International Lawyer

Volume 36
Number 2 *International Legal Developments in Review: 2001*

Article 13

2002

International Taxation

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This article provides a brief and selective overview of recent developments in the international tax field.

I. The United States Foreign Sales Corporations (FSC) Replacement and Extraterritorial Income Exclusion Act (ETI)

There continue to be problems associated with the tax benefits provided to U.S. companies engaging in export sales activities. In a recent decision—based on a complaint by the European communities, a World Trade Organization Panel[1] (WTO Panel) found that certain provisions of The United States FSC Replacement and Extraterritorial Income Exclusion Act[2] (ETI), constituted an unfair subsidy. The WTO Panel Report, which was upheld by the Dispute Settlement Appellate Body,[3] found that the ETI violates certain sections of the General Agreement on Tariff and Trade 1994[4] (GATT 1994). It also found the ETI to be in violation of the Agreement on Subsidies and Countervailing Measures[5] (SCM Agreement) and the Agreement on Agriculture.[6] The decision by the WTO Panel

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1. WTO Panel Report on United States on Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW (Aug. 20, 2001), *available at* http://www.wto.org (last visited July 3, 2002) [hereinafter WTO Panel Report].

2. *See* FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106–519, 114 Stat. 2423 (2000).

3. *See* Appellate Body Report on United States - Tax Treatment for Foreign Sales Corporations - Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/AB/RW, (Jan. 14, 2002), *available at* http://www.wto.org (last visited July 3, 2002).

4. *See* General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, LT/UR/A-1A/1/GATT/1, *available at* http://www.wto.org (last visited July 3, 2002).

5. *See* Agreement on Subsidies and Countervailing Measures, LT/UR/A-1A/9 (Apr. 15, 1994), *available at* http://www.wto.org (last visited July 3, 2002).

6. *See* Agreement on Agriculture, LT/UR/A-1A/2, (Apr. 15, 1994), *available at* http://www.wto.org (last visited July 2, 2002).

and Dispute Settlement Appellate Body are the latest in a string of adverse rulings from various GATT Panels finding that U.S. tax rules constitute unfair subsidies.

U.S. trading partners, particularly the European communities, have long complained that U.S. income tax benefits on export sales constitute an unfair subsidy. Charges of unfair subsidies emerged as early as 1971, after Congress enacted the Domestic International Sales Corporations[7] (DISC) rules. In 1984, in part to mollify complaints leveled against the DISC rules, Congress enacted the Foreign Sales Corporation law (FSC).[8] The renewed complaints against FSC rules culminated in yet another U.S. tax law change in the year 2000. The ETI was enacted on November 15, 2000 as a result of a GATT Panel Decision[9] that found the FSC rules to be an unfair subsidy. Recently, the ETI also has been found to be an unfair subsidy. The WTO Panel Report concluded that ETI was inconsistent with article 3.1(a) of the SCM Agreement as it involves subsidies 'contingent . . . upon export performance' within the meaning of article 3.1(a) of the SCM Agreement, and fails to fall within the scope of footnote 59 of the SCM Agreement because it is not a measure to avoid the double taxation of foreign-source income.[10] The Act, by reason of the requirement of 'use outside the United States,' involves export subsidies as defined in article 1(e) of the Agreement on Agriculture. The United States has acted inconsistently by applying the export subsidies. The Act is inconsistent with article III of the GATT 1994 by reason of the foreign articles/labour limitation as it accords less favorable treatment within the meaning of that provision to imported products than to like products of US origin. The United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with article 3.1(a) of the SCM Agreement. Therefore, the United States failed to implement the recommendations and rulings of the DSB made pursuant to article 4.7 SCM Agreement.[11]

The WTO Panel then stated that to the extent the United States has acted inconsistently with the various agreements, the benefits that are due the European communities under the agreements have been impaired or nullified.[12]

The core problem in this area of taxation is that U.S. persons are faced with worldwide income inclusion rules whereas other countries, including some in the European communities, are subject to territorial income rules. The DISC, FSC, and ETI tax regimes reflect congressional efforts at bringing tax parity to U.S. persons, which is absent due to the conflict between worldwide and territorial income tax rules. None of the efforts has received complete approval of the European communities or the WTO.

