The Third Strike: United States' Attempts at Achieving Tax Parity Between its Income Tax and the European Value-Added Tax

I. INTRODUCTION

On February 24, 2000, the World Trade Organization's (WTO's) Appellate Body upheld a dispute resolution panel's determination that the tax exemptions and deferrals available to United States (U.S.) exporters through the foreign sales corporation (FSC) regime constitute illegal export subsidies under the WTO's Agreement on Subsidies and Countervailing Measures (SCM) [1] and Agreement on Agriculture (AA). [2]

The FSC legislation attempted to achieve tax parity between contrasting systems of taxation: the extraterritorial income tax and the value-added tax (VAT). The VAT, the predominant system worldwide, imposes a tax on the consumption of goods. Thus, companies do not pay taxes on the income earned from exports. In contrast, the U.S. adheres to an extraterritorial income tax approach whereby the U.S. entity incurs tax liability on income earned worldwide. In an attempt to equalize these systems, the U.S. enacted the FSC legislation in 1984, allowing companies to exclude or defer taxation on a portion of the FSC's income derived from exports.[3]

In accordance with the determination of the Appellate Body that the FSC regime is prohibited, the U.S. was required to modify the offending provisions to make them WTO-compliant. On November 15, 2000, President Clinton signed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000,[4] which "modified the taxation of foreign trade income to comply with the standards set forth in the decisions of the WTO dispute panel and the Appellate Body."[5] To ensure WTO compatibility, the new tax structure cannot confer export-contingent benefits. However, the new legislation fails to accomplish this crucial requirement.

II. OVERVIEW OF THE WTO AS A LEGAL STRUCTURE

From 1947 to 1994, the General Agreement on Tariffs and Trade (GATT) was a

1. Agreement on Subsidies and Countervailing Measures, Apr. 14, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS: THE LEGAL TEXTS 264 (1994).

2. Agreement on Agriculture, Apr. 14, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS: THE LEGAL TEXTS 39 (1994).

3. 26 U.S.C. §§ 921-927 (1994).

4. H.R. 4986.

5. STAFF OF THE SENATE COMM. ON FINANCE, 106th Cong., FSC REPEAL AND EXTRATERRITORIAL INCOME EXCLUSION ACT OF 2000 106-416 (Sept. 20, 2000) (hereinafter SENATE REPORT).

provisional agreement comprised of trade rules and tariff concessions to guide much of the world's trade in goods. The GATT was "formed in a context of largely state-managed economics, where disputes would involve challenges to the exercise of governmental regulatory endowments and would be resolved through a process of bargaining that reflected respective power and the availability of bargaining gains."[6] Provisions in the GATT called for a dispute resolution panel to resolve differences among signatories. The determinations of the GATT panel were merely advisory, as either party to a dispute could prevent their adoption. Nonetheless, the GATT opinions were frequently understood as conclusive explanations of GATT obligations.[7]

For fifty years, a series of eight trade rounds concentrated on developing and enhancing the GATT and its obligations. After seven years of arduous bargaining culminating on December 15, 1993, the Uruguay Round resulted in the most ambitious global trade reform since the creation of the GATT. This reform resulted in the reconstitution of the GATT obligations under the newly-formed WTO and the creation of additional agreements with provisions for opening trade in the intellectual property and services areas.

Once a member of the WTO, a nation agrees to adhere to certain fundamental principles. Through these principles, the WTO advocates that the trading system should be without discrimination, freer, predictable, more competitive, and more beneficial for less developed countries.[8] These principles are the basic elements of a WTO dispute resolution decision.

With respect to trade without discrimination, WTO members agree to adhere to two fundamental principles: the most favored nation principle,[9] stating that a country should not discriminate between its trading partners, and the national treatment principle,[10] stating that a country should not discriminate between domestic and foreign products, services, or nationals once across the customs frontier. Limited exceptions are allowed, such as adherence to specific free trade agreements or the imposition of countervailing duties.[11]

The WTO advocates freer trade to be achieved "gradually, through negotiation" and "progressive liberalization."[12] It is important that member states bind themselves to the WTO agreements since doing so "is an attempt by governments to make the business

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6. Paul B. Stephan, *Sheriff or Prisoner? The U.S. and the World Trade Organization*, 1 CHICAGO J. INTL. L. 49, 51 (2000).

7. *See id.*

8. *See* http://www.wto.org/english/thewto_w/whatis_e/tif_e/fact2_e.htm (last visited Mar. 8, 2001).

9. *See, e.g.*, General Agreement on Tariffs and Trade, Basic Instruments and Selected Documents, Art. 1 (1958) (text of agreement in effect in 1958) (hereinafter GATT).

10. *See, e.g., id.* at Art. 3.

11. *See* http://www.wto.org/english/thewto_w/whatis_e/inbrief_e/inbr00_e.htm (last visited Mar. 8, 2001).

12. *Id.*

environment stable and predictable."[13] Predictability encourages investment, which increases employment and, according to the WTO theory, provides consumers with choices and lower prices.[14] Transparency promotes predictability, meaning that any obstacles to trade should be evident so that trading partners can work around them. The WTO adheres to the classical view in that freer trade also contributes to Third World development.

Importantly, the WTO is not a "free trade" institution – the complicated system of agreements clearly allows for various forms of protectionism. The baseline concept of the WTO is that it advocates fair competition and aims to develop a "system of rules dedicated to open, fair, and undistorted competition."[15] In that regard, export subsidies are an example of protectionist trade policies that are disallowed because they subvert the general principles of the WTO.

