Defining the Balance between Free Competition and Tax Sovereignty in EC and WTO Law: The "due respect" to the General Tax System

By Vanessa Hernández Guerrero[*]

"While direct funding of private enterprises has proven to be an efficient but rather crude and obvious device of public aid, States turn their attention to the elegant and indirect 'tax incentives.'"[1]

A. The Necessity of a Different Analytical Tool

Certain rulings of the World Trade Organization Appellate Body[2] and recent EC Commission decisions on State aids[3] have brought new attention on an old issue: States can use their tax systems to provide subsidies. The basic assumption against subsidies is that markets should not be distorted by government's intervention. However, a system of taxation without government is unthinkable. A different criterion must lead to the distinction of measures necessary to the effectiveness and fairness of the tax regime from tax measures that distort competition.

This paper departs from the concepts of State aid and subsidy adopted under EC and WTO Law respectively. Both legal regimes, although separated in many aspects, converge in their main goal and more interesting, have reached similar conclusions as to which is the right analysis that serves to identify tax regimes that

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[1] Schön, *Taxation and State Aid Law*, EU Common market law review 1999, 911-936.

[2] See WTO cases. US- Treatment of Foreign Sales Corporations (WT/DS108/R, WT/DS108/AB/R, WTO/DS108/RW and WT/DS108/AB/RW).

[3] See Commission Press Release on the 11 July 2001 announcing a "large scale State aid investigation into business taxation schemes" obtained from http://www.europa.eu.int/rapid . This initiative has resulted in 15 decisions that declared incompatible 15 tax schemes on 14 Member States.(see below)

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threaten free competition without impinging on the tax sovereignty of their Member States.[4]

B. The Approach Adopted Under the EC Rules on State Aids

The leading provision in arriving to a concept of fiscal State aid is Article 87.1 TEC: "*Any aid granted by a Member State of through State resources in any form whatsoever which distorts competition or threatens to distort competition by favouring certain undertakings or the production or certain good, insofar as it affects trade between Member States*". In accordance with this definition, there is consensus among scholars that a measure, to be a state aid, must fulfil the following requirements:

Be granted through State resources
Confer a benefit or an advantage
Be specific or selective
Distort competition or affect intra-community trade[5]

The Court has consistently held that, in order to assess whether a measure provides for a benefit, the effects of the measure, and not its form, aim or causes, must be considered.[6] Consequently, tax measures may also fall under the concept of State aid. In fact, the first judgment in which a tax measure was considered as an aid

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[4] Ehlermann, former Director General of Commission D.G. Competition, best expresses how the rules on State aids may interfere with national sovereignty: "*State aid rules limit the freedom of governments, even of parliaments, to grant financial advantages to certain sectors of their economy, irrespective of the technique that may be used including tax and social security rebates. State aid is therefore a serious and highly sensitive interference in national sovereignty*". Ehlermann, *State Aid Control in the EU : Success or Failure*, Fordham International Law Journal 18/1995, 1212, 1218.

[5] In the Philip Morris case (C-730/79, Philips Morris Holland BV v. Commission [1980], ECR 2671, para. 11), the Court adopted a test for determining the existence of distortions to competition: "*When financial aid strengthens the position of an undertaking as compared with other undertaking competing in intra-Community trade the latter must be regarded as affected by that aid*". Van der Esch, *Ayudas de Estado y Anti-Dumping*, Noticias CEE 1987, 85 n. 33., supports this approach on the fact that State aids interfere with a system of competition among undertakings on the basis of their own efforts. Arpio Sanacruz does not consider the distortion to competition an element of the concept of aid but a condition of incompatibility with the common market. Arpio Santcruz, *State Aids in EC law* EUI Ph.D. Thesis 1996.

[6] Case 30/59 *Steenkolenmijnen* [1961] ECR 1 at 19; C-173/73 *Italian Republic v Commission* (*First Italian textiles*) [1974] at paragraph 13; C-387/92, *Banco Exterior de España* [1994] ECR I-877 at 12; C-200/97 *Ecotrade* [1998] ECR I-907; C-295/97 *Piaggio v Ifitalia and Ministero della difesa* [1999] and Case C-143/99 *Adria Wien Pipeline and Wietersdorfer & Peggauer* [2001] ECR I-8365. In C-56/93 *Belgium v Commission* [1996] the Court found that a measure justified on commercial grounds is not a State aid even if it also pursues a political aim. In Case T-504/93, *Tiercé Ladbroke SA v. Commission* [1997] ECR II-923, the Court of First Instance stated that the causes or aims of the State measures fell to be appraised only in the context of determining whether such measures were compatible with the common market.

