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International Trade and Tax Agreements May Be Coordinated, But Not Reconciled

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INTERNATIONAL TRADE AND TAX AGREEMENTS MAY BE COORDINATED, BUT NOT RECONCILED

*Yariv Brauner**

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I. INTRODUCTION

A recent World Trade Organization (WTO) case held the United States export tax subsidies to be inconsistent with U.S. WTO obligations.¹ Despite strong political resistance,² which fed a long and costly legislative process,³ the United States recently repealed these

¹ Appellate Body Report, *United States — Tax Treatment for “Foreign Sales Corporations” — Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/AB/RW (Jan. 14, 2002), available at www.wto.org/english/tratop_e/dispu_e/108abrw_e.doc [hereinafter AB Report]. This decision ended the three-decade dispute in the WTO (formerly the General Agreement on Tariffs and Trade or GATT) over the U.S. tax export subsidy regimes. It affirmed the decision of the panel in the original ETI dispute, Panel Report, *United States — Tax Treatment for “Foreign Sales Corporations” — Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/RW (Aug. 20, 2001), available at http://www.wto.org/english/tratop_e/dispu_e/108_art215_e.pdf, which itself was just the last link in a series of related decisions. For a short summary of the dispute, see David L. Brumbaugh, *A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy*, WORLDWIDE TAX DAILY (Nov. 9, 2004) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2003 WTD 233-11); see also *infra* Part IV.B.

² See, e.g., Edmund L. Andrews, *Corporate Plea for Tax Breaks: Ours Come First*, N.Y. TIMES, Oct. 30, 2003, at A1; Ernest Christian & Gary Hufbauer, *Comment: End This Damaging Tax and Trade Charade*, FIN. TIMES USA, Mar. 9, 2004; Chuck Gnaedinger, *EU, Business Groups Size Up Thomas’s Corporate Tax Plan* (July 16, 2002) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2002 WTD 136-2); Sander M. Levin, *EU Trying to “Bully” U.S. on ETI Repeal Issue* (Nov. 7, 2003) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2003 WTD 216-27).

³ It took almost three years from the final decision to the repeal, which still provides for the grandfathering of some of the prohibited subsidies and a two-year transition relief, both of which are contested by the EU as illegal and expected to be reversed. See Appellate Body Report, *United States — Tax Treatment for “Foreign*

subsidies.⁴ This case and the U.S. reaction revealed that while the United States is the single economic superpower, it is not as dominant a player as some portray it.⁵ The case also shed light on the tension between the present international trade and tax regimes and the difficulty of applying WTO law to income tax measures. This tension did not escalate earlier mainly because countries tended not to use their income tax systems for protectionism.⁶ This article suggests that the use of tax systems to protect domestic interests may increase as a consequence of economic globalization. The proliferation of global trade and the increasing power of free trade arrangements leave income taxes as one of the few remaining measures that can potentially serve protectionist purposes.

Sales Corporations” — *Second Recourse by the European Communities to Article 21.5 of the DSU: Request for Consultations*, WT/DS108/27 at 1 (Nov. 10, 2004), available at <http://docsonline.wto.org>. The cost of the process became visible with the WTO’s permission for the EU to impose significant trade sanctions on U.S. exports as of March 1, 2004. See Alison Bennett et al., *WTO Gives EU Green Light for \$4 Billion in Sanctions Against United States over FSCs*, BNA DAILY TAX REP., Sept. 3, 2002, at GG-1; *Transatlantic Tiff: The Spat Between America and Europe Heats Up*, ECONOMIST, Mar. 4, 2004, at 38. The sanctions played a significant role in support of the legislation. See *Grassley Stresses Importance of ETI Repeal Bill*, TAX NOTES TODAY (Oct. 13, 2004) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2004 TNT 198-33).

⁴ See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 101, 118 Stat 1418, 1423–24.

⁵ For an interesting discussion of this point, see Paul B. Stephan, *Sheriff or Prisoner? The United States and the World Trade Organization*, 1 CHI. J. INT’L L. 49 (2000).

⁶ It is reasonable to expect that protectionism through the income tax regime will be undesirable from a domestic tax policy perspective. In general, the income tax is designed to tax primarily residents and foreigners with substantial business connections to the taxing jurisdiction. It is imposed on persons and it is difficult to distinguish between persons who export (or import) without specific reference to their underlying export or import activity. This difficulty mandates that protectionist rules be transparent, and therefore both difficult to disguise from foreign scrutiny and easy to exploit by taxpayers. Additionally, granting certain income tax benefits to exporters, for example, will adversely affect the desirable qualities of the income tax, such as efficiency and equity: there will be an inefficient tax incentive to export and taxpayers with equal incomes may pay unequal income tax amounts. Obviously, the progressivity of the income tax will also be skewed. Without getting into the desirability or a cost-benefit analysis of any of the above, it is easy to see the reluctance of policymakers to use the income tax for protectionism. See Michael Lennard, *Navigating by the Stars: Interpreting the WTO Agreements*, 5 J. INT’L ECON. L. 17 (2002) (developing a general discussion of estoppel issues in WTO jurisprudence. On other occasions, Lennard has applied this discussion to the income tax, asserting that countries may be estopped from using it for protectionism as part of their general WTO obligations.).

If this claim is true, then the current disconnect between the international trade and tax regimes will cause both regimes to be challenged, as they may both apply in some cases with different and conflicting results. This article maps the tension and the possible clashes between the international tax and trade regimes based on the existing legal constructs. It further elaborates on the aforementioned possible challenges to these regimes and attempts to contribute to a workable solution, which may lead to the relief of this tension.

The solution advanced is based on the observation that although the international trade and tax regimes cannot be simply reconciled or meshed together, their policies could (and should) be coordinated, with some adjustments made to the present legal constructs. This article suggests that such coordination would benefit from the establishment of an international tax organization, separate from the WTO, with responsibility for making the evolving international tax regime more compatible with the international trade regime. Further, the article analyzes and rejects other solution models, primarily the one I call the tax expenditure solution, which is based on the contention that the international tax and trade regimes do not conflict, and which is willing to subject some aspects of income taxes to WTO scrutiny without any adjustments.⁷

The above developments do not occur in a vacuum: free trade theory is continuously under attack today, almost two centuries after David Ricardo introduced the concept of comparative advantage.⁸ Despite serious misconceptions about the theory⁹ and public pessimism about the gains from trade, its primary promoter, the WTO, has survived and continues to evolve with a new round of negotiations, known as the Doha Round. This success has been shadowed lately by a vocal anti-globalization movement that picked the WTO as its main target on several occasions,¹⁰ and even more

⁷ The tax expenditure solution model is constructed here from a Tillinghast lecture by Professor Paul McDaniel on a closely related subject. See Paul R. McDaniel, *The David R. Tillinghast Lecture, Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions*, 57 TAX L. REV. 275 (2004).

⁸ DAVID RICARDO, *PRINCIPLES OF POLITICAL ECONOMY AND TAXATION* (InteLex Corp. 1993) (1817).

⁹ For a classic discussion of the theory of comparative advantage and common misconceptions, see PAUL R. KRUGMAN & MAURICE OBSTFELD, *INTERNATIONAL ECONOMICS* (6th ed. 2003).

¹⁰ See JAGDISH BHAGWATI, *IN DEFENSE OF GLOBALIZATION* 15, 81–83, 86–87, 137, 246–47 (2004) (providing several examples of misdirected attacks of globalization opponents on the WTO as a symbol of the phenomenon). For an example of a specific campaign, see GLOBAL EXCHANGE, *WORLD TRADE ORGANIZATION*, at

seriously, by the stall in the Doha Round negotiations, which was caused by a crisis in trust between some major developing countries (led by Brazil) and the developed world.¹¹ The recent agreement over agricultural subsidies¹² and the revival of the Doha Round negotiations may help resolve this crisis.¹³ In the meantime, globalization¹⁴ continues to thrive, markets (and economies) continue to open, and cross-border trade continues to grow. This is undoubtedly the result of the WTO framework, which focuses on the elimination of barriers to international trade.

Despite these developments, international tax policy has never been addressed at a supranational level, in the WTO or elsewhere. This is puzzling since the international trade and tax regimes are intimately related on many levels.¹⁵ Also, taxation, and in particular direct (or income) taxation, is, by definition, a barrier to international trade. On the other hand, the elimination of income taxes is unlikely in the near future, as most governments finance their operations to a large extent with income tax revenues.¹⁶ Insofar as the ideal of free trade cannot be achieved, a compromise that both promotes free trade

<http://www.globalexchange.org/campaigns/wto/> (last visited July 9, 2005).

¹¹ *The WTO Under Fire: The Doha Round*, ECONOMIST, Sept. 18, 2003. The crisis led to the establishment of the so-called G20 (formerly G21), led by Brazil, as a coordinated pressure group for developing world interests in agriculture. For a short summary of the history and goals of the G20, see G20 HISTORY, at <http://www.g-20.mre.gov.br/history.asp> (last visited July 9, 2005).

¹² The agreement, known as the "July Package," provided a framework for the continuance of the talks. See General Council Decision, *Doha Work Programme: Decision Adopted by the General Council on 1 August 2004*, WT/L/579 (Aug. 2, 2004), available at http://www.wto.org/english/tratop_e/dda_e/ddadraft_31jul04_e.pdf; see also Gary G. Yerkey, *Farm Deal Clears Way for Broader Pact Setting Framework for Future WTO Talks*, BNA INT'L TRADE REP., Aug. 5, 2004, at 1304; *Now Harvest It*, ECONOMIST, Aug. 5, 2004, at 34.

¹³ For example, the WTO director-general has recently expressed optimism regarding the revival of the Doha Round. See Supachai Panitchpakdi, *Beyond the Crossroads: Moving Forward on the Doha Development Agenda*, Address to the Parliamentary Assembly of the Council of Europe (Oct. 4, 2004) (transcript available at http://www.wto.org/english/news_e/spsp_e/spsp31_e.htm); see also Daniel Pruzin, *Supachai Cites Positive Spirit in Doha Talks, Urges Early Planning for Hong Kong Meeting*, BNA INT'L TRADE REP., Dec. 16, 2004, at 2021–22.

¹⁴ This paper uses the term "globalization" in the sense of economic globalization, as has become common in the economic literature. For an elaborate discussion of the term and its possible meanings, see BHAGWATI, *supra* note 10.

¹⁵ See discussion in Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 147–49 (2001).

¹⁶ Indirect taxes are growing in importance. See ORG. FOR ECON. COOPERATION & DEV., *REVENUE STATISTICS 1965–2003*, at 21 tbl.C (2004).

and allows for the existence of tax-related trade barriers must be established.

As already mentioned, the current international trade regime largely ignores the effects of income taxation. The international tax arrangements that construct the international tax regime¹⁷ are generally carved out of the WTO's jurisdiction over international trade¹⁸ (i.e., the supranational dimension of WTO law does not affect the operation of the international tax regime). Up to now, this arrangement has not caused any serious problems, but this is likely to change as the conflict between the international trade and tax regimes becomes more pronounced.

In early 2002, the United States lost a three-decade legal war over its export tax subsidies.¹⁹ The most recent of these subsidies, known as the Extraterritorial Income Exclusion (ETI), was not repealed by Congress until January 1, 2005, despite significant sanctions threatened for two years and finally imposed by the European Union (EU) on March 1, 2004.²⁰ This was the first important controversy related to income tax measures that went through the dispute settlement proceedings of the WTO. As suggested above, the use of income tax systems for protectionism is not and has never been common, mainly because of the potential negative impact it may have on domestic tax policy. The primary exception has been the use of export tax subsidies, which are now prohibited by WTO law. One might argue that because this is the only significant exception and it has been explicitly dealt with, it does not form a valid basis for questioning the effectiveness of the current legal framework, including the disconnect between the international tax and trade regimes.

Such an argument may be too simplistic for three reasons. First, in the tax export subsidy cases, the United States raised several arguments supporting the validity of its tax export subsidy regime. The WTO dispute settlement body could not refute these arguments and either disposed of them with unsatisfactory reasoning or simply

¹⁷ As originally termed by Professor Avi-Yonah. Reuven S. Avi-Yonah, *Commentary*, 53 TAX L. REV. 167, 169 (2000) (arguing that the network of bilateral tax treaties "constitutes an international tax regime, which has definable principles that underlie it and are common to the treaties.")

¹⁸ See Warren, *supra* note 15, at 141–46. This carve-out was not supported by any in-depth analysis or other normative discussion; it was an ad-hoc political compromise. See *infra* note 23.

¹⁹ See AB Report, *supra* note 1.

²⁰ See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 101, 118 Stat 1418, 1422–1423.

ignored them.²¹ Such a cursory disposition was problematic not only because of the nonrigorous analysis itself, but also because the tax export subsidies regime should have been easily disposed of by the WTO's Appellate Board (AB) as an "easy case" — a clear and blunt violation of the fundamental principles embedded in the WTO agreements. The WTO efforts in this regard raise questions about the sufficiency of the current legal basis of the WTO in such cases.²²

Second, the export subsidy case was special because the disputed regime evolved from an earlier compromise between the United States and the EU, which compromise supposedly immunized U.S. export tax subsidies from a European challenge in exchange for the U.S. promise not to challenge the European territorial tax systems and maybe even the zero-percent value-added tax (VAT) on exports.²³ If indeed the compromise reflected the status quo, which was disrupted by the EU's successful challenge of Foreign Sales Corporations (FSCs) (which in turn may have been triggered by the EU losses in other cases²⁴), then United States retaliation is possible, if not expected, until a new equilibrium is established. An effective way to reach that equilibrium could be to amend the current legal constructs to reflect more clearly the parties' present understanding on this matter.

Finally, and most importantly, countries that wish to engage in protectionism, either for efficiency or political reasons, may find it increasingly difficult to do so as the supranational WTO legal construct evolves.²⁵ Conversely, the potential gains from

²¹ See, e.g., AB Report, *supra* note 1, ¶¶ 89–90.

²² The author does not intend, however, to expand the discussion of the WTO and WTO dispute settlement process beyond the interaction between them and direct taxation.

²³ The GATT Council decision implementing the compromise over the European territorial tax systems is Tax Legislation, Dec. 7–8, 1981, GATT B.I.S.D. (28th Supp.) at 114 (1982). For the United States' arguments regarding the zero-rate VAT (and a good summary of the U.S. tax subsidies controversy), see, e.g., Brumbaugh, *supra* note 1.

²⁴ See, e.g., Gary Hufbauer, *The Case of Mutating Tax Incentives: How Will the DISC/FSC/ETI Drama End?*, WORLDWIDE TAX DAILY (Apr. 8, 2002) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2002 WTD 67-5); Gary Hufbauer, *The Foreign Sales Corporation Drama: Reaching the Last Act?*, WORLDWIDE TAX DAILY (Nov. 1, 2002) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2002 WTD 230-18).

²⁵ The increasing power of other international economic arrangements amplifies these constraints. For instance, EU members are bound by common VAT rules, the prohibition of state aid, which has recently been enforced by the European Commission, and other community restrictions.

protectionism are increasing with globalization. It is therefore likely that countries will try to employ protectionist techniques that escape the tight WTO grip, such as income tax measures. Under some circumstances, these countries may be willing to pay the price of the potential negative effects that such measures may have on their domestic tax policy. This article demonstrates that the present international trade regime cannot deal satisfactorily with such developments because of the (disconnect) between the trade regime and the international tax regime.

This disconnect is detrimental to the international tax regime, which for most purposes completely ignores the international trade regime. Some commentators suggest that the international tax regime that has evolved in the last half century around the Organization for Economic Cooperation and Development (OECD) Model Tax Convention (and currently consisting of more than 2000 bilateral tax treaties, most of which closely follow the OECD model) should be subjected to and embedded into the framework of the WTO.²⁶ These suggestions are the result of profound changes taking place in the markets as globalization continues to thrive.

Despite the stability and effective functioning of the international tax regime, it faces challenges because of the growth of global markets and the associated need to regulate larger trade volumes and increasingly sophisticated cross-border transactions involving multiple countries, which often have conflicting claims to tax revenues from such transactions. As such, the international tax regime will eventually be required to evolve and incorporate (or be incorporated into) a central international policy forum²⁷ or perhaps even a supranational legal arrangement. This author has elaborated elsewhere on some of these challenges and agreed with others that a central international tax forum must be established, although not necessarily under the canopy of the WTO.²⁸ This author suggested, alternatively, to build on the current success of the international regime by creating an international tax organization, separate from the WTO, mainly because of the latter's different focus, lack of tax expertise, political vulnerability, and insufficient compatibility with

²⁶ Joel Slemrod & Reuven S. Avi-Yonah, *(How) Should Trade Agreements Deal with Income Tax Issues*, 55 TAX L. REV. 533, 552–54 (2002).

²⁷ See, e.g., Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259 (2003); Kees van Raad, *International Coordination of Tax Treaty Interpretation and Application*, 29 INTERTAX 212, 218 (2001).

²⁸ See Brauner, *supra* note 27, at 315–16.

the fundamental norms of the present international tax regime.²⁹

Implicitly, the original analysis ignored the potential clashes and incompatibility of the international trade and tax regimes. The present article adds this dimension, advocating a requirement that the resulting international tax regime be constructed in compatibility with WTO law but not subject to its dispute settlement process.³⁰ The article further provides observations on how such compatibility could be achieved in a constructive and balanced manner, allowing both regimes to continue to adapt to the changing realities without clashing. This approach finds some support in the work of others,³¹ but it has not been elaborated on, and there is little scholarship on point. Perhaps because of the limited practical relevance until recently, no academic or other policy discourse existed, with the exception of the U.S. tax export subsidy cases themselves.