Export subsidies are financial or other incentives that stimulate exports. Article XVI:2 of the GATT states that "contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this Agreement."[16]

Export subsidies encourage exports by reducing the costs of production for exports below the costs of production for the domestic market (all else equal). Export subsidies, however, can adversely affect income distribution in the importing country. By lowering the price of the good to consumers, export subsidies can harm labor and capital in the competing local industries. The same can happen with third-country suppliers as well, the industries of which might compete with the exports in the importing country. Thus, the distortion caused by export subsidies is believed to cause economic inefficiency that inhibits worldwide market stability and Third World development.

III. TAXATION AS AN EXPORT SUBSIDY UNDER THE GATT

Article XVI:4 of the GATT prohibits the use of subsidies to stimulate exports: contracting parties "shall cease to grant either directly or indirectly any form of subsidy on the export of any product . . . [that] results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market."[17] More specifically, Article 1.1(a)(1) of the SCM states that a subsidy is deemed to exist where "government revenue that is otherwise due is foregone or not collected."[18] Further, Article 3.1(a) of the SCM disallows subsidies that are "contingent,

13. *Id.*
14. *See id.*
15. *Id.*
16. GATT, Art. XVI:3.
17. GATT, Art. XVI:4.
18. Agreement on Subsidies and Countervailing Measures, Article 1.1(a)(1).

in law or in fact, . . . upon export performance, including those illustrated in Annex I."[19] Annex 1 of the SCM provides an illustrative example of an export subsidy as "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises."[20]

A tax exemption is not always an illegal export subsidy. A tax exemption that satisfies two criteria complies with WTO/GATT obligations: 1) the tax exemption must be one of the "indirect" taxes specified in the SCM; and 2) the tax exemption affiliated with exports cannot be greater than the amount levied on the goods sold domestically.[21]

A. Indirect Tax Requirement

The GATT differentiates between a direct and indirect tax, and it allows a remission or exemption of indirect tax but not of direct tax. Direct taxes are those imposed on a person or corporation. An example is an income tax. In contrast, indirect taxes are those levied on the goods themselves. An example of an indirect tax is the VAT through which a tax is imposed on the value added to the product at successive stages of production. An interpretive note to Article XVI states that "[t]he exemption of an exported product from duties or taxes borne by the product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."[22] In combination with the illustrative example in Annex 1 of the SCM described above (that the exemption from "direct taxes" is a subsidy), the statement "borne by the product" supports the direct/indirect tax distinction in the GATT. Thus, it appears that the GATT permits the remission or exemption of indirect taxes.[23] On the other hand, governments may not exempt exporters from a direct tax. According to an interpretive report by a GATT working party, exempting or deferring the payment of direct tax from exporters would be considered an impermissible subsidy.[24] As a result, a member country is prohibited from using tax exemptions from or deferrals of an income tax to foster exports.

Traditional economic theory predicts that a general percentage tax on economic profits will have no effect on price or output; and, therefore, the full incidence of such a tax will fall on producers. Theoretically, the distinction between direct and indirect taxes in the GATT is based on this assumption. It assumes that producers will shift the cost of the indirect tax forward as a component of the price of the good, added in their entirety

19. *Id.* at Art. 3.1(a).

20. *Id.* at Annex 1.

21. Stephen E. Shay and Victoria P. Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029, 1049 (July, 1997).

22. GATT, Annex 1, Notes and Supplementary Provisions.

23. *See* Ronald Sernau, Note: *The Foreign Sales Corporation Legislation: A $10 Billion Boondoggle*, 71 CORNELL L. REV. 1181, 1183 (Sept. 1986).

24. *Subsidies: Report Adopted 19 November 1960*, GATT Doc. L/1381 *reprinted in* GATT BISD, at 185-86 (9th Supp. 1961).

to the consumer's cost of the good, whereas the same forward-shifting will not occur with direct taxes because they are paid at the source, most likely out of profit. Since they are paid out of profit, the theory concludes, direct taxes do not affect the final price of the product.[25] The consequence follows that only indirect taxes raise the domestic price and place local producers on an unfavorable competitive footing compared with foreign producers with a direct tax system. As a result, the indirect taxes require an adjustment, which is the function of the VAT rebate for exported goods.

The direct and indirect distinction in the GATT is artificial. Income tax may be shifted to the consumer in exactly the same degree as the VAT tax. Producers have highly accurate cost profit projections and can easily anticipate what the tax liability will be. Taxes, as a predictable cost of production, are certain and can be incorporated into the price of the goods as easily as marketing, wages, insurance, and other production costs.

A possible exception is an industry in perfect competition, where the increase in cost would raise the producer's supply curve above a profitable demand price; consumers will flock to other suppliers and the producer with the higher prices will be forced to lower prices or to go out of business. However, perfectly competitive markets are nearly impossible to achieve because they require perfect information. The absence of perfect information means that reality will always fall short of the perfectly competitive theoretical ideal. Even assuming the perfectly competitive theoretical ideal, however, taxes will be factored in as a cost of production and every producer will raise the price by the amount of the tax in the long run.

B. No Excess Tax Rebates for Exports

Similar to the national treatment principle, this second requirement means tax rebates from exports shall not exceed the tax levied on domestically-produced or imported goods. For example, a prohibited export subsidy would be the "exemption or remission in respect of the production and distribution of exported products of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption."[26] The VAT complies with this requirement.

IV. THE FOREIGN SALES CORPORATION STRUCTURE

A. Evolution of the FSC from the Domestic International Sales Corporation

In 1971, Congress enacted the Domestic International Sales Corporation (DISC)

25. *See* Sernau, *supra* note 23, at 1183.

