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Dealing with the Fragmented International Legal Environment

WTO, International Tax and Internal Tax Regulations

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Introduction

Taxation has become "the single most difficult substantive problem of international trade."[1]

The risk is that the pursuit of a more perfect globalization – more openness – endangers our imperfect, but still remarkable globalization by intensifying the conflicts that the system inevitably generates. (Rodrik 2007, p. 25)

Due mainly to the establishment of the World Trade Organization (WTO), the decline of trade barriers has been a major international accomplishment. In order to protect and enhance the liberalization of international trade, the WTO Agreements contain a fundamental obligation requiring WTO members to refrain from discriminatory or protectionist actions, including those using taxation instruments. However, one result of the unwarranted isolation of the independent tax and trade regimes has caused this policy of non-discrimination to be applied with less success in tax matters.

Even though there is a significant overlap in their objectives and effects, trade and tax regimes have been isolated from each other and have developed into two different legal schemas. Given the close relationship between trade and taxes, the continued sharp separation of the two regimes needs to be reexamined.

This study will search for a better understanding of the relationship between the two regimes within a historical context, and will explore the possibility of integrating international tax principles with international trade subjects. The continuing expansion and importance of international trade regulation and the relatively unchanged international income tax regime lead one to question the continuing validity of the separation of tax and trade regimes. This study will address the possibility of incorporating international tax principles into the WTO.

The fragmentation problem between international tax and trade issues emerges because there are "many parallels and overlaps between international trade and

[1] Professor John H. Jackson, discussing the Domestic International Sales Corporation (DISC) in 1978; this remains an issue. *See* Jackson (1978, pp. 747, 749).

taxation" (Warren 2001, pp. 131, 147–148). Over time, the two evolved into separate, non-collaborative legal regimes, although there is indisputable significant "overlap in their goals and effects" (Warren 2001, p. 148). Even the rationale for the two legal regimes is, according to Professor Alvin Warren, "basically the same, which is to reduce impediments to international commerce" (Warren 2001, p. 147).

The existing disconnects between the international trade and tax regimes poses serious challenges that could result in potential nullification of the WTO agreements. Warren writes that when tax and trade regimes are considered together, "no consistent principle explains the current dividing line" (Warren 2001, p. 158). Links between taxation and the international trading system, whether direct or indirect, are inevitable; thus, it is essential to establish guidelines for dealing with these links.

It is not as if taxation is unrelated to the GATT/WTO. The relationship is evident, for example, in a dispute over the US Federal Foreign Sale Corporate (FSC) income tax regimes, after which a WTO arbitration panel issued a decision allowing the European Union to impose $4.043 billion in trade sanctions against the USA,[2] and was also evident during the negotiations over the General Agreement on Trade in Services (GATS) treaty.[3] The relationship needs to be clarified, analyzed, and articulated in order to correct current mistakes and avoid future ones, or at least minimize the chances of conflict between the two regimes and manage those conflicts that do occur.

Reduced tax rates, tax holidays, or specific tax provisions to encourage exports, discourage imports, or otherwise discriminate against foreigners, or to protect local products and producers, or to achieve certain domestic policies (legitimate or otherwise), may be applied, either covertly or openly, to specific sectors or activities, possibly violating some of the WTO's rules. Manipulating some aspects of the tax base, such as depreciation schedules or deduction allowances, can achieve similar results.[4] Taxes can nullify WTO agreements, a possibility that is already a problem and needs to be confronted.

Tax and trade regimes sometimes clash. Although tax and trade share underlying goals, this should not discount the fact that taxes play major societal roles that are not necessarily based on economic considerations, and hence are not necessarily in harmony with international trade theory. Taxes are sometimes so fundamental to domestic systems that they are almost impossible to change, as when the tax system

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[2] *See* United States-Tax Treatment of "Foreign Sales Corporations," WT/DS108/AB/R (Feb. 10, 2000). The WTO appellate panel upheld an earlier holding that the US FSC is a prohibited subsidy in violation of WTO rules. The FSC measure was subsequently repealed in the Extraterritorial Income Exclusion Act 2000, Pub. L. No. 106-519, which was also invalidated by the WTO. An Arbitration Panel imposed $4.043 billion in trade sanctions against US imported goods. *See also* Tax Analyst (2004).

[3] *See* Chap. 5, *infra*.

