Shady Mawad*

To what extent can tax incentives be challenged under the WTO's Subsidy Agreement?

Abstract: This article focuses on government subsidies which distort the competition in the market due to discriminatory treatment of certain private economic actors. The WTO Agreement, like the GATT, regulates these government practices under the title 'Subsidy'. Although 'tax incentives' are adequate instruments to attract foreign investments, create job opportunities, and spread new projects in specific geographical areas, favorable tax treatment is one of the measures through which the subsidy can materialize. Therefore, the goal of this paper is to scrutinize the question when is tax incentive considered a subsidy from the WTO perspective? In short, every tax incentive is deemed a subsidy, but not every subsidy is prohibited under the WTO law. In order to challenge the tax incentive before the WTO Dispute Settlement Body some strict requirements must be met.

Keywords: Agreement on Subsidies and Countervailing Measures, traffic-light subsidies, tax incentives, WTO dispute settlement.

1. Introduction

In 1970s the theory of separation between state and economy has almost been out-of-date. The majority of governments have followed the modern universal trend which is known as the Economic Regulation or the State Economic Interventionism.[1] Economic interventionism has various forms that attempt to lead or control the commercial activities of firms or individuals. According to the traditional theory of economic interventionism

* PhD candidate, Department of Private International Law, University of Szeged, e-mail: shady1lawyer@gmail.com.

[1] Karagiannis (2001) 20.

the government interferes into the market seeking to stabilize market inefficiency or inequitable market practices. Thus, the government might control the prices of essential utilities such as electricity, gas, telecommunication, *etc*., or it might impose or remove restrictions on economic activities, for example, taxes, tariffs, and quotas.[2] On the other hand, the rationale behind such intervention can also aim to enhance domestic production or to favour certain undertakings over other (foreign) competitors. For instance, the case of providing loans with lower interest, tax breaks or relief, and others, which have distortive effects on the competition.[3]

The World Trade Organization (WTO), like the General Agreement on Tariffs and Trade (GATT), focuses on the elimination or reduction of tariffs and non-tariff trade barriers, for example, licenses, import quotas, and subsidies.[4] In 1994, the WTO Members have signed the Agreement on Subsidy and Countervailing Measures (ASCM) in order to cease the distortive effects of subsidies. The ASCM is one of the subsidiary agreements that belongs to the GATT. Therefore, it is deemed the main instrument in the field of subsidies regarding trade in goods particularly.[5] According to the ASCM subsidy is not prohibited unless specific requirements are satisfied.Favourable tax treatment is one of the measures through which the subsidy might exist. It has to be acknowledged that tax is deemed the cornerstone of the government revenue which enables the government to fund its expenditures. But, on some occasions, the government decides to concede a part of its revenue seeking greater advantages such

[2] Bailey (1995) 18. These contributions to the market can be justified by public interest purposes, ensuring fair competition, or even equal distribution of wealth.
[3] Mises (2011) 59.
[4] Vig (2019) 137.
[5] The Marrakesh Agreement (1994).

as attracting foreign investments, creating job opportunities, spreading new projects in specific geographical areas. This policy is known as 'tax incentive'.[6] Professor Luja calls tax incentives as 'harmful tax competition' that might have a negative effect on trade and competition.[7]

This paper aims at examining the question of when is tax incentive considered as state subsidy under the WTO agreements? The research follows the doctrinal legal method to describe and analyse legal rules contained in international agreements, especially, the ASCM and case law. The author has done the research after considering the assumption that tax incentives comply with all the general principles provided for in the GATT, General Agreement on Trade in Services (GATS), and Agreement on Trade - Related Investment Measures (TRIMs). For instance, Most Favoured Nation Treatment (MFN), National Treatment (NT), Transparency, and others. Therefore, the legality of tax incentives, from the above-mentioned aspects, fall outside the scheme of this paper. The paper consists of three main sections along with the introduction and conclusion. The first part analyses the definition and categories of subsidies under the ASCM. The second part answers the question what is the reason for having tax incentives? Finally, the third part provides a thorough explanation of the tax provisions within the framework of the ASCM by the mean of case analysis.

2. The definition of subsidy from the ASCM perspective in brief

Over the decades the regulation of subsidies has been a complicated task for policymakers. This can be partially traced back to the uncertainty regarding the definition of subsidies and

[6] Rogers (2000) 445.
[7] Raymond (2017) 72.

their various objectives. According to the Oxford Dictionary, subsidy is defined as ‘money that is paid by a government or an organization to reduce the costs of services or of producing goods so that their prices can be kept low’. The narrowest interpretation would be limited to the direct grant of money. In contrast, the practice has showed that tax concessions can serve as a subsidy while there is no direct transfer of money. From the recipient’s perspective, it does not really matter if the benefit is obtained as a direct grant of money or as tax reduction. Thus, to regulate this issue and to remove trade distortive effects of certain subsidies first the definition of subsidies should be determined.

It is the ASCM that gave the first international definition of subsidy. This definition is contained in art. 1, which states that a ‘subsidy is a financial contribution by a government or any public body within the territory of a Member that conferred a benefit’.[8] Along with art. 2 subsidy must be specific to an enterprise or industry or group of enterprises or industries. This definition requires three elements for a subsidy to exist. Hence, the recipient of the subsidy usually has a superior economic position compared to domestic or foreign competitors. That means the economic competition has been perverted by an external factor which is the government.