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incompatible with the common market was issued in 1961.[7] More recently, the process against harmful tax competition[8] has fostered the application of Article 87.1 to tax measures[9] and through it, the Commission has had the opportunity of testing the concept of State aid in many different fields of tax law.
It has been revealed that tax State aids may adopt varied forms: reductions in the tax base,[10] tax-free reserves to cover the risks connected to an activity,[11] special depreciation facilities,[12] derogations from general limits,[13] objective forms of quantify-

[7] Case 30/59 Steenkolenmijnen [1961] ECR 1.

[8] Instigated by the so-called "Monti Memorandum" of 1996, the EU process against harmful tax competition commenced when in 1997 the ECOFIN Council adopted unanimously a package of measures on direct taxation aimed at tackling tax evasion and the erosion of tax bases within the Union. Among them, a Code of Conduct for business taxation that sets forth the criteria to identify harmful tax measures. On 29 November 1999 a Group of Experts appointed to identify such measures within the existing tax regimes of the Member States presented a list of 66 tax schemes that were considered as having harmful effect. However, along 2000, States accorded to limit the movement against harmful tax competition to three main areas -finance branches, holding companies and headquarter companies- and adopted a special set of guidelines to assess tax schemes in those three areas. Finally, on the ECOFIN Council on 3 June 2003, the so-called tax package was adopted, though the effects of the Code of Conduct are still non-binding. (Conclusions of ECOFIN Council). See PINTO (2003) "*Tax Competition and EU Law*", Kluwer Law International.

[9] Paragraph J of the Code of Conduct acknowledged that some of the measures covered by the Code might fall within the scope of the provisions on State aids in Articles 92 to 94 TEC (now 87 to 89). The Commission was asked to publish guidelines on the application of State aid rules to measures relating to direct business taxation. The Commission did so on December 1998 [*Commission Notice on the application of State aid rules to measures relating to direct business taxation* (O.J. C 384, 10.12.1998)]. It expressly stated that State aid provisions would also contribute through their own mechanism to the objective of tackling harmful tax competition and gave the criteria that would prevail in the application of State aids to tax incentives. In practice, the Commission gathered together criteria that already existed within the case-law of the Court of Justice or the practice of the Commission.

[10] See judgement of the Court of First Instance in Ramondín [Joined cases T-92/00 and T-103/00 Diputación Foral de Málaga y Ramondín Cápsulas v Commission –hereinafter Ramondín-[2002] ECR II-1385, para. 10 et sub and Commission Decision in Spain – Newly established firms in Alava (OJ L 314/1, 18.11.2002)].

[11] The Dutch regime for international finance activities, also included within the Commission's investigation, provides for the possibility of creating a tax-free reserve to cover the risks connected to the financial activities up to a certain percentage of the total benefits [see C-51/2001 Netherlands – International Financing Activities (OJ L 180/52, 18/07/03) and MEUSSEN "*National Report on Netherlands*" for the EATLP Conference on Tax Competition in Europe (2003.01.25) http://www.eatlp.org, Lausanne 2002].

[12] Commission Decision 96/369/EC of 13 March 1996 concerning fiscal aid given to German airlines in the form of a depreciation facility (OJ L 146, 20.06.1996).Though the final advantage was deemed to be a deferral of the tax payment, the immediate effect of the measure was a reduction in the tax base. It is interesting to note that the Commission in this decision considered that the beneficiaries had reduced their taxable income with respect to the amount that would normally be due absent the special provision..

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ing the taxable base, exemption from paying taxes, or certain taxes,[14] and reduced tax rates.[15]

At the same time, it has evidenced that the application of the concept of State aids to fiscal measures demands a different analysis than the one used under positive benefits. [16]

For example, it had been stated that "*a loss of tax revenues is equivalent to consumption of State resources in the form of fiscal expenditure*". However, some States, to defend their tax regimes, alleged that these had contributed to the raise of more revenue,[17] since absent the special tax regime, the investment would not have taken place, the

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[13] C-46/2001 France – centrales de tresoreries adopted 12/12/02 C/2002/4827/3.