26. Victoria P. Summers, *The Border Adjustability of Consumption Taxes, Existing and Proposed*, 12 TAX NOTES INT'L 1793, 1795 n. 9 (June 3, 1996). *See also* Shay and Summers, *supra* note 21, at 1049 n. 90.

provisions as an incentive to foreign export.[27] A DISC was "a domestic 'paper' corporation through which its American exporting parent channels export income,"[28] the overarching purpose of which was to "remov[e] discrimination against those who export through U.S. corporations."[29] In enacting the DISC, "Congress accepted the modern view that no appreciable difference exists between the impact of direct and indirect taxes on prices [and] designed the DISC legislation's benefits to equalize American exporters with foreign counterparts exporting from countries providing indirect tax refunds and exemptions."[30]

Once certified as a DISC,[31] a company was allowed to follow an alternate, and favorable, tax regime that allowed a certain portion of the DISC's income to be nontaxable (or at least deferred). The DISC structure allowed a fixed percentage of the DISC's income to be treated as if earned by the parent corporation (and thus was taxable), but the remaining income was treated as offshore income, free from tax until repatriated through dividends.[32] The underlying purpose of the DISC was to "mimic what happens under a consumption tax: revenue from export sales does not enter into the tax base."[33]

The DISC structure disturbed the members of the GATT who traded with the U.S. The European Economic Community (EEC, precursor to the European Community) convened a GATT panel challenging this system.[34] The EEC asserted that the DISC structure was effectively an illegal export trade subsidy that permitted indefinite deferral of direct taxes on income earned in the U.S. from exports. This deferral was, the EEC alleged, equivalent to an exemption of direct taxation. The U.S., on the other hand, ar-

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27. Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497, 53553 (1971) (codified as amended at I.R.C. §§ 991-997 (1982 & Supp. III 1985)).

28. Sernau, *supra* note 23, at n.2.

29. *Id.* at 1185, citing S. REP. NO. 437, 92d Cong., 1st Sess. 90 (1971).

30. *Id.*, citing John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. 747, 750-51 (1978).

31. The main requirement is that the company seeking qualification as a DISC must be a wholly-owned subsidiary incorporated in the U.S. with the sole function of selling the parent company's goods overseas. *See* I.R.C. § 992(a)(1)(A)-(C) (1982 and Supp. III 1985).

32. Income earned by a foreign corporation from its foreign operations generally is subject to U.S.

> tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations though a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes a tax on such income at that time.

SENATE REPORT, *supra* note 5.

33. Stephan, *supra* note 6, at 62.

34. United States Tax Legislation (DISC), GATT BISD 23A/98 (1976). The EEC relied on Article XXIII of the GATT:

> If any contracting party believes a benefit it should get under GATT has been 'nulli fied or impaired' as a result of another contracting party's breach of *another* measure, then it may seek consultation and if that fails, the complainant may ask the plenary GATT body to authorize suspension of GATT obligations as a response.

gued to the GATT Council that the tax advantages accrued under the VAT's territoriality principle constitute an export subsidy because they have the same economic effect as any other export subsidy.[35]

Ruling on the dispute, the GATT panel determined that a signatory is not allowed to deviate from its normal pattern of income tax rules simply for the benefit of exporting companies.[36] Following the GATT decision, the U.S. and the EEC continued negotiating the use of tax benefits to stimulate exports in the Tokyo Round and reached an understanding that they incorporated into the 1979 Subsidies Code. The parties delayed adoption of the panel report until 1981, and then imposed a significant modification on the panel findings. Supposedly following the understanding achieved through the U.S. and EEC negotiations, the GATT Council announced that:

> [I]n 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 arms-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."[37]

After the modified Council decision, the U.S. did not formally concede that the DISC regime contravened the GATT's foundational policies. Perceiving the statements of the GATT Council, above, to be an authoritative interpretation of the GATT,[38] the Reagan administration proposed substituting the FSC for the DISC to placate U.S. trading partners.[39] Congress subsequently developed a formula that attempted to evade the problematic details of the DISC while incorporating a favorable tax regime for exporting

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35. *See id. See also, e.g.*, ¶¶ 18, 19, and 33 of the report on France, GATT, BISD, 23d Supp. at 117-18, 122 (1977).

36. *See id.*

37. *Id.*

38. *See* General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 Prepared by the Staff of the Joint Comm. on Taxation (1985) (stating that the FSC legislation is "intended to comply with GATT's requirement[s]"). In addition, U.S. Trade Representative Charlene Barshefsky stated that "[t]he FSC legislation was enacted expressly to conform to an understanding reached 17 years ago in the GATT which articulated the proper relationship between different systems of taxation and international trade rules." Office of the U.S. Trade Representative, Press Release, July 2, 1998. Commenting on the adverse FSC ruling by the Appellate Body, the Office of the U.S. Trade Representative stated that it is still the understanding of the U.S. that these principles did not expire with the reconstitution of the GATT but instead are reflected in the current WTO Subsidies Agreement. USTR Press Release, Feb 24, 2000.

39. "The Administration believes that enactment of . . . [FSC legislation] is essential if we are . . . ever to make progress toward resolving one of our longest outstanding trade disputes." *Foreign Sales Corporation Act; Hearings on S. 1804 Before the Senate Comm. on Finance*, 98th Cong., 2d Sess. 61 (1984) (prepared statement by Robert E. Lightizer).

companies.