The first element of the definition is the ‘financial contribution by the government’. The ASCM stipulates several examples for government activities based on which the financial contribution might emerge. Those examples are mentioned in an illustrative list through art. 1(a)(1). The first form is the direct or potential transfer of funds or liabilities. For instance, the amount of money that is given for a particular purpose as a grant, loan, or loan guarantee, increasing the capital of a company by

[8] The ASCM (1994) art. 1.

purchasing some of its stakes (equity infusion), etc. This way, the monetary contribution, or in–kind contribution[9], passes directly from the government's account to the recipient's hand. The enrichment of the recipient leaves no room for doubt.

The second form includes two practices: on one hand, engaging in economic practices that go beyond the general infrastructure. The United Nations Department of Economic and Social Affairs defines infrastructure as 'The system of public works in a country, state, or region, including roads, utility lines, and public buildings'.[10] Thus, the financial support exists when the government exceeds its ordinary activities for the public purpose. On the other hand, acquiring goods at artificial prices. This type of transaction intends to increase the revenues of the enterprise through purchasing its product at price higher than its actual value. Thus, this form of subsidy does not represent ordinary market transaction.[11]

The third form is any form of income or price support in the sense of art. XVI of the GATT 1994. This practice involves any contribution that ends with export escalation or import diminish from/to a territory of any Member. Additionally, the government can conduct any of the before-mentioned activities either by itself or through making payments to funding mechanism or directing or controlling a private body.[12] Moreover, one of the activities mentioned in the ASCM, which is discussed thoroughly later in this paper, is 'government

---

[9] The Appellate Body found that the term 'funds' included not only 'money' as a cash flow but also any form of financial resource. (Footnote original) Appellate Body Report, *United States - Countervailing Duty Investigation on Dynamic Random-Access Memory Semiconductors (DRAMS) from Korea* (2005) para 250; Appellate Body Report, *US-Large Civil Aircraft (2nd complaint)* (2019) para. 614. (emphasis added).

[10] Department of Economic and Social Affairs (2000) 188.

[11] Steenblik (2012) 26.

[12] The ASCM (1994) art. 1.1(a) 1(iv).

revenue that is otherwise due is foregone or not collected (*e.g.,* fiscal incentives such as tax credits)'.[13]

The second element of the subsidy is the benefit in the account of the recipient. The ASCM does not bring forth a certain method to calculate the benefit resulting from the subsidy. Instead, it sets out two requirements to be considered by the investigating authority of the concerned Member: (a) the method of the benefit calculation should be contained in the national legislation or implementing regulation of the concerned Member, and (b) the application of the method should be transparent and well explained on a case-by-case basis. The ASCM compares the situation of the actual market and the situation after the financial contribution occurred.[14] For instance, the benefit exists in the case of equity capital if the investment decision is inconsistent with the usual investment practice of private investors in the territory of issuing Member. Additionally, in the case of a loan, the benefit is materialized if there is a difference between the amount that the firm receiving the loan pays on the subsidized loan and the amount the firm would pay on a comparable commercial loan which the firm could actually obtain on the market. Furthermore, the benefit is conferred either when the government provides goods or services for less than adequate remuneration, or when the government purchases goods at price higher than adequate remuneration. Taking into consideration that adequate remuneration is to be determined according to the prevailing market of the country in which the provision is made or goods are purchased.[15]

---

[13] The ASCM (1994) art. 1(a)(1)(ii).
[14] The ASCM (1994) art. 14.
[15] The ASCM (1994) art. 14 (d). The adequacy of remuneration shall be determined in relation to prevailing market conditions for the good or service in question.

The issue of the presence of a benefit was examined in various cases. For example, in Canada-Aircraft, the Appellate Body upheld the Panel's finding that the benefit existed within the meaning of the ASCM when the economic position of the receipt had been 'better off' than it would have been compared with the ordinary marketplace.[16] However, it is important to remember that the subsidy is not prohibited or subject to countervailing measures, unless it is 'specific' as explained in art. 2 of the ASCM.

So, the specificity is the third element. The subsidy is specific if the access to it is limited, in law or in fact, to certain enterprises or group of enterprises/industry of group of industries/certain enterprises located within a designated geographical region.[17] On contrary, if receiving the subsidy is based on objective and automatic criteria, like size or date of establishment, then specificity does not exist. Moreover, positive evidence shall be submitted to prove the existence of specificity,[18] considering the exception with regard to red-light subsidies (explained in the following section).

The ASCM has a unique classification of subsidies. This trio classification is also known as 'traffic-light subsidies' due to the legitimacy of the action (subsidy) and the reaction (countervailing measure). The first one are so-called red-light subsidies. These are prohibited subsidies that shall not be conducted by any Member, while the injured Member has the right to impose countervailing duties[19] as compensation.

---

[16]Appellate Body Report, *Canada-Measures Affecting the Export of Civilian Aircraft* (1999) para. 157.
[17] The ASCM (1994) art. 2.
[18] The ASCM (1994) art. 2.
[19] The GATT (1994) art. VI para. 3. "… *The term countervailing duty shall be understood to mean a special duty levied for the purpose of offsetting any subsidy bestowed directly or indirectly upon the manufacture, production or export of any merchandise*".