To expand the scope of the discourse, this article explores and then rejects an alternative solution model, which is based on the premise that the trade and tax regimes are compatible. This solution model is reconstructed from a lecture by Professor Paul McDaniel, one of the nation's leading international tax experts, which was more limited in scope and suggested a similar solution in the context of the export subsidies rules.³² Professor McDaniel's model uses the logic and actual analysis of the domestic tax expenditure budgets to divide "jurisdiction" over income tax measures between the international tax and trade regimes. According to that model, tax expenditures would be subject to WTO law and the WTO dispute settlement process, while other income tax measures would be immune from it. This solution model has a strong appeal due to its apparent clarity and objectivity, as demonstrated by language of the WTO dispute settlement body supporting a similar line of thought.³³

This article argues that this appeal is illusory and that the above-mentioned solution model is not practically workable. Moreover, this article demonstrates that even if it were workable, it would be

²⁹ *Id.*

³⁰ On this point, this paper agrees with Professor Green, see Robert A. Green, *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 YALE J. INT'L L. 79, 137-39 (1998).

³¹ *See id.*

³² McDaniel, *supra* note 7.

³³ AB Report, *supra* note 1, ¶ 89. In consecutive paragraphs the AB struggles, however, with the practical difficulty of usefully implementing this logic, acknowledging the difficulty but avoiding the analysis of the feasibility of the tests that it was trying to dictate. *Id.* ¶¶ 90-91.

undesirable because it may corrupt whatever usefulness the domestic tax expenditure budget may have and introduce inefficiencies to both the international trade and tax regimes. The reconstruction of this solution and its critique are presented in Part IV of this article.

Part II sets the background for the discussion with a review of the likely scope of application of the current WTO law to direct taxation. It concludes that the scope of such application, except for direct and blunt tax subsidies, is likely to be limited at best. It further establishes the present dividing line between direct taxation and trade rules and explains why such a vague and possibly unsatisfactory division evolved.

Part III establishes the theoretically large potential scope of application of WTO law to direct taxation, in contrast to its limited actual current scope. This demonstrates the importance of the discussion in this article and the fragility of the current uncertain relationship of these two concepts. It further demonstrates the practical impossibility of reconciling the international trade and international tax regimes without completely overhauling one or both regimes.

Part IV rejects the constructed tax expenditure solution model. Part V concludes with some observations about a reasonable alternative route of international policy coordination that may not be able to reconcile tax and trade law, but should be able to coordinate tax and trade law policies and implement a workable legal framework for such policy coordination.

II. THE LAW OF INTERNATIONAL TAX AND TRADE

WTO law is the most developed source of international economic law. It nominally covers most international economic activities, although it is limited in scope in some cases. The rules related to the trade in goods, embedded primarily in the General Agreement on Tariffs and Trade (GATT),³⁴ are the most developed set of rules, forming a fairly coherent body of law. The rules related to trade in services took a parallel path through the General Agreement on Trade in Services (GATS), a similar but not identical agreement to GATT. Both are part of international law, but possess many characteristics of supranational laws and operate as such. The increasingly important international investment and trade in

³⁴ General Agreement on Tariffs and Trade, Oct. 30, 1947, 55 U.N.T.S. 187, T.I.A.S. 1700 [hereinafter GATT].

intellectual property are also being included in the framework of the WTO, but have yet to develop within this framework to the extent that trade in goods and services has.³⁵

The primary goal and interest of WTO law is the promotion and facilitation of free trade. The WTO operates in a virtual international economic space; or, if one wishes, it serves as an interface between the various legal systems, operating to reduce or eliminate barriers to trade. In general, it does not directly modify or relate to specific domestic regulation, but rather dictates standards to which the member countries align their domestic laws.

The current international tax regime, on the other hand, is based on a complex yet well-established, widespread, and fairly coherent network of more than 2000 bilateral tax treaties. It clearly is not a supranational body of law, but it is an integral part of international law.³⁶ The regime's main goal has always been to relieve double (over) taxation. More recently, the regime has also begun to correct for non (under) taxation.³⁷ It does that primarily by direct modification, on a case-by-case basis, of specific domestic tax rules as they apply to cross-border transactions involving only the two countries who are parties to the relevant treaty.

These differences in both form and substance cannot mask the intimate relationship between the two regimes. Direct tax is a barrier to trade, yet it must be levied to finance government activities, at least as long as other sources of revenues are not available or sufficient.³⁸ The direct consequence is that taxation is and will remain, for as long as the current political reality persists, a constant barrier to trade that cannot be completely eliminated. Thus, the ideal of free trade cannot be fully achieved in a world with taxes. A second-best regime — one that would account for taxation — had to be established as a result.³⁹

³⁵ International investment is regulated through a recently evolved network of bilateral investments treaties. See, e.g., *Contemporary Practice of the United States Relating to International Law: International Economic Law: Proposed New U.S. "Model" Bilateral Investment Treaty*, 98 AM. J. INT'L L. 836 (2004).

³⁶ See Reuven S. Avi-Yonah, *International Tax as International Law* (Mar. 2004) (unpublished research paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=516382.

³⁷ See Michael Lang, *General Report*, in CAHIERS DE DROIT FISCAL INTERNATIONAL, STUDIES ON INTERNATIONAL FISCAL LAW BY THE INTERNATIONAL FISCAL ASSOCIATION: VOLUME 89A—DOUBLE NON-TAXATION 73–119 (2004).

³⁸ The debate over the appropriate extent and nature of such services, although central to tax policy making, is beyond the scope of this article. It is sufficient to assume that some taxes are acceptably required.

³⁹ One can, of course, take the view of Liam Murphy and Thomas Nagel, who

Despite this strong and direct connection, most countries (including the United States) do not coordinate their trade and tax regimes. As best expressed by one U.S. scholar, “[t]his country’s tax framework is about as poorly adapted to GATT as is imaginable.”⁴⁰ This Part of the article elaborates on this observation and identifies the areas of potential conflicts, setting the stage for a later discussion of the measures that might be taken to alleviate or reduce such conflicts.

A. Format and Legal Status

First, the legal constructs of the two regimes differ in their formats. In the United States, WTO agreements⁴¹ take the form of “executive agreements”⁴² adopted by the President. As such, they

only view entitlements after-tax, see LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 32–34 (2002), but this view does not contribute to the solution of our problem. Simply put, as long as different countries apply different taxes, these differences will affect trade.

⁴⁰ Richard A. Westin, *Modifying the U.S. Tax Framework to Stimulate Employment Without Violating GATT Principles*, *WORLDWIDE TAX DAILY* (May 3, 2004) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2004 WTD 85-17).

⁴¹ For instance, all the agreements subjected to the Marrakesh declaration of 1994.

⁴² That is, it is a “treaty,” as understood by international law, even though it was concluded by the U.S. President alone, without “advice and consent” of two-thirds of the U.S. Senate, as required for a U.S. treaty by the U.S. Constitution. U.S. CONST. art. II, § 2, cl. 2. For a summary of the authorities, see the RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 111 (1987). In general, the U.S. Congress is granted the power to regulate U.S. international economic relations by the U.S. Constitution, U.S. CONST. art. I, § 8, cl. 3, but since the 1930s Congress has delegated power to the President to enter into international trade agreements. It was under this authority that GATT (and consecutive tariff agreements) were negotiated and signed by the United States. The power of the President to enter into such agreements has been affirmed by the U.S. Supreme Court. *United States v. Pink*, 315 U.S. 203, 229 (1942); *United States v. Belmont*, 301 U.S. 324, 331 (1937); see also U.S. Dep’t of State Circular No. 175 (Dec. 13, 1955), reprinted in 50 AM. J. INT’L L. 784, 785 (1956) (discussing the proper treaty-making and executive-agreement making powers of the United States); Myres S. McDougal & Asher Lans, *Treaties and Congressional-Executive or Presidential Agreements: Interchangeable Instruments of National Policy*, 54 YALE L.J. 181, 187 (1945) (stressing the traditional interchangeability of treaties and executive agreements and the identity of their legal consequences in the area of international commerce). Some have challenged the appropriateness of the President’s choice not to seek advice or consent from the Senate when concluding WTO agreements, a choice the boundaries of which are unclear under present law. See *The World Trade Organization and U.S. Sovereignty: Hearings before the Senate Comm. on Foreign Relations*, 103d Cong. (1994) (testimony of Ralph Nader, Center

constitute an international obligation of the United States,⁴³ yet are not “self-executing.”⁴⁴ Their execution depends on their transformation (implementation) into domestic legislation, without which they cannot be relied upon in a U.S. court or tribunal. There is a debate among U.S. constitutional experts as to the scope of the presidential power to conclude executive agreements.⁴⁵ However, it is now accepted that WTO agreements are outside the scope of this debate, following broad congressional approval⁴⁶ and the adoption of their implementing Act. It should be noted that the implementation of these agreements was not complete because, as provided in the implementing Act, the agreements do not supersede other U.S. laws.⁴⁷ Similarly, WTO dispute settlement body decisions do not constitute self-executing international obligations of the United States⁴⁸ because

for Responsible Law). The President did get general approval from Congress to enter into the negotiation in a special process known as “fast track” that does not allow amendments, for instance. The Uruguay Round Agreements were finally approved in the Uruguay Round Agreements Act of 1994, Pub. L. No. 103-465, 108 Stat. 4809 (codified as amended at 19 U.S.C. § 3511 (2005)) [hereinafter Uruguay Round Agreements Act]. The “fast track” authority for nontariff barrier negotiations was originally established in the Trade Act of 1974, Pub. L. No. 93-618, 88 Stat. 1978 (codified as amended in 19 U.S.C. § 2111 et seq. (2005)) [hereinafter Trade Act], and satisfactorily used thereafter in the implementation of the Tokyo Round.

⁴³ Note that GATT was entered into by the President as an executive agreement and never explicitly approved by Congress. Now, as part of Annex 1 to the WTO Agreement, GATT is part of the WTO agreements. See Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS: THE LEGAL TEXTS 5 (1994), 33 I.L.M. 1144 (1994) [hereinafter WTO Agreement]. The courts, however, have consistently applied the rules of GATT in many cases.

⁴⁴ An executive agreement could theoretically be self-executing and have direct effect as if it were a regular domestic law, but the Uruguay Round Agreements Act provides specifically that these agreements are not self-executing. See Uruguay Round Agreements Act § 102.

⁴⁵ These could follow several legislative paths. See JOHN H. JACKSON, THE WORLD TRADING SYSTEM: LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATIONS 83 (2d ed. 1997). For the more specific authority of the President, see *id.* at 90–91.

⁴⁶ Including more than two-thirds of the Senate, which is the supermajority required in the case of regular treaties. Uruguay Round Agreements Act § 101(a). The status of GATT prior to the establishment of the WTO was not in doubt, although the legal basis for its stability was not sound. See Ronald A. Brand, *The Status of the General Agreement on Tariffs and Trade in United States Domestic Law*, 26 STAN. J. INT'L L. 479, 480 (1990).

⁴⁷ Uruguay Round Agreements Act § 102(a)(1).

⁴⁸ WTO Agreement, *supra* note 43, art. XVI. This is one of the major

they generally require separate domestic implementing legislation.⁴⁹ The lingering failure of the U.S. Congress to repeal the ETI regime is a primary example of United States' direct confrontation and noncompliance with the WTO Dispute Settlement Understanding (DSU),⁵⁰ which clearly reflects the present limitations of the WTO supranational powers.

In contrast to the multilateral WTO agreements, income tax treaties, including those of the United States, are bilateral. They normally follow the globally accepted OECD model tax treaty,⁵¹ complemented by a very similar, U.S.-exclusive model.⁵² Unlike the U.S. trade agreements,⁵³ the U.S. bilateral tax treaties have traditionally followed the conservative track of a "treaty," rather than

differences between the GATT and WTO dispute resolution processes, and one that was strongly advocated by the United States.

⁴⁹ That is, unless it is otherwise within the power of the executive branch to respect the relevant obligation. A relevant example is the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423.

⁵⁰ Before the WTO, the United States' compliance with such decisions under GATT has been criticized as unsatisfactory. The United States itself complained about the insufficient authority of the GATT dispute settlement process, leading to the constitution of the WTO DSU. Professor Hudec noted that the U.S. policy in the 1980s and 1990s was to delay and even block the adoption of some of these decisions by the GATT Council (or Code Committee). Robert E. Hudec, *The New WTO Dispute Settlement Procedure: An Overview of the First Three Years*, 8 MINN. J. GLOBAL TRADE 1, 13 (1999). The DISC case started this as the epitome of the weaknesses of the GATT dispute settlement system. See JOHN H. JACKSON ET AL., LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS 267 (4th ed. 2002) [hereinafter JACKSON CASEBOOK]; see also John H. Jackson, *The Jurisprudence of International Trade: The DISC (Domestic International Sales Corporations) Case in GATT*, 72 AM. J. INT'L L. 747 (1978).

⁵¹ ARTICLES OF THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL (Org. for Econ. Cooperation & Dev. 2003), available at <http://www.oecd.org/dataoecd/52/34/1914467.pdf> [hereinafter OECD MODEL TAX TREATY].

⁵² U.S. MODEL INCOME TAX CONVENTION OF SEPT. 20, 1996 (U.S. Dep't of Treasury 1996), available at <http://www.treas.gov/offices/tax-policy/library/model1996.pdf> [hereinafter U.S. MODEL TAX TREATY]. The purpose of the model is to facilitate and serve as a general guideline for negotiations of U.S. bilateral tax treaties. It self-admittedly has a strong identity to the OECD model and does not represent any lack of U.S. support of that model. See U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL INCOME TAX CONVENTION OF SEPTEMBER 20, 1996: TECHNICAL EXPLANATION, available at <http://www.irs.gov/pub/irs-trty/usmtech.pdf>.

⁵³ Both multilateral and bilateral trade agreements have become more favorable lately as the administration's confidence in the WTO diminishes and the frustration from the stalled new round of negotiations increases.

an “executive agreement,” which is to say they are concluded by the executive branch *ad referendum*, and ratified by the Senate.⁵⁴ Once ratified and entered into force, such bilateral tax treaties are equal in status but not superior to other statutes or treaties. Thus they are subject, for instance, to the “later in time” rule, meaning that they may be overridden by subsequently enacted legislation or subsequently ratified treaties.⁵⁵ To avoid antagonizing treaty partners, the possibility of override is softened by the requirement that a subsequent statute must specifically acknowledge overriding a treaty to be given such effect.⁵⁶ Trade executive agreements and tax treaties are, therefore, different in form. In practice, however, the prevailing opinion is that both are of the same status.⁵⁷

As previously mentioned, the investment sector is currently covered, in large part, by bilateral investment agreements and some multilateral arrangements such as the North American Free Trade Agreement (NAFTA).⁵⁸ In this respect the international investment

⁵⁴ After the conclusion and negotiation of the treaty, it is typically signed by the negotiator for the government of the United States, then the President transmits it to the Senate, seeking its “advice and consent,” which practically requires a supermajority of two-thirds of the Senate. If the Senate advises ratification, the President may then ratify the treaty. Once the instruments of ratification are exchanged with the treaty partner, the President proclaims the treaty and it enters into force as “the supreme law of the land,” as per the U.S. Constitution. U.S. CONST. art. VI, cl. 2; *see also* Samann v. Commissioner, 313 F.2d 461, 463 (4th Cir. 1963). For an illustration of the typical process *see, e.g.,* the old U.S.-Japan income tax treaty, Convention for the Avoidance of Double Taxation, Mar. 8, 1971, U.S.-Japan, available at <http://www.irs.gov/pub/irs-trty/japan.pdf>.

⁵⁵ *See, e.g.,* Richard L. Doernberg, *Overriding Tax Treaties: The U.S. Perspective*, 9 EMORY INT’L L. REV. 71, 114 (1995).

⁵⁶ Whitney v. Robertson, 124 U.S. 190, 194 (1888); Cook v. United States, 288 U.S. 102, 120 (1933); RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 115 (1987).

⁵⁷ A possible caveat to this equality is the requirement that a court first attempt to reconcile any treaty with a possibly conflicting statute, or another treaty, in acknowledgement of the treaty being an international obligation of the United States. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 114 (1987). For completeness, note also that both treaties and executive agreements prevail over state laws in general. JACKSON CASEBOOK, *supra* note 50, at 104–05.

⁵⁸ North American Free Trade Agreement, art. 1103, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 605, 639 (1994), available at http://www.nafta-sec-alena.org/DefaultSite/index_e.aspx?DetailID=160#A1103 (last visited July 10, 2005) [hereinafter NAFTA]. Bilateral Investment Treaties (BITs) have become very popular lately and they typically include a MFN obligation very similar to the above. *See* MODEL BILATERAL INVESTMENT TREATY (U.S. Dep’t of State 2004), art. 4, available at <http://www.state.gov/documents/organization/29030.doc>. A full list of the

regime is very similar to the international tax regime. Since the direction of the investment regime does not seem clear at the present, the relationship between the international tax regime and the investment arrangements will not be covered in detail. It is a worthy project for the future.

B. Nondiscrimination as a Unifying Obligation

The different formats of the trade and tax regimes are not of particular concern to a reconciliation attempt. Consequently, the bulk of the following discussion will focus on the substantive incompatibility of the subject regimes. The “heart and soul” of the WTO law is its nondiscrimination obligation. As a multilateral regime attempting to eliminate barriers to trade, the WTO attempts to minimize domestic barriers and require that the associated benefits be granted to all the subjects of the regime. The current belief, which has largely proven true, is that countries would agree to concessions or compromises in a multilateral arrangement that they would never have made in a narrower context of a bilateral network. To make the elimination of trade barriers politically easier to digest and to pay respect to national sovereignty, there is no general nonqualified nondiscrimination rule, but rather two separate requirements. One, termed “national treatment,” forbids countries from treating some countries differently than they treat other countries; the other, “most favored nation status” (MFN), forbids countries from treating residents of some countries differently than they treat residents of other countries. Together, these requirements, while ignoring discrimination against one’s own nationals, amount to a general nondiscrimination rule to be adhered to without qualification. In reality, however, such adherence is rarely satisfied.

