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AN ANALYSIS OF FOREIGN SALES CORPORATIONS AND THE EUROPEAN COMMUNITIES' FOUR BILLION-DOLLAR RETALIATION

JAMES JOSEPH SHALLUE*

I. INTRODUCTION

Located in Geneva, Switzerland, the World Trade Organization[1] is comprised of over 140 members.[2] Since its inception in 1994,[3] the WTO has provided its members a forum for trade negotiations and disputes.[4] Through the use of this dispute resolution process, the WTO's ultimate goal is to ensure free trade and fair pricing throughout the world.[5]

Disputes in the WTO currently range from the European Communities' dispute with India over anti-dumping violations[6] to violations of Chilean alcohol taxation.[7] One dispute currently before the WTO is particularly important because it involves over four billion dollars in compensatory measures.[8]

In a dispute entitled the "United States: Tax Treatment for Foreign Sales Corporations,"[9] the European Communities allege that the Unites States is illegally

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1. In this article, the World Trade Organization will be referred to as the WTO. *See* WTO, Welcome to the WTO website, *at* http://www.wto.org (last visited June 23, 2003).

2. As of January 1, 2002, the WTO was comprised of 146 countries. *See* WTO, About the Organization, *at* http://www.wto.org/english/thewto_e/thewto_e.htm (last visited June 23, 2003).

3. *See* Uruguay Round of Multilateral Trade Negotiations, Agreement Establishing the World Trade Organization, (Apr. 15, 1994), *available at* WTO, Legal Texts, UR: The Final Act, http://www.wto.org/wto/english/thewto_e/whatis_e/eol/e/wto01/wto1_34.htm [hereinafter Uruguay Round Agreement].

4. *See* WTO, WTO: Main Functions, *at* http://www.wto.org/wto/english/thewto_e/whatis_e/eol/e/wto01/wto1_11.htm (last visited Oct. 17, 2002).

5. *See id.*

6. WTO Doc. WT/DS141/R (Mar. 1, 2001). All WTO documents, unless specified otherwise, are found Disputes and Dispute Settlement, either at All the Panel Reports or All the Appellate Body Reports, *at* http://www.wto.org/english/tratop_e/dispu_e/dispu_status_e.htm.

7. WTO Doc. WT/DS87/R (June 15, 1999).

8. *See* Paul Meller, *Europeans Seek $4 Billion in Trade Sanctions Against U.S.*, N.Y. TIMES, Nov. 18, 2000, at C1.

9. *See* WTO Doc. WT/DS108/RW (Aug. 20, 2001).

subsidizing exporters through the use of the Internal Revenue Code,[10] in violation of its WTO obligations.[11] The United States counters that the Code's provisions are not subsidies, and that its tax legislation is currently meeting all WTO obligations.[12]

This dispute is the culmination of a long and heated battle between the United States and the European Communities over the exact definition of the term subsidy. A subsidy can generally be defined as a "non-tariff measures utilized by governments either to inhibit imports (so-called 'domestic subsidies') or to enhance exports (so-called 'export subsidies'). Subsidies typically constitute direct or indirect economic benefits granted by governments to an industry or group of industries."[13] The United States and the European Communities, however, vehemently disagree over an exact definition of the term subsidy.

This disagreement, currently in its fourth decade, began in 1971 with the advent of Domestic International Sales Corporations (DISCs).[14] At the time, American corporations were losing the export battle because double taxation and value added taxation caused their prices to be much higher than those of their foreign competition.[15] In order to be competitive abroad, DISCs were developed so that American exporters could lower their overall prices. This was accomplished by deferring part of their tax liability through the use of a tax-free commission. Because exporters had lower tax liabilities through the use of DISCs, they could lower their prices and still maintain the same profit margins. These lower prices on exports eventually translated into a more competitive environment between American and foreign corporations.

