly in the United States, generally have expressed the view that trade agreements such as the World Trade Organization (WTO) or the North American Free Trade Agreement (NAFTA) should not impact the tax system(s) of a country; the interaction of tax systems should remain the subject of bilateral tax treaties. The European Union (EU), on the other hand, has moved more aggressively to bring trade and tax rules into closer harmonization. But the theoretical bases for either view have not been expressly explored, so far as I am aware.[1]

The purpose of this paper, therefore, is to establish in Part II, the normative bases for tax policy and trade policy (both

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1. *See* Ferdinand P. Schoettle, *Big Bucks, Cloudy Thinking: Constitutional Challenges to State Taxes - Illumination from the GATT*, 19 VA. TAX REV. 277 (1999) (addressing topics discussed in this article from a different perspective).

unilateral and bilateral) and to assess whether there is any inherent conflict between the two. Part III describes how tax and trade policies in fact have intersected over the past 25 years through the WTO (and its General Agreement on Tariffs and Trade (GATT) predecessor institutions) and the EU.[2] Part IV then provides a model under which normative tax and trade polices both can be pursued and, at the same time, offending provisions in a country's fiscal law can be subjected to agreed upon trade rules.[3]

## II. NORMATIVE BASES FOR TAX AND TRADE POLICY

### A. *Taxation*

A tax system must provide the answers to six questions:

1. What is the tax base?
2. What are the tax rates?
3. Who is to pay the tax (the taxable unit)?
4. When is the tax to be paid (accounting rules)?
5. How is the tax to be applied in cross-border transactions?
6. How is the tax to be administered?

It is important to understand that these are the *only* questions that *must* be addressed to establish a tax system. It is not necessary to address other questions, such as how to provide financial incentives or cost-sharing subsidies for specific economic or social activities. These questions may be raised, but in the analytical model set forth above, they are extraneous to the task of providing the structural elements required for an operative tax system.

The following summarizes briefly the issues involved as a country answers each of the above questions.

*The Tax Base.* The position taken here, and articulated in greater detail elsewhere, is that there is a normative or benchmark structure for any global tax system.[4] Thus, for an income

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2. Since taxation is excluded from NAFTA, that agreement will not be considered. *See* Paul R. McDaniel, *Formulary Taxation in the North American Free Trade Zone,* 49 TAX L. REV. 691 (1994).

3. This subject briefly was outlined by me in *The Impact of Trade Agreements on Tax Systems, in* STAATEN UND STEUREN (Paul Kirchkof et al. eds., C.F. Müller Verlag 2000) (a *feschrift* in honor of Professor Klaus Vogel).

4. *See* STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 186-87 (Harvard University Press 1985).

tax, the Schanz-Haig-Simons definition (personal income equals an individual's increase in net worth plus consumption between two points in time) provides that structure. A consumption tax falls on all expenditures for personal consumption, either on an *in rem* or personal basis. *Provisions in a country's law that deviate from these normative or benchmark structures are therefore to be analyzed as performing some other governmental role—e.g., spending, regulation—but not as tax rules.*[5] This point cannot be over-emphasized as it is crucial to the conclusions reached in this paper on the relation between tax systems and trade agreements. In this paper, I shall focus exclusively on the income tax.

*Tax Rates.* Countries can choose any generally applicable rate structure—progressive, proportional or even regressive.[6] But suppose there are deviations for specified classes of taxpayers or activity, *e.g.*, foreign investors or investment in a particular region of a country. In these cases, fiscal and trade rules may come into conflict.

*Taxable Unit.* In the case of individuals, the issues are whether to treat married couples as one or two taxpayers, whether to treat children as part of the parents' taxable unit, and so forth. In the case of corporations, the issues are whether to treat shareholders and corporations as separate taxpayers or to adopt some generally applicable method of integrating corporate and personal income taxes.[7] Countries may reach different conclusions on these issues. Again, if the rules adopted create special treatment for selected classes of taxpayers, there is a potential for conflict between fiscal and trade policies.

*Accounting period.* This question requires two responses. First, the time period itself must be established as, for example, one year. Second, rules must be provided to determine the proper period to which an item of income or deduction is to be assigned. Generally speaking, financial accounting standards can be employed although some deviations may be required to

5. This methodology was applied by tax experts from six OECD countries in INTERNATIONAL ASPECTS OF TAX EXPENDITURES: A COMPARATIVE STUDY (Paul R. McDaniel & Stanley S. Surrey eds., 1985).

6. *See* SURREY & MCDANIEL, *supra* note 4, at 191-92.

7. *Id.* at 190-191.

simplify tax administration or protect the revenue.[8] But deviations may be provided to achieve other economic or social objectives and, once again, there is the potential for interaction between fiscal and trade policies.

*Cross Border Transactions.* It is in this area that fiscal and trade policies most often intersect. In general, a residence country may choose one of three systems to apply to outbound transactions: worldwide taxation of income with a credit for foreign taxes paid; exemption of income derived outside the residence country; or, worldwide taxation with a deduction for foreign taxes paid.[9] There generally are accepted approaches for the application of any of these three methodologies, although as to any one there may be technical differences between countries in implementing them. Each approach, generally applied, is consistent with a benchmark structure. But countries, regardless of the approach adopted, often seek to achieve other economic objectives, for example, increasing exports. Obviously, in such situations the interactions of trade and fiscal rules can create conflict.

