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Tax and trade

Policy recommendations on international tax and trade regimes

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Analysis

The drive towards coordinating trade regulation and international tax rules

Speed read

More thought needs to be given about the interaction of tax and trade regimes. Global trade policy has focused on the broad scope of obstacles to trading, while international tax policy has traditionally focused on avoiding double taxation. Both tax and trade are key drivers for economic policy; however, in recent years, there have been instances where taxes have distorted trade rules, and vice versa. The rising awareness of potentially abusive tax practices has resulted in recent multinational initiatives, such as the BEPS Action Plan and EC rulings on illegal state aid, which are designed to deliver greater 'fairness' in tax. Whilst this is a generally acceptable goal, governments should ensure that global tax and trade policies are supportive of each other. Global trade rules should not move away from the principle of equal treatment and the goal of a fair and equitable trading system. An open, transparent tax system, consistent with trade obligations, can be a nation's most important trade policy.

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The regulation of international trade and the coordination of international tax rules have long existed in different areas of international relations. The interplay of international trade and tax rules has not been the subject of much analysis, and practitioners in one area have generally eschewed a role in the other. By its very nature, global trade policy in the post-war era has focused on a very broad scope of reducing obstacles to trade, while international tax policy has had the very limited scope of avoiding double taxation.

This was not always the case; in fact, during simpler times, international trade was often the easiest (and often only) way to tax. However, in the present day, the divergence springs from a different relationship to sovereignty, with taxation being a core attribute of sovereignty. The erosion of sovereignty in trade is a win-win, while the erosion of sovereignty in tax results in a reduction of the tax base for individual nations, a win-lose. And, in general, trade policy has been pursued at the multilateral, regional and bilateral levels, while tax has relied largely upon bilateral engagements to provide solutions.

Both areas, however, affect external economic policy making. In the present circumstances of stressed public finances in many countries, and in the context of heightened interest in the international coordination of tax rules, tax practitioners should take an interest in the interaction of trade and tax rules. The very recent European Commission decisions that selective tax advantages (for Fiat in Luxembourg and Starbucks in the Netherlands) constituted illegal state aid is a very clear reminder of such interaction. As G20 governments plan concerted global action on addressing risks to tax bases from cross-border activity, such as the action plan on BEPS, an understanding of trade rules as they relate to tax is important.

Growing interaction of tax and trade regimes

There have, however, been some instances of direct interaction between the two areas, when taxes have been found to have been used to distort trade. The World Trade Organisation (WTO) Panel rulings on alcohol excises in Chile (*AB Report/Panel Report Chile – Taxes on Alcoholic Beverages WT/DS87*), Korea (*AB Report/Panel Report-Korea – Taxes on Alcoholic Beverages, WT/DS75/AB/R, WT/DS84/AB/R*) and Japan (*Panel on Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages, L/6216, 1987, BISD 34S/83; AB Report/Panel Report Japan – Alcoholic Beverages II WT/DS8, WT/DS9 and WT/DS11*) are some notable examples where international trade rules have impacted rules on taxes. While the general view was that the definition of 'internal taxes' (see further below) in the General Agreement on Tariffs and Trade (GATT) covered indirect taxes such as sales tax, excises and VAT, the rulings on the US foreign sales corporation (FSC) and extraterritorial income exclusion (ETI) regimes on the provision of an equivalent to an export subsidy significantly modified this view (*Panel Report United States – Tax Treatment for Foreign Sales Corporations, WT/DS108/R*). A further significant case is the recent ruling of the WTO Panel on Argentina's so-called 'blacklist' of uncooperative jurisdictions (*DS453 Argentina – Measures Relating to Trade in Goods and Services*, 30 September 2015), which relates entirely to direct taxes and some other non-tax measures.

> The challenge is to ensure that global tax and trade policies remain supportive of each other

This limited interaction is changing under the influence of several factors. Chief amongst these has been the globalisation of production chains, where fragmented and 'unbundled' production processes have resulted in growing trade of intermediate goods and associated services; for example, the average import content of exports has grown from 20% of global trade to

40% in the last 20 years, and is expected to reach 60% in the near future. This fragmentation of trade has opened up new opportunities of corporate tax optimisation, with interest deductions, royalties paid for intellectual property, service charges, management and technical fees impacting on transfer prices paid within global supply chains.

> A possible area where the dialogue on international tax rules could benefit is to look at the well established investigation and dispute settlement procedures within the WTO arrangements

This occasionally gives rise to both the general perception, and sometimes the reality, of multinationals using transfer mispricing to reduce tax liabilities and indulge in abusive tax practices. The focus in international tax has thus moved from avoiding double taxation to determining whether the tax rules facilitate double non-taxation. The issue of 'fairness' has also been rising with the rebalancing of the world economy, with the merits of tax competition being increasingly questioned, especially after the global financial crisis.

