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Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes

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Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes

Robert A. Green[†]

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I. INTRODUCTION

Tax treaties and trade agreements employ radically different methods of settling intergovernmental disputes. Most bilateral income tax treaties rely exclusively on intergovernmental consultation and negotiation for this purpose.

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In contrast, the principal multilateral trade agreement, the General Agreement on Tariffs and Trade (GATT),¹ employs a quasi-judicial or legalistic system that generates decisions that cannot be blocked by the losing party. It is tempting to conclude that the GATT has evolved much further in its institutional structure than tax treaties have. If so, perhaps the dispute settlement systems of income tax treaties should be revised to resemble the more "sophisticated" GATT model.² Or, to go one step further, perhaps we should bring income tax measures directly under the GATT or a new multilateral agreement on investment with legalistic dispute settlement provisions.

Proposals for such innovations are becoming more common. Rather than simply assuming the GATT model to be more sophisticated, however, one should analyze carefully the appropriateness of specific dispute settlement mechanisms in different contexts. This Article begins by arguing that, in fundamental ways, the tax and trade contexts are much more closely related than the academic literature and government practice traditionally have recognized. Tax treaties and trade agreements have the same underlying goal of facilitating international trade and investment, and they employ analogous rules to achieve it. Given these fundamental similarities in goals and approaches, it is initially puzzling that the two kinds of agreements should employ radically different dispute settlement systems.

The Article goes on to argue that this disparity can usefully be analyzed by drawing upon analytical methods and insights developed by international relations theorists. This approach involves viewing intergovernmental dispute settlement systems not as means for dictating outcomes but as devices for facilitating international cooperation by changing the political context in which sovereign governments make self-interested decisions. This approach focuses

1. Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS—THE LEGAL TEXTS 1 (1994), 33 I.L.M. 1125 [hereinafter Final Act]. The Uruguay Round of GATT negotiations, which concluded in 1994, substantially strengthened the institutions for international trade, including the dispute settlement system. The Uruguay Round Agreements include the Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS—THE LEGAL TEXTS 5 (1994), 33 I.L.M. 1144 [hereinafter WTO Agreement]. A number of additional agreements are annexed to the WTO Agreement. These include the General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS—THE LEGAL TEXTS 21 (1994), 33 I.L.M. 1154 [hereinafter GATT 1994]. Article 1(a) of GATT 1994 in turn incorporates the original GATT agreement from 1947 as rectified, amended, or modified up to the date of entry into force of the WTO Agreement. *See* Text of the General Agreement on Tariffs and Trade, IV GATT B.I.S.D. 1 (1969) (the GATT agreement of 1947 as rectified, amended, or modified up to the date of entry into force of the WTO Agreement) [hereinafter GATT 1947]. The annexes to the WTO Agreement also include the General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS—THE LEGAL TEXTS 325 (1994), 33 I.L.M. 1167 [hereinafter GATS], and the Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS—THE LEGAL TEXTS 404 (1994), 33 I.L.M. 1226 [hereinafter Dispute Settlement Understanding].

2. *See, e.g.*, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS para. 4.168, at IV-54 (Organisation for Econ. Co-operation & Dev. 1995) [hereinafter OECD TRANSFER PRICING GUIDELINES] (suggesting that it might be desirable to reconsider design of tax treaty dispute settlement mechanisms in light of GATT's "increasingly sophisticated procedures and institutions to resolve international trade disputes").

one's attention on the similarities and differences in the contexts in which politicians make decisions about international cooperation in different regimes, such as the trade and tax regimes. The Article identifies significant differences between these two regimes from this perspective and concludes that it makes sense for the procedures for resolving intergovernmental tax disputes to remain much less legalistic than the procedures that have evolved under trade agreements.

Part II of the Article discusses the legalistic dispute settlement system that has developed under the GATT. It argues that tax treaties and trade agreements are very closely related, raising the question of why tax treaty dispute settlement mechanisms are so different from the dispute settlement system of the GATT. Indeed, during the Uruguay Round of GATT negotiations, many countries proposed that disputes about discriminatory income tax measures be brought directly under the jurisdiction of the GATT's dispute settlement system. The United States opposed this proposal, with the result that tax treaty mechanisms, where applicable, still have exclusive jurisdiction over income tax disputes.

Part III then turns to a more detailed analysis of dispute settlement mechanisms in tax treaties. Under most treaties, consultations and negotiations between designated tax officials of the two treaty countries are the exclusive means for resolving disputes. There is a nascent trend toward supplementing this mechanism with voluntary binding arbitration, but only in the case of fact-specific disputes. Indeed, the tax treaty dispute settlement mechanisms in general are extremely unlikely to resolve disputes that raise policy-level conflicts between domestic tax laws and tax treaty obligations. It is likely that such disputes will have to be pursued through diplomatic channels.

In Part IV, the Article begins its analysis of the polar cases of tax treaty dispute settlement and GATT dispute settlement from a theoretical perspective, drawing upon the international relations theory insight that international cooperation can emerge and be maintained if countries mutually adopt retaliatory strategies. The Article argues that intergovernmental dispute settlement systems can serve as devices for managing these strategies to prevent them from breaking down under uncertainty. The Article concludes, however, that this function is less critical in the tax context than in the international trade context.

Part V continues this theoretical analysis, utilizing the international relations theory that the maintenance of cooperative outcomes depends on the generation and dissemination of certain types of information. The Article argues that intergovernmental dispute settlement systems can serve as devices for such production and distribution of information about the requirements of the regime, the performance of the parties under the regime, and the reactions of other parties to one's own performance. Intergovernmental dispute settlement systems also can facilitate the development and spread of reputational information. The Article concludes, however, that the international tax regime is more transparent than the international trade regime, so there is less need for legalistic dispute settlement to perform these functions in the tax context than in the trade context.

Finally, Part VI discusses the costs of legalistic dispute settlement. The desirability of highly legalistic systems for any international regime depends

on the balance between the benefits and costs of such systems in the context of that particular regime. Part VI argues that legalistic dispute settlement could impose significant costs in the international tax context and that these costs probably would exceed those of the international trade context. Given the different balances between benefits and costs in the two areas, the legalistic dispute settlement procedures that have evolved under trade agreements should not be assumed to be the best model for resolving disputes under income tax treaties. This is particularly so in the case of disputes involving policy-level conflicts between domestic law and treaty obligations in which the problem of regime maintenance becomes prominent.

II. LEGALISTIC DISPUTE SETTLEMENT UNDER THE GATT AND ITS APPLICATION TO INCOME TAX DISPUTES

International trade scholars have long debated whether the dispute settlement systems in trade agreements should be based on a "legalistic" model or on a "pragmatic," "antilegalistic" model.³ The "legalistic" model favors clearly defined rules and third-party adjudication procedures that can apply such rules objectively in disputed cases. The "antilegalistic" model views rules merely as guidelines and favors the diplomatic resolution of disputes through intergovernmental consultation and negotiation.

Section A below discusses how the dispute settlement procedures in the GATT have evolved, particularly in recent years, into a highly legalistic system. Section B examines the theoretical relationship between trade agreements and income tax treaties. This Section argues that these two types of international agreements are much more closely related than has been recognized historically. In light of this relationship, it is puzzling that intergovernmental income tax disputes are not also subject to a legalistic dispute settlement system, similar to the system in the GATT. Finally, Section C discusses the controversy that arose during the Uruguay Round of GATT negotiations when trade negotiators from many countries proposed bringing income tax disputes directly under the jurisdiction of the GATT. This controversy was likely a precursor of future debates about the relationship between international trade and investment treaties, income tax measures, and income tax treaties and is examined as such.

A. *The Evolution of a Legalistic Dispute Settlement System in the GATT*

The GATT originally contained only a skeletal dispute settlement procedure. The rules governing dispute settlement were principally contained in

3. See, e.g., KENNETH W. DAM, *THE GATT: LAW AND INTERNATIONAL ECONOMIC ORGANIZATION* 3-5 (1970) (juxtaposing "legalism" and "pragmatism" within framework of GATT); OLIVIER LONG, *LAW AND ITS LIMITATIONS IN THE GATT MULTILATERAL TRADE SYSTEM* 61-64 (1985) (explaining that "[t]he General Agreement has both juridical and pragmatic features"); William J. Davey, *Dispute Settlement in GATT*, 11 *FORDHAM INT'L L.J.* 51, 65-67 (1987) (distinguishing "legalistic" and "antilegalistic" dispute settlement models); Robert E. Hudec, *GATT Dispute Settlement After the Tokyo Round: An Unfinished Business*, 13 *CORNELL INT'L L.J.* 145, 151-53 (1980) (discussing tension in GATT regulatory policy between "legalist" and "antilegalist" schools of thought); Phillip R. Trimble, *International Trade and the "Rule of Law"*, 83 *MICH. L. REV.* 1016, 1017-18 (1985) (describing "legalist" and "nonlegalistic" views of GATT).

a few sentences of article 23.⁴ This article provided for consultation between contracting parties in any dispute in which one contracting party believed that a GATT benefit was being “nullified or impaired” or that the attainment of any objective of the GATT was being impeded by the actions of another member.⁵ If consultation did not result in a satisfactory settlement, article 23 provided that the parties could refer the dispute to the GATT members.⁶ The members acting jointly would investigate the matter and make recommendations or rule on it.⁷ If the members ruled in favor of the complainant, they could authorize it to retaliate against the defendant by suspending the application of some of its own concessions or obligations under the GATT.⁸

Starting from these minimal provisions, the GATT dispute settlement procedures gradually evolved through innovation and practice, although not consistently in the direction of greater legalism. In particular, during the 1960s, the prevailing attitude toward GATT dispute settlement changed from an earlier commitment to a legalist approach to a decidedly antilegalist approach.⁹ Since then, it has moved sharply back in the direction of greater legalism.

4. GATT 1947, *supra* note 1, art. 23.

5. *Id.* art. 23(1). Specifically, article 23(1) provides that:

If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of

(a) the failure of another contracting party to carry out its obligations under this Agreement, or

(b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or

(c) the existence of any other situation,

the contracting party may, with a view to the satisfactory adjustment of the matter, make written representations or proposals to the other contracting party or parties which it considers to be concerned. Any contracting party thus approached shall give sympathetic consideration to the representations or proposals made to it.

Id.; see also *id.* art. 22 (outlining requirements for consultation).

6. See *id.* art. 23(2). Specifically, article 23(2) provides that:

If no satisfactory adjustment is effected between the contracting parties concerned within a reasonable time . . . the matter may be referred to the CONTRACTING PARTIES. The CONTRACTING PARTIES shall promptly investigate any matter so referred to them and shall make appropriate recommendations to the contracting parties which they consider to be concerned, or give a ruling on the matter, as appropriate. The CONTRACTING PARTIES may consult with contracting parties, with the Economic and Social Council of the United Nations and with any appropriate intergovernmental organization in cases where they consider such consultation necessary. If the CONTRACTING PARTIES consider that the circumstances are serious enough to justify such action, they may authorize a contracting party or parties to suspend the application to any other contracting party or parties of such concessions or other obligations under this Agreement as they determine to be appropriate in the circumstances. If the application to any contracting party of any concession or other obligation is in fact suspended, that contracting party shall then be free, not later than sixty days after such action is taken, to give written notice to the Executive Secretary to the CONTRACTING PARTIES of its intention to withdraw from this Agreement and such withdrawal shall take effect upon the sixtieth day following the day on which such notice is received by him.

Id.

7. See *id.*

8. See *id.*

9. See Hudec, *supra* note 3, at 151–53. Professor Hudec attributes this movement toward antilegalism to two factors. First, several of the original GATT rules became outdated, and governments no longer wished to be held to them. Second, the distribution of political power within the GATT changed as the European Economic Community (EEC) and Japan became more powerful relative to the United States. Unlike the United States, which had designed the legalist model, the EEC countries and Japan traditionally

The legalist position triumphed in the Uruguay Round, which produced a quasi-judicial dispute settlement system whose rulings cannot be blocked by one party. Under the procedures set forth in the Uruguay Round's Dispute Settlement Understanding, the complaining party may request the establishment of a panel to adjudicate the dispute.¹⁰ Upon receipt of such a request, the Dispute Settlement Body (DSB) must set up a panel unless there is a consensus in the DSB *not* to do so¹¹—a rule known as “reverse consensus.”¹² Since the complaining party can prevent the formation of this “reverse” consensus, that party effectively has a right to the establishment of a panel. “Reverse consensus” replaces the previous rule that the DSB would create a panel only if there were a consensus to do so.¹³ Under this earlier regime, the defendant could prevent the formation of consensus and thus always could block the formation of a panel.

The Dispute Settlement Understanding specifies time limits for completion of the various stages in the panel process.¹⁴ Under these new procedures, the panel normally should issue a report detailing its conclusions within six to eight months of its establishment.

The Dispute Settlement Understanding eliminates the possibility that one party will block adoption of the panel's decision by providing that “[w]ithin [sixty] days after the date of circulation of a panel report to the Members, the report shall be adopted at a DSB meeting unless a party to the dispute formally

have favored a more diplomatic approach. In addition, the developing country members became more powerful. These countries were excused from many GATT obligations, yet they began to demand strict enforcement of developed country obligations; the developed countries reacted by disparagingly dismissing these demands as excessively “legalistic.” *See id.*; *see also* ROBERT E. HUDEC, *ENFORCING INTERNATIONAL TRADE LAW: THE EVOLUTION OF THE MODERN GATT LEGAL SYSTEM* 12–13 (1993) (explaining how change in GATT's composition and “higher level of conflict” in 1960s resulted in “sharp decline in the status of GATT law”).

10. *See* Dispute Settlement Understanding, *supra* note 1, art. 4(7) (providing for complaining party's request to establish panel if consultation fails to resolve dispute). The general rules regarding consultations are set out in article 4 of the Dispute Settlement Understanding. *See id.*

The Dispute Settlement Understanding provides for alternatives to formal dispute settlement if parties cannot resolve their disagreements. Article 5 includes provisions on good offices, conciliation, and mediation, and states specifically that the Director-General may offer to provide such services in an effort to assist members in resolving disputes. *See id.* art. 5(6). These informal methods may be used in addition to or in lieu of the panel process. *See id.* art. 5(2)–(5). In addition, article 25 allows the parties, by mutual agreement, to submit a dispute to binding arbitration as an alternative to the establishment of a panel. *See id.* art. 25(1)–(2).

11. *See id.* art. 6(1).

12. The GATT Secretariat proposes panel members. *See id.* art. 8(6). If the parties do not agree on panel members, the WTO Director General may appoint the panel on his or her own authority, in consultation with the chair of the DSB and the chairs of the relevant council or committee. *See id.* art. 8(7). The Understanding gives the parties 20 days to establish their own terms of reference for the panel; if the parties are unable to agree, it provides default terms of reference. *See id.* art. 7(1).

13. Although the GATT established a one nation–one vote system, *see* GATT 1947, *supra* note 1, art. 25(3), it traditionally has operated on the basis of consensus. *See* Ministerial Declaration, Nov. 29, 1982, GATT B.I.S.D. (29th Supp.) at 9, 16 (1983) (noting that “[t]he CONTRACTING PARTIES reaffirmed that consensus will continue to be the traditional method of resolving disputes; however, they agreed that obstruction in the process of dispute settlement shall be avoided”). Because of the requirement of consensus, a single vote—including the vote of the defendant—could block the formation of a panel. Although the requirement of consensus rarely, if ever, resulted in a refusal to establish a panel, it did often result in long delays in doing so. *See* JOHN H. JACKSON ET AL., *LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS: CASES, MATERIALS AND TEXT* 341–42 (3d ed. 1995); Michael K. Young, *Dispute Resolution in the Uruguay Round: Lawyers Triumph over Diplomats*, 29 *INT'L LAW* 389, 402 (1995).

14. *See* Dispute Settlement Understanding, *supra* note 1, app. 3, para. 12.

notifies the DSB of its decision to appeal or the DSB decides by consensus *not* to adopt the report.¹⁵ Again, this “reverse consensus” rule replaces the previous rule that a panel report would be adopted only if there were a consensus to do so, a system that gave the losing party the power to block adoption.¹⁶

A party has the right to appeal an adverse panel decision to a new appellate tribunal, known as the “Appellate Body.”¹⁷ The Appellate Body’s rulings are subject to the same “reverse consensus” rule as regular panel reports. Such a ruling is to be adopted (absent consensus to the contrary) within thirty days of its circulation to DSB members.¹⁸

Finally, the Dispute Settlement Understanding provides for the monitoring of compliance.¹⁹ A losing defendant must indicate what actions it plans to take to implement “within a reasonable period of time” the panel’s recommendation.²⁰ If there is further disagreement regarding compliance, the aggrieved state may resort to the original panel for a ruling.²¹ Should the defendant continue to fail to implement the recommendation, the complaining state is to negotiate with the defendant to determine the amount of “mutually acceptable compensation.”²² If the parties cannot agree on the amount of compensation, the complainant may request authority from the DSB to retaliate by suspending concessions in an amount “equivalent to the level of the nullification and impairment” suffered.²³ The defendant may demand arbitration re-

15. *Id.* art. 16(4) (emphasis added) (footnote omitted).

16. Although parties did not often permanently block adoption of reports, this did happen on occasion, and on other occasions parties delayed the adoption of reports for months or years. *See JACKSON ET AL.*, *supra* note 13, at 342–43; Young, *supra* note 13, at 402.

17. *See* Dispute Settlement Understanding, *supra* note 1, arts. 16(4), 17. This tribunal has seven members and hears appeals in panels of three. *See id.* art. 17(1). The members are to be nongovernmental individuals “of recognized authority, with demonstrated expertise in law, international trade and the subject matter of the covered agreements generally.” *Id.* art. 17(3). In addition, the members are to be “broadly representative of membership in the WTO.” *Id.* The Appellate Body is limited to considering issues of law covered in the panel report and legal interpretations developed by the panel. *See id.* art. 17(6). The appellate proceedings are normally to take only 60 days and are never to exceed 90 days. *See id.* art. 17(5).

18. *See id.* art. 17(14). Given the “consensus to overrule” requirement for panel and Appellate Body decisions, countries disappointed by legal rulings may be tempted to turn to WTO “legislative” mechanisms to reverse judicial decisions, although, as currently structured, these mechanisms are extremely cumbersome. One such mechanism is to propose a formal amendment to the relevant treaty. Most important GATT provisions, including the dispute resolution provisions, however, cannot be amended without the unanimous consent of all WTO members. *See* WTO Agreement, *supra* note 1, art. 10(2), (8). Another possibility would be to propose that WTO member states approve an “interpretation” of the treaty that reverses an interpretation issued by the Appellate Body. The WTO Charter provides that “interpretations” can be adopted with less than a consensus vote, but it further stipulates that the interpretation procedure “shall not be used in a manner that would undermine the amendment provisions in Article X.” *Id.* art. 9(2). Thus, in the end, the “consensus to overrule” requirement embodied in the dispute resolution provisions is buttressed by the amendment and interpretation procedures.

19. Under the pre-Uruguay Round GATT, if the offending member declined to follow the panel report’s recommendations (as sometimes happened), the GATT usually proved to be too weak to induce compliance. *See* HUDEC, *supra* note 9, at 363 (noting “the very real possibility—indeed, practice—of government vetoes that block GATT Council adoption of panel rulings and also block Council authorization of retaliatory sanctions”); Young, *supra* note 13, at 404.

20. *See* Dispute Settlement Understanding, *supra* note 1, art. 21(3). The reasonable period of time may be set by the member concerned if approved by the DSB, by agreement of the contending parties, or, absent agreement, by arbitration. Normally, the period will not exceed 15 months. *See id.* art. 21(4).

21. *See id.* art. 21(5).

22. *Id.* art. 22(2).

23. *Id.* GATT article 23 has always permitted the GATT contracting parties to authorize the prevailing party to suspend concessions owed to the losing party (sometimes referred to as “retaliation”) if

garding the appropriate level of retaliation.²⁴ Such a determination is not appealable and can be overturned only by a unanimous vote of the DSB.²⁵

Under the domestic law of the United States, the Uruguay Round Agreements do not preempt inconsistent federal laws,²⁶ and rulings by dispute settlement panels and the appellate body have no legal effect.²⁷ A World Trade Organization (WTO) dispute settlement panel or appellate body ruling, however, apparently creates an obligation under *international law* to comply with the ruling's recommendation that the member country make its law consistent with the Uruguay Round Agreements.²⁸

Disputes raising issues of policy-level conflicts between domestic law and international obligations routinely are brought before the GATT dispute settlement system. Recent post-Uruguay Round examples include disputes about the legality under the GATT of a European Union ban on hormone-treated beef,²⁹ a U.S. ban on certain imports of shrimp (adopted as an environ-

the latter fails to end its violation of GATT rules. Such authorization has been granted only once—in 1955 to allow the Netherlands to suspend concessions to the United States as a result of U.S. quotas on Dutch agricultural products. See JACKSON ET AL., *supra* note 13, at 344. The Netherlands apparently never utilized the authorization. See *id.*

24. See Dispute Settlement Understanding, *supra* note 1, art. 22(6).

25. See *id.* art. 22(7).

26. The legislation implementing the Uruguay Round Agreements specifies that “[n]o provision of any of the Uruguay Round Agreements, nor the application of any such provision to any person or circumstance, that is inconsistent with any law of the United States shall have effect.” Uruguay Round Agreements Act § 102(a)(1), 19 U.S.C. § 3512(a)(1) (1994). This legislation further specifies that [n]o State law, or the application of such a State law, may be declared invalid as to any person or circumstance on the ground that the provision or application is inconsistent with any of the Uruguay Round Agreements, except in an action brought by the United States for the purpose of declaring such law or application invalid.

Id. § 102(b)(2)(A).

In contrast, income tax treaties are self-executing. See 2 FEDERAL INCOME TAX PROJECT, AMERICAN LAW INSTITUTE, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 22 (1992) [hereinafter FEDERAL INCOME TAX PROJECT] (noting that “[i]n the United States tax treaties are self-executing”). See generally RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 111 cmt. h, reporter’s note 5 (1986) [hereinafter RESTATEMENT] (discussing distinction between self-executing and non-self-executing international agreements). Thus, they preempt federal law under the later-in-time rule. See *infra* notes 125–126 and accompanying text.

27. Even in an action brought by the United States for the purpose of invalidating a state law that is inconsistent with the GATT, “a report of a dispute settlement panel or the Appellate Body convened under the Dispute Settlement Understanding regarding the State law, or the law of any political subdivision thereof, shall not be considered as binding or otherwise accorded deference.” 19 U.S.C. § 3512(b)(2)(B)(i).

28. The text of the Uruguay Round Agreements is not entirely clear on this point. The WTO Agreement provides that “[e]ach Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements.” WTO Agreement, *supra* note 1, art. 16(4). The meaning of this provision depends, however, on what a Member’s obligations under the Agreements are interpreted to be. Arguably, a Member does not have an absolute duty under the Uruguay Round Agreements to make its laws consistent with those Agreements because they provide for the alternative of compensating the complaining party with trade concessions. Professor Jackson discusses this language of the WTO Agreement as well as the language of the Dispute Settlement Understanding and concludes that a WTO ruling *does* create an international law obligation to comply with the ruling’s recommendation that the member country make its laws consistent with the Agreements. See generally John H. Jackson, *The WTO Dispute Settlement Understanding—Misunderstandings on the Nature of Legal Obligation*, 91 AM. J. INT’L L. 60 (1997).

29. See World Trade Organization, *Report of the Panel on EC Measures Concerning Meat and Meat Products (Hormones), Complaint by the United States*, WT/DS26/R/USA, available in 1997 WL 569984 (Aug. 18, 1997); World Trade Organization, *Report of the Panel on EC Measures Concerning Meat and Meat Products (Hormones), Complaint by Canada*, WT/DS48/R/CAN, available in 1997 WL 561677 (Aug. 18, 1997).

mental protection measure),³⁰ provisions of the U.S. Helms-Burton Act imposing economic sanctions on Cuba,³¹ Canadian policies restricting the importation of periodicals (adopted to preserve Canadian culture),³² and U.S. Environmental Protection Agency standards for gasoline.³³

B. *The Relationship Between Income Tax Treaties and Trade Agreements*

What are the implications of this evolution of legalistic GATT institutions for international income tax policy and treaties? This question has begun to surface in practice, but it has received virtually no scholarly analysis. Indeed, the academic literature largely fails to connect international tax policy to international trade policy.³⁴ This separation of disciplines is unfortunate. International tax policy can have an enormous impact on international trade.³⁵ Indeed, a country can use discriminatory income tax measures directly to undercut the commitments it makes in international trade agreements.

Although they seldom are discussed together, income tax treaties and trade agreements are closely related. As noted above, they have the same underlying goal of facilitating international trade and investment,³⁶ and they em-

30. See World Trade Organization, *First Written Submission by India, Panel on United States—Import Prohibition of Certain Shrimp and Shrimp Products*, available in 1997 WL 304821 (May 20, 1997) (statement of dispute). The DSB established a panel for this dispute on February 25, 1997. See World Trade Organization, *Communication from the Chairman of the Panel on United States—Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/10, available in 1997 WL 584387 (Sept. 22, 1997). The panel currently expects to complete its work by the end of March 1998. See *id.*

31. See World Trade Organization, *Request for the Establishment of a Panel by the European Communities, United States—The Cuban Liberty and Democratic Solidarity Act*, WT/DS38/2, available in 1996 WL 908910 (Oct. 4, 1996) (statement of dispute) [hereinafter World Trade Organization, *Request for the Establishment of a Panel by the European Communities*]. On April 25, 1997, the panel suspended its proceedings to allow the European Communities and the United States to attempt to negotiate a solution. See World Trade Organization, *Communication from the Chairman of the Panel on United States—The Cuban Liberty and Democratic Solidarity Act*, WT/DS38/5, available in 1997 WL 371060 (Apr. 25, 1997).