*Tax Administration.* Rules are necessary to provide a country with the ability to administer its tax system(s).[10] So long as the rules apply uniformly to all taxpayers and are transparent, no problems are created for trade. But if these conditions are not met, interferences with trade rules are possible.[11]

The statutory provisions and administrative actions that implement the foregoing normative or benchmark structure of a tax system are concerns of tax policy. We now turn to an examination of the normative elements of trade policy in order

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8. *Id.* at 188-90.

9. *Id.* at 192-93. For purposes of this paper, I adopt exclusive residence country taxation as the theoretically desirable approach although in practice, of course, countries exercise extensive source-based taxation.

10. *Id.* at 193-94.

11. *Cf.* ORGANIZATION FOR ECONOMIC COOPERATION & DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 28-30 (1998). Although the issues raised by the OECD report obviously are related closely to those considered in this paper, the OECD work will not be further analyzed. My interest is in formal trade agreements; the work of the OECD goes well beyond trade. In addition, the theoretical models for assessing the effects of tax competition are different from trade theory. *See* John Douglas Wilson, *Theories of Tax Competition*, 52 NAT'L TAX J. 269 (1999).

to assess the potential interactions between the tax system and trade policy.

### *B. Trade Policy*

The basic premise of free trade, advanced since the time of Adam Smith and David Ricardo, is that the welfare of residents of all countries is enhanced if they can purchase goods and services at their lowest prices on the world market. The essential principle in this premise is that of comparative advantage. This principle in turn rests on the proposition that countries differ in their ability to produce particular goods or provide needed services. Thus, if a country specializes in producing the good or providing the services which it can do more efficiently than other countries, and trades those goods or services for products of other countries, everyone's welfare is enhanced.[12]

Conversely, the welfare of all is reduced if the prices consumers pay are distorted by governmentally mandated tariffs, subsidies, taxes, regulations, import or export quotas, or other administrative burdens.[13] All of these techniques share a common feature: They differentiate between foreign and domestic producers of goods or suppliers of services, *e.g.*, by providing subsidies to foreign producers not available to domestic ones, by imposing barriers on foreign producers not imposed on domestic producers, or by subsidizing exports. In the case of subsidies, the economic benefit may be provided either by direct governmental outlays or through provisions in its tax system. Similarly, restrictions on proscribed activity can be imposed by regulation or by provisions in its tax system.

The question then becomes, do normative free trade policies and normative income tax policies conflict?

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12. For an accessible (to a non-economist) discussion of the principles summarized in the text, see ALAN C. SWAN & JOHN F. MURPHY, CASES AND MATERIALS ON THE REGULATION OF INTERNATIONAL BUSINESS AND ECONOMIC RELATIONS 404-09 (Matthew Bender 1999). Some economists argue that the premise of free trade is so strong, that a country can enhance the welfare of its own residence by adopting a free trade policy even if other countries do not. *See* PAUL R. KRUGMAN & MAURICE OBSTFELD, INTERNATIONAL ECONOMICS: THEORY AND POLICY 112 (2d ed. 1991).

13. *See* Jagdish H. Bhagwati, *Challenges to the Doctrine of Free Trade*, 25 N.Y.U. J. INT'L L. & POL. 219 (1993).

*C. Conclusion*

The foregoing discussion has demonstrated that, as a conceptual matter, there is no inherent conflict between a normative income tax and optimal trade policy. From a unilateral point of view, an accrual basis, full loss offset income tax, using an accepted form of treatment of cross-border transactions, should not interfere with the free trade objectives of that country or its trading partners. It is not the provisions that implement a *tax* system that conflict with free trade objectives. Rather, those provisions that are not necessary to implement a tax system—subsidies or penalties—create problems for achieving free trade objectives.

This does not mean, however, that taxpayers and fiscal authorities cannot encounter situations of double taxation or non-taxation in cross-border transactions. The fact that countries can and do give different answers to the basic, or aspects of the basic, questions means that potential non-neutralities can exist even in a world in which no country sought to use its tax system to encourage particular economic activity or subsidize selected social concerns.[14] Thus, from a bilateral or multilateral perspective, it is possible for two or more inconsistent aspects of normative or benchmark income tax systems to create distortions in the location and form of investment. In a world of "perfect" income tax systems, then, coordination among nations is required if these distortions are to be eliminated. But, I believe that the following discussion will demonstrate that these distortions are not those to which trade agreements are directed.

We now turn to an analysis of actions taken by the WTO (and its predecessor GATT institutions) and the EU with respect to provisions included in a country's tax law. The objective is to see if these actions fit within a model that reconciles these actions with a policy of non-interference in member states' *tax* systems as a result of entering into a trade or common market agreement.