[14] Foreign commercial and industrial firms were exempted from corporation tax in Greece [E-4/2000 Greece – taxation of foreign commercial and industrial firms (Act no 89/97) (OJ C 108 on 4/5/2002).] Gibraltar exempt companies are not subject to corporate tax either [E-7/2000 Ex C-53/2001 United Kingdom – Gibraltar Exempt Companies]. In some cases, the beneficiaries were exempted from some indirect taxes. For example, Belgian coordination centres, apart from applying a different regime of calculation of the tax base are exempted from the "droit d'apport", the "précompe inmobilier" and the "précompte mobilier" [C-15/2002 Belgium – Coordination Centres. (OJ L 282/25, 30/10/2003)]. C-15/2002 Belgium – Coordination Centers). Gibraltar Exempt Companies and Qualifying Companies are exempted from stamp duties [C-52/2001 United Kingdom – Gibraltar Qualifying companies and decision quoted] and companies established in Madeira do not pay local taxes, property tax and contribution fees [N-222/A/2002 – Portugal Zona Franca of Madeira for the period 2003-2006 approved on 11.12.2002].

[15] E-1/98 Ireland – International Financial Centre and Shannon customs-free airport zone. Proposal for appropriate measures (OJ C 395/14, 18.12.98). C-55/2001 Finland – tax regime of captive insurance in Aland Islands (OJ L 329 of 5/12/02). C-52/2001 United Kingdom – Gibraltar Qualifying companies.

[16] For the assessment of the advantage in cases involving positive benefits, the Commission practice and the Court case have developed a criterion: using the market as a benchmark. If it is understood that the recipient would have obtained the same conditions in the market, the measure is not considered a State aid (C-56/93 *Belgium v Commission* [1996] ECR I-723). On the contrary, if the undertaking has received a better treatment from the State than it would have achieved in the market, the measure is deemed to be an aid (C-142/87 *Belgium v Commission-Tubemeuse* [1990] and *Spain v Commission* [1994] and *Air France* [1996]). This "*private investor principle*" becomes more difficult to evaluate in cases where the State "hides" behind a semi-public institution (XXIX Commission Report on Competition Policy). On the impossibility of using the market as benchmark in tax cases, see SCHÖN (1999), p.923.

[17]See Belgium allegations in C-30/2002 Belgium – Tax ruling System for US FSC (adopted 24/06/03, not yet published) and C-15/2002 Belgium – Coordination Centres (quoted above at footnote 14). In similar terms, Netherlands argued that its regime intended the repatriation of benefits to the country (C-51/2001 Netherlands – International Financing Activities) and Ireland sustained that its scheme for foreign income was to bring back dividends to Ireland so as to help Irish unemployment considering that had the dividends not been repatriated, no tax liability would have arisen (C-54/2001 Ireland – foreign income [L 204/51, 13.08.2003]).

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State is thereby not reducing but increasing its collection of revenue.[18] The Commission has expressly rejected that argument, alleging that under a State aid analysis reference is done "*to the fiscal revenues that would have accrued if taxed under common [Belgian] law*".[19]

Therefore, the yardstick to measure the advantage awarded by tax State aids is the **general** tax system established by the Member State in question. This determines that in the field of taxation, the evaluation of the provision of an advantage appears inextricably tied to the test to assess the fulfilment of the selectivity requirement.[20] Consequently, the "general-specific" test constitutes the key to solve most of the cases on tax State aids.

This does not mean that the two requirements, advantage and selective character, cannot be differentiated in tax cases. On the contrary, tax rules may give a less favourable treatment to specific groups of taxpayers. And more important, some favourable tax provisions may be applicable to all taxpayers (the classical example in this case is the 12.5% Irish corporate tax rate). In none of the cases, a State aid can be appreciated.