These factors are leading to a weakening of the 'tax frontier', which, like other frontiers, is changing with globalisation. In consequence of erosion of the tax frontier, a different international tax regime is taking shape that is being driven from several points. These include multilateral initiatives, such as the G20 BEPS; unilateral measures, such as the UK 'Google tax'; and regional levels, such as the EU Association of Consumer Credit Information Suppliers (ACCIS) and the EU Commission under competition/state aids rules.

Trade principles that impact tax rules

It is useful to briefly examine the key trade provisions that affect tax rules. The complete WTO Agreement provides the institutional framework encompassing the GATT and some 15 other agreements on trade related issues. The central rule is a general and continuous prohibition of discrimination of imported goods through the domestic tax system (National treatment on Internal Taxation and Regulation, article III). The same principle applies for services (General Agreement on Trade in Services (GATS) article XVII) and intellectual property (IP) (Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS) article 3) in a slightly different manner.

This is supplemented by other provisions, the overall goal of which is to protect effectively equal competitive opportunities for all WTO members:

- Most favoured nation (MFN): Products (or services/IP) from one WTO member cannot be treated less favourably than products (or services/IP) from another WTO member.
- No tax subsidies: The subsidies and countervailing measures (SCM) agreement prevents the use of tax measures to support domestic industries.
- Transparency: All rules and regulations must be published and made publicly available. No secret rules providing *de facto* discrimination can be applied.

It is recognised that the MFN principle applies not only to tariffs and to all internal trade related rules, but also to other forms of indirect taxation. The SCM agreement allows the challenge of a domestic tax measure, provided the complainant can establish that the challenged provision constitutes a subsidy within the meaning of the SCM agreement.

An important aspect of the negotiation process for GATS was the 'carve out' negotiated for direct tax issues from the national treatment (NT) obligations under GATS article XVII. NT obligations in GATS, clearly modelled on GATT 1994 article III, remains applicable for indirect taxes. This has important implications in context of the fragmentation of supply chains mentioned above, where manufacturing can be done entirely by contractors, and a multinational manufacturing enterprise could be deriving the lion's share of its revenues from providing services to a national subsidiary, which contracts out most of its manufacturing to third parties.

Tax issues arising from trade provisions and future impact

While an extensive analysis of WTO jurisprudence would be out of the scope of this article, it is useful to consider some concepts that have potentially significant impact on cross border tax relationships between countries. As early as 1958, a panel decided that 'Affecting their internal sale' in GATT article III (the NT principle) covered not only laws and regulations which directly governed the conditions of sale or purchase, but also those which might 'adversely modify the conditions of competition' between domestic and imported goods within an internal market (Panel Report on Italian Discrimination Against Imported Agricultural Machinery, L/833, 1958, BISD 7S/60). The impact of this broad term could cover, for example, a direct tax depreciation regime which favours domestically produced equipment.

The SCM agreement defines a subsidy as a financial contribution granted by a government or any form of income or price support, whereby a benefit is conferred. 'Financial contribution' has been interpreted as including government revenue which is foregone and/or not collected, although otherwise due. 'Benefit conferred' means that the beneficiary of the measure at issue is in receipt of something which places him in a better position (AB Report Canada – Measures Affecting the Export of Civilian Aircraft, WT/DS70/AB/R, 1999). Thus, government policies, including tax, investment and expenditure policies, may constitute a subsidy. The SCM agreement explicitly refers to subsidies in the form of tax measures; tax incentives, whether in the form of indirect tax concessions or income tax exemptions, accelerated depreciation, reduced tax rates or tax credits, may fall within the ambit of the SCM agreement.

The MFN obligation refers to 'any advantage, favour, privilege or immunity granted' and the obligation is to 'accord immediately and unconditionally' such privileges to all other contracting parties. It has been ruled that 'the most favoured nation treatment principle embodied in that paragraph would be applicable to any advantage, favour, privilege or immunity granted with respect to internal taxes' (GATT Panel Report, Belgian Family Allowances, G/32, adopted 7 November 1952, BISD 1S/59). The Argentina/Panama ruling, by bringing in the application of the broad MFN obligation to a list of uncooperative jurisdictions for tax purposes, raises interesting questions about the ability of countries to apply controlled foreign companies (CFC) rules and anti-treaty shopping provisions.

Similar principles of providing equal competitive opportunities are reflected in the EC Treaty article 87(1) in the prevention of state aid within the EU. These principles, while differing somewhat from the obligations under SCM, are of direct relevance to EU member states. The EC Treaty has, over time, had significant (and perhaps unanticipated) influence over the direct tax systems of its member states; tax professionals should consider whether the Fiat and the Starbucks decisions are the start of a new chapter in this regard. There are also ongoing investigations against specific tax rulings granted by Ireland (Apple), Luxembourg (Amazon) and a Belgian corporate tax scheme.