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14. *See* H. David Rosenbloom, *International Tax Arbitrage and the International Tax System*, 53 TAX L. REV. 137 (2000) (arguing that these situations should not be a matter of concern for fiscal authorities). For a counterview, see Reuven Avi-Yonah, *Commentary*, 53 TAX L. REV. 167 (2000). *See also infra* note 65.

## III. INTERACTION OF TRADE AGREEMENTS[15] AND TAX REGIMES

### A. *WTO (GATT)*

The pre-1985 version of GATT does not appear to have been invoked frequently with respect to the tax rules of signatory states. The notable exception is the challenge by the European Community and Canada to the U.S. Domestic International Sales Corporation (DISC) regime.

Pursuant to GATT procedures, the GATT Council established a panel of experts to consider the challenge to DISC. The panel first concluded that DISC conferred a tax benefit "essentially related to exports."[16] The Treasury aggressively promoted the use of DISCs by U.S. corporations and it issued annual reports showing that exports had increased as a result of the DISC regime. This evidence made it rather easy for the panel to conclude that DISC constituted an "export subsidy."[17] The pre-1985 GATT applied only to a remission of tax or an exemption from tax. DISC, on the other hand, constituted tax deferral as tax was imposed at the time DISC profits were remitted to its parent corporation. However, tax deferral is the equivalent of an interest-free loan. The lack of an interest charge for the deferral, therefore, constituted a partial tax exemption subject to GATT rules. This partial exemption (subsidy) in turn benefitted the U.S. export sector by reducing prices, increasing export sales efforts, and increasing profits for items exported that qualified for DISC benefits.[18] Accordingly, the panel ruled that the DISC regime violated U.S. obligations under GATT.[19]

As part of its defense, the U.S. filed a counterclaim, charging that the exemption system used by many European countries also violated GATT if the panel decided against the U.S.

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15. There are differences between a free trade agreement such as NAFTA and a common market such as the EU. *See* H.C.A.W. SCHULZE, INTERNATIONAL TAX-FREE TRADE ZONES AND FREE PORTS, A COMPARATIVE STUDY OF THEIR PRINCIPLES AND PRACTICES (Butterworths 1997). For purposes of this discussion, however, I use the term "trade" to include both types of agreements.

16. United States Tax Legislation, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 98, para. 67 (1977).

17. *Id.* para. 68.

18. *Id.* para. 72.

19. *Id.* paras. 73-74. The conclusion of the panel that the DISC provisions constituted a subsidy was consistent with the inclusion of DISC in U.S. Tax Expenditure accounts from its inception.

on the DISC issue.[20] The same GATT panel concluded the French exemption of income from export sales likewise was a subsidy under GATT. The key to this seemingly surprising result was that France, Belgium, and the Netherlands were applying their exemption systems to transactions that originated in their respective countries, not just to transactions that took place wholly outside their countries. By virtue of this treatment, the exemption provided a benefit for export sales not available to domestic sales and, hence, constituted a partial exemption from taxes for export income in violation of GATT. The opinion of the panel, thus, was not to be read as concluding that an exemption system as such, properly operated to apply only to transactions taking place outside the residence country, violated GATT.[21] This was made clear in a subsequent decision by the GATT Council affirming the earlier panel's results but explicitly stating that a "pure" (my term) exemption system did not of itself constitute an export subsidy.[22]

The 1979 GATT Subsidies/Countervailing Measures Agreement broadened the definition of tax related export subsidies to include "the full or partial exemption, remission or deferral [of tax] specifically related to exports."[23] The Agreement noted, in relation to the DISC case, that tax deferral need not be an export subsidy when an appropriate interest charge is imposed on the deferral.

The latter point is of interest as the U.S. Congress in 1984 moved to respond to the adverse decision on DISC. It retained the DISC provisions but imposed an interest charge on the tax deferral equal to the U.S. Treasury borrowing rate.[24] Presum-

20. *See* Income Tax Practices Maintained by France, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 114, para. 47 (1977); Income Tax Practices Maintained by the Netherlands, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 136 (1977); Income Tax Practices Maintained by Belgium, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 127 (1977).

21. *See* A.R. Prest, *GATT and Company Taxation*, 1977 BRITISH TAX REV. 201.

22. *See Tax Legislation*, Dec. 7, 1987, GATT B.I.S.D. (28th Supp.) at 114.

23. Agreements on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS, art. 1(1)(a)(1)(2), 33 I.L.M. 1226 (1994) [hereinafter Subsidies and Countervailing Measures].

24. I.R.C. § 995(f) (2000). No interest charge is imposed with respect to a "small" DISC, a corporation with less than $10 million of export sales. I.R.C. §

ably, this action precluded further objection to the new DISC regime.

