



# **Don't blame it on WTO law: An analysis of the alleged WTO law incompatibility of Destination-Based Taxes**

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## Don't blame it on WTO law:

### An analysis of the alleged WTO law incompatibility of Destination-Based Taxes <sup>‡</sup>

Alice Pirlot\*

#### ABSTRACT

*The idea that corporations should be taxed in the jurisdiction where they make their sales or provide their services is getting more and more attention in the policy debate on international taxation. In 2016, U.S. House Speaker Paul Ryan proposed to introduce a destination-based cash flow tax (DBCFT) in order to reform America's corporate income tax (CIT). Moreover, in the last few years, more and more countries have considered the adoption of new rules to tax the digital economy in the country where the users and/or the consumers are located.*

*These proposals differ from traditional direct taxes imposed on corporations. They borrow from the tax design of indirect taxes, such as sales taxes or value added taxes. Consequently, it is difficult to predict whether these sui generis destination-based taxes will fit in with superior legal provisions, in particular international tax and trade law. One recurring legal argument against destination-based taxes is that they are likely to violate the law of the World Trade Organisation (WTO).*

*Using the DBCFT as a case study, this Article will assess the different conflicts that could arise between new types of destination-based taxes and international trade law. Based on a critical approach informed by the analysis of the history and case-law surrounding destination-based taxes, this Article concludes that the likelihood for a DBCFT to be found incompatible with international trade law is much lower than past legal scholars have concluded. WTO law does not in itself prevent countries from adopting such taxes. Since this conclusion could be extended by analogy to other, new types of destination-based taxes, this Article could have important implications for policy-makers who are willing to move towards taxation in the country of destination.*

#### I. Introduction

In 2016, U.S. House Speaker Paul Ryan proposed to introduce a destination-based cash flow tax (DBCFT) in order to reform America's corporate income tax (CITs).<sup>1</sup> This proposal, which was based

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<sup>1</sup> Majority Members of House Committee on Ways and Means, A Better Way: Our Vision for a Confident America, Tax Reform Task Force Blueprint, 24 June 2016, available at <https://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf> ["US 2016 Tax Blueprint"]. At the EU level, the European Commission mandated Ernst & Young in 2015 to study cash-flow tax systems "to gather information on the impact of the implementation of such a system in practice", including when such a system is applied on a destination basis (Ernst & Young, "Experiences with cash-flow taxation and prospects" (2015) 55 Taxation Papers, Working Paper, p. 6).

on the work of economists, failed.<sup>2</sup> But the political interest in destination-based taxes has remained high, both in the United States and elsewhere. More and more countries are considering destination-based taxes as a way to reform their tax system.<sup>3</sup> Moreover, since January 2019, the OECD/G20 inclusive framework has been exploring proposals to “allocate more taxing rights to market or users jurisdictions” in the context of its work on the taxation of the digitalised economy.<sup>4</sup>

As these proposals differ from traditional CITs, it is not clear whether they fit in with the international trade legal framework. If they do not comply with WTO law agreements, policy-makers need to anticipate that their implementation will require adaptation of the international trade legal framework. This can only be done by means of a critical review of the main arguments that could be made in support of the WTO law incompatibility of these new destination-based taxes. As the DBCFT has been criticised for being a blatant violation of WTO law, this Article uses it as an example in order to assess whether WTO law agreements, as they stand now, effectively prevent countries from moving towards a tax system based on the destination principle.

In contrast to previous works published on the topic, this Article argues that the likelihood for a destination-based tax such as the DBCFT to be found incompatible with WTO law is rather low. Consequently, this Article makes the case that the alleged incompatibility of new forms of destination-based taxes with WTO law should not be used as a decisive argument against their adoption. For the design features of the DBCFT that could potentially be problematic, this Article provides design options that are unlikely to be challenged under WTO law.<sup>5</sup> From this viewpoint, this Article informs policy-makers who are interested in alternatives to traditional CITs, whether it be the DBCFT or any other type of destination-based taxes.<sup>6</sup>

The article is structured in two main parts. The first part briefly recalls the distinguishing features of the DBCFT in comparison to traditional CITs and explains how the DBCFT would be characterised under international trade law (*section II*). The second part evaluates the alleged incompatibility of the DBCFT with WTO law in a two-steps analysis (*section III*). The first step focuses on the main claims that have been brought forward in the debate surrounding the alleged WTO law incompatibility of the DBCFT. Then, the second step of the analysis explores whether it is possible to formulate counter-arguments

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<sup>2</sup> Much of the academic work on the DBCFT has been led by Auerbach, Devereux, Keen and Vella. See Alan Auerbach, Michael P. Devereux, Michael Keen, John Vella, “Destination-Based Cash Flow Taxation” (2017) Oxford University Centre for Business Taxation Working Paper 17/01.

<sup>3</sup> See, among others, the UK digital services tax proposal (available at <https://www.gov.uk/government/publications/introduction-of-the-new-digital-services-tax>) and the French tax on digital services (Law n° 2019-759 of 24 July 2019). See also Itai Grinberg, “International Taxation in an Era of Digital Disruption: Analyzing the Current Debate” (2019) TAXES - The Tax Magazine 85-118, at p. 92.

<sup>4</sup> OECD/G20 Base Erosion and Profit Shifting Project, Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, approved on 23 January 2019, available at <http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf>. See also OECD, Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS, approved on 28-29 May 2019, available at <https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf>.

<sup>5</sup> In the same line, see Itai Grinberg, “A Destination-Based Cash Flow Tax can be structured to comply with World Trade Organization Rules” (2017) 70 Nat’l Tax J. 803-818. Yet, in contrast to Grinberg, this paper challenges the formalist interpretation of GATT provisions surrounding BTAs on imports and exports (*section III.1.A(iii)*). More information on Grinberg’s approach on WTO law can be found in the following paper: Itai Grinberg, “Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT” (2010) 63 Tax L. Rev. 309-358, at pp. 347 and following.

<sup>6</sup> Note that if a country decides to put into law a tax modelled after the DBCFT, additional legal issues will have to be considered. Apart from the general design of a tax measure, specific design and administration issues have an impact on whether a tax can be found incompatible with WTO law. This paper only briefly touches upon these issues, which are not specific to the DBCFT but could arise in respect of any type of tax (*infra, section III.1.D*). See Itai Grinberg, “The House GOP Blueprint Can Be Drafted to Comply with WTO Rules” (2017) Draft Paper, Georgetown University Law Centre, available at <http://scholarship.law.georgetown.edu/facpub/1969> (“No one can seriously opine on WTO-compatibility, let alone develop a WTO challenge until legislative language for the Blueprint is released”).

against these claims and whether the DBCFT can qualify as an exception under WTO law. This Article argues that most of the claims that have been made against the DBCFT can be criticized and challenged.

This reasoning in two steps - which could also be used to analyse other types of destination-based taxes aimed at replacing or complementing traditional CITs - largely reflects the way WTO law is being enforced and international trade disputes handled by the WTO dispute settlement body (DSB). The rules of the WTO set limits to the way and the extent to which its members can impose taxes on internationally traded goods and services.<sup>7</sup> Yet, no systematic control is exercised to guarantee that WTO members respect their commitments under WTO agreements. WTO members benefit from the presumption that they comply with their WTO obligations, unless otherwise proven.<sup>8</sup> Moreover, WTO members do not have the possibility to request a ruling to get certainty on the WTO implications of their legal system. The Panels and Appellate Bodies adjudicate on alleged violations of WTO law when a claim of a violation is brought by a WTO member.<sup>9</sup> Consequently, it is not necessary – and probably not possible - to positively prove that new destination-based taxes are compatible with WTO law.<sup>10</sup> It is sufficient to assess whether any convincing claim can be formulated in support of their incompatibility, which is less burdensome.<sup>11</sup> Section III of this Article provides such an assessment.

## II. The DBCFT – main features

The DBCFT is a tax on cash flows (namely inflows minus outflows) imposed in the country where final products are consumed and services supplied.<sup>12</sup> According to Auerbach, Devereux, Keen and Vella, a DBCFT is more robust to tax planning and immune to tax competition than traditional CITs.<sup>13</sup> Despite these advantages, many academic lawyers consider that the DBCFT is not a realistic option to reform the tax system because they anticipate that such a tax would violate the rules of the World Trade

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<sup>7</sup> On the interaction between tax and international trade law, see WTO, Appellate Body Report, *United States – Tax Treatment for “Foreign Sales Corporations”*, 24 February 2000, WT/DS108/AB/R (*US – FSC*), para. 90 (“A Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes. It is also free *not* to tax any particular categories of revenues. But, in both instances, the Member must respect its WTO obligations”) and para. 179 (“A Member of the WTO may choose any kind of tax system it wishes – so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations”).

<sup>8</sup> WTO members are presumed to “act in good faith”. See WTO, Appellate Body Report, *United States – Sunset Reviews of Anti-Dumping Measures on Oil Country Tubular Goods from Argentina*, 29 November 2004, WT/DS268/AB/R, para. 173 (“The presumption that WTO Members act in *good faith* in the implementation of their WTO commitments is particularly apt in the context of measures challenged “as such”. We would therefore urge complaining parties to be *especially diligent* in setting out “as such” claims in their panel requests as clearly as possible”).

<sup>9</sup> See article 3.7 of the Understanding on rules and procedures governing the settlement of disputes (“(...) In the absence of a mutually agreed solution, the first objective of the dispute settlement mechanism is usually to secure the withdrawal of the measures concerned if these are found to be *inconsistent* with the provisions of any of the covered agreement” (emphasis added)). However, in some instances, WTO law also provides its members with the possibility to take action against other WTO members in absence of a violation, for example in case of nullification or impairment of a benefit that accrues to another WTO Member directly or indirectly under the GATT or in the impediment of the attainment of an objective of the GATT Agreement (see GATT article XXIII:1(b) and article 3.1. of the DSU; see also GATS article XXIII:3). On the WTO Dispute Settlement System, see Isabelle Van Damme, *Treaty Interpretation by the WTO Appellate Body* (CUP 2009), pp. 13–31.

<sup>10</sup> This view on WTO law can be linked to the contractual theory of WTO law (by opposition with the constitutional approach to WTO law). See Chios Carmody, “A Theory of WTO Law” (2008) 11(3) *Journal of International Economic Law* 527-557. Moreover, it can be related to the allocation of the burden of proof under international law (including the rule “*actori incombis probatio*”) and WTO law. On this topic, see Michelle T. Grando, *Evidence, Proof, and Fact-Finding in WTO Dispute Settlement* (OUP 2009); Ho Cheol Kim, “Burden of Proof and the *Prima Facie* Case: The Evolving History and its Application in the WTO Jurisprudence” (2007) 6 *Rich. J. Global & L. & Bus.* 245-263, at pp. 252-253.

<sup>11</sup> Indeed, a tax measure that is compatible with WTO law will necessarily be “not incompatible” with WTO law provisions. However, the fact that no claim of incompatibility has been convincingly formulated against a tax measure does not mean that the measure is necessarily fully compatible with WTO law.

<sup>12</sup> Auerbach, Devereux, Keen & Vella, *supra* n. 2.

<sup>13</sup> *Ibid.* See also Michael P. Devereux & John Vella, “Gaming Destination Based Cash Flow Taxes” (2018) 71 *Tax L. Rev.* 477. Auerbach, Devereux, Keen & Vella highlight that the DBCFT scores high on four other criteria: economic efficiency, ease of administration, fairness and stability.

Organization (WTO).<sup>14</sup> One of their arguments is that the DBCFT is too different from the types of destination-based taxes that WTO law can accommodate. This claim, which is analysed in more details in the next section (*section III.1*), relies on the assumption that destination-based taxes that copy the features of existing indirect taxes are unproblematic under WTO law whereas new types of destination-based taxes would likely infringe international trade law. This section highlights that it is correct to say that the DBCFT differs from traditional destination-based taxes (*section II.1*) but incorrect to consider that the innovative features of the DBCFT necessarily make it incompatible with WTO law (*section II.2.A*). Therefore, this Article recommends analysing new forms of destination-based taxes in light of the WTO's own typology of taxes rather than by comparing them with existing tax measures (*section II.2.B*).

## II.1. The DBCFT as part of tax law

In some respects, the DBCFT resembles existing taxes, such as VATs and CITs, but, in other respects, it strongly differs from traditional taxes.

The cash-flow component of the DBCFT refers to the way its tax base is calculated: the tax is imposed on net receipts (inflows minus outflows).<sup>15</sup> Two main tax bases can be envisaged, either a real base ("R" base) or a real plus financial base ("R+F" base).<sup>16</sup> Under a "R" base, the tax is imposed on the receipts from sales and the supply of services minus real costs, including labour costs. Under a "R+F" base, financial inflows (e.g. borrowing) and outflows (e.g. lending) are also included in the tax base. In both cases, the DBCFT is neutral towards debt and equity.<sup>17</sup> This makes the DBCFT more economically efficient than most traditional CITs, which favour debt over equity (as interests are usually deductible from CITs).

The destination component of the DBCFT refers to the fact that inflows (namely sales and the supply of services) are taxed when they take place in the DBCFT jurisdiction.<sup>18</sup> In other words, the tax is imposed on domestic and imported products and on all services deemed to be provided within the DBCFT jurisdiction. By contrast, no tax is imposed on exported products and services supplied outside the DBCFT jurisdiction. The destination basis of the tax is the feature that makes it robust to tax avoidance and evasion. In comparison to traditional CITs that are imposed on profits (which can easily be shifted from one jurisdiction to another), the DBCFT is imposed on sales and/or the supply of services. This tax base is relatively immobile and thus not easy to manipulate.

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<sup>14</sup> Among the authors who analysed the US 2016 Tax Blueprint and/or the DBCFT under WTO law, many - including Avi-Yonah & Clausing, Becker & Englisch, Cui, Hillman and Schön - concluded that such taxes were likely to be found incompatible with WTO law provisions. See Reuven S. Avi-Yonah & Kimberley Clausing, "Problems with Destination-Based Corporate Taxes and the Ryan Blueprint" (2017) 8 Columbia Journal of Tax Law 229-255; Reuven Avi-Yonah, "Back to 1913? The Ryan Blueprint and Its Problems" (2016) Law and Economics research Paper Series 16-026; Johannes Becker & Joachim Englisch, "A European Perspective on the US Plans for a Destination Based Cash Flow Tax" 2017 WP 17/03; Jennifer Hillman, "Why the Ryan-Brady Tax Proposal will be found to be inconsistent with WTO Law" (2017/03) IIEL Issue Brief; Wolfgang Schön, "Destination-Based Income Taxation and WTO Law: A Note", Working Paper 2016, p. 11. *Contra*: Memorandum delivered by Keeler and Payne from Mayer Brown LLP (on behalf of Caterpillar, Inc.) in support of the WTO law compatibility of the US Blueprint (Timothy Keeler & Warren Payne (Mayer Brown LLP on behalf of Caterpillar, Inc.), Memorandum to the Honorable Kevin Brady, Chairman of the Committee on Ways and Means, U.S. House of Representatives, 22 May 2017, Doc. 2017-46486, Tax Notes).

<sup>15</sup> This and the next paragraphs are based on the work of Auerbach, Devereux, Keen & Vella, *supra* n. 2, in particular pp. 11-14.

<sup>16</sup> Auerbach, Devereux, Keen and Vella discuss the advantages and disadvantages of a real tax base in comparison to a real plus financial tax base at length in their paper.

<sup>17</sup> Auerbach, Devereux, Keen & Vella, *supra* n. 2, p. 14.

<sup>18</sup> *Ibid.*, pp. 9-13. See also Devereux & Vella, *supra* n. 13, p. 482: "To be more precise, therefore, the DBCFT combines elements of both destination and origin systems: while sales are taxed in the purchasers' location (destination), expenses receive relief where they are incurred (origin)".