The Commission's Notice tries to refine the general-specific test. It asserts that general tax measures are those "*effectively open to all firms on an equal access basis*." This means that "*tax measures of a purely technical nature (for example, setting the rate of taxation, depreciation rules, rules on loss carry-overs, provisions to prevent double taxation or tax avoidance)*" do not constitute State aid.[21] It is recognised that the interdiction

[18]Martìn Jimenéz, *El concepto de ayudas de Estado y las normas tributarias: problemas de delimitación del ámbito de aplicación del art. 87.1 TCE*, Noticias de la Unión Europea n 196/2001. The problem with this argument to validate tax incentives to attract new investment is that it implies a recognition that the operations are purely tax-driven, a result which is in principle contrary to the spirit of fair competition and common market. See CFI on Ramondin (quoted above at footnote 10) at para.67, and Decision on aid granted by the city of Hamburg (Commission decision 91/389/EEC of 18 July 1990 on aid granted by the city of Hamburg (O.J. L 2.8.91), where the Commission interpreted that "*the institution of a system of ensuring that competition is not distorted means that undertakings should determine their location on the basis of autonomous decisions, i.e., not influenced or swayed by aid*"(para. IV.2).

[19] Paragraph 55 on C-30/2002 Belgium – Tax ruling System for US FSC adopted on 24/06/03, not yet published C-30/2002.

[20] The close link among the two conditions, provision of a benefit and existence of selectivity, has led some authors to analyze these two requirements together (See Martìn Jimenéz, Shön and Pinto, *EU and OECD to Fight harmful Tax Competition: Has the Right Path Been undertaken*?, Intertax 2/1998, 386-411). In this study I have chosen to analyze them separately to follow the criterion of the ECJ (See Case 143/99 Adria-Wien Pipeline).

[21] Commission's Notice, para. 13 and 14.

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of selective measures does no intend to "*restrict the power of the Member States to decide on the economic policy.*"[22]

The Court has admitted that *special* measures justified under *the nature and general scheme of a tax* would not constitute State aid, even if they confer a differentiated treatment.[23] This exception or justification has been given content through the principles of "ability to pay" and "equality".[24] The Commission understands that this exception excludes from the concept of State aids the measures "*necessary to the functioning and effectiveness of the tax system*".[25] The application of this criterion allows the singling out of certain groups of taxpayers and enacts for them special tax provisions that respond to their specific problems at the time of implementing their tax obligations without rendering them State aids. The principle of proportionality is proposed to avoid abuses in the employ of these special rules.[26]

The general system has been especially difficult to recognise in cases dealing with transfer pricing schemes[27] and measures to avoid double taxation.[28] Transfer pricing methods intend to assess the tax in transactions between associated enterprises.

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[22] *Id*.

[23] The exception based on the nature and general scheme of the tax system was first recognized by the ECJ in C-173/73, Italy v. Commission.

[24] Shön refers to the "ability to pay" principle as a general principle recognized in all European tax systems. He assures that "*One should admit that only tax rules which try to describe the parameters of the tax basis according to the 'ability to pay' principle belong to its 'nature and scheme'*"(Shön, Op. Cit, p.927). Prof. Martín Jiménez considers that the principle of equality and non-discrimination in tax matters constitutes a better expression of this theory (Martìn Jimenéz, Op. Cit, p.17). In a recent decision the Commission has referred to the principles of equality and progressiveness as expressed in Article 31 of the Spanish Constitution when assessing the compatibility of some Basque Country incentives [Commission Decision on 11 July 2001, 2002/806/EC(OJ L 279/35, 17.10.2002)].

[25] Commission's Notice, para. 23 et seq.

[26] Bacon, *State Aids and general measures*, Yearbook of European Law 1997, 306-309. This author introduces the concept of proportionality within the concept of aid itself and not only as a means of measuring the exceptions of Article 87.2 and 87.3 TEC.

[27] E-3/2000 Sweden – tax regime of foreign insurance companies appropriate measures on Commission Recommendation SG (2001) D/289718, 12.07.2001; C-45/2001 France – headquarters and logistic centres. Press release on 16/05/2003; C-47/2001 Germany – foreign companies coordination centres (OJ L 177/17 16/07/2003); C-48/2001 Spain - Vizcaya coordination centres (OJ L 31/26 6/02/2003); C-49/2001 Luxembourg - Coordination centres (OJ L 170/20, 9/7/2003); C-50/2001 Luxembourg - Finance Companies adopted on 19/10/2002; C-51/2001 Netherlands – International Financing Activities (OJ L 180/82, 18/07/03); C-15/2002 Belgium – Coordination Centres.(OJ L 282/25 30/10/2003) and C-30/2002 Belgium – Tax ruling System for US FSC adopted 24/06/03, not yet published

[28] C-54/2001 Ireland – foreign income (OJ L 204/51, 13.08.2003).