At the same time, however, Congress instituted a new type of foreign corporation, the Foreign Sales Corporation (FSC).[25] Space does not permit detailed explanation of the FSC rules.[26] For our purposes, the important point is that the U.S. took the view that an exemption from tax on export income would survive a GATT challenge if all the economic activities to produce that income took place outside the U.S. Accordingly, a qualifying FSC was required to carry out significant economic activities outside the U.S. If this and other conditions were satisfied, part of the income of the FSC was exempt from U.S. tax.[27]

Unfortunately for the U.S., the FSC legislation contained a number of provisions that made it suspect under GATT:

> a. The exemption granted to an FSC was a deviation from the generally applicable U.S. system of worldwide taxation with foreign tax credit.
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> b. Despite the nominal requirement that economic processes take place outside the U.S., by agency agreements the FSC could have its U.S. parent or related subsidiary carry out all the activities in the U.S. As a result, a FSC was simply a paper corporation typically organized in a tax haven country.
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> c. In order to qualify for the exemption, no more than 50% of the fair market value of the exported property could be attributable to articles imported into the U.S.; a "rule of origin" in trade terms.
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> d. Special transfer pricing rules applied to transactions between the U.S. parent and its FSC which deviated from normal U.S. transfer pricing rules and were intended to maximize export sales profit in the FSC.

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995(b)(1)(E) (2000). However, the EU has not seen fit to challenge this relatively inconsequential provision. A subsidy element could be present in an interest charge DISC if a company's borrowing rate were in excess of the U.S. Treasury rate.

25. I.R.C. §§ 921-927 (2000).

26. *See* PAUL R. MCDANIEL & HUGH J. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 156-62 (4th rev. ed. 1998).

27. The amount exempted depended on the transfer pricing method adopted by the taxpayer. In general, the so-called "23%" method exempted about 15% of the combined taxable income of the U.S. parent and the FSC from qualified export sales; if the "1.83%" method were used, about 30% of the combined taxable income was exempt.

Subsequently, however, new rounds of GATT created the WTO and expanded significantly its scope with respect to taxation measures. The first step under the WTO processes is to establish that a challenged provision is a "subsidy." The Agreement on Subsidies and Countervailing Measures defines the term to include provisions pursuant to which "government revenue that is otherwise due is foregone or not collected (*e.g.*, fiscal incentives such as tax credits)."[28] A "prohibited subsidy" is one which is contingent on export performance or which requires the use of domestic rather than imported goods, *i.e.*, an export subsidy.[29] In turn, the term "export subsidy" is defined to include "full or partial exemption, remission or deferral, specifically related to exports, of direct taxes,"[30] and the allowance of "special deductions" directly related to exports or export performance.[31] To ensure that the special tax provisions are readily identifiable by all signatory countries, each country is required to submit by June 30 of each year a list of the subsidies it employs and the list must identify the form the subsidy takes, *e.g.*, tax exemption.[32] In 1998, the EU asked the WTO to investigate the validity under GATT of the U.S. FSC rules described above.

Pursuant to WTO procedures, a dispute panel was created to hear the dispute.[33] The EU initially advanced two principal bases to establish that the FSC rules constituted a "subsidy": (1) the exemption from tax accorded the FSC and any distributions out of income qualifying for the exemption to its U.S. parent; and (2) the derogation from normal U.S. pricing rules

28. *See* Subsidies and Countervailing Measures, at art. 1(1)(a)(1)(2).

29. *Id.* at arts. 3(1)(a)-(b).

30. *Id.* at Annex 1E.

31. *Id.* at Annex 1F. Tax subsidies for research and development are permitted if specified conditions are met. *Id.* art. 8(2)(a).

32. *Id.* at art. 25(3). Countries have begun filing the required reports. *See* U.S. Report to the WTO Committee on Subsidies and Countervailing Measures, G/SCM/N/3/USA Supp. 1 (Nov. 19, 1998).

33. The U.S. raised several jurisdictional arguments that the WTO should not be involved in resolving the dispute, among them a claim that the matter should be resolved under existing bilateral tax treaties. Panel Report on U.S. Foreign Sales Corporation Regime, WT/DS108/R (Oct. 8, 1999) paras. 4.89-4.98, *available at* http://www.wto.org [hereinafter Panel Report on U.S. Foreign Sales]. Interestingly, the EU responded that the "dispute is about a prohibited export subsidy and *is not a tax dispute.*" (emphasis added). The panel rejected the U.S. position. *Id.* paras. 7.12-7.22.

for an FSC.[34] Since the FSC benefits were contingent on export performance, the EU argued they constituted a "prohibited subsidy."[35]

Somewhat surprisingly, in response, the U.S. raised as its first argument the assertion that if the FSC regime were invalid under GATT, so were the exemption systems used by many countries in the EU.[36] It did concede the point made in Part II of this paper, that countries were free to adopt either a worldwide system or a territorial system. But it then introduced the logically fallacious argument that a country could have a "system" that incorporates elements of both.[37] The U.S. then went on at considerable length to rebut the EU's two arguments that the FSC regime—through its exemption and artificial transfer pricing rules—constituted an export subsidy. Having conceded that an exemption system is not an export subsidy, the U.S. argued that since FSCs simply replicated exemption systems they too did not constitute export subsidies.[38]

In response, the EU seized upon the facts noted earlier that the economic processes of a FSC all could be contracted back to the U.S. and that the transfer pricing rules for an FSC deviated from the normal U.S. rules to place a higher profit in the exempt pocket of the FSC.[39]

