

Jennifer E. Farrell

The Interface of International Trade Law and Taxation



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26

The Interface of International Trade Law and Taxation

Defining the role of the WTO

Jennifer E. Farrell

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Abstract

This thesis explores the ill-defined and oft-underestimated relationship between the World Trade Organization (WTO) and taxation. By adopting a two-pronged approach, the work will (i) examine the extent to which the WTO legal framework exerts influence upon domestic tax law and international tax policy, and will (ii) question whether it is appropriate for the WTO to play a regulatory role in the field of taxation, and whether this role should be expanded or curtailed.

The thesis presents an examination of the historical development of international trade law and international tax law, and reveals that these two separate areas of law are closely linked in terms of their underlying principles and historical evolution. The work then goes on to offer a doctrinal analysis of the tax content found in the WTO legal texts and highlights ambiguities therein. Analysis focuses on the General Agreement on Tariffs and Trade 1994 (GATT), the Agreement on Subsidies and Countervailing Measures (SCM Agreement) and the General Agreement on Trade in Services (GATS). Throughout the analysis, attention is placed on the income tax litigation between the European Union and the United States (the Domestic International Sales Corporation and the Foreign Sales Corporation tax breaks), and on future possible tax conflicts.

It is found that the WTO plays a crucial role in regulating taxation matters, but that the rules pertaining to taxation are often unmanageably ambiguous, and this may result in unforeseen conflicts with domestic and international tax policy. Four recommendations are offered to resolve this legal ambiguity: a reappraisal of the direct-indirect tax distinction, the clarification of legal texts, the establishment of a WTO Committee on Trade and Taxation, and the development of institutional linkages and dialogue between the WTO and the traditional international tax institutions, the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN).

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Abbreviations

AA	Agreement on Agriculture
AJCA	American Jobs Creation Act
BIAC	Business and Industry Advisory Committee
BISD	Basic Instruments and Selected Documents
BTAs	Border tax adjustments
CEN	Capital export neutrality
CFA	Committee on Fiscal Affairs
CIN	Capital import neutrality
DISC	Domestic International Sales Corporation
DSB	Dispute Settlement Body
DSU	Understanding on Rules and Procedures Governing the Settlement of Disputes
EC	European Communities
ECJ	European Court of Justice
ECOSOC	United Nations Economic and Social Council
EPZ	Export processing zone
ETI	FSC Repeal and Extraterritorial Income Exclusion Act
EU	European Union
FDI	Foreign direct investment
FSC	Foreign Sales Corporation
FTZ	Free trade zone
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GST	Goods and services tax
ICC	International Chamber of Commerce
IC-DISC	Interest-Charge Domestic International Sales Corporation
ICJ	International Court of Justice
ILC	International Law Commission
ILO	International Labour Organization
IRC	US Internal Revenue Code
IRS	US Internal Revenue Service
ITO	International Trade Organization
LDCs	Least developed countries
MAI	Multilateral Agreement on Investment
MAP	Mutual agreement procedure
MFN	Most-favoured nation
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development

Abbreviations

OECD MTC	OECD Model Tax Convention on Income and on Capital
OEEC	Organisation for European Economic Co-operation
PE	Permanent establishment
R&D	Research and development
SCM Agreement	Agreement on Subsidies and Countervailing Measures
SEZ	Special economic zone
TEC	Treaty establishing the European Community
TFEU	Treaty on the Functioning of the European Union
TIPRA	Tax Increase Prevention and Reconciliation Act 2005
TPR	Trade Policy Review
TPRB	Trade Policy Review Body
TPRM	Trade Policy Review Mechanism
TRAINS	Trade Analysis and Information System
TRIMs	Agreement on Trade-Related Investment Measures
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UN MTC	United Nations Model Tax Convention
USC	United States Code
USD	United States dollars
US MTC	United States Model Tax Convention
VAT	Value added tax
VCLT	Vienna Convention on the Law of Treaties 1969
WCO	World Customs Organization
WTO	World Trade Organization
WTO agreements	The results of the Uruguay Round: the WTO legal texts

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Chapter 1

Introduction

Trade is vital to the world. And, further, the work of trade and the law of trade increasingly intersect with much else that is also vital to the world.¹