The international tax regime, on the other hand, typically only forbids discrimination against foreigners as compared to domestic persons. Moreover, the prohibition applies separately to each set of bilateral treaty partners. It is similar in meaning to the WTO national treatment requirement, ensuring a level playing field, but limited to the extent agreed upon in each bilateral setting. In theory, therefore, there is no expectation for global convergence of tax treatments since each bilateral setting should produce a different negotiated outcome that presumably maximizes the benefits to the participating countries in that particular situation. In reality, the development and

crystallization of the current international tax regime and the relative convergence of the rules along the lines of the OECD model⁵⁹ have produced an outcome that is close to, albeit not actually, a global level playing field. The absence of an MFN obligation in bilateral tax treaties may be explained by the treaties' bilateral natures. Although theoretically they may include an MFN provision of some sort, bilateral tax treaties are usually struck in an exclusive bilateral setting, generally ignoring other countries' interests and concerns.

To sum up, the international trade regime includes both MFN and national treatment requirements. In contrast, the international tax regime, which regulates a major barrier to trade, requires only national treatment. The result is that adherence to the international tax regime may not allow the strict application of the MFN requirement — a fundamental principle of the international trade regime. This difficulty is further complicated by the limited application of WTO law in various circumstances, and specifically the limited application of its nondiscrimination provisions in circumstances where WTO law clearly governs. These limitations should be discussed separately in order to better understand the extent of the incompatibility of the subject regimes.

1. MFN

The MFN clause ensures that a country does not discriminate among a group of foreigners from various other countries who are parties to the relevant agreement. This clause is a fundamental pillar of the WTO regime, and is symbolically placed in Article I of GATT. Its application is natural in the context of tariff concessions, the traditional focal point of GATT, but less natural in the context of income taxes. Article I of GATT applies to any taxes that affect imports and exports.⁶⁰ Conceptually, it is therefore plausible to apply Article I to income tax measures that affect imports or exports. One must remember, however, that GATT applies only in the context of "like" products, and therefore application of GATT to income tax measures is limited to the extent that such measures affect imports or

⁵⁹ Brauner, *supra* note 27, at 263.

⁶⁰ General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 [hereinafter GATT]. Article I includes a specific reference to Article III matters (internal taxes and government regulations), which makes its interpretation dependent on the interpretation of Article III as far as the relevant taxes are concerned, i.e. indirect taxes. See GATT art. I.

exports of like products.⁶¹ Other than that, GATT contains no specific limitations or carve-outs for income tax measures.

In contrast, the international trade-in-services regime includes specific limitations and carve-outs as far as its applicability to income taxes. Article II of GATS also includes an MFN provision. This provision is limited, however, by the general scope of GATS, which, unlike GATT, is an “opt-in” (disguised as an “opt-out”) regime. In GATS, each country’s obligations are contained in the schedules, including the MFN exemptions schedule.⁶² The schedules limit countries’ specific commitments in order to soften the unconditional nature of the general MFN obligations. This is most often done with respect to industries where a significant difference in the degree of openness in the countries’ economies could mean that reciprocity is unlikely to be satisfactory.⁶³ The U.S. list of MFN exemptions includes, for instance, an important insistence on control over immigration, despite its major role in the assurance of free trade in services;⁶⁴ traditional exemptions for some land use and transport services; major exemptions for the politically strong financial services and telecommunication industries; exemptions for taxation measures, including special direct tax benefits (or denial thereof) to specific countries⁶⁵ and industries;⁶⁶ and, in some cases, exemptions for state and local tax benefits. These limitations likely target measures that may be outside the scope of a bilateral tax treaty and are therefore viewed as needing another level of protection from the strict application of GATS’ general MFN provision.

Article II of GATS is supported by a dispute resolution procedure in Article XXII. Article XXII:3 provides an internal limitation on the relevance of Article II to direct taxation by

⁶¹ As there is a general agreement that “like” does not have to be interpreted similarly on different occasions when it might be a crucial determinant in GATT, it is possible that different interpretations would apply in different circumstances.

⁶² The U.S. commitment to GATS is relatively significant, as the United States acknowledged the importance of the trade in services to its economy, which is only bound to grow.

⁶³ In reality, the main benefactors were the politically well-connected financial services and telecommunications industries.

⁶⁴ The United States has clarified in a study submitted to GATT that it would not negotiate immigration issues in international trade forums. JACKSON CASEBOOK, *supra* note 50, at 862–63.

⁶⁵ Examples include Canada, Mexico, U.S. possessions, and the Caribbean Basin Initiative. Denial of benefits is also possible for foreign policy reasons, for instance to countries that participate or cooperate with an international boycott.

⁶⁶ Examples are transportation, communication, and in some cases, advertising.

specifically excluding measures covered by bilateral tax treaties.⁶⁷ A second internal limitation is found in Article XIV(e) of GATS, which provides a specific exemption from the Article II MFN obligation so long as the difference in treatment (discrimination) is the result of application of a bilateral tax treaty.⁶⁸ In practice, the United States seems to interpret the above as general immunity exempting any tax measures contained in its bilateral tax treaties from the GATS' MFN obligations.

As noted above, the current international tax regime⁶⁹ does not generally contain an MFN provision.⁷⁰ Some specific treaties, however, contain provisions with similar effects. One example is Article XXV:2 of the U.S.-Canada bilateral tax treaty, which is an MFN-type obligation with respect to "taxation or any requirement connected therewith." The standard used is that treatment "other or more burdensome" than the tax treatment of domestic taxpayers is prohibited in that bilateral setting.⁷¹ The third NAFTA member — Mexico — secured a more limited MFN-type provision in the 2003 protocol to its 1992 bilateral tax treaty with the United States. With

⁶⁷ General Agreement on Trade in Services, Apr. 15, 1994, art. XIV, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS: THE LEGAL TEXTS 325 (1994), 1869 U.N.T.S. 183, 33 I.L.M. 1167 (1994) [hereinafter GATS], art. III XXII:3.

⁶⁸ The exemption is denied if the discrimination is "arbitrary or unjustifiable" or is a "disguised restriction." GATS, *supra* note 67. This caveat seems meaningless, however, and has never been triggered to the best of this author's knowledge.

⁶⁹ Based primarily on the network of over 2000 bilateral tax treaties worldwide. See Avi-Yonah, *supra* note 17, at 169.

⁷⁰ It does however contain a nondiscrimination obligation, dating back to Article 15 of the original League of Nations Model Tax Treaty of 1943. This obligation is standard: the equalization of domestic tax treatment of foreigners resident in the country of the treaty partner to that of domestic taxpayers, subject to certain exceptions, such as taxation by withholding. There was some debate over the level of neutrality required in this context, but that is irrelevant to our purposes. This obligation is similar, but stricter, than the "national treatment" obligation, which is the other major antidiscrimination measure of GATT, elaborated on in the next Part, as it does not forbid discrimination against foreign investors, for instance. See Green, *supra* note 30, at 88–89, 91–92.

⁷¹ Convention Regarding Double Taxation: Taxes on Income and Capital, Sept. 26, 1980-Mar. 28, 1984, U.S.-Can., art. XXV, T.I.A.S. No. 11,087, at 23. The complete equalization of tax treatment implied by the addition of the word "other" is unique insofar as the normal bilateral tax treaty standard, including the U.S. model, which only protects from a more burdensome treatment. In practice, the "other or more burdensome" standard is obviously not strictly observed.

the added protocol, the United States is obligated to negotiate an equalizing protocol with Mexico should it grant a better treatment of dividend income to another country.⁷² Apart from NAFTA, Article 13(2)(b)(iii) of the 1976 U.S.-Philippines bilateral tax treaty provides for a one-sided MFN obligation of the Philippines to ensure that its withholding tax rate on royalties paid to U.S. residents is the lowest rate allowed by law under similar circumstances.⁷³

Another, less direct, MFN-type treatment is the U.S. allowance of EU ownership to count towards “domestic” ownership of its EU treaty partners for purposes of the limitation of benefits articles in the respective treaties.⁷⁴ Interestingly, none of the above articles use the term “MFN” in either the text or the technical explanation of each treaty.

Despite these exceptions, the accepted norm is still to exclude MFN obligations from bilateral tax treaties. A provision found in most recent U.S. bilateral tax treaties,⁷⁵ derived from Article 1(3)(b)

⁷² Second Additional Protocol that Modifies the Convention for the Avoidance of Double Taxation, Nov. 25, 2002, U.S.-Mex., art. II(b), S. TREATY DOC. NO. 108-3 (2003) (replacing paragraph 8 of the original 1992 protocol).

⁷³ Convention with Respect to Taxes on Income, Oct. 1, 1976, U.S.-Phil., art. 13(2)(b)(iii), 34 U.S.T. 1277. This provision was implicated lately when the Philippines granted such lower rate to China, thereby requiring it to reduce the rate for royalty payments to U.S. residents. See Benedicta Du-Baladad, *Lower Royalty Rate May Apply Under Philippines-U.S. Tax Treaty*, WORLDWIDE TAX DAILY (July 12, 2002) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2002 WTD 134-4).

⁷⁴ See, e.g., Convention for the Avoidance of Double Taxation, July 24, 2001, U.S.-U.K., art. 23(7)(d), S. TREATY DOC. NO. 107-19 (2003). EU implications are beyond the scope of this article. This is not, however, exactly an MFN obligation and is limited to this anti-treaty shopping provision that, at least until the recent expansion of the EU, did not bother the United States much in these circumstances.

⁷⁵ See Convention for the Avoidance of Double Taxation, U.S.-Italy, art. 3(1)(b), Aug. 25, 1999, S. TREATY DOC. NO. 106-11 (1999); Convention for the Avoidance of Double Taxation, U.S.-Den., art. 1(3)(b), Aug. 19, 1999, S. TREATY DOC. NO. 106-12 (2003); Convention for the Avoidance of Double Taxation, U.S.-Slovn., art. 1(3)(b), June 21, 1999, S. TREATY DOC. NO. 106-9 (1999); Convention for the Avoidance of Double Taxation, U.S.-Venez., art. 1(3)(b), Jan. 25, 1999, S. TREATY DOC. NO. 106-3 (1999); Convention for the Avoidance of Double Taxation, U.S.-Est., art. 1(3)(b), Jan. 15, 1998, S. TREATY DOC. NO. 105-55 (1999); Convention for the Avoidance of Double Taxation, U.S.-Lat., art. 1(3)(b), Jan. 15, 1998, S. TREATY DOC. NO. 105-57 (1999); Convention for the Avoidance of Double Taxation, U.S.-Lith., art. 1(3)(b), Jan. 15, 1998, S. TREATY DOC. NO. 105-56 (1998); Convention for the Avoidance of Double Taxation, U.S.-Ir., art. 1(3)(a)(ii), July 28, 1997, S. TREATY DOC. NO. 106-15 (1999); Convention for the Avoidance of Double Taxation, U.S.-S. Afr., art. 1(3)(b), Feb. 17, 1997, S. TREATY DOC. NO. 105-9 (1997); Convention for the Avoidance of Double Taxation, U.S.-Thail., art. 1(5)(b), Nov. 26, 1996, S.

of the 1996 U.S. Model Tax Treaty, further augments this understanding:

[U]nless the competent authorities determine that a taxation measure is not within the scope of this Convention, the nondiscrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favored-nation obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade. No national treatment or most-favored-nation obligation under any other agreement shall apply with respect to that measure.”⁷⁶

TREATY DOC. NO. 105-2 (1997); Convention for the Avoidance of Double Taxation, U.S.-Switz., art. 28(2)(b), Oct. 2, 1996, S. TREATY DOC. NO. 105-8 (1997); Convention for the Avoidance of Double Taxation, U.S.-Aus., art. 1(3)(b), May 31, 1996, S. TREATY DOC. NO. 104-31 (1997); Convention for the Avoidance of Double Taxation, U.S.-Lux., art. 1(5)(b), Apr. 3, 1996, S. TREATY DOC. NO. 104-33 (1997); Convention for the Avoidance of Double Taxation, U.S.-Turk., art. 1(5)(b), Mar. 28, 1996, S. TREATY DOC. NO. 104-30 (1997); Protocol to the Convention for the Avoidance of Double Taxation, U.S.-Port., art. 1(a)(iii), Sept. 6, 1994, S. TREATY DOC. NO. 103-34 (1995); Convention for the Avoidance of Double Taxation, U.S.-Swed., art. 1(3)(b), Sept. 1, 1994, S. TREATY DOC. NO. 103-29 (1995); Convention for the Avoidance of Double Taxation, U.S.-Fr., art. 29(8)(b), Aug. 31, 1994, S. TREATY DOC. NO. 103-32 (1995). The 1993 tax convention with Kazakhstan provides, in the exchange of notes, somewhat differently that the bilateral tax treaties’ mutual agreement procedure in Article 25 has exclusivity over any GATS application to a measure that is within the scope of the bilateral tax treaty. *See* Convention for the Avoidance of Double Taxation, U.S.-Kaz., Oct. 24, 1993, S. TREATY DOC. NO. 104-15 (1996). This provision was, of course, drafted prior to the conclusion, but with the expectation of the conclusion of GATS, and prior to the publication of the U.S. Model Income Tax Treaty in 1996.

⁷⁶ RICHARD L. DOERNBERG & KEES VAN RAAD, *THE 1996 UNITED STATES MODEL INCOME TAX CONVENTION: ANALYSIS, COMMENTARY AND COMPARISON* 6 (1997). The Treasury Department’s technical explanation of this provision elaborates:

[U]nless the competent authorities determine that a taxation measure is not within the scope of this Convention, the nondiscrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favored-nation (“MFN”) obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade (“GATT”). No national treatment or MFN obligation under any other agreement shall apply with respect to that measure. Thus, unless the competent authorities agree otherwise, any national treatment and MFN obligations undertaken by the Contracting States under agreements other than the Convention shall not apply to a taxation measure, with the exception of GATT as applicable to trade in goods.

This provision clarifies the preemption of bilateral tax treaties' nondiscrimination provision by any other possible nondiscrimination obligations that may apply to tax measures within the scope of the relevant bilateral tax treaty. This exclusive application is not absolute, however. The antidiscrimination obligations in GATT, specifically limited to "trade in goods," continue to apply in parallel.⁷⁷

Note that Article 1(3)(b) of the U.S. Model Tax Treaty is not coherent⁷⁸ and lacks an obvious purpose. It is difficult to see what is different about GATT in this context. A possible explanation for singling out GATT's dispute settlement procedure as equal to that of the bilateral tax treaties may be that it was inconceivable that significant income tax disputes would arise under GATT, in contrast to the possibility of such disputes under the Agreement on Trade-Related Investment Measures (TRIM) or GATS.⁷⁹ TRIM and GATS, unlike Articles I and III of GATT, expressly apply to direct taxes. Another possible, but unlikely, interpretation is that the above exception was intended to open the door for future application of GATT's MFN obligation to direct tax measures.

The Internal Revenue Code (Code) does not include nondiscrimination provisions. In fact, it contains unique, and potentially discriminatory, provisions applicable to foreigners.⁸⁰ Despite the lack of nondiscrimination provisions in the Code itself, it explicitly refers, under certain circumstances, to bilateral tax treaties — an indirect and even awkward reference to their nondiscrimination obligations.⁸¹ U.S. domestic law also provides for MFN treatment for

Id. at 280.

⁷⁷ Note that the above provision does not coordinate GATT and bilateral tax treaties, but rather declares their independence from each other.

⁷⁸ See, e.g., DOERNBERG & VAN RAAD, *supra* note 76, at 10 n.32.

⁷⁹ The trade in services is extremely important to the U.S. economy. It represents most of the U.S. output and almost all of its growth at the end of the last millennium. It also presents challenges to important domestic issues, such as immigration, investment, and regulatory policies, which may not be greatly affected by the international trade in goods.

⁸⁰ Foreign persons are subject to taxes by withholding, imposed on the gross amount of the income item, whereas domestic taxpayers may be taxed more lightly due to the "normal" net income taxation. The Internal Revenue Code (Code) may limit certain deductions to foreigners in situations where these deductions would be allowed to domestic taxpayers. See I.R.C. § 163(j). The Code also provides for certain retaliatory devices which have never been supported with regulations and have never been applied. See I.R.C. §§ 891, 896.

⁸¹ I.R.C. §§ 894(a)(1), 897(i), 884(e)(1), 906(a).

most imports.⁸² For political reasons, however, certain countries are denied such treatment when tariffs are concerned.⁸³ Other exceptions to this general rule include sections 301 through 310 of the Trade Act of 1974,⁸⁴ the U.S. free trade agreements,⁸⁵ and the Generalized System of Preferences for developing countries.⁸⁶ The United States had provided this treatment even prior to the post-World War II trade talks, while always stressing the importance of reciprocity. The expectation for reciprocity practically created a conditional MFN — a concept that was largely rejected in the realm of GATT and WTO.