Congress thus created the FSC structure in 1984,[40] whereby a portion of the income earned by a foreign subsidiary of a U.S. corporation engaged in minimal economic activity[41] could be exempted from U.S. income tax until repatriated back to the U.S. parent corporation as dividend income. The FSC structure was an attempt to offset the perceived disadvantages to exporters of an income tax regime compared to a consumption-based structure and to comply with GATT obligations. Under these guidelines, the replacing regime "must (1) be GATT consistent; (2) be revenue neutral; (3) maintain the same level of benefit for U.S. exporters as existed under the DISC."[42]

B. Overview of the FSC Structure

An FSC is a foreign corporation set up by a U.S. parent to handle the export activities of the parent. The FSC must have a genuine foreign presence and its income must be attributable to substantial commercial activity outside the U.S.[43] It must be incorporated in a foreign jurisdiction that is party to a "satisfactory" exchange of information agreement with the U.S. or that is a U.S. possession (other than Puerto Rico); the FSC must also maintain an office with "permanent books of account."[44] An FSC is not exempt from traditional transfer pricing requirements in that its income must be derived from an appropriate transfer pricing methodology under either I.R.C. § 482 or administrative rules.[45]

Only the "foreign trade income" of an FSC will be subject to the favorable FSC taxing rules, potentially exempt from U.S. income.[46] Income is considered to be "foreign trade income" when: (1) the income is export-related; (2) the FSC is managed outside the U.S.;[47] and (3) the economic activities generating the FSC's income occur outside

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40. Congress created the FSC as part of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) (codified in scattered sections of 26 U.S.C.). Division A of the Act is the Tax Reform Act of 1984. Title VII of the Tax Reform Act of 1984 includes the FSC legislation. Pub. L. No. 98-369, §§ 801-805, 98 Stat. 985-1103 (1984) (codified at I.R.C. §§ 921-927 (Supp. III 1985)).

41. Generally, the U.S. does not tax the income of a foreign corporation earned outside the U.S.; however, if income is "effectively connected with the conduct of a trade or business within the United States," then this foreign-source income will be considered taxable under U.S. tax law to the extent not credited with respect to foreign income taxes paid on that income. 26 U.S.C. § 882(a).

42. *Foreign Sales Corporation Act; Hearings on S. 1804 Before the Senate Comm. on Finance*, 98th Cong., 2d Sess. 61, 62 (1984) (prepared statement by Robert E. Lightizer).

43. 26 U.S.C. § 922(a).

44. 26 U.S.C. § 922(a)(1)(A), (D).

45. 26 U.S.C. § 922(a).

46. 26 U.S.C. § 922. Note that the benefit of a FSC to the U.S. parent is reduced if the jurisdiction in which the FSC is located requires income tax to be paid by the FSC. Although a tax credit is given for foreign income taxes paid by a foreign entity subject to U.S. income tax, the thrust of the FSC legislation is to exempt the foreign-source income from as much taxation as possible. Therefore, FSCs are likely located in non-tax or low-tax jurisdictions, such as the U.S. Virgin Islands, which was one of the first jurisdictions to pass special legislation exempting foreign trade income from local taxation.

47. 26 U.S.C. §§ 924(b)(1)(A) and 927(d)(3).

the U.S.[48] This foreign trade income is treated as foreign source income that is not "effectively connected with a trade or business in the United States."[49] This foreign source income is reduced by the FSC's deductions; such deductions are not allowed to offset the U.S. parent's income for purposes of U.S. income tax. Examples of transactions that generate foreign trade income for an FSC are: the sale, lease, or rental of export property;[50] services related and subsidiary to such a sale, lease, or rental of export property; engineering and architectural services for projects outside the U.S.; and export management services.[51]

If export property is sold to an FSC by a related entity, the income allocated between the FSC and the related entity must be computed based on a transfer price determined under section 482 or one of two administrative pricing formulas. The exempt portion of the FSC's income depends on the pricing rule used to derive the total income of the FSC. If the FSC's income is calculated through the arm's-length transfer pricing methodologies of section 482, then thirty percent of the FSC's gross foreign trade income is exempt, subject to the FSC's deductions.[52] If, on the other hand, the FSC's income is determined by an administrative pricing rule, fifteen percent of the combined foreign trade income of the FSC and its parent is exempt from U.S. taxation.[53] The latter formulation is complicated, but it derives from the original DISC calculations.

Conceptually, the exempt foreign trade income of an FSC is not taxed in the U.S. because it is not sufficiently connected with the activities of a trade or business in the U.S.[54] Therefore, the net earnings derived from that exempt foreign trade income may be distributed tax-free to the U.S. parent.[55] The remaining income is taxable.[56]

In addition to treating a portion of the export income of an FSC as exempt from federal income tax, the FSC legislation also allowed the U.S. parent corporation a significant deduction for a portion of the dividends distributed from the FSC back to the parent. Thus, there is no corporate level tax imposed on a portion of the income from exports.[57] Estimates of the tax benefits to exporters under the FSC regime are approxi-

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48. 26 U.S.C. § 924(b)(1)(B).

49. 26 U.S.C. § 882(a).

50. Export-related property is "property manufactured or produced in the United States by a person other than the FSC, sold or leased by or to a FSC for use, consumption, or disposition outside the United States, and of which no more than 50 per cent of its fair market value is attributable to imports." 26 U.S.C. § 927(a). Forms of intellectual property, oil and gas products, and "property in short supply" are excluded from the definition of export-related property. 26 U.S.C. § 927(a)(2).

51. *See* SENATE REPORT, *supra* note 5.

52. 26 U.S.C. §§ 923(a)(2) and 921(b).

53. 26 U.S.C. §§ 924(a)(3), 921(b), and 925(a)(2).

54. 26 U.S.C. § 921(a). *See also* 26 U.S.C. § 882(a), stating the prevailing policy that foreign source income is taxed in the U.S. if there is a sufficient connection with a "trade or business within the United States."

55. 26 U.S.C. § 245(c).

56. 26 U.S.C. § 921(d).

57. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 Prepared by the Staff of the Joint Comm. on Taxation (1985).

mately $ 4.5 billion.[58]

V. THE VALUE-ADDED TAX REGIME

International practice is to rely on a mixture of income- and consumption-based taxes. The VAT falls within the latter category. Most countries that are members of the Organization for Economic Co-operation and Development (OECD) rely more heavily on the consumption-based taxation as a percentage of total tax revenue than on the taxation of income.[59] With the exception of the U.S. and Australia, all of the OECD countries have national-level general consumption taxes in the form of credit-invoice VATs.[60] Worldwide, seventy-five percent of other countries use the credit-invoice VAT system.[61]

The usual VAT is an indirect tax imposed on each sale beginning at the start of the production and distribution cycle and culminating with the sale to the customer. All the sellers in the chain collect the VAT from the purchasers at the time of sale, deduct from this amount any VAT they themselves have paid on the purchase, and remit the balance to the government. The net effect of offsetting purchasers and sales is to impose the tax at each stage of production on the sum of wages, interest, rents, profits, and other factors of production not furnished by suppliers subject to the tax at the previous stage of production. Thus, it is a tax on the "value added" to the good. In other words, the tax is levied directly on products, and only indirectly shifts to individuals. When a product is exported from a country using the VAT system, the country rebates the VAT to the exporter. GATT permits the rebate based on the supposed economic difference in forward-shifting between direct and indirect taxation described previously.

The tax advantage to exporters under the VAT system, compared to U.S. exporters, depends at least in large part to whether the VAT countries also impose a direct tax system. The imposition of income taxes could offset the exporters' advantage as long as the distinction between direct and indirect taxation prevails in the GATT.

As mentioned above, the U.S. argued to the GATT Council that the tax advantages accrued under the VAT's territoriality principle constitute an export subsidy. The response of the EEC was textual and technical and did not dispute the economic principles underlying the argument that GATT Article XVI:4 allowed territorial tax systems based on indirect taxation and thus the economic similarities of the territorial tax regime and

58. This is the amount that the EU seeks to impose in retaliatory trade sanctions against the U.S. 17 I.T.R. 1764, (BNA) Nov. 23, 2000. *See also* Sernau, *supra* note 23, at n. 78, estimating the tax savings as $ 9 to $ 13 billion.

59. *See* Shay and Summers, *supra* note 21, at 1066, citing *Revenue Statistics of OECD Member Countries*, 1965-1993, OECD (1994), reprinted in Staff of Joint Comm. on Taxation, 104th Cong., Description and Analysis of Proposals to Replace the Federal Income Tax, 82 Stand. Fed. Tax Rep, (CCH) No. 29 (June 15, 1995).

60. *See* Shay and Summers, *supra* note 21, at 1065.

61. *See id.*

export subsidies was irrelevant.[62] The GATT panel determined that either tax regime is permissible; however, the panel held that neither tax regime can be manipulated to meet the needs of the exporters. Once manipulated for the benefit of exporters, it becomes a subsidy in violation of the GATT obligations.

It seems that both arguments of the U.S. and EEC are correct, but they cannot peacefully co-exist. Although Article XVI:4 does support the territoriality principle and the system of exemption of exporters from indirect taxation, the economic advantages of the territoriality principle do constitute export subsidies in that they provide export-contingent financial incentives. The tricky part for the U.S. is that, given a textual reading of GATT Article XVI:4, such "export subsidies" are legal under GATT and any attempt to circumvent the inherent economic benefits from within an extraterritorial system applying direct, i.e., income, taxation must fail because it explicitly gives a financial advantage based merely on export functions.

VI. THE WTO FSC DISPUTE: APPELLATE BODY DETERMINATION

On November 18, 1997, the European Union (EU) requested the establishment of a dispute panel to hear its complaint that the FSC structure violates U.S. obligations under the WTO. The EU alleged that the FSC provisions violated both the SCM and the AA as a prohibited export subsidy and a prohibited import substitution subsidy. The Panel agreed with the EU and held that the FSC structure tax exemption violated Article 3.1(a) of the SCM and Articles 3.3 and 8 of the AA as an illegal export subsidy.[63]

The U.S. appealed the panel decision to the Appellate Body, based on "multiple legal errors on both substantive and procedural issues."[64] The Appellate Body upheld the panel decision.[65]

A. Disputed Issues

The U.S. urged the Appellate Body to consider the historical background to this dispute, claiming that "the FSC measure . . . can be understood only in the context of basic tax principles, the application of those principles through the FSC measure, and the historical events that led to the creation of the FSC regime."[66] Specifically, "the FSC provisions 'were intended to provide a limited territorial-type system of taxation' for United States exports that complied with GATT subsidy rules."[67]

62. Robert E. Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN. L. REV. 1443, 1484 (June, 1988).

63. World Trade Organization, Report of the Appellate Body, *United States – Tax Treatment for "Foreign Sales Corporations,"* WT/DS 108/AB/R (Feb. 24, 2000), ¶¶ 2(a), (b) (hereinafter Appellate Body Report).

64. USTR Press Release, October 28, 1999.

65. *See generally* Appellate Body Report, *supra* note 63.

66. *Id.* ¶ 19.

67. *Id.* ¶ 22.

According to the Appellate Body, "the issue in dispute is whether, *having decided to tax a particular category of foreign-source income*, namely, foreign-source income that is 'effectively connected with a trade or business within the United States,' the United States is *permitted to carve out an export contingent exemption from the category of foreign-source income that is taxed under its other rules of taxation*."[68] The Appellate Body's clear answer was a resounding no.[69]

1. Arguments by the United States – Appellant

In this appeal, the U.S. contested the Panel's interpretation of footnote 59[70] of the SCM as well as the GATT Council's 1981 "understanding."[71]

a. Footnote 59 of the SCM

The U.S. "considers that footnote 59 permits tax exemptions for foreign-source income even if it is 'specifically in relation to exports.'"[72] The U.S. claimed that footnote 59 qualifies the Illustrative List characterizing certain tax practices as export subsidies so that the FSC regime is exempted from being an export subsidy. In particular, the U.S. makes two arguments regarding footnote 59: First, the second sentence of footnote 59, which affirms the arm's length principle, "*assumes* that foreign-source income *may* be exempted from tax or taxed to a lesser extent than domestic-source income, and would have no meaning if foreign-source income could *not* be exempted from tax."[73] Secondly, the fifth sentence of footnote 59, which excludes measures taken to avoid double taxa-