Although the DBCFT differs from existing taxes, some of its features make it comparable to traditional direct and indirect taxes. The DBCFT is presented as an alternative to CITs and it could therefore be compared to a direct tax.<sup>19</sup> However, the DBCFT can also be compared to existing indirect taxes, such as VATs or excise duties. The taxation of sales and services in the place of consumption is a design feature that mirrors the one used under VAT systems. Therefore, some authors describe the DBCFT as a combination of a value-added tax (i.e. an indirect tax) and a payroll subsidy.<sup>20</sup>

Depending on its design, the DBCFT will share more or less similarities with existing direct or indirect taxes. For example, the design of the deduction of labour costs can influence the nature of the DBCFT and its resemblance to a consumption tax in combination with a payroll subsidy. Deductible labour costs can be defined in a restrictive way (for example, as in-jurisdiction labour income paid by businesses subject to the DBCFT) or in a broader way (for example, as any type of in-jurisdiction labour income, including labour income paid by exempted businesses and public authorities).<sup>21</sup> Depending on the chosen definition of labour costs, the DBCFT will be more easily assimilated to a cash flow tax (under a restrictive definition) or to a consumption tax in combination with a payroll subsidy (under a broad definition).

Another feature that could influence the nature of the DBCFT relates to the use and the effects of exemptions. Exemptions are not a key design feature of a DBCFT but they may be necessary for practical reasons (e.g. exemption for small businesses in order to limit compliance burden).<sup>22</sup> If certain businesses are exempt from the DBCFT, the question arises as to whether the transactions that take place between exempt businesses and taxable businesses are deductible for the latter.<sup>23</sup> If this is the case, the DBCFT will differ from a credit-invoice method VAT, since, under such a method, taxable businesses are not allowed to deduct purchases from exempt businesses.<sup>24</sup>

## II.2 The DBCFT as seen by WTO law

The description of the DBCFT as a tax that presents similarities to a cash flow or a consumption tax is helpful, but it can also be misleading (*section A*). Traditional tax categories may not be relevant under WTO law. This can be explained by the specific goal of WTO law in tax matters, which is to set limits to the taxation of internationally traded goods and cross-border services. Consequently, under WTO law, taxes are framed in terms of taxes on goods and services. WTO law provisions distinguish between customs duties, discriminatory taxes on imports, export subsidies (including tax reliefs on exports) and taxes on the supply of cross-border services (*section B*).

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<sup>19</sup> See Schön, *supra* n. 14, p. 15.

<sup>20</sup> E.g. Grinberg (2017), *supra* n. 5.

<sup>21</sup> If labour income is defined in a restrictive way, those who finance their consumption expenditures with revenue derived from share ownership, pension funds, unemployment benefits, labour income paid by enterprises, organisations or institutions that are not subject to the DBCFT (e.g. teachers) could also bear some of the incidence of the tax.

<sup>22</sup> Auerbach, Devereux, Keen & Vella, *supra* n. 2, p. 67-68.

<sup>23</sup> *Ibid.*, p. 69, footnote 66: “a small business exemption is more problematic in a DBCFT or subtraction-method VAT, because purchases from exempt small businesses may still be deducted by registered traders (...)”, quoting Grinberg (2010), 342-43). Grinberg explains (*supra* n. 5) that this problem can be avoided in the case of a “sophisticated subtraction-method VAT” by “identifying and denying deductions for supplies from an exempt supplier”. Under a DBCFT, such solution may not be appropriate since the idea is to tax cash-flows (outputs – inputs). In the light of this objective, there is – in principle – no reason to refuse the deduction of inputs from exempted businesses.

<sup>24</sup> Grinberg (2010), *supra* n. 5, pp. 326-327. On the distinction between credit- and subtraction methods, see Itai Grinberg, “Implementing a Progressive Consumption Tax: Advantages of Adopting the VAT Credit-Method System” (2006) 59 National Tax Journal 929-954.

### *A. The DBCFT, existing taxes and WTO law*

The comparison of the DBCFT with existing taxes is useful to better understand its design and objectives. From a WTO law perspective, analogy with existing taxes is also useful but only under very specific circumstances.

First, the use of analogy can help policy-makers anticipate the incompatibility of a new tax with WTO law when the specific characteristics of this new tax resemble features of taxes that have been found (not) incompatible with WTO law by the DSB.

Second, analogy might be useful when a new tax is similar to existing taxes that have never been questioned under WTO law in the past. In this hypothesis, analogy helps predict that the new tax is unlikely to be problematic under WTO law. Indeed, WTO members are less likely to challenge tax measures that are similar to taxes that are part of their tax system. From this perspective, new taxes that replicate the design features of existing taxes benefit from a “political protection” under WTO law. Therefore, if new destination-based taxes were a mere replication of a VAT, there would seem to be no reason to consider them at risk under WTO law.<sup>25</sup>

Nevertheless, the use of analogy is not risk-free in that it might lead to inaccurate legal conclusions. First, one needs to be careful in using analogy to defend new taxes based on traditionally acceptable tax models. The fact that an existing tax has not been challenged in the past does not necessarily mean that it is fully WTO law compliant.<sup>26</sup> The assessment of a tax (or regulatory) measure under WTO law takes place when a WTO member brings a case in front of the DSB. Therefore, from a legal perspective, it is – to a certain extent – imprecise to assess the WTO law compatibility of new destination-based taxes by comparing them with unchallenged existing taxes based on the assumption that such taxes are WTO law compliant.<sup>27</sup>

Second, even greater caution is required when the absence of analogy between traditional and new taxes is used to oppose the adoption of new tax models. The design features of traditional taxes may or *may not* be explained by the need to comply with WTO obligations. If a new tax proposal differs in its design from traditional taxes, it may or *may not* lead to a violation of WTO law. Following this line of reasoning, this Article argues that new destination-based taxes cannot be deemed incompatible with WTO law simply because traditional direct taxes have not been implemented on a destination basis (*sections III.1 and III.2*).

Given the risks linked to a legal analysis based on analogy and, in order to avoid preconceptions about the WTO law incompatibility of new forms of destination-based taxes, this Article compares the DBCFT to existing tax measures (such as VAT or CITs) only when the specific characteristics of the DBCFT resemble features of taxes that have been found (not) incompatible with WTO law by the DSB.

In the next section, this Article provides a WTO-based typology of tax measures. This typology, which is structured around WTO law provisions that apply to taxes, is, to a large extent, detached from the traditional tax typologies used in domestic and international tax law. It is later used to analyse the

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<sup>25</sup> Grinberg (2017), *supra* n. 5.

<sup>26</sup> Similarly, the fact that a tax measure is not found incompatible with WTO law by the DSB does not mean that the tax is compatible with WTO law. Indeed, the DSB does not proceed to a comprehensive analysis of the WTO law compatibility of the measure.

<sup>27</sup> For example, a few authors put into question the compatibility of some features of VAT systems with WTO law. See Alan Schenk & Oliver Oldman, “The Business Activities Tax: Have Senators Danforth & Boren Created A Better Value Added Tax?” (1994) *Tax Analysts*, at p. 12 (on “deemed” input credits) and at p. 25 (on multiple rates and transactional exemptions).

DBCFT (*section III*) but it could also be used as the basis for the assessment of other types of new destination-based taxes under international trade law.

### ***B. Typology of taxes under the GATT, the ASCM and the GATS***

The main goal of WTO law is to prevent WTO members from adopting tax and regulatory measures that distort international trade.<sup>28</sup> Put simply, the General Agreement on Tariffs and Trade (GATT) and the Agreement on Subsidies and Countervailing Measures (ASCM) regulate international trade in goods where cross-border trade in services falls under the General Agreement on Trade in Services (GATS).<sup>29</sup> **The relevant provisions in these agreements are reproduced in the Annex (*section V*).**

The intensity of the WTO-legal constraints on WTO members varies depending on the type of tax measure at stake. For example, customs duties are subject to specific rules under WTO law. Consequently, in order to assess the risks that new destination-based taxes are found incompatible with WTO law, it is useful to briefly introduce the typology used in the provisions of the GATT, the GATS and the ASCM to classify the taxes that are subject to their control.

First, the GATT puts limits on the adoption of customs duties, namely taxes on products that are triggered by the act of importation.<sup>30</sup> WTO members cannot set customs duties above the level mentioned in their schedule of concessions, which is a document that lists their tariff commitments (GATT article II:1, *see* category A in the table below).<sup>31</sup> For example, if a WTO member commits not to raise its customs duties on apples over 4%, a rate of 5% would, in principle, violate the GATT. Moreover, WTO members are, in principle, forbidden from imposing customs duties that are less favourable to certain WTO members.<sup>32</sup> In the example above, all imported apples, regardless of their country of origin, should, in principle, be subject to the same rate of customs duties. This non-discrimination principle is called the most-favoured nation principle (“MFN”, GATT article I). It is a general principle that applies to customs duties but also to other types of tax and regulatory measures imposed on imported products.

Second, the GATT prohibits discrimination against or between imported products by means of tax measures other than customs duties (GATT articles I:1, II:2(a) and III:2, *see* category B in the table below).<sup>33</sup> Whereas discrimination between imported products falls under the MFN principle (GATT article I), discrimination between domestic and imported products falls under the national treatment principle (GATT article III).<sup>34</sup> The national treatment principle “protects expectations on the competitive

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<sup>28</sup> On the difference and similarities between the constraints imposed by international tax and trade law, *see* Alvin C. Warren, Jr., “Income Tax Discrimination Against International Commerce” (2001) 54 Tax L. Rev. 131, at pp. 141-144.

<sup>29</sup> Although it is not always possible to clearly distinguish between international trade in goods and services, WTO agreements largely rely on this distinction. *See* the case *Canada – Periodicals*, in which the Panel and Appellate Body applied the GATT to a tax that Canada considered to be a tax regulating trade in services (WTO, Appellate Body Report, *Canada – Certain Measures concerning Periodicals*, 30 June 1997, WT/DS31/AB/R, at p. 18: “By its very structure and design, it is a tax on a periodical. It is the publisher, or in the absence of a publisher resident in Canada, the distributor, the printer or the wholesaler, who is liable to pay the tax, not the advertiser”).

<sup>30</sup> Similar limits apply to “other duties or charges of any kind imposed on or in connection with the importation” of products (*see* GATT article II).

<sup>31</sup> *See* WTO, Appellate Body Report, *India – Additional and Extra-Additional Duties on Imports from the United States*, 30 October 2008, WT/DS360/AB/R, para. 159. Note that, in this dispute, the Appellate Body made clear that “tariffs are legitimate instruments to accomplish certain trade policy or other objectives such as to generate fiscal revenue” and that they are not “inherently discriminatory”.

<sup>32</sup> There are exceptions (e.g. in cases of regional trade agreements and preferential trade arrangements).

<sup>33</sup> There are exceptions (e.g. GATT article XX).

<sup>34</sup> For a broad overview of the case-law on the national treatment principle, *see* the overview of cases in Henrik Horn & Petros C. Mavroidis (eds.), *Legal and Economic Principles of World Trade Law* (CUP 2013), pp. 347 and following. At the EU level, GATT article III:2 has been compared to article 110 of the TFEU but also to the principle of fiscal neutrality (CJEU, *Commissioners for Her Majesty’s Revenue and Customs*, 10 November 2011, C-259/10 and C-260/10). However, the rationale underlying GATT article III:2 differs from the rationale underlying EU law provisions.



relationship between imported and domestic products” not the “expectations on trade volume”.<sup>35</sup> The case-law indicates that assessment of the tax differential treatment between domestic and imported products is made by comparing “actual tax burdens (not merely nominal tax burdens)”.<sup>36</sup>

Conversely, the GATT does not prevent the adoption of non-discriminatory taxes on imported products. For example, the GATT allows for the imposition of VATs on imported products, unless imported products are treated less favourably than like domestic products. When VATs and similar types of non-discriminatory taxes are imposed on imported products, they are commonly referred to as border tax adjustments (BTAs) in respect of imports.<sup>37</sup>

Third, the GATT and the ASCM forbid the adoption of taxes and tax reliefs that encourage the consumption of domestic products over imported products (GATT article III:4 and article 3.1(b) of the ASCM in that it regulates domestic content subsidies, *see* category C in the table below).<sup>38</sup> For example, a tax reduction granted to businesses upon the condition that they use a certain percentage of domestic products in their production process could violate both the GATT and the ASCM.

Fourth, the GATT and the ASCM forbid the adoption of export subsidies, including export tax reliefs (GATT article XVI and article 3.1(a) of the ASCM, *see* category D in the table below). A well-known example of an export tax subsidy that was analysed under these provisions is the *US – Foreign Sales Corporation (FSC)* case. In this dispute, the Panel and Appellate Body analysed the tax regime by which the US granted exemptions to certain corporations (called “foreign sales corporations”) in respect of their export-related foreign source trade income.<sup>39</sup> This example should be distinguished from cases where exported products are exempted from the taxes that are imposed on domestic and imported products (such as under VAT and excise duty systems). Neither the GATT nor the ASCM forbid such exemption, which are commonly referred to as “BTAs” in respect of exports.

Aside from domestic content and export subsidies, the ASCM also regulates the adoption of subsidies that cause adverse effects to the interests of other WTO members (so-called “actionable subsidies”). Although actionable subsidies are not strictly prohibited, the ASCM allows affected WTO members to adopt countervailing duties in order to counter their negative effects.

Fifth, the GATS puts certain limits on the adoption of tax measures that impact trade in services with other WTO members (*see* category E in the table below). Like the GATT, the GATS require WTO members to respect two main non-discrimination principles (the MFN and the national treatment principles). However, in comparison to the GATT, the GATS includes exceptions that apply specifically to tax measures (GATS articles XIV (d) and (e)).<sup>40</sup> Moreover, the GATS national treatment principle applies only to services that have been included by WTO members in their “schedule of specific

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<sup>35</sup> See GATT, Panel Report, *United States – Taxes on Petroleum and Certain Imported Substances*, 17 June 1987, L/6175, 34S/136, para. 5.1.9. See also WTO, Appellate Body Report, *Japan – Taxes on Alcoholic Beverages*, 4 October 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, at p. 16 (“Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products”). Therefore, under GATT article III:2, first sentence, there is no need to demonstrate that the differential tax treatment has negative effects on trade (*see* WTO, Appellate Body Report, *Canada – Periodicals*, *supra* n. 29, at p. 18).

<sup>36</sup> WTO, Panel Report, *Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather*, 19 December 2000, WT/DS155/R, paras. 11.182-11.183 (“We consider that Article III:2, first sentence, requires a comparison of actual tax burdens rather than merely of nominal tax burdens. Were it otherwise, Members could easily evade its disciplines”).

<sup>37</sup> See Robert H. Floyd, “GATT Provisions on Border Tax Adjustments” (1973) 5 *Journal of World Trade* pp. 489-499, p. 491 and footnote 5.

<sup>38</sup> Unless GATT exceptions provisions applies (e.g. GATT article XX).

<sup>39</sup> WTO, Panel Report, *United States – Tax Treatment for “Foreign Sales Corporations”*, 8 October 1999, WT/DS108/R; Appellate Body Report, *United States – Tax Treatment for “Foreign Sales Corporations”*, *supra* n. 7.

<sup>40</sup> See also GATS article XXII(3) that refer to measures that “fall within the scope of an international agreement (...) relating to the avoidance of double taxation”.

commitments” under the conditions that these commitments are not subject to additional limitations.<sup>41</sup> From this perspective, the GATS appears to be less restrictive than the GATT.

The table below provides an overview of these different tax categories.

TAX TREATMENT OF IMPORTED PRODUCTS		
<b>A</b>	Customs duties (II:1 GATT).	Incompatible if excessive or discriminatory, unless an exception applies.
<b>B</b>	Taxes on imported products, other than customs duties (I:1, II:2(a) and III:2 GATT).	Incompatible if discriminatory, unless an exception applies. <i>Not to be confused with non-discriminatory taxes on imports (so-called “BTAs in respect of imports”): these measures are not prohibited under GATT art. III:2 and II:2(a).</i>
<b>C</b>	Preferential tax regimes and tax reliefs related to the consumption/use of domestic products (III:4 GATT & 3.1(b) of the ASCM).	Incompatible, unless an exception applies.
TAX TREATMENT OF EXPORTED PRODUCTS		
<b>D</b>	Export tax relief (article XVI GATT & 3.1(a) of the ASCM).	Incompatible. <i>Not to be confused with internal tax measures that are not imposed on exported products (so-called “BTAs in respect of exports”): these measures are not prohibited under the GATT/the ASCM.</i>
TAX TREATMENT OF SERVICES & SERVICE SUPPLIERS		
<b>E</b>	Tax measures that affect trade in services (mainly GATS II and XVII).	Incompatible if discriminatory, unless the measure has not been included in the commitments of the WTO member or an exception applies.