In conclusion, the combination of Article 1(3)(b) of the U.S. Model Tax Treaty with similar provisions in specific tax treaties, all of which exclude direct taxes from GATS' nondiscrimination provisions,⁸⁷ reflects the U.S. position that bilateral tax treaties are superior to trade agreements with regard to direct taxation. GATT is most likely excluded because it is not expected to have an actual effect on direct taxation in the United States.⁸⁸ This expectation was proven wrong with the outcome of the recent ETI case, which rejected the U.S. position.

2. National Treatment

The other major antidiscrimination norm in WTO law does resemble the tax nondiscrimination provisions. This is the “national treatment” obligation, which prohibits discriminatory and protectionist taxation, among other things. Article III of GATT is its general national treatment provision.⁸⁹ It is normally understood to

⁸² Trade Act, *supra* note 42, § 126(a), 88 Stat. 1978 (codified as amended at 19 U.S.C. § 2136 (2000)).

⁸³ U.S. HARMONIZED TARIFF SCHEDULE, General Note 3(a) (2001), *available at* <http://www.usitc.gov/tata/hts/archive/0100/0100GN.PDF>. This exception also used to include the communist countries during the Cold War.

⁸⁴ Trade Act, *supra* note 44, §§ 301–10.

⁸⁵ For a list and full text of these agreements, see http://www.ustr.gov/Trade_Agreements/Bilateral/Section_Index.html.

⁸⁶ For a short explanation of the GSP, see <http://www.unctad.org/Templates/Page.asp?intItemID=2309&lang=1>. The waiver document itself is available at <http://www.worldtradelaw.net/misc/gsp.pdf>. For the U.S. position regarding this agreement, see <http://www.itds.treas.gov/gsp.html>.

⁸⁷ *See, e.g.*, Convention for the Avoidance of Double Taxation, U.S.-Kaz., Oct. 24, 1993, S. TREATY DOC. NO. 104-15 (1996).

⁸⁸ The sources of this exception may be political or may follow Lennard's estoppel argument. *See* Lennard, *supra* note 6.

⁸⁹ For a good recent review and analysis of WTO law regarding GATT Article

apply only to indirect, rather than income, taxation, yet such an interpretation is implicit and is not clear from the language of the provision.⁹⁰ It is useful, however, to understand the basic principles of the national treatment obligation if one wishes to reconcile them with the rules in bilateral tax treaties in a clear and constructive manner.

GATT's Article III:2 prohibits discrimination against imported goods by the means of internal (nontariff) taxes.⁹¹ Discrimination is measured by comparison between the treatment of the imported goods and "like" domestic products. The determination of "likeness" is obviously crucial and, not surprisingly, has been a central area of dispute throughout the years. The dispute settlement body has not been successful in dealing with this determination. Its general rhetoric has been to apply rather mechanically, and as objectively as possible, a "likeness" of products test. On the other hand, the U.S. challenge of Japan in the alcoholic beverages case employed a broad, nonmechanistic interpretation of the "likeness" term, arguing for the need to determine the protectionist "aim or effect" of likeness.⁹² Recent cases, however, reflect the rhetoric of the objective approach, rejecting the need for the "aim or effect" determination to determine likeness.⁹³ Despite this seeming preference for the objective approach, the dispute settlement body continues to consider subjective factors in its attempt to distinguish between bona fide and illegitimate regulatory measures.⁹⁴

III, see Henrik Horn & Petros C. Mavroidis, *Still Hazy After All These Years: The Interpretation of National Treatment in the GATT/WTO Case-law on Tax Discrimination*, 15 EUR. J. INT'L L. 39 (2004).

⁹⁰ GATT SECRETARIAT, ANALYTICAL INDEX: GUIDE TO GATT LAW AND PRACTICE 133 (6th ed. 1994).

⁹¹ See GATT, *supra* note 60 at art. III, para. 2. This provision, like the national treatment principle, was incorporated into GATT on the insistence of the United States. See Michael J. Trebilcock & Shiva K. Giri, *The National Treatment Principle in International Trade Law* 1–2 (Am. Law & Econ. Ass'n 14th Annual Meeting, Working Paper No. 8, 2004), available at <http://law.bepress.com/alea/14th/art8> (last visited June 9, 2005).

⁹² JACKSON CASEBOOK, *supra* note 50, at 494, 500–02.

⁹³ See Robert E. Hudec, *GATT/WTO Constraints on National Regulation: A Requiem for an "Aim and Effects" Test*, 32 INT'L LAW. 619 (1998); Donald Regan, *Further Thoughts on the Role of Regulatory Purpose Under Article III of the General Agreement on Tariffs and Trade: A Tribute to Bob Hudec*, 37 J. WORLD TRADE 737 (2003); Frieder Roessler, *Beyond the Ostensible: A Tribute to Professor Robert Hudec's Insights on the Determination of the Likeness of Products Under the National Treatment Provisions of the General Agreement on Tariffs and Trade*, 37 J. WORLD TRADE 771 (2003); see also TREBILCOCK & GIRI, *supra* note 91, at 17.

⁹⁴ See Hudec, *supra* note 93, at 633–36.

Determining whether two goods are “alike” is irrelevant for the purposes of the federal income tax.⁹⁵ The same is true regarding the second sentence of GATT’s Article III:2, which extends the national treatment to products not necessarily “alike” but nonetheless “in competition” with the imported goods. Some have advocated the use of antitrust concepts in these inquiries,⁹⁶ but this should not affect the nonrelevance of the “likeness” test to direct taxation in the United States. In addition, the same treaty rules (Article 1(3)(b) of the U.S. Model Tax Treaty in particular) that were discussed with regard to the MFN provisions of GATT and GATS should apply here (for example, the rule that when applicable, bilateral tax treaties trump GATS and operate in parallel to GATT obligations, which are not likely to be material in this context).⁹⁷

In GATS, Article XVII provides for national treatment within the boundaries set in each member country’s schedules of commitments.⁹⁸ The U.S. specific commitments in GATS include most of the major services and some expected traditional limitations, such as those on professional services (legal, accounting, engineering, etc.), and a variety of policy specific limitations, including the denial of some direct tax benefits. More significant are the supplements reserving special treatment to the financial and telecommunication services industries. Article XVII:1 further provides that the national treatment applies to all measures affecting the supply of services.⁹⁹ “Measures” are defined in Article XXVIII(a) widely, encompassing laws, regulations, rules, procedures, decisions, administrative actions, or any other form.¹⁰⁰ The discrimination test is consequential in that “less favorable treatment” is measured by the effect of the relevant measure on the “conditions of competition.” The form of treatment of foreign services or service suppliers is not a conclusive indication of discrimination: depending on the circumstances, identical formal treatment may or may not be discriminatory.¹⁰¹ In the negotiation of

⁹⁵ Even if Article III were interpreted to apply to direct taxation, it probably would not matter much since direct taxation is not commonly used for protectionism. This could change if countries decided to increase the use of direct taxation to gain trading advantages; but such a move appears unlikely since it could trigger a trade war, something that most countries are hoping to avoid.

⁹⁶ TREBILCOCK & GIRI, *supra* note 91, at 60–61.

⁹⁷ See discussion *infra* Part III.

⁹⁸ GATS, *supra* note 67, at art. XVII.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at art. XXVII.

¹⁰¹ JACKSON CASEBOOK, *supra* note 50, at 886.

GATS, the United States proposed to adopt a general and binding national treatment obligation for all services. This proposal did not prevail, leading to the current schedule-based obligation system, in which the U.S. schedules are the most extensive. In practice, foreign service providers are usually taxed in the United States similarly to their U.S. competitors because they typically operate a U.S. trade or business (or maintain a “permanent establishment” in the context of a bilateral tax treaty). Some specific differences in treatment are protected by the schedule of specific commitments.

Article XIV of GATS parallels Article XX of GATT, providing for certain circumstances that justify discrimination for the sake of, or in order to balance, free trade promotion with competing values.¹⁰² Unlike Article XX of GATT, Article XIV of GATS includes reference, in paragraph (e), to “avoidance of double taxation” as one of these competing values.¹⁰³ This reference practically exempts bilateral tax treaties from the national treatment obligation in GATS.¹⁰⁴ On the procedural level, Article XXII of GATS requires a bona fide consultation process among member countries regarding any relevant matter or, alternatively, a consultation with either the dispute settlement body or the Council for Trade in Services.¹⁰⁵ Article XXII:3 complements Article XIV(e) by denying the right for consultation or initiation of a dispute settlement process with respect to measures covered in a bilateral tax treaty.¹⁰⁶ Article XXII:3 further provides that in case of uncertainty whether a measure falls within the scope of the bilateral tax treaty, the matter could be brought to the Council for Trade in Services, which shall refer it to a final and binding arbitration. Article XXIX:6 of the U.S. bilateral tax treaty with Canada includes a coordinating rule with Article XXII of

¹⁰² GATS, *supra* note 67, at art. XIV; GATT, *supra* note 60, at art. XX.

¹⁰³ GATS, *supra* note 67, at art. XIV.

¹⁰⁴ Article XIV of GATS provides a caveat that these exceptions must not constitute a means of arbitrary or unjustifiable discrimination between countries. *See* GATS, *supra* note 67, at art. XIV. This caveat has not been discussed in the United States to the best of this author’s knowledge. The caveat may also be redundant with respect to GATS Article XIV(e), since its subject must be an international agreement, which is unlikely to serve as a means of arbitrary or unjustifiable discrimination against a bilateral treaty partner. It may be worth noting that equivalent domestic measures such as the foreign tax credit rules of the United States are not covered by this exception, but it is hard to think how these could realistically be attacked as discriminating against foreign service providers.

¹⁰⁵ GATS, *supra* note 67, at art. XXII.

¹⁰⁶ Such measures could be contained in a bilateral tax treaty or a similar international agreement relating to the avoidance of double taxation.

GATS.¹⁰⁷ The rule provides that a measure falls within the scope of the treaty if it relates to a tax to which the nondiscrimination clause of the bilateral tax treaty (Article XXV) applies.¹⁰⁸ A measure is similarly held to fall within the scope of the treaty if it relates to any other tax to which another provision of the bilateral tax treaty applies, but only to the extent of such application.¹⁰⁹ The rule further provides that, notwithstanding Article XXII:3 of GATS, any question regarding interpretation of the above exception will be dealt with by the mutual agreement mechanism in the bilateral tax treaty (or any other procedure agreed upon by the bilateral tax treaty parties) and not by a final and binding arbitration under the auspices of the Council for Trade in Services.¹¹⁰ Despite the dominant role of bilateral tax treaties, there may still be situations not covered by them, either because of their scope or because of the lack of a bilateral tax treaty between the United States and the relevant country.¹¹¹

In conclusion, the national treatment requirements in the realm of the WTO do not significantly affect direct taxation in the United States at the present time. Theoretically, these requirements may apply to discredit a variety of widely acceptable but potentially discriminatory international and domestic tax norms. Then again, this scenario is unlikely without a change in the present political equilibrium. Similar protection from discrimination is provided by

¹⁰⁷ Protocol Amending the Convention with Respect to Taxes on Income and Capital, U.S.-Can., art. 17(2), Mar. 17, 1995, 2030 U.N.T.S. 236, 247-48 (amending Article XXIX:6 of the original 1980 treaty).

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.* This provision is a typical Canadian bilateral tax treaty provision and does not appear in other U.S. bilateral tax treaties. The Treasury Department's technical explanation of the Canadian bilateral tax treaty sheds some light on the U.S. interpretation of Article XXII of GATS. The Treasury seems to view this provision broadly as a carve-out of direct tax measures, as covered by bilateral tax treaties, from the national treatment obligation under GATS. See U.S. DEP'T OF TREASURY, TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND CANADA WITH RESPECT TO TAXES ON INCOME AND CAPITAL, available at <http://www.intltaxlaw.com/TREATIES/CANADA/canada%20tech%20explanation.pdf> (last visited July 17, 2005). The same applies to nonincome tax measures covered in the bilateral tax treaty. For a specific reference in a treaty, see Convention for the Avoidance of Double Taxation, U.S.-Kaz., Oct. 24, 1993, S. TREATY DOC. NO. 104-15 (1996).

¹¹¹ The United States has a significant network of bilateral tax treaties, especially with developed countries, but is not considered a world leader in this respect. For a good summary of the current status of U.S. bilateral tax treaties, see the constantly updated review in *Tax Management International Journal*.

bilateral tax treaties. Such protection, however, is less robust than a potential WTO nondiscrimination protection, and it only partially covers U.S. international trade.

3. Export Subsidies

Nowhere is the conflict between the international tax and international trade regimes more apparent than in the area of export tax subsidies. Theoretically, direct government spending could be designed as a tax expenditure and vice versa.¹¹² A direct export subsidy may, therefore, be designed as a tax export subsidy instead. Subsidizing through the income tax system is theoretically the same as doing so through any other method of taxation. In reality, however, income tax export subsidies are difficult to effectively implement, and thus are not commonly used.¹¹³ Those that are more likely to be used are generally prohibited by WTO law.¹¹⁴

The WTO definition of a “subsidy” is found in the Agreement on Subsidies and Countervailing Measures (SCM Agreement or SCM).¹¹⁵ Pursuant to Article 1, a “subsidy” includes any forgone or uncollected revenue “that is otherwise due.”¹¹⁶ Not all subsidies, however, are prohibited;¹¹⁷ only those that are contingent in law or in fact upon export performance or discriminatory importation are prohibited. Direct tax preferences to exporters naturally belong to this group. Furthermore, the SCM Agreement incorporates a specific “illustrative list” of measures into the definition of prohibited subsidies, including

¹¹² See David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs* (U. Chi. Olin Program L. & Econ., Working Paper No. 194, 2003), available at <http://ssrn.com/abstract=442063> (last visited June 9, 2005).

¹¹³ In the same way, it is difficult to replace tariffs with income tax measures. See Joel B. Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 INT’L TAX PUB. FIN. 471 (1995).

¹¹⁴ Countries generally do not use disguised export income tax subsidies.

¹¹⁵ The SCM rules were originally in GATT, but were separated from it into the SCM Agreement in the Tokyo Round.

¹¹⁶ Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, art. 1.1(a)(1)(ii), Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS: THE LEGAL TEXTS 264 (1994), available at <http://docsonline.wto.org> [hereinafter SCM Agreement].

¹¹⁷ This group of subsidies is subject to an expedited action procedure through the WTO Dispute Settlement Body. Other subsidies may also be “actionable” if they adversely affect the interests of another WTO member, but these are not subject to the expedited dispute settlement process. Still other subsidies are not actionable.

some tax-related measures, such as “the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes.”¹¹⁸ This item is explained in a reference footnote 59, which provides that: (1) if appropriate interest is collected on deferred revenue, the deferral does not constitute an export subsidy; (2) the arm’s length standard must be included in the analysis, i.e., deviation from this standard may indicate a subsidy; and (3) measures to avoid double taxation of foreign sourced income are exempt from subsidy scrutiny.¹¹⁹ This footnote and the illustrative measures list were at the center of the Domestic International Sales Corporation (DISC), Foreign Sales Corporation (FSC) and ETI saga, which is the primary and most developed dispute relevant to international trade and taxation in general, and the U.S. export subsidies aspects in particular.

These cases were all about de jure export contingency. De facto export contingency of a direct tax subsidy would be hard to find using the current jurisprudence because it requires the application of a consequential test. Transfer pricing and multinational enterprise (MNE) taxation pose the biggest challenge to the current regime. In that context it is extremely difficult to identify and measure exports. The questions one must ask in this context illustrate this difficulty. First, whose income is identified and measured? One may simply answer: any taxpayer. But who is a country X taxpayer? There is no easy answer to this question. Countries vary in their definitions of residency (and nonresident taxpayers for that matter) for tax purposes. Bilateral tax treaties provide a satisfactory tie-breaking mechanism in the case of individuals but not for business entities.¹²⁰

Second, the current transfer pricing rules are fairly converged worldwide, based on the arm’s length principle. Does this mean that one cannot plan ahead and leave a very small profit for tax purposes in the home country, parking the rest of it in a low-tax jurisdiction, or just another jurisdiction? Of course not; it is extremely naïve to assume that these rules are as effective as they are intended to be. So, here we have tax that was otherwise due, and is saved only if exportation occurs. Nominally, deferral and the current transfer pricing regime could be considered de facto subsidies contingent on export. Add services and investments to the mix, and you have a very dicey situation.

¹¹⁸ SCM Agreement, *supra* note 116, at Annex I, item (e).

¹¹⁹ *Id.* at n.59.

¹²⁰ See, e.g., Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 320 (2001).

Finally, it will be difficult for WTO members to agree whether one should test the overall tax burden of taxpayers, or conform to economical or geographic isolation. In other words, the question is whether to deviate from the generally accepted fiction in the tax world that respects legal persons as “separate” taxpayers for these purposes. A territorial test would encourage conferring of benefits that do not necessarily appear as tax due and may shift protectionist pressures to the less WTO-regulated investment. An overall test may catch simple concessions or international division of income, which are very common in the tax world.¹²¹

The U.S. foreign tax credit (FTC) regime is also suspect in this regard. It is suspect because it allows “averaging” of income within the various foreign source income categories employed by the Code for the purposes of FTC limitations under Code section 904(d), known as “baskets.”¹²² Basically, a domestic corporation earning high-taxed foreign source income (related to exports) can reduce its overall effective tax rate by earning other unrelated, low-taxed income. This opportunity is further enhanced by source rules particularly favorable to exporters.¹²³

¹²¹ Another possibly relevant transfer pricing rule is contained in the U.S. cost-sharing regulations that allow U.S. corporations to adjust ownership ratios between themselves and a related foreign entity based on original costs rather than fair market value. If sale of goods is involved, the effect would likely be to make exports cheaper. The classic case is when a technology corporation establishes an offshore subsidiary, financed by a simple contribution from the U.S. parent. The subsidiary co-finances a project with the parent (let's say 50/50), with the prospect that it will sell the products anywhere in the world except for the United States, where the parent holds the selling rights. Now assume that the project is successful and the reality is that the non-U.S. market comprises 60 percent rather than the projected 50 percent of the market. In compliance with the technical requirements of the regulations, the group can adjust to this new reality on the basis of the original (low) costs of development, rather than having to transfer ownership rights (10 percent) at the current (high) price, or resorting to active (expensive) export. The supposedly retrospective construction of the regulations may provide a defense, namely providing for adjustments rather than actual exports; the central principle of the regulations is that no export is involved. Note that the U.S. regulations are not coordinated with other countries, and that in this context they cannot be considered a measure to avoid double taxation. Finally, regarding transfer pricing in general, it is possible to argue that it represents a measure to avoid double taxation; thus, if it arises from an international agreement, it is out of the scope of the SCM Agreement, pursuant to the Agreement's Illustrative List of Export Subsidies in Annex I, item (e), and the related footnote 59.