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They fulfil a double function: to estimate the fair market value (arm's length price) of the transaction in order to determine the tax base of the taxpayer and to allocate the income generated by cross-border operations between the jurisdictions involve.[29] Measures to avoid double taxation are designed to alleviate the negative effect that the taxation by two or more jurisdictions might have in cross-border transactions.

To appraise the advantage in cases involving transfer pricing methods, the Commission has taken as reference the OECD Guidelines on transfer pricing for multinational enterprises and tax administrations.[30] It has expressly stated that "*in the area of transfer pricing the internationally agreed standard is the arm's length principle as set out in Article 9 OECD Model*."[31] However, the EC Commission cannot become the "guardian" of the OECD Recommendations. The Guidelines represent agreed principles as to the manner in which arm's length transfer prices should be established but they are not binding for the Member States. In order to use the OECD guidelines as a yardstick, these should have been adopted by the State in question, either through an express provision in their national legislation or by alleging them in their defence of the contested measure.

To arrive at a proper arm's length price, the OECD Guidelines recommend comparing the transaction between associated companies with similar transactions between non-related companies. For cases where this is not possible, the Guidelines foresee two alternative methods: the so-called cost-plus and resale-minus methods. The Commission considers that the "*alternative methods of profit determination should normally aim at taxing at a level comparable to the balance sheet method*"[32] and studies each of the features of the special methods of transfer-price determination at the light of the OECD Report, to check whether the concrete application adopted by the Member State in question leads to lower taxation than under the traditional method. This task becomes very complex and the comparison with the general tax system of the Member State in question is somehow lost in the analysis.

[29] See CALDERON CARRERO, José Manuel (2003) "*Análisis de la Normativa Española sobre Precios de Transferencia desde una PerspectivaInternacional,, Comunitaria y Constitucional*" (publication forthcoming), at p.37.

[30] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, 1995.

[31] C-47/01 Germany – foreign companies coordination centres (OJ L 177/17, 16.07.2003).

[32] C-15/2002 First Belgium Coordination Centre, C-49/2001 Luxembourg Coordination Centres and C-50/2001 Luxembourg Finance companies, C-48/2001 Vizcaya Coordination Centres. This affirmation is also important in relation to other objective methods of profit determination such as the used for fisheries (?).

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The selective character of transfer pricing methods is also difficult to assess. Transfer pricing rules are selective *per se* since they only apply where the companies are related companies, that is, one belongs to the other at least to a certain extent. Where two companies are independent, the price charged for the services rendered by one to the other is presumed to be the price payable under perfect competition conditions. Still, the regimes examined by the Commission were found selective as far as they applied only to international groups fulfilling certain strict conditions,[33] which were allowed to perform only determined activities.

The case dealing with the Irish exemption scheme as a *measure to avoid double taxation* has revealed that a given tax scheme might provide an advantage, not with respect to the general system, but with reference to other States' legal systems.[34] From a practical point of view, it is accurate to conclude that an exemption system as designed by Irish authorities confers an advantage only when the effective taxation in the source country is lower than the taxation in the residence country (in this case, Ireland). On the contrary, where the effective taxation in the source country is higher, the system does not provide an advantage, at the most, it is neutral. In fact, once the tax rate in Ireland falls down to 12.5%, Ireland will be maintaining the lowest tax rate in Europe and therefore, its exemption scheme will no longer constitute an advantage.[35]

However, from the State aid point of view, it does not constitute an appropriate analysis. As has been emphasised, the appraisal of the advantage is to be done with respect to the general system of the State in question.[36] Therefore, the existence of advantage under the Irish foreign income scheme should be based on different

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[33] Imposition of certain objective thresholds relative to the capital of the parent company, to the existence of a minimum amount of investment in the country or the creation of certain number of jobs. See the conditions to apply the Belgian scheme for coordination centres, the Luxembourg schemes for coordination centres and financial companies, the Dutch scheme for financing activities and the Spanish scheme for coordination centres.

[34] "W*here the* ***domestic tax liability is greater than the tax paid in the foreign source jurisdiction****, under an exemption system, no further tax is due. Therefore, where a specific tax exemption for foreign income is granted under a system where the general rule provides for a credit, this exemption constitutes a tax advantage and reduces the beneficiary company's tax burden*" para. 33 of C-54/2001 Ireland – foreign income (OJ L 204/51, 13.08.2003).