It is not possible here to summarize the hundreds of pages of argument and counter-argument between the EU and the U.S., as well as interventions from third-party countries. In the end, however, the panel ruled in favor of the EU and held that the FSC regime constituted a prohibited export subsidy. The panel concluded:

> 1. The FSC regime constituted a subsidy because it resulted in revenue foregone, *i.e.*, in examining the tax system of the U.S., revenue was lost by virtue of the tax exemption as compared to that it would have obtained under its generally applicable regime for taxing income of foreign subsidiaries.[40]

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34. *Id.* paras. 4.268-4.290.
35. *Id.* paras. 4.229-4.308.
36. *Id.* para. 4.310.
37. *Id.* para. 4.320.
38. *Id.* paras. 4.351-4.448.
39. Panel Report on U.S. Foreign Sales, *supra* note 33, paras. 4.609, 4.610, 4.618-4.633.
40. *Id.* paras. 7.98-7.100.

2. It was undisputed that the FSC scheme conferred a benefit.[41]

3. The subsidy was contingent upon export performance since only foreign trading income derived from export property qualified.[42]

Because its ruling on the exemption issue resolved the dispute, the WTO panel did not address the EU's claims with respect to the special transfer pricing rules available to an FSC,[43] nor its objection to the 50% domestic content requirement for a qualifying FSC.[44]

For purposes of this paper, the most telling sentences in the panel report were the following:

> [T]he United States is free to maintain a world wide system, a territorial tax system or any other system it sees fit. This is not the business of the WTO. What it is not free to do is to establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim it is entitled to provide such an export subsidy because it is necessary to eliminate a disadvantage to exporters created by the U.S. tax system itself. In our view, this is no different from imposing a corporate tax of, say, 75 per cent, and then arguing that a special tax rate of 25 per cent for exporters is necessary because the generally applicable corporate tax rates in other Members is only 25 per cent.[45]

In my view, the WTO panel got the matter exactly right, a point to which we shall return in Part IV.[46]

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41. *Id.* para. 7.103.
42. *Id.* paras. 7.108-7.111.
43. *Id.* para. 7.127.
44. *Id.* paras. 7.131-7.132.
45. Panel Report on U.S. Foreign Sales, *supra* note 33, para. 7.122.
46. Although not directly relevant to this paper, some subsequent history is interesting. The U.S. appealed the ruling of the panel to the WTO's Appellate Body. That body affirmed the panel decision on February 24, 2000. Tax Analysts 2000 WTD 38-33, WESTLAW, Feb. 25, 2000. On April 7, 2000, the U.S. announced that it would accept the WTO ruling. Tax Analysts 2000 WTD 70-2, WESTLAW, Apr. 11, 2000. The U.S. was given until October 1, 2000 to comply with the WTO ruling (later extended to November 1 and then informally to November 17). Negotiations with the EU as to an acceptable substitute extended through the summer of 2000, but no agreement was reached. Then, legislation revising the FSC regime was introduced in Congress. *See* Staff of Joint Committee on Taxation, Description of H.R. 4986, *reprinted in* FSC Repeal and Extraterritorial Income Exclusion Act of 2000, JCX-87-00 (July 27, 2000). On November 1, the

### B. EU: State Aids and the Code of Conduct

Article 92(1) of the Treaty of Rome provides that "any aid granted by a Member State or through State resources *in any form whatsoever* which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, insofar as it affects trade between member states, be incompatible with the common market."[47]

The European Commission (EC) has taken the position that special tax benefits fall within the quoted language.[48] According to the European Competition Commissioner Karel Van Miert, state aid in the form of a special tax benefit is subject to challenge if it meets four conditions: (1) beneficiaries must gain an advantage; (2) the country must pay for the advantage; (3) competition and trade among EU member states must be affected; and, most importantly, (4) the tax treatment must benefit only certain companies or productions.[49]

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Senate passed H. Res. 4986 repealing the FSC provisions and enacting a new "territorial" regime. *See* Staff of Joint Committee Technical Explanation of the Senate Amendment to H.R. 4986, The "FSC Repeal and Extraterritorial Exclusion Act of 2000," JCX-111-00 (Nov. 1, 2000), *reprinted in* Tax Analysts 2000 WTD 214-36, WESTLAW, Nov. 1, 2000. The House then adopted and passed the Senate bill on November 14. *See* Tax Analysts 2000 WTD 221-1, WESTLAW, Nov. 14, 2000. President Clinton signed the measure into law on November 15, 2000. The EU rejected the new legislation, European Union Trade Commissioner Pascal Lamy calling it "even worse" than the original FSC legislation. Tax Analysts 2000 WTD 226-9, LEXIS, Nov. 22, 2000. It is easy to understand the EU position. While purporting to grant a general exemption for foreign income, income does not qualify if it is not "qualifying foreign trade income." In addition, the agency rule that allows all production processes to take place in the U.S. is retained as well as the 50% domestic content rule. Finally, the special transfer pricing rules are replaced by special sourcing rules.