¹²² I.R.C. § 904(d). Note that the American Jobs Creation Act has finally reduced the number of baskets to two. See American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

¹²³ Such as section 863(b), which allows a manufacturer that sells its products

The analysis of de facto export contingency may be overly hypothetical to some at this early stage of the discourse. Nevertheless, such analysis is relevant with respect to the interpretation of the double tax avoidance measures mentioned in paragraph (e) of GATT Article XX and footnote 59 of the SCM Agreement. As mentioned above, the United States based one of its arguments in the DISC/FSC/ETI case on the fifth sentence of footnote 59, which exempts measures designed to avoid double taxation of foreign-source income from being an export subsidy within the meaning of SCM Article 3.1(a). The argument interprets the footnote as providing general immunity for measures aimed at avoiding double taxation, however defined domestically.¹²⁴ ETI was argued to be such a measure, as it exempts certain foreign source income from U.S. taxation, which is an accepted method of double tax relief. The AB rejected¹²⁵ these arguments as it viewed some of the income exempted under ETI as not having a sufficient link to a foreign state. As a result, the AB was not convinced that ETI exempts “only” foreign source income. This is a question of how one understands the “source” concept, which could mean different things with respect to different types of income (as is often the case with tax terminology,

abroad (i.e., exporter) to use an arbitrary rule which allocates 50 percent of its export profits outside of the United States as foreign source income. Purchased (rather than manufactured) inventory is sourced under another arbitrary rule: the “title-passage” rule, pursuant to Code section 861(a)(6) and Treasury Regulations section 1.861-7(c), which allow sellers of U.S. inventory abroad (i.e., exporters) to determine at will whether their income generated in such transactions will be domestic or foreign source income. This rule allows exporting taxpayers to choose the better tax treatment, so rationally there must be a tax forgone by the Treasury, but it is essentially an arbitrary rule with no economic rationale, which makes its comparison with any “baseline” arbitrary as well. Similarly, the royalties source rule, pursuant to section 861(a)(4), provides that the place of use of the intellectual property will determine the source of the income (royalties) it generates. Once combined with the rule that sources research and development expenses (allowing a deduction of half of these expenses according to the location of R&D activities and half according to the location of the sales activities), this rule must also amount to an effective de facto subsidy. None of the above provisions are regularly thought of, or serve, as measures to avoid double taxation. For a review of the effect of the U.S. FTC rules on export, see Mihir A. Desai & James R. Hines, Jr., *The Uneasy Marriage of Export Incentives and the Income Tax* (Nat’l Bureau of Econ. Research, Working Paper No. 8009, 2000), available at <http://www.nber.org/papers/w8009> (last visited Apr. 27, 2005). Of course, the FTC rules may be out of the scope of the SCM Agreement as measures to avoid double taxation, if found in a bilateral tax treaty.

¹²⁴ It also defines these measures and provides the definition of foreign source income. See AB Report, *supra* note 1, ¶ 36.

¹²⁵ See *id.* ¶¶ 165, 184.

one can seldom rely on the plain meaning of a word as its definition can vary from one context to the next).¹²⁶

Note, finally, that the United States is promoting a more equal treatment of direct and indirect taxation in a future WTO, especially in the context of export subsidies. The current law of export subsidies treats direct and indirect taxation differently, making it more likely for a direct tax measure to be found a prohibited export subsidy than an equivalent indirect tax measure.¹²⁷

III. WHAT IS AT STAKE? THE POTENTIAL SCOPE OF TRADE AND TAX CLASHES: THE U.S. PERSPECTIVE

Limited disputes and general satisfaction with the current status quo led to the present underdeveloped doctrine of trade law as applied to tax measures. There is no escape from the conclusion that countries had not been concerned about the practice of protectionism through direct tax measures and therefore had not bothered with bringing direct tax issues to the table of trade negotiations. They were politically satisfied with the status quo of practical nonapplication of WTO law to direct tax measures.

This state of affairs is likely to change, however, as a result of several developments, including the FSC decision. Probably more significantly, the international tax regime faces certain new challenges that will require its material modification anyway. Prior to the discussion of the possible outcomes of such changes and the presentation of possible solutions to the present incoherence between the two constructs, it would be useful to map the potential battlefield in order to understand what is at stake. This Part of the article attempts to do that from the perspective of the United States. Even so, it is likely that many of the mentioned tax rules are also used in many other countries.

As already mentioned, this article follows the traditional

¹²⁶ One important point not developed in this article is the difference between the concept of source as it has evolved in the current international tax regime and the way it is viewed by the AB in the ETI report, equalizing it to the concept of origin, which in many cases is exactly the opposite from source as we know it in the tax world — another professional failure of the WTO Dispute Settlement Body resulting from its lack of expertise in the field. The origin principle just determines the tax rate to be applied, but not the division of the revenue between the competing jurisdictions, which is exactly the role of the source rules.

¹²⁷ Negotiating Group on Rules, United States — Subsidies Disciplines Requiring Clarification and Improvement, TN/RL/W/78 (Mar. 19, 2003).

approach used in the scarcely available relevant literature, focusing on the three sets of WTO rules that might be violated by direct tax measures: the MFN clause, the national treatment clause, and the subsidies rules. In addition, it may be useful to think about three different flavors of direct tax rules: administrative (including anti-avoidance) rules, direct tax rules that are generally accepted worldwide in a form similar to that of the United States, and rules that are unique to the United States.

A. MFN

The most visible potential violation of a general (hypothetical) MFN obligation is different withholding tax rates for the various types of income covered by tax treaties. Every country that is party to a bilateral tax treaty commits this violation. Some treaties even exempt certain items from taxation if earned by residents of the country that is party to the treaty, while other equivalent treaties do not do so.¹²⁸ Additionally, some tax treaty provisions use certain thresholds, both substantive and quantitative, that must be passed in order to ensure beneficial tax treatment for certain types of income. The tax treaties of many countries typically use different thresholds for different treaty partners.¹²⁹ The classic example is the taxation of dividend income. The 2001 U.S.-Luxembourg treaty, for example, provides for a five percent withholding tax (similarly to the OECD model), and the

¹²⁸ Similarly, some treaties provide for withholding of taxes on capital gains, *see, e.g.*, Agreement for the Avoidance of Double Taxation, U.S.-P.R.C., art. 12, Apr. 30, 1984-May 10, 1986, T.I.A.S. No. 12065, at 13, and some do not allow it. In the United States this case is less important since the United States does not withhold on capital gains. This is mainly an investment issue, but an expansive reading of other trade agreements may lead to the understanding that some of the effects prohibited in GATT and GATS, for instance, could be very similarly achieved through an investment scheme.

¹²⁹ One good example is the definition of a permanent establishment (PE), which varies between countries and therefore identical facts can trigger full domestic taxation of U.S.-related business income for residents of one treaty partner and no domestic taxation of such income for residents of another country. The most visible example is the minimal period that is required for a construction project to trigger a PE. This period is 12 months in the OECD model tax treaty, OECD MODEL TAX TREATY, *supra* note 51, art. 5(3), the U.S. model tax treaty, U.S. MODEL TAX TREATY, *supra* note 52, art. 5, and the 2001 U.K. bilateral tax treaty, Convention for the Avoidance of Double Taxation, U.S.-U.K., art. 5, July 24, 2001, S. TREATY DOC. NO. 107-19 (2002). This period is, however, 183 days out of any 12 months in the 1999 Venezuelan bilateral tax treaty, Convention for the Avoidance of Double Taxation, U.S.-Venez., art. 5, Jan. 25, 1999, S. TREATY DOC. NO. 106-3 (1999).

threshold is set at ten percent of the voting stock of a U.S. subsidiary.¹³⁰ The 2001 U.S.-U.K. treaty includes the same rule, yet it adds a more beneficial provision that exempts, *inter alia*, dividends paid by a U.S. corporation to its U.K. parent company if the parent holds at least eighty percent of the subsidiary's voting power. Additionally, there may be a difference between voting power and percentage of voting stock. Other treaties do not include these rules. The treaty with Luxembourg's neighbor, Belgium, for instance, sets a single reduced withholding rate for dividends at fifteen percent.¹³¹

A more subtle example of differential treaty treatment of similar income is the "other income"¹³² clause that appears only in some of the U.S. bilateral tax treaties.¹³³ This means, for example, that incidental U.S. income of an Israeli resident will not benefit from treaty protection and is likely to be fully taxed in the United States, whereas an Indian resident under the same circumstances will be fully exempt from U.S. tax on the same income, simply due to the "other income" clause included in the 1989 U.S.-India bilateral tax treaty.¹³⁴

In short, U.S. bilateral tax treaties reflect no obligation of the

¹³⁰ Convention for the Avoidance of Double Taxation, Apr. 3, 1996, U.S.-Lux., art. 10, S. TREATY DOC. NO. 104-33 (1996).

¹³¹ Convention for the Avoidance of Double Taxation, July 9, 1970, U.S.-Belg., art. 10, 23 U.S.T. 2687 (1970).

¹³² Following the OECD model tax treaty, other income is taxed only in the resident country. If such a provision is missing from a treaty, both the residence and the source country may tax it, or the source country gets the first bite, and the resident country provides a foreign tax credit for such a bite. See the 1975 bilateral tax treaty with Israel, which lacks such a provision, Convention with Respect to Taxes on Income, U.S.-Isr., Nov. 20, 1975-May 30, 1980, Hein's No. KAV 971.

¹³³ An interesting relevant case is the applicability of the U.S. bilateral tax treaties to limited liability companies (LLCs), which are a relatively new form of business entity in the United States. Some countries, most notably Canada, refused to apply the treaty with the United States (which predated the LLC laws) to such entities, but would accept very similar entities in other countries into the scope of the relevant bilateral tax treaties. This is a case of a basic MFN violation that is perfectly acceptable in the bilateral tax treaty world. In the context of GATS, Canada is probably not protected by the treaty-related limitations since it is its own argument that this matter is not covered by a bilateral tax treaty, and therefore may be challenged by the United States in the context of non-Article II exempted sector. A similar argument under GATT is harder and less probable, but not theoretically impossible. This case also raises the issue of time passage and the slow updating of treaties. Necessarily, an updated bilateral tax treaty will provide for different treatment than older ones.

¹³⁴ Convention for the Avoidance of Double Taxation, Sept. 12, 1989, U.S.-India, art. 23, S. TREATY DOC. NO. 101-5 (1989).

United States to afford uniform treatment to all treaty partners.¹³⁵ A similar lack of the uniform treatment obligation is evident in domestic tax legislation that allows certain benefits to income tax treaty partners but not to others, sometimes even distinguishing between treaty partners. For instance, the new U.S. dividend tax regime permits the benefit of a tax reduction in the cross-border context, but conditions extension of the benefit on the distributing corporation's eligibility to enjoy the benefits of a comprehensive bilateral tax treaty with the United States (i.e., one that includes an exchange of information program).¹³⁶

This provision seems to create two classes of bilateral tax treaties. It is expected, however, that most U.S. bilateral tax treaties will be treated as comprehensive.¹³⁷ Any differential treatment will have a significant effect on the trade in goods and services.

B. National Treatment

This Part elaborates on the provisions of the Internal Revenue Code that may be considered potential violations of the U.S. national treatment obligation, if applied to direct taxation.¹³⁸ Some of these provisions are ubiquitous and are expected to be found in most income tax systems. The universal nature of these provisions suggests that they would be difficult to repeal, despite the presence of a trade law violation. These provisions include¹³⁹ the standard deduction, which is not available to nonresidents pursuant to section 63(c)(6)(B);¹⁴⁰ the thin capitalization provisions of section 163(j),¹⁴¹ which do not apply to residents;¹⁴² the consolidation regime, which excludes foreign corporations pursuant to section 1504(b), and applies to any other Code provision referring to the section 1504(b) definition of "includable corporation," such as the old dividend received

¹³⁵ This is obviously true with regards to nontreaty countries as well.

¹³⁶ American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat 1418.

¹³⁷ Indeed, see I.R.S. Notice 2003-69, 2003-42 I.R.B. 851, which lists all U.S. bilateral treaties that are considered comprehensive.

¹³⁸ This does not mean that these provisions are not otherwise justified, or that it is the opinion of this author that they are such violations. See also Warren, *supra* note 15, at 151 n.92. For further discussion of potential subsidies, see also *infra* Part V.

¹³⁹ Note that this is an illustrative and by no means exhaustive list.

¹⁴⁰ I.R.C. § 63(c)(6)(B).

¹⁴¹ I.R.C. § 163(j).

¹⁴² See Green, *supra* note 30, at 135.

deduction regime (with the exception of section 243(e)),¹⁴³ the transfer pricing rules that apply solely to cross-border situations (although it is not clear that they are more burdensome to foreigners);¹⁴⁴ and finally, the branch profit tax¹⁴⁵ and excess interest rules that apply only to foreigners.¹⁴⁶

The taxation of technology transfers is an interesting case in this context. Cross-border intellectual property transactions represent an underdeveloped area of international economic relations in the WTO. Nonetheless, the relevant WTO agreement — the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)¹⁴⁷ — provides, in Article 3, for a national treatment obligation. Article 3 provides such treatment “with regard to the protection of intellectual property,” adding in footnote 3 that “protection” “shall include matters affecting the availability, acquisition, scope, maintenance and enforcement of intellectual property rights.”¹⁴⁸ Thus, theoretically it is possible that discriminatory taxation of intellectual property (IP) is prohibited by this provision.

In general, the United States withholds thirty percent of the gross royalties paid to foreigners. The rate is significantly reduced if a bilateral tax treaty applies. Assuming, however, that most royalties are paid to residents of treaty partners, it is disturbing to imagine a

¹⁴³ I.R.C. § 1504(b).

¹⁴⁴ I.R.C. § 482 and the regulations. See in particular the examples in the regulations, e.g., Treas. Reg. 1.482-1(d)(3)(ii)(C). An interesting point raised by Professor Green is that enforcement-based discrimination, an accusation raised against the United States in the context of transfer pricing, may have an effect similar to a substantive *de facto* discrimination, but may be hard to manage with a legalistic approach. Green, *supra* note 30, at 122. Of course, this may be true regarding other provisions, such as withholding taxes, foreigners’ information reporting and thin capitalization.

¹⁴⁵ I.R.C. § 884. This was conceded as a discriminatory treaty override. Green, *supra* note 30, at 102 n.127.

¹⁴⁶ I.R.C. § 884(f).

¹⁴⁷ Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS: THE LEGAL TEXTS 365 (1994), 1869 U.N.T.S. 299, 33 I.L.M. 1197 (1994) [hereinafter TRIPS]. Note that the United States has consistently advocated stronger intellectual property (IP) rights and enforcement in the trading community. The TRIPS agreement followed several IP conventions that have failed to satisfactorily settle the issue. The national treatment provision in TRIPS is not new; it was included in other IP conventions, including primarily the Berne Convention, which the United States joined only recently.

¹⁴⁸ TRIPS, art. 3 n.3.

claim that this treatment is discriminatory under the “no less favorable” standard for national treatment violation, in light of the worldwide acceptability of this method of taxing foreigners. Another relevant provision is Code section 881(a)(4), which taxes gains from the sale or exchange of certain IP in a manner similar to royalties.¹⁴⁹ This tax is contingent on the productivity, use, or disposition of such IP to foreign corporations, as long as these gains are not effectively connected with a U.S. trade or business.¹⁵⁰ In the purely domestic context, such gains may be taxed at a lower rate of fifteen percent, which increases the chance of a discrimination claim in a nontreaty situation, where a thirty percent tax on the gross amount would apply. Unless used in the context of tax havens, which are more likely to be susceptible to WTO scrutiny based on direct tax measures, this claim would be problematic.¹⁵¹

Other rules that could be suspected of national treatment violation may nevertheless be necessary for the effective operation of the income tax system in a global business and investment environment. They may be considered discriminatory simply because it is more difficult, at times, to collect from foreigners, especially when asymmetric information risks are prevalent. Section 1446, requiring partnerships to only withhold taxes from foreign partners, and the different reporting requirements for foreigners under sections 6038(c) and 6038A, are just two examples of these rules, even though it is not clear that the reporting requirements for foreign companies under sections 6038(c) and 6038A are necessarily more burdensome than the reporting requirements for domestic corporations.¹⁵²

As mentioned, there are other rules that are somewhat unique to the United States, such as section 367, which denies certain system-wide tax deferral benefits when property leaves the country.¹⁵³ In particular, section 367(e) denies deferral benefits to distributions in spin-off transactions and other section 355 situations, and in liquidations to foreign parent corporations.¹⁵⁴ Another such rule

¹⁴⁹ I.R.C. § 881(a)(4).