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68. *Id.* ¶ 99 (emphasis in original).
69. *See id.*
70. The full text of footnote 59 is as follows:

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

71. In its appeal, the U.S. referred to the 1981 GATT Council action in United States Tax Legislation (DISC), 285 GATT BISD 114 (1981), as the "1981 Understanding." The Appellate Body declined to consider the Council action to be as formal as the reference to "1981 Understanding" implies, and instead referred to the action as the 1981 "understanding." *See* Appellate Body Report, *supra* note 63, at n.45.
72. Appellate Body Report, *supra* note 63, ¶ 25.
73. *Id.* (emphasis in original).

tion from the scope of the Illustrative List, functions "as a tax exemption measure to avoid the double taxation of foreign-source income, the FSC measure is permitted by footnote 59."[74]

b. The 1981 "understanding"

The U.S. claims that the 1981 "understanding" resolved the disagreement between the EEC and the U.S. over the DISC regime,[75] and that it "specifically states that economic processes located outside the territory of the exporting country 'should not be regarded as export activities.'"[76] Such characterization would be important because "[t]he import of this language is to remove such processes from the ambit of Article 3.1(a) and Annex 1 of the SCM Agreement, both of which deal exclusively with export subsidies. If foreign economic processes do not constitute 'export activities,' then exempting the income from such processes from taxation cannot be deemed to be an export subsidy."[77] The U.S. also argues that the 1981 "understanding" applies principles of general applicability that have the level of a "decision" carried forward to the WTO.[78]

c. The WTO is not the appropriate dispute resolution forum

The U.S. has stated that the WTO dispute resolution process may not be the best forum to adjudicate the dispute between the U.S. and the EU regarding the tax policies of the FSC regime.[79] In its appeal to the Appellate Body, the U.S. requested that the "decision of the Panel not to dismiss or defer consideration of the European Communities' claims relating to the administrative pricing rules unless and until these rules had been raised in an appropriate tax forum."[80] The U.S. request focused on the fourth sentence of footnote 59, "which directs Members to resort to appropriate tax fora before invoking WTO dispute settlement."[81]

2. Arguments by the European Communities – Appellee

It is on procedural grounds that the EU objects to the U.S. argument that the FSC structure is a permissible measure designed to avoid double taxation: the EU argued that the U.S. "is relying on a new 'affirmative defence,' which it did not raise before the

74. *Id.* ¶ 26.

75. *Id.* 28. The 1981 "understanding" accepted the principles codified in footnote 2 of the *Tokyo Round Subsidies Code*, which "recognized that countries should take steps to avoid double taxation of foreign-source income, and that foreign-source income should be determined on the basis of the arm's length principle." *Id.*

76. *Id.* ¶ 27.

77. *Id.* (emphasis in original).

78. *Id.* ¶¶ 28, 29.

79. Comment of USTR Barshefsky, Discussion with Members and Guests of EU Committee of U.S. Chamber of Commerce, Brussels, Oct. 19, 1998. *See also* Appellate Body Report, *supra* note 63, ¶¶ 41-43.

80. *Id.* ¶ 41.

81. *Id.* ¶ 42.

Panel."[82] In addition, the EU objects to U.S. arguments in that neither "footnote 59 nor the 1981 'understanding' relate to or can create such an exception."[83] The EU asserts that the WTO dispute resolution mechanism is the appropriate forum to resolve this dispute "*because they involve export subsidies prohibited by the SCM Agreement*, and the 'alternatives' suggested by the United States are in any case inappropriate."[84]

B. The Panel Report

In short, the Panel determined that:

> Viewed as an integrated whole, the exemptions provided by the FSC scheme represent a systematic effort by the United States to exempt certain types of income which would be taxable in the absence of the FSC scheme. Thus, application of special source rules for FSCs serves to protect a certain proportion of the foreign trade income of a FSC from direct taxation, whether or not that income would be taxable under the source rules provided for in Section 864 of the US Internal Revenue Code. The exemption from the anti-deferral rules of Subpart F of the US Internal Revenue Code ensure that the undistributed foreign trade income of a FSC is not immediately taxable to the US parent of a FSC, even though such income might otherwise be subject to the anti-deferral rules. Finally, the 100 per cent dividends-received deduction ensures that, even when the FSC distributes earnings attributable to foreign trade income to the US parent company, the US parent will not be subject to US income taxes on that income. Taken together, it is clear that the various exemptions under the FSC scheme result in a situation where certain types of income are shielded from taxes that would be due in the absence of the FSC scheme.[85]

C. The Appellate Body Determination

In determining that the FSC structure serves as an illegal export subsidy, the Appellate Body agreed with the EU that the FSC rules modify the generally-prevailing U.S. tax rules. The Appellate Body stated that the FSC tax regime "establishes three main exemptions which affect the United States tax liability of the FSC, of its United States supplier, and, possibly, American shareholders"[86] differently from how they would be treated if not a FSC.