Regarding the group at hand, the ASCM adopts an irrebuttable assumption on specificity, which says that subsidies falling into this group are specific without submitting any positive evidence.[20] This category consists of two kinds of subsidies: export subsidies that are contingent, in law or in fact, upon export performance, and domestic subsidies that are contingent upon the use of domestic over imported goods.[21] In Canada-Aircrafts dispute, the Appellate Body upheld the Panel's interpterion regarding the term 'conditioned' as a synonym of 'contingency', then a relationship of conditionality or dependence must be demonstrated.[22] Therefore, the investigation authority must prove the statement that the subsidy would not have been granted unless anticipated exportation/favouritism had been the main goal. However, the ASCM stipulates an illustrative list of what is considered for export subsidy. This list is contained in Annex I of the ASCM. The second, the green-light subsidies are actionable subsidies, because they are not prohibited generally unless the injured Member demonstrates the adverse effects of such subsidies; then, they can be subject to countervailing measures. However, the adverse effects may have three different forms determined in art. 5 of the ASCM: (a) injury to the domestic industry of another Member, (b) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994, (c) serious prejudice to the interests of other Members calculated in the line with art. 6 of the ASCM. Into the third group fall so-called yellow-light subsidies which are non-actionable subsidies. In contrast to actionable subsidies, this group is always legitimate and can neither be prohibited nor countervailed. This group covers: (a) subsidies that are not specified according to art. 2, (b) subsidies that are specific,

---

[20] WTO (2003) 899.

[21] The ASCM (1994) art. 3.

[22] Appellate Body Report, *US - Large Civil Aircraft (2nd complaint)* (2019) para. 171.

based on specific purposes such as assistance to disadvantaged regions within the territory of a Member,[23] and assistance to promote the adaptation of existing facilities to new environmental requirements imposed by law and/or regulations.[24]

Finally, it should be noted that one activity should not fall within the scope of two groups due to the different rights and obligations of the Members. Therefore, if the investigating authority claims that the financial contribution of a Member constitutes a prohibited subsidy, it should prove it based on the requirements codified under the related provisions.

3. Tax incentives

Economic development is one of the essential goals of every government. Generally, economic development includes growth of industrialization and role of environment, understanding essential institutional changes, and changing trade pattens.[25] To that end, governments may prefer to scarify some of their public revenue, through which it can pay for services, enhance the infrastructure, and run commercial activities, in order to achieve long-term goals.[26] For instance, economic growth, job creation, spreading economic activity throughout the state (through geographic targeting), focusing on high-value industries, competing with other states and foreign countries for business investments that promise jobs, and increased economic activity.

---

[23] Regions must be considered disadvantages according to neutral and objective criteria that must be indicated in any legal instrument.
[24] The ASCM (1994) art. 8.
[25] Cypher (2004) 19.
[26] McCleary (1991) 82.

The tax system is the cornerstone of public revenue.[27] Therefore, governments tend to use the tax system to accomplish the task of economic development. In particular, tax incentives are a key part of many states' economic development strategies, because it is easier to use these tools, than correcting deficits in the legal system, and they do not need a direct consumption of the funds, even if it causes a reduction in the government revenue. Moreover, proponents argue that on one hand, tax incentives are a successful tool to attract new investments. On the other hand, the costs of those incentives are partially or wholly recompensed by the additional tax revenue derived from the increased economic activity.[28]

Determining the term tax incentives is the first important step. According to the Cambridge Dictionary, 'incentives' are tools that stimulate or encourage someone to take a specific action. While 'tax' is a compulsory payment levied by the government on individuals or corporations - national or foreigner - on different bases such as income, property, sales, *etc*.[29] When the incentive is followed by the noun 'tax', it means a special tax treatment is provided to taxpayers encouraging them to do a specific economic activity.

Moreover, due to the important role of tax incentives in attracting new investments, it can be said that they have a great influence on investment decision. In this sense, the government should not build up its own tax system without considering the tax regimes of other countries. Thus, investors become more enthusiastic about running their business in a state where the tax rate is lower than in their own states. Tax invectives can be classified into three major categories:

---

[27] Shaviro (2006) 9.
[28] Organization for Economic Cooperation and Development (2001) 18.
[29] Hines (1996) 4.

3.1. Tax deduction

It is also known as tax concession or tax break. It occurs when the government subtracts the tax liability of certain taxpayers by reducing the total taxable income.[30] As an illustrative example: the government provides a tax deduction at 30 percent for the undertakings that operate their business in a specific area. If the taxable income of one of the undertakings is $200.000, this undertaking can subtract $60.000. Thus, the new taxable income is $140.000.

Some scholars have justified the tax deduction because, firstly, it can increase the ability of taxpayers to tolerate the state taxation and reduce tax avoidance. Secondly, on long term it enhances the government revenue and escalates the quality of the public infrastructure.[31] Conversely, other scholars have criticized tax deduction due to the crucial role of the tax in financing public benefits.[32]

3.2. Tax credit

It occurs when the government subtracts the tax liability of certain taxpayers by reducing the total amount of tax bills that should have been paid.[33] Continuing with the previous example, mentioned regarding the tax deduction, when the government provides a 30 percent tax credit. Then, the $60.000 should be subtracted not from the taxable income, but instead from the total tax bill. Obviously, the tax credit system constitutes, like the other incentives, a direct foregone revenue. However, one can ask, do the taxpayers receive money from the government based on the tax credit? Undoubtedly, yes, they do. According

---

[30] Welner (2008) 32.
[31] Gladriel (2016) 331.
[32] Galle (2008) 808.
[33] Welner (2008).

to the ASCM, foregone revenue is deemed as a financial contribution.