[35] The Commission conclusion for the Irish tax scheme is that " *from the current financial year, corporation tax is 12.5% and that in principle, such rate is lower than those applied in those jurisdictions where the branched are established. Therefore, the Commission accepts that branch no longer confers an advantage on those companies*" para. 39 of C-54/2001 Ireland – foreign income (OJ L 204/51, 13.08.2003).

[36] Para.81 on C-51/2001 Netherlands Intenational Financing Activities (OJ L 180/52, 18.07.2003): "*Dans le cadre de l'analyse des aides d'État, l'avantage doit etre évalué uniquement au niveau national* »

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considerations. For example, that the conditions to obtain the exemption are related to the investment of the income and hence, it is impossible to claim that the objective of the measure is to grant relief from double taxation. If the Commission refers to other States' regimes to appraise an advantage, commonly accepted measures to avoid double taxation such as participation-exemption schemes applicable only to groups of companies, could be considered as State aids.

These cases reveal that to pursue a proper State aid analysis of tax regimes dealing with international transactions presents more difficulties than the appraisal of the advantage in purely domestic cases. The identification of the benchmark system and the consequent appraisal of the incompatible degree of selectivity has been done with reference to either international soft rules or third States' tax regimes. This approach should be criticised as far as it goes beyond the purpose of the rules on State aid and encompasses a certain harmonization.

C. The Interpretation of the WTO Concept of Subsidy in the FSC/ETI Case

The experience of the GATT/WTO dealing with direct tax subsidies does not comprise a broad range of measures but it departs from 1979, when a GATT Panel considered a US tax scheme and three European regimes as subsidies.[37] However, it was not until 1994 that the Agreement on Subsidies and Countervailing Measures [ASCM] contained for the first time a definition of subsidy.

A subsidy, as defined in the ASCM,[38] has two elements; there must be a "*financial contribution by a government or any public body within a territory of a Member*"[39] and "*a*

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[37] The so-called "taxation cases" declared the incompatibility with GATT rules of the USA DISC regime and the territoriality principle of some European countries (GATT Doc. L/4422, L/4423, L/4424 and L/4425, 2 November 1976. Also published in INTERTAX 1977/1). Under the WTO, the fist time that a WTO panel assessed the existence of a tax subsidy was in Indonesia-Certain Measures Affecting the Automobile Industry (WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R) where the panel studied the effect of the Indonesian National Car Programme, a package of measures in favour of certain car producers that included exemption of tariffs and indirect taxes. However, a specific reference to the possibility of granting subsidies through taxes was first included under the Tokyo Round in the Illustrative List of Export Subsidies, due to the problems of interpretation that the so-called "tax legislation cases" had posed to Panels in 1976. Nevertheless, some authors defend that the inclusion of tax benefits within the discipline of subsidies had always been present in the negotiators' intention, since a Working Party Report adopted in 1960 dealing expressly with the "Provisions of Article XVI:4" already included a reference to taxes. See Hufbauer and Erb, *Subsidies in International Trade*, Institute for International Economics, Washington 1984 and JOHN J. JACKSON, THE WORLD TRADING SYSTEM (Cambridge, Massachusetts 1989).

[38] Article 1.1 of the ASCM. See also TREBILOCKI AND HOWSE, THE REGULATION OF INTERNATIONAL TRADE :POLITICAL ECONOMY AND LEGAL ORDER (1995).

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benefit."[40] In Brazil-Aircraft,[41] the Appellate Body understood "*the issues – and the respective definitions – of "financial contribution" and "benefit" as two separate legal elements in Article 1.1 of the* ***SCM Agreement****, which* ***together*** *determine whether a subsidy* ***exists.***" The ASCM explicitly states that a State can contribute to the support of its enterprises through the foregoing of government revenue.[42]

This statement has been interpreted in the **Foreign Sales Corporation** Cases (FSC).[43] In the FSC case, the US measure examined by the WTO Dispute Settlement Body was a tax scheme that allowed certain foreign companies wholly owned by US Corporations to highly reduced their US-source income arising from certain transactions; in practice it exempted them from paying corporation tax on export income. After the condemnation by the WTO, the FSC scheme was substituted by the so-called **Extraterritorial Act** [ETI]. This time the regime introduced a specific measure to avoid double taxation that exempted only export income received by certain resident corporations from paying taxes in the US.

