DSB's General Rules in Dealing with Tariffs on Similar Imported Products and Their Implications for Domestic Practices: Taking the WTO Chilean Wine Duty Case as an Entry Point

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Abstract: The principle of national treatment ensures that foreign nationals receive(natural persons, legal persons, or things) economic treatment comparable to that given to a state's nationals. In international trade, national treatment is reflected primarily in the taxation of imported goods of the same kind (including but not limited to substitutable and directly competitive goods). A lack of uniform standards exists in defining similar goods, and the WTO Dispute Settlement Body (DSB) mainly considers the identification of similar products in terms of their use, substitution elasticity, physical characteristics, consumer preferences, sales channels, prices, tariff categories, etc., and at the same time, it needs to take into account the potential competition. On the other hand, the identification of "different taxes" is mainly based on the "different tax" principle, and the determination of "different taxation" is mainly judged by "whether it is more than a minor difference" and "whether it provides protection for domestic production". This lack of codified standards contributes to disputes regarding the application of the national treatment principle. Through the introduction and analysis of the Chilean Wine Duty case combined with the opinions of the Panel and the Appellate Body, this paper will try to draw the general rules of the DSB in dealing with similar cases, and use them to guide China's future practice, to playing the role of a large developing country on the road of international trade.

Keywords: DSB; Similar products; Tariff; National treatment principle.

1. Introduction

1.1. Briefing on the Case

In the late 1990s, the European Community requested the Dispute Settlement Body (DSB) to enter and negotiate with Chile regarding a special tax on alcohol and an additional surtax on alcohol imposed by Chile. However, the parties failed to reach an agreement, and the International Law Association (ILA) proposed a transitional tax system, where spirits are taxed based on their alcohol content and price. The higher the alcohol concentration, the higher the rate of tax levied on them, whereas most of the domestic spirits in Chile have a lower alcohol concentration, with the imported spirits mostly taxed domestically. Most of the imported alcohol is strong, which results in Chile taxing domestic alcohol at a much lower rate than imported alcohol, and at a much higher rate than the slightest difference, protects Chilean domestic production.

The Chilean side argued, first, that the transitional tax system was introduced to strike a balance between “curbing alcohol consumption” and “preserving tax revenues”, second, Pisco (Chile's domestic spirit) is not a homogeneous product with other distilled spirits, and third, the majority of products subject to the highest rate of tax are domestic products rather than imports. Furthermore, the majority of products subject to the highest rate are domestically produced rather than imported. As a result, the burden of the highest tax bracket primarily falls on domestic products (70% of the products subject to the rate bracket for products with an alcoholic strength of more than 35 proof are Chilean). The Panel noted that the new Chilean regime is likely to result in higher taxes on higher-priced products with low alcohol content compared to lower-priced products with high alcohol content, second, that the majority of Chilean imports currently exhibit a higher alcohol concentration than that of domestic wines, and third, the Panel should assess the status of the like products by evaluating specific details in each case, such as tariff classification, physical attributes, intended use, and market presence of the product. Each determination should be conducted individually, with careful consideration of the pertinent details of the specific case.

1.2. Focus of the Dispute

First, whether the imported and domestic products have a(directly competitive or substitutable product) relationship. The Panel found that, in terms of end-use, the imported and domestic products are substituted on certain occasions by certain consumers for certain purposes. In terms of physical characteristics, the differences between Chilean domestic and imported spirits in terms of color, odor, storage, and other procedures are not so important as to make the products irreplaceable [1]. In terms of distribution channels and points of sale, Chilean domestic and imported spirits are sold through the same distribution channels and are often sold over counters in the same locations. In terms of price, there exists a measurable cross-price elasticity between Chilean domestic and imported distilled spirits, the Panel concludes that Chilean domestic and imported spirits are like products, that there is a certain degree of competition, and that Chile's differing tax treatment violates its commitments under Article III (2) of the GATT[2].