Both governments and the corporate world have become increasingly aware of the impact of the World Trade Organization's rules and decisions in shaping international trade activity, and influencing domestic policy. In part, this awareness has resulted from the escalating trend of the World Trade Organization (WTO) to impinge upon other areas of law that have not traditionally fallen under its classic domain, such as labour standards, human rights, intellectual property, investment and environmental protection. This trend, commonly known as "Trade and ..." issues or "WTO linkages",² often leads to tensions between, on the one hand, international trade values, and on the other hand, competing "non-trade" interests. An oft-unacknowledged "linkage", and yet a matter that is emblematic of a Member State's national sovereignty, concerns the omnipresent matter of taxation: this thesis seeks to examine the WTO-tax linkage.

Naturally, it must be stressed from the outset that the relationship between taxation and international trade is not a novel subject matter. Customs duties, commonly regarded as traditional trade taxes, and internal indirect taxes (e.g. sales tax, value added tax (VAT)) have been regulated under the international trade framework since the inception of the General Agreement on Tariffs and Trade 1947 (GATT 1947). The GATT 1947 (now the GATT 1994) plays a key role in regulating trade taxes and internal indirect taxes, most significantly through tariff bindings, enforcing the principle of non-discrimination and confirming the practice of border tax adjustments (BTAs). There is, however, a danger in assuming that this is where the role of international trade law begins and ends for taxation. Indeed, a corollary myth has developed that cross-border indirect tax matters are regulated by international trade law, and cross-border direct tax matters are regulated by the international tax system and never the twain shall meet.

1. J. Bacchus, *Groping Toward Grotius: The WTO and the International Rule of Law*, 44 Harvard International Law Journal 2 (2003) 533, at 540.

2. There is voluminous literature on the issue of "WTO linkages". For an in-depth discussion, see *Symposium: The Boundaries of the WTO*, 96 American Journal of International Law 1 (2002) 1.

Since the establishment of the WTO – the successor to the GATT 1947 – the reach of international trade rules over taxation matters has significantly increased. The Uruguay Round of Trade Negotiations (1986-1994) created new ambitious multilateral agreements – collectively known as the WTO agreements – that broadened opportunities for Member States' tax policies to conflict with international trade rules, and have, in turn, created new regulatory consequences for discriminatory income tax practices that extend far beyond the original purview of the GATT 1947.³ The three major trade agreements – the GATT 1994, the Agreement on Subsidies and Countervailing Measures (SCM Agreement) and the General Agreement on Trade in Services (GATS) – all contain substantive tax obligations. Tax-related obligations are also to be found in the Agreements on Trade-Related Investment Measures (TRIMs) and the Agreement on Agriculture (AA). Yet, despite this broader jurisdiction over taxation matters, the relationship between international trade rules and taxation is oft-underestimated. Until relatively recently, this underestimation has been reflected in the dearth of academic literature connecting taxation and international trade.⁴ Moreover, the WTO, and its

3. The 1988-94 Uruguay Round of Trade Negotiations resulted in the Marrakesh Agreement Establishing the World Trade Organization, 15 April 1994 (hereinafter: the Marrakesh Agreement) which acts as an umbrella framework for the legal texts of the WTO – collectively known as the “WTO agreements”. The agreements are organized under four annexes of the Marrakesh Agreement: the Multilateral Agreement on Trade in Goods – containing 13 agreements (annex 1A), the General Agreement on Trade in Services (GATS) (annex 1B), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (annex 1C), the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) (annex 2), the Trade Policy Review Mechanism (TPRM) (annex 3) and Plurilateral Trade Agreements (annex 4). The Multilateral Agreement on Trade in Goods contains 13 agreements, including the General Agreement on Trade and Tariffs 1994, the Agreement on Agriculture (AA), the Agreement on Trade-Related Investment Measures (TRIMs) and the Agreement on Subsidies and Countervailing Measures (the SCM Agreement). While the GATT 1947 remains legally distinct from the new GATT 1994, the GATT 1994 absorbs the text of the GATT 1947 (as amended), and therefore any reference to the “GATT 1947” or “GATT” refers to the same legal text. In order to promote consistency, the Marrakesh Agreement states: “... the WTO shall be guided by the decisions, procedures and customary practices followed by the CONTRACTING PARTIES to the GATT 1947 and the bodies established in the framework of GATT 1947” (article XVI:1).