II. Harmful Tax Practices and the Organization for Economic Cooperation and Development (OECD) Response

For a number of years now, there has been a growing concern among members of the international community, in general, and the European Union (EU) in particular, concerning the harmful tax practices of certain "tax haven" countries that enable the tax laws of

7. *See* I.R.C. §§ 991–997 (2001).
8. *See* I.R.C. §§ 921–927 (2001).
9. *See* Appellate Body Report on United States—Tax Treatment for "Foreign Sales Corporations," WT/DS 108/AB/R (Feb. 24, 2000), *available at* http://www.wto.org (last visited July 3, 2002).
10. WTO Panel Report, *supra* note 1, at para. IX.
11. *Id.* para. IX (a), (c), (d), (e).
12. *Id.*

other countries to be frustrated. For example, certain international financial centers do not impose a withholding tax on cross-border interest payments, and they refuse (frequently, because of bank secrecy laws) to exchange information with the residence country of the depositor or investor. Other jurisdictions encourage foreign investment by providing favorable tax regimes to non-residents that are not available to residents (so-called "ring-fencing" schemes). These latter jurisdictions refuse to exchange information with the residence country of the foreign investor. Such practices encourage capital flight and tax evasion.

In 1997 the OECD announced that it was going to address the issue of tax evasion on cross-border payments. The OECD issued two recommendations intended to combat tax evasion, the most important of which was its recommendation on the use of tax identification numbers (TIN) in an international context. The TIN recommendation would compel non-residents to disclose their residence country tax identification numbers to the income payer (such as a bank or financial institution paying interest on deposits) in the source country (the country from which the payment was made), and would compel the payor to report that information to the taxing authorities in the source country. The source country would then be in a position to exchange that information with the tax authorities of the residence countries.

In 1998, the Committee on Fiscal Affairs of the OECD issued a report entitled "Harmful Tax Competition: An Emerging Global Issue."[13] The OECD Council approved the report on April 9, 1998, although not without abstentions from Luxembourg and Switzerland. The 1998 Report expressed concerns over the erosion of government tax bases as a result of the actions of tax haven countries and listed the main factors identifying a tax haven: (1) no or only nominal effective tax rates; (2) lack of effective exchange of information; (3) lack of transparency; and (4) absence of any requirement of substantial domestic activities.[14] The recommendations of the 1998 Report would have had the effect of limiting the application of bank secrecy laws in tax matters and increasing inter-governmental cooperation for tax enforcement and collection.

The recommendations of the 1998 Report are to be implemented by, among other things, an agreement of EU countries (EU Directive) to exchange information automatically about cross-border interest payments received by individuals. The EU Directive becomes effective in 2003, after approval by EU member states in 2002. Although a withholding tax was discussed and debated, the United Kingdom and other financial centers strongly opposed a withholding tax because of the potential disruption of their financial markets. Austria, Belgium and Luxembourg opposed the exchange of information because of their bank secrecy laws. The automatic information exchange requirement will become effective seven years after the EU Directive enters into force, subject to transitional withholding procedures (by Austria, Belgium and Luxembourg) and transitional information exchange procedures by other EU members during the seven-year transition period.

On January 16, 2001, the Internal Revenue Service (IRS) issued proposed regulations evidencing an important change in U.S. policy. The policy would require banks within the United States to report annually to the IRS on Form 1042-S, all interest earned by non-

13. OECD Comm. On Fiscal Affairs, *Harmful Tax Competition: An Emerging Global Issue*, *available at* http://www.oecd.org (last visited July 3, 2002).

14. *See* OECD on Harmful Tax Competition: An Emerging Global Issue, *available at* http://www.oecd.org/pdf/m00004000/m00004517.pdf (last visited July 2, 2002) [hereinafter OECD TAX].

resident alien individuals on bank deposits in the U.S., not effectively connected with a U.S. trade or business. Like the EU Directive, the IRS proposal would apply only to interest payments made to individuals and not to those made to companies. Unlike the EU Directive, the IRS proposal applies only to bank deposits, and not to interest paid by other U.S. obligors, and the exchange of information is not automatic (e.g., the IRS could decide to provide the information only on request by a treaty partner).