3.3. Tax exemption or forgiveness

It is a temporary reduction or elimination of a tax, meaning that a certain tax is reduced or ceased for a certain period of time by the end of which the advantaged taxpayers should pay the usual tax. It is commonly known as 'tax holiday'.[34] Historically, tax holiday can be traced back to Pakistan where it was adopted in 1959. The first tax holiday provided the industrial firms with a full income tax exemption. The duration of the exemption ranked from eight to two years based on the degree of the economic development of the area in which those firms were located. Indeed, the less developed area had the longest period. The program was terminated in 1972.[35]

4. Regulation of tax incentives under the ASCM

After a brief presentation of tax incentives, this part comprehensively analyses the tax provisions of the ASCM in order to answer the question raised in this paper. As stated earlier, the second form through which the subsidy can appear is 'government revenue that is otherwise due is foregone or not collected (*e.g.,* fiscal incentives such as tax credits)'.[36] Government revenue is the amount of money that is allocated to provide public services, promote the infrastructure, fund public economic activities. Thus, better services demand greater government revenue.[37] Revenue can be sourced from two major groups: a) tax revenue, including the internal tax and tariffs that are levied on the cross - border goods and services; b) non-tax

---

[34] Bond (1981) 88.
[35] Azhar(1974) 410.
[36] The ASCM (1994) art. 1.
[37] Bhandari (ed) (2017) 1.

revenue involves administrative and commercial revenue, for example, 'fees' that are charged for the enjoyment of certain services, such as issuing a passport, driving license, etc.[38] 'Fines and penalties' are sanctions imposed in case of law infringement and failure to comply with some regulations.[39] Notedly, they are not a main source of revenue. Furthermore, 'commercial revenue' includes the surplus of the public enterprises that are involved in a commercial transaction, for example, utilities (gas, electricity etc.), railway, banking *etc*.[40]

The meaning of 'foregone' has been defined by the Appellate Body (AB) in the US-Large Civil Aircraft (2nd complaint) as 'the government has given up an entitlement to raise revenue that it could otherwise have raised'. Additionally, the AB, in the same dispute, stated that 'the foregoing of revenue otherwise due implies that less revenue has been raised by the government than would have been raised in a different situation'.[41] Thus, when the government decides to forgive to an undertaking any due and anticipated revenue, it can constitute a subsidy under the ASCM. To dive into the details, the starting point is footnote 1 of the ASCM which indicates two situations where the exemption of an exported product from duties or taxes is allowed and is not deemed as a subsidy. First, when the like product, allocated for domestic use, bears the duties or tax instead of the exported product. Second, when the percent of remission is less than the total amount that is actually due.[42]

---

[38] Shoup (2004) 764.
[39] Manns (1993) 267.
[40] Tarschys (1988) 8.
[41] Appellate Body Report, *US - Large Civil Aircraft (2nd complaint)* (2019) para. 806.
[42] Panel Report, *European Union - Countervailing Measures on Certain Polyethylene Terephthalate from Pakistan*, (2018), paras. 7.36-7.37. The Panel stated that '*the 'duties' that 'accrued' in this context are import duties that accrued on imported inputs consumed in the production of a subsequently exported product. Thus, the comparison under Article 1.1(a)(1)(ii) is between*

Moreover, the difference between exemption and remission is based on the liability to pay. In case of remission, unlike the exemption, the liability to pay was annulled after it has risen.[43] Besides, remission includes a refund and rebate, fully or partially, of the taxes.[44]

To better understand this issue, two leading cases are discussed the first one being the dispute between the U.S. and European Community (EC) on tax treatment for Foreign Sales Corporation (FSC). The FSC means any corporation which is established or regulated either under the law of a qualified foreign country or under U.S. possession[45].[46]

A FSC attains a tax exemption on an amount of its 'foreign trade income'[47] that is earned by the corporation run outside of the US Besides, two kinds of administrative pricing rules. The first affords the FSC an exemption of 23 % of the total combined taxable income earned by the related supplier and the FSC

---

remissions of duties obtained by a company under a duty drawback scheme, on the one hand, and duties that accrued on imported production inputs used by that company to produce a subsequently exported product, on the other hand. A subsidy exists insofar as the former exceeds the latter'.

[43] Panel Report, *India - Export Related Measures* (2019) para. 7.169.

[44] The ASCM (1994) fn. 58.

[45] Cornell Law School (2014). The term U.S. possession means American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands.

[46] Cornell Law School (1987). There are some certain requirements must be fulfilled, such ac a) FSC may not have more than 25 shareholders at any time during the taxable year. b) A FSC must conserve an office outside of the United States and maintain a set of permanent books of account (including invoices or summaries of invoices) at such office.

[47] It means the gross income which are generated by qualifying transactions that involve the sale or lease of 'export property'.

together. The second permits the FSC to take 1.83 % of the total foreign trading gross receipts to form its transaction.[48]

The panel was established upon the request of the EC, complainant, due to the failure of the consultation with the US respondent. The EC alleged that both the tax exemptions and special administrative pricing rules provided by the US to the FSCs are subsidies contingent upon export performance. Canada, a third party, has confirmed the EC's claim by stating that 'the tax reduction offered to United States exporters through the FSC program clearly represents tax revenue which would otherwise be due were it not for the operation of the FSC program'.[49] Firstly, the US justified its tax exemptions regarding FSC by claiming that art. 3 of the ASCM, on export subsidies, must be implemented in the light of the Illustrative List of Export Subsidies contained in Annex I to the Agreement. In particular, subparagraph (e), which deals with the issue in question, stated that the 'full or partial exemption, remission, or deferral specifically related to exports, of direct taxes' is a probable export subsidy for purposes of the SCM Agreement.