Secondly, regarding whether imported and domestic products that are directly competitive or substitutable are subject to similar taxation, the Appellate Body observed that the tax imposed on imported products should not exceed that on equivalent domestic products in a way that would disadvantage the imports. Additionally, the tax burden disparity must be significant, a determination that should be made on an individual case basis. In this case, the tax rate applied to imported spirits was over double that of domestic Chilean liquors, while the tax rate on other liquors was more than five percent higher than that on Pisco. This exceeded the minimal difference threshold, thereby affording protection to the local industry.

Third, on whether it protects domestic production, due to the low alcohol concentration of Chilean domestic alcohol, under a policy of setting tariff tax gradients based on alcohol concentration, the average value of Chile's domestic alcohol taxes is around 25 percent, which results in imported alcohol with higher alcohol concentrations being taxed at least five percentage points higher than the rate for Chile's domestic alcohol, and imported whisky being taxed at a rate as high as 53 percent. In addition, the panel found that the tax rate on alcohol with an alcohol concentration of more than 40 percent was set directly at 47 percent, whereas the majority of Chilean domestic wines have an alcohol concentration of less than 40 percent and such a leapfrog tax gradient was suspected of imposing a hidden protection on Chilean domestic wines.

2. Identification of Relevant Concepts and Approaches to Existing Disputes

2.1. Identification of Relevant Concepts

First, in terms of defining like products, variations exist in the interpretation and scope of like products across different provisions within GATT Article III's national treatment principle. Therefore, the Japanese Appellate Body introduced the accordion theory, suggesting that no single judgment method applies universally, and the determination of "like-kind" is the same as that of "accordion that expands and contracts" in different places. Like "accordions stretch and contract in different places", the determination of "like-kind" needs to be made in light of the particular provision and case in which the term "like-kind" is used. The Border Tax Adjustment Task Force Report states that "the term like-kind should be interpreted individually for each case to ensure fair evaluation on case-by-case". Specifically, the determination should consider a range of factors, including products like physical characteristics, end-use, distribution channels, price, tariff classification, and consumer preferences and behaviors that vary from country to country. Furthermore, assessing "like products" should involve examining both actual and potential competition, specifically the likelihood of substitution between products (i.e., whether there is a possibility of substitution between the two products) [3].

Secondly, regarding the application of similar taxes to directly competitive or substitutable imported and domestic products, it is essential to recognize that the criteria for identifying identical products differ from those for directly competitive or substitutable products. The criteria for tax differentiation also vary, and the more similar the products are, the more likely it is that they will violate the "minor differences" provision, even if the difference in taxes is relatively small. The more similar the products are. Even a slight tax discrepancy can easily breach the "minor differences" provision. It is important to note that minor tax differences that do not exceed "minor differences" are allowed to exist, as they do not significantly impact fair competition between products. Applying an identical tax rate universally is an idealistic approach that does not align well with practical economic principles, and the existence of allowing minor discrepancies somehow lowers the threshold of goods import and export, partially eliminating the need for pricing. Allowing the existence of small differences to some extent lowered the threshold for the import and export of goods, exempting part of the pricing survey obligations and retaining part of the sovereign country's discretionary tax rates [4].

Thirdly, concerning protection for domestic production, the Appellate Body clarified in the Japan Sake Duty case that such protection is not determined by the intent of lawmakers or policy implementers and that the panel is not required to assess if there was a protectionist intent or if neutral criteria were used. Instead, it examines the specific measure and its impact on domestic production protection. Rather, the assessment focuses on the design, organization, and structure of the measure in question. In the specific analysis, elements like the protective impact of trade in the market and significant tax differentials between products served as indicators of a protective approach. However, it was neither required nor was it necessary for the complainant to prove that the tax measure demonstrated a specific protective effect, a method of analysis similarly used in both the Korea Wine Tax case and the Chilean Wine Tax case.