In a June 2000 Report, the OECD listed thirty-five tax havens and specified that by July 31, 2001, it would complete a list of Uncooperative tax havens. This list would not include jurisdictions that made an advance commitment to eliminate the harmful tax practices. On June 19, 2000, the OECD announced that six jurisdictions (Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino) had entered into advance commitments to implement reforms to eliminate harmful tax practices by the end of 2005, adopting international tax standards for transparency, exchange of information, and fair tax competition. The June 2000 Report establishes a schedule and review process to determine whether jurisdictions that have made an advance commitment are complying with their commitments. The June 2000 Report also contains a list of "defensive measures" that may be taken by OECD member countries against uncooperative jurisdictions. The OECD subsequently issued a November 2000 Framework, which establishes a standardized timetable for jurisdictions to eliminate harmful tax practices and avoid the "blacklist."[15]

On July 18, 2001, U.S. Treasury Secretary Paul O'Neill gave a statement to the Senate Government Affairs Permanent Investigations Subcommittee concerning the position of the administration with respect to the OECD harmful tax practices initiative. He stated that the U.S. was urging the OECD to hold off on sanctions against the tax haven jurisdictions and to refocus its efforts on the need for countries to exchange information to prevent noncompliance with their tax laws.[16] He also indicated that the U.S. would not support any effort to dictate taxation policy to sovereign nations.[17]

Subsequently, the OECD extended the July 31, 2001 deadline for publishing its list of Uncooperative Tax Havens to November 30, 2001, citing ongoing negotiations.[18] It has been widely reported that lack of solid U.S. support for the OECD initiative and the ongoing dispute between Spain and the United Kingdom over Gibraltar contributed heavily to this decision.[19] The OECD also agreed to postpone any coordinated defensive measures against noncooperative tax havens until April 2003.[20] On November 14, 2001, after the United Kingdom resolved its dispute with Spain over Gibraltar, the OECD extended the November 30 deadline until February 28, 2002.[21] On November 28, 2001, the United States signed a tax information exchange agreement with the Cayman Islands, signaling U.S. support for OECD efforts to promote information exchange, rather than tax harmonization.[22]

15. OECD Framework For a Collective Memorandum of Understanding on Eliminating Harmful Tax Practices, Nov. 24, 2000, *available at* http://www.oecd.org (last visited July 3, 2002).

16. OECD TAX, *supra* note 14.

17. *See* OECD June 2000 Report - Towards Global Tax Cooperation, *available at* http://www.oecd.org/pdf/m000014130.pdf (last visited July 3, 2002).

18. *See id.*

19. *See id.*

20. *See id.*

21. *See id.*

22. *See* David E. Spencer, *Stepping Up the Pressure on Tax Havens: An Update (Part 1)*, 12 J. INT'L TAX'N 26 (2001) (for a more detailed discussion of the historical developments in this area); *see also* David E. Spencer, *Stepping Up the Pressure on Tax Havens: An Update (Part 2)*, 12 J. INT'L TAX'N 36 (2001).

III. Alternative Dispute Resolution Procedures and Income Taxation

The use of alternative dispute resolution (ADR) processes, particularly arbitration, continue to grow in the international business transaction area. I.R.C. § 7123(b) addresses the use of ADR in tax matters by providing as follows:

> The Secretary shall prescribe procedures under which a taxpayer or the Internal Revenue Service Office of Appeals may request non-binding mediation on any issue unresolved at the conclusion of . . . appeals procedures . . . or unsuccessful attempts to enter into a closing agreement . . . The Secretary shall establish a pilot program under which a taxpayer and the Internal Revenue Service Officer may jointly request binding arbitration on any issue unresolved at the conclusion of . . . appeals procedures . . . or . . . unsuccessful attempts to enter into a closing agreement under Section 7121 or a compromise under section 7122.

The section codifies the use of alternative dispute resolution processes in tax disputes.[23]

The IRS has formulated procedures to guide taxpayers in the use of ADR in tax controversies.[24] Although the Code language states that "any issue" that is unresolved at the times indicated in the statute could be available for mediation and/or arbitration, IRS procedures restrict the issues open to ADR to factual disputes.[25] In the international tax area this means mainly transfer pricing and other valuation issues.

The IRS reports over eighty mediations to date, resolving about eighty-five percent of those cases. The tax liability in the mediated cases was over $10 billion. Four arbitration procedures have also been reported. Some influential organizations have pushed for discussing the need to expand the applicability of tax ADR beyond strictly factual issues. The International Chamber of Commerce is pushing for binding arbitration in cases involving disputes arising from a tax treaty. In a similar vein, the American Society of International Law has established a new International Tax Law Interest Group. Among other issues, the Group is studying the possibility of expanding ADR procedures beyond strictly factual issues.

23. *See* I.R.C. § 7123 (2001).
24. Test of Arbitration Procedures for Appeals Announcement 2000-4, 2000-3 I.R.B. 317 (Jan. 18, 2000).
25. *See id.*