32. See World Trade Organization, *Report of the Appellate Body on Canada—Certain Measures Concerning Periodicals*, WT/DS31/AB/R, available in 1997 WL 398913 (June 30, 1997).

33. See World Trade Organization, *Report of the Appellate Body on United States—Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, available in 1996 WL 227476 (Apr. 29, 1996).

34. See Richard J. Vann, *A Model Tax Treaty for the Asian-Pacific Region?* (pt. 1), 45 BULL. FOR INT'L FISCAL DOCUMENTATION 99, 109 (1991) (noting that tax treaties are usually written in their own terms without any clear connection to trade policy).

35. See JOEL SLEMROD, FREE TRADE TAXATION AND PROTECTIONIST TAXATION 1 (National Bureau of Econ. Research Working Paper No. 4902, 1994) (stating that “tax policy can have at least as large an effect on the flow of goods across countries . . . and the gains from trade as the[] trade policy instruments”); Joel Slemrod, *Comments on John Mutti, TRIMS, Policy Change, and the Role of the GATT*, in ANALYTICAL AND NEGOTIATING ISSUES IN THE GLOBAL TRADING SYSTEM 496, 497 (Alan V. Deardorff & Robert M. Stern eds., 1994) (arguing that “tax policy can have an enormous impact on the cross-border flow of commodities”).

36. International trade agreements explicitly have the goal of facilitating international trade and investment. For example, the North American Free Trade Agreement declares its objectives, among others, to be to “eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties” and to “increase substantially investment opportunities in the territories of the Parties.” North American Free Trade Agreement, *done on* Dec. 8–17, 1992, art. 102, 32 I.L.M. 289, 297 [hereinafter NAFTA]. Similarly, the preamble to the WTO Agreement declares that the agreement is “directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations.” WTO Agreement, *supra* note 1, pmb1.

ploy similar rules to achieve that goal. In particular, the GATT permits member countries to impose taxes on imported goods, both at the border (tariffs) and after the goods have entered the country (internal taxes). The GATT members agree, however, to limit or "bind" many of their tariffs at fixed levels.³⁷ These tariff bindings are backed up by a "national treatment" or nondiscrimination obligation applicable to internal taxes on goods: Member countries are prohibited from imposing internal taxes on imported goods that are less favorable than the internal taxes they impose on similar domestic goods.³⁸

In much the same way, income tax treaties generally permit countries to impose taxes on the income from imported capital, both when the income is repatriated across the border (withholding taxes on dividends, interest, royalties, and similar items of income)³⁹ and when the income is earned within the country (regular income taxes).⁴⁰ The treaty countries agree, however, to limit withholding taxes to reciprocally agreed-upon rates.⁴¹ These limits are backed up by a nondiscrimination obligation⁴² applicable to regular income taxes.⁴³

Although it is perhaps not so obvious, international tax agreements also have the goal of facilitating international trade and investment. *See, e.g.*, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL art. 1 commentary, para. 7, at c(1)-2 to c(1)-3 (Organisation for Econ. Co-operation & Dev. 1995) [hereinafter OECD MODEL TAX CONVENTION] ("The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons."); FEDERAL INCOME TAX PROJECT, *supra* note 26, at 1 ("The principal function of income tax treaties is to facilitate international trade and investment by removing—or preventing the erection of—tax barriers to the free international exchange of goods and services, and the free international movement of capital and persons.").

37. *See* GATT 1947, *supra* note 1, art. 2.

38. *See id.* art. 3(2).

39. *See, e.g.*, Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, U.S.-Can., arts. 10(2) (dividends), 11(2) (interest), 12(2) (royalties), T.I.A.S. No. 11,087, at 10, 12, 14 (entered into force Aug. 16, 1984) [hereinafter U.S.-Canada Tax Convention]; OECD MODEL TAX CONVENTION, *supra* note 36, arts. 10(2) (dividends), 11(2) (interest).

40. *See, e.g.*, U.S.-Canada Tax Convention, *supra* note 39, arts. 7(1) (business profits), 14 (independent personal services), 15(1) (dependent personal services), at 8, 17; OECD MODEL TAX CONVENTION, *supra* note 36, arts. 7(1) (business profits), 14(1) (independent personal services), 15(1) (dependent personal services).

41. *See, e.g.*, U.S.-Canada Tax Convention, *supra* note 39, arts. 10(2) (limiting withholding taxes on dividends to 10% or 15%, depending on degree of ownership), 11(2) (limiting withholding taxes on interest to 15%), 12(2) (limiting withholding taxes on royalties to 10%), at 10-12, 14; OECD MODEL TAX CONVENTION, *supra* note 36, arts. 10(2) (limiting withholding taxes on dividends to 5% or 15%, depending on degree of ownership), 11(2) (limiting withholding taxes on interest to 10%), 12(1) (prohibiting withholding taxes on royalties).

42. *See, e.g.*, U.S.-Canada Tax Convention, *supra* note 39, art. 25, at 23; OECD MODEL TAX CONVENTION, *supra* note 36, art. 24.

One explanation of the tax treaty nondiscrimination article is that it protects the parties' bargain concerning withholding-tax rates. *See* U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 77 n.12 (1992). Tax treaties directly limit withholding-tax rates but generally do not directly limit host country corporate income tax rates. Host countries, therefore, could alter the bargain, without increasing withholding-tax rates, by increasing the level of corporate income taxation of foreign and foreign-owned firms. The treaty nondiscrimination obligation indirectly prevents this by requiring that changes in corporate income taxation burden wholly domestic firms to the same extent as foreign and foreign-owned firms. *See id.*

Another explanation of the nondiscrimination article is that it serves as a backstop to the treaty provisions on elimination of double taxation. These provisions require the treaty partners to eliminate the international double taxation of their residents either by exempting certain foreign-source income from taxation or by giving a tax credit for foreign taxes paid on certain foreign-source income. *See, e.g.*, OECD MODEL TAX CONVENTION, *supra* note 36, arts. 23A, 23B. If residence countries adopt the exemption method, investment in host countries will bear the same rate of tax (the rate established by the host country) regardless of the place of residence of the investor—so-called "capital import neutrality." A

Under the nondiscrimination obligation, a treaty country may not tax the domestic "permanent establishment" of a firm that is a treaty resident of another treaty country less favorably than it would tax a domestic firm carrying on the same business.⁴⁴ Similarly, it may not tax a domestic firm that is owned or controlled by residents of the other treaty country less favorably than it would tax a similar domestic firm that was owned and controlled by domestic residents.⁴⁵

Notwithstanding this close relationship between international income taxation and international trade, international agreements historically have failed to link the two subjects. Until the Uruguay Round, the GATT was virtually silent about income taxes, as opposed to taxes on goods such as tariffs⁴⁶ and internal taxes on goods.⁴⁷ The principal exception was that the pre-Uruguay Round GATT prohibited the use of income tax preferences as a means of subsidizing exports and authorized importing countries to impose "countervailing duties" to offset such subsidies.⁴⁸

This prohibition was the basis on which a GATT panel struck down not only a narrow provision of the U.S. income tax system but also a fundamental feature of the income tax systems of Belgium, France, and the Netherlands.⁴⁹ Under prior American tax law, a U.S. corporation could set up a foreign export subsidiary as a Domestic International Sales Corporation (DISC). The

nondiscrimination rule is necessary to prevent the host country from subverting this equal treatment. If residence countries adopt the credit method, host countries with low tax rates will have a strong incentive to impose discriminatory taxes—so-called "soak-up taxes"—on foreign investment; these taxes ultimately will be borne by the residence countries rather than by the investors and therefore will not discourage investment. The nondiscrimination rule is necessary to prohibit such opportunistic behavior.

43. Although the nondiscrimination obligation in tax treaties is analogous to the national treatment obligation in the GATT, the two obligations are not identical: The tax treaty nondiscrimination obligation is generally less restrictive than the GATT's national treatment obligation. *See infra* note 62. Moreover, the concept of nondiscrimination in the international tax context is problematic if viewed as a requirement of competitive neutrality, because it is the *interaction* of the host country's tax system and the residence country's tax system that determines the competitive position of the residence country's firms when they engage in business operations in the host country. For example, if those firms are able fully to credit host country taxes against their residence country tax liability, the host country's tax system will have no effect on the competitive position of those firms, even if it is discriminatory.

44. *See, e.g.*, OECD MODEL TAX CONVENTION, *supra* note 36, art. 24(3).

45. *See, e.g., id.* art. 24(5).

46. Tariffs are taxes on goods and services as they are imported or exported across national borders.

47. *See, e.g.*, GATT 1947, *supra* note 1, arts. 2 (tariff bindings), 3 (national treatment on internal taxation of goods), 6(4) (rebate of taxes on exported goods at border).

48. *See id.* arts. 6 (countervailing duties), 26 (subsidies); *see also* Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the GATT, Illustrative List of Export Subsidies, Apr. 12, 1979, GATT B.I.S.D. (26th Supp.) at 80 (1980). This prohibition was at issue in the DISC cases. *See infra* note 49 and accompanying text.

49. *See* Panel Report on United States Tax Legislation (DISC), Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 98 (1977); Panel Report on Income Tax Practices Maintained by Belgium, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 127 (1977); Panel Report on Income Tax Practices Maintained by France, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 114 (1977); Panel Report on Income Tax Practices Maintained by the Netherlands, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 137 (1977). In response to the European Community's complaint in this case, the United States brought three countercomplaints alleging that the territorial tax systems of Belgium, France, and the Netherlands also violated the GATT. For further discussions of the DISC case, *see generally* HUDEC, *supra* note 9, at 59–100; Robert E. Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN. L. REV. 1443 (1988); and John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. 747 (1978). Hudec notes that "[t]he DISC case is considered by many to be the largest and most conspicuous failure in the history of GATT litigation." HUDEC, *supra* note 9, at 59.

combined export earnings would be allocated between the DISC and its parent company according to one of several formulas in the statute. Taxation of a portion of the profits allocated to the DISC would be deferred until one of a number of future events occurred. In 1972, the European Community brought a GATT complaint charging that this tax deferral violated article 16(4) of the GATT, which prohibits certain export subsidies.⁵⁰ The GATT dispute settlement panel reasoned that deferral is equivalent to a partial exemption from taxation because the interest component normally levied for late or deferred payments is not applicable. Therefore, the panel concluded, the DISC legislation violated article 16(4).⁵¹ In addition, the GATT panel ruled in favor of the United States on its countercomplaints that the basic territorial tax systems of the Netherlands, Belgium, and France also violated article 16(4).⁵² In 1981, the United States and the European Community reached a compromise agreement in which the GATT Council adopted the panel reports in the DISC case with an "understanding" that limited their broad scope but under which the DISC legislation still violated the GATT.⁵³ Congress ultimately repealed the DISC legislation in 1984, replacing it with arguably GATT-consistent legislation authorizing Foreign Sales Corporations (FSCs).⁵⁴

This pre-Uruguay Round case dramatically illustrates the potential for the GATT dispute settlement system to take on conflicts raising issues of fundamental tax policy and to strike down domestic tax laws that violate GATT principles. Prior to the Uruguay Round, however, such cases were very rare because the GATT's restrictions on income tax measures were so narrow.

50. See *supra* note 47 and accompanying text.

51. In a 1960 Declaration, the contracting parties agreed that the practices in an attached "Illustrative List of Export Subsidies" were generally to be considered as subsidies in the sense of article 16(4). See Provisions of Article XVI:4, Nov. 19, 1960, GATT B.I.S.D. (9th Supp.) at 185 (1961). At the time of the DISC case, this list included the exemption or remission, specifically as related to exports, of direct taxes.

52. In each instance, the panel ruled that since territorial systems allow part of the income from export activities to be exempt from domestic tax, these systems constituted partial exemptions from direct taxes in violation of GATT article 16(4). See Panel Report on Income Tax Practices Maintained by the Netherlands, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 137 (1977); Panel Report on Income Tax Practices Maintained by Belgium, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 127 (1977); Panel Report on Income Tax Practices Maintained by France, Nov. 12, 1976, GATT B.I.S.D. (23d Supp.) at 114 (1977).

53. Specifically, the GATT Council adopted the panel reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country, need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income. Tax Legislation, Dec. 7-8, 1981, GATT B.I.S.D. (28th Supp.) at 114 (1982).

54. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494, 985-1003 (1984) (codified at I.R.C. §§ 921-927 (1994)). This legislation provides that if American corporations establish foreign subsidiaries that qualify as FSCs, certain income earned by the FSCs will not be subject to current U.S. tax. On November 18, 1997, the European Union filed a complaint in the World Trade Organization challenging the FSC legislation. See Joseph Kirwin & Gary G. Yerkey, *EU Files Complaint in WTO Against U.S. Tax Breaks for FSCs*, 14 Int'l Trade Rep. (BNA) 2044 (Nov. 26, 1997).

C. *The Uruguay Round Controversy About Bringing Income Tax Disputes Under the Jurisdiction of the GATT*

The Uruguay Round expanded the GATT beyond its original subject of trade in goods⁵⁵ to include trade in services.⁵⁶ This is significant for international tax purposes because trade in services often requires the establishment of a commercial presence in the importing country. As a result of this local commercial presence, suppliers of exported services are likely to become subject to the importing country's income tax laws.⁵⁷ Discriminatory income taxation of foreign service suppliers therefore could be a significant barrier to trade in services. Uruguay Round negotiators from many countries sought to address this issue in the new agreement.

Specifically, extensive negotiations took place over the extent to which the national treatment obligation of the General Agreement on Trade in Services (GATS) should apply to income tax measures.⁵⁸ This obligation requires each member country, to the extent articulated in its Schedule of Commitments,⁵⁹ to treat services and service providers of other members no less favorably than it treats its own services and service providers.⁶⁰ The GATS de-

55. See MICHAEL J. TREBILCOCK & ROBERT HOWSE, *THE REGULATION OF INTERNATIONAL TRADE: POLITICAL ECONOMY AND LEGAL ORDER* 215 (1995) (noting that pre-Uruguay Round GATT framework applied only to trade in goods).

56. See GATS, *supra* note 1, pmb1.

57. Under typical tax treaty rules, countries generally do not impose income taxes on foreign business enterprises or entrepreneurs unless they establish a commercial presence in the country. See, e.g., OECD MODEL TAX CONVENTION, *supra* note 36, arts. 5 (defining "permanent establishment"), 7 (covering taxation of business profits), 14 (covering taxation of independent personal services).

One should note, however, that the potential for using income tax measures as trade barriers is not confined to the services context. Trade in goods, particularly the increasingly important categories of intermediate goods and goods involving intellectual property, also often requires the establishment of a commercial presence in the importing country. Therefore, trade in goods can also give rise to significant international income tax concerns.

58. See Frances Williams, *Warning to U.S. over Tax Demands*, FIN. TIMES (London), Nov. 24, 1993, at 7 (referring to "two years of laborious negotiations on a tax clause for services"). The GATS applies to "measures" by members affecting trade in services. See GATS, *supra* note 1, art. 1(1). A "measure" includes any law, regulation, rule, procedure, decision, or administrative action. See *id.* art. 28(a).

59. The GATS is an incomplete agreement, since the members did not agree on a "comprehensive set of initial specific . . . commitments." TREBILCOCK & HOWSE, *supra* note 55, at 227-28. Instead, the GATS contemplates that each member will subsequently agree to undertake specific commitments with respect to specific sectors of services; this agreement is to be set out in a Schedule of Commitments. See GATS, *supra* note 1, art. 20(1) (requiring each member to set out specific commitments in a schedule, including terms, limitations, and conditions on market access, and conditions and qualifications on national treatment).

60. See GATS, *supra* note 1, art. 17(1). The GATS also contains a "most favored nation" obligation, which generally requires each member to accord to services and service suppliers of any other member treatment no less favorable than it accords to like services and service suppliers of any other country. See *id.* art. 2(1). The OECD's *Model Tax Convention* does not impose a most favored nation obligation, but many bilateral treaties are accompanied by protocols under which the treaty partners undertake that they will not grant more favorable terms (typically in respect to withholding-tax rates on dividends, interest, and royalties) to other countries without granting the same concession to the other treaty partner. See Vann, *supra* note 34, at 110; see also Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Apr. 8, 1991, Can.-Mex. (entered into force May 11, 1992), available in LEXIS, Fedtax Library, IBFDTR File (providing that if Mexico subsequently agrees in tax treaty with OECD member country to withholding tax on interest or royalties that is lower than 15%, then such lower rate, which shall not fall below 10%, shall apply for purposes of the tax treaty between Canada and Mexico).

finer treatment as "less favorable" if it modifies the conditions of competition in favor of the member's own services or service suppliers compared to like services or service suppliers of any other member.⁶¹

This national treatment obligation is stricter than the nondiscrimination obligation imposed by income tax treaties.⁶² Insofar as the national treatment obligation were to apply to income tax measures, complaints alleging that a member country's income tax system discriminates against the services or service suppliers of another member country would fall under the jurisdiction of the dispute settlement procedures of the GATT and would be adjudicated using this stricter standard.

Shortly before the December 15, 1993, deadline for completing the entire Uruguay Round Agreement, the United States announced for the first time that it considered it unacceptable for the national treatment obligation of the GATS to apply to income tax measures.⁶³ The United States argued that discriminatory income tax measures are uncommon⁶⁴ and that any such measures can be dealt with adequately through the dispute settlement procedures in income tax treaties.⁶⁵ In addition, the United States expressed concern that the

61. See GATS, *supra* note 1, art. 17(3).

62. In particular, the nondiscrimination article in the OECD MODEL TAX CONVENTION, *supra* note 36, art. 24, a comprehensive tax treaty nondiscrimination article, prohibits a host country from imposing discriminatory taxes on a business enterprise operating within its territory that is carried on, owned, or controlled by residents of the other treaty country, but it does not prohibit the host country from imposing discriminatory taxes on the nonresident investors in such an enterprise: Although article 24(1) prohibits a treaty country from imposing discriminatory taxation on nationals of the other treaty country "in the same circumstances," *id.* art. 24(1), a nonresident taxpayer is not considered to be "in the same circumstances" as a resident taxpayer. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 262. Therefore, article 24(1) does not prohibit discriminatory taxation of nonresident investors. The other clauses of article 24 also fail to prohibit such discrimination. See *id.* A common example of discrimination against nonresident investors occurs when a source country integrates its corporate and individual income tax systems by giving shareholders a credit against their individual tax liability for the corporate taxes that were paid on distributed earnings. Countries typically do not extend the benefits of such integration systems to nonresident shareholders. Although this treatment of nonresident investors is discriminatory, it does not violate the nondiscrimination article of income tax treaties. See *id.* at 186-90, 264-65; U.S. DEP'T OF THE TREASURY, *supra* note 42, at 79 (noting that "[n]o treaty requires that foreign shareholders receive the same tax credits as domestic shareholders"). This treatment of nonresident investors does modify the conditions of competition in favor of domestic enterprises, however, and thus presumably would violate the national treatment obligation of the GATS.

63. See David Dodwell, *GATT Clash over US Tax Is Defused*, FIN. TIMES (London), Dec. 11, 1993, at 3 [hereinafter Dodwell, *GATT Clash over US Tax Is Defused*] (reporting on settlement of dispute); David Dodwell, *US Blocks International Fair Tax Plan*, FIN. TIMES (London), Oct. 28, 1993, at 7 [hereinafter Dodwell, *US Blocks International Fair Tax Plan*] (reporting on initial American opt-out); David Dodwell, *US Fights Its Corner over Tax Demands*, FIN. TIMES (London), Nov. 23, 1993, at 6 [hereinafter Dodwell, *US Fights Its Corner over Tax Demands*] (describing U.S. objections); Williams, *supra* note 58, at 7 (reporting on dispute).

64. See Bob Davis & Julie Wolf, *U.S., EC Believe Deal Is in Sight on World Trade*, WALL ST. J., Dec. 3, 1993, at A3 (describing U.S. opposition to draft tax proposal); Asra Q. Nomani & Bhushan Bahree, *GATT Teams Push Final Efforts to Set Global Trade Pact as Deadline Looms*, WALL ST. J., Dec. 9, 1993, at A3 (noting other negotiators' frustration with U.S. demands); *U.S. to Continue Efforts to Exclude Taxes from GATT Talks on Services*, *Samuels Says*, 1993 Daily Tax Rep. (BNA) No. 231 (Dec. 3, 1993), available in LEXIS, Fedtax Library, DTR File, 1993 DTR 231 d12 ") [hereinafter *U.S. to Continue Efforts*] (describing American objections to tax measures and noting statement of U.S. Assistant Secretary of Treasury for Tax Policy that "if you ask about direct tax measures that are disguised trade barriers, no one comes up with an example).

65. See *GATT Director Opposes U.S. Position on Taxation of Services in Trade Talks*, 1993 Daily Tax Rep. (BNA) No. 225 (Nov. 24, 1993), available in LEXIS, Fedtax Library, DTR File, 1993 DTR 225 d6 [hereinafter *GATT Director Opposes U.S. Position*]; *U.S. to Continue Efforts*, *supra* note 64.

application of the GATS to income tax measures “would upset the existing system of bilateral tax treaties, and could tie the hands of Congress in enacting new tax laws.”⁶⁶

Every other country participating in the negotiations reportedly opposed the United States’s eleventh-hour position.⁶⁷ The other countries believed that it was necessary that the GATS include additional protection against discriminatory tax measures.⁶⁸ Some countries apparently suspected that the United States wanted to carve income tax measures out of the national treatment obligation because it intended to pursue discriminatory tax policies, particularly in the area of transfer pricing regulation.⁶⁹ This conflict threatened to scuttle not only the negotiations on services but the entire Uruguay Round.⁷⁰

In the end, the United States abandoned its extreme position and agreed to the inclusion in the GATS of language bringing income tax measures under the national treatment obligation.⁷¹ The final language is very limited, however. Article 14(d) creates an exception to the national treatment obligation of the GATS for measures in which “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.”⁷² “Direct taxes” for this purpose include all taxes on income or capital.⁷³ A footnote to this provision lists broad categories of discriminatory income tax measures that will *not* be considered to violate the national treatment obligation.⁷⁴

66. Williams, *supra* note 58, at 7; see also Dodwell, *GATT Clash over US Tax Is Defused*, *supra* note 63, at 3; Dodwell, *US Fights Its Corner over Tax Demands*, *supra* note 63, at 6.

67. The Director of the GATT reportedly told the U.S. Assistant Secretary of the Treasury for Tax Policy on November 23, 1993, that all of the other 114 nations involved in the talks opposed the U.S. position that tax measures should be carved out of the GATS. See Davis & Wolf, *supra* note 64, at A3 (noting that U.S. position on discriminatory income tax measures “has escalated into a high-profile dispute between the Europeans and the U.S., which is raising it without much visible support from other countries”); *GATT Director Opposes U.S. Position*, *supra* note 65; Nomani & Bahree, *supra* note 64, at A3 (noting that United States had failed to convince key negotiators, particularly those from European countries, that discriminatory income tax measures would not be used as trade barriers); Williams, *supra* note 58. These other countries were concerned that taxes might be used as a disguised barrier to trade in services; they also believed that the GATS was the appropriate place to address this issue and that it was necessary to have the extra protection that would result from including tax measures under the GATS. See Davis & Wolf, *supra* note 64, at A3; *GATT Director Opposes U.S. Position*, *supra* note 65; *U.S. to Continue Efforts*, *supra* note 64. The U.S. Assistant Secretary of the Treasury for Tax Policy noted, however, that the tax authorities of some other countries had expressed sympathy with the U.S. position but had been asked by trade negotiators to play a subordinate role. See *id.*

68. See Davis & Wolf, *supra* note 64, at A3 (“The U.S. argues that it wouldn’t use tax laws to inhibit trade, but other countries contend that such a pledge isn’t enough and that extra protection needs to be included in the world trade agreement.”); Nomani & Bahree, *supra* note 64, at A3 (“The U.S. insists the U.S. proposal wouldn’t be used as a trade barrier, but it hasn’t yet convinced key negotiators, particularly from European countries.”); *U.S. to Continue Efforts*, *supra* note 64 (“[W]hen the United States strenuously objected to the draft carve-out, some countries suspected [that] the United States opposed national treatment because it wanted to pursue discriminatory tax policies . . .”).

69. See *U.S. to Continue Efforts*, *supra* note 64; Williams, *supra* note 58, at 7.

70. See *GATT Director Opposes U.S. Position*, *supra* note 65; Williams, *supra* note 58, at 7.

71. See Bob Davis & Asra Q. Nomani, *Officials Closer to Completing a Trade Accord*, WALL ST. J., Dec. 14, 1993, at A3; Dodwell, *GATT Clash over US Tax Is Defused*, *supra* note 63, at 3.