¹⁵⁰ An equivalent provision would do the same for individuals.

¹⁵¹ See Slemrod & Avi-Yonah, *supra* note 26, at 542–44.

¹⁵² I.R.C. § 1446; I.R.C. §§ 6038(c), 6038A. Unless an obviously more burdensome rule applies to foreigners, it is inherently difficult to determine discrimination on this basis. For instance, it is understandable that foreigners may find it more burdensome to report in English (in comparison to their U.S. competitors). It is hard to justify, however, that this amounts to discrimination.

¹⁵³ I.R.C. § 367.

¹⁵⁴ I.R.C. § 367(e).

requires payment for deduction of original issue discount on a debt instrument held by a foreign related person pursuant to section 163(e)(3).¹⁵⁵ Section 911 provides a tax exemption, under certain circumstances, to a capped amount of wages earned by U.S. expatriates.¹⁵⁶ Finally, a nonresident cannot be a shareholder in an S-corporation under section 1361(b)(1)(C).¹⁵⁷

C. Subsidies

The subsidies category presents actual and current violations of WTO law. The obvious example is the DISC/FSC/ETI case, where the U.S. export tax subsidy regimes of the last three decades were ruled by the WTO to be prohibited subsidies. Those three regimes are not the only violations in the subsidies category. Other candidates, while not in obvious violation of the present WTO legal scheme, may be found on the annual notification of the list of subsidies, required to be provided by countries to the Committee on Subsidies and Countervailing Measures pursuant to Article 25 of the SCM Agreement, and Article XVI:1 of GATT.¹⁵⁸ The United States has traditionally issued extensive lists to demonstrate its support of increased transparency in the WTO. The recent U.S. subsidies list includes ample direct tax concessions to the agricultural,¹⁵⁹ energy,¹⁶⁰

¹⁵⁵ I.R.C. § 163(e)(3).

¹⁵⁶ I.R.C. § 911.

¹⁵⁷ I.R.C. § 1361(b)(1)(C).

¹⁵⁸ The most recent notification was for the fiscal year 2002 (October 1, 2001–September 30, 2002), dated October 29, 2003. See Committee on Subsidies and Countervailing Measures, *New and Full Notification Pursuant to Article XVI:1 of the GATT 1994 and Article 25 of the Agreement on Subsidies and Countervailing Measures*, G/SCM/N/95/USA (Oct. 31, 2003), available at <http://docsonline.wto.org>.

¹⁵⁹ Solo farmers are allowed to currently deduct, with some limitations, certain expenses used to enrich farmland even though the benefit is beyond the current fiscal year. *Id.* at 11. Farmers are allowed to expense multi-period livestock and crop production costs under Code section 263A. *Id.* at 12. Farmers are forgiven tax liability on certain forgiven debt, pursuant to Code sections 108 and 1017. *Id.* at 13. Certain ordinary agricultural income can get capital gains treatment, pursuant to Code section 1231. *Id.* at 13–14.

¹⁶⁰ Subject to some limitations, exploration and development costs for oil, gas, and other fuels may be expensed, pursuant to Code sections 57(2), 263(c), 291, 616, 617 and 1254. *Id.* at 24–25. Independent fuel mineral producers and royalty owners are allowed to take percentage depletion deductions rather than cost depletion for oil, gas, and other fuels, pursuant to Code sections 291, 611–613 and 613A. *Id.* at 25–26. Qualifying producers and royalty owners are granted a fixed tax credit per barrel of alternative fuels, phased out according to market price, pursuant to Code section 29.

lumber and timber,¹⁶¹ medical,¹⁶² metals, minerals, and nonfuel extraction industries,¹⁶³ as well as to certain geographical zones,¹⁶⁴ including a series of concessions to the New York Liberty zone surrounding the World Trade Center in New York City.¹⁶⁵ An even longer list of potential subsidies at the subfederal level is also attached to the notification, and includes direct tax concessions at almost every state and local jurisdiction, as long as such taxes are still in use. All of the above are subsidies, but none are de jure contingent on export. Alternatively, passing the de facto export contingency test or pursuing the actionable subsidies route may be more difficult. An in-depth factual inquiry always appears to be necessary whenever a question arises about a subsidy being subject to the latter test.¹⁶⁶

Id. at 26–27. Individuals can get capital gains treatment for sales of coal under royalty contracts, pursuant to Code sections 631 and 1231. *Id.* at 27–28. Petroleum producers and royalty holders are granted an enhanced oil recovery credit in the United States, pursuant to Code section 43. *Id.* at 28. Nonutility taxpayers are granted a special tax credit for investing in solar and geothermal energy facilities, pursuant to Code sections 46 and 48. *Id.* at 29. Qualifying producers and blenders of fuels containing alcohol are granted a special tax credit, pursuant to Code sections 38 and 40. *Id.* at 29–30. Producers of electricity from wind, biomass and poultry waste are granted a special tax credit, pursuant to Code section 45. *Id.* at 31.

¹⁶¹ Certain ordinary timber income may be treated as capital gains, pursuant to Code sections 631 and 1231. *Id.* at 37. Timber owners may expense multi-period timber growing costs (the benefit of which extends beyond the fiscal year), pursuant to Code sections 162 and 263A(c)(5). *Id.* at 38. Taxpayers are granted investment credit and special amortization for reforestation expenses, pursuant to Code sections 48(b) and 194. *Id.* at 38–39.

¹⁶² Qualifying taxpayers are granted a special credit for research and development of certain drugs for rare diseases or conditions, pursuant to Code section 45(c). *Id.* at 39–40.

¹⁶³ Nonfuel mineral extractors are allowed percentage rather than cost depletion for nonfuel mineral extraction expenditures, pursuant to Code sections 291 and 611–613. *Id.* at 41–42. Nonfuel mineral producers and royalty owners are granted the option of expensing, rather than capitalizing, exploration and development costs for nonfuel minerals, pursuant to Code sections 56, 263, 263A, 291, 616–617 and 1254. *Id.* at 42–43. Taxpayers are granted the option of capital gains treatment for iron ore sales, pursuant to Code sections 631 and 1231. *Id.* at 43. Taxpayers are allowed deductions of mine reclamation and solid waste disposal property closing costs, based on accrual of liabilities, pursuant to Code section 468. *Id.* at 44.

¹⁶⁴ Certain concessions target the revitalization of distressed areas. The concessions vary among zones and include a new markets credit, employment tax credit, special expensing allowances, tax-exempt bonds, and special capital gains treatment pursuant to Code sections 45D and 1391–1400J. *Id.* at 50–51, 53–54.

¹⁶⁵ The concessions have various sunset periods, and are granted pursuant to Code section 1400L. *Id.* at 54–55.

¹⁶⁶ In addition to this list, see the discussion of Code provisions that potentially

D. Conclusion

The amount and scope of tax provisions and fundamental constructs that are placed at risk under the hypothetical full application of WTO law may seem devastating to any tax expert. A repeal or significant amendment of the tax rules due to such application of trade law could be likened to an earthquake in the tax world. It is difficult to imagine such a scenario, particularly because the income tax systems of all major economic powers include similar or identical provisions.

The stakes would unquestionably be high in this battle between the international tax and trade regimes, were they to clash. The increasingly important international tax regime is stable and accommodating to economic globalization, but this stability has been achieved over half a century of international tax policy coordination. It now faces serious new challenges, aside from the conflict with the international trade regime. The incongruity between these two regimes presents a real risk of instability to the already sensitive equilibrium of the international tax regime. Due to fundamental differences between the two regimes, it would be practically impossible to reconcile them in the short term, without overhauling one or both, a dubious and risky strategy. Next, the article elaborates on some possible tactics to alleviate this tension, and possibly reduce the incongruity between these two regimes.

IV. SHOULD TAX EXPENDITURES BE SUBJECT TO WTO LAW ALONE?

One solution model attempts to reconcile the international trade

violate the national treatment obligation, *supra* Part IV. One area that is not problematic in the United States is tax sparing, as the United States has never allowed it in either its tax code or bilateral tax treaties. Article 27 of the SCM Agreement allows differential treatment of developing country members. SCM Agreement, *supra* note 116, art. 27. It normally applies to subsidies granted by developing member countries themselves, though it may also apply to subsidies of other countries relating to, for instance, privatization programs in developing countries. Bilateral tax treaties could also be affected by this provision — especially when tax sparing is involved (benefiting a bona fide developing country). Since the United States does not grant tax sparing, it is not relevant to this article. Note that there has been some criticism in the United States of the lack of bilateral tax treaties with developing countries as a means of support for these countries. If effective, inclusion of tax sparing provisions in bilateral tax treaties may be more relevant in the future, although there are no signs of such developments at present.

and tax regimes by the adoption of an acceptable “jurisdiction” or dividing line between these regimes. The term “solution model” rather than “solution” is used in this context because the basic premise of possible reconciliation is still being evaluated, and has not led to any actual known proposals. The basic premise was promoted by Professor Paul McDaniel in his recent Tillinghast lecture,¹⁶⁷ as well as by the AB, albeit implicitly, in its recent ETI decision.¹⁶⁸ The model discussed in this Part is constructed for the purposes of this article from Professor McDaniel’s lecture. He proposed, albeit in the more limited context of export tax subsidies, to follow logic similar to that of the domestic device known as the tax expenditures budget (which is why this article refers to this solution model as the “tax expenditure solution”). The central idea of this model is to draw a dividing line between the international tax and trade regimes that assigns and divides jurisdiction over the contested tax measures. The so-called “pure” tax measures would not be subject to WTO law, while everything else (i.e., tax expenditures) would be fully and exclusively subject to such law. Practically, this means that the tax expenditure measures would lose the shelter of the international tax regime and the special carve-outs provided for bilateral tax treaty measures, such as those in footnote 59 of the SCM Agreement.¹⁶⁹ The obvious example and primary target of Professor McDaniel’s analysis was the ETI regime. Professor McDaniel viewed the ETI regime as a clear example of a tax expenditure: a deviation from the accepted U.S. norm of worldwide taxation of its residents. Professor McDaniel therefore concluded that the ETI regime amounted to a “subsidy” that should be subject to WTO jurisdiction and denied the preferential treatment reserved for “pure” tax measures.

This Part of the article takes Professor McDaniel’s approach beyond its original scope¹⁷⁰ and develops it as a possible model for complete reconciliation between the international trade and international tax regimes. The conclusion reached is that such a solution model is both unsatisfactory and undesirable. The key for the success of this solution model is our ability to easily identify a clear dividing line between “pure tax measures,” immune from WTO

¹⁶⁷ McDaniel, *supra* note 7.

¹⁶⁸ See AB Report, *supra* note 1.

¹⁶⁹ See *supra* Part III.B.3.

¹⁷⁰ This article does not, therefore, criticize the specific point that Professor McDaniel makes in his lecture. The author agrees with Professor McDaniel’s particular point and results. The dispute is over the methodology and its application to a problem with scope much larger than originally proposed by Professor McDaniel.

scrutiny, and tax expenditures. Merely shifting the debate to this dichotomy is counterproductive if it does not produce clearer and more desirable results. Professor McDaniel argues that the dividing line should be each country's "normative" or "baseline" tax system, which contains, as he concludes, the desirable characteristics. His argument was made in the context of the FSC cases and the EU attack on state aid, leading him to the conclusion that the normative tax structure and free trade principles are not in conflict with each other. The perceived objectivity, clarity, and simplicity of this solution would be attractive had they been real.

The tax expenditure solution model is based on several assumptions. First, it assumes that every country has an easily identifiable and noncontroversial "normative" income tax system that could be used as a benchmark for these purposes. Second, it is assumed that in most cases it will be easy to identify deviations from the benchmark. Specifically, it must be simple enough for the WTO Dispute Settlement Body (DSB) to be able to identify such deviations without much controversy. Third, such deviations are assumed to be included in each country's tax expenditure budget or similar mechanism. At the very minimum, countries must at least agree to produce fair tax expenditure budgets, using the "right" (noncontroversial) benchmark, and consent to the use of such budgets not only for internal political monitoring purposes, but also for international trade compliance. Fourth, the model not only assumes that a benchmark income tax system could be identified for each country, but that different countries may have different benchmark systems, and that such disparities between them will not destabilize the international trade regime internally. Moreover, should these differences in benchmarks have undesirable effects on other interactions between the relevant countries, the model assumes that these negative effects will not be significant enough to pose an external threat to the stability of the international trade regime (for example, the countries negatively affected could demand renegotiations of their other agreements). Fifth, the model assumes that it is either desirable to strengthen the role of the WTO and the DSB by explicitly widening their jurisdiction over direct taxes (up to this point, the WTO has exercised a very limited jurisdiction over direct taxes, as demonstrated in Part II above), or that WTO members are clearly in agreement about the boundary constructed by the tax expenditure solution. This assumption includes an agreement to subject direct tax matters (expenditures) to the WTO "legalistic" dispute settlement process. As will be demonstrated in the following

sections, many of the above assumptions are not entirely realistic.

A. *The Tax Expenditure Budget*

To refute these assumptions, one must first present the tax expenditure concept as it is currently used in the domestic budget process. Professor McDaniel, together with Professor Stanley Surrey, defined this concept during Surrey's days as the Assistant Secretary of the U.S. Treasury for Tax Policy.¹⁷¹ The purposes of the U.S. tax expenditures budget are highlighted in the following legislative excerpt:

The Congress declares that it is essential — (1) to assure effective congressional control over the budgetary process; (2) to provide for the congressional determination each year of the appropriate level of federal revenues and expenditures; (3) to provide a system of impoundment control; (4) to establish national budget priorities; and (5) to provide for the furnishing of information by the executive branch in a manner that will assist the Congress in discharging its duties.¹⁷²

Three (at times competing) dimensions affected the evolution of the U.S. tax expenditures budget and the academic and professional debate over its interpretation and desirability.¹⁷³ The first and most obvious is the provision of information about the tax side of the budget, which promotes government transparency and a more educated budgetary process, primarily through comparison of different budget years. This is the least controversial dimension, as it is difficult to argue that less data is superior to more data in this respect. This is true so long as the tax estimates are not viewed as representing figures equivalent to those of actual direct expenditures. The second dimension attempts to do exactly that — it compares the dollar amounts of the tax and direct spending programs, with either the purpose of gaining political capital, or perhaps as a genuine

¹⁷¹ See, e.g., STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985).

¹⁷² Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 2, 88 Stat. 297, 299.

¹⁷³ See, e.g., Julie Roin, *Truth in Government: Beyond the Tax Expenditure Budget*, 54 HASTINGS L.J. 603 (2003); Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language* (N.Y.U. Law School, Public Law Research Paper No. 72, 2003), available at <http://ssrn.com/abstract=444281>.

exploration of the desirability of either program. Finally, the third and purely political dimension (the one which energized Professor Surrey's efforts in this regard) is the general belief that spending programs should not be executed through the Internal Revenue Code. Some have tried to use the tax expenditure budget in the debate between proponents of large and small government. In reality, both Democrats and Republicans have exploited both sides of this debate (sometimes diverting from their traditional stances) while cynically disguising the fact that shifting a program from one side of the budget (spending) to another (tax) does not necessarily reduce the size of the government.¹⁷⁴ Many have criticized the tax expenditure budget on a conceptual basis — disputing our ability to agree on the baseline system, or the ability to produce accurate and useful dollar estimates — while other criticism was simply the result of the cynical and devious political exploitation of the budget by the various Democratic or Republican administrations.¹⁷⁵

The debate over the desirability of the tax expenditure budget goes beyond the scope of this article and will not be addressed. Nevertheless, the criticism of the budget is useful as far as the budget's application as a model solution for reconciliation of the international trade and tax regimes. The first dimension of the tax expenditure budget, transparency and information reporting, is value-neutral in principle, and has no legal consequences. Therefore it is largely irrelevant for purposes of this article. The same is true about an apolitical comparison of direct spending versus tax expenditure programs. Each of them is not good or bad per se. A tax expenditure solution could result in some tax measures being subjected to the WTO scrutiny and held illegal, while others could be immune from such scrutiny. Adoption of a solution that assigns legal consequences to the choice between tax expenditures and direct spending will inevitably corrupt the clarity and supposed objectivity of these dimensions. The political dimensions of the tax expenditures debate are therefore irrelevant to our problem. Realistically, it is hardly conceivable that anyone will support WTO intervention in the decidedly domestic debate over the desirable size of the U.S. government.

¹⁷⁴ Daniel N. Shaviro, *The Bush Administration's Huge Tax Cuts: Steps Towards Bigger Government?* (N.Y.U. Law School, Public Law Research Paper No. 67, 2003), available at <http://ssrn.com/abstract=444201>.

¹⁷⁵ See, e.g., Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969).

B. The DISC/FSC/ETI Cases

As already mentioned, the WTO's single most important intervention in domestic income tax policy is found in the U.S. export tax subsidies cases. These cases also triggered Professor McDaniel's lecture, which provides the basis for the tax expenditure solution model developed in this article. This saga comprises three consecutive and closely related cases, which should be read together for our purposes. The AB ruled on the most important segment of the trio in February 2000. The ruling was that the FSC regime constituted a prohibited subsidy under Article 3.1(a) of the SCM Agreement.¹⁷⁶ The FSC regime, enacted in 1984, replaced the DISC regime, which provided indefinite deferral to a portion of the eligible corporations' export earnings.¹⁷⁷ The DISC provisions were immediately attacked by the European Commission (EC), and in 1976 were determined to contradict U.S. obligations under Article XVI:4 of GATT.¹⁷⁸ At the same time, the United States challenged some of the European territorial income tax systems. The GATT panel disapproved of these as well, but in 1981, after a compromise was reached with the United States, the GATT council approved these tax systems in a decision that served as a de facto roadmap for the FSC legislation, enacted as part of the Tax Reform Act of 1984.¹⁷⁹

The FSC regime served essentially the same purposes as the DISC regime, while attempting to adjust itself to the language of the council's opinion that permitted nontaxation of extraterritorial income. Still, the FSC regime exempted a portion of a corporation's export-related foreign source income from U.S. taxation that would have otherwise been taxed, contrasting with the normal U.S. policy of worldwide income taxation. The EC waited thirteen years before it challenged this second regime in November 1997, followed by a July 1, 1998 official request for a dispute settlement panel, based on violations of SCM Articles 1.1, 3.1(a), and the SCM illustrative list.¹⁸⁰

¹⁷⁶ See AB Report, *supra* note 1.