Accordingly, on November 17, 2000 the EU requested the WTO to authorize up to $4.03 billion in trade sanctions against the U.S. For details of the EU request and an indicative list of U.S. products subject to sanction, see Tax Analysts 2000 WTD 226-33, LEXIS, Nov. 22, 2000. As expected the U.S. rejected the claim for sanctions. *See* 89 TAX NOTES 1220 (Dec. 4, 2000). Final resolution of the issue under WTO procedures was not expected until mid-2001.

Finally, the U.S. battle on behalf of the FSC was, in fact, an effort on behalf of a very few large U.S. multinational companies. *See* Jose Oyola, *Foreign Sales Corporation Beneficiaries: A Profile*, 2000 TAX NOTES INT'L 157-40 (Aug. 11, 2000) (showing that the top 20 U.S. companies, ranked by the size of reported FSC benefits in 1998, obtained 87% of the total FSC benefits in that year).

47. Treaty of Rome, Mar. 25, 1957, art. 92, § 1, 1 C.M.L.R. 573.

48. That view was upheld in early decisions by the European Court of Justice. Case 70/72, Fed. Rep. of Germany v. Commission, 1973 E.C.R. 813; Case 173/73, Italy v. Commission, 1974 E.C.R. 709.

49. *See also* Piergiorgio Valente & Franco Roccatagliata, *Fiscal Aids: (In) Com-*

Pursuant to its position, the EC has moved quite aggressively to challenge special tax provisions that it believes conflict with Article 92(1) and its own tests interpreting that article.[50] In addition, in 1998, the EC adopted a formal set of guidelines which, if violated, would make illegal all preferential tax provisions that adversely affect trade and competition among EU states.[51]

The focus of the guidelines is on "specific" tax advantages, *i.e.*, those that benefit certain enterprises or production activities. The EC includes as tax advantages such items as lower rates of taxation, tax breaks, accelerated depreciation, or debt cancellation. A tax advantage is "specific" if it is an exception to its generally applicable tax rules or administrative practice. Rules of general application are not state aids. But tax benefits, if applied without discrimination, can be provided for environmental protection, research and development, training, and employment. In addition, even if a state aid is specific, it may be granted an exemption if the country can justify it by an economic rationale that makes the provision necessary to the functioning and effectiveness of its tax system. A measure found to be a prohibited state aid implemented without prior EC approval or, if already enacted, must be repealed unless a Treaty of Rome exemption applies, *e.g.*, for environmental protection or regional development.

The EC guidelines follow in many respects the approach

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*patibility with EU Rules*, 17 TAX NOTES INT'L 206, 259 (July 27, 1998).

50. *See id.* at 262-265 for a description of some of the cases that had arisen by mid-1998. One held prohibited by article 92(1) was a package granted by the Basque Country in Spain to attract business including *inter alia*, a 20% corporate or personal income tax credit; immediate depreciation of the assets used in a new investment; and an additional 20% tax credit on technology investments. *Id.* at 262. *See also* 98 TAX NOTES INT'L 143-4 (July 27, 1998) (EC agreement with Ireland to replace preferential provisions for certain trading activities with a general 12 ½% corporate rate). Later actions are reported at Tax Analysts, 2000 WTD 194-8 (Oct. 4, 2000), 2000 WTD 184-6 (Sept. 18, 2000), and Tax Analysts, 2000 WTD 217-18 (Nov. 25, 2000).

51. Commission Notice on the Application of State Aid Rules Relating to Direct Business Taxation, 1998, O.J. (C 384) 3. The vigorous EC position on special tax provisions as state aids is, potentially, a matter of considerable concern to those countries in Eastern Europe and the former Soviet Union aspiring to join the EU. Many of them employ substantial tax incentives for investment and exporting. These issues are discussed in Alex Easson, *Duty-Free Zones and Special Economic Zones in Central and Eastern Europe and the Former Soviet Union*, Tax Analysts 98 TAX NOTES INT'L 26-19 (Feb. 9, 2000).

developed in Part II.A., above. Thus, state aids do not include tax measures that set the rate of taxation, depreciation rules and rules on loss carry-overs, provisions to prevent double taxation, and rules to prevent tax avoidance. The process to be followed in identifying state aids is first to identify a country's "common system." Exceptions or deviations from the system then must be examined to see if they are justified by the "nature or scheme of the tax system, that is to say, whether they derive directly from the basic or guiding principle of the tax system" of the country.[52] If they do not, proscribed state aid is involved.[53]

The concept of "state aids" in the Treaty of Rome is connected closely to the notion of "tax competition." "Tax competition" generally refers to the process by which countries seek to gain an advantage in attracting investments and manufacturing by reducing tax liabilities below those of countries competing for the same investment/manufacturing activities. If other countries then retaliate by lowering their taxes, a "race to the bottom" begins and all countries lose tax revenue.[54] The problems posed by tax competition are especially acute in a common market such as the EU: Distortions in location of investment and industrial activity are precisely what the common market is intended to end. But, I assert that "tax competition" is much better understood as "subsidy competition."