Footnote 59, referred to in the mentioned subparagraph, excluded one case from the scope of this provision which is the measures aim to avoid the double taxation of foreign-source income. The US claimed that its FSC tax rules meet this exemption.[50] The US approved its arguments by relying on the principle set forth in the GATT original ban on export subsidies.[51] This principle declares that the decision not to tax

---

[48] Panel Report, *United States - Tax Treatment for 'Foreign Sales Corporations'* (2000) paras. 2.5 and 2.6.
[49] Panel Report, *United States – Tax Treatment for 'Foreign Sales Corporations'* (2000) para. 5.11.
[50] Panel Report, *United States - Tax Treatment for 'Foreign Sales Corporations'* (2000) para. 4.93.
[51] This decision was adopted by the GATT Council based on the reports of four Panels. Those Panels were established, in 1972, to solve the dispute

the earnings that are obtained from businesses allocated outside the tax jurisdiction of a country, is not a prohibited subsidy.[52] On the flip side, the EC contended this justification in three points. Essentially, the members of the Organization of Economic Cooperation and Development (OECD) and many non-member countries have adopted various bilateral double taxation treaties and the US is a party to many of them.[53] Secondly, the US has created comprehensive tax rules, in order to avoid double taxation, based on the principle of 'capital-export neutrality' that encourages the investors, who are willing to launch their businesses domestically or broadly, not to take into account the local or foreign tax considerations.[54] Thirdly, the decision, on which the US relied, (a) is not obligatory and does not ban the GATT Members from levying taxes on the cross-border profits, and (b) neither deprives the Member of enjoying their rights nor abolish or reduce their obligations.[55]

Furthermore, the Panel continued its reasoning by illustrating the meaning of the adjective 'due', according to Oxford English

---

between the US and the E.C. on direct taxation. The US applied a differential tax treatment scheme, such as exempting the Domestic International Sales Corporation (DISC) from corporate income tax. Daly (2005) 5.

[52] Panel Report, *United States – Tax Treatment for 'Foreign Sales Corporations*' (2000) para. 4.352.

[53] Panel Report, *United States - Tax Treatment for 'Foreign Sales Corporations'* (2000) para. 4.166. For more information, see the U.S. Model Income Tax Convention (2016).

[54] Panel Report, *United States - Tax Treatment for 'Foreign Sales Corporations'* (2000) para. 4.167. This argument was supported by Canada that discussed thoroughly and accurately the U.S. tax law and emphasized the absolute intent of the FSC program to promote the U.S. For more detail, paras. 5.7 and 5.42 of the Panel Report.

[55] Panel Report, *United States - Tax Treatment for 'Foreign Sales Corporations'* (2000) para. 7.54 and 7.68. The statement of the Chairman of the Council which was attached to the 1981 decision '*Finally,* [the Chairman] *noted that the adoption of these reports together with the understanding does not affect the rights and obligations of contracting parties under the General Agreement*".

Dictionary, as a debt that is 'owing or payable'. Then, it suggested that government revenue is otherwise 'owing or payable' shall be determined by reference to that government's own tax regime.[56] In other words, the determination of whether the government revenue is otherwise due must include a comparison of the situations before and after the measure has been implemented.[57] For that comparison, the 'but for' test should be applied.[58] The major question that should be asked is whether that is the foregone amount payable in the case of elimination of the measure? By applying this test to the FSC scheme, it is obvious that in the absence of the FSC scheme, the income taxes on dividends earned from foreign trade would be paid by the parent of a foreign corporation.[59]

Moreover, the Panel recognized that the FSC scheme includes various exemptions that are deemed as foregoing revenue which is otherwise due and thus constitutes a financial contribution within the meaning of art. 1.1(a)(1)(ii) of the SCM Agreement.[60] This finding was evidenced through an OECD report on tax expenditures which illustrates 'revenue foregone' of US $1.4 billion in 1995 arising from the 'exclusion of income from foreign sales corporations'.[61] Finally, the AB, like Canada and Japan as a third parties, upheld the finding of the panel and concluded that 'The FSC measure creates a 'subsidy' because it

---

[56] Panel Report, *United States - Tax Treatment for 'Foreign Sales Corporations'* (2000) para. 7.42.
[57] Panel Report, *Indonesia - Certain Measures Affecting the Automobile Industry* (1998) para. 14.155.
[58] Panel Report, *United States - Tax Treatment for 'Foreign Sales Corporations'* (2000) para. 7.93. As the panel suggested the application of this test requires panels to apply their best judgement on a case-by-case basis.
[59] Panel Report, *United States - Tax Treatment for 'Foreign Sales Corporations'* (2000) para. 7.98.
[60] Panel Report, *United States - Tax Treatment for 'Foreign Sales Corporations'* (2000) para. 7.102.
[61] OECD (1996) 107.

creates a ‘benefit’ by means of a ‘financial contribution’, in that government revenue is foregone that is ‘otherwise due’. This ‘subsidy’ is a ‘prohibited export subsidy’ under the SCM Agreement because it is contingent upon export performance’.[62]