For assessing the WTO law incompatibility of new destination-based taxes such as the DBCFT, it is necessary to determine whether they – or some of their features - can be assimilated to one of the tax measures mentioned in the above table. The features of the DBCFT related to the taxation of imported products could fall either under categories (A), (B) or (C). The non-taxation of exported products and outflows (including labour costs) could fall under category (D). Finally, when the DBCFT is imposed on services, it could fall under category (E).

### III. Assessing the WTO law incompatibility of destination-based taxes

This section reviews the likelihood for a DBCFT to be found incompatible with WTO law by systematically analysing the arguments that have been used to support the claim that the DBCFT violates WTO law. These arguments have been retrieved from the main academic papers published on the topic.<sup>42</sup> Moreover, in addition to the arguments previously mentioned in the legal literature, this section discusses a few other arguments that could potentially be brought forward against the DBCFT and other destination-based taxes under WTO law.

This section is structured based on the WTO law typology of taxes described above (*section II.2.B*). This structure allows to clearly identify the legal arguments that have been made – or could be made - against some of the design features of the DBCFT and other new types of destination-based taxes under WTO law. First, *section III.1* analyses the claims that have been made under the GATT and the ASCM concerning the tax treatment of imported products. Second, *section III.2* reviews the arguments related to the treatment of exported products. Third, the alleged incompatibility of the DBCFT with WTO law is assessed under the GATS in *section III.3*

<sup>41</sup> See Article XVII GATS. WTO members can limit the scope of their commitments by means of horizontal limitations (i.e. limitations that apply to all sectors listed in the schedule) or sectoral limitations (i.e. limitations specific to certain sectors).

<sup>42</sup> See the authors mentioned in footnote n. 14.

### III.1. Tax treatment of imported products

Authors have made three main arguments related to the tax treatment of imported products in their analysis of the incompatibility of the DBCFT with WTO law. This section analyses each of them as well as one additional argument that has been made before in past case-law (*section D*).

#### ***A. If destination-based taxes qualify as direct taxes, they are necessarily discriminatory against imported products and/or amount to customs duties***

A first argument in support of the alleged incompatibility of the DBCFT with WTO law relies on the characterization of the DBCFT as a direct tax or, as mentioned in *section II.1*, a tax that cannot be assimilated to traditional indirect taxes.<sup>43</sup> According to most authors, GATT articles III:2 and GATT II:2(a) forbid WTO members to impose direct taxes on a destination basis. Their argument goes as follows: if the DBCFT is described as a direct tax in domestic tax law, the taxes imposed on imported products in accordance with the destination principle will automatically qualify either as discriminatory taxes on imported products or as customs duties (categories A and B in the above table).<sup>44</sup> In their opinion, this implies that the DBCFT will necessarily violate GATT provisions.

This section examines three main arguments to oppose the idea that direct taxes cannot be based on the destination principle under WTO law. First, *section (i)* analyses the claim according to which direct taxes can never be found in violation of the GATT and explains why such a claim is unconvincing. Second, *section (ii)* briefly discusses the formal argument, which puts into question the characterisation of the DBCFT as a direct tax. Third, *section (iii)* explores a more radical argument, namely that the distinction between direct and indirect taxes should not be relied upon to determine which taxes can be based on the destination principle under the GATT.<sup>45</sup>

#### *(i) Direct taxes are not subject to the GATT*

A first way to counter the claim that the DBCFT is discriminatory or amounts to a custom duty because it is a direct tax is to argue that direct taxes fall outside the scrutiny of the GATT.<sup>46</sup> Based on this argument, direct taxes would never be found in violation of GATT provisions since they would altogether be out of its scope. This argument is weak: the case-law highlights that disputes involving direct taxes have been assessed by Panels and Appellate Bodies under the GATT. Although direct taxes “are generally considered not to be subject to [GATT] Article III:2”, the GATT applies to tax measures imposed on products, regardless of the fact that these tax measures are described as or linked to direct

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<sup>43</sup> See, among others, Hillman, *supra* n. 14, p. 4, footnote 8 (“As a general rule, it is only indirect taxes that are considered eligible for border adjustments”). See also Kimberly A. Clausung, Statement before the House Ways and Means Committee, 23 May 2017, available at <https://waysandmeans.house.gov/wp-content/uploads/2017/05/20170523FC-Testimony-Clausung.pdf>, pp. 7-8; Stephen E. Shay & Victoria P. Summers, “Selected International Aspects of Fundamental Tax Reform Proposals (1997) 51 U. Miami L. Rev. 1029. See also Robin W. Boadway & Jean-François Tremblay, “Corporate Tax Reform. Issues and Prospects for Canada” (2014) Mowat Research 88, p. 30 (“In particular, border tax adjustments are not allowed for direct taxes, unlike with indirect taxes such as the GST/HST (...”).

<sup>44</sup> Although this may appear contradictory (a direct tax being classified as a custom duty and/or a discriminatory tax), it is not. The DBCFT, taken as a whole, is not assimilated to a custom duty and/or a discriminatory tax, it is only the part of the tax that applies to imported products that would be classified as such.

<sup>45</sup> This argument has been explored earlier in Alice Pirlot, *Environmental Border Tax Adjustments and International Trade Law* (EE 2017), in particular pp. 180-206.

<sup>46</sup> This argument is mentioned – and rightly criticized – by Schön (*supra* n. 14). For an overview of the historical background underlying this argument, see Michael Lennard, “The GATT 1994 and Direct Taxes: Some National Treatment and Related Issues”, in Michael Lang, Judith Herdin, Ines Hofbauer (eds.), *WTO and Direct Taxation* (2005 Linde), pp. 79 and following (making a distinction between GATT articles III:2 and III:4).

taxes in domestic tax law.<sup>47</sup> The fact that a tax (or a tax regime) is described as a direct tax (or is part of a direct tax system) does not make the tax “WTO-proof”.<sup>48</sup> Both indirect and direct taxes can violate the GATT if they are implemented in a discriminatory way vis-à-vis imported products.

(ii) *The DBCFT is an indirect tax*

A second counterargument is to oppose the direct nature of the DBCFT and assimilate it to an indirect tax. This argument has been developed by Grinberg, who argues that the 2016 U.S. proposal to move towards a destination-based tax system could simply be designed as a “standard subtraction-method VAT” in combination with a “business-level tax credit” in order to become “WTO-proof” (which he calls the “American Jobs Credit Plan”). He writes as follows:

“The Jobs Credit Plan should be WTO-compliant. To begin with, the plain vanilla subtraction-method VAT component of the Jobs Credit Plan should be border adjustable by definition. WTO agreements and reports specifically conclude that the value-added tax is an “indirect” and therefore border-adjustable tax [footnote]. As for the payroll tax, it is not subject to any WTO rules.”<sup>49</sup>

Grinberg replies to the formalistic critiques against the adoption of new forms of destination-based taxes by using a formalist reasoning. His response to the argument that the direct tax nature of the DBCFT makes it incompatible with WTO law is to formally change the design of the DBCFT so that it becomes an indirect tax. The idea is to keep the substance of the DBCFT while modifying its form. Framed as a VAT in combination with a “business-level tax credit”, the DBCFT would no longer face the risk of being found incompatible with WTO law.<sup>50</sup> Under existing VAT systems, imported products are subject to taxation, which has never been challenged under WTO law.<sup>51</sup>

Grinberg’s argument is inventive but it presents two drawbacks. First, it strongly relies on the assumption that new destination-based taxes that are similar to existing consumption taxes will necessarily be WTO law compatible. As explained *above* (section II.2.A), such assumption can lead to inaccurate legal conclusions. Second, it does not challenge the formalist interpretation of GATT provisions surrounding (non-)discriminatory taxes on imports (GATT articles III:2 and II:2(a)), which is based on the distinction between direct and indirect taxes. Yet, as will be shown in the next section, there are good arguments to challenge such reading of WTO law provisions surrounding BTAs.

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<sup>47</sup> See the case *Argentina – Hides and Leather* (WTO, Panel Report, *Argentina – Hides and Leather*, *supra* n. 36, para. 11.159 (“We ... agree that income taxes, because they are taxes not normally directly levied on products, are generally considered not to be subject to Article III:2. It is not obvious to us, however, how the fact that the IG [“Impuesto de Ganancias”, an annual tax “levied on all sources of income, including the profits derived from the sale of merchandise and other movable property, both domestic and imported”] is an income tax outside the scope of Article III:2 logically leads to the conclusion that RG 3543 [i.e. the general resolution that defines the collection method for the IG when it is imposed on imported products] does not fall within the ambit of Article III:2, even though RG 3543 is a tax measure applied to products. Not only do we see nothing in the provisions of Article III:2 which would preclude the applicability of these provisions to RG 3543 merely because of the latter’s linkage to the IG. Were we to accept Argentina’s argument, it would also not be difficult for Members to introduce measures designed to circumvent the disciplines of Article III:2”). In the context of the ASCM, see the *DISC* (GATT, Panel Report, *United States Tax Legislation (DISC)*, 2 November 1976, L/4422; 23S/98), *FSC* (WTO, United States – Tax Treatment for “Foreign Sales Corporations”, DS108) and *ETI* (US – FSC (article 21.5 – EC), DS108) and *Jobs Act* (US – FSC (Article 21.5 – EC II, DS108) cases concerning US direct taxes.

<sup>48</sup> See Vincent Beyer, “Income Tax and Nondiscrimination in the GATT” (2018) 21 *Journal of International Economic Law* 547-566.

<sup>49</sup> Grinberg (2017), *supra* n. 5, p. 814. Hillman makes a similar argument (*supra* n. 14 p. 10: “The more the tax is structured as a tax on sales, the more likely it is to be considered an indirect tax, for which border adjustments are permitted”).

<sup>50</sup> Grinberg (2017), *supra* n. 5, p. 812-816. Moreover, Grinberg argues that the “business-level tax credit”, detached from the tax on products, is comparable to a “general subsidy” that is unlikely to be found contrary to WTO law (in particular the ASCM). This last part of Grinberg’s argument is discussed in sections III.1.B and III.2.

<sup>51</sup> *Ibid.*, p. 814.

*(iii) Both direct and indirect taxes can be imposed on a destination basis*

A third argument against the claim that the DBCFT necessarily amounts to a violation of WTO law if it is characterised as a direct tax is to use a non-formalist approach to WTO law. Such approach allows to disregard the distinction between direct and indirect taxes in interpreting GATT provisions surrounding (non-)discriminatory taxes in respect of imports (GATT articles III:2 and II:2(a)). If such distinction is not relevant under these GATT provisions, the direct or indirect nature of new types of destination-based taxes will have no impact on their legal assessment under WTO law.<sup>52</sup> This argument goes as follows: WTO law does not prevent countries from imposing taxes on imported products as long as these taxes replicate the taxes that are imposed on domestic products. In other words, this argument posits that the key requirement for imposing taxes on imports under WTO law is the non-discriminatory character of the tax, which is a requirement that can be met by any type of taxes, regardless of their direct or indirect nature.

New taxes, regardless of the fact that they cannot be described as indirect taxes (either because they are characterised as direct taxes or because they do not fall into this traditional distinction) do not violate GATT article III:2, unless they discriminate against imported products. Evidence in support of this claim can be found in a careful analysis of both the historical documents that underpin the (alleged) requirement to distinguish between direct and indirect taxes in the context of BTAs (*iii.1*) and the case-law surrounding GATT article II:2(a) and III:2 (*iii.2*).

*(iii.1) Historical background of the concept of BTAs*

In formulating claims on the WTO law incompatibility of destination-based *direct* taxes, most authors point to the text of GATT article III:2 (which refers to taxes “applied directly or indirectly to (...) products”) and to the findings of a GATT report on BTAs issued in 1970. A careful reading of this report, together with an analysis of its history, indicates that it is not a reliable source of information to reject the adoption of destination-based direct taxes under WTO law.<sup>53</sup>

The origin of the GATT report dates back from the 1960s. At the time, the US was concerned about the developments taking place in Europe where countries had started to introduce VATs in their tax systems.<sup>54</sup> According to the US, these new taxes, that relied on BTAs, could have a negative impact on the US trade balance. Therefore, the US required the OECD and the GATT to produce reports on the use of BTAs. The objective of these reports was to assess the role and the economic effects of existing BTAs so as to evaluate the need to modify the GATT.<sup>55</sup>

The OECD released its report in 1968 and the GATT working party published its report two years later, in 1970.<sup>56</sup> The two reports define BTAs as follows:

“While border tax adjustments may be defined in various ways, it is most convenient for dealing with the problems which they present to regard them *as any fiscal measures which put into effect, in whole or in part, the destination principle (i.e. which enable exported products to be relieved of some or all of the tax charged*

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<sup>52</sup> Grinberg also touches upon this point regarding the treatment of export subsidies (*supra* n. 5, p. 809).

<sup>53</sup> See also Schön, *supra* n. 14, p. 7 & 11. Schön considers that “this report does not provide a legal basis for an outright prohibition [of direct taxes for adjustment]”.

<sup>54</sup> GATT, Minutes of Meeting held at the Palais of Nations on 27-28 March 1968, 5 April 1968, C/M/46, pp. 8-9.

<sup>55</sup> *Ibid.*, p. 10.

<sup>56</sup> OECD, Report on Tax Adjustments Applied to Exports and Imports in OECD Member Countries (1968), p. 11 [hereafter: OECD 1968 Report]. GATT, Report of the Working Party adopted on 2 December 1970, Border Tax Adjustments, L/3464 [hereafter: GATT 1970 Report]. The OECD 1968 report is very rarely referred to in the literature.

in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products)".<sup>57</sup>

Subsequently, the OECD 1968 report indicates that indirect/consumption taxes are eligible for BTAs while other taxes are not.<sup>58</sup> The language in the GATT 1970 report is not as strong and, as such, it does not explicitly exclude direct taxes from BTAs. The GATT report explains that "(...) certain taxes that were not directly levied on products were not eligible for tax adjustment", such as "social security charges whether on employers or employees and payroll taxes".<sup>59</sup> This suggests that the commonly accepted view that only indirect taxes can be imposed in the destination country is not based on the GATT report, which has an interpretative value, but on the OECD report, which has only informative/descriptive value.<sup>60</sup>

In any case, even if the OECD report had had legal value, it should not be relied upon to interpret WTO law since the conclusions made in this report as to the ineligibility of direct taxes for BTAs seem to be based on a practical – but erroneous - assimilation of the definitions of the destination principle in tax and international trade law. In international trade law, the destination principle should merely be understood as a principle that allows for the relief of exported products from the taxes imposed on like domestic products and for the taxation of imported products in the same way as like domestic products are being taxed.<sup>61</sup> By contrast, in tax law, the destination principle is traditionally understood as a principle that characterizes indirect taxes that are collected and/or imposed on products and services in the country of consumption. In comparison, origin-based indirect taxes are collected/imposed in the country of production.<sup>62</sup> Traditionally, in tax law, direct taxes are regulated by principles that differ from the origin and destination principles, namely the principles of source and residence. The introduction of "direct" taxes based on the destination principle are a new phenomenon.

In considering that indirect taxes cannot be based on the destination principle under the GATT, the OECD report assimilates the fiscal and trade definitions of the destination principle. This inaccurate assimilation is likely to be explained by the fact that the conclusions made in the OECD report have largely been based on countries' practices at the time it was written.<sup>63</sup> When the OECD was published, the practices of the 21 countries that formed the OECD seemed to support the assimilation of these two definitions of the destination principle: BTAs were adopted only in respect of indirect taxes (apart from

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<sup>57</sup> OECD 1968 Report, *supra* n. 56, p. 16, para. 6. The GATT Working party report uses the same definition, referring to the OECD (see para. 4).

<sup>58</sup> The OECD 1968 report states as follows, in paragraph 7 (*supra* n. 56, p. 16): "Under present international practices, which are based on the rules formulated in GATT, indirect taxes on goods themselves (hereafter referred to as consumption taxes), whether known as sales taxes, turnover taxes, value-added taxes, excise taxes or State monopolies, are considered eligible for border tax adjustments while other taxes such as income taxes, profits taxes, payroll taxes, social security charges and property taxes are not regarded as eligible; to put it differently the principle of destination generally applies to indirect taxes on particular goods while the principle of origin applies to other kinds of taxes".