¹⁷⁷ I.R.C. §§ 991–997 (as enacted in 1971). The DISC regime was not repealed outright, but rather curtailed, leaving in place the so-called interest-charge DISCs. See Robert Feinschreiber & Margaret Kent, *Using Formal Agreements to Achieve DISC Benefits*, 33 TAX MGM'T INT'L J. 303, 303 (2004).

¹⁷⁸ United States Tax Legislation (DISC), Nov. 2, 1976, GATT B.I.S.D. (23d Supp.) at 98, 113 (1977).

¹⁷⁹ Tax Legislation, Dec. 7–8, 1981, GATT B.I.S.D. (28th Supp.) at 114 (1982).

¹⁸⁰ Annex I to the SCM agreement, available at <http://www.worldtradelaw.net/uragreements/scmagreement.pdf>.

The panel issued a final report against the United States on October 8, 1999, finding that the FSC constituted an export subsidy inconsistent with the SCM Agreement. The U.S. appeal was rejected on February 24, 2000.¹⁸¹ In response, the United States enacted a third regime, the ETI, which was designed to comply with the panel decision similarly to the FSC regime.¹⁸² Specifically, ETI purported to incorporate the now-allowed¹⁸³ territorial aspects into the U.S. worldwide system of taxation.¹⁸⁴ The EU promptly responded, arguing that ETI did not comply with the FSC ruling. A panel was again established and issued a report against the United States on August 20, 2001.¹⁸⁵ The United States appealed, but its appeal was rejected on all grounds by the AB on January 14, 2002.¹⁸⁶ The United States then conceded this battle, and Congress's failure to repeal ETI had led to EU retaliation as of March 1, 2004.¹⁸⁷

Perhaps the most important aspect of this final ruling¹⁸⁸ is its firm support of the logic that each country has a "baseline" normative tax system that could be established as a benchmark for an inquiry into a specific measure suspected of functioning as an export subsidy; a deviation from that benchmark would indicate a subsidy because, technically, the tax would be "otherwise due."¹⁸⁹ Moreover, the AB emphasized the elective character of the ETI regime, ruling that

¹⁸¹ Appellate Body Report, *United States — Tax Treatment for "Foreign Sales Corporations"*, ¶ 179, WT/DS108/AB/R (Feb. 24, 2000).

¹⁸² FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000). For a concise review of the ETI rules, see Ernest R. Larkins, *Extraterritorial Exclusion Replaces FSC Regime: Mirror Rules, Broader Spectrum*, 12 J. INT'L TAX'N 22 (2001).

¹⁸³ See Appellate Body Report, *supra* note 181.

¹⁸⁴ The United States stated that the ETI was not just a replacement for the FSC regime, but a real reform of the U.S. tax system to include territorial tax aspects. See *U.S. Opening Statement at WTO Hearings on ETI Act Appeal*, WORLDWIDE TAX DAILY (Dec. 4, 2001) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2001 WTD 233-14).

¹⁸⁵ See World Trade Organization, *United States — Tax Treatment for "Foreign Sales Corporations" — Recourse to Article 21.5 of the DSU by the European Communities: Report of the Panel*, WT/DS108/RW (Aug. 20, 2001), available at http://www.wto.org/english/tratop_e/dispu_e/108_art215_e.pdf.

¹⁸⁶ See AB Report, *supra* note 1.

¹⁸⁷ ETI was finally repealed as of January 1, 2005, with some still debated transition and grandfathering provisions, by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 101, 118 Stat. 1418, 1423–24. For retaliation provisions, see Council Regulation 2193/2003, 2003 O.J. (L 328) 3 (EC).

¹⁸⁸ This article will refer to the final AB Report as incorporating all former actions.

¹⁸⁹ AB Report, *supra* note 1.

making the ETI election guaranteed that the taxpayer would pay a smaller amount of tax than the amount “otherwise due” absent such an election.¹⁹⁰

The next subpart of the article elaborates on the weaknesses in the AB’s position, which is similar in its logic to Professor McDaniel’s suggestion. It is also worth noting that the AB’s rhetoric regarding the elective character of the ETI regime ignores the widespread use of elections in income tax systems and, despite the AB’s attempts to bolster its position with “mathematical” proof, reveals the AB’s incomplete understanding of this area of the law.¹⁹¹ For instance, the so-called “check-the-box” election allows a U.S. parent company to treat some foreign subsidiaries as branches for U.S. tax purposes and vice versa (treat some of the foreign branches as subsidiaries). Such an election is likely to have a positive effect on U.S. exporters. True, it will be difficult to prove direct dependency on export, but it is unlikely that anyone will imagine ever subjecting this elective regime to exclusive WTO jurisdiction.

C. The Tax Expenditure Solution is Unsatisfactory

The most problematic part of an argument in support of the tax expenditure solution is the claim that a benchmark income tax system is obvious, easily identifiable, and that such a system would be widely acceptable, at least in principle. Note that it is not Professor McDaniel — a leading U.S. tax expert — but the WTO’s DSB, whose members typically have no tax expertise, that performs this analysis. Even in the domestic context, very prominent tax figures, most famously Professor Boris Bittker, seriously doubted the possibility of a consensus among the best tax minds. Indeed, even during the making of the tax expenditure budgets one can see that the Treasury and the Joint Committee on Taxation (JCT) publish separate and different versions of the budget based on different benchmarks. How, then, can one seriously argue that foreigners with no knowledge of tax law, especially U.S. international tax law,¹⁹² would be able to reach

¹⁹⁰ *Id.*

¹⁹¹ For a more elaborate discussion of AB’s failure in this context, see *infra* Part V.

¹⁹² Our income tax systems are all hybrids. They all deviate from the Schanz-Haig-Simmons economic definition of income, at least by being mostly, but not completely, based on realization. They also represent a part accretion tax, taxing income arising from capital, and part consumption tax, exempting (or deferring) such income. See Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition*

consensus? The ETI case, which was still attempting to “square the circle” and follow this flawed logic, serves as a good example of these difficulties. The heroic attempt to identify a single benchmark system failed, and the AB had to resort to a more pragmatic “smell test.”¹⁹³

This is not to say that the AB’s final conclusion was incorrect. The United States should have repealed these measures. The concern, however, is with the poor guidance that these cases provide. The best explanation given by the AB for adopting this reasoning was that such analysis allowed it to reach an “objective conclusion.”¹⁹⁴ Cynicism aside, this is a very weak justification for cyclical and unsubstantiated reasoning. Applying a general “smell test” that practically incorporates both consequential and intent-based tests — neither of which were adopted by the DSB — may be practical in the current environment, where few direct tax measures conflict with WTO law, but such a test does not help us to better understand the meaning of a tax “otherwise due.”¹⁹⁵

Once one realizes the difficulty of agreeing on a benchmark system, it is not difficult to understand the potential impossibility of clearly identifying deviations from such a benchmark. Deviations are relative by definition¹⁹⁶ and cannot be measured satisfactorily or serve as reasonable public guidance without a clear consensus on the benchmark system. Therefore, it is a mistake to infer a general rule from Professor McDaniel’s analysis of the ETI case. For one, this case was the typical “easy case” — a blunt export subsidy that was originally designed as such in an explicit compromise with the EC. Second, the subsidy rules themselves are more precise, which makes identifying violations of these rules easier than identifying violations of more subtle discriminatory nature. Inductive reasoning is therefore inappropriate in this case.

One may argue that using each country’s tax expenditures budget

Rules Under the Federal Income Tax, 48 TAX L. REV. 1 (1992). The variety of international rules just compounds the problem; no well-known tax systems in the world are entirely territorial, and by the same token, none are really “worldwide.”

¹⁹³ AB Report, *supra* note 1.

¹⁹⁴ *Id.* ¶ 89.

¹⁹⁵ Unfortunately, in the specific proceedings, the United States has not presented an alternative, coherent norm, except for asking the AB for deference to each country’s own system.

¹⁹⁶ This is inherent to any such legal definition, and particularly the subsidy definition as “revenue forgone.” “Forgone” necessarily means that the revenue was “otherwise due,” so the latter expression is only repetitive and redundant, and therefore does not require separate analysis.

as an indicator of deviations from the benchmark system may be a simple solution to the problem of identifying such deviations. This is also the third assumption discussed earlier. It is not, however, a satisfactory solution. Many countries still do not have tax expenditures budgets. The countries that have adopted them use them in very different ways and based on very different assumptions. Moreover, in countries such as the United States, where the Treasury Department and JCT publish different budgets, it may be difficult to decide which one to use. Finally, having in place a rule that uses countries' tax expenditures budgets to determine WTO jurisdiction over their direct tax measures may encourage countries to change their tax expenditure budget guidelines in order to limit the risk of WTO intervention. This will inevitably be counterproductive.¹⁹⁷

Similar concerns cast doubt on the fourth assumption mentioned in Part IV.A above. It is reasonable to assume that countries will differ in the intensity and speed of their reactions to a tax expenditure solution. Some may even think that the domestic importance of their tax expenditures budget supersedes the international implications and thus refuse to change their current system — showing willingness to fight off the WTO if and when a problematic case comes along. This, as the United States realized in the ETI case, is not merely a theoretical scenario. The problem is that once the tax expenditures solution is adopted, some countries will suffer because they will have to repeal some of their direct tax measures, or face the prohibition against adopting new ones. Such countries may seek “compensation,” or resetting of the agreed-upon balance. This sentiment is now prevalent in the United States in connection with the U.S. defeat in the ETI case.¹⁹⁸ Such rebalancing of interests may be undesirable because it may have a “snowball” effect and trigger reopening of issues the settlement of which had already been costly. These “dynamic” effects surely must be taken into account before the tax expenditure solution is adopted. The magnitude of these effects is difficult to predict, but it is most likely to be felt in the tax area. It would be especially problematic if the result is detrimental to the stability of the current international tax regime. No solution to the relatively rare disputes arising from income tax protectionism

¹⁹⁷ This will also be undesirable, as suggested in the next subpart.

¹⁹⁸ Some even argue that the EC brought the FSC cases forward in response to its defeat in several WTO disputes, primarily the bananas case. See Gary Clyde Hufbauer, *The Case of Mutating Tax Incentives: How Will the DISC/FSC/ETI Drama End?*, WORLDWIDE TAX DAILY (Apr. 8, 2002) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2002 WTD 67-5).

warrants the destabilization of the international tax regime. This is admittedly a speculative and normative point. The next subpart deals with the more concrete and empirical aspects of the tax expenditures solution.

D. The Tax Expenditure Solution is Undesirable

This article is skeptical not only about the ability of the tax expenditure solution to reconcile the international tax and trade regimes, but also about the desirability of such a reconciliation. The uncalculated risk the solution model poses to the stability of the international tax regime is just one problem.

The most fundamental aspect of the tax expenditure solution is the identification of the baseline tax system. The two tax expenditures budgets (taking into account the separate budgets prepared by the Treasury and the JCT) used in the United States at the present time are constantly debated. Regardless of the ongoing debate, they represent an accepted political and practical income tax system, rather than a pure or normative economic system. In the domestic context, the use of the tax expenditures budget is widely considered useful so long as the budget is not seen as accurately measuring the various tax expenditures it contains, but simply reporting useful information to the public. In addition, the budget is seen as a helpful device to track expenditure trends over time.¹⁹⁹ In most cases, there is no normative condemnation in characterizing something as a tax expenditure rather than a direct expenditure. The distinction, however, makes a big difference when defining a subsidy, since any deviation from the baseline is a subsidy, and once a subsidy is dependent on export it is automatically prohibited.²⁰⁰

Adopting the tax expenditure solution will expose the U.S. tax expenditures budget to the pressures and demands of international politics, in addition to the pressures it already faces from the domestic

¹⁹⁹ See Roin, *supra* note 173, at 608, 615.

²⁰⁰ Take, for example, the opportunity to defer taxation of certain foreign source income earned through foreign subsidiaries. This is probably the most “basic” relevant tax expenditure in the United States. It also includes income that falls into certain exceptions for active income in the major antideferral regime in the United States — subpart F of the Code. Under Professor McDaniel’s method, it should be considered a subsidy, but this is one of the most popular tax measures in the United States, and its being part of the normative “baseline” is just a question of perspective, whether that coveted baseline is a pure (and nonexistent) worldwide taxation system without deferral, or a more balanced worldwide tax system, protected by acceptable anti-avoidance rules.

political process. The attempt to piggyback on the domestic tax expenditures budget for identifying international violations of WTO law will only result in an even more corrupt domestic tax expenditures budget. Such a result cannot be desirable unless one believes that the destruction of the tax expenditures budget is a desirable outcome.²⁰¹ Moreover, the very need to piggyback on the tax expenditures budget signals that the interpretation and application of WTO law to direct taxation is problematic. Otherwise, one would simply apply the WTO law without reference to the tax expenditures budget. Again, this problem is illustrated by the ETI case, when even after the U.S. acceptance of the logic of turning to the tax expenditures budget²⁰² (in cases of blunt and conspicuous tax export subsidies), the AB failed to put this concept to work, resorting to the aforementioned “smell test.”²⁰³ It appears that the AB was desperate to cling to something with a hint of objectivity, so it focused on the tax expenditures budget as a rhetorical device, without providing any further useful guidance.

All the prior discussion assumes that the country in question actually employs a tax expenditures budget. Would the adoption of a tax expenditure solution mean that every WTO country would have to employ a tax expenditures budget? Such a requirement seems excessive and may trigger resistance. Moreover, if the information in the tax expenditures budget is used to arrive at a presumption (even a refutable one) of the existence of a subsidy, there will inevitably be a difference in treatment of countries with and without a tax expenditures budget. Such a difference may affect decisions of countries with regard to tax expenditures budgets: decisions the main purpose of which should be the improvement of the domestic government and budgetary processes, not making the life of the DSB easier. It is also likely that countries without tax expenditures budgets have either developing or transitional economies.²⁰⁴ The construction of a reliable budget process in such countries is crucial to their chances of maintaining a stable political regime, which is also in the interest of the developed world. These efforts are being supported

²⁰¹ One must note that it is not clear that this will indeed lead to the disappearance of the tax expenditures budget. Even if one is sympathetic to the destruction of the budget, it is not clear that this is the most efficient way to do that.

²⁰² See *U.S. Opening Statement at WTO Hearings on ETI Act Appeal*, WORLDWIDE TAX DAILY (Dec. 4, 2001) (LEXIS, FEDTAX lib., TNI file, elec. cit., 2001 WTD 233-14) (remarks by Deputy Treasury Secretary Kenneth W. Dam).

²⁰³ See *supra* Part IV.C.

²⁰⁴ OECD countries have all adopted tax expenditure budgets as of the end of the century.

and monitored by the World Bank and the IMF despite obvious difficulties. Tampering with these vital efforts for the purpose of determining whether something is a subsidy is clearly undesirable.²⁰⁵

The dynamic elements mentioned above may or may not be desirable in theory. Nevertheless, they raise some skepticism regarding the tax expenditures model, since any negotiation of agreements at the international level involves fragile compromises, and the risk of frustrating the equilibrium in already settled areas seems unjustified. This is particularly true due to the present vulnerable position of the WTO. Despite the recent achievements in the agricultural subsidies area, the Doha Round is still stalled, and anti-WTO sentiment is still strong across the political map. The fifth assumption underlying the tax expenditures model, i.e., that it is desirable to widen WTO's jurisdiction over income tax measures, is related to this reality. It seems unlikely that countries will presently support an expansion of WTO's powers. This is particularly true when such an expansion gives WTO power over direct taxation, one of the most cherished symbols of national sovereignty in a world where sovereignty is becoming increasingly limited. Another aspect of subjecting direct taxation to the WTO power is the necessity to accept the WTO dispute settlement process and its "legalistic" approach, which is undesirable on its own, as explained by Professor Robert Green in one of the first articles written on this topic.²⁰⁶ Professor Green drew on the significant differences between the trade and tax regimes — the superior transparency of the latter in particular — to argue for continuing to use the mutual agreement approach of the international tax regime in the resolution of tax disputes, in contrast to the WTO's "legalistic" approach.²⁰⁷

Finally, since there is no structured support for the tax expenditure solution other than Professor McDaniel's limited analysis and the AB's confusing tautology in the ETI case, there appears to be no structured argument in support of its superiority over other solutions. Because this area of research is new, little evidence of alternative arguments is available. The next Part of the article will discuss this author's coordination solution and demonstrate that it is a

²⁰⁵ This is not to say that WTO law should accommodate IMF and World Bank programs in all cases. The relationship between these international institutions has not yet been explored in the literature, but at least one project to this effect is expected to be published soon (details with the author).

²⁰⁶ See Green, *supra* note 30.

²⁰⁷ *Id.* at 139. For a more conceptual exploration of the issues on our agenda, which actually predated Green's article, see Slemrod, *supra* note 113.

feasible and superior alternative to the tax expenditure solution.