The second leading dispute in this regard is Brazil-Certain Measures Concerning Taxation and Charges. The EU and Japan, complainants, have requested the establishment of the Panel to rule against Brazil, defendant, as follows:
(a) INOVAR - AUTO Program and Informatics, PADIS, PATVD and Digital Inclusion programs provide tax subsidies contingent upon the use of domestic over imported products,[63] and
(b) RECAP Program constitutes tax subsidies contingent upon export performance.[64]

In order to solve this dispute, the Panel started with explaining the challenged measures as demonstrated. Firstly, Informatics program,[65] covers the tax on Industrial Products (IPI tax)[66] on information technology and automation goods. This program offered a 95% reduction until 31 Dec 2024, a 90% reduction until 31 Dec 2026, and a 85% reduction until 31 Dec 2029. The

[62] Panel Report, *United States - Tax Treatment for ‘Foreign Sales Corporations’* (2000) para. 180.
[63] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) paras. 3.1.i.f-3.2.i.f-3.1.ii.f-3.2.ii.f.
[64] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) paras. 3.1.iii-3.2.iii.
[65] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 2.2.1.
[66] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 2.3. The IPI tax is a Brazilian Federal tax that applies to all national or foreign industrialized (*i.e*., manufactured) products. The rate of this tax is based on the value, or the price of the industrialized products and it must be borne by the purchaser of the finished products.

beneficiaries of the program at hand are goods produced in Central - West Region, SUDAM, and SUDENE.[67]

Additionally, The PADIS program[68] involves semiconductors and information displays (displays), as well as inputs, tools, equipment, machinery, and software (so for 'production goods'). Under this program, the tax exemptions (through zero rates) entered into force in 2007 and were in effect until January 22, 2022. This program benefited every legal person previously accredited, by the Brazilian Federal Revenue Service (RFB), to import or sell the mentioned products in the Brazilian market. Besides, the RECAP program,[69] involves new machinery, tools, apparatuses, instruments, and equipment for incorporation into the tangible fixed assets by legal persons registered as predominantly exporting companies. The incentive presents the suspension of the PIS/PASEP, COFINS, PIS/PASEP - Importation and COFINS - Importation contributions.

One of the essential arguments of Brazil is that the challenged programs fall outside the scope of the ASCM because they include only the pre-marketing obligations by producers. Besides, the provisions of the ASCM are limited to factors related to the origin and the use of products or to percentages of domestically produced inputs.[70] On one hand, the European Union contested Brazil's argument and noted that the fundamental fact to be considered while determining the scope of the ASCM is whether the measures negatively affect the equality of conditions of competition between domestic and

---

[67] Regions of influence of the Superintendence for the Development of Amazonia (SUDAM) and the Northeast (SUDENE).
[68] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 2.2.1.
[69] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 2.2.2.
[70] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 7.61.

imported products. On the other hand, Japan further argued that 'if merely being directed towards particular producers or pertaining to production processes cured any WTO - inconsistency, then circumvention of WTO disciplines would be trivially easy'.[71]

The Panel upheld the Appellate Body' finding in China - Publications and Audio-visual Products and found that government measures are inconsistent with the GATT and then with the ASCM, if they affect trade in products by imposing obligations on enterprises, whether or not they regulate goods or importation of goods.[72] However, the Panel concluded that INOVAR-AUTO program[73] and the tax exemptions, reductions, and suspensions under the ICT Programs constitute a financial contribution in the form of government revenue that is otherwise due.[74] The Panel proved the former case by stating that if the buyers of the incentivized products do not have to pay the full amount of taxes and contributions concerned, they are better off with the reductions than in the benchmark scenario of

---

[71] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 7.62.

[72] Appellate Body Report, China - Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audio-visual Entertainment Products (2010) para. 227.

[73] Panel Report, Brazil - Certain Measures Concerning Taxation and Charges (2019), paras. 2.25-2.113. The INOVAR - AUTO program includes Motor cars and other motor vehicles subject to certain conditions. For instance,

1 - To be entitled to presumed IPI tax credits, a company must be accredited as a 'domestic manufacturer', an 'investor', or an 'importer/distributor'.

2 - To be entitled to the reduced IPI tax rates, a company must

a. Be accredited as a 'domestic manufacturer' or 'investor' imports from countries that are signatories to the relevant agreements);

b. Import certain vehicles from Uruguay under the relevant agreements.

c. Be accredited as an 'importer/distributor' of certain vehicles under the INOVAR - AUTO program. Ibid, para 2.110.

[74] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) paras. 7.4.5.5-7.488.

having to pay the full amount of taxes concerned on their purchases on non-incentivized products.[75]

Moreover, this case was evidenced through comparing the customs duties collected from accredited and non - accredited companies.[76] Thus, the Brazilian Government will receive the full amount of ordinary customs duties from the non-accredited company purchasing the inputs, capital goods and computational tools, but not from the accredited companies that are beneficiaries of these tax incentives programs.[77]

Regarding PEC and RECAP, the Panel decided that they are contingent upon export performance within the meaning of art. 3.1(a) of the SCM Agreement. Thus, they are prohibited subsidies.[78] The Panel based its finding on the previous benchmark comparison (accredited and non - accredited companies) and, thus, concluded the Government is foregoing revenue in the form of the implicit interest on the tax revenue collected where the offsetting credits have not (yet) been used.[79] In return, Brazil rebutted the Panel's determination of the benchmark for comparison and claimed that the tax suspensions are the benchmark treatment for structurally credit-accumulating companies, including the predominantly exporting companies, and not an exemption to the rule.[80] Thus,