<sup>59</sup> GATT 1970 Report, *supra* n. 56, para. 14. *See*, however, the references to indirect taxes in paras. 8 & 21.

<sup>60</sup> The GATT report has been used several times in the case-law to interpret the concept of "likeness" in GATT article III. *See* for example the reference to the "traditional likeness criteria established in the GATT panel report on Border Tax Adjustments" in *India – certain Measures relating to solar cells and solar modules* (WT/DS456/R, footnote 326). *See* also Becker & Englisch, *supra* n. 14, p. 15; Grinberg (2017), *supra* n. 5, p. 814; Schön, *supra* n. 14, pp. 12-13. On the binding effect of the report, *see* Gene M. Grossman, Henrik Horn & Petros C. Mavroidis, "Legal and Economic Principles of World Trade Law: National Treatment" (2018) IFN Working Paper No. 917, pp. 51-52.

<sup>61</sup> *See* the underlined part in the definition of BTAs mentioned *supra*. *See* also *infra*, section (iii.2).

<sup>62</sup> *See*, e.g. the distinction between the origin and destination principles in EU VAT law. Both the origin and destination principles have been used to locate the transaction, collect the tax and/or allocate taxing rights between Member States.

<sup>63</sup> The OECD report is structured into three parts. Part I of the report provides a "description and analysis of border tax adjustment practices and consumption taxes". Part II explains the "rationale of border tax adjustments and their effect on international trade". Part III contains 21 "country chapters". As mentioned in the foreword of the OECD report, it "has been compiled largely from answers to a questionnaire sent to Member countries on 1st March, 1967 (...)".

a few exceptions).<sup>64</sup> Consequently, the report interprets WTO law in a way that leads to the entrenchment of the traditional design of direct and indirect taxes. Indeed, this interpretation prevents countries from adopting new types of destination-based taxes in order to reform their tax system.

The DBCFT and new models of destination-based taxes challenge this traditional view by putting into question the relevance of the distinction between direct and indirect taxes for assessing the compatibility of destination-based taxes with WTO law. The interpretation of WTO law provisions surrounding (non-)discriminatory taxes on imports should not be influenced by the fiscal definition of the destination principle and the fiscal practices of OECD countries in the 1960s. Nor should it be influenced by an OECD report that compiles these practices and thereupon draws general conclusions regarding GATT provisions on BTAs.

### (iii.2) WTO law case-law surrounding destination-based taxes

In addition to arguments based on the historical development of the BTAs' concept, arguments based on previous GATT/WTO case-law support the claim that the distinction between direct and indirect taxes should not be used as a decisive criterion in assessing the WTO law compatibility of destination-based taxes.

To this author's knowledge, the GATT 1970 report has never been used in a dispute in order to automatically assimilate destination-based direct taxes to discriminatory taxes or customs duties.<sup>65</sup> In the case *Argentina – Hides and Leather*, one of the few cases discussing direct taxes and GATT article III, references to the GATT report are found in support of two main claims. In none of these two instances, references to the GATT report support the idea that destination-based direct taxes automatically violate WTO law, quite the opposite. First, the Panel refers to the GATT report in support of the claim that direct taxes are usually excluded from the control of the GATT.<sup>66</sup> This statement of the Panel is fairly logical. There is no reason to subject traditional direct taxes that do not involve any tax on imported products to GATT provisions that apply to discriminatory taxes on imports.<sup>67</sup> Second, the Panel refers to the GATT report in support of the claim that the equivalence between the taxes on imports and the taxes on domestic products should be "achieved at least by reasonable approximation".<sup>68</sup> This claim seems to suggest that direct taxes can be imposed on a destination basis, although the

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<sup>64</sup> OECD 1968 Report, *supra* n. 56, p. 16, footnote 2 (mentioning, among others, employer's social security charges and payroll taxes).

<sup>65</sup> In the *DISC* and *FSC* cases, the United States made an explicit reference to the distinction between direct and indirect taxes in the context of BTAs (in respect of taxes on exports), on which the Panel did not comment (GATT, Panel Report *United States Tax Legislation (DISC)*, *supra* n. 47, para. 58: "The representative of the United States made the additional point that under the theory used to justify the GATT border tax adjustment rules, direct taxes were not considered to be borne by goods and were held to have no price effect. It would seem logical that relief from direct taxes would therefore also have no price effect and could not result in bi-level pricing"); WTO, Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations"*, *supra* n. 39, para. 4.1375 ("(...) traditional, if conceptually dubious, GATT distinctions between direct and indirect taxes and the border tax adjustment practices that relate to them"). *See*, nevertheless, the reference made in the *US – Tuna I (Tuna/Dolphin I)* case to the GATT report in order to interpret GATT article III and determine whether it should be applied to regulations on "the domestic harvesting on yellowfin tuna to reduce the incidental taking of dolphin" (paras. 5.13-5.14). In this dispute, the panel stated as follows: "(...) under the national treatment principle of Article III, contracting parties may apply border tax adjustments with regard to those taxes that are borne by products, but not for domestic taxes not directly levied on products (such as corporate income taxes)" (GATT, Panel Report (*not adopted*), *United States – Restrictions on Imports of Tuna*, 3 September 1991, DS21/R, para. 5.13). Usually, Panels and Appellate Bodies refer to the GATT report in order to assess "likeness" between products under GATT article III. On the concept of likeness, *see* Donald H. Regan, "Regulatory Purpose and 'Like Products' in Article III:4 of the GATT (With Additional Remarks on Article II:2)" (2002) 36(3) J. World Trade 443-78, in particular at pp. 464 and following (on the GATT 1970 report).

<sup>66</sup> WTO, Panel Report, *Argentina – Hides and Leather*, *supra* n. 36, para. 11.159 and footnote 456.

<sup>67</sup> However, as mentioned in *section III.1.A(i)*, this does not imply that direct taxes fall outside the scrutiny of the GATT.

<sup>68</sup> WTO, Panel Report, *Argentina – Hides and Leather*, *supra* n. 36, para. 11.232 and footnote 519. The European Communities also seemed to support this interpretation of GATT provisions (paras. 8.126 & 10.17). Interestingly, the European Communities referred to GATT article II:2(a) in support of their claim.

implementing country might need to use approximation to achieve equivalence between the tax on domestic and imported products.<sup>69</sup>

Other cases on GATT articles II and III provides additional evidence to support this view and reject the distinction between direct and indirect taxes as the relevant criterion to determine whether a tax can be imposed based on the destination principle. The formal identity or the qualitative and quantitative equivalence of the tax on domestic and imported products (and not the direct/indirect nature of a tax) seem to be the relevant criteria to assess a measure under GATT articles III:2 and/or II:2(a).

On the one hand, GATT article III:2 seems to allow for the adoption of taxes on imported products that are formally identical to the tax imposed on domestic products. These taxes on imported products perfectly mimic the tax that is imposed on domestic products because they are part of an internal tax system that applies both to domestic and imported products. It is generally assumed that traditional indirect taxes meet this requirement of formal identity since the design of indirect taxes on imported products usually replicates the design of the taxes imposed on domestic products (e.g. there is one VAT system that applies to both domestically manufactured products and imported products). This assumption is not necessarily in line with economic theory (the tax on domestic products may be partially shifted to producers whereas this shifting might not be possible to the same extent for the tax on imported products). But no dispute has been brought in front of the DSB to challenge a tax system that applies in the exact same way to domestic and imported products on the ground that it might, from an economic viewpoint, discriminate against imported products.<sup>70</sup>

As for traditional direct taxes, it is impossible to design taxes on imported products that would be formally identical to the tax imposed on domestic products. This is simply because traditional direct taxes are generally not framed in terms of “taxes on products” but in terms of taxes imposed on domestic businesses. Where, for VAT, the impact of the tax on products’ price is presumed to equal the tax mentioned on the VAT invoice, such presumption cannot be used for traditional direct taxes. This makes these taxes, when applied on imported products, prone to be assimilated to a custom duty or to be found “in excess” of the tax imposed on domestic products (given the difficulty to establish the identity between potential adjustments on imported products and the impact of the CIT on domestic products).<sup>71</sup> Unlike traditional direct taxes, new types of destination-based taxes such as the DBCFT are designed in a way that makes it possible for the tax on imported products to be compared with the tax that is imposed on domestic products. This design implies that, regardless of their direct or indirect nature, new destination-based taxes could be seen as imposing a burden which is formally identical on imported and domestic products.

On the other hand, GATT article II:2(a) (read *a contrario*, in combination with GATT article III:2) seems to allow for the adoption of taxes on imported products that mirror taxes on domestic products without fully replicating the design of these taxes. The tax on imported products – although not formally identical to the tax on domestic products – should be quantitatively and qualitatively equivalent to the

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<sup>69</sup> Other cases emphasize that “differences in the system of taxation for imported and for domestic products” can be justified by “objective reasons proper to the tax in question”. See WTO, Appellate Body Report, *Japan – Taxes on Alcoholic Beverages*, 4 October 1996, WT/D8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, p. 29, referring to GATT, Panel Report, *Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, 13 October 1987, L/6216, p. 26.

<sup>70</sup> Unless other features of the tax system are *de jure* or *de facto* discriminatory (see, e.g., section III.1.D). Although the US has criticized the discriminatory impact of VAT systems at several occasions (including in the context of the OECD 1968 and GATT 1970 reports), the US never brought a claim on that ground to the DSB.

<sup>71</sup> In other words, if traditional CITs have been considered ineligible for BTAs, this may not be due to their direct nature but to the fact that adjustments in respect of such taxes have been automatically assumed to exceed the tax borne on domestic products. The DBCFT should be distinguished from traditional CITs in this respect.



tax on domestic products. Therefore, GATT article II:2(a) seems to provide a second avenue to justify that new destination-based taxes are being imposed on imported products under the condition that the taxes on imports are economically equivalent to the taxes on domestic products, regardless of the fact that these taxes are not perfectly identical. Roessler writes as follows:

“(…) in many instances, governments cannot apply to imported products the same charges that they apply to domestic products. For instance, a tax on domestic products that takes the form of a business turnover tax cannot be levied in that form on imported products because there is in respect of imported products no business turnover that could be the basis of taxation. To equalize conditions of competition in such a case, governments must be permitted to levy a charge upon importation that is economically equivalent but not identical to the domestic turnover tax. An additional function of Article II:2(a) thus is to exempt border charges that are not identical to internal taxes but economically equivalent to such taxes from the general prohibition of charges other than ordinary customs duties”.<sup>72</sup>

The case *India – Additional Duties* provides a concrete example of taxes that were analysed by the WTO DSB under GATT article II:2(a). In this case, the United States challenged the WTO law compatibility of an “additional duty” and an “extra-additional duty” imposed by the Central Government of India on certain imported products to “offset the incidence of certain internal taxes” (i.e. some “state excise duties” and certain “sales tax, value added tax and other local taxes and charges”).<sup>73</sup> These charges on certain imported products were not formally identical to the taxes on domestic products. Therefore, the Panel and Appellate Body analysed them under GATT article II:2(a), seeking to determine whether they were economically equivalent or discriminatory.

Overall, the analysis of the GATT/WTO case-law highlights that claims supporting the WTO law incompatibility of new form of destination-based taxes such as the DBCFT on the basis of their direct tax nature are not very convincing. If such claims were made in front of the WTO DSB, it is very unlikely that the DSB would find a violation of the GATT on the mere ground that such taxes are *direct* taxes. The tax on imports can neither be presumed to amount to a custom duty (based on GATT article II:1) nor to a discriminatory tax on imports (based on GATT articles II:2(a) and/or III:2) without further analysis of the formal identity or the economic equivalence of the tax on domestic and imported products.<sup>74</sup>

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<sup>72</sup> Frieder Roessler, “Comment: *India – Additional and Extra-Additional Duties on Imports from the United States*” (2010) 9(1) World Trade Review 265-272, at pp. 268-269. The *Superfund* case (*supra* n. 21) supports the views expressed by Roessler (see the reference made to GATT article II:2(a) in relation to the tax on certain imported substances in para. 5.2.7). Other cases have touched upon the distinction between GATT articles II & III. See i.a. the *Belgian Family Allowance* case (BISD 1S/59), the *EEC measures on animal feed proteins* case (BISD 25S/67) and the GATT Panel Report, *Canada – Measures affecting the sale of gold coins*, 17 September 1985, L/5863.

<sup>73</sup> WTO, Panel Report, *India – Additional and Extra-Additional Duties on Imports from the United States*, 9 June 2008, WT/DS360/R, para. 4.50.

<sup>74</sup> If a WTO member brings a claim against the DBCFT based on GATT article II:1(b) (assimilating the DBCFT to a custom duty), the WTO DSB would likely consider that the complaining party needs to prove that GATT articles II:2(a) and/or III:2 do not apply. Indeed, under certain circumstances, the complaining party that considers a measure to be a custom duty in violation of the GATT is required to bring evidence of the fact that the measure is not a BTA. According to the Appellate Body in *India – Additional Duties*, such circumstances include cases “where the potential for application of Article II:2(a) is clear from the face of the challenged measures” (WTO, Appellate Body Report, *India – Additional Import Duties*, *supra* n. 31, para. 190). This is likely to be the case for the DBCFT given the clear connection between the tax on domestic and imported products. See also WTO, Panel Report, *Argentina – Hides and Leather*, *supra* n. 36, para. 11.169. On the interaction between GATT articles II:1(b) and III:2, see WTO, Panel and Appellate Body reports, *China – Measures affecting imports of automobile parts*, 18 July 2008, WT/DS339/R, WT/DS340/R, WT/DS343/R, and 15 December 2008, and Appellate Body Report, *China – Measures affecting imports of automobile parts*, WT/DS339/AB/R, WT/DS340/AB/R, WT/DS343/AB/R (*China – Auto Parts*). See also *Ad Article III*.

The next sections analyse the substantive arguments that have been made in support of the claim that the tax on imported products is neither identical nor equivalent to the tax on domestic products under a DBCFT.

### ***B. The DBCFT discriminates against imported products***

In addition to the formal criticism of the DBCFT based on its direct tax nature, authors have expressed more substantive concerns as to its compatibility with WTO law. These concerns relate to the allegedly discriminatory character of the DBCFT due to some of its design features, namely the deduction of domestic input costs (*section B.1.*) and the deduction of labour costs (*section B.2.*).

As these concerns directly relate to the specific design of the DBCFT, the analysis provided in this section may not seem that relevant for other types of destination-based taxes. Yet, other types of destination-based taxes are likely to be challenged on similar grounds as the ones used to challenge the DBCFT, including the ground that some of their features discriminate against imported products.<sup>75</sup> From this perspective, this section can serve as a basis for analysing other types of new destination-based tax proposals. Indeed, this section provides a detailed discussion of the legal provisions that apply to discriminatory taxes, including an extensive analysis of the case-law.<sup>76</sup>

The main legal basis for the arguments discussed in this section is found in GATT article III:2. GATT article II:2(a) is also relevant in that this article contains an explicit reference to GATT article III:2.<sup>77</sup> Alternatively, one could argue that the deduction of domestic inputs is contrary to article III:4 of the GATT and/or article 3.1(b) of the ASCM, which prohibit the adoption of subsidies that are conditional upon the use of domestic products.<sup>78</sup> To the best of this author's knowledge, GATT article III:4 and article 3.1(b) of the ASCM have not been mentioned in past analysis of the DBCFT under WTO law.<sup>79</sup>

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<sup>75</sup> For example, proposals in favour of digital service taxes have been criticized for being discriminatory. See, among others, Gary Clyde Hufbauer & Zhiyao (Lucy) Lu, "The European Union's Proposed Digital Services Tax: A De Facto Tariff" (2018) Peterson Institute for International Economics Policy Brief, available at <https://piie.com/system/files/documents/pb18-15.pdf>. Note, however, that the main criticisms in this case concern the discriminatory treatment of foreign services and service suppliers rather than imported products.