Foreign countries affected by DISCs, however, felt that they were an illegal subsidy rather than a tax deferral. The United States argued that because DISCs mirrored territorial and value added taxation systems, they could not be considered subsidies. Eventually, under the General Agreement on Tariffs and Trade,[16] DISCs were held to be subsidies.

In 1984, because DISCs could no longer be used as intended, the United States implemented the Foreign Sales Corporation (FSC) as a vehicle to increase

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10. In this article, the term Code will refer to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

11. *See generally* WTO Doc. WT/DS108/RW Annex A-1 (Aug. 20, 2001), First Written Submission of the European Communities.

12. *See generally* WTO Doc. WT/DS108/RW Annex A-2 (Aug. 20, 2001), First Written Submission of the United States.

13. Rosendo Lopez-Mata, *Income Taxation, International Competitiveness and the World Trade Organization's Rules on Subsidies: Lessons to the U.S. and to the World From the FSC Dispute*, 54 TAX LAW. 577, 580 (2001) (footnotes omitted).

14. For a discussion of DISCs, *see infra* notes 129-153 and accompanying text.

15. For a discussion of double taxation and value added taxation, *see infra* notes 107-121 and accompanying text.

16. The General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194 [hereinafter GATT]. As a note, all WTO legal documents (except for the Tokyo Round Subsidies Code, *see infra* note 74) can be found at WTO, Legal Texts - The WTO Agreements, *at* http://www.wto.org/english/docs_e/legal_e/legal_e.htm.

competition between American and foreign corporations.[17] Unlike a DISC, a FSC was designed to be a foreign corporation that operated on a dividend-basis with its domestic parent corporation. The United States felt that FSCs complied with GATT, and were not an illegal subsidy because they mirrored territorial and value added taxation systems used by others in Europe and throughout the world.

Many foreign countries, however, argued that FSCs, like DISCs before them, were an illegal subsidy under GATT and other international trade agreements, including the Agreement on Subsidies and Countervailing Measures[18] and the Agreement on Agriculture.[19] These foreign countries, now formally known as the European Communities, again argued that FSCs provided an illegal subsidy rather than a tax deferral. They also argued that because FSCs were export-contingent, they were also an illegal subsidy under various other WTO agreements. The newly formed WTO agreed, effectively terminating the FSC method of taxation.[20]

Still in need of a vehicle to facilitate competition between American and foreign corporations, the United States enacted its current method of taxation called Extraterritorial Income (ETI) in 2000.[21] Unlike the previous methods of taxation, ETI allows both domestic and foreign corporations to take advantage of its tax benefits. This distinction between ETI and FSCs, the United States feels, should placate the European Communities' previous arguments regarding illegal subsidies because this system is not export-contingent.

Unfortunately, the WTO disagreed. On August 20, 2001, the WTO held that ETI was in violation of the Agreement on Subsidies and Countervailing Measures and the Agreement on Agriculture because it was, in fact, export-contingent.[22] This ruling was recently upheld by the WTO's Appellate Body.[23] In addition to these rulings, the WTO also allowed the European Communities to commence with four billion dollars in retaliation against the United States, equal to the savings afforded American exporters under FSCs.[24]

This ruling, however, does not mean that there is a consensus on the exact definition of the term subsidy. The United States, being consistent with its argument throughout, feels that if the exact definition of a subsidy is simply a deferral of taxation, as the European Communities argue, then many other countries are also illegally subsidizing their exporters.[25] These other countries

17. For a discussion on FSCs, *see infra* notes 154-213 and accompanying text.

18. Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, *available at* http://www.wto.org/ english/ docs_e/legal_e/24-scm.pdf.

19. Agreement on Agriculture, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, *available at* http://www.wto.org/english/docs_e/legal_e/14-ag.pdf.

20. For a discussion on the WTO decision, *see infra* notes 195-204 and accompanying text.

21. For a discussion on ETI, *see infra* notes 214-294 and accompanying text.

22. *See* WTO Doc. WT/DS108/RW, at 9.1(a).