Thus, assume a two-country world in which Country A and Country B start out with the same income tax bases and identical rates. To attract more investment, Country B reduces its rates below that of A. A then may retaliate by reducing its rates below the now lower rates of B, and so on. That is true "tax competition," but it is not "harmful" tax competition. Indeed, this point was recognized by the EC when it approved an Irish 12.5% corporate tax rate of general application, though that rate is far below that of most other EU countries.[55]

But of course, countries do introduce special provisions in their income taxes to attract investment or increase exports, to name two examples. After years of unsuccessfully prodding EU

52. Commission Notice, *supra* note 51.
53. *Id.* paras. 13-16.
54. "Tax competition" is discussed in greater detail in Alex Easson, *Tax Competition and Investment Incentives*, 2 EC TAX J. 63 (1997).
55. *See* Tax Analysts 98 TAX NOTES INT'L 143-4 (July, 27, 1998).

countries in the direction of "tax coordination" in their corporate income tax systems,[56] in 1997 the EC shifted tactics and terminology to attack the distortions caused by the utilization of a preferential tax regime by member states. The EC prepared a report recommending a "Code of Conduct" which EU members would observe with respect to special tax measures.[57] On December 1, 1997, the Council of the European Union formally adopted the Code of Conduct.[58]

The Code of Conduct covers only business taxation. It is a political rather than a legal document and is concerned with measures which affect business location decisions within the EU.[59] The offending provisions identified as "potentially harmful" are those which provide "a significantly lower effective level of taxation, including zero taxation than those levels which *generally apply*."[60]

The Code of Conduct sets forth a non-exclusive list of factors to be considered in assessing whether the prohibited level of tax has been violated by a particular provision:

> a. Whether special tax measures are open only to nonresidents or transactions with nonresidents;
>
> b. Whether the tax base is affected by the measure (ring-fencing);
>
> c. Whether the absence of economic activity precludes the granting of the tax benefits (*i.e.*, can a tax benefit be

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56. *See* Paul R. McDaniel, *Personal Income Taxes: The Treatment of Tax Expenditures*, *in* TAX COORDINATION IN THE EUROPEAN COMMUNITY (Sijbren Cnossen ed., 1987).

57. Communications from the Commission to the Council, Toward Tax Coordination in the European Union: A Package to Handle Harmful Tax Competition, COM(97)495 (Jan. 10, 1997).

58. Conclusions of the ECOFIN Council Meeting on Dec. 1, 1997, 1998 O.J. (C 211) at 1 [hereinafter Conduct]. The Code is set forth in Annex 1 to the Conclusions. The Council is made up of government representatives from each country in the EU. See *infra* Part V for a discussion of the difference between the tax coordination and the tax competition approaches.

59. *See* Conduct, *supra* note 58, para. A. The focus on locational distortions may have procedural implications. Normally, EU legislation in the field of taxation requires a unanimous vote of the member states. *See* Treaty of Rome, *supra* note 47, at art. 101. But, measures designed to eliminate distortions can be adopted by a majority of the Council. *See* Treaty of Rome, at art. 101. *See also* Anno Rainer, *European Commission Presents Draft Code of Conduct for Business Taxation*, Tax Analysts, 97 TAX NOTES INT'L 198-10 (Oct. 14, 1997).

60. *See* Conduct, *supra* note 58, at para. B. The reduced level of taxation may result from the normal tax rate, the tax base or any other relevant factor (emphasis added).

obtained even if no economic activity takes place in the country?);

d. Whether intercompany profit determinations deviate from OECD transfer pricing principles; and,

e. Whether administrative procedures to take advantage of the measure lack transparency.[61]

There obviously is a close connection between state aids under the Treaty of Rome and the harmful tax competition proscribed by the Code of Conduct. The Commission Notice on the state aids rules, discussed above, declares that a tax measure determined to be harmful under the Code does not necessarily determine that it is state aid under the Treaty. However, the application of the Code is a relevant factor in making the state aids determination.[62]

## IV. SYNTHESIS

The WTO panel in the FSC case, the concept of prohibited state aids under the Treaty of Rome, and the Code of Conduct all use different language to describe and identify provisions in a member country's tax system that are proscribed by the relevant treaties. I believe, however, it is clear that the approaches of all three are consistent with the proposition asserted in Part I.C. The rules that form part of the normative or benchmark system of taxation do not conflict with, and are not even covered by, the trade agreements.

Of course, countries adopt numerous provisions that are not responsive to or necessary for the implementation of a normative tax system. These provisions are the equivalent of government spending programs, and it has been recognized for over 30 years that they must be analyzed as such. The terminology employed by a number of OECD countries is "tax expen-

61. For a discussion of these factors, see Jacques Malherbe, *Special Report*, Tax Analysts, 2000 WTD 132-17, July 10, 2000. A Code of Conduct (business taxation) group headed by U.K. Paymaster Dawn Primarolo in May and December 1999, issued interim reports identifying some 285 tax measures that should be investigated under the Code of Conduct principles. Subsequently, the group reduced the December 1999 number to 66. *See* 20 TAX NOTES INT'L 1283 (Mar. 20, 2000). Reported examples of the group's actions may be found at 19 TAX NOTES INT'L 1777 (May 3, 1999), and on the Tax Analysts electronic source at 1999 WTD 1-17, 131-7, 131-8, 201-5, and 220-3.