<sup>76</sup> However, as the DBCFT is a tax that would generally apply to any type of product, this section does not elaborate on the "likeness test" (which consist in determining if the different treatment applies to "like" domestic and imported products). For new destination taxes that are specifically targeted at certain types of goods (e.g. goods sold over digital platforms), the "likeness test" is likely to play a more important role in the assessment of their WTO law incompatibility. On the "likeness test" in the context of e-commerce, see Marie Lamensch, *European Value Added Tax in the Digital Era* (2015) IBFD Doctoral Series, sections 3.4.

<sup>77</sup> Authors also consider that the deduction for labour costs could be found a violation of GATT provision on customs duties (GATT article II:1(b)). Under this provision, the DBCFT would not even need to be found discriminatory. Evidence of the excessive character of the tax would be enough to prove that the tax infringes GATT article II:1. Yet, for the reasons explained above (at the end of *section III.1.A*), it seems unlikely that the WTO DSB would accept a claim based on GATT article II:1(b) without first analysing whether GATT articles III:2 applies. See Hillman, *supra* n. 14, at p. 5. She considers that "the lack of a deduction for imports" could be considered either a tariff or a BTAs based on GATT article II:2(a). See also Grinberg (2017), *supra* n. 5, p. 805, referring to GATT article II ("Alternatively, one might view deduction disallowance as a border charge rather than an internal tax").

<sup>78</sup> On the interaction between GATT articles III:2, III:4 and the ASCM, see WTO, Panel Report, *Indonesia – Certain Measures Affecting the Automobile Industry*, 26 July 1999, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, para. 14.38: "When subsidies to producers result from exemptions or reductions of indirect taxes on products, Article III:2 of GATT is relevant. In contrast, subsidies granted in respect of direct taxes are generally not covered by Article III:2, but may infringe Article III:4 to the extent that they are linked to other conditions which favour the use, purchase, etc. of domestic products." See also para. 14.33: "In short, Article III prohibits discrimination between domestic and imported product while the SCM Agreement regulates the provision of subsidies to enterprises".

<sup>79</sup> Similarly, the Agreement on Trade-Related Investment Measures (TRIMs) has not been mentioned even though a claim could also be made under this agreement. See WTO, Panel and Appellate Body Reports, *Brazil – Certain measures concerning taxation and charges*, 30 August 2017, WT/DS472/R, WT/DS497/R (in particular paras. 7.1.2.2. and following) and 13 December 2018, WT/DS472/AB/R; WT/DS497/AB/R.

### ***B.1. Only domestic input costs are deductible***

Some authors consider that the DBCFT discriminates against imported products because inputs used in domestic products are deductible by domestic businesses where imported products will be taxed with no deduction granted for the inputs used abroad.<sup>80</sup>

Two arguments can be made to oppose this view. First, *section (i)* refers to the rationale underlying the deduction of input costs to highlight that the deduction makes the DBCFT neutral and does not grant advantages to domestic products. Second, *section (ii)* explains that it is not the deduction of input costs that leads to discriminatory treatment but the hypothetical combination of this deduction with an exemption regime in favour of certain businesses. This section then argues that such an exemption regime does not discriminate between products – which is forbidden under GATT article III:2 – but between producers - which is not, as such, prohibited under the GATT/the ASCM.

#### *(i) The deduction of input costs is neutral*

A first way to reject the argument based on the discriminatory character of the deduction of input costs is to put into question the assumption on which it relies, namely that a deduction is granted in respect of domestic inputs used in domestically manufactured products. This assumption is correct but not unequivocal. In most cases (virtually all cases when only a few businesses are exempted from the DBCFT), inputs are deducted only if they have been taxed at an earlier stage. This means that the same amount of tax will be generated by the sale of two products with the same price to a final consumer, regardless of how much inputs have been used for each of these goods. This mechanism, which allows for the deduction of input costs under the condition that inputs have been taxed at an earlier stage, is similar to the one used under VAT systems.<sup>81</sup> Under traditional (credit-invoice based) VAT systems, VAT is collected along the production chain. A similar idea applies to the DBCFT: if policy-makers choose to apply the DBCFT at each stage of the production process, each business along the production chain will remit part of the tax.<sup>82</sup> Ultimately, the total tax will amount to the price of the final product multiplied by the tax rate. Therefore, the deduction of inputs does not make the DBCFT discriminatory vis-à-vis imported products: the same total tax will be remitted in respect of domestic and imported products.

#### *(ii) The combination of the deduction of inputs with an exemption regime may be problematic*

In a few circumstances, a difference exists in the amount of total tax remitted in respect of domestic and imported products. This happens when, at the level of the DBCFT jurisdiction, some businesses are exempted from the tax and transactions between these exempt businesses and taxable businesses are nevertheless deductible for the latter. Two situations should be distinguished: (a) the situation where one of the intermediate businesses is exempted and (b) the situation where the last business in the production chain is exempted.

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<sup>80</sup> See, among others, Hillman, *supra* n. 14, p. 4 (“From that base of sales revenues, the plan, at least as it is usually described in public discourse, permits a deduction for the value of input materials and labour used to produce the good or service. However, the plan as described would not permit a deduction for the cost of imported input materials or services.”)

<sup>81</sup> Grinberg makes a similar analogy with VAT systems (Grinberg (2017), *supra* n. 5, p. 805, footnote 8). Under the EU VAT Directive, input VAT is deductible under the condition that the “the goods and services are used for the purposes of the taxed transactions of a taxable person” (see article 168 and following of Council Directive 2006/112/EC of 28 November 1996 on the common system of value added tax, latest consolidated version on 16 January 2019).

<sup>82</sup> Policy-makers could also choose to impose the DBCFT on the final products without allowing for the deduction of the inputs: the economic result would be the same (“netting out”) under the assumption that no business is exempt from the tax. See Auerbach, Devereux, Keen & Vella, *supra* n. 2.

In the first case, the difference that arises between the total tax remitted in respect of the sale of domestic products and the sale of imported products is specific to the DBCFT. Under a VAT system, the fact that one of the intermediate businesses is exempted from the tax does not, in theory, influence the total amount of the tax to be remitted on the products sold to final consumers.<sup>83</sup> In the second case, the differential treatment is not specific to the DBCFT: a similar difference between domestic and imported products applies under a VAT system when the last operator of the chain is exempted. Yet, as explained above, such comparison is not helpful to counter arguments in support of the incompatibility of the DBCFT with WTO law. The fact that many VAT systems include exemptions for certain types of businesses (e.g. small businesses) does not mean that such exemption systems are WTO law compliant. WTO members may have decided not to refer such matters to the WTO DSB for political reasons or merely because they, too, use exemptions in their VAT system.<sup>84</sup> From a political viewpoint, however, the fact that most WTO members rely on VAT systems that also include exemption measures that lead to an indirect discrimination vis-à-vis imported products may discourage them to challenge the DBCFT on this ground (as this would threaten their own tax system).

The next paragraphs discuss and critically assess the two main legal arguments that can be made to support the WTO law incompatibility of the DBCFT when certain businesses benefit from an exemption.

First, one can argue that the possibility to deduct (untaxed<sup>85</sup>) inputs from exempted businesses creates an incentive for taxable businesses to prefer domestic products over imported products (*see* category C in the table above). A similar argument was used in the *ETI* case, in which the Panel and the Appellate Body analysed the US ETI regime, which provided a tax exemption in respect of income from certain transactions. In its report, the Appellate Body described the ETI regime as follows:

“under the ETI measure, a taxpayer producing property in the United States will be eligible to obtain a tax exemption in respect of income derived from an export-sale of such property on the condition that, inter alia, not more than 50 percent of the fair market value of the product is attributable to articles produced outside the United States or to direct costs for labour performed outside the United States” (emphasis added).<sup>86</sup>

The main argument against the ETI was that it could be assimilated to a prohibited export subsidy under article 3.1(a) of the ASCM. In addition to this claim, the ETI regime was found problematic under GATT article III:4 as it encouraged the use of articles from a U.S. origin.<sup>87</sup> Following the same logic, the ETI

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<sup>83</sup> Unless the intermediate business has bought inputs from a taxable business: in this case, the total VAT on domestic products could be higher than on imported products. Indeed, the intermediate business is not allowed to deduct input VAT.

<sup>84</sup> Another feature of EU VAT system that has not been (but could be) put into question under WTO law concerns the differential treatment between the VAT imposed on goods supplied with transport within the EU to a final consumer (in principle taxed in the country of origin) and the VAT imposed on goods supplied with transport from a third country (in principle taxed in the country of destination). Given that rates differ between Member States, it could be more advantageous for a customer living in a country with high VAT rates to “import” the product from a Member State with lower tax rates than to buy the product from a supplier located outside of the EU. The same differential treatment existed, until 2015, for the supply of electronic services. This point has been analysed extensively in Lamensch, *supra* n. 76, sections 3.6.1. & 3.6.3. On the place of supply of goods with transport, *see* articles 32 and following of the VAT Directive (the ‘general’ rule knows several exceptions, e.g. when the total value of the supplies of goods in a Member State exceeds 35 000 or 100 000 Euros). On the place of supply of electronic services, *see* article 58 of the VAT Directive (as amended by Council Directive 2008/8/EC of 12 February 2008).

<sup>85</sup> As a matter of principle, untaxed inputs would not be deductible. Businesses subject to the DBCFT would only be able to deduct untaxed inputs when they are bought from exempted businesses.

<sup>86</sup> WTO, *United States – Tax Treatment for “Foreign Sales Corporations”*. *Recourse to Article 21.5 of the DSU by the European Communities*, 14 January 2002, WT/DS108/AB/RW, paras. 211 and following.

<sup>87</sup> *See* the condition underlined in the quote of the Appellate Body Report mentioned above. *See* also WTO, Appellate Body Report, *United States – Foreign Sales Corporations (Article 21.5)*, *supra* n. 86, para. 220: “In sum, if the manufacturer wishes to obtain the beneficial tax exemption under the ETI measure, the fair market value rule provides a considerable impetus, and in some circumstances, in effect, a requirement, for manufacturers to use domestic input products, rather than like imported ones. As such, the fair market value rule treats

tax exemption was also analysed under article 3.1(b) of the ASCM, which prohibits the adoption of (domestic content) subsidy. Indeed, the ETI subsidy – in the form of a tax exemption – was bound to the domestic nature of the inputs.

The question arises as to whether the same reasoning could be used to challenge a DBCFT that allows for the deduction of inputs bought from exempt businesses. In fact, the *ETI* measure is not fully comparable with the DBCFT. Under the ETI tax regime, taxpayers received a fiscal advantage only if the fair market value of their products was not made of more than 50 % of foreign inputs (or labour costs). This clearly encouraged the consumption of domestic products in comparison to imported products (although, according to the US, access to the tax benefits was not conditioned upon the use of domestic products as there were other ways to meet the requirements of the ETI regime).<sup>88</sup> In comparison, under the DBCFT (and under VAT systems), the tax advantage is not conditioned upon the use of domestic products but it is limited to businesses that meet certain characteristics (such as being a “small business”).<sup>89</sup> This indicates that, unlike the ETI regime, the primary effect of the deduction of inputs from exempted businesses is not to encourage the use of domestic over imported products. The objective is to favour certain types of businesses, which benefit from the exemption for specific reasons, such as, for example, the need to avoid compliance problems for small businesses.<sup>90</sup> In other words, it is an advantage to certain types of businesses (and, possibly<sup>91</sup>, to the products sold by these businesses in comparison to all other products, both domestic products sold from non-exempted businesses and imported products). The exemption is business-specific rather than product-specific. Although this distinction between products and producers may seem arbitrary, it is a well-recognised distinction under the GATT and the ASCM. Article III:4 of the GATT and article 3.1(b) of the ASCM prevent WTO members from conditioning the granting of a tax advantage on compliance with requirements related to the use of domestic over imported products. In principle, they do not prevent WTO members from limiting the scope of a tax advantage to domestic producers only.<sup>92</sup> Therefore, a DBCFT that includes an exemption regime for small businesses is unlikely to violate GATT article III:4 or to qualify as a prohibited (domestic content) subsidy under article 3.1(b) of the ASCM.

However, a second argument related to the exemption regime can be made to support the WTO law incompatibility of the DBCFT. Indeed, it could be argued that the exemption in favour of certain types of businesses ultimately leads to a differential treatment between domestic and imported products, which violates GATT article III:2 (*see* category B in the table above). Similar claims have been made in the past before the DSB. In the case *Brazil – Taxation*, the Panel and Appellate Body considered that a tax with identical tax rates for domestic and imported products constituted a violation of GATT article III:2 because the final tax burden on imported products was higher, since only “accredited” (domestic) manufacturers could benefit from tax incentives.<sup>93</sup> In other words, the case *Brazil – Taxation* underlines

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imported products less favourably than like domestic products”. In this dispute, the argument based on GATT article III:4 was linked to the argument based on article 3.1(b) of the SCM Agreement (*see* para. 8.160-8.163 of the Panel report). *See* also WTO, Panel Report, *Brazil - Taxation*, *supra* n. 79 & WTO, Panel Report, *Indonesia – Autos*, *supra* n. 78 (exemption for domestically produced cars).

<sup>88</sup> *See*, WTO, Panel Report, *United States – Foreign Sales Corporations (Article 21.5)*, *supra* n. 86, paras. 8.152 & 8.157.

<sup>89</sup> In other words, the exemption will be defined by reference to criteria that relate to the type of business (e.g. small businesses) and not by reference to criteria related to the types of goods that certain businesses produce. If a country decides to adopt a DBCFT with an exemption regime, which is not specific to domestic businesses but to domestic products, this will necessarily violate GATT article III:2.

<sup>90</sup> Auerbach, Devereux, Keen & Vella, *supra* n. 2, p. 67-68.

<sup>91</sup> This other claim is analysed *infra* in the next paragraph.

<sup>92</sup> Such discrimination could, however, amount to an actionable subsidy (*infra*, section III.2.B).

<sup>93</sup> WTO, Panel Report, *Brazil - Taxation*, *supra* n. 79, paras. 7.173-7.174 & 7.655. *See* also WTO, Appellate Body Report, *Brazil – Taxation*, *supra* n. 79, paras. 6.2 & 6.3. Similarly, WTO members are not allowed to distinguish between domestic and imported products on the basis that “the characteristics and circumstances of the producers of those products are different” or that “the characteristics and circumstances of

that the GATT does not allow tax subsidies in favour of domestic producers/businesses that indirectly lead to a discrimination against imported products.<sup>94</sup> In other words, indirect discrimination arises when a tax advantage in favour of domestic businesses is linked to the tax imposed on domestic products. It could be argued that such indirect discrimination exists under a DBCFT that includes an exemption regime since the amount of the tax advantage will be proportionate to the price of the *products* sold by exempted businesses.<sup>95</sup> Consequently, in order to avoid the risk that the exemption is found in violation of GATT article III:2, it may be advisable to deny the deduction of inputs bought from exempted businesses.<sup>96</sup>

## ***B.2. Only domestic labour income is deductible***

Some authors consider that the DBCFT is discriminatory not only because of the deduction of input costs but also because of the tax deduction of labour costs.<sup>97</sup> Under a DBCFT, only sales (and the supply of services) are imposed on a destination basis. By contrast, the deduction of labour costs is granted on an origin-basis.<sup>98</sup> *Section (i)* argues that the deduction of labour income does not make the DBCFT discriminatory, although a destination-based tax that integrates a deduction of labour costs will entail specific risks under WTO law. Therefore, *section (ii)* explains that it may be “safer” to subsidise labour costs independently from the destination-based tax.

### *(i) The deduction of labour costs is not product-specific*

Two main arguments, similar to the ones that have been made in the previous section (*B.1.ii*), support the claim that the deduction of labour costs makes the DBCFT discriminatory vis-à-vis imported products. None of these two arguments are fully convincing.

First, it can be argued that the deduction for labour costs is a violation of GATT article III:4 and article 3.1(b) of the ASCM (*see* category C in the table above). This argument reflects the reasoning made in the *ETI* case, mentioned above, in which the panel analysed a tax advantage that was conditioned upon criteria related to the use of US articles and labour performed within the United States.<sup>99</sup> However, the DBCFT differs from the ETI tax regime. Where the benefit of the ETI tax exemption was conditional upon the use of domestic products, this is not the case of the deduction for labour costs under a DBCFT, which is only conditioned upon the fact that labour costs are incurred in the DBCFT jurisdiction.<sup>100</sup> The tax advantage varies from business to business based on their respective labour costs, irrespective of the domestic or foreign nature of input products bought and of the price and number of products sold. In other words, companies with high labour costs will benefit from a higher tax deduction, regardless of

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the sellers or purchasers of those products” are different (*see* WTO, Panel Report, *Argentina – Hides and Leather*, *supra* n. 36, paras. 11.211 and footnote 500).