72. GATS, *supra* note 1, art. 14(d) (footnote omitted).

73. See *id.* art. 28(o).

74. See *id.* art. 14(d) n.6. These exceptions include, among others, measures that “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”; measures that “apply to non-residents in order to ensure the imposition or collection of taxes in the Member’s territory”; measures that “apply to non-residents or residents in order to prevent the avoidance or evasion of taxes, including

On the other hand, article 14 contains a general proviso that measures—including income tax measures—may not be “applied in a manner which would constitute . . . a disguised restriction on trade in services.”⁷⁵ Under this language, a GATT panel with jurisdiction over an income tax measure might use a least restrictive alternative or balancing test to conclude that the measure constitutes a “disguised restriction on trade in services” and therefore violates the national treatment obligation, even though, on its face, it falls under the article 14(d) exception for direct taxes.

Having created this risk, however, the GATS then virtually eliminates it as a practical matter by severely limiting the jurisdiction of GATT panels over income tax measures. Article 22(3) of the GATS provides that a member may not invoke the GATT dispute settlement procedures to challenge another member’s income tax measure as violating the national treatment obligation of article 17 whenever the measure falls within the scope of an income tax treaty between the two countries.⁷⁶ If the members disagree about whether the income tax measure in question falls within the scope of an income tax treaty, either member may bring the matter before the Council for Trade in Services, which must refer the matter to final and binding arbitration.⁷⁷ With respect to income tax treaties that were in force on January 1, 1995, however, such a matter may be brought before the Council for Trade in Services only with the consent of both parties to the tax treaty.⁷⁸

This leaves only the risk that disputes about income tax measures that fall within the scope of income tax treaties that come into force *after* January 1, 1995, might become subject to the GATS dispute settlement procedures without consent. Countries can eliminate this risk, too, by including language in these income tax treaties that preempts the language of article 22(3) of the GATS, and, indeed, they have begun to do so.⁷⁹

compliance measures”; and measures that “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.” *Id.*

75. *Id.* art. 14.

76. *See id.* art. 22(3); *see also* OECD MODEL TAX CONVENTION, *supra* note 36, art. 25 commentary, paras. 44.1–7, at c(25)-15 to c(25)-17 (discussing interaction of mutual agreement procedure of OECD’s *Model Tax Convention* with dispute resolution mechanism provided by GATS).

77. *See* GATS, *supra* note 1, art. 22(3).

78. *See id.* art. 22(3) n.11. In addition, article 14(e) allows exceptions to the most favored nation treatment otherwise required by the GATS, provided that the difference in treatment is the result of an income tax treaty. *See id.* art. 14(e).

79. The OECD’s commentary on article 25 of the OECD’s *Model Tax Convention* suggests that this preemption be accomplished by adding the following provision in new income tax treaties:

For purposes of paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, the Contracting States agree that, notwithstanding that paragraph, any dispute between them as to whether a measure falls within the scope of this Convention may be brought before the Council for Trade in Services, as provided by that paragraph, only with the consent of both Contracting States. Any doubt as to the interpretation of this paragraph shall be resolved under paragraph 3 of Article 25 (Mutual Agreement Procedure) or, failing agreement under that procedure, pursuant to any other procedure agreed to by both Contracting States.

OECD MODEL TAX CONVENTION, *supra* note 36, art. 25 commentary, para. 44.6, at c(25)-16 to c(25)-17.

The income tax treaty between the United States and France adopts such an approach, providing in part:

Notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning whether a measure is within the scope of this Convention shall be considered only by the competent authorities of the Contracting States, as defined in subparagraph

Subsequent to this experience in the Uruguay Round, the issue of making international tax dispute settlement more legalistic—either by modifying tax treaties or by including income tax measures in trade or investment agreements—has resurfaced several times. For example, a recent report of the Organisation for Economic Co-operation and Development (OECD) Committee on Fiscal Affairs remarks on the similarities between the problems of inter-governmental dispute settlement under tax treaties and trade agreements⁸⁰ and suggests that it might be desirable to reconsider the design of tax treaty dispute settlement mechanisms in light of the GATT's "increasingly sophisticated procedures and institutions to resolve international trade disputes."⁸¹ More recently, member countries of the OECD negotiating a Multilateral Agreement on Investment (MAI) formed an experts' group to determine the extent to which tax-related provisions should be included in an eventual agreement.⁸² As they did in the Uruguay Round, U.S. officials have taken the position that income taxes should be carved out of the MAI, arguing that the bilateral tax treaty network is adequate to deal with income tax issues affecting investment and that the mutual agreement provisions of tax treaties are the optimal way to resolve income tax disputes.⁸³

1(h) of Article 3 (General Definitions) of this Convention, and the procedures under this Convention exclusively shall apply with respect to the dispute.

Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Aug. 31, 1994, U.S.-Fr., art. 29(8)(a), S. TREATY DOC. NO. 103-32, at 73 (1994) [hereinafter U.S.-France Treaty]. Similar provisions appear in the United States's income tax treaties with Kazakhstan, Portugal, and Sweden. See Exchange of Diplomatic Notes Accompanying the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, July 10, 1995, U.S.-Kaz., reprinted in 2 Tax Treaties (CCH) ¶¶ 5311-5312, at 34,419-3 to 34,420 (1995); Protocol to the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 6, 1994, U.S.-Port., para. 1(a)(ii), S. TREATY DOC. NO. 103-34, at 59 (1994); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 1, 1994, U.S.-Swed., art. 1(3)(a), S. TREATY DOC. NO. 103-29, at 2 (1994).

80. See OECD TRANSFER PRICING GUIDELINES, *supra* note 2, paras. 4.167-.168, at IV-53 to IV-54.

81. *Id.*; see also *id.* para. 4.171, at IV-55. In contrast, in a report issued in 1984, the OECD Committee on Fiscal Affairs specifically chose not to recommend the adoption of compulsory arbitration procedures to supersede or supplement the mutual agreement procedure. See ORGANISATION FOR ECON. CO-OPERATION & DEV., TRANSFER PRICING AND MULTINATIONAL ENTERPRISES: THREE TAXATION ISSUES para. 63, at 25 (1984) [hereinafter OECD, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES].

82. See OECD Investment Negotiators Form Group to Examine Tax Issues, INSIDE U.S. TRADE, Feb. 2, 1996, at 24; see also Robert Couzin, *Taxation and the Multilateral Agreement on Investment*, 12 Tax Notes Int'l (Tax Analysts) 2049 (June 24, 1996). Couzin notes that a "colorable tax measure may be used to effect an expropriation, to establish a performance requirement, to block the repatriation of profits, or to discriminate in almost any other way against foreign investors in general (defeating national treatment), or even against foreign investors from certain countries (defeating MFN status)." *Id.* at 2051.

Note that article 13 of the U.S. Model Bilateral Investment Treaty carves out taxation, except for certain matters relating to expropriation. See Pamela B. Gann, *The U.S. Bilateral Investment Treaty Program*, 21 STAN. J. INT'L L. 373, 426-27 (1985) (discussing relationship between tax treaties and tax provisions in bilateral investment treaties and treaties of friendship, commerce, and navigation). The NAFTA also carves out most direct taxation issues, except for expropriation and some performance requirements. See NAFTA, *supra* note 36, art. 2103. For more on this issue, see Malcolm Gammie, *The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement*, 49 TAX L. REV. 615, 622-23 (1994).

83. See Albertina M. Fernández & Susan M. Lyons, *The Transatlantic Tax Outlook: European and U.S. Tax Relations*, 12 Tax Notes Int'l (Tax Analysts) 1923, 1925 (June 17, 1996) (reporting such remarks of Joseph Gutentag, International Tax Counsel, U.S. Department of the Treasury, at transatlantic tax conference held June 4, 1996); OECD Investment Negotiators Form Group to Examine Tax Issues, *supra* note 82, at 24 (1996) (quoting unnamed "senior Administration official" on similar matters).

III. ANTILEGALISTIC DISPUTE SETTLEMENT UNDER INCOME TAX TREATIES

Part II described the legalistic dispute settlement system that has evolved under the GATT and argued that there is a close relationship between international tax policy and international trade policy. Nevertheless, a widely supported proposal to bring disputes about discriminatory income tax measures under the jurisdiction of the GATT dispute settlement system was largely defeated by the United States during the Uruguay Round of GATT negotiations. Under the final agreement, the tax treaty dispute settlement mechanism will have exclusive jurisdiction when a tax treaty is applicable to an income tax dispute.

This Part of the Article shows that dispute settlement mechanisms under income tax treaties are highly "antilegalistic." These mechanisms attempt to resolve relatively fact-specific disputes through consultation and negotiation between designated tax officials from the relevant countries. Even this informal, nonbinding approach was never really intended to apply, however, to disputes that involve policy-level conflicts between domestic law and tax treaty obligations. Instead, such disputes realistically can be settled, if at all, only through diplomatic channels.

More specifically, income tax treaties typically contain a dispute settlement procedure similar to the "mutual agreement procedure" of article 25 of the OECD *Model Tax Convention on Income and on Capital*. Article 25 places dispute settlement in the hands of a tax official in each treaty country who is designated to be that country's "competent authority."⁸⁴ The competent authority's functions are set forth in three clauses of article 25, commonly known as the "specific case" provision, the "interpretative" provision, and the "legislative" provision.⁸⁵

The specific case provision requires each competent authority to "endeavor" to resolve specific disputes in which taxpayers assert that they are not being taxed in accordance with the treaty.⁸⁶ A competent authority may resolve a specific dispute unilaterally, or he or she may seek settlement through

Guttentag conceded, however, that taxes used for expropriatory purposes should be covered by the MAI. See Fernández & Lyons, *supra*, at 1925.

84. See OECD MODEL TAX CONVENTION, *supra* note 36, art. 25. The United States's income tax treaties designate the Secretary of the Treasury or his delegate as the U.S. competent authority. See U.S. DEP'T OF THE TREASURY, MODEL INCOME TAX CONVENTION, art. 3(1)(e)(i) (Sept. 20, 1996), reprinted in 1 Tax Treaties (CCH) ¶ 214, at 10,587 (1996), available at <<http://ftp.fedworld.gov/pub/tel/t0txmod1.doc>> (visited Dec. 5, 1997) [hereinafter U.S. DEP'T OF THE TREASURY, MODEL INCOME TAX CONVENTION]. The Secretary of the Treasury has delegated this authority to the IRS Assistant Commissioner (International). In the case of treaty interpretation, he or she acts with the concurrence of the Associate Chief Counsel (Technical and International). See Deleg. Order No. 114 (Rev. 9), 1990-33 I.R.B. 326.

85. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 94-112; John F. Avery Jones et al., *The Legal Nature of the Mutual Agreement Procedure Under the OECD Model Convention* (pt. 2), 1980 BRIT. TAX REV. 13, 18-20.

86. See OECD MODEL TAX CONVENTION, *supra* note 36, art. 25(2). See generally FEDERAL INCOME TAX PROJECT, *supra* note 26, at 99-111 (discussing "specific case" provision). Although the taxpayer has the right to submit a request to initiate a mutual agreement procedure, the taxpayer has no specific right to participate in the process. See OECD TRANSFER PRICING GUIDELINES, *supra* note 2, para. 4.57, at IV-19. In practice, however, the tax administrations of many OECD member countries routinely give taxpayers opportunities to present relevant facts and arguments, keep them informed of the progress of the discussions, and often ask during the course of the discussions whether they can accept the settlements contemplated by the competent authorities. See *id.* para.4.60, at IV-20.

mutual agreement with the competent authority of the other treaty country. The interpretative provision requires the competent authorities to “endeavor” to resolve questions of treaty “interpretation or application” by mutual agreement.⁸⁷ Finally, the legislative provision authorizes the competent authorities to “consult together for the elimination of double taxation in cases not provided for in the Convention.”⁸⁸

In analyzing this competent authority system, it is useful to distinguish between two types of intergovernmental tax disputes. One type is fact-specific; the other raises issues of policy-level conflicts between domestic law and treaty obligations. Consider first the case of a fact-specific dispute. In such a dispute, the treaty partners would agree in principle on the applicable treaty rules and would intend to comply with those rules but would reach different results in the context of the specific set of facts.⁸⁹ The classic example would be a transfer pricing dispute, involving the allocation of profits between a parent corporation and its subsidiary in another country or between a corporation’s home office and a branch located abroad.

Suppose, for example, that a Japanese manufacturing corporation establishes a wholly owned U.S. subsidiary to distribute its products in the United States. Suppose further that it manufactures goods for \$50 and sells them to its

87. OECD MODEL TAX CONVENTION, *supra* note 36, art. 25(3).

88. *Id.* Although the scope of this legislative authority is unclear, there are indications that the U.S. Congress, at least, intends it to be very narrow. For example, the Senate Foreign Relations Committee’s report on the U.S.-Malta tax treaty describes the scope of the legislative provision as follows:

It permits the competent authorities to deal with cases that are within the spirit and sense of the provisions but which are not specifically covered. Thus, the authority delegated should be construed as analogous to a grant of broad regulatory authority to deal with problems that may arise as distinguished from a grant of legislative authority. It might, for example, be compared to the regulatory authority granted to the Secretary of the Treasury under section 385 or section 482. The provision is not intended to authorize the competent authorities to deal with problems of major policy significance that normally would be the subject of negotiations if they had been focused on during that process.

SENATE FOREIGN RELATIONS COMM., TAX CONVENTION WITH THE REPUBLIC OF MALTA, S. EXEC. REP. NO. 97-30, at 27 (1981), *reprinted in* 2 Tax Treaties (CCH) ¶ 5845, at 35,568 (1990). The Senate Foreign Relations Committee’s report on the U.S.-Argentina tax treaty contains similar language. *See* S. EXEC. REP. NO. 97-44, at 30 (1981).

Similarly, Representative Dan Rostenkowski, then Chairman of the House Committee on Ways and Means, testified in hearings held in 1981 that “the scope of this delegation of authority [in the legislative provision] must be clarified and limited to include only noncontroversial technical matters, not items of substance.” *Tax Treaties: Hearings Before the Senate Committee on Foreign Relations on Tax Treaties*, 97th Cong. 58 (1981).

Notwithstanding this restrictive language, the U.S. and Canadian competent authorities engaged in an expansive exercise of legislative authority in negotiating an agreement covering Canadian taxation of offshore drillers. *See* Letter from J.R. Robertson, Director-General Audit Directorate, to P.E. Coates, Assistant Commissioner (Operations) (IRS) (Jan. 26, 1984), *reprinted in* 1 Tax Treaties (CCH) ¶ 1945, at 21,041-43 (1997). For discussions of this agreement, see FEDERAL INCOME TAX PROJECT, *supra* note 26, at 112 & n.343; and Russell K. Osgood, *Interpreting Tax Treaties in Canada, the United States, and the United Kingdom*, 17 CORNELL INT’L L.J. 255, 267-68 (1984).

89. For example, in *Boulez v. Commissioner*, 83 T.C. 584 (1984), Pierre Boulez, a French citizen and German resident, contracted with CBS Records to make recordings of orchestral works in the United States. The contract provided that Boulez would be paid a percentage of sales revenues. The Internal Revenue Service (IRS) characterized this income as compensation for personal services performed in the United States, which was taxable by the United States. The German tax administration, however, characterized the income as “royalties,” which were taxable exclusively by Germany under the tax treaty then in effect between the United States and Germany. *See id.* at 588. Boulez requested that the two countries institute dispute settlement proceedings under the treaty to resolve this conflict and eliminate the double taxation. The countries were unable, however, to reach an agreement. *See id.*

U.S. subsidiary for \$80. The U.S. subsidiary then sells the goods to unrelated U.S. customers for \$100. Under these facts, the Japanese corporation would report \$30 in profits to the Japanese tax authority, and the U.S. subsidiary would report \$20 in profits to the Internal Revenue Service (IRS). The IRS, however, might argue that the two related corporations set the transfer price of \$80 at an artificially high level. Suppose the IRS asserted that the proper transfer price was \$70. This would mean that the Japanese corporation reported \$10 too much in profits to the Japanese tax authority, and the U.S. subsidiary reported \$10 too little in profits to the IRS. Therefore, the Japanese corporation should get a tax refund from Japan, and the U.S. subsidiary should pay additional taxes to the IRS. The Japanese tax authority might well disagree with the IRS's position, however, giving rise to a dispute between the two governments. The governments almost certainly would agree that the applicable standard was the treaty's arm's length standard.⁹⁰ Under this standard, the proper transfer price is the price that two unrelated corporations dealing at arm's length with one another would have used had they engaged in the same transaction. The governments also likely would agree in principle on what the arm's length standard means. Nevertheless, they might use different methods or consider different data in applying the arm's length standard and therefore might reach different numerical results.

At some point, a disagreement over transfer pricing methodology could rise to the level of a fundamental disagreement in principle. The United States, in particular, has adopted several controversial interpretations of the arm's length standard.⁹¹ The run-of-the-mill transfer pricing case, however, is

90. See, e.g., OECD MODEL TAX CONVENTION, *supra* note 36, arts. 7(2) (providing that income attributed to permanent establishment should reflect "the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment"), 9 (providing that income attributed to enterprise that engages in transactions with other commonly controlled enterprises should reflect profits that it would have earned if those transactions had been made between "independent enterprises").

91. See, e.g., Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (1986) (codified at 26 U.S.C. § 482 (1994)) (amending I.R.C. § 482 to require that income that taxpayer derives from transfer of intangible property to related party be "commensurate with the income attributable to the intangible"). The Joint Committee on Taxation's explanation of the Act states that Congress intended that the IRS should not determine arm's length transfer prices for intangibles (which typically take the form of royalties) solely on the basis of profit expectations at the time of the transfer, but rather should also take into account the level of actual profits earned after the transfer. See STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1016 (Comm. Print 1987); cf. OECD TRANSFER PRICING GUIDELINES, *supra* note 2, paras. 1.36-.41, at I-15 to I-17, paras. 6.32-.34, at VI-12 to VI-13 (discussing limited circumstances in which tax administrations may take subsequent developments, such as actual profits in excess of anticipated profits, into account in determining arm's length prices).

Furthermore, in the final Treasury regulations under section 482, adopted in 1994, the U.S. Treasury Department prescribed a "comparable profits method" under which arm's length prices are determined by comparing the profits of a controlled corporation to the profits of comparable uncontrolled corporations. See Treas. Reg. § 1.482-5(a) (as amended in 1995). Again, many treaty partners have argued that such methods conflict with the arm's length standard. The OECD's *Transfer Pricing Guidelines* prescribe a similar, but not identical, method, called the "transactional net margin method," which compares the profits that result from particular transactions of a controlled corporation to the profits that arise from comparable transactions between uncontrolled corporations. See OECD TRANSFER PRICING GUIDELINES, *supra* note 2, paras. 3.26-.48, at III-9 to III-16 (defining "transactional net margin method" as method that "examines the net profit margin relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I)"). The final Treasury regulations and the OECD's *Transfer Pricing*

likely to turn on the application of an agreed-upon methodology to a specific set of facts.

It is widely recognized that the competent authority procedure is a weak mechanism for resolving such fact-specific disputes.⁹² The treaty countries promise merely to “endeavor” to resolve disputes;⁹³ there is no guarantee that they will succeed.⁹⁴ Moreover, it is widely perceived that when treaty countries do manage to resolve disputes, the settlement is often based on political negotiation and compromise rather than on the neutral application of legal rules to the facts of the specific case.⁹⁵

One solution would be to strengthen the competent authority procedure by including an arbitration provision.⁹⁶ Countries recently have begun to experiment with this approach. The European Union’s Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of

Guidelines were published almost simultaneously, suggesting that they might have been developed in tandem.

92. See, e.g., FEDERAL INCOME TAX PROJECT, *supra* note 26, at 107; PHILIP BAKER, DOUBLE TAXATION AGREEMENTS AND INTERNATIONAL TAX LAW 332–35 (1991); GUSTAF LINDENCRONA & NILS MATTSSON, ARBITRATION IN TAXATION 25 (1981); Avery Jones et al., *supra* note 85, at 18–20; Lotfi Maktouf, *Resolving International Tax Disputes Through Arbitration*, 4 ARB. INT’L 32, 41 (1988).

93. OECD MODEL TAX CONVENTION, *supra* note 36, art. 25(2); *id.* art. 25(3).

94. See OECD MODEL TAX CONVENTION, *supra* note 36, art. 25 commentary, paras. 26, at C(25)-9, 45, at C(25)-17 (1995) (noting that mutual agreement procedure does not assure resolution of disputes); FEDERAL INCOME TAX PROJECT, *supra* note 26, at 101, 107 (same); LINDENCRONA & MATTSSON, *supra* note 92, at 25 (same); Maktouf, *supra* note 92, at 41 (same). The *Boulez* case is a good example of a case in which the competent authorities failed to reach agreement. See *supra* note 89 and accompanying text (discussing *Boulez v. Commissioner*, 83 T.C. 584 (1984)).

95. See OECD TRANSFER PRICING GUIDELINES, *supra* note 2, para. 4.41, at IV-14 (noting that “[t]axpayers have expressed fears that their cases may be settled not on their individual merits but by reference to a balance of the results in other cases”); FEDERAL INCOME TAX PROJECT, *supra* note 26, at 107 (stating that “the competent authorities may inevitably engage in a certain amount of bargaining or trading-off among cases not based on their individual merits”); LINDENCRONA & MATTSSON, *supra* note 92, at 25 (noting that there is no guarantee that competent authorities will follow any “fundamental legal principles in international tax law” in reaching agreement); John Iekel, *U.S. Transfer Pricing Regime Roundly Disliked, Informal Survey Finds*, 10 Tax Notes Int’l (Tax Analysts) 36 (Jan. 2, 1995) (describing competent authority process as “good old-fashioned horse trading” without regard to individual taxpayers’ cases); Maktouf, *supra* note 92, at 41 (noting that “[a]n overall agreement may often be reached, irrespective of the merits of each particular case”).

96. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 110–11 (endorsing use of supplemental dispute resolution procedures, including “voluntary” procedure for binding arbitration); LINDENCRONA & MATTSSON, *supra* note 92, at 59–88 (proposing arbitration of tax treaty disputes in cases where the competent authorities fail to reach agreement); Maktouf, *supra* note 92, at 42–49 (concluding that arbitration could complement mutual agreement procedure). See generally INTERNATIONAL FISCAL ASS’N, RESOLUTION OF TAX TREATY CONFLICTS BY ARBITRATION (1994).

The commentary on article 25 of the OECD’s *Model Tax Convention* discusses the use of advisory opinions from an impartial third party, submission of questions to the Committee on Fiscal Affairs, and arbitration as alternative methods of resolving disputes. See OECD MODEL TAX CONVENTION, *supra* note 36, art. 25 commentary, paras. 45–48, at C(25)-17 to C(25)-28.

The OECD’s 1984 report on transfer pricing discussed some of the advantages and disadvantages of arbitration, concluding that “for the time being” it was not appropriate to recommend a mandatory arbitration procedure. See OECD, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES, *supra* note 81, para. 63, at 25. The OECD’s 1995 *Transfer Pricing Guidelines* conclude, however, that in light of developments since 1984,

it seems appropriate to analyze again and in more detail whether the introduction of a tax arbitration procedure would be an appropriate addition to international tax relations. Therefore, the Committee on Fiscal Affairs has agreed to undertake a study of this topic and to supplement these Guidelines with the conclusions of that study when it is completed.

OECD TRANSFER PRICING GUIDELINES, *supra* note 2, para. 4.171, at IV-55.

Associated Enterprises,⁹⁷ which entered into force on January 1, 1995,⁹⁸ provides for arbitration of transfer pricing disputes between European Union (EU) member states.⁹⁹ Similarly, Germany's bilateral tax treaties with France and Sweden permit the competent authorities to submit a dispute to arbitration.¹⁰⁰

In addition, the United States has negotiated arbitration clauses in its income tax treaties with Canada,¹⁰¹ France,¹⁰² Germany,¹⁰³ Kazakhstan,¹⁰⁴ Mexico,¹⁰⁵ and the Netherlands,¹⁰⁶ as well as in a proposed income tax treaty with Switzerland.¹⁰⁷ These clauses represent timid steps, however, and only the German provision currently is in force.¹⁰⁸ The arbitration provisions in the

97. Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, Aug. 20, 1990, 1990 O.J. (L 225) 10 [hereinafter EU Arbitration Convention].

98. See Luc Hinnekens, *The European Tax Arbitration Convention and Its Legal Framework* (pt. 1), 1996 BRIT. TAX REV. 132, 132. The EU Arbitration Convention is concluded for a period of five years. See EU Arbitration Convention, *supra* note 97, art. 20. Six months before the expiration of that period, the contracting states are to meet to decide whether to extend the Convention. See *id.*

99. See EU Arbitration Convention, *supra* note 97, arts. 6-14. For a general discussion of this issue, see Luc Hinnekens, *The European Tax Arbitration Convention and Its Legal Framework* (pt. 2), 1996 BRIT. TAX REV. 272, 272; and Franz-Josef Kolb, *Pros and Cons of the EC Arbitration Convention*, 13 Tax Notes Int'l (Tax Analysts) 241 (July 22, 1996).

100. See Convention for the Avoidance of Double Taxation with Respect to the Taxes on Income and Capital as Well as on Inheritances, F.R.G.-Swed., art. 41.3 (entered into force Oct. 13, 1994), available in LEXIS, Fedtax Library, IBFDTR File (unofficial translation); Amending Protocol to the Convention of 21 July 1959 for the Avoidance of Double Taxation, Sept. 28, 1989, F.R.G.-Fr., art. 7 (entered into force Oct. 1, 1990) (adding art. 25A to treaty), available in LEXIS, Fedtax Library, IBFDTR File (unofficial translation). For discussions of the arbitration provision in the treaty between Germany and Sweden, see Leif Mutén, *New German-Sweden Tax Convention Examined*, 5 Tax Notes Int'l (Tax Analysts) 531, 535 (Sept. 14, 1992); and Joseph H. Guttentag & Ann E. Misback, *Resolving Tax Treaty Issues: A Novel Solution*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 350 (1986).