---

[75] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 7.844.
[76] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 7.414.
[77] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 7.483.
[78] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 7.1224.
[79] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) paras. 7.1179, 7.1194, and 7.1207
[80] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 7.1197.

it was more appropriate for the Panel to determine the benchmark after a better understanding of the principles and structure of Brazil's taxation regime and selecting comparably situated taxpayers.[81]

In conclusion, the AB's final statement can be divided into two groups confirming and reversing the Panel's findings. On the one hand, the AB relatively upheld the Panel's finding with regard to the ICT Programs and INOVAR - AUTO program as to constitute financial contributions where 'government revenue that is otherwise due is foregone or not collected'.[82] Hence, The Panel succeed in implementing the three - phase test, pointed out by the AB, to prove whether the revenue is foregone: '(i) identify the tax treatment that applies to the income of the alleged subsidy recipients; (ii) identify a benchmark for comparison, and (iii) compare the challenged treatment and reasons for it with the benchmark tax treatment'.[83]

Furthermore, the AB decided, unlike the Panel, that the ICT programs and INOVAR - AUTO programs are subsidies contingent upon the use of domestic over imported goods only if they involve what is called 'nested basic productive processes' (PPBS). By the way of explanation, the PPBSs are the production - step requirements that must be met by a particular company in order to be eligible for the tax treatment available under the mentioned programs.[84] However, the 'nested PPBSs' are the requirements that specific input or

---

[81] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 5.140.
[82] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 5.222.
[83] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) para. 5.196.
[84] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) Appendix, para. 9.1.

component can be produced by third parties in Brazil.[85] Thus, a company can only retain the tax benefits in question if those inputs or components are produced in Brazil in accordance with their own PPBS, and thus are domestic products.[86] On the other hand, the AB reversed the Panel's finding and supported Brazil's argument with regard to benchmark treatment for the PEC and RECAP programs. Therefore, the AB found that tax suspension under the mentioned programs is not a subsidy contingent upon the export performance.[87] The AB justified that the Panel applied the comparison to prove the existence of revenue foregone only to predominantly exporting companies, while the tax suspensions are available to various groups of companies, including predominantly exporting companies, among them the comparison should have been done.[88]

5. Conclusion

Subsidies in the form of tax incentives can be adequate instruments for enhancing and stimulating business. Indeed, the reactions of businesses are significantly different to each kind of government interventionism policy. At the same time, distortion effects of interventions on cross-border trade is almost certain. Therefore, the WTO, as an inter-governmental organization that regulates, facilitates and observes the flow of international trade, endeavours to ensure that the economic transactions between nations are not distorted. To that end, the Marrakesh Agreement, which created the WTO, contains several agreements which guarantee the rights and obligations

---

[85] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019), fn. 1619.

[86] Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges* (2019) Appendix, para. 9.40.

[87] Appellate Body Report, *Brazil – Certain Measures Concerning Taxation and Charges* (2019) para. 6.21.

[88] Appellate Body Report, *Brazil – Certain Measures Concerning Taxation and Charges* (2019) para. 5.170.

of the Contracting Members and reduce and eliminate trade barriers, such as subsidies. Moreover, the ASCM contains a set of rules that regulate the use of the subsidies, particularly in the trade in the goods sector, and stipulate for adequate compensation for the adversely affected Members. The government through tax incentives subtracts some of the government revenue that is maintained through the tax system. This revenue reduction, on most occasions, meets the definition of subsidies provided for in the ASCM.

As a result, every tax incentive is a subsidy because it constitutes the basis for government revenue that is foregone and conferred a benefit in the account of the recipient, but not every tax incentive is a subsidy, tax incentives provided in the service sector are still unregulated within the WTO regime. Therefore, the WTO Members are required to respond promptly in order to subject subsidies on trade in services to strict multilateral disciplines.[89] Besides, most of the tax incentives, when certain conditions are met, can be classified as either: (a) a prohibited subsidy if they are provided upon export (export subsidies), or favour/promote the domestic over imported products, or (b) an actionable subsidy when they are provided particularly within a specific geographical area or for a specific field of industry or for certain undertakings. Bearing in mind that, there is no presumption on the prohibition of actionable subsidy, but instead it is subject to challenge before the WTO Dispute Settlement Body. Therefore, it would be difficult for a country to prove the existence of subsidies in the form of tax incentives as long as the specificity is not meant to exist. Thus, the 'specificity' test, in particular *de facto* specificity, shall be paid more consideration and stricter rules in the case of challenged tax incentives.

---

[89] The GATS (1995) art. 15.

Literature

Primary sources

Agreement on Subsidies and Countervailing Measures (ASCM), 15 April 1994, Annex 1A to the Marrakesh Agreement Establishing the World Trade Organization, 1869 U.N.T.S. 14.

Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, 1867 U.N.T.S. 154, 33 I.L.M. 1144 (1994).

Brazil – Certain Measures Concerning Taxation and Charges WT/DS472/R, and WT/DS497/R (Panel Report, adopted on 11 January 2019).

Brazil – Certain Measures Concerning Taxation and Charges WT/DS472/AB/R; WT/DS497/AB/R (Appellate Body Report, adopted on 11 January 2019).