The first main exemption relates to Subpart F. Under traditional U.S. tax law, Subpart F requires that the U.S. parent of a controlled foreign corporation (CFC) include in its gross income a pro rata share of the CFC's income that has yet to be distributed to the U.S. parent.[87] This Subpart F income is taxable to the U.S. parent without deferral, re-

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82. *Id.* ¶ 45.
83. *Id.* ¶ 47.
84. *Id.* ¶ 61 (emphasis in original).
85. World Trade Organization, Report of the Panel, *United States – Tax Treatment for "Foreign Sales Corporations,"* WT/DS108/R (Oct. 8, 1999) (hereinafter Panel Report).
86. Appellate Body Report, *supra* note 63, ¶ 16.
87. 26 U.S.C. § 951(a).

gardless of whether the parent has yet received the income. The Appellate Body determined that the FSC regime altered this general structure of U.S. tax law in that "the foreign trade income is generally exempted from Subpart F . . . [which means that] the parent of an FSC is *not* required to declare its *pro rata* share of the undistributed income of an FSC that is derived from the foreign trade income of the FSC and is *not* taxed on such income."[88]

Second, under general U.S. tax law, the foreign source income of a foreign corporation is taxable to the extent that it is "effectively connected with the conduct of a trade or business within the United States."[89] Traditionally, a determination whether there is a sufficient connection with a U.S. trade or business is a factual inquiry;[90] however, the Appellate Body found that "the exempt portion of the FSC's foreign trade income is not subject to [this] factual inquiry . . . [but is] *legislatively determined not to be* 'effectively connected' and, therefore, is not taxable in the hands of the FSC."[91]

The Appellate Body Report also describes a third exemption regarding the taxation of dividends. General U.S. tax law provides that dividends associated with foreign source income are taxable when received by the U.S. corporation.[92] Again, the Appellate Body determined that the FSC structure deviates from the typical system, in that "United States corporate shareholders of an FSC generally may deduct 100 percent of dividends received from distributions made out of the foreign trade income of an FSC [which means that] the parent of an FSC is generally not taxed on dividends received that are derived from the foreign trade income of the FSC."[93]

It is true that the FSC regime altered the traditional tax treatment of foreign income. Tax policies of many other countries followed the "territoriality" principle and thus "these laws did not tax income earned outside the country's territory, nor did they impose more than a token tax on foreign earnings remitted to the home country."[94] The territoriality principle is reflected in the VAT. The Internal Revenue Code of the U.S. did not automatically allow for such export savings as the U.S. applies the "extraterritoriality" principle, in which the U.S. imposes a tax liability on any U.S. person, even if residing abroad. The U.S. system of income tax, where any U.S. person incurs tax liability anywhere in the world, reflects this fundamental difference. Under Subpart F of the Internal Revenue Code, "U.S. exporters were required to pay income taxes on the export income of tax-haven subsidiaries that conducted no manufacturing in the tax-haven country."[95] As a result of Subpart F, U.S. exporters paid more income

88. Appellate Body Report, *supra* note 63, ¶ 17 (emphasis in original), citing Panel Report, *supra* note 85, ¶ 7.96. *See also* 26 U.S.C. § 951(e).

89. 26 U.S.C. § 882(a).

90. 26 U.S.C. § 864.

91. Appellate Body Report, *supra* note 63, ¶ 16 (emphasis in original).

92. *See* Panel Report, *supra* note 85, ¶ 7.97.

93. Appellate Body Report, *supra* note 63, ¶ 18, citing 26 U.S.C. § 245(c).

94. Hudec, *supra* note 62, at 1448.

95. Revenue Act of 1962, Pub. L. No. 87-834, § 12, 76 Stat. 1006-27 (codified at I.R.C. §§ 951-964

taxes on their export income than the exporters from countries that followed the territoriality principle.[96] In that regard, the DISC and the FSC regimes could be explained as attempts for tax parity, rather than expression of an intent to subsidize exporting companies.

D. Decision of The Dispute Settlement Body

The Dispute Settlement Body adopted the reports of the Appellate Body and the dispute settlement panel. The EU "expressed its satisfaction at the conclusions of the reports, [but] the United States said that this outcome unjustifiably discriminated between Members on the basis of their tax systems."[97]

VII. NEW LEGISLATION REPLACING THE FSC STRUCTURE

U.S. Trade Representative Charlene Barshefsky stated that the view of the U.S. "remains that the FSC is completely consistent with U.S. WTO obligations."[98] Similarly, U.S. Secretary of the Treasury Lawrence Summers stated that "[t]he FSC rules are widely viewed as creating a level playing field with European tax systems and are important to our business community."[99] Both Ambassador Barshefsky and Secretary Summers asserted that they would seek a compromise with the EU because "it is in neither the interest of the U.S. nor the EU to allow this case to damage our bilateral relationship or to impede progress on a range of U.S.-EU activities."[100]

In fact, the U.S. and the EU did reach an agreement "regarding procedures for reviewing whether the . . . FSC repeal and replacement legislation . . . is WTO consistent."[101] On November 15, 2000, President Clinton signed into law H.R. 4986, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ("FSC replacement legislation").[102] This law was introduced in order to implement the findings of the WTO, and passed with strong bipartisan support.[103]

In short, the FSC replacement legislation provides that part of the income generated by sales outside the U.S. from goods manufactured with more than fifty percent U.S. inputs would be tax-free. The legislation introduces a new formula for calculating the nontax portion of extraterritorial income, and tax is paid on the remainder in the same

(1982)).

96. Hudec, *supra* note 62, at 1449.

97. "DSB Establishes Two New Panels, Adopts Salmon and FSC Reports," *Nouvelles* (Mar. 22, 2000), *available at* http://www.wto.org/french/news_f/news00_f/dsbmar_f.htm (last visited Mar. 10, 2001).

98. USTR Press Release, Feb. 24, 2000.

99. *Id.*

100. *Id.*

101. USTR Press Release, Sept. 30, 2000.

102. *See* http://thomas.loc.gov (last visited Mar. 10, 2001). *See also* "Clinton Signs Law Replacing Foreign Sales Corporation Tax Regime," Press Release of the United States Mission to the European Union (Nov. 17, 2000).