2.2. Existing Dispute Settlement Methods

First, the mutual agreement procedure (MAP) allows sovereign states to coordinate and consult on tax disputes, enabling relevant national authorities to address and resolve inter-state tax issues, with the main purpose of ensuring the accurate and efficient implementation of tax agreements, helping to prevent double taxation and resolve interpretative or application-related differences between the contracting parties [5]. However, since only countries can initiate MAP negotiations, it does not apply to disputes between foreign taxpayers and a country's tax authorities. It is necessary for taxpayers to file applications for dispute resolution with their home or national countries, which then decide whether to activate the application after reviewing the request. There is a time limit on the taxpayers' application for activation of the MAP, which results in the MAP mechanism not being able to resolve disputes promptly and effectively [6].

Second, is tax arbitration. The tax arbitration procedure, as a key approach for solving international tax disputes efficiently and neutrally, is widely recognized and adopted by the international community. In 1990, the EU finalized the Convention on the Avoidance of Double Taxation from the Adjustment of Profits of Associated Enterprises, significantly revising the mandatory arbitration program and formally integrating arbitration into tax dispute resolution. In 2002, the International Chamber of Commerce (ICC) developed provisions for International Tax Dispute Arbitration, and in 2008, the Organization for Economic Co-operation and Development (OECD) introduced a tax arbitration clause in Article 25 of the revised model, positioning arbitration as an additional resolution method for international tax conflicts [7]. In September 2015, the OECD adopted Action Plan 14 within the Base Erosion and Profit Shifting (BEPS) framework, aiming to improve dispute resolution mechanisms by integrating them into the Forum for Tax Administration and Control (FTAC) and promoting the inclusion of arbitration clauses in tax agreements to strengthen the resolution of cross-border tax issues [8].

These major international tax treaties and key legal documents illustrate that arbitration is increasingly recognized as a standard mechanism for resolving international tax disputes Third, the Appointment Pricing Agreement (APA).

Thirdly, Appointment Pricing Agreements (APAs). APAs are an important approach to disputes arising from adjustments to transfer pricing investigations. According to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Authorities, an appointment pricing agreement refers to an arrangement in which the tax authority and the taxpayer resolve transfer pricing disputes, decide to establish a set of applicable criteria (e.g., how the transaction is conducted, the price reference, and the key assumptions) for the price of the transaction if a connected transaction takes place within a certain period in the future, before the occurrence of the controlled transaction. China's State Administration of Taxation (SAT) also proposed in April 1998 that appointment pricing agreements could be used to resolve disputes between tax authorities and enterprises over transfer pricing [9].

In summary, as the WEC concept continues to evolve, arbitration has shifted into a role as an adjunct or additional procedure to MAP, with the potential to function as an independent method for resolving tax disputes alongside MAP in the future. Using the United States as an illustration, Article 25 of the U.S. 2016 Standard Bilateral Tax Agreement stipulates that if MAP cannot resolve a dispute within two years, arbitration is mandated, thereby enhancing dispute resolution efficiency and acknowledging the complementary role of international tax arbitration. In addition, there is a breakthrough in the protection of taxpayers. If the MAP or the arbitration body does not provide an optimal solution or if the taxpayer finds the outcome unsatisfactory, the ICC model grants the taxpayer a more active role in presenting information and evidence, i.e., the ability to submit written or oral evidence independently, without needing a request from the arbitration committee, and the right to inform the committee of arbitration termination at any time.

3. Implications for China's Domestic Practice

3.1. The Principle of Economy of Hearing before the DSB

The principle of economy of process, which gives panels a certain amount of discretion depending on the specific market situation, has been reflected in many disputes handled by the DSB and has been applied throughout the entire process of adjudication. First, panels and the Appellate Body usually do not review issues that they do not consider necessary to review. Second, they have the power to combine "the same matter raised by multiple members" and "multiple matters raised by a single member" [10]. Third, it is not necessary to review all legal claims raised by the complaining party. Thirdly, it is not necessary to examine all the legal claims made by the complaining party but only the specific matters necessary to resolve the dispute to rationally utilize the limited resources in the process of dispute resolution, effectively protect the lawful rights and interests of the parties and supports a constructive and efficient dispute resolution. In addition, although our country has not incorporated case law into our legal framework, we can still derive insights from comparable or analogous cases and, based on specific fact analysis, refer to the statements of expert panels and the appellate body from past cases, and align with the structure of their analyses and reasoning approach, particularly the appellate body's interpretations and rulings, which hold near-unquestionable authority [11].