4. Prior to the advent of the *US – FSC* dispute, very little was written on the tax-trade nexus. There are a handful of notable exceptions where the international tax-trade nexus has been examined: J. Fischer-Zernin, *GATT versus Tax Treaties? The Basic Conflicts between International Taxation Methods and the Rules and Concepts of the GATT*, 21 *Journal of World Trade* 3 (1987) 39; A.H. Qureshi, *Trade-Related Aspects of International Taxation – A New WTO Code of Conduct?*, 30 *Journal of World Trade* 2 (1996) 161; D. Devgun, *International Fiscal Wars for the Twenty-First Century: An Assessment of Tax-Based Trade Retaliation*, 27 *Law & Policy in International Business* 2 (1996) 353; A.H. Qureshi, *TRIT – A New WTO Code of Conduct on Trade-Related Aspects of International Taxation?* in G. Parry (ed.), *The Legal and Moral Aspects of International Trade – Free-*

predecessor the GATT 1947 Council, have themselves failed to investigate the tax-trade nexus to any substantive degree.⁵

Any misconceptions that the WTO plays a marginal role in regulating Member States' tax policies were dismissed when the European Union successfully challenged the United States' Foreign Sales Corporation and Extraterritorial Income Exclusion tax breaks offered to US exporters. The impact of these income tax disputes (collectively known as *US – FSC*) cannot be underestimated and, in many ways, have been unprecedented. The disputes resulted in the largest penalties ever sanctioned in the WTO history – amounting to USD 4.043 billion per annum. This represented a wake-up call for both international trade and international tax experts who had, up until the emergence of the *US – FSC* dispute, ignored, or, at least, underestimated the potential impact of international trade law upon income tax policy. The repeated defeats of the US tax breaks led to a considerable emotive rhetoric, including threats of a full scale transatlantic “trade war” not seen in magnitude since the Boston Tea Party.⁶ The oft-quoted US Trade Representative Robert Zoellick likened the authorization of the sanctions to unleashing a nuclear bomb in the world trading system.⁷ These perceived threats, combined with the recent history of other high-profile transatlantic trade disputes,⁸ led some US representatives to call for the United States to rescind its WTO membership,⁹ while there have been other calls to use the

dom and Trade: Volume III (Routledge 1998); R.A. Green, *Antilegalistic Approaches To Resolving Disputes between Governments: A Comparison of the International Tax and Trade Regimes*, 23 *Yale Journal of International Law* 1 (2002) 79 (Green notes that literature “largely fails to connect international tax policy to international trade policy” at 87).

5. Notably, the Doha Development Round of trade negotiations did not place tax issues on its “to-do” list of 20 trade topics. Since the inception of the GATT 1947, there has been just one substantive enquiry on taxation; this concerned the application of border tax adjustments (BTAs). *See*, inter alia, GATT Council, Working Party on Border Adjustments, *Meeting of 18 to 20 June 1968 – Note by the Secretariat*, L/3039 (11 July 1968) and section 4.1.2.

6. *See*, inter alia, “America’s Taxing Trade Troubles” *The Economist* (London, 21 Aug. 2001); P. Magnusson, “Commentary: This Tax Break Could Trigger a Trade War” *Businessweek* (New York, 4 Sept. 2000).

7. E. Olson, “US Loses a Trade Dispute with Europe” *New York Times* (New York, 23 June 2001).

8. Other high-profile cases that proved a source of friction between the United States and the European Union included the Beef Hormones, the Steel Safeguard Measures, and the Biotech Products disputes. A comprehensive analysis of the disputes between the United States and the European Union can be found in E.U. Petersmann & M.A. Pollack, *Transatlantic Economic Disputes: The EU, the US and the WTO* (OUP 2005).

9. In 2005, a Joint Resolution was submitted to the US Congress requesting the withdrawal of the United States from the WTO. The Resolution failed to pass through Congress by a vote of 86 to 338. This Resolution was not solely based on the *US – FSC*