<sup>94</sup> *See* WTO, Panel Report, *Brazil - Taxation*, *supra* n. 79, para. 7.66.

<sup>95</sup> The tax advantage could be averaged as follows: “costs of *products* sold by the exempted business multiplied by the tax rate of the DBCFT”.

<sup>96</sup> This idea is briefly discussed by Devereux & Vella (*supra* n. 13, p. 493).

<sup>97</sup> *See* i.a. Becker & Englisch, *supra* n. 14; Gary Clyde Hufbauer & Zhiyao (Lucy) Lu, “Border Tax adjustments: Assessing Risks and Rewards” (2017) Peterson Institute for International Economics PB 17-3; Cui, *supra* n. 14, p. 332, referring to the DBCFT as a combination of an import tariff and export subsidy.

<sup>98</sup> Devereux & Vella, *supra* n. 13, p. 482.

<sup>99</sup> WTO, Panel Report, *United States – Foreign Sales Corporations (Article 21.5)*, *supra* n. 86. In the Panel report (article 21.5), this condition was referred to as the “foreign articles/labour limitation”.

<sup>100</sup> *See* also the arguments made by Grinberg (2017), *supra* n. 5, p. 811, note 26 on the distinction between what he calls the ‘Greenprint’ and the FSC case. Grinberg points out that “(...) no labour outside the United States is used internally to the United States. Thus the ruling reached in the Article 21.5 proceeding is inapposite in considering the deduction for wages paid to U.S. residents at stake under the Greenprint”. Grinberg seems to imply that, unlike a deduction conditioned upon the use of domestic products *over imported products*, the deduction of labour costs cannot be framed as a discrimination between domestic and foreign labour since foreign labour cannot be used within the U.S. (unlike imported products, which can easily be used within the U.S. as part of the manufacturing process).

the price of inputs bought and products sold. Like the deduction of inputs from exempted businesses, the deduction of labour costs is a business-specific advantage rather than a product-specific advantage. Therefore, as explained in the previous section (*B.1.ii*), it is unlikely to be found contrary to GATT article III:4 or article 3.1(b) of the ASCM.

Second, it can be argued that the deduction of labour costs is a violation of GATT article III:2 (*see* category B in the table above). This argument goes as follows: the deduction of labour costs allows domestic businesses to systematically reduce the tax that they should remit in respect of their sales, which means that the overall tax burden on domestic products will necessarily be lower than on imported products. To counter this claim, one can again refer to the fact that the tax advantage derived from the labour cost deduction is not product-specific. It is not proportionate to how many products are produced or sold, but it is proportionate to the level of labour costs. From this viewpoint, the deduction for labour costs is less problematic under GATT article III:2 than the exemption regime analysed above. In comparison to the advantage derived from the exemption regime, which can be linked to products' price (*see* the end of *section III.1.B.1.ii*), the deduction for labour costs is independent from products' price. Indeed, the deduction of labour costs does not discriminate between domestic and imported products but between domestic producers (depending on how much they spend on labour and how labour intensive their business is). In other words, although such deduction will result in a reduction of the overall tax to be remitted by domestic enterprises, it does not create a discrimination between products.

As mentioned above, the GATT and the ASCM prevent the adoption of subsidies that encourage the consumption of domestic products over imported products, but they do not prohibit the adoption of general subsidies to domestic producers. To a certain extent, it could be argued that WTO law requires countries to limit the granting of tax advantages to producers located in their jurisdiction and not to extend them to foreign businesses and workers operating abroad. In practice, it might not be easy to extend the labour costs deduction to foreign producers, but it is not impossible. One option would be to extend the deduction through the taxation of imported products. Imports would not be taxed on their full value but on a reduced value, which could be calculated by reducing their full value by a certain percentage or a certain amount, which would represent the presumed average labour costs in the country of origin.<sup>101</sup> In this case, if extended, the deduction of labour costs would no longer be producer-specific but would become product-specific.<sup>102</sup> Given that labour costs are likely to differ between jurisdictions, the measure could be found to infringe the MFN principle: products from countries made in jurisdictions with higher average labour costs would be taxed less. Moreover, the national treatment principle could be infringed as soon as labour costs in the implementing jurisdiction are higher than in other jurisdictions.

*(ii) The safest option is to independently subsidise labour costs*

Although there are good arguments to support the non-discriminatory character of the deduction of labour costs vis-à-vis imported products, policy-makers may still fear that this feature of the DBCFT will be challenged on the basis that the higher overall tax burden on importers amounts to an indirect discrimination against imported products.

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<sup>101</sup> Averaging would be required since it is unlikely that the importing country would have sufficiently precise pieces of information as to the exact amount of labour costs linked to imported products and services.

<sup>102</sup> In contrast, under a deduction for labour costs limited to in-jurisdiction labour costs, the deduction can be granted regardless of the fact that products are sold in the DBCFT jurisdiction. In the case of a hypothetical business located in the DBCFT jurisdiction, which has high labour costs and does not sell any products within the DBCFT jurisdiction, this business would still get a deduction for labour costs.

In order to avoid this risk, policy-makers may consider the design of the deduction for labour costs as an independent subsidy from the tax on sales and services. GATT article III:8(b) protect these subsidies from claims based on the national treatment principle. However, subsidies “attached” to product taxes do not seem to benefit from the same protection. GATT article III:8(b) states as follows:

“[GATT article III] shall not prevent the payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchases of domestic products”.

In interpreting this provision, WTO Panels and Appellate Bodies have made a distinction between “payments after tax” to producers (namely “direct subsidies involving a payment” or “expenditure of revenue by a government”) and the “remission of a tax on a product”.<sup>103</sup> Although the economic effects of these two categories of subsidies might be identical, only the former category is protected under GATT article III:8(b).<sup>104</sup> In the case *US – Measures affecting the importation, internal sale and use of tobacco*, the Panel stated that this distinction is “a formal one, not one related to the economic impact of a measure”.<sup>105</sup> The formal interpretation of GATT article III:8(b) has two consequences. First, subsidies paid to producers are unlikely to be found in violation of GATT article III.<sup>106</sup> In other words, GATT article III:8(b) prevents *non-fiscal* subsidies (through payments after tax) from being systematically found in violation of GATT article III.<sup>107</sup> Second, subsidies in the form of tax deductions, tax credits and reduced tax rates in respect of taxes imposed on products do not benefit from the protection provided by GATT article III:8, although their impact might be the same as direct payments to producers or tax subsidies in respect of a tax not imposed on products.<sup>108</sup> This second consequence of the formal interpretation of GATT article III:8(b) is aimed at preventing that discriminatory rules against imported products be “hidden” under provisions designed as “preferential (tax) regimes in favour of producers”, which can in principle not be challenged under GATT article III.<sup>109</sup> In other words,

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<sup>103</sup> Cases discussing GATT article III:8(b) include GATT, Panel Report, *United States – Measures affecting alcoholic and malt beverages*, 19 June 1992, DS23/R – 39S/206, paras. 5.10 - 5.12; WTO, Panel Report, *Indonesia – Autos*, *supra* n. 78, in particular para. 14.118-14.112; WTO, Appellate Body Report, *Canada – Periodicals*, *supra* n. 29, p. 32, point VII; WTO, Panel Report, *Brazil - Taxation*, *supra* n. 79. *See also* GATT, Panel report, *US- Measures affecting the importation, internal sale and use of tobacco*, 12 August 1994, DS44/R, para. 109. *Contra see* the separate opinion of one Appellate Body Member on Article III:8(b) of the GATT 1994 in WTO, Panel Report, *Brazil - Taxation*, *supra* n. 79, paras. 5.125 to 5.138.

<sup>104</sup> *See* GATT, Panel report, *US- Measures affecting the importation, internal sale and use of tobacco*, *supra* n. 103, para. 109. Interestingly (and probably wrongly), in *US – Malt Beverages*, *supra* n. 103, para. 5.10, the Panel argued that this formal distinction “makes sense economically (...)” (“(...) Even if the proceeds from non-discriminatory product taxes may be used for subsequent subsidies, the domestic producer, like his foreign competitors, must pay the product taxes due”).

<sup>105</sup> GATT, Panel report, *US- Measures affecting the importation, internal sale and use of tobacco*, *supra* n. 103, para. 109. *See also* GATT, Panel Report, *US – Malt Beverages*, *supra* n. 103, para. 5.10. *Contra*, the separate opinion of one Appellate Body Member in *Brazil - Taxation* *supra* n. 79, paras. 4.125 – 4.138.

<sup>106</sup> In the case *Brazil - Taxation*, the Panel stated that GATT III:8 cannot be used to fully exempt subsidies from a review under GATT article III. According to the Panel (Panel Report, *Brazil - Taxation*, *supra* n. 79): “(...) subsidies that are provided exclusively to domestic producers pursuant to Article III:8(b) of the GATT 1994 are not *per se* exempted from the disciplines of Article III of the GATT 1994 (para. 7.87)”; “(...) Article III:8(b) does not exempt from the substantive disciplines of Article III components of such production subsidies that introduce tax discrimination on imported like products” (para. 7.93). The Appellate Body reversed this finding in paras. 5.123 and 5.124. In the case *US – Tax Incentives*, the Appellate Body made clear that compliance with GATT article III:8(b) does not imply that the measure necessarily complies with the ASCM (WTO, Appellate Body Report, *United States – Conditional Tax Incentives for Large Civil Aircraft*, 4 September 2017, WT/DS487/AB/R, para. 5.16: “(...) even if the granting of a subsidy is exempt from the GATT national treatment obligation by virtue of it being paid exclusively to domestic producers within the meaning of Article III:8(b) of the GATT 1994, it may still be found to be contingent upon the use by those producers of domestic over imported goods under Article 3.1.(b) of the SCM Agreement”).

<sup>107</sup> WTO, Panel Report, *Brazil - Taxation*, *supra* n. 79, paras. 7.77 and 7.78 and Appellate Body Report, para. 5.108.

<sup>108</sup> *See* GATT, Panel Report, *US – Malt Beverages*, *supra* n. 103, para. 5.9; WTO, Appellate Body Report, *Brazil - Taxation*, *supra* n. 79, para. 5.120.

<sup>109</sup> *See* GATT, Panel Report, *US – Malt Beverages*, *supra* n. 103, paras. 5.9-5.12. Around the same line, *see* WTO, Panel Report, *Brazil - Taxation*, *supra* n. 79, paras. 7.66.



the second objective behind the formal interpretation of GATT article III:8(b) is to increase transparency and prevent taxpayers from using this provision to circumvent the general rules of GATT article III.<sup>110</sup> However, this does not imply that tax deductions, tax credits and reduced tax rates in favour of producers will automatically be found in violation of GATT article III:2. A violation of GATT article III:2 will arise only when a tax deduction, tax credit or a reduced tax rate effectively discriminates against imported products.

The main consequence of GATT article III:8(b) on the DBCFT is that it encourages policy-makers to design the deduction for labour costs as a separate element from the tax on sales.<sup>111</sup> Designed in that way, the DBCFT jurisdiction could rely on GATT article III:8(b) to argue that the deduction of labour costs does not lead to a violation of GATT article III:2. This design option would ensure that the deduction of labour costs is a direct subsidy, unlikely to be found contrary to GATT article III. Moreover, policy-makers could choose to define the deduction of labour costs in a broad way, for example by extending it to businesses that are not subject to the DBCFT (e.g. because they are small businesses). Such design feature would guarantee that the deduction of labour costs is detached from the tax on sales/services.

This formal ground of defence will not be available if the DBCFT is designed as one tax, namely as a tax on final sales minus labour costs -. In that case, policy-makers will need to rely on the substantive arguments explained above (*section i*), namely that the deduction of labour costs does not make the DBCFT discriminatory against imported products because it is not product-specific.

### ***C. New destination-based taxes seem to discriminate against imported products***

This argument suggests that new types of destination-based taxes violate WTO law simply because they seem to discriminate against imported products, regardless of the fact that economic analysis might indicate the opposite.<sup>112</sup> Such argument is not convincing. In order to violate GATT non-discrimination provisions, evidence of a discriminatory treatment is required and not merely of an “appearance of discrimination”. Moreover, it implies that the WTO DSB does not base its decision on economic theory when the design of a tax points towards facial discrimination. From this perspective, this argument contributes to the idea that WTO law broadly relies on formal interpretation.

This idea is partially correct: in certain circumstances, legal form matters under WTO law. For example, as explained above (*section III.1.B.2.ii.*), Panels and Appellate Bodies have traditionally interpreted GATT article III:8(b) as applying to subsidies granted to producers only when they are designed as “payments after tax”. In many other circumstances, however, legal form does not matter to the same extent and the interpretation of WTO law provisions may be based on economic reasoning.<sup>113</sup> First, the case-law highlights that Panels and Appellate Bodies have often interpreted GATT article III in a way that prevents WTO members from using formalism to escape their scrutiny. For example, in the case *Argentina – Hides and Leather*, the Panel made clear that the direct nature of the tax could not be used as a formal argument to escape from the control of GATT article III:2 altogether (*section III.1.A(i)*). The various unsuccessful attempts by the US to make its exemption regime in favour of foreign sales corporation compliant with WTO law also illustrate this point. Regardless of its form, the regime was

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<sup>110</sup> *Ibid.*

<sup>111</sup> Grinberg reaches the same conclusion but based on other arguments (Grinberg (2017), *supra* n. 5).

<sup>112</sup> See the reference to economic theory in Schön, *supra* n. 14, p. 13.

<sup>113</sup> See Christian A. Melischek, *The Relevant Market in International Economic Law. A Comparative Antitrust and GATT Analysis* (CUP 2012) on the role of econometrics in interpreting WTO law (in particular the concept of like products).

repeatedly found incompatible with WTO law provisions.<sup>114</sup> Second, the case-law indicates that GATT article III prevents countries from adopting certain tax measures because of their effects rather than their form.<sup>115</sup> The form of a measure might make it less easily justifiable under WTO law but it should not – as such – lead the DSB to the conclusion that it violates WTO law.

#### ***D. The collection method discriminates against imported products***

If destination-based taxes are collected in such a way that imported products face a heavier tax burden than domestic products, the tax could be found in violation of GATT articles III:2 or III:4. This argument has not been made in the literature on the WTO law compatibility of the DBCFT. However, as it has been used in previous case-law, this section briefly discusses it so as to help policy-makers avoid such type of discrimination.

First, policy-makers should not establish administrative burdens that lead to potential discrimination against imported products vis-à-vis domestic products. Although WTO law allows for the use of different methods of taxation in respect of domestic and imported products, differences in the method of tax collection should not result in a heavier tax burden on imported products.<sup>116</sup> For example, in the case *Thailand – Cigarettes (Philippines)*, the fact that resellers of imported cigarettes had to meet specific administrative requirements to offset their tax liability, which resellers of domestic cigarettes did not have to meet, was found contrary to GATT article III:2.<sup>117</sup>

Second, policy-makers should not discriminate against imported products by means of differences in the temporal application of the tax (e.g. deferral). In the case *Argentina – Hides*, the Panel considered that an Argentinian tax regime regarding advance tax payments violated GATT article III:2 because the prepayment requirement that applied to some import transactions (and not to like internal sales transactions) implied a loss of interest for taxpayers.<sup>118</sup>

### **III.2. Tax treatment of exported products**

In addition to the arguments related to the treatment of imported products, new form of destination-based taxes can be challenged on the basis of arguments related to the treatment of exported products. The next sections analyse the two main arguments that have been made by legal scholars in this context. The main legal basis for these two arguments is the ASCM.<sup>119</sup>

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<sup>114</sup> Initially, this regime was called the DISC (*Domestic International Sales Corporations*) regime. Then, this regime was renamed the FSC (*Foreign Sales Corporation*) regime and, later the ETI (*Extraterritorial Income Exclusion*) regime. On these disputes, see Yariv Brauner, “International Trade and Tax Agreements May Be Coordinated, But Not Reconciled” (2005) 25 Va. Tax Rev. 251-311; Hale E. Sheppard, “Rethinking Tax-Based Export Incentives: Converting Repeated Defeats Before the WTO into Positive Tax Policy” (2003) 39 Texas International Law Journal 111, at p. 129-130.