3.2. Differential Taxation and the Finding of Protection for Domestic Production

In understanding the MFN rule, we must consider the reality that tariff protection is allowed within the multilateral trading framework, leading to value assessments in applying the MFN rule that is distinctly different from those in Article III regarding national treatment, which enforces a stricter standard of equality than MFN [12]. The national treatment principle broadens the range of similar products to encompass categories such as direct competition and substitution relationships in the market, thereby extending the protection scope of national treatment does not require that the goods be identical, and as long as there is potential competition between two goods, they are included in the scope of protection, whereas the MFN treatment does not require the creation of a fair trade environment, and it permits a nuanced differentiation in products through varied tariff rates to prevent free-riding, thereby attaining "fairness" from a different perspective. From a narrow understanding, as long as a member imposes more taxes on imported products than on domestic products, it constitutes a different tax, and there is no need to consider the impact of the magnitude of the tax difference on the fairness of the transaction, which is not in line with the purpose of the legislation, and therefore other factors should be taken into account, not only from the point of view of the rate of taxation. Otherwise, the "different tax" clause and the "different tax for domestic production" clause are not in line with the purpose of the legislation. Otherwise, the distinction between the "different taxation" clause and the "protection of domestic production" clause would be lost.

3.3. Insights Gained on Distinguishing Identical Products from Those that are Directly Competitive or Substitutable

Identical products represent a category within directly competitive or substitutable products, with the former being narrower in scope and more strictly defined than the latter. For the definition of identical products, complete consistency in chemical composition and physical characteristics is of particular importance, in addition to being regarded as identical by consumers and having the same tariff classification and end use [13]. However, defining products that are directly competitive or serve as substitutes, is more flexible. The physical characteristics do not need to be entirely consistent; as long as they are similar or approximate, while functional substitutability becomes more important. In the three cases on the assessment of whether products are directly competitive or substitutes, the panel in Japan examined the product's physical traits, intended use, tariff classification, and substitution elasticity. In Korea, it added the examination of sales channels and outlets and price elasticity and took potential competition into account. In Chile, the range of the panel's examination mirrored that of Korea and also factored in potential competition. The scope of the panel's review in Chile was the same as that in Korea and also considered the issue of potential competition. As can be seen from the analysis of the panel in Chile, among the factors considered in determining if a product is directly competitive or substitutable, having the same end-use is the most crucial and decisive factor, while shared sales channels, points of sale, tariff categories, and price elasticity contribute supportively but are not determinative. In sum, the competitive relationship between goods should be dynamically grasped from multiple perspectives to create a fair trading environment.

4. Conclusions

The Chilean wine tax case has triggered discussions on such topics as "the principle of trial economy", "the determination of similar, goods that are directly competitive and substitutable", "the determination of different taxation and the protection of domestic production", etc. The present study has been able to draw preliminary conclusions on these topics, which have certain significance in guiding China's practice in international trade. The discussion of topics such as "determination of similar goods and directly competitive and substitutable goods", "determination of different taxation and protection of domestic production", and so on, through the current study, has been able to draw preliminary conclusions, which have certain guiding significance to the practice of China's international trade. As the limitations of MAP and tax arbitration procedures are highlighted, the international community has begun to turn its attention to the international study judicial settlement of international tax disputes, which will provide new ideas and directions for the settlement of international tax disputes. As a member of WTO, China should, as always, comply with WTO regulations and play the role of a developing country in international trade.

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