Canada – Measures Affecting the Export of Civilian Aircraft, WT/DS70/AB/R (Appellate Body Report, adopted 20 August 1999).

China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audio-visual Entertainment Products, WT/DS363/AB/R (Appellate Body Report, adopted on 19 January 2010).

European Union – Countervailing Measures on Certain Polyethylene Terephthalate from Pakistan WT/DS486/R (Panel Report, adopted on 25 May 2018).

India – Export Related Measures WT/DS541/R (Panel Report, adopted 31 October 2019).

Indonesia – Certain Measures Affecting the Automobile Industry WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R and Corr.1 and 2 (Panel Report, adopted 23 July 1998).

United States – Tax Treatment for 'Foreign Sales Corporations' WT/DS108/R (Panel Report, adopted 20 March 2000).

United States – Tax Treatment for 'Foreign Sales Corporations' WT/DS108/AB/R (Appellate Body Report adopted 20 March 2000).

United States – Final Countervailing Duty Determination with respect to certain Softwood Lumber from Canada WT /DS257/AB/R (Appellate Body Report, adopted on 17 February 2004).

United States – Countervailing Duty Investigation on Dynamic Random-Access Memory Semiconductors (DRAMS) from Korea WT/DS296/AB/R (Appellate Body Report adopted 20 July 2005).

US – Large Civil Aircraft (2nd complaint) WT/DS353/AB/R, (Appellate Body Report, adopted on 11 April 2019).

Secondary sources

Azhar, S., and Sharouh, M., 'The Effects of Tax Holiday on Investment Decision' (1974) 13 Pak Dev Rev 409-432.

Bhandari, M., *Philosophical Foundations of Tax Law* (Oxford University Press 2017).

Bailey, S. J., *Public Sector Economics: Theory, Policy and Practice* (Macmillan International Higher Education 1995).

Bond, E., 'Tax Holidays and Industry Behavior, (1981) 63 Rev Econ Stat 88-95.

Cornel Law School, 'Reporting with respect to specified foreign financial assets, definition of terms' (2014) <www.law.cornell.edu/cfr/text/26/1.6038D-1> accessed 8 April 2022.

Cornell Law School, Foreign Sales Corporation- general rules' (1987) <www.law.cornell.edu/cfr/text/26/1.921-2> accessed 8 April 2022.

Cypher, J. M., and Dietz, J. L., *The Process of Economic Development* (Psychology Press, 2004).

Daly, M., *The WTO and Direct Taxation* (World Trade Organization, 2005).

Galle, B., 'Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction' (2008) 106 Mich. L. Rev 805-852.
Gladriel, S., 'Disaggregating the State and Local Tax Deduction' (2016) 35 VaTaxRev 327-386.
Hines, J. R. Jr.,'Tax Policy and the activities of Multinational Corporations' Working Paper 5589 (National Bureau of Economic Research 1996).
Rogers, J. R., 'The Effectiveness and Constitutionality of State Tax Incentive Policies for Locating Businesses: A Simple Game Theoretic Analysis' (2000) 53 The Tax Lawyer 431-458.
Karagiannis, N., 'Key Economic and Politico-Institutional Elements of Modern Interventionism' (2001) 50 Social and Economic Studies 17-47.
Manns Jr, F. P., 'Internal Revenue Code Section 162 (f): When Does the Payment of Damages to a Government Punish the Payor' (1993) 13 Va. Tax Rev 271-327.
McCleary, W., 'The Earmarking of Government Revenue: A Review of Some World Bank Experience' (1991) 6 World Bank Res Obs 81-104.
Mises, von L., *Interventionism: An Economic Analysis* (Liberty Fund 2011).
Organization for Economic Co-operation and Development, *Tax Policy Studies Corporate Tax Incentives for Foreign Direct Investment* (OECD Publishing 2001).
Organization for Economic Co-operation and Development, *Tax Expenditures – Recent Experiences* (OECD 1996). p. 107.
Shaviro, D. N., *Tax, Spending, and the U.S. Government's March Toworad Bankruptcy* (Cambridge University Press 2006).
Shoup, D. C, 'The ideal source of local public revenue' (2004) 34 Regional Science and Urban Economics 753-784.
Steenblik, R., *A Subsidy Primer*, (Global Subsidies Initiative of the International Institute for Sustainable Development, 2012).

Tarschys, D., ‘Tributes, Tariffs, Taxes and Trade: The Changing Sources of Government Revenue’ (1988) 18 CUP 1-20.

United Nation*, Handbook on Geographic Information Systems and Digital Mapping* (United Nations Department of Economic and Social Affairs, Statistics Division 2000).

Vig, Z., ‘Interstate Relations*’* in Z. Fejes, M. Sulyok, A. Szalai (eds), *International Economic and Financial Organizations* (Iurisperitus Kiadó 2019).

Welner, K., *NeoVouchers: The Emergence of Tuition Tax Credits for Private Schooling* (Rowman & Littlefield 2008).

World Trade Organization, WTO negotiations on GATS rules, (October 2016) <https://www.wto.org/english/tratop_e/serv_e/gats_rules_negs_e.htm > accessed 8 April 2022.

World Trade Organization, *WTO Analytical Index Guide to WTO Law and Practice*, (2003) V1, 899. <https://docs.wto.org/gtd/Default.aspx?pagename=AnalyticalIndex&langue=e> accessed 8 April 2022.