<sup>115</sup> See, for example, section III.1.A.(iii).

<sup>116</sup> See WTO, Panel Report, *Argentina – Hides and Leather*, supra n. 36, para. 11.150.

<sup>117</sup> See WTO, Appellate Body report, *Thailand – Customs and fiscal measures on cigarettes from the Philippines*, 17 June 2011, WT/DS371/AB/R (*Thailand – Cigarettes (Philippines)*), paras. 116-118 and paras. 120-140. Among other issues, this case analysed “additional administrative requirements” imposed on resellers of imported cigarettes.

<sup>118</sup> WTO, Panel Report, *Argentina – Hides and Leather*, supra n. 36, paras. 11.198 to 11.211, paras. 11.253-11.254. See also in the context of the GATS, the case *Argentina – Measures Relating to Trade in Goods and Services*, WT/DS453/R and WT/DS453/AB/R/, in which the Panel and Appellate Body ruled on Argentina’s provisions on the allocation of expenditures (accrual rule for domestic transaction vis-à-vis payment received rule for cross-border transactions). The Panel found that the measure was contrary to GATS national treatment principle but the Appellate Body reversed this finding on the ground that the Panel had not properly analysed the likeness between domestic and cross-border transactions.

<sup>119</sup> See also GATT articles VI and XVI.

***A. If destination-based taxes qualify as direct taxes, the exemption of exported products automatically amounts to a prohibited export subsidy***

A first argument in support of the incompatibility of the DBCFT with the ASCM is based on its direct nature. The logic of this argument is very similar to the one explained above under the GATT (*section III.1.A*): WTO law would always prevent the adoption of destination based *direct* taxes. On the export side, this argument implies that the exemption of exported products in respect of a direct tax automatically amounts to a prohibited export subsidy.<sup>120</sup>

Authors who support this argument usually refer to the text of Annex I of the ASCM, which contains “an illustrative list of export subsidies”. In this illustrative list, an explicit reference is made to direct taxes, which could be interpreted as prohibiting tax reliefs related to exports in respect of direct taxes (paragraph (e) and footnotes 58 and 59 of Annex I of the ASCM).<sup>121</sup> In analysing the provisions of the ASCM, Schön also suggests that, for direct taxes, footnote 59 of the ASCM “requires the Member States to adhere to the arm’s length standard for the time being”.<sup>122</sup> The DBCFT, under the assumption that it is a direct tax, would violate this requirement since transfer pricing rules would lose their relevance under a tax system modelled after a DBCFT.<sup>123</sup>

Three main counter-arguments allow to oppose the claim that new forms of destination-based direct taxes will automatically violate the ASCM.

First, one can put into question the classification of these new destination-based taxes as direct taxes in the context of the ASCM.<sup>124</sup> Indeed, new destination-based taxes such as the DBCFT differ from the few direct taxes that have been analysed under this agreement. The DBCFT is not comparable to the US DISC, FSC and ETI tax regimes that were found contrary to the ASCM. In these cases, the disputed US tax measure was part of a traditional CIT characterised by a special regime in respect of exported products.<sup>125</sup> Consequently, this tax could easily be classified as a “direct tax” under the ASCM. The classification of the new types of destination-based taxes as direct or indirect taxes is not as clear-cut. Footnote 58 of Annex I of the ASCM defines these two categories as follows:

“The term “direct taxes” shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property.  
(...)”

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<sup>120</sup> Scott Lincicome, “Will House Republicans’ ‘Border Adjustable’ Tax Plan Cause a Trade War? (Spoiler: Maybe Not!)” (2017) Cato at Liberty, Cato Institute (“First, in order for the tax exemption or rebate on US exports to avoid being designated a prohibited export subsidy, the adjusted corporate tax must not be a “direct tax,” as defined in the WTO Subsidies Agreement”); Avi-Yonah & Clausing, *supra* n. 14, p. 234, quoting the US 2016 Tax Blueprint; David A. Weisbach, “Does the X-Tax Mark the Spot?” (2003) 56 SMU Law Review 201, p. 213 (“The GATT allows rebates at the border for indirect taxes but prohibits them for direct taxes”). See also Christopher Deal, “The GATT and VAT: Whether VAT Exporters Enjoy a Tax Advantage under the GATT” (1995) 17 Loy L.A. Int’l & Comp. L.J. 649-670. Deal criticises the distinction between direct and indirect taxes in the context of GATT provisions surrounding subsidies.

<sup>121</sup> Compare the language of paragraphs (e) and (g) with the (more general) language of the interpretative note to GATT article XVI (Ad Article XVI: “The exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy”).

<sup>122</sup> Schön, *supra* n. 14, pp. 15-16. Footnote 59 clarifies the interpretation of paragraph (e) of Annex I ASCM, referring to the arm’s length principle in the following terms: “(...) The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm’s length.”

<sup>123</sup> Schön, *supra* n. 14, p. 15: “The border tax adjustment under the DBCFT is primarily designed to reduce the incentives multinational taxpayers have in manipulating transfer prices”.

<sup>124</sup> Hillman, *supra* n. 14, pp. 9-10. On the import side, this argument corresponds to the one that has been analysed under *section III.1.A(ii)*.

<sup>125</sup> WTO, Appellate Body Report, *United States – Tax Treatment for “Foreign Sales Corporations”*, *supra* n. 7, para. 93 “(...) tax measures identified in footnote 1 as not constituting a ‘subsidy’ involve the exemption of exported products from product-based consumption taxes. The tax exemptions under the FSC measure relate to the taxation of corporations and not products. Footnote 1, therefore, does not cover measures such as the FSC measure”.

The term “indirect taxes” shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;”

Based on these two definitions, the question arises as to whether taxes such as the DBCFT should be classified as direct or indirect taxes. It can certainly be argued that a DBCFT is a direct tax because it is a tax aimed at replacing the CIT.<sup>126</sup> But it could also be argued that a DBCFT is an indirect tax because it is a tax on “sales” in the jurisdiction of consumption or a tax “other than direct taxes and import charges”. If the DBCFT is classified as an indirect tax under the ASCM, the formal critique against the DBCFT based on its direct tax nature would no longer be relevant.<sup>127</sup>

Second, one could put into question the claim that destination-based direct taxes automatically violate the ASCM. Annex I seems to imply that such taxes cannot be implemented on a destination-basis, but the effects of this Annex are, in fact, limited. WTO members should rely on the illustrative list of Annex I only if they are able to prove that the measure mentioned in the list can qualify as a subsidy under article 1 of the ASCM.<sup>128</sup> According to this article, for a tax measure to amount to the granting of a subsidy, it needs to be proven that “revenue which would have been otherwise due” has been foregone or not collected (article 1.1(a)(1) (ii) of the ASCM).<sup>129</sup> Since destination-based taxes such as the DBCFT are aimed at imposing sales in the jurisdiction of consumption, there is no reason to tax exported products.<sup>130</sup> Put another way, it is not possible to determine which “revenue would have been otherwise due” under a DBCFT since the normative benchmark is the taxation of sales in the jurisdiction of consumption.

Third, it is probably excessive to interpret footnote 59 as a general requirement to use transfer pricing rules in respect of direct taxes. It should be read only as a limitative requirement imposed on those WTO members that rely on a tax system in which the value of transactions between associated companies need to be assessed. Footnote 59 prevents these WTO members to subsidize their exports through the pricing of transactions between associated enterprises.<sup>131</sup>

### ***B. The deduction of labour costs amounts to a prohibited export subsidy or to an actionable subsidy***

A second argument brought forward against the WTO law compatibility of the DBCFT under the ASCM is based on the substantive claim that the deduction of labour costs leads to an excessive remission of

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<sup>126</sup> See the analysis of Ismer & Jescheck on the distinction between income taxes and other types of taxes in the context of tax treaties: Roland Ismer & Christoph Jescheck, “The Substantive Scope of Tax Treaties in a Post-BEPS World: Article 2 OECD MC (Taxes Covered) and the Rise of New Taxes” (2017) 45(5) *Intertax* 382, pp. 384-385.

<sup>127</sup> See Annex I of the ASCM indicates that tax reliefs in respect of indirect taxes are problematic only when they are assimilated to export subsidies, namely when they are “in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption” (Annex I, (g) of the ASCM).

<sup>128</sup> See Hillman’s argument (*supra* n. 14, p. 8). See also Becker & Englisch, *supra* n. 14, p. 14; Grinberg (2017), *supra* n. 5, p. 807. See also WTO, Panel report, *Canada – Export Credits and Loan Guarantees for Regional Aircraft*, 28 January 2002, WT/DS222/R, para. 7.395.

<sup>129</sup> See the reasoning used by the Appellate Body in the case *US – FSC (Article 21.5 – EC)* to determine whether revenue was “otherwise due” (para. 98): “(...) the normative benchmark for determining whether revenue foregone is otherwise due must allow a comparison of the fiscal treatment of comparable income, in the hands of taxpayers in similar situations”.

<sup>130</sup> Becker & Englisch, *supra* n. 14, p. 14: “This core design objective (...) implies the need for border tax adjustment. It can therefore be established that the exemption of revenue resulting from the export of goods and services forms an integral part of the proposed tax system, and does not qualify as forgone revenue “that is otherwise due”. Exemption of exports therefore does not amount to a subsidy within the meaning of Art. 1.1(a)(1)(ii) ASCM.” See also GATT VI:4 and Footnote 1 of the ASCM, which states as follows: “(...) the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy”. *Contra*: Schön, *supra* n. 14, pp. 14-16.

<sup>131</sup> We agree with Schön when he states as follows (Schön, *supra* n. 14, p. 16): “This Footnote is meant to blacklist legislation which combines an exemption of foreign based-income with overly lenient transfer pricing legislation and practice in the exporting state”. Schön quotes Van Thiel: Servaas van Thiel, “General report”, in Michael Lang, Judith Herdin, Ines Hofbauer (eds.), *WTO and Direct Taxation* (2005 Linde), p. 27.

the tax in respect of exports, which would be assimilated to an export subsidy (based on paragraphs (e) and (g) of Annex I of the ASCM).<sup>132</sup>

However, the deduction of labour costs is not specific to exports. As mentioned before, it is a general measure granted based on where labour costs have been incurred. It is granted on an origin basis, regardless of whether products are consumed domestically or abroad. Therefore, there is no reason to assimilate the deduction of labour costs to an export subsidy.

Moreover, such type of measure is unlikely to amount to an actionable subsidy (articles 5 and 6 of the ASCM). Indeed, the deduction of labour costs will not be granted to a limited group of enterprises, which means that the criterion of “specificity” mentioned in article 2 of the ASCM will not be met. In any case, unlike export subsidies, actionable subsidies are not prohibited under the ASCM but they merely open the door for other WTO members to adopt countervailing duties (article 5 of the ASCM).

### III.3. Tax treatment of services and service suppliers

A third category of arguments in support of the WTO law incompatibility of new types of destination-based taxes relates to their allegedly discriminatory effect on cross-border services.<sup>133</sup> The legal basis for these arguments is the GATS, which, like the GATT, contains non-discrimination provisions. Consequently, most of the arguments that have been explained in the sections above can also be used in the framework of the GATS.<sup>134</sup> Yet, despite their similarities, the GATS and the GATT differ from each other.

First, the GATS does not contain any provision similar to GATT provisions on customs duties and its national treatment provision (GATS article XVII) does not contain a specific paragraph on “taxes”.<sup>135</sup>

Second, the national treatment provision under the GATS does not seem to embrace the (somewhat artificial) distinction between products and producers that characterises this provision under the GATT.<sup>136</sup> Indeed, under the GATS (article XVII), the national treatment principle explicitly requires to “accord to services *and service suppliers of any other Member*, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers” (emphasis added).

Third, in contrast to the GATT, the GATS national treatment principle has a limited scope of application. It applies only to services that have been included by WTO members in their “schedule of specific

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<sup>132</sup> Grinberg (2017), *supra* n. 5, p. 806. See also, Lincicome, *supra* n. 120: “the DBCFT cannot provide a border adjustment on export that is greater than the amount of tax actually levied or due”.

<sup>133</sup> The case *Argentina – Financial Services* illustrates the relevance of the GATS for tax matters (WTO, Panel and Appellate Body reports, *Argentina – Measures relating to Trade in Goods and Services*, WT/DS453/R & WT/DS453/AB/R).

<sup>134</sup> The main instance where that would not be true is the hypothetical case where a WTO member would have adopted a horizontal limitation and an article II exemption in order to exclude taxes altogether from its GATS commitments. In this case, tax measures, including the DBCFT, would fall out of the scope of GATS provisions. In other words, such a broad limitation would eliminate the risks for a tax measure to be found in violation of the GATS. According to Farrell, “19 WTO Members have submitted tax limitations”, most of which are “specific” (Jennifer E. Farrell, *The Interface of International Trade Law and Taxation* (IBFD 2013), p. 189).

<sup>135</sup> The GATS, however, refers to direct taxes in the carve-out of the national treatment principle (see article XIV(d)) and provides a definition of “direct taxes” (see article XXVIII, (o): ““direct taxes” comprise all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation”).

<sup>136</sup> This point has been discussed by the Group of Negotiations on Services. See Note on the meeting of 15 – 17 September 1987, MTN.GNS/10, 15 October 1987 (in particular, paras. 11-21). This note is quoted by Marie Lamensch, “WTO Appellate Body Report in *Argentina – Financial Services*: Further Clarity on Likeness Analyses in Aa GATS Context?” (2017) 19(5) *Derivatives & Financial Instruments*, footnote 38). The GATS does not contain any equivalent provision to GATT article III:8(b).

commitments” under the conditions that these commitments are not subject to additional limitations.<sup>137</sup> For a general tax such as the DBCFT, the more limited scope of application of the GATS is unlikely to make any difference.<sup>138</sup> However, it will be relevant for new destination-based taxes that are imposed only to specific types of services (e.g. digital services). These taxes will be subject to the GATS national treatment principle only if they have been adopted by WTO members that have included these types of services in their schedule of specific commitments.

Fourth, unlike the GATT, the GATS contain specific tax exceptions, where the GATT does not. One of these exceptions is GATS article XIV(d), which provides a carve-out to the national treatment principle “provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members”. Such exception could be useful to justify the features of destination-based taxes that are potentially problematic under the national treatment principle (for example, in the case of the DBCFT, the exemption regime or the deduction for labour costs).<sup>139</sup> Subject to the condition mentioned in the chapeau of GATS article XIV(d) (namely that the measure does not lead to “arbitrary or unjustifiable discrimination or disguised restriction”), GATS tax carve-out allows distinguishing between resident and non-resident service suppliers as well as between “service suppliers subject to tax on worldwide taxable items” and “other service suppliers”.<sup>140</sup>

The sections below review how the main differences between the GATT and the GATS influence the analysis of destination-based taxes under these two agreements.

#### ***A. The argument related to the “direct nature” of destination-based taxes is not worth analysing under the GATS***

Unlike the GATT national treatment provision that refers to “*taxes applied, directly or indirectly, to domestic products*”, the text of the GATS in no way supports argument related to the impossibility for WTO members to adopt destination-based *direct* taxes. This is not surprising: the concepts of BTAs and destination-based taxes originated in the context of international trade in goods (not in the context of international trade in services). When the OECD and GATT reports defined the concept of BTAs in the 1960s/1970s, the GATS did not exist.

The arguments in support of the WTO law incompatibility of destination-based *direct* taxes are very much grounded in the text of the GATT and in the OECD and GATT reports on BTAs. Therefore, it is not worth reviewing these arguments under the GATS.

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<sup>137</sup> See Article XVII GATS. WTO members can limit the scope of their commitments by means of horizontal limitations (i.e. limitations that apply to all sectors listed in the schedule) or sectoral limitations (i.e. limitations specific to certain sectors).