[4] Malaysia and Singapore exempt from taxation any shipping company income derived from the operations of ships owned by domestic companies, creating an incentive for the use of shipping services provided by resident companies. *See* Daly (2006, pp. 527–557).

is part of a nation's majority religion or is linked to another value deeply rooted in local communities, such as housing or farming. In such situations, people's tax contributions, deductions or subsidies to local mosques or churches, farms, social or homeownership programs, and the like, are difficult to deal with on a global level. Professor Warren writes that "[w]hatever one thinks about the relationship between trade and tax policies, an answer to the question of how free a country is to use its income tax to discriminate against international commerce requires consideration of both legal regimes" (Warren 2001, p. 149).

The Saudi Arabian tax system exemplifies the tension between religion, tax and trade, because tax has a role in the country's religion and is an essential part of its laws. The system subjects Saudi-Muslims to *zakat*,[5] a religious tax of 2.5% on wealth, while non-Saudis are subject to a "higher" income tax rate of 20% (flat rate) of their income. It is more difficult to decide this kind of tax case in Geneva,[6] since the effects of those decisions affect the religion of Saudi Arabians. There is a danger in the Geneva-based entity making decisions for people living in distant locations with regard to tax issues related to their local needs and wants.

Further, although many of the WTO agreements could potentially apply to national tax laws, because WTO agreements require national treatment and most-favored-nation status,[7] having implications on tax rules, some international tax scholars have expressed skepticism about the relevance and logic of combining both regimes. Common arguments that have been raised include: trade concepts are not analogous to tax policy (Rosenbloom 1994, p. 593); trade and tax serve different purposes, such as distribution of income[8] or encouragement of certain types of investments[9] and activities (Birde and Zolt 2003);[10] and tax is closely linked to nations' sovereignty (Green 1998, pp. 79, 131). Although these arguments might also apply to trade, they remain powerful and require careful consideration.[11]

Thus, there are two conflicting, strong points of view. From one perspective, taxation can affect trade so fundamentally as to nullify trade agreements. From the

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[5] Zakat is an Islamic tax, discussed in details in Chap. 3, *infra*.

[6] It is interesting to note that changes usually resisted if coming from outside. Professor William P. Alford writes regarding China that respect for private property rights cannot be externally implanted (Alford 1995). After providing a historical account of copyright protection in China, he argued that the "institutions, personnel and values needed to undergird a rights-based legality" must support the laws themselves and not be imposed or forced on them; otherwise it would be of "limited value" (Alford 1995, p. 120).

[7] This issue will be discussed in Chap. 6, *infra*, The WTO Agreements.

[8] "What is the place of equity in comprehensive tax reform? The first goal ought to be to protect the lowest-income families in the society" (Gillis 1989, p. 167).

[9] "Many tax incentives have been employed to encourage investment" (Jorgenson and Landau 1993, p. 138).

[10] Birde and Zolt listed the following as possible objectives of tax laws: (1) Raising revenue; (2) Economic efficiency and the costs of taxation; (3) Fairness concerns; (4) Tax administration and tax policy; (5) Taxation and growth; (6) Taxation and decentralization; and (7) Using the tax system for non-fiscal objectives such as correcting market failures.

[11] *See* Chap. 4, *infra*, The Literature Review.

other point of view, tax is associated with deep local values that are hard to manage on an international level.

Consequently, there is a danger that countries with unchecked power to tax may use disguised taxes to purposely undermine the WTO agreements. To a large extent, tax and trade do overlap, but also clash in their objectives.[12] Tax does, to some extent, work as a barrier to the freedom of movement, with the potential to cause nullification of the WTO agreements. If tax rules continue to move in a direction incompatible with trade rules, trade liberalization cannot be implemented. There is a need to recognize the problems, and focus and put more effort into devising rules that can manage them, instead of proceeding with a market-opening agenda as if the problems were of little consequence or as if the market would solve them by default.

Therefore, there is a need for maintaining a delicate balance between local needs and international commitments with respect to taxation. The issue this study attempts to raise the complexity and difficulty of the tax issues, and cases addressed and/or litigated under the WTO. Cases are wrongly brought to the WTO, not wrongly decided. If they are to be brought, there must be a flexible infrastructure to offer countries the needed marginal freedom to move within acceptable levels in their own internal environment so that the WTO decisions are not viewed as threatening local interests.

The need is for more than exception. Due to this complex relationship, this author is of the opinion that tax issues need to be decided according to a different set of rules, a "soft" jurisdiction before a tax panel, where more understanding and more flexibility can foster respect for international rules while respecting local, deeply rooted values and interests. The ideal solution would be a flexible international tax agreement, which could provide a platform governing all tax-trade related issues on the one hand, while on the other hand leaving WTO members with as much freedom as possible to decide their own fundamental domestic tax issues.