In the first FSC ruling, the Appellate Body read that "*the* ***foregoing*** *of revenue* ***otherwise*** *due implies that less revenue has been raised by the government that would have been raised in a different situation.(…) There must, therefore, be some defined normative bench-*

[39] This disposition implies the recognition of sub-national entities with the power to enact measures that could come under the category of subsidies. In our case, it implies the existence of sub-national entities empowered to raise direct taxes, or at least, to grant certain kinds of incentives within the general scheme created by the central government.

[40] The notion of benefit was firstly proposed to limit the use of countervailing duties imposed by some States. Goetz, Granet and Schwartz, *The Meaning of "Subsidy" and "Injury" in Countervailing Duty Law* International Review of Law and Economics 1986, 17., were the precursors of the use of the notion of benefit to limit the scope of USA countervailing duty laws. It was held that subsidies do not distort competition if they do not provide with a special benefit to the recipients, placing them in a better situation than their foreign competitors. If competition was not distorted, there was no reason to impose countervailing duties. Also Diamond, *Economic Foundations of Countervailing Duty Law*, Virginia Journal of International Law 1989, 759,783.

As interpreted nowadays, however, the prerequisite of benefit means that the "*financial contribution*" should make the recipient "better off" than it would otherwise have been, absent that contribution. This understanding implied some kind of comparison with the appropriate marketplace. (Canada- Measures Affecting the Export of Civilian Aircraft, WT/DS70/AB/R adopted on 2 August 1999, paragraphs 153 and 157 and United States-Imposition of Countervailing Duties on Certain Hot-rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom WT/DS138/AB/R, adopted on 10 May 2000, paragraph 68).

[41] Brazil- Export Financing Programme for Aircraft WT/DS46/AB/R adopted on 2 August 1999, paragraph 157 (emphasis in original).

[42] Article 1.1(a)(1)(ii) ASCM.

[43] See documents quoted in footnote 2.

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mark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised 'otherwise'."[44] The basis of such a comparison was identified as "*the tax rules applied by the Member in question*" with emphasis on the fact that WTO obligations do not "*compel Members to choose a particular kind of tax system*".

Therefore the general tax regime of the system becomes once more the necessary benchmark of comparison for tax subsidies. This general-specific test was proposed by the EC in its argumentation against the US measure. This test should distinguish "*neutral or objective*" measures that have an independent tax policy purpose from "*special or programmatic*" measures that intend to create advantages for certain producer interests. However, the Panel rejected the test on the ground of textual difficulties, due to the fact that specificity is an independent requirement under Article 2 of ASCM.

In fact, specificity[45] is interpreted in a particular way under the ASCM. Apart from Article 2 ASCM- that foresees two different ways of rendering a measure specific: either explicitly[46] or *de facto*[47], there is also a presumption of specificity if subsidies are contingent upon export performance or promote the use of domestic over imported goods, that is to say, when they qualify as prohibited subsidies.[48] Surely, the specificity requirement is an independent condition for certain kinds of subsidies (direct expenditures programs), but in cases dealing with tax matters, it constitutes the key factor to be appraised together with the existence of an advantage.

To put it differently, the Panel adopted the so-called "but for" test, which considers that a subsidy exists whenever the taxpayer would have been taxed more heavily BUT FOR the rules considered. The Appellate Body expressed "*abiding reservations*" about the Panel "but for" test for assessing when revenue was otherwise due on the grounds that "*it would be not be difficult to circumvent such a test by designing a tax regime under which there would be no general rule that applied formally to the revenues in question*".[49]

[44] FSC AB Report, para. 90.

[45] Apart from a financial contribution and a benefit, Article 1.2 ASCM requires a measure to be specific to be considered as a subsidy.

[46] Article 2.1(a) of the ASCM.

[47] Article 2.1(c) of the ASCM.

[48] Article 2.3 of the ASCM.

[49] FSC AB Report, para.91.

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It is difficult to describe a situation where no general rule exists at all. It is certainly possible to encounter a tax system where the general rule is not embodied in a single provision, but spread in several ones along the legislation (as on the FSC case). However, this should not prevent the judge from identifying the applicable rule. Where only "special" rules exist in a given area, one should then think that those rules must be fulfilling tax purposes (each of then constitute a different taxable event as in the luxury taxes or the country has opted for a schedular system of taxation).