V. COORDINATING THE INTERNATIONAL TRADE AND INTERNATIONAL TAX REGIMES

As is apparent from the analysis above, this article doubts the feasibility of reconciling the current international tax and international trade regimes. Maintaining the current status quo, however, is risky,²⁰⁸ and is not the only available option, since the policies of these two dynamically evolving international regimes could be coordinated in a manner that should prevent serious conflicts from holding back the advancement of these regimes, at least in the short term. In the long term, a more comprehensive, permanent solution may be sought, yet such a solution will most likely involve dramatic restructuring of one or both of the relevant regimes, and is therefore beyond the scope of this article. Moreover, this article does not attempt to provide a detailed prescription for such coordination. Rather, it aims at convincing the reader that coordination is a feasible solution method for these currently conflicting regimes. The article does provide some observations that may assist in the design of an actual solution — the solution that must be designed by governments in the normal course of negotiations of the relevant regimes.

The FSC saga serves as an important lesson to designers of any potential solution. First, it demonstrates that income tax protectionism is not merely theoretical. The argument that the U.S. export tax subsidies were unique and acceptable in the context of the compromise between the EU and the United States over DISC and the European exemption systems can no longer hold after the WTO's unequivocal decisions against the United States and the EU's firm insistence on enforcing these decisions. This practical lesson complements and makes more concrete the theoretical argument made above, that income tax protectionism is expected in a world that denies governments the full authority and flexibility over most economic policy measures.

Another clear lesson from the FSC decisions is that current WTO law and DSB practice are hardly capable of handling income tax related cases. Despite some direct references to income tax treaties in

²⁰⁸ The FSC saga is not alone as an income export tax subsidies case. China uses its income tax extensively for protectionism as well. See, e.g., Daniel Pruzin, *U.S. Questions Array of Chinese Subsidies in Notification Circulated to WTO Members*, WTO REPORTER (Oct. 12, 2004) (WL, BNA-INTLTRADE database, elec. cit., 10/12/2004 BNA WTOR d12).

the WTO's primary legal sources, there is no developed doctrine or jurisprudence that could have assisted the panel and the AB in deciding these relatively easy cases. Instead, the AB struggled through unrelated jurisprudence before finally reaching the inevitable result — but without a firm legal footing, and only supported by verbiage that amounted to a typical “smell test.”²⁰⁹

For example, in its report,²¹⁰ when defining a subsidy, the AB repeats the rhetoric of the FSC case and the decision of the panel in the ETI case regarding the meaning of “tax otherwise due,” stating that “the mere fact that revenues are not ‘due’ from a fiscal perspective does not determine that the revenues are or are not ‘otherwise due’ within the meaning . . . of the SCM Agreement.”²¹¹ The AB appears desperate to support the result it needed to reach based on its “legalistic” doctrine, and it comes through despite the flaws in its reasoning.

Even if we took the quote above seriously, two material difficulties arise. First, the AB implied that the fiscal doctrine and its terms of art do not intersect with WTO law. Indeed, WTO law does not rely on fiscal definitions and concepts, even when the subject matter is the income tax. This again demonstrates both the incongruity between the international trade and international tax regimes, and the inability of the DSB to handle income tax matters. Second, the AB demonstrates a lack of understanding of the modern income tax system, which is built from a mesh of norms, some conflicting and some complementing each other — norms that cannot be explained by a single grand theory.

Nonetheless, the AB insists on imposing on the parties (the United States in this case) the assumption that there must be a defined normative benchmark to which it is possible to compare the measure under review.²¹² At most, the existence of such a normative benchmark is debatable,²¹³ and the benchmark is unquestionably difficult to identify, with the AB being the first to acknowledge this difficulty in its decision.²¹⁴ Of course the AB wanted to support its decision with an apparently objective legal source, and the existence of an easily identifiable normative benchmark would assist it with

²⁰⁹ For the best example for this struggle, see footnote 66 of the AB Report. AB Report, *supra* note 1, at 28 n.66.

²¹⁰ *Id.* ¶ 88.

²¹¹ *Id.*

²¹² *Id.* ¶ 89.

²¹³ See discussion of the tax expenditures solution, *supra* Part IV.C.

²¹⁴ AB Report, *supra* note 1, ¶ 90.

that. Yet in reality the AB ended up building its legal construction out of thin air, in the process exposing both the insufficiency of the current WTO law in dealing with tax matters and its own discomfort and lack of expertise in this area.

The significance of this lack of expertise is the third lesson taken from the FSC cases. While struggling with the difficult task of forcing an obvious result into the confines of a shaky doctrinal mold, the panel and the AB proved their lack of expertise once again. In addition to the above, note just a few other examples: for one, the decisions devoted some discussion to the elective aspect of ETI, concluding that absent such an election there must be a tax “otherwise due.”²¹⁵ This is nominally true just because of the nature of an election, but since elections are so frequently used in income tax systems, they cannot all be viewed as subsidies.²¹⁶ Familiarity with the normal design of income tax systems would prevent the panel and the AB members from elaborating on this irrelevant point; if protectionism is the concern, then the election point adds nothing but rhetoric. It is not difficult to see that the ETI election could have been redesigned as a nonelective provision applicable only to those benefiting from it, but it would still be a prohibited export subsidy.

Another fundamental concept of income tax law is “source.”²¹⁷ This concept is exclusive to international tax matters and its purpose is to divide income between jurisdictions that may have overlapping taxing claims regarding an item of income. Normal international tax practice designates each item of income as having either a “foreign” or “domestic” source. The consequence of this designation may be the grant of some tax relief — but such relief is universally granted only to foreign source income. Source rules determine which country (typically called the source country) gets the “first bite” in taxing the item of income, and such “bite” is typically capped under international norms. Source rules also determine what competing jurisdiction (typically called the residence country) gets the residual right to tax the item of income. Residence country is the country that grants the tax relief; in doing so, it is likely to take into consideration the “first bite” allowed to the source country. There are various source rules that facilitate these determinations with regard to different types of income (one source rule for business income, one

²¹⁵ *Id.* ¶¶ 103–104.

²¹⁶ The desirability of the use of such elections may be questionable at times but this is irrelevant to the point made and beyond the scope of this article.

²¹⁷ Source rules are discussed at more length in REUVEN S. AVI-YONAH, U.S. INTERNATIONAL TAXATION ch. 2 (2002).

for dividends, etc.).

The AB ignores the role of source rules without discussion, resorting to the dictionary observation that “in ordinary usage, the word ‘source’ can refer to the place where a thing originates, and that the words ‘source’ and ‘origin’ can be synonyms.”²¹⁸ Note that while “origin” is an important concept of indirect taxes, it is meaningless in the realm of income taxes. Immediately after this light and somewhat hesitant linguistic discussion, the AB oddly proceeds to make a conclusion that “the word ‘source,’ in the context of the fifth sentence of footnote 59, has meaning akin to ‘origin’ and refers to the place where the income is earned.”²¹⁹ Again, cynicism aside, this conclusion is both potentially self-contradictory and plainly wrong. It is potentially self-contradictory because origin and the place where income is earned are not necessarily the same. For example, the origin of income from the sale of a manufactured good could be the place of manufacture, whereas the income could be earned elsewhere — such as in the country where the property rights reside. The conclusion is also wrong because source is neither of the above. In the immediately preceding example for instance, the source of income could be in a third country where the ultimate purchaser resides.²²⁰

The discussion of source came up in the context of footnote 59, which exempts measures to avoid the double taxation of foreign source income.²²¹ The concept of double taxation has been historically important in the realm of income taxes, yet it does not have a strong normative significance. Its acceptable meaning serves as a useful starting position on which countries base their income division norms and, in most cases, their agreements to relieve excessive taxation that may hinder cross-border transactions. Moreover, it is now understood that under-taxation, likewise, affects international transactions and may create similar inefficiencies.²²² The difficulty of using the concept of double taxation and its incomprehensiveness are not the fault of the AB. In fact, the concept illuminates the flaw in the reference to it in footnote 59 — another indication of the incongruity between the international tax and international trade regimes. The AB is at fault,

²¹⁸ AB Report, *supra* note 1, ¶ 137.

²¹⁹ *Id.*

²²⁰ See Treas. Reg. § 1.861-7(c) (1960).

²²¹ The AB complicated its analysis by elaborating on this measure, using clearly unrelated tax concepts and examples. The criticism of the language of the whole decision is, however, beyond the scope of this article, and the examples explained are not meant to be comprehensive — they are illustrative only.

²²² See Lang, *supra* note 37, at 81–88.

however, because it applied the concept mechanically without reference to the underlying principles that guide international tax norms today.²²³

These lessons support Professor Green's point about the undesirability of subjecting the international tax regime to the "legalistic" approach of the WTO and the DSB, and the FSC decisions further prove his point. Therefore, any attempt to reconcile the international tax regime with the international trade regime (such as the conceptual solution model constructed in Part IV) in a manner that will require subjecting income tax measures to exclusive DSB scrutiny is undesirable.

Nonetheless, it is understood that there is no complete escape from WTO law and jurisprudence; the international tax regime cannot evolve to permit and serve as a safe haven to blunt violations of undisputable obligations of WTO members. This article argues that the only way to reconcile this difficulty is to require coordination of these two international regimes. The international tax regime's nonlegalistic dispute resolution mechanisms can accommodate this at the present time; it is much more difficult the other way around due to the formalities to which the court-like the WTO DSB must adhere. Primary assignment of such disputes to the international tax regime is therefore more workable.

Another recent development provides some complementary lessons. Although anecdotal and admittedly driven by different motivations, the struggle between various domestic direct tax systems of the EU member states and the European Court of Justice (ECJ) can serve as a warning to proponents of solutions that attempt to subject income taxes to WTO law, or, as a matter of fact, to any other supranational law that is not designed with specific attention to income tax policy. In short, the EU member states specifically agreed to leave income taxation out of the scope of the harmonizing union. Only a few measures have been harmonized since,²²⁴ and even these measures were practically left for the member states to implement at

²²³ Admittedly, many tax experts constantly refer to double taxation as if it were a plain-meaning doctrinal term. Even income tax treaties are still commonly called double tax treaties. Therefore, this is probably a less problematic example of the insufficiency of the AB analysis.

²²⁴ Most famous examples are the parent-subsidiary and merger directives. For the official summary of the current state of affairs, see European Union, *Direct Taxation: Introduction*, available at <http://europa.eu.int/scadplus/leg/en/lvb/l26036.htm> (last visited June 9, 2005).

their own pace.²²⁵ An attempt to harmonize corporate taxation in Europe, for example, stumbled despite strong institutional support.²²⁶ The resistance of the member states' governments is understandable if one considers the scope of current limitations on these governments' economic policies. Their monetary policies are, in most cases, subject to the European Monetary Union (EMU). Fiscal policies (deficit size in particular) are restricted by the Stability and Growth Pact.²²⁷ Indirect taxes (primarily VAT in Europe) are being harmonized,²²⁸ and the social security and spending programs are under immense pressures. The income tax is left as one of the few measures that governments can use relatively freely to implement their economic policies. Even that measure, however, is heavily constrained by economic globalization.²²⁹

The ECJ stepped into this reality and has recently attempted to implement a constitution-like approach, mandating the repeal of certain income tax measures that distinguished between citizens and other Europeans for income tax purposes.²³⁰ The court's approach has been based on the so-called European fundamental "freedoms,"²³¹

²²⁵ Implementation of the merger directive is one example. See Council Directive 90/434/EEC art. 12, of 23 July 1990 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States, 1990 O.J. (L 225) 1 (EC), available at <http://europa.eu.int/scadplus/leg/en/lvb/l26039.htm>.

²²⁶ For a recent development, see, e.g., Joe Kirwin, *Marks & Spencer Case Demonstrates Need for Common Tax Base in EU, Official Says*, BNA INT'L TAX MONITOR (Feb. 3, 2005) (LEXIS, BNA lib., BNAITM file) (citing, on the condition of anonymity, an EU commission official supporting tax base harmonization, and evaluating whether it would be better to get there directly through member states' negotiation, or with the pressure of an ECJ decision to that effect).

²²⁷ See Council Resolution 97/C, Amsterdam, 17 June 1997, 1997 O.J. (C 236) 1, 2 (EC), available at http://europa.eu.int/eur-lex/lex/rech_reference_pub.do (last visited July 18, 2005).

²²⁸ See Council Directive 77/388/EEC, Harmonization of the Laws of the Member States Relating to Turnover Taxes — Common System of Value Added Tax: Uniform Basis of Assessment, 1977 O.J. (L 145) 1 (EC), available at http://europa.eu.int/eur-lex/lex/rech_reference_pub.do (last visited July 18, 2005).

²²⁹ See Reuven S. Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1575–76 (2000).

²³⁰ See, e.g., David B. Oliver, *The David R. Tillinghast Lecture: Tax Treaties and the Market State*, 56 TAX L. REV. 587, 593–95 (2003).

²³¹ See, e.g., The Charter of Fundamental Rights of the European Union, 2000 O.J. (C 364) 1, available at <http://europa.eu.int/scadplus/leg/en/lvb/l33501.htm> (last visited July 18, 2005). For the court's jurisprudential attitude, see, e.g., Case C-319/02, *In re Manninen*, 2004 E.C.R. 342, ¶ 71 (striking down the Finnish imputation system,

particularly the freedom of establishment. Reading these freedoms expansively, the court seemed exclusively to reject domestic income tax measures as interfering with the single market. This is reasonable in theory; in practice, however, it conflicts with the above-mentioned inability of European governments to implement national economic policies. It is not clear how severe the reaction of the member states' governments will be to this development.

This article does not evaluate the desirability of these developments in Europe but wishes to emphasize that a country that agrees to be subjected to general standards (the European so-called freedoms or, in our case, the general nondiscrimination rules of the WTO) without explicit caveats must be prepared for its laws to be diverted in directions not agreed upon, despite explicit agreements that domestic laws would not be so diverted. The case of the EU is different from the WTO, which does not attempt to promote a "single market," yet the dynamics are similar.

Despite the above criticism, this article is not essentially skeptical of the WTO. On the contrary, it wishes to allow the WTO to focus on its core mission, rather than dumping on it everything even remotely related to trade (especially taxation, being a politically sensitive and technically complex area that is rather well-regulated at the present time.)

Moreover, keeping the international tax regime out of the WTO is important for the maintenance of its effectiveness. The success of the currently separate international tax regime should not be taken lightly. This is especially true since tax practitioners are notoriously conservative and unwelcoming to change. Tax, in addition, is perceived by governments as one of the fundamental symbols of sovereignty in a time when the force of sovereignty fades and transforms from an absolute to a relative notion.²³²

One may argue that Professor McDaniel may still be correct in his observation that the international tax and international trade regimes do not necessarily conflict, even if the tax expenditure solution model is not workable or desirable. It is theoretically possible to deepen the incongruity between these regimes and formally carve out all income tax measures from the scope of WTO law and its dispute settlement process.

which did not extend its benefits to income earned abroad, based on free movement of capital grounds).

²³² For an interesting discussion of the issue by a renowned expert, see SASKIA SASSEN, *LOSING CONTROL? SOVEREIGNTY IN AN AGE OF GLOBALIZATION* (1996).

This rule would not solve the problem, but rather would present countries with *carte blanche* (and an explicit incentive) to exploit their income tax systems for protectionist purposes. Such exploitation would be immune from international scrutiny despite the direct effect it would have on the flow of international trade. In addition, it would create problems with using domestic income tax incentives, which might result in undesirable inefficiencies. Any attempt to refer to specific products or industries will affect behavior and result in new inefficiencies. Some international trade-related supervision over the international tax regime should therefore be maintained. The current status quo is not sustainable not only because it lacks any guidance, but also because the current international tax regime will have to change in the near future. It is not clear whether a new balance could be achieved in a similar manner to the current balance. The desirability of such a new balance is also unpredictable.

It is likely and desirable that the international tax regime will develop in the direction of creating an international tax organization. Such an organization will serve, at the least, as a global policy forum with some interpretation authority. The process of increased international coordination of income tax policies is deterministic: it must result in an increased, if not a formal, harmonization of principles.²³³ That is where one can see a possibility of incorporation of international trade-related standards, such as the already acceptable nondiscrimination requirement, which is closely related to the WTO “national treatment” principle. Another obvious provision that could be incorporated is the prohibition of export tax subsidies. It is inconceivable that MFN-type provisions could be incorporated into such a solution in the short term, but one can think of several similar measures, such as the minimum and maximum rates provisions, harmonization, setting of a capped range of possibilities, thresholds, preferred rates – all of which may result in consequences that *de facto* approximate the effect of MFN provisions.

Another benefit of this solution is that it is likely to generate a more cohesive tax regime than an external solution. A solution that requires WTO-level rules is likely to follow the current division between trade in goods, services, investment, etc. These separate agreements are not necessarily coordinated and are currently in different evolutionary stages, which may render difficult any attempt of incorporating income tax into these agreements in an effective and equitable manner.

²³³ See Brauner, *supra* note 27.

Finally, relieving the WTO of the challenge of regulating income taxes should be welcomed at a time when the organization faces some serious political challenges in its quest to complete the Doha Ministerial Round. As an extremely political subject matter, taxation will place on WTO additional responsibilities and pressures, which could impede its efforts towards achieving its goals. Additionally, the FSC cases and the general exposure of income tax systems to WTO scrutiny discussed in this article could serve as a good lesson for WTO in its attempt to develop coherent jurisprudence — particularly in the area of formalizing the aim and effect requirement for discrimination finding.²³⁴

²³⁴ See discussion *supra* Part II.B.2.