101. See Revised Protocol Amending the 1980 Tax Convention, Apr. 24, 1995, U.S.-Can., S. TREATY DOC. NO. 104-4 (1995) [hereinafter U.S.-Canada Protocol]. Article 14(2) of this Protocol adds a new paragraph 6 to article 26 (Mutual Agreement Procedure), providing for voluntary binding arbitration of income tax disputes that the competent authorities are unable to resolve by agreement. See *id.* art. 14(2), at 13-14.

102. See U.S.-France Treaty, *supra* note 79, art. 26(5), at 66.

103. See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Aug. 29, 1989, U.S.-F.R.G., art. 25(5), S. TREATY DOC. NO. 101-10, at 69 (1990) (entered into force Aug. 21, 1991) [hereinafter U.S.-Germany Treaty].

104. See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Oct. 24, 1993, U.S.-Kaz., art. 25(5), S. TREATY DOC. NO. 103-33, at 42 (1994) (entered into force Dec. 30, 1996) [hereinafter U.S.-Kazakhstan Treaty].

105. See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, U.S.-Mex., art. 26(5), S. TREATY DOC. NO. 103-7, at 52 (1993) (entered into force Dec. 28, 1993) [hereinafter U.S.-Mexico Treaty].

106. See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18, 1992, U.S.-Neth., art. 29(5), S. TREATY DOC. NO. 103-6, at 90 (1993) (entered into force Jan. 1, 1994) [hereinafter U.S.-Netherlands Treaty].

107. See Convention for the Avoidance of Double Taxation with Respect to Taxes on Income, Oct. 2, 1996, U.S.-Switz., art. 25(6), reprinted in 3 Tax Treaties (CCH) ¶ 9101.25, at 42,005-16 (1996) (not yet in force) [hereinafter U.S.-Switzerland Treaty].

108. An exchange of diplomatic notes accompanying the U.S.-Germany treaty provides rules for arbitration. See Letter from Vernon Waters, Ambassador of the United States of America to the Federal Republic of Germany, to German Ministry of Foreign Affairs (Aug. 29, 1989), in U.S.-Germany Treaty, *supra* note 103, at 13-15 [hereinafter Diplomatic Note]. These rules provide for the establishment of an arbitration board of at least three members that will be instructed by the competent authorities regarding specific rules of procedure. Otherwise, the board will establish its own rules of procedure. See *id.* para. 3, at 14. The arbitration board is to decide each specific case on the basis of the treaty and to render a written

other U.S. treaties will come into force only through a future exchange of diplomatic notes.¹⁰⁹ In the case of the United States–Mexico treaty, a protocol provides that the competent authorities will meet three years after the treaty enters into force to determine whether such an exchange is appropriate.¹¹⁰ The Treasury Department’s technical explanation of the United States–Mexico treaty states that one of the key factors for the U.S. competent authority in making that determination will be the U.S. experience under the arbitration provision of the United States–Germany treaty.¹¹¹ An Understanding relating to the United States–Netherlands treaty¹¹² and the U.S. legislative history of the treaties with Canada,¹¹³ France,¹¹⁴ and Kazakhstan¹¹⁵ contain similar language.

Arbitration under these U.S. treaties will be voluntary, occurring only when both governments and the affected taxpayer agree to submit the case and to be bound by the award.¹¹⁶ The United States, Germany, Mexico, and the Netherlands have further stipulated that they generally will *not* agree to arbitrate matters concerning “tax policy” or “domestic tax law.”¹¹⁷ The U.S. leg-

decision. *See id.* para. 5, at 14.

109. *See* U.S.-Switzerland Treaty, *supra* note 107, art. 25(6), at 42,005-16; U.S.-Canada Protocol, *supra* note 101, art. 14(2), at 13; U.S.-France Treaty, *supra* note 79, art. 26(5), at 66; U.S.-Kazakhstan Treaty, *supra* note 104, art. 25(5), at 42; U.S.-Netherlands Treaty, *supra* note 106, art. 29(5), at 90; U.S.-Mexico Treaty, *supra* note 105, art. 26(5), at 52.

110. *See* U.S.-Mexico Treaty, *supra* note 105, protocol, para. 18(a), at 67.

111. *See* Treasury Department Technical Explanation of the Convention and Protocol Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income Signed at Washington on September 18, 1992, *reprinted in* 2 Tax Treaties (CCH) ¶ 5943, at 35,829-37 (1994).

112. *See* Understanding Regarding the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18, 1992, U.S.-Neth., art. 27(A), S. TREATY DOC. NO. 103-6, at XVII to XVIII (1993) [hereinafter U.S.-Netherlands Memorandum of Understanding].

113. *See* S. EXEC. REP. NO. 104-9, at 46 (1995); STAFF OF THE JOINT COMM. ON TAXATION, 104TH CONG., EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND CANADA 44 (Comm. Print 1995).

114. *See* STAFF OF THE JOINT COMM. ON TAXATION, 104TH CONG., EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE FRENCH REPUBLIC 25 (Comm. Print 1995); Treasury Department Technical Explanation of the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Signed at Paris on August 31, 1994, *reprinted in* 2 Tax Treaties (CCH) ¶ 3058, at 27,197-41 (1995) [hereinafter Technical Explanation].

115. *See* Treasury Department Technical Explanation of the Convention and Protocol Between the Government of the United States of America and the Government of the Republic of Kazakhstan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Signed at Almaty on October 24, 1993, *reprinted in* 2 Tax Treaties (CCH) ¶ 5348, at 34,421-30 (1995) [hereinafter U.S.-Kazakhstan Technical Explanation].

116. *See* U.S.-Switzerland Treaty, *supra* note 107, art. 25(6), at 42,005-16; U.S.-Canada Protocol, *supra* note 101, art. 14(2), at 13; U.S.-France Treaty, *supra* note 79, art. 26(5), at 66; U.S.-Kazakhstan Treaty, *supra* note 104, art. 25(5), at 42; U.S.-Mexico Treaty, *supra* note 105, art. 26(5), at 52; U.S.-Netherlands Treaty, *supra* note 106, art. 29(5), at 90; U.S.-Germany Treaty, *supra* note 103, art. 25(5), at 69; Diplomatic Note, *supra* note 108, at 13.

117. These agreements state that “[t]he competent authorities will not generally accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either Contracting State.” U.S.-Netherlands Memorandum of Understanding, *supra* note 112, para. 27(A)(1), at XVIII; U.S.-Mexico Treaty, *supra* note 105, protocol, para. 18(b)(i), at 67; Diplomatic Note, *supra* note 108, at 13. The relevant language is the same in each treaty, although the Mexican version does not include the words “generally” and “contracting,” and the Dutch version omits the word “contracting.”

islative history of the treaties with Canada,¹¹⁸ France,¹¹⁹ and Kazakhstan¹²⁰ also suggests that arbitration under these tax treaties likely will be confined to fact-specific disputes.¹²¹

The use of arbitration or some other legalistic dispute settlement mechanism to resolve fact-specific disputes is unlikely to pose a serious threat to the stability of the underlying tax treaty regime. The losing country most likely will accept the loss in the expectation that it will win other cases in the future and that it will not be systematically disadvantaged over time.¹²²

This Article focuses, however, on disputes that involve policy-level conflicts between domestic law and treaty obligations. Typically, such conflicts will arise as a result of tax treaty overrides. Suppose the U.S. Congress enacts legislation that arguably—or perhaps even admittedly—violates a tax treaty obligation, such as the nondiscrimination obligation.¹²³ Under U.S. constitutional law, statutes and international treaties have equal force.¹²⁴ A domestic court will apply a subsequently enacted statute over an earlier treaty if the two conflict. Thus, under domestic law, Congress can override an existing treaty provision by enacting new legislation.¹²⁵ In doing so, however, Congress breaches U.S. obligations under international law.¹²⁶ Other governments and commentators have expressed concern that such legislative overrides of tax treaties have become increasingly common in recent years.¹²⁷

118. See S. EXEC. REP. NO. 104-9, at 46 (1995); STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 113, at 44.

119. See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 114, at 25; Technical Explanation, *supra* note 114, art. 26, at 27, 197-41.

120. See U.S.-Kazakhstan Technical Explanation, *supra* note 115, art. 26, reprinted in 2 Tax Treaties (CCH) ¶ 5348, at 34, 421-30 (1995).

121. For a discussion of the types of cases that the United States might agree to arbitrate, see David R. Tillinghast, *The Choice of Issues to Be Submitted to Arbitration Under Income Tax Conventions*, in ESSAYS ON INTERNATIONAL TAXATION 349 (Herbert H. Alpert & Kees van Raad eds., 1993).

122. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 111 (noting that it is unlikely that, over time, revenue interests of either country would be significantly prejudiced by decisions of impartial arbitral panels).

123. For example, in 1989, Congress enacted a tax provision that denies the U.S. subsidiary of a foreign corporation a deduction for any “excess” interest that it pays to its foreign parent. See *infra* note 293. This provision arguably discriminates against foreign-owned U.S. corporations and therefore violates the nondiscrimination articles of the United States’s income tax treaties. See *infra* notes 294-295 and accompanying text.

124. See U.S. CONST. art. VI, § 2; I.R.C. § 7852(d)(1) (1994); RESTATEMENT, *supra* note 26, § 115 (1)(a), § 115 cmt. a & reporter’s note 1; FEDERAL INCOME TAX PROJECT, *supra* note 26, at 63-72.

125. See *The Cherokee Tobacco*, 78 U.S. (1 Wall.) 616, 621 (1871) (“A treaty may supersede a prior act of Congress, and an act of Congress may supersede a prior treaty.”).

126. See RESTATEMENT, *supra* note 26, § 115(1)(b), § 115 cmt. b & reporter’s note 2; FEDERAL INCOME TAX PROJECT, *supra* note 26, at 73-76.

127. See, e.g., FEDERAL INCOME TAX PROJECT, *supra* note 26, at 78-80; Committee on U.S. Activities of Foreign Tax Payers and Foreign Activities of U.S. Taxpayers, N.Y. St. B. Ass’n, *Legislative Overrides of Tax Treaties*, 37 Tax Notes (Tax Analysts) 931 (Nov. 30, 1987); Richard L. Doernberg, *Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority*, 42 TAX LAW. 173 (1989) [hereinafter Doernberg, *Legislative Override of Income Tax Treaties*]; Richard L. Doernberg, *Overriding Tax Treaties: The U.S. Perspective*, 9 EMORY INT’L L. REV. 71 (1995) [hereinafter Doernberg, *Overriding Tax Treaties*]; EEC Group of Six Warns Against Treaty Overrides, reprinted in 36 Tax Notes (Tax Analysts) 437 (July 27, 1987); OECD Comm. on Fiscal Affairs, *Report on Tax Treaty Overrides* (1990), reprinted in 2 Tax Notes Int’l (Tax Analysts) 25 (Feb. 14, 1990); OECD Ambassadors Protest Foreign Tax Bill (Aug. 5, 1992), available in LEXIS, Fedtax Library, TNI File, 92 TNI 32-H.

It is unrealistic to expect the competent authority procedure to deal effectively with such policy-level conflicts.¹²⁸ One would hardly expect the U.S. competent authority—an IRS official—to agree to disregard domestic legislation that conflicts with an earlier treaty when that legislation is controlling under domestic law.¹²⁹ Quite simply, the competent authority procedure never was intended to deal with fundamental disputes about the international consensus on income tax rules.¹³⁰ The arbitration provisions discussed above also would fail to deal with policy-level conflicts. The EU Arbitration Convention applies only to transfer pricing disputes, which generally are regarded as fact-specific rather than as involving policy-level conflicts between domestic law and treaty obligations.¹³¹ Moreover, the arbitration provisions in recent U.S. income tax treaties provide only for voluntary arbitration. They are expressly intended not to apply to disputes that raise issues of “tax policy” or “domestic tax law.” Indeed, under the current international tax regime, a country aggrieved by a tax treaty override usually will lack *any* legalistic remedy for the breach of international law.¹³² Ultimately, such disputes can be dealt with only through diplomatic channels—in other words, through an antilegalist approach.

The inclusion of income tax measures under the GATT, as proposed during the Uruguay Round of negotiations, would have made a wide range of “tax policies” and “domestic tax laws” subject to mandatory legalistic GATT dispute settlement procedures. The United States’s opposition was based in large part on its unwillingness to have its tax policies and tax laws subject to quasi-judicial international review.¹³³ This raises the question of why the United States led the way in the Uruguay Round negotiations in making most domestic laws that affect trade subject to legalistic international dispute settlement¹³⁴ but attempted completely to exclude domestic tax laws.

128. Several U.S. income tax treaties do, however, contain provisions addressing this situation. Article 29(6) of the 1992 treaty with the Netherlands provides that if the competent authority of one of the states becomes aware that a domestic law may be applied in a manner that impedes the full implementation of the treaty, it is obligated to consult the other side. See U.S.-Netherlands Treaty, *supra* note 106, art. 29(6), at 90–91. The protocol accompanying the 1992 treaty with Mexico contains similar language. Paragraph 20 of the protocol provides that if the competent authority of one state considers the law of another state to be applied in a manner that “eliminates or significantly limits a benefit” of the treaty, that state may request consultations “with a view to restoring the balance of benefits of the Convention.” U.S.-Mexico Treaty, *supra* note 105, protocol, para. 20, at 70.

129. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 73 (noting that “it is unrealistic to expect that a competent authority would systematically redress treaty breaches through the mutual agreement process”); Doernberg, *Legislative Override of Income Tax Treaties*, *supra* note 127, at 204 (noting that “it is unlikely that the Treasury will circumvent domestic law through the competent authority process”).

130. Originally, the League of Nations served as the principal international forum for developing a consensus on income tax rules. See Richard J. Vann, *The Role of International Economic Organisations in Promoting International Tax Cooperation 2* (Feb. 1997) (unpublished manuscript, on file with author). In the case of developed countries, this function has now been taken over primarily by the OECD. *Id.* at 3–6.

131. As noted earlier, however, some transfer pricing disputes might involve such conflicts. See *supra* note 90 and accompanying text.

132. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 73–74 (discussing available remedies); Doernberg, *Legislative Override of Income Tax Treaties*, *supra* note 127, at 204–06 (same); Doernberg, *Overriding Tax Treaties*, *supra* note 127, at 115 (same).

133. See *supra* note 66 and accompanying text.

134. See Young, *supra* note 13, at 390 (noting that United States has usually been leading proponent of “legalistic” approach to GATT dispute settlement).

IV. DISPUTE SETTLEMENT AS A MEANS OF MANAGING RETALIATORY STRATEGIES

Part III of this Article argued that the mechanisms for resolving tax treaty disputes are markedly antilegalistic, even in fact-specific disputes and particularly in disputes that involve policy-level conflicts between domestic law and tax treaty obligations. Scholars have given little attention to the design of intergovernmental dispute settlement mechanisms for resolving such policy-level conflicts between domestic tax laws and tax treaty obligations. They appear to assume that decisions to override tax treaty obligations are matters of sovereign prerogative that cannot usefully be subjected to the discipline of international dispute settlement procedures. But, as discussed in Part II, the dispute settlement system in the GATT routinely deals with precisely this type of policy-level conflict. How can one account for the radically different treatment of such conflicts under the two regimes?

To analyze this paradox, one needs a theory of how intergovernmental dispute settlement works. This Part and Part V of the Article draw on international relations theory to develop a theory of dispute settlement as a device for promoting and maintaining cooperative international regimes.

The international relations approach begins with the simple observation that international economic organizations, even relatively legalistic ones such as the GATT, ultimately lack coercive power.¹³⁵ Treaties and treaty organizations are therefore incapable of establishing rules that countries must follow. As a result, intergovernmental dispute settlement systems must operate very differently from domestic systems. Domestic dispute settlement systems facilitate cooperation by enabling parties to make binding commitments. This is not possible in the intergovernmental context. Self-interested governments will violate their agreements and defy the rulings of dispute settlement bodies when they benefit from doing so.

International relations theorists draw different conclusions from these premises. The "realist" school argues that nations are fundamentally concerned with survival in the anarchy of world politics. Although nations form alliances to achieve balances of power, they are always concerned that their allies will gain more from a cooperative relationship than they do—today's ally might become tomorrow's enemy. Because of the need for all countries to achieve *relative* gains, cooperation tends to be exceptional and short-lived. Under this view, institutions for long-term cooperation are largely "window-dressing."¹³⁶ If one accepts this conclusion, then intergovernmental dispute settlement mechanisms are essentially irrelevant, and there is little point in analyzing them.

135. On the other hand, certain international economic organizations, such as the International Monetary Fund and the World Bank, are able to exercise considerable economic leverage over some countries.

136. See Kenneth W. Abbott, *Modern International Relations Theory: A Prospectus for International Lawyers*, 14 YALE J. INT'L L. 335, 337-38 (1989) (noting that "Classical Realists see a world of states obsessed with their power vis-à-vis other states. International rules and institutions are mere window-dressing: their creation and decline, and the degree to which states respect them, depend solely on the current power realities") (footnotes omitted); see also HELEN V. MILNER, INTERESTS, INSTITUTIONS, AND INFORMATION: DOMESTIC POLITICS AND INTERNATIONAL RELATIONS 6-7 (1997) (noting that for Realists, "long-term, institutionalized cooperation among nations seems particularly anomalous").

The “neoliberal institutionalist” school, however, rejects this conclusion and argues that even though treaties and treaty organizations lack coercive power, they are not necessarily ineffective.¹³⁷ Neoliberals regard nations as concerned with absolute gains rather than with relative gains; this greatly magnifies the possibilities for long-term cooperation. Neoliberals acknowledge that governments are self-interested, but they argue that international regimes¹³⁸ can affect government behavior by changing the domestic political context in which governments make decisions based on self-interest.¹³⁹

If one adopts this latter viewpoint, as this Article does, then one can draw upon powerful analytical tools and insights to analyze how dispute settlement systems aid in promoting international cooperation. First, the neoliberal school has drawn upon noncooperative game theory, particularly as it is applied to the iterated prisoner’s dilemma, to argue that international cooperation can emerge and be sustained if countries adopt retaliatory strategies. Applying this approach to intergovernmental dispute settlement, one can analyze dispute settlement as a device for managing these retaliatory strategies. Second, the neoliberal school has drawn upon another game, the “assurance game,” and upon the economics of information to argue that noncompliance can result from information failures. Under this approach, the primary function of dispute settlement is to generate and disseminate the information that is necessary for the maintenance of cooperation.

This Part examines the role of dispute settlement mechanisms in managing retaliatory strategies, both in the international trade context and in the international tax context. Part V then examines the role of dispute settlement mechanisms in generating and disseminating information. The Article argues ultimately that legalistic dispute settlement mechanisms are much more important in ensuring that these functions are adequately performed in the international trade context than in the international tax context.

A. *Retaliatory Strategies in the International Trade Regime*

International trade theorists commonly view trade agreements as cooperative solutions to a prisoner’s dilemma.¹⁴⁰ Noncooperative game theory

137. For brief summaries of the current debate between realists and neoliberal institutionalists, see MILNER, *supra* note 136, at 23–26; and David A. Baldwin, *Neoliberalism, Neorealism, and World Politics*, in NEOREALISM AND NEOLIBERALISM: THE CONTEMPORARY DEBATE 4, 4–8 (David A. Baldwin ed., 1993).

138. According to a widely cited definition, international regimes are sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors’ expectations converge in a given area of international relations. Principles are beliefs of fact, causation, and rectitude. Norms are standards of behavior defined in terms of rights and obligations. Rules are specific prescriptions or proscriptions for action. Decision-making procedures are prevailing practices for making and implementing collective choice.

Stephen D. Krasner, *Structural Causes and Regime Consequences: Regimes as Intervening Variables*, in INTERNATIONAL REGIMES 1, 2 (Stephen D. Krasner ed., 1983). For an elaboration of this definition, see ROBERT O. KEOHANE, *AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY* 57–61 (1984).

139. See KEOHANE, *supra* note 138, at 13.

140. See, e.g., PAUL R. KRUGMAN & MAURICE OBSTFELD, *INTERNATIONAL ECONOMICS: THEORY AND POLICY* 238–41 (3d ed. 1994); TREBILCOCK & HOWSE, *supra* note 55, at 91; G. Richard Shell, *Trade Legalism and International Relations Theory: An Analysis of the World Trade Organization*,

shows that, in an iterated prisoner's dilemma, cooperation can emerge and be sustained if the players adopt retaliatory strategies.¹⁴¹ One then can conceptualize dispute settlement as a means of managing these strategies. To utilize this theory, one must determine why international trade is a prisoner's dilemma, how retaliatory strategies result in cooperation, and why it is necessary to manage these retaliatory strategies.

The characterization of international trade as a prisoner's dilemma might seem at odds with the standard conclusion of international trade economics that a country will maximize its national economic welfare by adopting a policy of free trade, regardless of what other countries do.¹⁴² This conclusion depends on the assumptions that markets are perfectly competitive, that the country in question is "small,"¹⁴³ and that the country takes the trade policies of other countries as a given.¹⁴⁴ Many economists argue, however, that even when these assumptions are not satisfied—so that a theoretical case for government intervention in trade exists—governments are unlikely to have the necessary information or incentives to intervene in ways that maximize national economic welfare.¹⁴⁵ Thus, free trade is virtually always the best policy in practice. Under this view, if countries were run by rational, well-informed politicians whose objectives were to maximize national economic welfare, the international trade game would not be a prisoner's dilemma, but rather a game of "harmony":¹⁴⁶ The dominant strategy for each player would be to practice

44 DUKE L.J. 829, 862-63 (1995); Alan O. Sykes, "Mandatory" Retaliation for Breach of Trade Agreements: Some Thoughts on the Strategic Design of Section 301, 8 B.U. INT'L L.J. 301, 305-10 (1990). For a brief discussion of the iterated prisoner's dilemma, see *infra* notes 153-162 and accompanying text.

141. See *infra* notes 158-161 and accompanying text.

142. See SLEMROD, *supra* note 35, at 2.

143. "Small" for this purpose means that the level of the country's imports and exports do not significantly affect the world price of those products.

144. See SLEMROD, *supra* note 35, at 3-4.

145. See, e.g., KRUGMAN & OBSTFELD, *supra* note 140, at 234-36; Paul R. Krugman, *The Narrow and Broad Arguments for Free Trade*, 83 AM. ECON. REV. 362, 364-65 (1993); Rachel McCulloch, *The Optimality of Free Trade: Science or Religion?*, 83 AM. ECON. REV. 367, 369-71 (1993).

146. See Abbott, *supra* note 136, at 357 (noting that two countries with preferences of liberal economists would find international trade a harmony game).

The game of harmony has the following payoff structure:

		Country II	
		Cooperate	Defect
Country I	Cooperate	4,4	2,3
	Defect	3,1	2,1

In this table, each row represents a strategy that Country I might adopt (cooperate or defect) and each column represents a strategy that Country II might adopt (cooperate or defect). Each cell therefore represents a possible outcome of the game. The pair of numbers in the cell indicate the payoffs to Country I and Country II for that outcome. For example, the cell in the upper left-hand corner represents the outcome in which Country I and Country II mutually cooperate. Each country receives a payoff of 4 in this outcome. If Country I were unilaterally to defect, the result would be the cell in the lower left-hand corner. In this outcome, Country I receives a payoff of 3, and Country II receives a payoff of 1—both countries are worse off than under mutual cooperation. In this game, each country obtains the highest possible payoff by cooperating, regardless of what the other country does.

free trade.¹⁴⁷ There would be no need for international trade agreements or institutions, including dispute settlement systems.

Of course, governments are not run by such politicians. As a crude but illuminating assumption, suppose that the objective of politicians is not to maximize national economic welfare but rather to maximize their political rewards.¹⁴⁸ Politicians then would find it in their interest to support tariffs and other import restrictions. These measures usually redistribute income from consumers to import-competing producers. Since producers in a single industry are usually more able than the consumers of their products to overcome collective action problems, they usually will be able to “pay” politicians more for voting for the redistributive policy than consumers will be able to pay them for voting against it.¹⁴⁹ From this perspective, the international trade game is not a game of harmony at all but rather a game of “deadlock”.¹⁵⁰ The dominant strategy for each politician-player is to impose tariffs and other import restrictions.

An international trade agreement changes the payoff structure of this game. The prospect of entering into such an agreement mobilizes a countervailing interest group—producers of exports—who will support the agreement because it will give them greater access to foreign markets.¹⁵¹ Assuming that

147. See Abbott, *supra* note 136, at 357.

148. See Sykes, *supra* note 140, at 306 & n.28 (noting that such “rewards” might take form of votes, campaign contributions, and so forth). This assumption underlies the economic theory of legislation, which has been described as follows:

In the economists’ version of the interest-group theory of government, legislation is supplied to groups or coalitions that outbid rival seekers of favorable legislation. The price that the winning group bids is determined both by the value of legislative protection to the group’s members and the group’s ability to overcome the free-rider problems that plague coalitions. Payment takes the form of campaign contributions, votes, implicit promises of future favors, and sometimes outright bribes. In short, legislation is “sold” by the legislature and “bought” by the beneficiaries of the legislation.