This author strongly believes that the best resolution is not one single set of rules, but rather the establishment of a forum in the WTO designed to create a set of guidelines that would apply soft pressures implemented through dispute settlement mechanisms to achieve cooperation in tax matters, while at the same time offers WTO members the needed space to move as their internal pressures require. Professor Rodrik called this the "policy space" approach (Rodrik 2007, p. 26).

This study will attempt to fill the current gap in scholarship between the fields of trade and tax, taking into account both historical and religious factors. The analysis will be based on international trade, in particular WTO rules and policies, as well as on international tax policies. The author suggests a novel framework in which to resolve existing and potential tensions between international tax and international trade.

[12] Professor Reuven S. Avi-Yonah agreed that there exists some overlap. "The question is, how important is this area of overlap .... I would argue that it is extremely important ... perhaps the WTO is the most promising forum for finding a solution" (Avi-Yonah 2001, pp. 1683, 1692).

The goal of this work is to develop a practical proposal that takes into account historical circumstances as well as present needs and challenges, and to predict probable future circumstances and suggest potential resolutions. This work will take seriously two ideas. One is found in the GATS, Financial Annex, Article 4, which states that: "Panels for disputes on prudential issues and other financial matters shall have the necessary expertise relevant to the specific financial service under dispute."[13]

The second idea is found in the Appellate Body (AB) ruling, which states: "... we observe that many States have adopted bilateral or multilateral treaties to address double taxation ... In seeking to give meaning to the term 'foreign-source income' in footnote 59 to the *SCM Agreement*, which is a tax-related provision in an international trade treaty, we believe that it is appropriate for us to derive assistance from these widely recognized principles which many States generally apply in the field of taxation."[14]

Book Structure

The book is divided into three parts. Part I, entitled "The Problems," contains three chapters. Chapter 1 analyzes the problem of direct and indirect taxation. It is an issue that has fueled the tension between the USA and the EU, having different tax systems that rely on direct and indirect taxes. This chapter will attempt to show concretely the questionable foundation upon which this differentiation between direct and indirect taxes under the WTO is built. The meaning of each term varies greatly depending upon the source of the definition, so a variety of meanings are presented and analyzed. Scholars' views on the differentiation, both for and against, are also discussed.

Chapter 2 deals with existing problems illustrating the disconnect between the international trade and tax regimes, which can best be comprehended by examining and analyzing actual individual cases. The chapter is divided into two parts: part one covers tax-trade problems, presenting hypothetical cases that could arise; and part two discusses cases already litigated under the GATT/WTO involving tax issues that illustrate actual and potential conflicts.

Chapter 3 provides an investigation of taxation in the context of religion, which is another problem facing trade and tax when they interact. The chapter focuses on the Saudi Arabian tax system of zakat, specifically its religious aspects, to show situations in which the tax–religion relationship can be a barrier to international trade.

Part II, Analysis, begins with an examination of how other intellectuals have tackled this issue. Chapter 4 analyzes the existing literature regarding the

[13] WTO Annex on Financial Services, art 4.

[14] WTO Annex on Financial Services, art 4 ¶¶ 141–143.

incorporation of taxation into trade agreements. The scholarly works included represent the full spectrum of prior recommendations, from arguments against including any tax issues under the WTO to those that support the proposition.

Chapters 5 provides answers to major objections against including tax under the WTO, starting with the issue of sovereignty, including its meaning, applications, and relationship to the tax regime. The European Union Direct Tax Model is discussed in detail, with special attention paid to specific cases and the role of the European Court of Justice (ECJ). Then this chapter concludes with a summarized historical background of the tax and trade relation before proposing a suggested solution. The historic development of the GATT, for example, clearly indicates the political difficulties the negotiators faced. The failure to establish the International Trade Organization (ITO) is the strongest evidence of such a politically sensitive environment.

Chapter 6 investigates the tax issues in the most important agreements of the WTO: the General Agreement on Tariffs and Trade (GATT), the General Agreement on Trade in Services (GATS), and the Agreement on Subsidies and Countervailing Measures (SCM). A new and challenging construction will be proposed for some of the clauses, and the legal texts will be interpreted with the help of the Appellate Body decisions and other international sources.

Part III examines The Future. Chapter 7 proposes a new, workable tax model (the tax agreement option), designed to handle the relationship between tax and trade. The author proposes that such an option is particularly likely to succeed under the WTO; and discusses the particular factors that should be taken into account in order to avoid potential pitfalls. In addition, it is suggested that a "soft law" approach is the best fit for this option.