In the **Extraterritorial Act** case, the AB analysis avoided the choice between the "but for" test or the "general-specific" test. It resorted to a new concept, *the comparable income.* At least one commentator has, in my opinion, rightly understood[50] that "*the AB's "comparability" test is asking the same question that the "but for" test and the search for general rules, but doing so indirectly*". Actually, the wording of the AB report somehow evidenced this equivalence when stating "***absent the** [ETI] **measure**, the US would tax the income under the otherwise applicable rules of taxation we have used as our benchmark*" (emphasis added).[51]

As said by the commentator, *the AB seems intuitively correct, given the general perception of the ETI statute as a narrow exception to the general principles of US tax law. By the same token, however, the explanation of the result is neither clear nor satisfying.* I would go further and say that the problem of the FSC and more intensively of the ETI measure is not that much based on the characterization of the exception but on the identification of the benchmark.

That is, again, as shown for the EC law, while the benchmark of taxation of purely domestic transactions is rather clear and well defined, the benchmark for the taxation of international transactions is rather more imprecise. Still, through different formulations, the Appellate Body has made an effort to find the right yardstick to measure the advantage granted by a subsidy: the general system.

D. Conclusion: The "due respect" to the General Tax System

It is obvious that States can finance their enterprises through the tax system. It is clear that to identify these tax subsidies without unduly interfering with the fiscal sovereignty of those States, the general tax systems must be the benchmark of com-

[50] Hudec, *Industrial Subsidies: Tax treatment of Foreign Sales Corporations*, Draft for conference on transnational relations held in the European University Institute, Florence, in 13-14 September 2002 (book forthcoming).

[51] AB Report paragraph 103.

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parison. It is then true, that only special tax measures can be considered as subsidies, while at the same time, it is recognized that those special tax measures might sometimes serve valid tax purposes.

The domestic rules embodied in the general system of taxation of States that try to assess the "fair" tax on international transactions seem to be more difficult to identify.[52] These rules answer two main questions: [53]

Rules designing a method to avoid double taxation (relief rules) seek to alleviate the double taxation that residents taxpayers bear when investing abroad (outbound investment).
Rules defining the fiscal jurisdiction of the State (source rules) determine how to tax non-resident taxpayers when they invest or do business in the State in question (inbound investment).

In principle, States remain completely free at the time of drafting their relief rules and their source rules. However, the requirements of an ever-more interdependent world have determined that States need to respect certain international obligations assumed under free trade treaties. These cannot attempt to create a normative international tax to which all countries should conform but just impose certain constraints on their Member States at the time of designing the tax regimes, mainly an obligation of coherence. Once a State has enacted its general tax rules in a given way, the creation of an exceptional source rule that does not follow the general classification (as the source rule for export earnings under US law) or the adoption of a different method for the elimination of double taxation for certain kinds of entities (special schemes for only certain companies) is perceived as disruptive.

However, not necessarily all "different" rules are banned subsidies under international trade law. First of all, some of the specific rules might not be conferring any benefit. Second, not all kinds of "specificities" are forbidden. Under WTO law, for example, only schemes that promote exports or favour the use of domestic over imported goods are prohibited, while under EC law, incompatible State aids are usually subject-specific.

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[52] "*A tax treaty neither generates a tax claim that does not exist under domestic law nor expands the scope or alters the type of an existing claim. The extent to which a State levies taxes within the boundaries drawn by DTCs is determined exclusively by its own domestic law.(…) In contrast, DTCs may grant benefits.*" VOGEL KLAUS VOGEL ON DOUBLE TAX CONVENTIONS 3rd Edition 46 (Kluwer Law International 1997).

[53] Roy ROHATGI "Basic International Taxation", 2002 (p.3).

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The due respect to the general tax system of the States is the only way of reconciling two areas of international law, trade and taxation, which seem to employ very different languages while sharing common goals: the promotion of trade and investment.[54] Both systems stand parallel and try not to interfere with each other (taxes should not be an obstacle to trade while trade disciplines should not impinge on the tax sovereignty of States). Perhaps a better integration between the two systems might be desirable, but if the dichotomy is to be sustained, the rules on State aids/subsidies must be used to tackle only SPECIFIC measures.

[54] Green, *Antilegalistic Approaches to Resolving Disputes between Governments: A Comparison of the International Tax and Trade Regimes* 23 Yale J.Int'l L. 79 (1998).

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