William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & ECON. 875, 877 (1975). For a critical discussion of this theory, see DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION* 21–33 (1991).

149. See KRUGMAN & OBSTFELD, *supra* note 140, at 237.

150. The game of deadlock has the following payoff structure:

		Country II	
		Cooperate	Defect
Country I	Cooperate	2,2	1,4
	Defect	4,1	3,3

See Abbott, *supra* note 136, at 357–59.

151. See I.M. DESTLER, *AMERICAN TRADE POLITICS* 289 (3d ed. 1995); KRUGMAN & OBSTFELD, *supra* note 140, at 239–41. Other potential interest groups on the side of free trade include industrial users of imports, retailers, and even foreign firms and governments. See DESTLER, *supra*, at 291 (discussing potential role of retailers and industrial users of imported inputs in supporting liberal trade politics); Stephen Engelberg & Martin Tolchin, *Foreigners Find New Ally in U.S. Industry*, N.Y. TIMES, Nov. 2, 1993, at A1 (discussing U.S. industry support of foreign governments and firms lobbying for free trade).

One might ask why a country’s producers of exports would not be mobilized to oppose import restrictions on a case by case basis, even when a trade agreement is not on the political agenda. After all, if their home country were to enact trade restrictions, they could anticipate that foreign countries might retaliate, impairing their ability to sell abroad. One answer is that the trade agreement provides a prominent “focal point” that facilitates concerted political action. Cf. THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* 57–58 (2d ed. 1980) (discussing importance of focal points in facilitating coordination).

these producers will pay more in support of the agreement than import-competing producers will pay in opposition, politicians will perceive it in their interest to support the free trade agreement.

This analysis assumes that the producers of exports believe that foreign governments will comply with the agreement. Obviously, if the agreement is a meaningless piece of paper, it is not worth paying for. Adherence is not assured because there is no supranational enforcement power.¹⁵² Nor will the politicians necessarily adhere voluntarily to the agreement: On the contrary, once an international trade agreement is in place, politicians themselves face a prisoner's dilemma.¹⁵³ From their perspective, the best outcome occurs if other countries comply with the agreement while they cheat by enacting trade restrictions that violate the agreement.¹⁵⁴ This outcome pleases all domestic interest groups because the producers of exports get the foreign free trade policies for which they paid, and the import-competing producers get the protection that they want (and for which they are willing to pay) as well.¹⁵⁵ Moreover, the worst outcome for domestic politicians occurs if other countries cheat while they comply. This outcome *displeases* all domestic interest groups. Despite the agreement, the domestic producers of exports face foreign trade restrictions; because of the agreement, domestic import-competing producers face competition from foreign imports unaided by legislative protection.

Given this situation, the dominant strategy for domestic politicians trying to maximize their political support is to cheat.¹⁵⁶ If the other country complies, this produces the best outcome; if the other country cheats, it avoids the worst outcome.

The dilemma is that if all countries adopt this dominant strategy of cheating, the outcome is worse for each country than if all countries had complied with the agreement.¹⁵⁷ Mutual cheating is an inferior outcome to mutual compliance, even from a politician's perspective, because of our assumption that the producers of exports (who prefer mutual compliance) are a more powerful interest group than the import-competing producers (who prefer mutual cheating). Also, the global welfare benefits of free trade—for which the politician might be able to claim credit—are lost.

Despite this pessimistic analysis, it is possible in practice for cooperation to emerge and be maintained. This is because international trade is not a single-play game, as discussed above, but rather a game of indefinitely repeated

152. See Sykes, *supra* note 140, at 305.

153. The prisoner's dilemma game has the following payoff structure:

		Country II	
		Cooperate	Defect
Country I	Cooperate	3,3	1,4
	Defect	4,1	2,2

154. See Sykes, *supra* note 140, at 306.

155. See Shell, *supra* note 140, at 862.

156. See Sykes, *supra* note 140, at 307.

157. See *id.*

play.¹⁵⁸ In such an iterated game, players can adopt retaliatory strategies.¹⁵⁹ The best known of these strategies is "tit-for-tat."¹⁶⁰ In this strategy, a player "cooperates" on the first move. On each succeeding move, that player mimics what the other player did in the previous move. If one player knows that the other player has adopted this strategy, then he rationally will adopt the strategy that maximizes the present value of the stream of his future payoffs against this strategy. To the extent that he values a payoff received in the future less than the same payoff received today, he will discount each future payoff in calculating the present value of the stream of future payoffs.¹⁶¹ But as long as he does not discount the future too heavily, the optimal strategy might be cooperation. It will not pay to cheat if the immediate benefit from cheating is outweighed by the discounted costs imposed in the future when the other player retaliates.

In the international trade context, tit-for-tat and other retaliatory strategies work by affecting the balance of political forces in the target country. As noted above, a country is likely to adopt a policy of restricting trade if the domestic interest groups that benefit from such a policy (import-competing producers) are politically more powerful than the domestic groups that are harmed (consumers). Retaliation by another country, if carefully targeted, will cause economic harm to other concentrated interest groups in the target country (producers of exports). Those interest groups then will bring political pressure that might offset the pressure of the interest groups that sought the trade restriction in the first place.¹⁶²

The theory that international cooperation emerges and is maintained through the adoption of retaliatory strategies runs into difficulties in practice. First, the theory assumes that each player is able to interpret the other's moves accurately as either cooperation, defection, or retaliation for a previous defection.¹⁶³ If this determination cannot be made reliably, retaliatory strategies such as tit-for-tat break down.¹⁶⁴ For example, suppose that a treaty obligation is ambiguous. Country *A* takes an action that it believes to be in compliance with this obligation. Country *B*, however, interprets *A*'s action to be a

158. *See id.*

159. *See id.*

160. *See generally* ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984) (discussing computer simulation that utilizes "tit-for-tat" strategy); Robert Axelrod, *The Emergence of Cooperation Among Egoists*, 75 AM. POL. SCI. REV. 308 (1981) (describing cooperative strategy between two interacting players where at each successive stage of action players act reciprocally).

161. *See* AXELROD, *supra* note 160, at 12-13. Players tend to value payoffs less the longer they have to wait to receive them; in addition, they tend to discount future payoffs because of the possibility that the game will not continue to that point. *See id.* at 12. One can take this into account by discounting future payoffs to "present value" by multiplying them by the fraction w^n , where w is the "discount parameter" and n measures the length of time (e.g., number of moves or number of years) until the payoff is obtained. Axelrod gives the following example:

[S]uppose that each move is only half as important as the previous move, making $w = 1/2$. Then a whole string of mutual defections worth one point each move would have a value of 1 on the first move, $1/2$ on the second move, $1/4$ on the third move, and so on. The cumulative value of the sequence would be $1 + 1/2 + 1/4 + 1/8 \dots$ which would sum to exactly 2.

Id. at 13.

162. *See* Davey, *supra* note 3, at 100-01.

163. *See* Abbott, *supra* note 136, at 366.

164. *See* AVINASH K. DIXIT & BARRY J. NALEBUFF, *THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS, AND EVERYDAY LIFE* 109-13 (1991); Sykes, *supra* note 140, at 310.

breach of the treaty. *B* therefore retaliates. *A*, believing that it has complied with the treaty, will view *B*'s action as an unprovoked breach and therefore will retaliate as well. *B*, in turn, will view *A*'s retaliation as another breach and will retaliate again—and so on ad infinitum. In the case of international trade, the result is a “trade war.”

In theory, one can invent “nicer” versions of the tit-for-tat strategy under which this series of echoing retaliations will tend to dampen out over time.¹⁶⁵ In practice, however, it likely will be difficult to solve this problem through the adoption of modified strategies. A better approach might be to develop an institution—a dispute settlement system—to interpret actions as being in compliance or noncompliance with treaty obligations and to sanction retaliations in instances of noncompliance.¹⁶⁶ All treaty countries might find it in their interest to adhere to the determinations of such a system in order to prevent the cooperative equilibrium that results from the use of retaliatory strategies from breaking down under conditions of ambiguity.

A dispute settlement mechanism also could facilitate the convergence of expectations that is necessary for cooperation. In order for a country to calculate whether a cooperative strategy will maximize the discounted present value of its future payoffs, it must understand what strategy the other country has adopted. One difficulty is that there are many different retaliatory strategies that “solve” the iterated prisoner's dilemma.¹⁶⁷ One example other than tit-for-tat is the “grim” strategy, in which a player cooperates on the first move and continues to cooperate on succeeding moves as long as the other player also cooperates.¹⁶⁸ Once the other player defects, however, the first player defects forever after. This multiplicity of potential strategies can impede the convergence of expectations necessary for cooperation. A dispute settlement mechanism can promote this convergence by defining appropriate levels of retaliation for given breaches.¹⁶⁹ The GATT dispute settlement system, for example, deals with this issue in detail.¹⁷⁰

Finally, a dispute settlement system can help to legitimize the use of retaliatory strategies. Unilateral retaliation generally will lack legitimacy. When a government imposes unilateral sanctions, it acts as both prosecutor and judge; the resulting sanctions are more likely to be perceived as the exertion

165. See DIXIT & NALEBUFF, *supra* note 164, at 113–15.

166. See John G. Cross, *Comments on Kovenock and Thursby*, in *ANALYTICAL AND NEGOTIATING ISSUES IN THE GLOBAL TRADING SYSTEM*, *supra* note 35, at 396, 397 (arguing that it may be more efficient to create public organizations to distinguish cooperation from noncompliance than to attempt to develop conditional trade strategies); Dan Kovenock & Marie Thursby, *GATT, Dispute Settlement, and Cooperation*, in *ANALYTICAL AND NEGOTIATING ISSUES IN THE GLOBAL TRADING SYSTEM*, *supra* note 35, at 361, 385 (arguing that dispute settlement procedures serve as monitoring device that distinguishes between true deviations from cooperative agreement and mistaken perceptions or claims that such deviation has occurred); see also Abbott, *supra* note 136, at 366–68 (discussing why international regimes may be better than states at interpreting behavior and defining sanctions).

167. See DAVID M. KREPS, *GAME THEORY AND ECONOMIC MODELLING* 96–99 (1990); Sykes, *supra* note 140, at 308.

168. See KREPS, *supra* note 167, at 97–98; Sykes, *supra* note 140, at 308. One seldom sees the “grim” strategy employed in practice. Because it is completely unforgiving, it does not do well when played against many other strategies. See AXELROD, *supra* note 160, at 35–40 (discussing importance of “forgiveness” in strategies for playing prisoner's dilemma game repeatedly).

169. See Cross, *supra* note 166, at 398.

170. See *Dispute Settlement Understanding*, *supra* note 1, arts. 22–23 (specifying procedures for determining appropriate methods and levels of retaliation).

of power by the stronger country over the weaker rather than as the enforcement of common norms.¹⁷¹

This theory of cooperation describes international trade relations quite well. Countries have frequently employed unilateral retaliatory strategies in their international trade relations. In particular, unilateral trade retaliation has been highly formalized and institutionalized in the United States.¹⁷² American trade law contains several provisions authorizing the President unilaterally to impose trade sanctions against foreign governments. The most important of these provisions is section 301 of the Trade Act of 1974.¹⁷³ Section 301(a) requires the administration to take “mandatory” action in cases in which a foreign government violates an international trade agreement with the United States.¹⁷⁴ Section 301(b) provides for “discretionary” action in cases in which a foreign act, policy, or practice is “unreasonable or discriminatory and burdens and restricts United States commerce” but does not violate any international trade agreement.¹⁷⁵ The statute provides for a range of possible actions,¹⁷⁶ including retaliation. For example, the United States could impose duties or other restrictions on imports of goods or services from the country under investigation.¹⁷⁷ The level of retaliation must “be devised so as to affect goods or services of the foreign country in an amount that is equivalent in

171. See ABRAM CHAYES & ANTONIA H. CHAYES, *THE NEW SOVEREIGNTY: COMPLIANCE WITH INTERNATIONAL REGULATORY AGREEMENTS* 106-08 (1995).

172. In 1984, the European Community adopted a trade retaliation measure similar to the U.S. section 301 measure. See Council Regulation 2641/84 on the Strengthening of the Common Commercial Policy with Regard in Particular to Protection Against Illicit Commercial Practices, 1984 O.J. (L 252) 1. See generally Daniel Partan, *Retaliation in United States and European Community Trade Law*, 8 B.U. INT'L L.J. 333 (1990) (discussing U.S. trade retaliation).

173. Trade Act of 1974 § 301, 19 U.S.C. § 2411 (1994).

174. Specifically, section 301(a) applies when “the rights of the United States under any trade agreement are being denied” or when “an act, policy, or practice of a foreign country . . . violates, or is inconsistent with, the provisions of, or otherwise denies benefits to the United States under, any trade agreement, or . . . is unjustifiable and burdens or restricts U.S. commerce.” 19 U.S.C. § 2411(a)(1).

A section 301 proceeding can be initiated after “interested persons” such as domestic firms and workers, representatives of consumer interests, or U.S. exporters file a petition with the U.S. Trade Representative (USTR). See *id.* § 2412(a)(1). The USTR must then review the petition and determine whether to initiate an investigation. See *id.* § 2412(a)(2). Alternatively, the USTR may begin an investigation on his or her own initiative. See *id.* § 2412(b). After the USTR commences an investigation, he or she must request informal consultations with the foreign government in question. See *id.* § 2413. If these consultations are unsuccessful, or in any case after 150 days, the USTR must invoke the dispute settlement procedures of any trade agreement in question—usually, although not always, the GATT. See *id.* § 2413(a)(2). No later than 18 months after the initiation of the investigation, whether or not the international dispute settlement procedures have concluded, the USTR must determine whether the practice in question violates the legal rights of the United States or otherwise falls within the scope of section 301. See *id.* § 2414. If this determination is in the affirmative, the USTR must, in the case of mandatory action cases, take action in response to the practice, subject to the specific direction of the President. See *id.* § 2415. Even in the case of mandatory actions, however, the statute provides a list of situations in which the USTR is not required to act, such as (in the case of an alleged GATT violation) if the GATT DSB adopts a report finding that the practice does not violate the GATT; if the USTR finds that the foreign country is taking satisfactory measures to conform its practice to the GATT; if it is impossible for the foreign country to take satisfactory measures, but it agrees to provide compensatory trade benefits; if the taking of action would have an adverse impact on the U.S. economy out of proportion to the benefits; or if action would cause serious harm to national security. See *id.* § 2411 (a)(2).

175. See *id.* § 2411(b).

176. Non-retaliatory options include the negotiation of an agreement to eliminate the practice or its harmful effect on U.S. commerce, or, alternatively, to provide compensation to the United States in the form of trade concessions on other goods or services. See *id.* § 2411(c)(1)(D).

177. See *id.* § 2411(c).

value to the burden or restriction being imposed by that country on United States commerce¹⁷⁸—in other words, the statute contemplates a tit-for-tat strategy.¹⁷⁹

Although the practice of unilateral retaliation under section 301 has been widely criticized,¹⁸⁰ several studies have concluded that, as the theory described above predicts, section 301 has been reasonably successful in opening foreign markets and has made a positive contribution to moving the global trading system toward significant reforms.¹⁸¹ At the same time, however, the unilateral use of retaliation has led to considerable international dissatisfaction. By the time of the Uruguay Round, many countries perceived a need to bring unilateral retaliation under the control of a stronger dispute settlement mechanism. This is widely believed to have been the principal reason why many countries that traditionally had opposed legalistic trade dispute settlement ultimately agreed to support the Uruguay Round reforms to the GATT dispute settlement process.¹⁸²

In particular, prior to the Uruguay Round reforms, the GATT dispute settlement system was weak because it required consensus at each step: formation of a panel, adoption of the panel report by the contracting parties, and authorization of retaliation. A losing country that was unwilling to redress its violation of the GATT would block consensus at some stage before retaliation was authorized. As a result, the pre-Uruguay Round GATT dispute settlement system authorized retaliation only once in its history, in 1955.¹⁸³ In the Uruguay Round, U.S. negotiators argued that the U.S. Congress would continue to insist on a policy of unilateral retaliation against “unfair” trade practices unless the GATT had a legal enforcement procedure that met U.S. standards of effectiveness.¹⁸⁴ Faced with the alternative of continued use of unilateral

178. *See id.* § 2411(a)(3).

179. In addition, two provisions of the Trade Act of 1974 require the administration to self-initiate section 301 investigations in certain cases. “Special 301” requires the U.S. Trade Representative (USTR) to identify “priority foreign countries” that deny “adequate and effective protection of intellectual property rights” and that are not making progress to eliminate the problem. *See id.* § 2242. After identifying those countries, the USTR must self-initiate section 301 investigations unless he or she determines that doing so would be detrimental to U.S. economic interests. *See id.* § 2412(b)(2). Finally, “Super 301” requires the USTR to identify “priority foreign country practices, the elimination of which is likely to have the most significant potential to increase U.S. exports.” *See id.* § 2420 (a)(1)(b). The USTR is then required to self-initiate section 301 investigations with respect to all identified priority foreign country practices. *See id.* § 2420(b).

180. Critics have argued that the bypassing of multilateral procedures will undermine the long-term sustainability of the GATT system. They also argue that section 301 will result in market closing rather than market opening because if section 301 threats fail, the resulting U.S. retaliation will result in increased protection and, moreover, might trigger foreign counterretaliation, resulting in further protection. They also argue that the threat of unilateral retaliation against a foreign country is likely to result in bilateral agreements that discriminate in favor of the United States; that is, governments in the targeted country will divert trade from other countries to the United States, keeping total imports steady, rather than genuinely liberalizing trade. Finally, they argue that the ability of export-oriented interests to achieve their market-opening objectives through aggressive unilateralism reduces the incentives for these interests to oppose protectionist measures in order to promote free trade. *See, e.g.,* THOMAS O. BAYARD & KIMBERLY ANN ELLIOT, RECIPROCITY AND RETALIATION IN U.S. TRADE POLICY 53–55 (1994) (criticizing aggressive unilateral action).

181. *See id.*; Alan O. Sykes, *Constructive Unilateral Threats in International Commercial Relations: The Limited Case for Section 301*, 23 LAW & POL’Y INT’L BUS. 263 (1992).

182. *See* HUDEC, *supra* note 9, at 237, 362; Shell, *supra* note 140, at 898–99.

183. *See supra* note 23.

184. *See* HUDEC, *supra* note 9, at 237; *Transcript of Discussion Following Presentation by*

retaliation by the United States, governments that would have preferred a more voluntary adjudication system apparently became persuaded that a more legalistic GATT dispute settlement system was the lesser of two evils.¹⁸⁵

B. *Retaliatory Strategies in the International Tax Regime*

Section A analyzed how international trade can be viewed as a prisoner's dilemma, how the use of retaliatory strategies can lead to cooperative outcomes, and how the need to manage these strategies can lead to the adoption of legalistic dispute settlement mechanisms. One now must examine whether a similar analysis applies to the international tax regime.

Under generally accepted principles of international taxation, countries assert jurisdiction to tax income on the basis of both the residence principle and the source principle.¹⁸⁶ Under the residence principle, a country is entitled to tax its nationals and residents on their worldwide income.¹⁸⁷ Under the source principle, a country is entitled to tax nonresidents on the income they derive from sources within the country.¹⁸⁸ High or discriminatory source-based taxation of nonresidents can act as a barrier to foreign trade and investment. Tax treaties therefore facilitate international trade and investment by limiting source-based taxation in several ways.¹⁸⁹

First, they limit the tax rates that source countries may impose on cross-border payments of investment income, such as dividends, interest, and royalties, to nonresidents.¹⁹⁰ They also prohibit source countries from taxing the income of foreign enterprises that do not maintain a substantial presence, in the form of a "permanent establishment," in the source country.¹⁹¹ Second, tax treaties prohibit source countries from imposing discriminatory taxes on nonresidents.¹⁹² This nondiscrimination rule restricts the use of source-based taxes to favor domestic enterprises over foreign enterprises. It also indirectly constrains the overall level of source-based taxation. Given the nondiscrimination rule, a source country that wants to impose high income taxes on foreign-

Kenneth W. Abbott, 1992 COLUM. BUS. L. REV. 151, 154 (remarks of Robert E. Hudec).

185. See HUDEC, *supra* note 9, at 237; Andreas F. Lowenfeld, Note, 89 AM. J. INT'L L. 663 (1995) (reviewing HUDEC, *supra* note 9).

The Dispute Settlement Understanding requires GATT members to pledge that they will pursue claims of violation and/or nullification and impairment exclusively through the multilateral dispute settlement procedures. See Dispute Settlement Understanding, *supra* note 1, art. 21. The U.S. Congress has explicitly provided, however, that the Uruguay Round Agreements do not preempt section 301 of the Trade Act of 1974 as a matter of municipal law. See Uruguay Round Agreement Act § 102(a)(1), (a)(2)(B), 19 U.S.C. § 3512(a)(1), (a)(2)(B) (1994).

186. See RESTATEMENT, *supra* note 26, at 258 (noting broad international consensus on law of jurisdiction to tax); FEDERAL INCOME TAX PROJECT, *supra* note 26, at 5 (noting general acceptance of these two principles as bases for jurisdiction).

187. See RESTATEMENT, *supra* note 26, § 412(1)(a). In the case of the United States, see I.R.C. § 61(a) (1994), which defines gross income to mean all income "from whatever source derived."

188. See RESTATEMENT, *supra* note 26, § 412(1)(b)-(c); FEDERAL INCOME TAX PROJECT, *supra* note 26, at 5. In the case of the United States, see I.R.C. § 871 (1994), which imposes a tax on nonresident alien individuals; *id.* § 881, which places a tax on the income of foreign corporations not connected with a U.S. trade or business; and *id.* § 882, which imposes a tax on the income of foreign corporations connected with a U.S. trade or business.

189. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 2, 9-10.

190. See *id.* at 9.

191. See *id.* at 10.

192. See *id.* at 11; *supra* notes 42-45 and accompanying text.

owned enterprises must impose equally high income taxes on domestically owned enterprises; in doing so, however, it will be constrained by the political power of the domestic owners. Third, tax treaties coordinate the domestic tax systems of the two treaty countries to eliminate the trade- and investment-restricting double taxation that would occur if the countries were to make inconsistent determinations of the residence of a taxpayer or the source of an item of income.¹⁹³

Section A began with the proposition of international trade economics that a government that seeks to maximize national economic welfare generally will choose, on a unilateral basis, not to impose tariffs or other trade restricting measures. Just as international trade economists have analyzed the design of optimal trade policies, tax economists have studied the design of optimal tax policies. There is a significant difference between the trade context and the tax context, however. Reducing tariffs and other trade barriers to zero is a feasible objective, but reducing all taxes to zero is not because governments must raise revenue somehow. The question, then, is how to design a tax system that raises the required revenue with the least distortion of the economy. Although zero taxation is not possible in general, there is a rule of "optimal" international taxation that holds that if capital is fully mobile internationally, a small, open economy should not impose any source-based taxes on the income from capital; that is, such taxes are always unnecessarily distortionary.¹⁹⁴

A country following this prescription would not impose any withholding taxes on cross-border flows of income. Moreover, it would refrain not merely from imposing discriminatory internal income taxes on foreign-owned firms (as required by most tax treaties) but would refrain from imposing *any* internal income taxes on such firms.¹⁹⁵ A fortiori, a country following this optimal tax prescription would have no incentive to violate tax treaty restrictions on source-based taxation.

The underlying reason for this optimal tax rule is that if capital is fully mobile internationally, a source-based income tax cannot have the effect of reducing the after-tax return to capital invested in the country. If it did, investors would transfer their funds elsewhere and continue to earn the world rate of return. Similarly, a source-based income tax cannot raise the price of goods produced by firms in the source country, assuming that there is competition from goods produced abroad and exported to the source country. Thus, the burden of the tax will not be borne by suppliers of capital or by consumers. Instead, it will fall on the suppliers of relatively immobile factors of production, such as labor and land, in the host country. In economic equilibrium, the wages and rents earned by these individuals will drop by enough to compensate the firms for the tax payments. But if domestic laborers and landowners will bear the burden of the tax in any case, it would be preferable to tax these individuals directly by using some form of residence-based tax, such as an in-

193. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 5-9.

194. See SLEMROD, *supra* note 35, at 12; Roger H. Gordon, *Can Capital Income Taxes Survive in Open Economies?*, 47 J. FIN. 1159, 1159 (1992); Joel Slemrod, *Tax Cacophony and the Benefits of Free Trade*, in 1 FAIR TRADE AND HARMONIZATION 284, 300 n.2 (Jagdish Bhagwati & Robert E. Hudec eds., 1996).

195. If government expenditures produce services that benefit foreign-owned firms, however, the country should charge those firms for the marginal costs they impose. The charge would be based on costs imposed rather than income earned. See Gordon, *supra* note 194, at 1163.

come or wage tax imposed on residents, or a real estate tax. Such taxes would have the same effect as source-based income taxes in terms of who ultimately bears the burden, but they would be less distortionary because they would not discourage investment in the country.¹⁹⁶ Therefore, they represent the “optimal” tax policy in the sense described above. Many countries adopt this optimal tax policy in the case of portfolio interest payments made to nonresidents, unilaterally exempting such payments from source-based taxation in the realization that the economic burden of such taxation would be borne by resident debtors rather than by nonresident debt holders.¹⁹⁷

Thus, optimal tax theory yields the strong prescription that governments should not impose any source-based income taxes. Countries generally do not follow this prescription, however.¹⁹⁸ If the idealized economic assumptions underlying the optimal tax model are relaxed and if additional complications are introduced, one can find a number of reasons why governments might want to impose nonzero source-based income taxes and why they even might want to violate tax treaty rules restricting such taxes.