62. *See* Treaty of Rome, para. 30.

ditures," denoting that a spending (or regulatory) program is being run through a tax system rather than through the direct spending budget (or administrative rules). It is these types of provisions to which trade agreements can and must apply.[63]

Indeed, tax expenditure language and analysis were put forth specifically by the EU in the WTO FSC case. The reference arose in connection with the issue as to whether there was "revenue foregone" within the meaning of the GATT.[64] Here, the EU pointed expressly to the U.S. tax expenditure accounts, to the U.S. methodology for identifying tax expenditures, to the fact that the FSC regime is listed as a tax expenditure in U.S. accounts, and to the methodology used to determine the costs of tax expenditures, *i.e.*, the revenue foregone method.[65]

While neither of the WTO agreements, the Code of Conduct, or the interpretation of State aid employ the term "tax expenditure," it is clear that provisions found to fall within the varying language of those documents all would constitute "tax expenditures" as the concept is employed by the U.S. and other OECD countries. This in turn leads to the following description of the principles regarding the interaction of trade agreements and tax systems:

> 1. The provisions of a country's tax system that comprise the normative or benchmark structure of a tax should be outside the scope of trade agreements and procedures. These provisions are the real "tax" rules of a country and are not substitutes for direct subsidy programs.[66]
>
> 2. Subsidies provided through a tax system (tax expenditures, state aids, harmful tax competition, or special exemptions) should be subject to scrutiny under trade agreements just as are direct subsidies affecting trade or competition. Subsidies cannot be removed from the scrutiny of trade

63. For descriptions of tax expenditures employed by eleven OECD countries, see Organization for Economic Co-Operation and Development, TAX EXPENDITURES-RECENT EXPERIENCES (1996).

64. General Agreements on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S 1700, 55 U.N.T.S. 194.

65. *See* Panel Report on U.S. Foreign Sales, *supra* note 33, paras. 4.596-4.601.

66. Of course, the tax rules can and do distort the free movement of capital and, by extension, trade. Trade agreements typically do not cover capital flows; instead, mitigation of income tax-induced barriers to the free flow of capital is left to the bilateral tax treaty process.

agreements just because they are provided through (non-) tax rules.

The actions to date of the WTO and the EU are consistent with these principles.

V. POST-SCRIPT

It is appropriate to say a word about the distinction between "tax competition" and "tax coordination" as those notions have developed in the EU context. The exposition of tax coordination in the EU reached its zenith with the publication of the Ruding Committee Report in 1992.[67] That Report, and its concept of tax coordination (in fact, the harmonization of the corporate tax systems of all EU countries), was not accepted by EU member states. In 1997, the EC shifted to the notion of harmful tax competition. Are there practical differences in the two approaches? An example may shed light on the question.

Assume that all countries in the EU, except France, adopted straight-line depreciation as their general depreciation rule. Assume that France adopted, as its general provision, the immediate deduction of all costs of investment in tangible assets. The rule applied both to investment by French investors and to investment by foreign investors. The French action clearly would violate a Ruding Committee tax coordination approach. But it apparently would not violate the harmful tax competition approach embodied in the Code of Conduct because it would not be a "specific" provision and it would not discriminate in favor of foreign investors.

But, to continue the above hypothetical, assume a U.S. company is deciding whether to invest in France or another EU country. All other things being equal, the U.S. company clearly will decide to invest in France. Yet, this is precisely the kind of locational distortion which the Code of Conduct ostensibly addresses. Why would the EU accept this result? The answer probably lies in practicality rather than theory. Note that in order for France to attract foreign investors, it must forego the revenue from all of its domestic investment. This is a trade

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67. *See* Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation (1992), *at* http://www.europarl.eu.int/experts/s_en.htm.

off the major EU countries are unlikely to accept.

But suppose the EU country adopting immediate deduction is one which has very little domestic investment to begin with (and there are several of them). Adoption of the "general" rule now has the effect, but not the form, of a "specific provision" to attract foreign direct investment. How is the EU to proceed in such a case?

One way, of course, is the tax coordination route, but that approach did not fare well in the 1980s and 1990s. Another, is to adopt the approach outlined in Part I.A. There, I suggested that classification of a provision as a "tax" or as a "subsidy" measure be determined by testing it against a normative or benchmark structure.[68] Such an approach, applied in the above example, would classify the accelerated portion of France's cost recovery system as a "special" provision and subject to the Code of Conduct rules.

It is true that many, perhaps most, items are relatively easy to classify as subsidies under both the current EC and the normative or benchmark approaches. Nonetheless, it seems likely that at some point the EC is going to need to make reference to a norm that exists independently of a country's existing tax legislation.

68. *See* SURREY & MCDANIEL, *supra* note 4, at 2-6, 184-194 (detailing this methodology).