Chapter 8 concludes the study, providing recommendations based on the history and analyses covered throughout the work, and reiterating the advantages of the proposed tax agreement option, which is anticipated to help ease existing international tensions with respect to tax and trade, solve current problems, and avoid potential difficulties that could present a major barrier to international commerce.

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Contents

Part III The Future

Part I
The Problems

This part will deal with three sets of problems to illustrate the tension that can emerge from the separation of tax and trade. The first issue is the unsound differentiation between direct and indirect taxes, a theoretical problem that results in unnecessary, sometimes costly consequences and lasting costly disputes, starting with the Domestic International Sales Corporation (DISC), FSC, and Extraterritorial Income Exclusion (ETI). These cases are not isolated; they have been linked to other disputes. In fact, some have argued that the seeds of the FSC case "had nothing to do with tax policy and everything to do with the European search for 'bargaining chips' to trade against EU losses in the Bananas and Beef Hormone cases."[1] And the seeds of the Bananas and Beef disputes can be traced to the DISC. The list of trade disputes goes on. One benefit of bringing tax issues into the WTO would be to subject this divisive issue to scrutiny and reexamination with a new perspective, taking into account the lasting, consistent and costly trade disputes between the two major blocks, in addition to the unclear theoretical foundation.

The second chapter will discuss tax cases related to the WTO. Section 2.1 will discuss cases that have been litigated because of tax issues. They will illustrate the magnitude of this fragmentation. Many important tax issues have been litigated under the WTO. In fact, the tax cases brought were started early on, even before establishment of the WTO. Many of these cases have been previously discussed in the existing literature, and some are covered in other parts of this book. Some observers viewed "the DISC case as the largest and most conspicuous failure in the history of GATT's litigation procedure" (Hudec 1988, p.1444). And the DISC came back wearing a different name, FSC, which the USA also lost. The US loss resulted in $4 billion. So, the issue of taxes under the WTO is not negligible.

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[1] *See* Agnew (2000, pp. 139, 141); *see* Hufbauer (2001, p. 1555); discussing the timing of the FSC, Hufbauer writes that the "origins of the FSC case had nothing to do with tax policy and everything to do with the European search for 'bargaining chips' to trade against EU losses in the Bananas and Beef Hormone cases, and the prospective expiration of the agricultural 'peace clause' in 2003" Hufbauer (2001, p. 1563, footnote 20).

Discussing the cases makes the problem of separation, which begs for a solution, more visible.

Section 2.2 will discuss hypothetical cases that also can be envisioned. A brief survey of some tax rules reveals problems and conflicts just waiting to arise.

The third chapter of Part I will show the problems of tax and trade created when tax is linked or attached to deep social values in the society. Saudi Arabia's tax system, for example, has its roots in religion. Now that it is a WTO member, potential problems are not unlikely to occur when the Saudi tax system clashes with the WTO rules.

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Chapter 1
Differentiation Between Direct and Indirect Taxes

Mr. King asked what was the precise meaning of direct taxation? No one answered.
(Max Farrand 1966, p. 350)

Taxation under every form presents but a choice of evils.
(Ricardo 1817, ¶ 9.29)

Tax issues are, at times, buried in the WTO under different names or misleading labels, and may be mishandled or mischaracterized because of historical misunderstandings that no longer apply. One issue, which this author believes has been interpreted incorrectly, is that of the distinction between direct and indirect taxation, and the treatment of the two under the GATT, a problem that emerges because of the fragmentation and isolation between the two fields, tax and trade. The fact that tax issues are handled outside the WTO has left the WTO with old foundations and unexamined bases for allowing outdated concepts to continue living under the WTO. It is very safe to state that the differentiation between direct and indirect taxes is a disputed issue within the tax community. Yet, it seems undisputed within the WTO. If there were a tax agreement, tax department, and tax staff, more attention would have been given to this issue and would have been reasonably addressed. The isolation between the two regimes has led to this sort of distortion. After presenting the relation of direct and indirect taxes to the WTO, this chapter will offer an overview of the literature and theoretical foundation behind the distinction between direct and indirect taxes.

1.1 Background

It is understood that the GATT applies only to indirect taxation, such as sales tax, rather than direct taxation (i.e., income tax), although "such an interpretation is implicit and is not clear from the language of the provision" (Brauner 2005, pp. 251, 274).

For many years, the discussion regarding direct and indirect taxes has not been focused on the classification of the taxes; rather, the emphasis has, in essence, been placed upon the implications of implementing one or both tax forms, or neither. Major themes of any discussion regarding the influences and effects of the GATT include the tax incidence, tax shifting, and the economic burden of taxation. In

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