First, the optimal tax model discussed above assumes that capital is fully mobile internationally. There is considerable empirical evidence, however, suggesting that capital is quite immobile internationally.¹⁹⁹ If capital is immobile internationally, a tax on the income from capital invested in a source country will not be shifted fully to other factors of production in the source country, such as labor and land; therefore, capital-importing countries might find it attractive to tax such income.²⁰⁰ Similarly, a country large enough to have market power with respect to imported capital can increase its national economic welfare by imposing a nonzero tax on the income from foreign capital invested in the country.²⁰¹ This is analogous to the nonzero “optimal tariff” in international trade theory.²⁰² International trade economists generally consider the optimal tariff to be theoretically interesting but to have lit-

196. See Slemrod, *supra* note 194, at 307 n.2; see also Gordon, *supra* note 194, at 1161 (stating that such taxes cause less distortion); Lawrence H. Summers, *Comments on Joel Slemrod, Effect of Taxation with International Mobility*, in *UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX* 148, 149–55 (Henry J. Aaron et al. eds., 1988) (discussing Slemrod’s analysis and effects of taxation).

197. See, e.g., I.R.C. § 871(h) (1994) (repealing tax on interest of nonresident alien individuals received from certain portfolio debt investments); *id.* § 881(c) (repealing tax on interest of foreign corporations received from certain portfolio debt investments).

198. See SLEMROD, *supra* note 35, at 9 (observing that optimal tax theory has not prevented source-based taxation of capital income from being international norm); Slemrod, *supra* note 194, at 306 (noting that “[t]here is no convincing evidence that world tax systems are moving toward harmonization at a zero capital income tax rate or any other uniform rate”).

199. For a summary of this evidence and a discussion of possible explanations, see Roger H. Gordon & A. Lans Bovenberg, *Why Is Capital So Immobile Internationally? Possible Explanations and Implications for Capital Income Taxation*, 86 AM. ECON. REV. 1057, 1057–60 (1996).

200. See *id.* at 1058. Gordon and Bovenberg argue, however, that the immobility of capital can best be explained by asymmetric information between investors in different countries. The surprising result of their analysis is that a capital-importing country should subsidize rather than tax capital imports—the opposite of standard practice, at least in developed countries. See *id.* at 1070–73.

201. See Gordon, *supra* note 194, at 1163–64; Joel Slemrod, *Effect of Taxation with International Capital Mobility*, in *UNEASY COMPROMISE*, *supra* note 196, at 115, 133–35; Summers, *supra* note 196, at 151.

202. For a large country, there is an “optimal tariff” at which the marginal gain from improved terms of trade just equals the marginal efficiency loss from production and consumption distortion. See KRUGMAN & OBSTFELD, *supra* note 140, at 231–32; see also Slemrod, *supra* note 194, at 307 n.2.

tle or no practical significance.²⁰³ Tariffs are explained much better by public choice theory than by the existence of national market power in world markets. To some extent, however, national market power in capital markets might explain observed levels of source-based taxation.²⁰⁴

Second, foreign firms might be able to earn location-specific economic rents on their investment in the source country. The source country then could tax those rents without causing the firms to disinvest, again making source-based taxation attractive.²⁰⁵

Third, some residence countries, including the United States, relieve international double taxation by employing foreign tax credit systems. That is, they allow their residents a credit against their domestic tax liability for the foreign income taxes they pay on their foreign source income. If an investor's residence country were to employ such a system, a source country's income tax would be borne, at least up to a point, by the residence country's treasury.²⁰⁶ This would be the clearest situation in which a country could impose a source-based tax without restricting investment.²⁰⁷

In conclusion, the economic burden of source-based taxation undoubtedly falls to some extent on immobile factors such as labor in the source country, as optimal tax theory predicts, and to some extent on foreign investors and foreign governments, as refinements to the theory suggest. To the extent that the burden of source-based taxation falls on foreign investors and foreign governments, such taxation succeeds in increasing national eco-

203. KRUGMAN & OBSTFELD, *supra* note 140, at 232 (stating that, in practice, "optimal tariff" argument is emphasized more by economists as theoretical proposition than it is used by governments as justification for trade policy).

204. See Gordon, *supra* note 194, at 1163-64 (discussing this possibility, but noting that it does not fully explain observed patterns of source-based taxation).

205. See *id.* at 1163; Charles E. McLure, Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm*, 45 NAT'L TAX J. 145, 148-49 (1992). Taken to its logical conclusion, however, this possibility suggests that countries should not employ income taxes at all. See Gordon, *supra* note 194, at 1163. Income taxes tax not only economic rents but also the normal return to capital and thus discourage investment in the host country. If countries wanted to tax foreign firms without restricting investment, they would have to employ cash-flow taxes instead of income taxes. Cash-flow taxes allow the immediate deduction of all business-related expenditures, including purchases of depreciable property and other expenditures that, under an income tax, must be capitalized and depreciated or amortized over several years. The cash-flow tax does not tax the return to marginal investments but only the return to inframarginal investments (economic rents) and thus does not discourage investment. The income tax does tax the return to marginal investments as well as the return to inframarginal investments and thus discourages investment. See McLure, *supra*, at 145-50.

206. See Slemrod, *supra* note 201, at 128-31; Summers, *supra* note 196, at 150-51.

207. See Slemrod, *supra* note 201, at 128. For example, the fact that the United States maintains a foreign tax credit system probably accounts, at least historically, for Canada's employment of a source-based income tax at about the same rate. See Robin Boadway, *Corporate Tax Harmonisation: Lessons from Canada*, in BEYOND 1992: A EUROPEAN TAX SYSTEM (PROCEEDINGS OF THE FOURTH IFS CONFERENCE) 52, 54 (Malcolm Gammie & Bill Robinson eds., 1989) (noting that as long as United States allows foreign tax credit on corporate taxes paid by subsidiaries abroad, "Canada would be foolish not to tax these firms on an origin basis and up to the limit of the allowable credit"). More generally, Professor Gordon has used game theory to argue that the United States's dominance as a capital exporting country during much of the postwar period and its maintenance of a foreign tax credit system might have contributed to the survival of a nonzero equilibrium level of source-based income taxation in spite of the international mobility of capital. See Gordon, *supra* note 194, at 1160. This cannot be a complete explanation for the existence of source-based income taxes, however. Many residence countries employ exemption systems rather than foreign tax credit systems. See Slemrod, *supra* note 201, at 129. Moreover, even where the residence country does employ a foreign tax credit system, that system is unlikely fully to offset the source country's taxes on account of other features of the tax system such as deferral and limitations on the foreign tax credit.

conomic welfare because it transfers revenue from foreign investors and governments to the source country's treasury—assuming, for the moment, that the behavior of other countries is taken as given. But even to the extent that the burden of source-based taxation falls on the source country's residents, such taxation still might appeal to the source country's politicians.

First, source-based taxation of foreign firms generally is not investment-restricting *in the short run*—foreign direct investment tends to be fixed in the short run. Foreign firms generally cannot instantly move their physical investments from one country to another in response to tax changes. Politicians therefore can tax the income from such investment and have the burden fall on the foreign firms or on foreign treasuries in the short run. In the long run, however, foreign investment will adjust to the taxes: The burden of the tax will shift to the suppliers of immobile factors of production in the host country, and the investment distortions induced by the tax will reduce economic welfare in the host country. The question, then, is whether the discounted future costs exceed the present benefits. Even if they do not from the perspective of a country's residents, they might from the viewpoint of a politician, who might discount the future heavily because of the short time between elections or because of the difficulty of claiming credit for long-term growth.

Moreover, politicians often desire to create fiscal illusion; that is, to increase government revenues at no *apparent* cost to voters. High taxation of foreign firms, even if it is ultimately investment-restricting, can achieve this goal. Although the economic incidence of the tax will fall on domestic residents in the long run, the mechanism by which this occurs will be opaque to most taxpayers, and the tax will appear to be borne both economically and legally by foreign firms.

These considerations explain why politicians might have incentives to impose high, discriminatory source-based taxes on foreign and foreign-owned firms. As in the international trade context, these incentives can lead to a prisoner's dilemma situation: The politicians in each country have an incentive to use high, discriminatory, source-based taxes to appropriate revenue from residents of the other country or from the other country's treasury. But if both nations follow this strategy, the result might be worse for both than if they had "cooperated" and confined their source-based taxes to normal, nondiscriminatory levels. The two countries will end up simply appropriating revenue from one another. Their mutually predatory strategies could cancel each other out if capital flows are roughly equal in the two directions. But these strategies, however, also would restrict international trade and investment and impose potentially high enforcement and compliance costs, resulting in a net loss to the welfare of both countries.

Although similar prisoner's dilemma outcomes manifest themselves in the international trade and tax regimes, the political incentives that lead to these outcomes are very different in the two contexts. As discussed in Section A, politicians have an incentive to support tariffs and other import restrictions because they redistribute income from consumers to an organized interest group: the domestic producers of products that compete with the imports being restricted. In contrast, when countries break tax treaty rules restricting source-based taxation, the violation typically will not occur because of domestic interest group pressures. Unlike the case of trade restrictions, the

distributional effects of income tax or other measures that restrict foreign direct investment are complicated and imperfectly understood.²⁰⁸ A very simple model of inward foreign direct investment suggests that such investment redistributes income from domestic owners of capital as a group to domestic labor as a group.²⁰⁹ Compared to international trade restrictions, however, international tax rules that restrict inward foreign direct investment are unlikely to have an impact that falls overwhelmingly on one narrowly defined industry. Thus, both industry and labor groups are likely to experience collective action problems when it comes to lobbying for or against international tax rules that violate tax treaties. This is not to say that international tax rules that restrict inward foreign direct investment do not sometimes result from specific lobbying by specific industries,²¹⁰ but it does suggest that industries are much less likely to seek protection through international tax measures than through measures that more directly relate to international trade.

Rather than occurring in response to narrow interest group pressures, tax treaty violations tend to result from politicians' incentives to raise revenue from foreigners (as discussed above) or from domestic residents in a way that hides the true cost of the policy. The violations that result from these incentives are likely to be much broader than the targeted violations of trade agreements that occur in response to concentrated interest group pressure.

This feature of tax treaty violations has two important implications for international cooperation in the tax regime. First, the employment of retaliatory strategies is likely to be much less suitable as a means of achieving and maintaining cooperation in the tax context than in the trade context. In the trade regime, trade agreement violations generally will be focused narrowly to protect a single industry, and retaliatory strategies typically will focus on another single industry, which will respond by bringing countervailing pressure on its government to cease the violation. In the tax context, rules generally have broad applicability; moreover, tax treaty violations generally will be designed to raise as much revenue as possible and therefore will tend to affect a broad spectrum of foreign and foreign-owned firms. Other countries are likely to find it difficult to devise narrowly targeted retaliatory strategies that will create domestic interest group pressure in the first country sufficient to offset this generalized desire to raise revenue. Other countries might succeed if they were to employ broad-based retaliatory strategies, but the risks would be very high compared to the risks of employing targeted retaliatory strategies in the trade context.²¹¹ Thus, one

208. See RICHARD E. CAVES, *MULTINATIONAL ENTERPRISES AND ECONOMIC ANALYSIS* 131-59 (2d ed. 1996) (discussing effects of foreign direct investment on income distribution and labor relations from both theoretical and empirical perspectives); see also Edward M. Graham, *Government Policies Towards Inward Foreign Direct Investment: Effects on Producers and Consumers*, in *MULTINATIONAL ENTERPRISES IN THE WORLD ECONOMY* 176, 192-93 (Peter J. Buckley & Mark Casson eds., 1992) (discussing effects of closed direct investment policies on home-based firms).

209. See CAVES, *supra* note 208, at 111.

210. Of course, tax rules that directly affect specific domestic industries (as opposed to tax rules that are directed at foreign investment) are very often the result of just such lobbying. See, e.g., JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM* (1987); Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 *MINN. L. REV.* 913 (1987).

211. As reported by the Federal Income Tax Project:

would not expect retaliatory strategies to be used frequently in the tax context.

Second, the employment of retaliatory strategies is likely to be much less necessary as a means of achieving and maintaining cooperation in the tax context than it is in the trade context. A government contemplating a tax treaty violation will know that its violation will have broad-based effects on foreign interests, and it will also know that if other governments retaliate, the retaliation similarly will have broad-based effects on the first country. Violating a tax treaty therefore will be a very high-stakes gamble. Given the risks, politicians will likely resist the incentives to violate the treaty in the first place rather than giving in to the incentives, violating the treaty, and seeing whether retaliation actually occurs.²¹²

The empirical evidence supports this conclusion: It is extremely rare for countries to retaliate in response to tax treaty violations.²¹³ The United States's tax law does contain provisions authorizing retaliation against foreign countries whose income tax systems discriminate against U.S. citizens or corporations. Section 891 of the Internal Revenue Code authorizes the President to double the taxes imposed on citizens or corporations of foreign countries that subject U.S. citizens or corporations to "discriminatory or extraterritorial taxes."²¹⁴ In addition, section 896(b) empowers the President by proclamation to adjust effective tax rates on citizens, residents, or corporations of foreign countries that subject U.S. citizens or corporations to "a higher effective rate of tax" than their own citizens or corporations.²¹⁵ Neither of these provisions has ever been used.²¹⁶

There is one instance in which the United States used section 301 to retaliate against a Canadian income tax provision.²¹⁷ In 1976, Canada enacted a

While a partial termination [of a tax treaty] in response to a material breach is in theory possible, there is no reported instance in which this has been done with respect to an income tax treaty. Treaty partners have been understandably reluctant to take this action in light of the potentially disruptive effects on such terminations on the settled pattern of international tax relationships.

FEDERAL INCOME TAX PROJECT, *supra* note 26, at 75; *see also* OECD Comm. on Fiscal Affairs, *supra* note 127, ¶ 34 ("Member countries have so far refrained from taking retaliatory measures (which all agree would not be conducive to better understanding in the international tax field) against overriding legislation.").

212. The above analysis has focused on tax treaty rules that restrict source-based taxation. As noted, tax treaties also contain rules that coordinate the domestic tax systems of the two treaty countries to eliminate double taxation. These treaty rules are also likely to be relatively stable without the need for retaliatory strategies since they represent a solution to a coordination game. *See, e.g.*, Abbott, *supra* note 136, at 371-74 (discussing coordination games played between states). Once players agree on a rule of coordination, departing from it is likely to entail high costs. *See id.* at 373-74 (noting that "[o]nce a coordination regime is established, it will . . . tend to be self-enforcing; normally, a state can only hurt itself by deviating from the agreed solution").

213. *See supra* note 211.

214. I.R.C. § 891 (1994). For a brief history of this provision, *see* Derek Devgun, *International Fiscal Wars for the Twenty-First Century: An Assessment of Tax-Based Trade Retaliation*, 27 LAW & POL'Y INT'L BUS. 353, 357-58 (1996).

215. *See* I.R.C. § 896(b) (1994). Devgun also provides history on this portion. *See* Devgun, *supra* note 214, at 358.

216. *See* Devgun, *supra* note 214, at 358.

217. *See id.* at 356-57 (discussing incident); Andrew L. Stoler, *The Border Broadcasting Dispute: A Unique Case Under Section 301*, 6 INT'L TRADE L.J. 39 (1981) (same). *See generally* Cynthia S. Chegwidden, *Treasury Supports Tax Retaliation Against Canada*, 15 Tax Notes (Tax Analysts) 692 (May 24, 1982).

provision that denied an income tax deduction for the cost of advertising paid to U.S. television and radio broadcasting stations located near the U.S.-Canada border for advertising aimed primarily at the Canadian market.²¹⁸ A group of U.S. television licensees petitioned for a section 301 investigation of this measure, which the United States Trade Representative (USTR) initiated.²¹⁹ After consultations between the U.S. and Canadian governments failed to lead to a mutually acceptable solution,²²⁰ the President determined that the Canadian tax measure was unreasonable and burdened and restricted U.S. commerce within the meaning of section 301, and that the most appropriate response was to propose legislation to Congress that would mirror the Canadian measure in U.S. law.²²¹ Congress enacted the proposed legislation in 1984,²²² but this instance of tax retaliation has been a conspicuous failure. The retaliation was intended to pressure Canada to repeal its tax measure, but instead both the discriminatory Canadian provision²²³ and the discriminatory U.S. response²²⁴ remain in place. It seems plausible that retaliatory strategies were used in this case precisely because the income tax measure in question was directed at a specific industry. Thus, this isolated occurrence does not suggest that retaliatory strategies are likely to be employed in the common case where the tax measure is one of general applicability.

A more widely publicized instance of threats of income tax retaliation occurred between the United Kingdom and the United States over California's worldwide unitary income tax system.²²⁵ California requires enterprises to allocate a portion of their total income to California using a formula based on the proportion of the firm's total property, payroll, and sales located in the state.²²⁶ California combines this formula apportionment with "unitary" taxation. That is, it requires a group of corporations under common control and engaging in interdependent operations to file a combined report. It then uses formula apportionment to allocate a fraction of the group's combined income to California. This unitary taxation is applied on a worldwide basis; that is, foreign as well as domestic affiliates must be included in the combined report. A number of foreign countries have strongly opposed the use of worldwide unitary taxation as a method of determining the local taxable income of foreign-based multinational enterprises, principally on the grounds that it can re-

218. An Act to Amend the Income Tax Act, July 16, 1976, ch. 106, § 3, 1974-1975-1976 S.C. 2145 (Can.) (amending Income Tax Act by adding section 19.1).

219. See Office of the Special Representative for Trade Negotiations, 43 Fed. Reg. 39,617 (1978).

220. See Determination Under Section 301 of 1974, 45 Fed. Reg. 51,173 (1980).

221. See Presidential Determination Under Section 301 of the Trade Act of 1974: Memorandum for the United States Trade Representative, 45 Fed. Reg. 51,173 (1980).

222. Trade and Tariff Act of 1984 § 232, Pub. L. No. 98-573, 98 Stat. 2948, 2991 (amending I.R.C. § 162(j) to deny income tax deductions for costs of advertising primarily aimed at U.S. audiences and placed on broadcast stations located in foreign country if similar deduction under income tax law of that country is denied for advertising principally aimed at its audience and placed on U.S. broadcasting stations).

223. Income Tax Act, R.S.C., ch. 1 (5th Supp.), § 19.1 (1985) (Can.).

224. I.R.C. § 162(j) (1994).

225. See Devgun, *supra* note 214, at 366-72; Doernberg, *Overriding Tax Treaties*, *supra* note 127, at 128-30.

226. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES* ¶ 8.10(1), at 8-66 (2d ed. 1993).

sult in double taxation of income and that it imposes heavy administrative burdens on foreign taxpayers.²²⁷

The United Kingdom, in particular, has been active since the 1970s in opposing California's worldwide unitary income tax system.²²⁸ In 1985, Parliament enacted legislation that authorized retaliation against corporations not resident in the United Kingdom that maintained a "qualifying presence" in a "unitary state" as identified by the U.K. Treasury.²²⁹ This retaliation was to be effected principally by unilaterally withdrawing certain tax credits that would otherwise be due to the corporations in question under U.K. tax treaties.²³⁰ In May 1993, the U.K. government set in motion the procedures to designate California as a unitary state.²³¹ In June 1993, the Inland Revenue wrote to major U.S. corporations with subsidiaries in the United Kingdom as well as directly to those subsidiaries, requesting information that presumably would be used in connection with the threatened retaliation.²³² This crisis was defused without the retaliatory legislation being put into effect when California enacted and then broadened a "water's edge" election that permitted foreign taxpayers to limit state taxation to income arising within U.S. borders.²³³ It is not clear how instrumental the British threats of retaliation were in bringing about these changes in California law; perhaps California would have changed its law in any case.

This incident does indicate the potential for using retaliatory strategies in response to general tax measures. It is also possible that there are other, less publicized cases in which countries have employed retaliatory tax strategies.²³⁴

227. For example, the governments of Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom filed amici briefs in support of Barclays Bank in its Supreme Court cases challenging California's worldwide unitary tax system. *See Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 324 n.22 (1994).

228. For a brief discussion of the United Kingdom's unsuccessful efforts in the 1970s and 1980s to negotiate an income tax treaty with the United States barring the use of worldwide unitary taxation and to lobby Congress to enact legislation having the same effect, see Devgun, *supra* note 214, at 368-70.

229. Finance Act, 1985, § 54 & sched. 13 (U.K.), *reenacted as* Income and Corporation Taxes Act, 1988, ch. 1, §§ 812-815 (U.K.). *See generally* Stephen E. Fiamma, *U.K. Retaliation Against Unitary Taxation*, 28 Tax Notes (Tax Analysts) 1137 (Sept. 2, 1985) (providing overview of act's provisions and discussing its effects).

230. *See* Income and Corporation Taxes Act, 1988, ch. 1, § 812(1) (U.K.). In response to this threatened treaty override, Senator Max Baucus introduced legislation in the Senate that would have imposed federal income tax sanctions on corporations of a foreign country that used legislation designed to retaliate against U.S. states' use of worldwide unitary taxation. *See* 131 CONG. REC. 31,327 (daily ed. Nov. 12, 1985) (statement of Sen. Baucus).

231. *See* Alison Smith & Andrew Jack, *UK Warns on Unitary Tax*, FIN. TIMES (London), May 14, 1993, at 6.

232. *See* Julianne MacKinnon, *Inland Revenue Warns U.S. Multinationals of Unitary Method Retaliation*, 6 Tax Notes Int'l (Tax Analysts) 1501, 1501 (June 21, 1993); John Turro, *U.K. Inland Revenue Informs U.S. Firms' Subs About Retaliatory Legislation*, 7 Tax Notes Int'l (Tax Analysts) 20, 20 (July 5, 1993).

233. *See generally* Eric J. Coffill, *A Kinder, Gentler "Water's Edge" Election*, 7 Tax Notes Int'l (Tax Analysts) 1049 (Oct. 25, 1993) (summarizing bill's provisions and outlining events leading to its passage).

234. Professor Roin notes that U.S. congressional overrides of tax treaty obligations could be viewed as a tit-for-tat response by the United States to earlier treaty violations committed by treaty partners, such as the adoption of integrated tax systems that discriminate against U.S.-owned firms. *See* Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1758 n.16 (1995). If so, this is certainly a much less explicit form of retaliation than that which occurs in the trade context.

This is particularly so since tax negotiations are often carried out between tax officials who communicate directly with one another in secrecy. There would have to be a considerable number of such unpublicized cases, however, for international tax to come close to international trade in the frequency of resort to retaliatory strategies. It is also possible that countries have employed enforcement-based retaliatory strategies. Governments can use otherwise neutral tax laws as a means of discriminating against foreign firms by targeting those firms for aggressive auditing and enforcement. Many observers suspect that this has happened in the case of transfer pricing regulation.²³⁵ The United States has implemented a rigorous set of transfer pricing regulations, enacted severe penalties for noncompliance, and stepped up enforcement against foreign and foreign-owned firms engaging in business in the United States. Other countries apparently have perceived these actions as an attempt by the United States to grab revenues from foreign treasuries, and they have reacted by threatening to adopt (or by actually adopting) similar measures in retaliation.²³⁶ It is difficult to determine how widespread enforcement-based tax discrimination and retaliation are since it is difficult to distinguish between discriminatory enforcement and the normal use of a tax agency's broad enforcement discretion to focus on cases in which it believes it can obtain the most revenue. For the same reason, it would be difficult for a legalistic dispute settlement system to deal effectively with disputes involving allegations of discriminatory enforcement.

In conclusion, the available evidence strongly suggests that the use of retaliatory strategies in the tax area, although not unheard of, is extremely rare. Thus, there does not appear to be a strong argument for including legalistic dispute settlement procedures in tax treaties if the purpose of these procedures is to manage retaliatory strategies.

Rather than stopping here, however, one must consider the alternative of covering at least some income tax measures (such as discriminatory measures) under trade agreements, as trade negotiators from virtually all countries except the United States wanted during the Uruguay Round negotiations. This alternative to including legalistic dispute settlement procedures in tax treaties would create an explicit linkage between tax treaty obligations and trade agreement obligations and possibly expand the scope of possible retaliation. For example, one country could retaliate against another country's discriminatory tax measure by raising a tariff on one of the second country's exports. This strategy would facilitate more narrowly targeted retaliation, which might make retaliatory strategies more effective in maintaining compliance with tax

235. For a brief discussion of transfer pricing regulation, see *supra* notes 89-91 and accompanying text.

236. See Sunghak Andrew Baik & Michael Patton, *Japan Steps Up Transfer Pricing Enforcement: Joins the APA Fray*, 11 *Tax Notes Int'l (Tax Analysts)* 1271, 1271 (Nov. 13, 1995) (noting that "[m]any observers have commented that [Japan's new transfer pricing] policy's real objective was to go after foreign-affiliated companies active in Japan as a form of 'retaliatory taxation' vis-à-vis the U.S. section 482 regulations"); Haroldene F. Wunder & Stephen R. Crow, *International Tax Reform Since 1986: An Update*, 14 *Tax Notes Int'l (Tax Analysts)* 1163, 1165 (Apr. 7, 1997) (noting that "more than one country . . . threatened conformity as a retaliatory measure" in response to new U.S. transfer pricing standards and penalties, which "were seen by the retaliatory country as a way for the United States to transfer funds from a competing national treasury").

treaty obligations. There are several potential problems with this approach, however.