103. *See* "Clinton Signs Law," *supra* note 102. *See also* USTR Press Release, Nov, 14, 2000.

manner as the previous regime.[104] The legislation replaces the 1984 FSC regime with approximately $4.5 billion in tax savings over ten years.[105]

The FSC replacement legislation fundamentally changes the U.S. tax treatment of extraterritorial income by excluding it from gross income to the extent that it is "qualifying foreign trade income." This change moves the U.S. toward a more territorial tax system. Qualifying foreign trade income is defined as the amount of gross income which, if excluded, will result in a reduction of the taxable income by the greatest of: (1) thirty percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction; (2) 1.2 percent of the "foreign trading gross receipts" derived by the taxpayer from the transaction; or (3) fifteen percent of the "foreign trade income" derived by the taxpayer from the transaction.[106] According to the Senate Report by the Committee on Finance, this exclusion of extraterritorial income "parallels the foreign-source income excluded under most extraterritorial tax systems, particularly those employed by the European Union member states."[107]

The U.S. claims that under the FSC replacement legislation, "'the general rule is that extraterritorial income, for example income earned from foreign sales of goods, is not subject to tax. Pursuant to this general rule, the U.S. does not forgo any revenue otherwise due, but instead, as is our right, refrains from subjecting such income to tax in the first place.'"[108] Through the FSC replacement legislation, Congress purports to "treat all foreign sales alike" by applying the general exclusion "to foreign trade income, whether the goods are manufactured in the United States or abroad – a substantially greater category of income than that which was exempted from tax under the FSC provisions."[109] The problem, however, is that the FSC replacement legislation still grants a tax break from payment of direct tax based on exports. In the category of exports, the fundamental principle is that tax breaks cannot be export-contingent. The FSC replacement legislation maintains that crucial distinction, exempting only the extraterritorial income derived from export activities, and thus is not WTO-compliant.

It does not seem that the FSC replacement legislation complies with the WTO simply because "[u]nder neither the U.S. tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting."[110] The FSC replacement legislation excludes a portion of income on the sole justification that it was earned on account of exports. The FSC re-

104. 17 ITR 1506 (BNA) Oct. 5, 2000.

105. 17 ITR 1596 (BNA) Oct. 19, 2000. Note that this is slightly higher than the amount of tax revenue that the FSC regime is estimated (by the Congressional Research Service) to cost the U.S. government. 17 ITR 1506 (BNA) Oct. 5, 2000.

106. H.R. 4986, Sec. 941.

107. Joint Comm. on Taxation, *Technical Explanation of the Senate Amendment to H.R. 4986, the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000,"* (JCX-111-00) Nov. 1, 2000.

108. 17 ITR 1338 (BNA) Sept. 17, 2000, quoting the Sept. 1, 2000 statement of a "senior U.S. official."

109. *See* SENATE REPORT, *supra* note 5.

110. *Id.*

placement legislation contains a foreign requirement: "property constitutes qualifying foreign trade property if, among other things, the property is held primarily for lease, sale, or rental, in the ordinary course of business, for direct use, consumption, or disposition outside of the United States."[111]

The FSC replacement legislation is an attempt to "ensure that the current recipients of the FSC structure continue to enjoy the same level of benefits as before, without addressing aspects of the existing FSC system that violate WTO export subsidy rules."[112] Certainly, the FSC replacement legislation does not change the defining characteristics of an FSC. In order to enjoy these tax savings, the entity must be a foreign corporation set up by a U.S. parent to handle the export activities of the parent that must have a genuine foreign presence and earn income attributable to substantial commercial activity outside the U.S. Similarly, no foreign tax credit is allowed for income paid with respect to the excluded extraterritorial income and the FSC must adhere to traditional arm's length pricing guidelines under Section 482 or one of the two administrative rules. The only apparent change is that rather than allow a tax deferral or exemption of a portion of foreign trade income, the FSC replacement legislation now simply does not include this income in gross income in the first place. The U.S. is on shaky ground.

The FSC replacement legislation attempts to reconcile the Appellate Body's prohibition on giving back direct taxes through exemptions or indefinite deferrals. Not including a portion of the income affiliated with export activities from income tax liability, however, is the functional and literal equivalent of exempting or indefinitely deferring the same amount. The formula for calculating the exempted income differs between the two enactments, but the result is indistinguishable. Although the legislation "fundamentally changes" the general U.S. tax regime by excluding extraterritorial income, it only excludes a portion of specific extraterritorial income – that income derived from exports. U.S. entities abroad earn income from activities other than export-related activities. Yet, under this legislation, such "extraterritorial" income would be taxed as usual. This inconsistency will be the legislation's undoing before the WTO. As the GATT panel ruled that the DISC structure violated GATT obligations *and* as the WTO Appellate Body determined that the FSC regime does not comply with WTO obligations, the FSC replacement legislation also "serves to protect a certain proportion of the foreign trade income of a FSC from direct taxation."[113] Thus, U.S. efforts to cushion the differential impact of income tax with the rest of the world's VAT has not found an acceptable solution.

Functionally, the FSC replacement legislation approximates the VAT in that exporters do not pay taxes because the goods do not remain for consumption in the exporting country. However, the FSC replacement legislation does not comply with Article XVI of the GATT since it excludes a portion of direct tax from tax liability. It is

111. *Id.*
112. 17 ITR 1338 (BNA) (Sept 17, 2000).
113. Panel Report, *supra* note 85, ¶ 7.92.

unlikely that the U.S. will be able to modify its existing tax regime to achieve tax incentives for exporters and to comply with WTO requirements as long as (1) the U.S. maintains its direct, extraterritorial system or (2) the WTO does away with the distinction between direct and indirect taxation.

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