<sup>138</sup> Given that the DBCFT is imposed on all types of goods and services, the GATS is likely to apply even if the DBCFT jurisdiction has maintained limitations on national treatment for certain sectors or services. Indeed, it is not unreasonable to expect that at least some services would fall under the specific commitments of the DBCFT jurisdiction.

<sup>139</sup> The exemption of certain resident service suppliers could maybe be justified under GATS article XIV(d) under the condition that they are subject to a broader personal income tax than non-resident (so as to meet the condition of the chapeau).

<sup>140</sup> According to Schön, *supra* n. 14, p. 14: “In the context of the DBCFT the decisive question seems to be whether the carve-out in Art. XIV(d) GATS simply builds a fence around the traditional international tax system (ensuring territorial taxation on a source basis and worldwide taxation on a residence basis) or whether it can be relied upon in order to introduce a completely new international arrangement of profit taxation.”

***B. The counterarguments used to challenge the claim that the DBCFT is discriminatory are also valid under the GATS***

The GATS seems to define the national treatment principle in broader terms than the GATT. Indeed, under the GATS, the national treatment principle explicitly targets “services and service suppliers of any other WTO member” while, under the GATT, the focus is on imported products. This could have an impact on the (in)compatibility of some features of the DBCFT with the GATS.

Indeed, the differences between the GATS and the GATT raise the question as to whether the counterarguments made earlier to defend the exemption regime and the labour costs deduction would still be valid under the GATS. These arguments were strongly based on the observation that these two features of the DBCFT were not product-specific. If the GATS forbids distinction between domestic and foreign services but also between domestic and foreign service suppliers, these arguments would no longer hold under the GATS. The only way to justify the exemption regime and the deduction for labour costs would be to rely on GATS tax carve-out.

However, one should not overestimate the differences between the national treatment principle under the GATS and the GATT. First, regarding the GATT, the case-law highlights that favourable measures granted to domestic producers are not automatically safe under GATT article III:2 (*sections III.1.B.1.ii & B.2.ii*). If such favourable measures are used to “hide” differential treatment between products, they will fall under GATT article III:2. Second, regarding the GATS, GATS article XVII makes clear that the application of the national treatment principle to “service suppliers” is limited to “measures affecting the supply of services”. In other words, the GATS does not prohibit any type of differential treatment between service suppliers but only those differentiations that affect the supply of services.<sup>141</sup>

Consequently, the same arguments as the ones that have been used to defend the DBCFT against the claim that the exemption regime and the deduction of labour costs lead to a violation of GATT article III:2 could be used under the GATS.<sup>142</sup> Moreover, the exemption regime and the deduction of labour costs are similarly problematic under the GATS and the GATT.<sup>143</sup> As explained before, these two features of the DBCFT could be considered discriminatory vis-à-vis imported products as they might lead to a reduction of the overall amount of taxes that domestic manufacturers remit to the DBCFT jurisdiction in comparison to importers. This is also true under the GATS: the exemption regime and the deduction of labour costs could be considered discriminatory vis-à-vis the cross-border supply of services as the overall tax burden on domestic service suppliers will be lower than on “cross-border” suppliers. In order to avoid the risk that the DBCFT is found incompatible with GATS article XVII, policy-makers are advised to deny the deduction for the costs of services received from exempted businesses.<sup>144</sup> As for the deduction of labour costs, the least risky design option is to establish the tax

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<sup>141</sup> On the interpretation of this condition, see WTO, Appellate Body report, *European Communities – Regime for the importation, sale and distribution of bananas*, 9 September 1997, WT/DS27/AB/R, para. 220.

<sup>142</sup> For example, the argument made earlier based on the analogy between exemption regime under VAT systems and the DBCFT could also be made under the GATS. Indeed, current VAT systems are also characterised by exemption measures, which could potentially be discriminatory vis-à-vis cross-border service suppliers. See the *Schmelz* case, where the Court of Justice of the EU was asked to rule on an exemption measure under the Austrian VAT system, which was accused of being discriminatory against a German national who was asked to pay VAT on the rental of an apartment located in Austria where an Austrian national would have been exempted under the same circumstances. The Court found that the measure was justified (CJEU, *Ingrid Schmelz v Finanzam Waldviertel*, 26 October 2010, C-97/09, para. 71).

<sup>143</sup> See Schön, *supra* n. 14, pp. 13-14: “Similar concerns would come up for an internationally active service-provider, e.g. a global law firm, which would not be allowed to deduct wages for foreign-based professional employees from their domestic profit under the “border tax adjustment” forming part of the DBCFT framework”.

<sup>144</sup> Alternatively, the exemption regime could be extended to foreign suppliers who are active in the DBCFT jurisdiction (through commercial presence or presence of natural persons) and meet the same conditions as domestic suppliers. The extension of the exemption regime to foreigners with commercial presence or person of natural persons is required because of the broad definition of cross-border supply of services

advantage for domestic labour costs as an independent subsidy, separated from the tax on the supply of services.

### *C. The argument related to the effects of the DBCFT on exports is not relevant under the GATS*

The GATS does not contain similar provisions on subsidies as under the GATT and the ASCM. GATS provision on subsidy vaguely states that “Members recognize that, in certain circumstances, subsidies may have distortive effects on trade in services”.<sup>145</sup> Yet, WTO members are not completely free to adopt any type of subsidies under the GATS. They need to make sure that they do not violate general GATS provisions, such as the national treatment or MFN principles. For example, WTO members should make sure that their subsidies do not discriminate against the cross-border supply of services, including the supply of services by foreign service suppliers through commercial presence or through presence of natural persons.<sup>146</sup> Aside from these general requirements, the GATS does not prevent the adoption of export subsidies. Therefore, the argument based on the claim that the DBCFT – by not taxing “exports” - provides an export subsidy to suppliers located in the DBCFT jurisdiction, which encourages them to export their services abroad, is not relevant under the GATS.

## **IV. Conclusion**

This Article has shed light on the strengths and weaknesses of the arguments that have been expressed to support the view that the DBCFT violates WTO law. These arguments are summarized in the table below. This analysis will be useful to assess and anticipate the legal issues that new types of destination-based taxes could potentially face under international trade law. Overall, this Article highlights that the likelihood for a carefully designed DBCFT to be found in violation of WTO law is not as high as legal scholars have suggested in their analysis of the topic.

The *sui generis* character of new destination-based taxes does not seem to be a good reason to support their incompatibility with international trade law, despite the commonly accepted view that only indirect taxes can be adopted on a destination-basis. This Article shows why this incorrect view has initially emerged in an OECD report released in 1968 and how it has been shaped over the years. The analysis of the GATT and WTO law case-law also explains why the direct/indirect distinction is not a relevant criterion to assess the compatibility of new destination-based taxes under WTO law.

Only two of the design features of the DBCFT are potentially problematic. First, the exemption of certain businesses could be problematic under the GATT and the GATS. However, VAT regimes are characterized by similar legal issues. Therefore, countries that rely on a VAT regime that includes exemptions are unlikely to use this argument against the DBCFT. Second, it is not impossible – though unlikely - that the deduction of labour costs would be found in violation of the national treatment

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under the GATS. Indeed, the cross-border supply of services can take place through 4 modes, including the supply of services through commercial presence (mode 3) and through presence of natural persons (mode 4).

<sup>145</sup> GATS Article XV.

<sup>146</sup> See Rudolf Adlung, “Export Policies and the General Agreement on Trade in Services”, WTO Working Paper ERSD-2014-09, available at [https://www.wto.org/english/res\\_e/reser\\_e/ersd201409\\_e.pdf](https://www.wto.org/english/res_e/reser_e/ersd201409_e.pdf), referring to WTO, Guidelines for the scheduling of specific commitments under the General Agreement on Trade in Services (GATS), adopted by the Council for Trade in Services on 23 March 2001, 28 March 2001, S/L.92, para. 16: “(...) Therefore, any subsidy which is a discriminatory measure within the meaning of Article XVII would have to be either scheduled as a limitation on national treatment or brought into conformity with that Article. Subsidies are also not excluded from the scope of Article II (MFN). In line with the paragraph above, a binding under Article XVII with respect to the granting of a subsidy does not require a Member to offer such a subsidy to a services supplier located in the territory of another Member”.



principles under the GATT and the GATS. However, this potential incompatibility could be avoided by designing the labour costs deduction as an independent element from the tax on products and services.

From a policy perspective, this means that WTO law should not be used as a scapegoat to blame for preventing WTO members from adopting a DBCFT or new types of destination-based taxes. Nor should WTO law be used as an excuse to disregard a move towards destination-based taxation as a relevant policy option to reform tax systems.

<b>TAX TREATMENT OF IMPORTED PRODUCTS (III.1) –GATT ARTICLE III &amp; ASCM</b>	
<b>A. Direct taxes cannot be implemented on a destination-basis</b>	
<i>The DBCFT is a direct tax in combination with “adjustments” on imported products, which is forbidden under GATT article III:2. The “adjustments” qualify as customs duties or discriminatory taxes</i>	Unconvincing argument
<b>B.1. Discrimination against imported products (deduction of input costs)</b>	
<i>The deduction of input costs discriminates against imported products. The deduction of input costs amounts to a prohibited (domestic content) subsidy [when some businesses are exempted from the tax] and/or they make the DBCFT discriminatory</i>	Unlikely to be problematic (similar under VAT systems)
<b>B.2. Discrimination against imported products (deduction of labour costs)</b>	
<i>The deduction of labour costs amounts to a prohibited (domestic content) subsidy and/or discriminates against imported products</i>	Unlikely to be problematic (not discriminatory against imported products). Design issue (GATT article III:8)
<b>C. Formal discrimination</b>	
<i>The DBCFT formally seems to discriminate against imported products.</i>	Unconvincing argument
<b>D. Discrimination against imported products (method of tax collection)</b>	
<i>The method of collection of the DBCFT discriminates against imported products</i>	Design issue
<b>TAX TREATMENT OF EXPORTED PRODUCTS (III.2) – GATT ARTICLE XVI &amp; ASCM</b>	
<b>A. Direct taxes cannot be implemented on a destination-basis</b>	
<i>The DBCFT is a direct tax in combination with “adjustments” on exported products (exemptions), which is forbidden under the ASCM. The DBCFT does not rely on the ALP. The “adjustments” qualify as export subsidies.</i>	Unconvincing argument
<b>B. Prohibited subsidy (deduction of labour costs)</b>	
<i>The deduction of labour costs amounts to a prohibited subsidy</i>	Unconvincing argument
<b>TAX TREATMENT OF SERVICES &amp; SERVICE SUPPLIERS (III.3) - GATS</b>	
<b>A. Direct taxes are not eligible for BTAs on exports</b>	Not an argument under the GATS
<b>B. Discrimination against cross-border services (deduction of input costs)</b>	
<i>The deduction of input costs discriminates against cross-border services when the exemption regime is limited to domestic service suppliers</i>	Unlikely to be problematic (similar under VAT)
<b>B. Discrimination against cross-border services (deduction of labour costs)</b>	
<i>The deduction of labour costs discriminates against cross-border services</i>	Unlikely to be problematic
<b>C. Prohibited export subsidy</b>	
<i>The DBCFT provides a subsidy in favour of service suppliers who “export” their services</i>	Not an argument under the GATS

## V. Annex

### Relevant provisions in the GATT

#### Article I: General Most-Favoured-Nation Treatment (MFN)

1. With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III,\* any advantage, favour, privilege or immunity granted by any

contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties. (...)

#### **Article II: Schedules of concessions**

1. (a) Each contracting party shall accord to the commerce of the other contracting parties treatment no less favourable than that provided for in the appropriate Part of the appropriate Schedule annexed to this Agreement. (...)

#### **Article II:2(a)**

2. Nothing in this Article shall prevent any contracting party from imposing at any time on the importation of any product:

(a) a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III\* in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part; (...)

#### **Article III:2**

2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.\* (...)

#### **Add article III, paragraph 2**

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

#### **Article III:4**

4. The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.

### **Relevant provisions in the ASCM**

#### **Article 1: Definition of a Subsidy**

1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as “government”), i.e. where:

- (i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);
- (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)<sup>(1)</sup>;
- (iii) a government provides goods or services other than general infrastructure, or purchases goods;
- (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;

or

(a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994;

and

(b) a benefit is thereby conferred.

1.2 A subsidy as defined in paragraph 1 shall be subject to the provisions of Part II or shall be subject to the provisions of Part III or V only if such a subsidy is specific in accordance with the provisions of Article 2.

#### **Footnote 1**

1. In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.

#### **Article 3: Prohibition**

3.1 Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

(a) subsidies contingent, in law or in fact<sup>(4)</sup>, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I<sup>(2)</sup>;

(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

3.2 A Member shall neither grant nor maintain subsidies referred to in paragraph 1.

#### **Article 5: Adverse Effects**

No Member should cause, through the use of any subsidy referred to in paragraphs 1 and 2 of Article 1, adverse effects to the interests of other Members, i.e.:

(a) injury to the domestic industry of another Member<sup>(11)</sup>;

(b) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994 in particular the benefits of concessions bound under Article II of GATT 1994<sup>(12)</sup>;

(c) serious prejudice to the interests of another Member.<sup>(13)</sup>

This Article does not apply to subsidies maintained on agricultural products as provided in Article 13 of the Agreement on Agriculture.

#### **Annex I: Illustrative List of Export Subsidies**

(...)

(e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes<sup>(58)</sup> or social welfare charges paid or payable by industrial or commercial enterprises.<sup>(59)</sup>

(g) The exemption or remission, in respect of the production and distribution of exported products, of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.

#### **Footnote 58**

For the purpose of this Agreement:

The term "direct taxes" shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;

The term "import charges" shall mean tariffs, duties, and other fiscal charges not elsewhere enumerated in this note that are levied on imports;

The term "indirect taxes" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;

"Prior-stage" indirect taxes are those levied on goods or services used directly or indirectly in making the product;

"Cumulative" indirect taxes are multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of production are used in a succeeding stage of production;

"Remission" of taxes includes the refund or rebate of taxes;

"Remission or drawback" includes the full or partial exemption or deferral of import charges.

#### **Footnote 59**

The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence. Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

### **Relevant provisions in the GATS**

#### **Article II: most-favoured nation treatment**

1. With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.

2. A Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in, and meets the conditions of, the Annex on Article II Exemptions.

3. The provisions of this Agreement shall not be so construed as to prevent any Member from conferring or according advantages to adjacent countries in order to facilitate exchanges limited to contiguous frontier zones of services that are both locally produced and consumed.

#### **Article XIV: General Exceptions**

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:

(d) inconsistent with Article XVII, provided that the difference in treatment is aimed at ensuring the equitable or effective<sup>(6)</sup> imposition or collection of direct taxes in respect of services or service suppliers of other Members;

(e) inconsistent with Article II, provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound.

#### **Footnote 6**

Measures that are aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures taken by a Member under its taxation system which: (i) apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items sourced or located in the Member's territory; or (ii) apply to non-residents in order to ensure the imposition or collection of taxes in the Member's territory; or (iii) apply to non-residents or residents in order to prevent the avoidance or evasion of taxes, including compliance measures; or (iv) apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Member's territory; or (v) distinguish service suppliers subject to tax on worldwide taxable items from other service suppliers, in recognition of the difference in the nature of the tax

base between them; or (vi) determine, allocate or apportion income, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member's tax base. Tax terms or concepts in paragraph (d) of Article XIV and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure.

**Article XV: Subsidies**

1. Members recognize that, in certain circumstances, subsidies may have distortive effects on trade in services. Members shall enter into negotiations with a view to developing the necessary multilateral disciplines to avoid such trade-distortive effects.<sup>(7)</sup> The negotiations shall also address the appropriateness of countervailing procedures. Such negotiations shall recognize the role of subsidies in relation to the development programmes of developing countries and take into account the needs of Members, particularly developing country Members, for flexibility in this area. For the purpose of such negotiations, Members shall exchange information concerning all subsidies related to trade in services that they provide to their domestic service suppliers.

2. Any Member which considers that it is adversely affected by a subsidy of another Member may request consultations with that Member on such matters. Such requests shall be accorded sympathetic consideration.

**Article XVII: National Treatment**

1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.<sup>(10)</sup>

2. A Member may meet the requirement of paragraph 1 by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers.

3. Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member.

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