First, this tactic raises issues of institutional competence. A traditional concern of GATT pragmatists has been that countries would bring GATT complaints that presented issues beyond the decisionmaking capacity of the panel procedure, resulting in bad decisions with which members would not comply.²³⁷ The DISC case, in which a panel found that European territorial tax systems as well as the U.S. DISC legislation violated GATT obligations, is often cited as the classic example of such a case.²³⁸

If income tax disputes were added to the WTO's agenda, however, there is no reason why the WTO could not develop the necessary competence. At the panel stage, the GATT Secretariat could propose international tax experts as panel members. It also could retain international tax experts, on either a permanent or an ad hoc basis, to provide legal assistance to the panel.²³⁹ If the dispute progressed to the Appellate Body, the problem of institutional competence would be more difficult to solve. The Appellate Body has only seven members; appeals are heard by panels consisting of three of the members. It is highly unlikely that any members of the Appellate Body would be experts in international taxation.²⁴⁰ As at the panel stage, however, the GATT Secretariat could provide the Appellate Body with the assistance of international tax experts. In any case, the GATT increasingly will have to deal with disputes that raise issues outside its traditional core competence—for example, issues raised by the new Uruguay Round agreements on product standards, services, trade related investment measures, and intellectual property. Moreover, this problem is not peculiar to the international trade context. Many international as well as national judicial bodies have to decide cases in complex areas in which the judges lack subject matter expertise.²⁴¹ The parties then have the responsibility to educate the judges.

A more serious difficulty with permitting trade retaliation against breaches of tax obligations involves the problem of legitimacy. The legitimacy of retaliation appears to depend on how closely related the retaliation is to the

237. See Hudec, *supra* note 3, at 163–66.

238. See *id.*

239. It is widely believed that such legal assistance is extremely important to the success of the panel process. The greatest improvement in the quality of GATT legal decisions over the last decade has come from creating a legal staff in the GATT Secretariat, and reinforcing that legal staff would probably be the most effective contribution to the quality of GATT legal practice in the immediate future. See Hudec, *supra* note 49, at 1508.

240. The Appellate Body is to comprise “persons of recognized authority, with demonstrated expertise in law, international trade and the subject matter of the covered agreements generally.” Dispute Settlement Understanding, *supra* note 1, art. 17(3). Income taxation arguably falls within the scope of this language. But even if income tax measures were brought more generally under the coverage of the GATT, it is unlikely that income tax disputes would constitute more than a small fraction of the GATT dispute settlement system's docket. Thus, even with such a change, Appellate Body members would much more likely be chosen for general international trade expertise than for specialized international tax expertise.

241. The argument that the GATT dispute settlement system should not hear international tax disputes because of lack of competence parallels the argument that appellate jurisdiction in tax cases should be moved from the U.S. courts of appeal to a specialist tax court of appeals—an argument that has not prevailed. See FEDERAL COURTS STUDY COMM., JUDICIAL CONFERENCE OF THE U.S., REPORT OF THE FEDERAL COURTS STUDY COMMITTEE 69–70 (1990) (recommending creation of Article III appellate division of United States Tax Court with exclusive jurisdiction over appeals in federal income, estate, and gift tax cases; arguing that this proposal would increase quality of tax adjudication by shifting it to court of “highly trained specialists”).

initial breach.²⁴² It is unlikely that trade retaliation against a breach of a *tax* obligation would be perceived to be as legitimate as trade retaliation against a breach of a *trade* obligation. The legitimacy of retaliation also appears to depend on the degree of equivalence or proportionality between the retaliation and the initial breach.²⁴³ It would be difficult to make this comparison in the case of trade retaliation against a tax breach.

Of course, trade retaliation that was approved by a decision of a third party panel or neutral appellate body might have *greater* legitimacy than unilateral tax retaliation, such as occurred in the U.S.-Canada case and was threatened in the U.S.-U.K. case, discussed previously. Nevertheless, international *tax* regime maintenance based on *trade* retaliation against tax treaty breaches is unlikely to be as effective as international trade regime maintenance based on trade retaliation against trade agreement breaches.

V. DISPUTE SETTLEMENT AS A MEANS OF GENERATING AND DISSEMINATING INFORMATION

Part IV discussed the role of dispute settlement mechanisms as devices for managing retaliatory strategies. This approach was based on viewing the underlying international regime as a prisoner's dilemma. In the single-play prisoner's dilemma, each player is better off cheating, regardless of what the other player does. In the repeated-play prisoner's dilemma, however, the players can achieve cooperation through the adoption of retaliatory strategies.

This approach is not without problems. There are theoretical reasons for questioning the usefulness of retaliatory strategies as a means of maintaining compliance with international treaty norms, even in the context of international trade, where such strategies are prevalent. One problem is that countries likely will have an inadequate incentive to carry through on their retaliatory strategies. Retaliation is costly. Retaliatory trade restrictions, for example, generally reduce the national economic welfare of the country imposing the restrictions.²⁴⁴ A country's desire to preserve good diplomatic relations also

242. See Avinash Dixit, *How Should the United States Respond to Other Countries' Trade Policies?*, in U.S. TRADE POLICIES IN A CHANGING WORLD ECONOMY 245, 271-72 (Robert M. Stern ed., 1987). Professor Dixit gives the example of the United States threatening to abandon its defense commitment to Europe or Japan as a way of achieving economic aims. He argues: "In practice ethics and credibility demand a closer link between the threat and the action to be deterred. In fact it is largely the perceived impropriety of an unrelated response that makes the adversary think that it will never be used and so removes its credibility." *Id.* at 272.

243. The enforcement model of retaliation suggests that the normative considerations that apply to punishments in general should be applicable to retaliatory sanctions. See CHAYES & CHAYES, *supra* note 171, at 106. It is widely believed that morally legitimate punishments must be proportional to the offenses for which they are administered. See, e.g., IMMANUEL KANT, *THE METAPHYSICAL ELEMENTS OF JUSTICE* *332. Consistent with this view, both the GATT and U.S. trade law require that retaliatory sanctions be proportionate to the "nullification or impairment" of GATT obligations to which they respond. See Dispute Settlement Understanding, *supra* note 1, art. 22(4) (mandating that level of retaliation authorized by DSB shall be "equivalent to the level of the nullification or impairment"); 19 U.S.C. § 2411(a)(3) (1994) (mandating that retaliatory section 301 sanctions be devised so as to cause harm to offending trading partner in amount equivalent to harm inflicted on United States by unfair trade practice under investigation).

244. See Robert E. Hudec, *Thinking About the New Section 301: Beyond Good and Evil*, in AGGRESSIVE UNILATERALISM 113, 138 (Jagdish Bhagwati & Hugh T. Patrick eds., 1990) (noting that retaliation generally "inflicts nearly as much pain upon one's own importers and users as it does on exporter interests on the other side"); Young, *supra* note 13, at 408 (noting that trade sanctions frequently

might cause it to forbear retaliating against certain violators.²⁴⁵ This incentive problem becomes worse when the initial breach of a treaty obligation affects more than one country, as often will be the case.²⁴⁶ Given the costs of retaliation, each country will have an incentive to free ride, leaving retaliation to other countries.²⁴⁷ As a result, retaliatory strategies generally will not be completely credible and thus will tend to be insufficient to induce compliance.

A related problem is that, in practice, retaliation will tend to have an ad hoc character. In deciding whether to incur the costs of retaliating, countries inevitably will take into account a wide range of political and diplomatic considerations. Retaliation will be most likely to occur when the costs are small and the likelihood of success is great. Such might be the case when the retaliating country is large and the target is small.²⁴⁸ These features will undermine the legitimacy of retaliatory strategies, reducing their effectiveness as a means of regime management.²⁴⁹

These observations suggest that there might be a different, or additional, explanation for international cooperation. Perhaps the characterization of the international regime as a prisoner's dilemma underestimates the prospects for achieving international cooperation.²⁵⁰

Some international relations theorists and international legal scholars have argued that countries have a propensity to comply with international agreements that they have signed, even apart from the fear of specific retaliation that leads to cooperation in the iterated prisoner's dilemma. There are a number of grounds for finding such an assumption plausible. The first, which is by no means universally accepted, is that governments are constrained by a moral sense of "international obligation."²⁵¹

Second, governments fear that their own treaty violations will create precedents that will weaken the force of treaty commitments generally, increasing the likelihood that other countries will breach their commitments in the future.²⁵² This concern is unlikely to be a completely effective deterrent,

"hurt the country enforcing the sanction almost as much as it hurts the country against which the sanction is imposed").

245. See Shell, *supra* note 140, at 901-02.

246. Although tax treaties are bilateral, countries generally enter into a network of similar treaties with a number of countries. A tax measure that breaches one treaty will therefore often breach many others as well.

247. See KEOHANE, *supra* note 138, at 105 (noting that, because of collective action problems, "if a given state's violation of a particular rule does not have a large effect on any one country, retaliation is unlikely to be severe, even if the aggregate effect of the violation is large"); Abbott, *supra* note 136, at 367 (discussing free rider problems in regime maintenance through retaliation); Shell, *supra* note 140, at 901-02.

248. See Young, *supra* note 13, at 408.

249. See CHAYES & CHAYES, *supra* note 171, at 106-08.

250. The payoff structure of a regime can change over time as events take place and the actors' perceptions of their interests change. Thus, a regime might be represented by a prisoner's dilemma at one time, by a more conflictual game such as deadlock at another time, and by a less conflictual game such as the assurance game, see *infra* note 260, at yet another time. See Robert Axelrod & Robert O. Keohane, *Achieving Cooperation Under Anarchy: Strategies and Institutions*, in *NEOREALISM AND NEOLIBERALISM: THE CONTEMPORARY DEBATE*, *supra* note 137, at 85, 87-91.

251. See CHAYES & CHAYES, *supra* note 171, at 3-4. Although the "realist" conception of states as rational, self-interested actors denies the existence of a normative sense of "international obligation," many foreign policy practitioners operate on the assumption that governments do, in fact, acknowledge an obligation to comply with the international agreements they have signed. See *id.*

252. See KEOHANE, *supra* note 138, at 105; see also FEDERAL INCOME TAX PROJECT, *supra* note

however, because of collective action problems. A country will have an incentive to violate a treaty if it expects that its own gain from the violation will exceed the harm that it *alone* experiences as a result of the weakened regime.²⁵³ Optimal deterrence, however, would require a comparison of the gain to the breaching country with the harm to *all* regime members.

Third, treaty rules serve as rules of thumb,²⁵⁴ and it is normally efficient to adhere to such rules.²⁵⁵ When countries enter into treaty obligations, they make an initial calculation that the expected benefits of compliance exceed the expected costs. Thereafter, it is an inefficient use of a country's limited decisionmaking resources to engage in a continual recalculation of expected benefits and costs. Absent exceptional circumstances, it makes more sense to assume that the initial calculation remains valid and to continue to adhere to the rule. Moreover, the adoption of rules of thumb enables decisions to be delegated to lower-level officials; these officials are very likely to comply with the rules that their superiors have directed them to follow.

Finally, and most importantly, countries tend to comply with international rules because of concern for their reputation.²⁵⁶ A country's reputation provides the most reliable information about its willingness and ability to keep its commitments. The importance of reputation is suggested by analogy to the "market for lemons" problem in microeconomic theory. One can show that if sellers of used cars are unable to convey reliable information about the quality of their cars to potential buyers, the market can break down to the point where good used cars will not be bought and sold.²⁵⁷ Analogously, the "market" for international agreements can break down if countries lack reliable information about the willingness and ability of their potential treaty partners to keep their commitments. In the absence of information, nations might fail to make agreements that are in all of their interests.

26, at 78 ("The benefits of a broad and stable international consensus as to principles of taxation may be lost if treaties are debased in value.").

253. See KEOHANE, *supra* note 138, at 105.

254. See *id.* at 115-16.

255. See CHAYES & CHAYES, *supra* note 171, at 4.

256. See KEOHANE, *supra* note 138, at 105-06 (explaining importance of reputation as incentive to conform to standards of behavior in world politics); Abbott, *supra* note 136, at 402-03 (noting that performance of breach of obligation may be "capitalized" into reputation and considered by rational states in future negotiations).

257. Suppose that the only reliable way to tell whether a used car is a good car or a "lemon" is to own it for a length of time. This information will be available asymmetrically. Owner-sellers of used cars will have it, but buyers will not. Suppose that a good car is worth \$10,000 to a seller and \$12,000 to a buyer; a lemon is worth \$5,000 to a seller and \$6,000 to a buyer. If a used car on the market were equally likely to be a good car or a lemon, a risk-neutral buyer would be willing to pay at most \$9,000 for a used car. At that price, however, no owners of good cars would be willing to sell. Thus, only lemons would be placed on the market. Buyers would soon realize this and then would be willing to pay at most \$6,000 for a used car, knowing that it would be a lemon.

The result is a market failure. No good cars will be bought and sold, even though both buyers and sellers would be better off if good cars changed hands at any price between \$10,000 and \$12,000. The problem is that sellers have no way of reliably conveying information about the quality of their cars to buyers. If a seller repeatedly sold used cars, however, it would be in his interest to develop and maintain a reputation for honestly representing the quality of his cars. Doing so would create a market for good cars. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). For discussions of the "market for lemons" problem in the context of international relations, see KEOHANE, *supra* note 138, at 193-94; and Abbott, *supra* note 136, at 402-03.

This analysis suggests that three types of information are important for the maintenance of cooperative outcomes. The first is information about the meaning of ambiguous treaty rules.²⁵⁸ If countries have a propensity to comply with the international agreements that they have signed, then compliance generally will be forthcoming *provided that the rules are clear*. Reduction of ambiguity is also important because it facilitates a common understanding of treaty norms among countries making independent decisions.

In principle, treaty rules can be clarified through renegotiation of the treaty. The renegotiation process is extremely slow and cumbersome,²⁵⁹ however, requiring attention at the highest political levels in the countries involved. It is therefore not a suitable method for resolving most ambiguities that arise in the routine course of international relations. A dispute settlement mechanism can resolve these ambiguities with lower transaction costs. Resolution of disputes through ad hoc political compromise, however, will not adequately generate and disseminate information about the requirements of the regime. Instead, it is necessary to have a legalistic system that produces precedents.

A second type of information that is necessary for international cooperation is information about parties' performance and intentions under the regime. If one assumes that countries have a propensity to comply with their treaty obligations, the treaty regime resembles the "assurance game" or "stag hunt" rather than the prisoner's dilemma.²⁶⁰ This game is based on the following parable.²⁶¹ The members of a primitive society can hunt stags or hunt rabbits. All must cooperate to kill a stag, but a single hunter can kill a rabbit. If the group kills a stag, each member will eat well, but if the members hunt rabbits instead, they will eat poorly. Now suppose that while the group is hunting for a stag, a rabbit jumps out. If every member of the group cooperates and ignores the rabbit, the group will eventually kill a stag. But if any one member defects to pursue the rabbit, the remaining group will be unable to kill a stag; each member will then be reduced to hunting rabbits. In this situation, no member of the group has an incentive to defect as long as he or she is

258. Cf. FEDERAL INCOME TAX PROJECT, *supra* note 26, at 95 (noting that "income tax treaties are articulated in broad conceptual terms and employ words and phrases that often are unlike those used in domestic law").

259. In the case of the GATT, negotiating rounds typically require many years to complete. The Kennedy Round required five years (1962-67), the Tokyo Round six years (1973-79), and the Uruguay Round eight years (1986-94). See JACKSON ET AL., *supra* note 13, at 292. The provisions for amending the pre-Uruguay Round GATT were so difficult to satisfy that the Uruguay Round Agreements were structured as a wholly new treaty rather than as amendments to the GATT. See *id.* at 313. The provisions for amending the Uruguay Round Agreements are similar; therefore, amending these agreements is likely to continue to be difficult, too. See *id.*

260. The assurance game has the following payoff structure:

		Country II	
		Cooperate	Defect
Country I	Cooperate	4,4	1,3
	Defect	3,1	2,2

For a discussion of stag hunt game in the context of international relations theory, see Abbott, *supra* note 136, at 368-70.

261. See *id.* at 368 n.174.

sure that the other members of the group also will cooperate. But if he or she is not sure that the other members of the group will cooperate, he or she might be better off defecting.

Unlike the situation in the prisoner's dilemma, no player in this assurance game has an incentive to take advantage of the other player by defecting, as long as he or she believes that the other player also will cooperate. If one player believes that another will defect, however, an incentive to defect will exist for purely defensive reasons. As long as each player is confident that the other players share a common understanding of the game and its preferences, the outcome will be mutually beneficial cooperation. If information about the other player's understandings and preferences is incomplete or incorrect, however, each player rationally might be suspicious of the other, leading to the possibility of a breakdown in cooperation. Maintenance of cooperation therefore requires that each player receive continual assurances that the other player is cooperating.

A legalistic dispute settlement system can provide some of this assurance information—in particular, information about the requirements of the regime and about other parties' performance under the regime. In addition, such a system can provide information to domestic political actors about how other countries perceive their actions. In the absence of such information, the treaty norms might have so little prominence that they are ignored in the domestic political process. The commencement of a dispute settlement proceeding will raise the prominence of the treaty norm and also will create a series of opportunities for placing the allegedly breaching measure back on the political agenda for reconsideration.

In the international trade context, it can be very difficult to generate and disseminate the types of information discussed above without the use of a legalistic dispute settlement system. Trade disputes often present difficult problems of characterization because breaches of trade agreements often take the form of "disguised" restrictions on trade. In particular, they can take the form of facially nondiscriminatory internal regulations of seemingly non-trade-related subjects such as environmental protection or consumer safety. Such regulations nevertheless might have the effect of placing greater burdens on imports than on domestically produced goods. Such restrictions present difficult questions of interpretation. Are they consistent with the trade agreement? If not, do they signal a general unwillingness or inability to comply? Or do they represent an understandable reaction to new circumstances rather than a fundamental breakdown in the cooperative equilibrium? Legalistic dispute settlement mechanisms help generate the information necessary to answer these questions. In the dispute settlement process, the country that is alleged to have breached the treaty is called upon to defend its actions. If a neutral dispute settlement system determines that the action in question is consistent with treaty obligations, this will help provide the necessary assurance to the complaining country. If the system determines that the action constitutes a breach, however, then the breaching country will know that it has to provide additional assurance of its intentions and capabilities in order to maintain the cooperative relationship. This will give the breaching country a strong incentive to bring its action into compliance with the treaty or at least to provide assurance that the breach is explained by exceptional circumstances.

In contrast, income tax measures that arguably conflict with income tax treaties are usually much more transparent. They generally will be included in a country's income tax code rather than in some seemingly unrelated statute. At least in the case of the United States, it is likely that the issue of the consistency of a measure with tax treaties will have been raised during the legislative process²⁶² and that the legislative history will have addressed this issue.²⁶³ Thus, even without a legalistic dispute settlement system for tax disputes, other countries easily can become aware of the measure²⁶⁴ and learn the United States's justification for it.

In addition, at least in the case of OECD countries, OECD studies can substitute for legalistic dispute settlement as a means of generating the information necessary to facilitate the role of international obligation, precedent, and reputation in maintaining international tax cooperation. Recent examples are OECD studies of the consistency of transfer pricing rules and thin capitalization rules with the OECD *Model Tax Convention's* arm's length standard and nondiscrimination obligation²⁶⁵ and an OECD study of the problem of treaty overrides generally.²⁶⁶ Although the GATT has provisions for surveillance,²⁶⁷ this mechanism is likely to be less effective in the trade area than in the tax area because of the multiplicity of domestic regulations that affect trade and because of their lack of transparency.

VI. THE COSTS OF LEGALISTIC DISPUTE SETTLEMENT FROM THE PERSPECTIVE OF REGIME MAINTENANCE

Parts IV and V of this Article argued that legalistic dispute settlement systems can facilitate cooperation by managing retaliatory strategies; by providing information about the requirements of a regime, the performance of parties under the regime, and the reactions of other parties; and by facilitating

262. The Treasury Department often raises the issue of potential conflicts between proposed legislation and treaty commitments. For example, Treasury urged Congress not to adopt the treaty-overriding limitation-of-benefits provisions of the branch profits tax in order to give Treasury an opportunity to renegotiate existing treaties that do not contain effective treaty shopping prohibitions. See N.Y. St. B. Ass'n, *supra* note 127, at 931.

263. See, e.g., H.R. CONF. REP. NO. 101-386, at 569-70 (1989) (arguing that "earnings stripping" provision enacted as section 163(j) of Code is consistent with arm's length standard), *reprinted in* 4 U.S.C.C.A.N. 3018, 3172-73 (1989).

264. Several recent U.S. treaties contain provisions requiring a competent authority to consult with the other competent authority with a view to establishing a basis for the full implementation of the treaty, if the first competent authority becomes aware that a domestic law may be applied in a manner that may impede the full implementation of the treaty. See U.S.-Netherlands Treaty, *supra* note 106, art. 29(6); U.S.-Mexico Treaty, *supra* note 105, protocol, para. 20, at 70.

265. See OECD TRANSFER PRICING GUIDELINES, *supra* note 2, paras. 1.1-1.5, at I-1 to I-2; OECD, 2 ISSUES IN INTERNATIONAL TAXATION, THIN CAPITALISATION: TAXATION OF ENTERTAINERS, ARTISTES AND SPORTSMEN 29-32 (1987) [hereinafter OECD, THIN CAPITALISATION]. The OECD plans to review regularly the issue of thin capitalization in future supplements to the *Guidelines*. See *Preface to OECD TRANSFER PRICING GUIDELINES*, *supra* note 2, para. 19, at P-6.

266. See OECD Comm. on Fiscal Affairs, *supra* note 127.

267. See, e.g., CHAYES & CHAYES, *supra* note 171, at 244-46 (outlining GATT surveillance procedures); HUDEC, *supra* note 9, at 194-95 (discussing development of surveillance provisions); JOHN H. JACKSON, RESTRUCTURING THE GATT SYSTEM 79-80 (1990) (discussing policy goals of surveillance provisions); Davey, *supra* note 3, at 107-08 (questioning merits of establishing surveillance procedures); Hudec, *supra* note 3, at 168-70 (detailing genesis of and policy considerations behind development of surveillance provisions).

the development and dissemination of reputation. Parts IV and V analyzed these functions in the contexts of both international trade and international tax, concluding that legalistic dispute settlement is much more important to the maintenance of cooperation in the trade context than in the tax context. Retaliatory strategies are prevalent in the international trade context, and the need to manage them was apparent to most countries during the Uruguay Round negotiations. In the international tax context, however, such strategies are likely to be ineffective; indeed, they are seldom used in practice. Similarly, because of the "disguised" nature of many international trade restrictions, the information described above tends to be difficult to generate and disseminate in the international trade context except through legalistic dispute settlement. In the tax context, however, there tends to be greater transparency, so the relevant information is likely to be available without legalistic dispute settlement.

This Part of the Article turns to the cost side of the equation. Legalistic dispute settlement imposes costs on an international regime as well as producing benefits. These include not only the obvious costs of administering the system, but, more significantly, the costs that arise because legalistic dispute settlement can weaken the stability of the cooperative regime. In assessing the appropriateness of a legalistic dispute settlement system in the context of a given regime, one must weigh the expected benefits against the expected costs. This Part concludes that the potential costs of legalistic dispute settlement are substantial, both in the international trade context and in the international tax context; if anything, they are greater in the tax context.

A. "Poisoning the Atmosphere"

A longstanding concern of international trade "pragmatists" is that legalistic dispute settlement procedures are more confrontational and adversarial than diplomatic procedures and that the use of legalistic procedures therefore will tend to undermine friendly relationships.²⁶⁸ This, in turn, will tend to undermine compliance with international agreements, since compliance is more likely if the parties to the agreement maintain amicable relations among themselves. Pragmatists also argue that it is undesirable that legalistic dispute settlement ultimately produces a clear ruling in favor of one side or the other, given that the parties are locked in an ongoing relationship.²⁶⁹ Unless the ruling is acceptable to the losing party, it is likely to undermine that relationship. Indeed, even in the domestic context, it is widely recognized that litigation is far more likely to occur when there is no ongoing relationship between the parties or where such a relationship has definitively terminated.²⁷⁰

This concern might be overstated, however. Even with a legalistic dispute settlement system in place, the great majority of disputes will likely be settled amicably in the "shadow of the law" established by the legalistic system. Therefore, while this concern should be given some weight, it seems unlikely by itself to tip the balance against legalistic dispute settlement in any re-

268. See CHAYES & CHAYES, *supra* note 171, at 205-06.

269. See *id.*

270. See *id.* at 206.

gime. Moreover, this cost would be similar in both the trade context and the tax context.

B. Noncompliance

Trade pragmatists also have been concerned that the clear rulings of a legalistic dispute settlement system will lead to equally clear cases of noncompliance.²⁷¹ Inevitably, the political forces that led a country to breach the agreement in the first place sometimes will prove so powerful that the country will refuse to comply with an adverse ruling from a dispute settlement body.²⁷² If such outcomes become commonplace, the conspicuous failure of the dispute settlement system will threaten to destroy the prestige of the regime.

Refusals to comply with legalistic dispute settlement rulings might be even more of a problem in the tax context than in the trade context. Arguably, politicians might view dispute settlement rulings on international tax matters as intruding more on domestic sovereignty than do rulings on international trade matters.²⁷³ Countries generally agree on the benefits of free trade but disagree widely about optimal tax policy, which involves tradeoffs among such objectives as economic efficiency, fairness, and administrative feasibility, and which depends on each country's economic and social structure.²⁷⁴ Countries depend on taxation not only to raise revenue but also as an instrument of economic and social policy. Compliance with an international dispute settlement ruling on tax matters therefore could have devastating consequences to a government.