In addition, in December 2014, the Commission asked all member states to provide information about their tax ruling practices to see if they were creating competitive distortions by providing state aid through tax benefits. The scope of 'tax benefits' can be significant; it could include, for example, tax expenditures, exclusion of taxable income, tax deferrals and even cancellation of tax debts.

The broader context and possible benefits from interaction

While the foregoing shows that trade rules may have a significant impact on tax rules going forward, it is also necessary to consider both global tax and trade rules in their broader context. This is necessary to ensure that rules written 50 years ago by a smaller group of nations in a bipolar world remain viable in the much more complex world, with:

- the much greater, and growing, value of trade in services as compared to goods;
- the increasing share of global trade between related parties within MNC groups; and
- North/South trade outpacing intra-North trade.

Certain issues cause increasing complexity in trade and tax policy. In global trade, the 'precautionary' principle with requirements for health and safety standards, security controls, etc. is already the largest component in regulatory costs in trade. For example, where tariffs now constitute an average of 5% cost in trade amongst countries, the costs associated with the precautionary principle can be as high as 20%. Further, it is very difficult for companies to standardise solutions and manage costs, as these standards can often, in practice, be individually set by countries, and even competitors. This is the core purpose of the ongoing Transatlantic Trade and Investment Partnership (TTIP) discussion between the EU and US.

In the tax space, the issues raised by digitisation and e-commerce should be seen as a precursor to the much more complex responses that will be needed to deal with digital manufactures and services. Further, challenges around tax evasion are likely to be further connected to surveillance for illicit flows of funds, anti-corruption efforts and the fight against drugs and terrorism. In other words, concerns regarding the integrity of global tax arrangements, and the need for information for security reasons, are likely to be considered a higher priority than the need to avoid double taxation. We see many of these concerns reflected in the work of the common reporting standard and the action plan on BEPS.

Within this broad context, the challenge is to ensure that global tax and trade policies remain supportive of each other. And, while the challenges are significant, there are opportunities for coordination and for benefits to be gained from the lessons learned.

A possible area where the dialogue on international tax rules could benefit is to look at the well established investigation and dispute settlement procedures within the WTO arrangements. While these much stronger mechanisms are probably not directly transferable, there are lessons to be learned for the resolution of tax disputes, perhaps through bilateral agreement on the arbitration of tax disputes. It is important to note that in the US FSC/ETI case, a trade tribunal was able to deliver binding rulings on an international tax issue, while there is no equivalent tax body with the same powers able to consider issues from an objective standpoint.

Conclusions and recommendations

We would conclude that the interaction between trade and tax rules should be a win/win versus a zero sum game. One approach could be to develop a common approach, for both tax and trade arrangements, to accurately identify where value was being created. While it was acceptable to tax where value is created, the challenge continues to lie in identifying and allocating the shares. Also, while in principle fairness was a generally acceptable goal, agreeing what is fair will continue to be a challenge. In the taxation arena, fairness will continue to be a debatable issue, as taxation presents very different collective preferences between nations in public services, levels of redistribution, etc.

Developing countries have genuine concerns about their knowledge of global supply chains, and a possible information lag when it comes to value addition by multinational enterprises. They are likely to continue to have concerns about the allocation of values until they have increased confidence in the information being submitted. On the other hand, the scale of globalisation and increased compliance requirements create unprecedented challenges for multinational corporations.

> An open, transparent tax system, consistent with trade obligations, can be a nation's most important trade policy

Governments will need to continue to work to ensure that global tax and trade policies are supportive of each other, and continue to promote trade and investment in an open system. There will continue to be a need to build capacity in developing countries, and to be aware of the risks of 'tax protectionism', i.e. overemphasis in protecting the tax base to the benefit of a country to the detriment of the principles of an open trading system. The commonly acceptable principles continue to apply: transparency, mandatory exchange of information, non-discrimination, predictability and stability.

We feel that global trade rules should not move away from the principle of equal treatment and the goal of a fair and equitable trading system. The G20 BEPS Action Plan should be seen as a first step towards addressing perceived flaws in international tax rules to accurately identify value addition. A common approach can simplify efforts for both trade regulation and the coordination of international tax rules. An open, transparent tax system, consistent with trade obligations, can be a nation's most important trade policy. ■

This article is based on the inaugural Frenzel Memorial Lecture delivered by Pascal Lamy on 17 April 2015 in Washington, DC, initiated by the International Tax and Investment Center (ITIC) in honour of Congressman Bill Frenzel, founding chairman of ITIC.