For the most part, however, tax treaties constrain only one aspect of taxation: the manner in which it applies to foreign persons.²⁷⁵ The rulings of

271. See Hudec, *supra* note 3, at 159-66.

272. See *id.* at 159.

273. Cf. FEDERAL INCOME TAX PROJECT, *supra* note 26, at 63-80 (noting congressional sensitivity to treaty intrusions on United States's unilateral prerogatives to tax as it wishes); COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE ON INDEPENDENT EXPERTS ON COMPANY TAXATION 45 (1992) (noting that member states of European Community "remain extremely reluctant to cede any of their sovereignty in tax matters to Community"); OECD, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES, *supra* note 81, para. 55, at 59 (stating that several member countries of OECD have made it clear that they would find a system of mandatory arbitration of transfer pricing disputes unacceptable because it would involve unprecedented surrender of fiscal sovereignty); Slemrod, *supra* note 194, at 305 (noting that one obstacle to multilateral tax coordination "is that countries are unwilling to cede sovereignty over such an important element of domestic policy").

274. In contrasting trade agreements and tax agreements, Professor Slemrod argues:

In the case of tariffs, there exists a clear benchmark goal of zero tariffs, a goal which does not severely compromise the revenue needs of most countries. In the case of tax policy, countries differ enormously in their revenue requirements, capacity to raise taxes, and their predisposition toward alternative tax systems, including the perceived need to use tax policy to affect economic activity. For this reason I see no prospect for a comprehensive international agreement that sets severe limits on tax policy.

Joel Slemrod, *Tax Principles in an International Economy*, in *WORLD TAX REFORM: CASE STUDIES OF DEVELOPED AND DEVELOPING COUNTRIES* 11, 21 (Michael J. Boskin & Charles E. McLure, Jr. eds., 1990).

275. U.S. tax treaties generally contain a "saving clause," which typically provides that "a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect." U.S. DEP'T. OF THE TREASURY, MODEL INCOME TAX CONVENTION, *supra* note 84, art. 1(4). There are exceptions to the saving clause, however. See *id.* art. 1(5). For example, the United States generally makes a treaty commitment to continue to provide its residents and citizens with relief from double taxation of their foreign source income

an international tax dispute settlement body usually would not require a country to change the way it taxes its own residents.²⁷⁶ Arguably, this is no more of a constraint on sovereignty than GATT obligations, particularly insofar as the latter constrain the government's freedom to adopt internal regulations relating to goods and services. Because of concern that GATT dispute settlement panels might strike down U.S. consumer safety, environmental protection, and other laws and regulations as "disguised restrictions on trade," Congress specified that, under domestic law, the WTO/GATT Agreement would not preempt federal law and that it would preempt state law only in the case of an action brought by the United States.²⁷⁷ Even in the case of a federal challenge to state law, GATT dispute settlement body rulings have no effect under domestic law.²⁷⁸ Potentially, WTO/GATT decisions could even strike down domestic measures relating to national security, raising the greatest possible sovereignty concerns. For example, the European Union has filed a complaint in the WTO contending that certain provisions of the United States's Helms-Burton Act violate the GATT.²⁷⁹ The central controversy relates to provisions of the Act that impose penalties on foreign persons who knowingly "traffic" in U.S. property confiscated by Fidel Castro's regime. When a WTO panel was formed to examine this complaint, U.S. officials declared that the United States would not even appear before the panel, arguing that the WTO "has no competence to proceed because this is a matter of U.S. national security and foreign policy."²⁸⁰ It is not clear, however, that the United States is correct that the mere invocation of national security is sufficient to remove the matter from the WTO's jurisdiction. The GATT does contain a national security exception,²⁸¹ but it is written narrowly.²⁸² Arguably, the WTO at minimum has jurisdiction to interpret the national security exception to determine whether it applies in a given case. If so, even disputes that raise national security concerns could become subject to GATT adjudication.

through a foreign tax credit mechanism. *See id.* art. 23.

276. In at least one case, however, the U.S. Congress arguably has overridden one of its tax treaty obligations as a residence country. The Tax Reform Act of 1986 introduced a new alternative minimum tax and limited the foreign tax credits usable against this tax obligation to 90% of the amount of the tax due. Congress made clear that this provision was to override any obligation under a tax treaty to relieve double taxation. *See Pending Bilateral Tax Treaties and OECD Tax Convention: Hearing Before the Senate Comm. on Foreign Relations*, 101st Cong. 13 (1990) (statement of Kenneth W. Gideon, Assistant Secretary of the Treasury for Tax Policy).

277. *See supra* note 26.

278. *See supra* note 27.

279. *See* World Trade Organization, *Request for the Establishment of a Panel by the European Communities*, *supra* note 31.

280. Rossella Brevetti et al., *U.S. Says WTO Not Competent to Judge Cuba Dispute*, 14 Int'l Trade Rep. (BNA) 351, 351 (1997) (quoting Stuart Eizenstat, Undersecretary of Commerce for International Trade); *see also* David E. Sanger, *U.S. Won't Offer Trade Testimony on Cuba Embargo*, N.Y. TIMES, Feb. 21, 1997, at A1 (same).

281. *See* GATT 1947, *supra* note 1, art. 21.

282. In particular, the national security exception applies to any action that a member

(b) . . . considers necessary for the protection of its essential security interests

relating to fissionable materials or the materials from which they are derived;

(ii) relating to the traffic in arms, ammunition and implements of war and to such traffic in other goods and materials as is carried on directly or indirectly for the purpose of supplying a military establishment; [or]

(iii) taken in time of war or other emergency in international relations

Id. art. 21(b).

A more critical distinction than the one based on sovereignty concerns might be that, in the international trade context, politicians often might want to lose cases in the dispute settlement process.²⁸³ Politicians typically have conflicting motives. A politician might want to promote free trade because of pressure from export producing interests, because it enhances the country's aggregate economic welfare, because it is a policy favored by "elites," or for any number of other reasons.²⁸⁴ At the same time, the politician might find it difficult to resist the demands for protection asserted by import-competing interests. Trade agreements are a way of "solving" this internal dilemma. The politician gets free trade and can deflect interest group demands for protection in the future by claiming that the agreement leaves no choice.²⁸⁵

This mechanism will not be completely effective, however, if dispute settlement is based on diplomatic negotiation. In close cases, where there is a reasonable, albeit weak, argument that a particular measure is not a breach of the agreement, politicians might come under pressure to enact the measure and attempt to defend it, perhaps ultimately reaching a compromise that does not involve removing the offending measure. If the trade agreement contains effective legalistic dispute settlement procedures, however, the politician can resist on the ground that the weak argument supporting the measure almost certainly will lose in the end and that the dispute settlement body will demand removal of the measure. Thus, a trade agreement backed up with legalistic dispute settlement procedures generally enables politicians to deflect the blame for the dislocations caused by free trade to an international organization.

Measures that violate tax treaties, in contrast, seldom will be driven by narrow interest group pressures that a politician might prefer to resist. Instead, politicians often will enact such measures as a way of solving short-term budgetary problems without encountering strong domestic opposition. An adverse dispute settlement body ruling would force the politicians to look for other means of achieving this objective. Thus, politicians might welcome legalistic dispute settlement procedures in the trade context, but they are unlikely to do so in the tax context.

C. *Lack of Legitimacy*

A legalistic dispute settlement system is likely to promote cooperation by clarifying treaty norms only if countries perceive the resulting interpretation of the norms to be legitimate. Legitimacy generally results if the domestic political process accepts the outcome. In the case of domestic litigation (not involving constitutional issues), there is a political check on the outcome: The legislature can overrule a politically unacceptable judicial decision.²⁸⁶ Legalistic international dispute settlement procedures do not provide any such politi-

283. See Shell, *supra* note 140, at 900.

284. See Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 81-87 (1990) (discussing politicians' varied motives).

285. See Kenneth W. Abbott, *The Trading Nation's Dilemma: The Functions of the Law of International Trade*, 26 HARV. INT'L L.J. 501, 522 (1985).

286. See Kenneth W. Abbott, *The Uruguay Round and Dispute Resolution: Building a Private-Interests System of Justice*, 1992 COLUM. BUS. L. REV. 111, 142-43 (1992) (noting that in national systems based on separation of powers, political branches have procedures for responding to judicial decisions that they see as inappropriate or socially harmful).

cal check on the outcomes.²⁸⁷ A “wrong” decision can be overturned only by treaty amendment, an extremely slow and cumbersome process.²⁸⁸

Moreover, in domestic litigation, the judges generally will be attuned to the popular will.²⁸⁹ They are usually residents of the country in question who were elected or appointed through a political process. International dispute settlement, in contrast, typically involves individuals from third countries who might have little understanding of the particular domestic norms and concerns of the countries that are parties to the dispute.

D. *Inflexibility*

Legalistic dispute settlement is likely to prove inflexible. Regime maintenance requires a mechanism for accommodating the treaty to changing circumstances and issues. In the case of the GATT, for example, trade “pragmatists” historically have been concerned that some of the original GATT norms became obsolete over time and were no longer generally complied with.²⁹⁰ Nevertheless, if a contracting party were to challenge a trade measure that violated such a norm, a dispute settlement panel probably would strike the measure down, even though a political consensus supporting the norm no longer existed. The new WTO/GATT Agreement has alleviated this concern since it reflects a new consensus, but the problem of treaty adaptation is a continuing one. An ideal dispute settlement system would be flexible enough to use “creative interpretation” as a means of treaty revision.²⁹¹

In particular, in the case of international taxation, there is a danger that a legalistic dispute settlement system would strictly interpret treaty language in ways that would interfere with efforts to solve emerging problems.²⁹² Specifically, tax measures designed to combat international tax avoidance sometimes will impose greater burdens on foreign and foreign-owned enterprises than on purely domestic enterprises. A legalistic dispute settlement system might interpret a treaty nondiscrimination or national treatment rule to prohibit such measures, even if there were an international political consensus that such measures are appropriate.

287. See Trimble, *supra* note 3, at 1026–28; see also Shell, *supra* note 140, at 906 (raising specter of “governance by a group of unelected, multinational judges striking down domestic laws on the basis of economic theory”).

288. See Abbott, *supra* note 286, at 143 (noting that GATT procedure for joint action by contracting parties has not been used extensively and might be resisted); *Transcript of Discussion Following Presentation by Kenneth W. Abbott, supra* note 184, at 155–56 (1992) (remarks of Robert E. Hudec) (noting that GATT lacks adequate legislative filter capable of overruling wrong decisions).

289. See Trimble, *supra* note 3, at 1027 (arguing that unelected judges are products of domestic political system and are responsive to political changes in society).

290. See Davey, *supra* note 3, at 108; Hudec, *supra* note 3, at 160–63.

291. See CHAYES & CHAYES, *supra* note 171, at 209, 211–13.

292. The Federal Income Tax Project states:

The United States should not adopt a mechanistic or overly-technical approach to determining whether a proposed legislative provision is inconsistent with treaties. . . .

Certain legislative enactments may conflict with the literal terms of an existing treaty, but would not be inconsistent with the expectations of the treaty partner. Such changes should be permitted to take effect without modifying the treaty.

FEDERAL INCOME TAX PROJECT, *supra* note 26, at 78–79.

Consider, for example, thin capitalization rules. One of the ways that multinationals can shift income among tax jurisdictions is through strategic use of debt financing. For income tax purposes, interest payments are generally deductible by the payor and includable in the income of the recipient. Therefore, if a parent corporation in one country makes a loan to a subsidiary in another country, the interest payments will shift taxable income from the subsidiary to the parent corporation. A number of countries have enacted income tax measures to prevent the erosion of their corporate income tax base through such "thin capitalization" of foreign-owned domestic corporations. These measures generally deny the thinly capitalized domestic corporation a deduction for interest paid to related foreign parties on excessive debt. The United States enacted such a measure in 1989.²⁹³ Although Congress argued that this measure is nondiscriminatory,²⁹⁴ its argument is not very persuasive.²⁹⁵

Two provisions of the nondiscrimination article of the OECD *Model Tax Convention* seem to prohibit thin capitalization rules that apply, either facially or in practice, only to interest paid to nonresidents. The OECD, however, has resorted to creative interpretation to prevent the model treaty from acting as a bar to such measures,²⁹⁶ which the OECD countries apparently regard (at least in some cases) as an appropriate response to the tax avoidance behavior of multinationals.

First, paragraph 4 of article 24 ("Non-discrimination") of the OECD *Model Tax Convention* provides in part that interest paid by an enterprise of one treaty country to a resident of another treaty country shall be deductible, in computing the enterprise's taxable income, under the same conditions as if it had been paid to a resident of the first treaty country.²⁹⁷ An exception is made when certain other treaty provisions apply, including paragraph 1 of article 9 ("Associated Enterprises").²⁹⁸ This paragraph provides that if related enterprises engage in commercial or financial transactions that differ from those in which independent enterprises acting at arm's length would have engaged, the treaty countries may adjust the taxable income of the enterprises to reflect the arm's length result.²⁹⁹ In its report on thin capitalization rules, the OECD argued that article 24(4) does not prohibit thin capitalization rules—even those that apply only to interest paid to nonresidents—as long as they disallow deductions for interest payments only when the payor is excessively debt-financed in relation to similar independent enterprises operating at arm's

293. See Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7210(a), 103 Stat. 2106, 2339-42 (1989) (enacting I.R.C. § 163(j)). Under § 163(j), interest paid by a corporation to a related, tax-exempt (e.g., foreign) party is not deductible under certain conditions—generally, to the extent that the payor's interest expense exceeds 50% of its adjusted taxable income and its debt-to-equity ratio exceeds 1.5:1. See *id.*

294. See H.R. CONF. REP. NO. 101-386, at 568-70 (1989), reprinted in 1989 U.S.C.A.N. 3018, 3171-73 (quoting managers of Revenue Reconciliation Act of 1989 arguing that U.S. thin capitalization rule does not violate tax treaty rules and, in particular, is consistent with treaty nondiscrimination rules).

295. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 258-59, 280-82 (refuting congressional arguments that thin capitalization rule does not violate tax treaty nondiscrimination rules).

296. See Vann, *supra* note 34, at 108.

297. See OECD MODEL TAX CONVENTION, *supra* note 36, art. 24(4) commentary, paras. 55-56, at c(24)-19 to c(24)-20.

298. See *id.*

299. See *id.*

length with creditors.³⁰⁰ This interpretation of article 24(4) is strained for two reasons. First, as the OECD report acknowledges, the arm's length standard provides virtually no guidance for determining when debt financing is "excessive."³⁰¹ Second, it is one thing to say that article 24(4) is subject to the adjustment authority of article 9, but another thing to say, as the OECD report does, that this adjustment authority can be applied discriminatorily to payments to nonresidents without violating the nondiscrimination article.³⁰²

Second, article 24(5) prohibits one treaty country from taxing enterprises that are owned or controlled by residents of the other treaty country in a manner that is more burdensome than the manner in which it taxes similar domestically owned and controlled enterprises. The OECD's treatment of article 24(5) is also strained. On its face, this provision seems to prohibit thin capitalization rules that apply only to foreign-owned firms. The OECD report "solves" this problem by arguing that article 24(5) should be interpreted more narrowly than its language would indicate—in particular, that it should be interpreted to prevent only "tax protectionism" and not to prevent anti-tax-avoidance measures.³⁰³ The OECD report further argues that because article 24(5) is written in general terms, it should be treated as subordinate to the more specific constraint of article 24(4).³⁰⁴ Therefore, the report concludes, since thin capitalization measures survive scrutiny under article 24(4),³⁰⁵ they should not be invalidated under article 24(5).³⁰⁶

The OECD has announced that it intends to continue its work on thin capitalization measures.³⁰⁷ This process is therefore an example of ongoing regime maintenance. More generally, the OECD engages in ongoing flexible

300. See OECD, THIN CAPITALISATION, *supra* note 265, para. 66(a), at 26, paras. 75–76, at 30–31; cf. OECD TRANSFER PRICING GUIDELINES, *supra* note 2, para. 1.37, at I-15 to I-16. The United States's thin capitalization legislation does not satisfy this test because that legislation is based on a fixed debt to equity ratio rather than on comparisons of actual firms. See OECD, THIN CAPITALISATION, *supra* note 265, para. 79, at 31 (noting that when "a fixed debt/equity ratio is employed by the tax authorities [as an irrebuttable presumption of thin capitalization], then the majority of countries consider that the results would undoubtedly be inconsistent with the arm's length principle").

Several commentators have argued that section 163(j) violates the nondiscrimination articles found in many tax treaties. See Richard L. Doernberg, *The Enhancement of the Earnings-Stripping Provision*, 7 Tax Notes Int'l (Tax Analysts) 985, 986–87 (Oct. 18, 1993); Robert J. Misesy, Jr., *An Unsatisfactory Response to the International Problem of Thin Capitalization: Can Regulations Save the Earnings Stripping Provision?*, 8 INT'L TAX & BUS. LAW. 171, 191 (1990).

301. The OECD report concedes that an arm's length approach is difficult to apply to thin capitalization problems because of "the absence of any clear guidelines as to what are the practices adopted by independent parties, and thus the difficulty of devising any consistent practice . . ." OECD, THIN CAPITALISATION, *supra* note 265, para. 25, at 15.

302. See FEDERAL INCOME TAX PROJECT, *supra* note 26, at 281.

303. Specifically, the OECD report states:

So far as concerns article 24[(5)], the Committee took the view that this paragraph is relevant to thin capitalisation but is worded in very general terms and aims broadly at preventing "tax protectionism"—i.e. the deterrence by tax measures of investment from outside the country. It had not, the Committee considered, been designed to deal with measures introduced to prevent the transfer of profits in the guise of interest. Because it is in such general terms, the Committee concluded, it must take second place to more specific provisions in the treaty. Thus Article 24[(4)] . . . takes precedence over it in relation to the deduction of interest.

OECD, THIN CAPITALISATION, *supra* note 265, para. 66(b), at 27.

304. See *id.*

305. See *id.* para. 66(a), at 26–27.

306. See *id.* para. 66(b), at 27.

307. See *Preface* to OECD TRANSFER PRICING GUIDELINES, *supra* note 2, para. 19, at P-6.

interpretation of tax treaties through its revision of the commentaries to the OECD *Model Tax Convention*.³⁰⁸ These commentaries can significantly influence how countries interpret actual bilateral income tax treaties.³⁰⁹ For example, in *North West Life Assurance Co. of Canada v. Commissioner*,³¹⁰ the Tax Court relied extensively on the OECD commentaries in deciding that the U.S.-Canada Income Tax Treaty prohibits the United States from taxing U.S. branches of Canadian insurance companies in accordance with section 842(b) of the Internal Revenue Code. Similarly, in *Taisei Fire and Marine Insurance Co. v. Commissioner*,³¹¹ the Tax Court relied extensively on the OECD commentaries in deciding that a U.S. corporation operating in the United States was an "agent of independent status" with respect to certain Japanese insurance corporations within the meaning of the U.S.-Japan Income Tax Treaty.³¹²

VII. CONCLUSION

The dispute settlement procedures in the GATT have evolved into a highly legalistic, quasi-judicial system. If a trade dispute is not resolved through intergovernmental consultation and negotiation, it will be referred to a third party panel for decision. The losing party may appeal the panel's decision to a standing appellate body. The final decision cannot be blocked by the losing party. The system monitors compliance and can authorize retaliation in the event of noncompliance. Policy-level conflicts between domestic laws and GATT obligations are routinely brought before this system, which stands ready to judge domestic laws dealing with such politically sensitive subjects as environmental protection, consumer protection, health and safety, preservation of national culture, and even national security.

In contrast, the dispute settlement procedures in tax treaties are antilegalistic. Under most tax treaties, consultations and negotiations between designated tax officials of the two treaty countries are the exclusive means for resolving disputes. There is no assurance that this process actually will produce a resolution. Even if it does, the resolution is likely to represent a political compromise rather than a reasoned decision based on the application of legal rules. Moreover, this mechanism is intended to deal with relatively fact-specific disputes. It is highly improbable that it will succeed in resolving a dispute involving a policy-level conflict between a domestic tax law and a tax treaty obligation. The resolution of such disputes likely will require resort to diplomatic channels.

Yet, tax treaties and trade agreements are very closely related. They share the same goal of facilitating international trade and investment, and they

308. See OECD MODEL TAX CONVENTION, *supra* note 36, para. 9, at I-3 to I-4 (1995) (discussing revision of OECD Model Income Tax Treaty and commentaries as ongoing process).

309. See *id.* para. 29, at I-10 (noting that commentaries can "be of great assistance in the application and interpretation of the conventions [signed by member countries] and, in particular, in the settlement of any disputes"); Hugh J. Ault, *The Role of the OECD Commentaries in the Interpretation of Tax Treaties*, in ESSAYS ON INTERNATIONAL TAXATION, *supra* note 121, at 61.

310. No. 4694-94, 1996 U.S. Tax Ct. LEXIS 50 (Dec. 12, 1996).

311. 104 T.C. 535 (1995).

312. If the U.S. corporation was an "agent of independent status," the Japanese corporations would not be deemed to have a "permanent establishment" in the United States, so their business profits would not be taxable by the United States under the U.S.-Japan Income Tax Treaty.

employ similar methods for achieving that goal. Increasingly, the negotiators of international trade and investment treaties are realizing the potential for income tax measures to be used as barriers to international trade and investment. In particular, under a widely supported proposal during the Uruguay Round of GATT negotiations, income tax measures would have been included under the General Agreement on Trade in Services, and disputes about such measures would have come under the jurisdiction of the GATT dispute settlement system. The United States, which led the way in promoting a legalistic dispute settlement system for international trade disputes, led the way in *opposing* this proposal.

To analyze these polar cases of tax and trade dispute settlement mechanisms, one needs a theory of how intergovernmental dispute settlement works. This Article has drawn upon international relations theory to argue that intergovernmental dispute settlement systems function as devices for promoting and maintaining cooperative international regimes.

Drawing upon the study of the iterated prisoner's dilemma, international relations theorists have argued that international cooperation can emerge and be maintained if countries mutually adopt retaliatory strategies. These strategies can break down, however, if the players sometimes make errors in interpreting one another's actions. A legalistic dispute settlement system can help solve this problem by making more authoritative determinations, by facilitating the convergence of expectations necessary for cooperation, and by legitimizing retaliation when it is necessary.

The Article has argued, however, that this function is much more crucial in the international trade context than in the international tax context. The GATT system evolved in a context in which countries—particularly the United States—were resorting to the regular use of unilateral retaliatory strategies in an effort to maintain international compliance with GATT obligations. Even countries that traditionally had opposed legalistic dispute settlement procedures in the international trade context ultimately were persuaded that such procedures were needed to bring these strategies under multilateral control. Tax treaties have had a different history. The use of retaliatory strategies to maintain compliance has been rare, and there are reasons to believe that in most cases such strategies will be ineffective. Therefore, to the extent that legalistic dispute settlement procedures are viewed as a means of managing retaliatory strategies, they appear to be largely unnecessary in the international tax context.

International relations theorists have also drawn upon the “assurance game,” or “stag hunt,” as well as upon the economic theory of information, to argue that the maintenance of cooperative regimes depends critically on knowledge of several elements. These include the requirements of the regime, the performance of the parties under the regime, the reactions of other parties to one's performance, and the reputation of the players involved. A legalistic dispute settlement system can help provide information and help facilitate the development and dissemination of reputation.

The Article has argued, however, that legalistic dispute settlement is much more crucial to the performance of this function in the international trade context than in the international tax context. The restrictions on trade that come before the GATT dispute settlement system are often “disguised.”

They at least nominally take the form of legitimate domestic measures promoting such purposes as environmental protection, consumer protection, or the preservation of national culture. Nevertheless, they place a greater burden on foreign goods than on domestic goods. A legalistic dispute settlement system can play a vital role in generating and disseminating information about the justifications for these measures and their legitimacy under the GATT. In the international tax context, in contrast, measures that violate a treaty obligation and their justifications are likely to be much more transparent. Thus, legalistic dispute settlement will have a less significant role to play in uncovering and disseminating this information. Employing less confrontational and more flexible dispute settlement procedures, and using international fora such as the OECD for interpreting treaties and monitoring countries' practices, are likely to be more suitable means of providing the necessary information in the international tax context.

Finally, the Article has argued that legalistic dispute settlement systems also impose costs on cooperative international regimes. The most significant costs are not the obvious costs of administering the system. Rather, they include the possibility that the use of confrontational and adversarial processes will undermine ongoing relationships; that political forces will lead to conspicuous cases of noncompliance that will threaten the prestige of the regime; that the decisions of politically unaccountable international dispute settlement bodies will be perceived as lacking in legitimacy; and that legalistic systems will fail to be sufficiently flexible to accommodate treaty rules to changing circumstances and issues.

In determining the optimal dispute settlement system for any international regime, these costs must be weighed against the benefits discussed above. Legalistic dispute settlement plays a less critical role in maintaining cooperation in the tax context than in the trade context. The costs of legalistic dispute settlement are at least as great in the tax context as in the trade context. Therefore, the balance of costs and benefits suggests that the legalistic GATT dispute settlement system is not an ideal model for the resolution of intergovernmental income tax disputes.