23. *See* WTO Doc. WT/DS108/AB/RW *at* 256(a).

24. *See Extraterritorial Income: EC Plans $4 Billion Sanctions Against U.S., Will Fight Appeal of WTO Rulings on FSCs*, 161 DAILY TAX REP., Aug. 21, 2001, at GG-1. For a discussion on the tax savings of FSCs, *see infra* notes 169-172 and accompanying text.

25. In fact, the Bush administration is considering bringing a dispute against the European

forego taxation on income by using value added taxation, a territorial taxation system, or a combination of those systems. The WTO and the European Communities argue that a subsidy is present when a country foregoes taxation on income because of the income's export nature.[26]

To understand this lack of consensus on an exact definition of a subsidy, this article will first provide background into various aspects of the international trade community and how these aspects affect the current dispute over the term. Specifically, Part II of this article will analyze the mechanics of the WTO dispute resolution process, and how countries settle trade issues. Part III will then discuss the evolution of GATT, the WTO, and various agreements signed by the United States defining subsidies. Part IV will compare and contrast the different methods of taxation in Europe and the United States. Next, this article will examine the heart of the current disagreement over the term subsidy. Part V will look at the evolution of American taxation methods from the advent of Subpart F[27] to the FSC Repeal Act and Extraterritorial Income Exclusion Act of 2000 (ETI).[28] It will also analyze the arguments made by the European Communities and United States to the WTO on each taxation method. Part VI will discuss the different options for the United States regarding compliance with its WTO obligations. Finally, Part VII will analyze the disparity between the world's tax systems and international obligations in general. This article will conclude that it is necessary to have meetings with European Communities and WTO representatives to address future United States tax legislation specifically, and determine whether this future legislation will be WTO compliant.

II. WTO AND THE DISPUTE RESOLUTION PROCESS[29]

As previously stated, the WTO attempts to enable free trade through the use of its dispute resolution process.[30] Governed by the Understanding on Rules and Procedures Governing the Settlement of Disputes,[31] this process is divided into

Communities and their use of VAT taxation. *See Aldonas Says US to Seek WTO Review of Vat Deductions EU Allows for Exports*, 82 DAILY TAX REP., Apr. 29, 2003, *at* G-4. For a discussion on the VAT tax and why it is similar to ETI, *see infra*, notes 108-119 and accompanying text. *See also* notes 179 and 229-30 and accompanying text.

26. *See* "but for" analysis of FSCs, *infra* at notes 197-198, and ETI, *infra* at note 257 and accompanying text.

27. *See* Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 TEX. L. REV. 1525, 1527-28 (2001) (stating that the original Subpart F proposal was in 1961 under the Kennedy Administration).

28. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. Law No. 106-519, 114 Stat. 2423 (2000) (codified as amended in scattered sections of 26 U.S.C.).

29. This article discusses specifically the Dispute Resolution Process and its general affect on complaints brought by WTO members. For a discussion on the WTO's Dispute Resolution Process and its affects on investments and foreign policy, *see generally* Kevin C. Kennedy, *Foreign Direct Investment and Competition Policy at the World Trade Organization*, 33 GEO. WASH. INT'L L. REV. 585 (2001).

30. *See supra* notes 4-5 and accompanying text.

31. Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex Two, *available at*

five parts, culminating in a binding obligation between the WTO and its members.[32] If the country in violation of WTO agreements cannot comply, or refuses to comply, with this binding obligation, the process allows for compensatory and retaliatory measures against the non-complying country. Each of the five parts of the dispute resolution process is discussed below.

A. *Procedures for Resolving Trade Disputes*

The first step in settling a trade dispute between members of the WTO is a formal consultation.[33] The purpose of this consultation is to set the groundwork for a conclusion to the disagreement. Usually lasting two to three hours,[34] it allows for confidential discussions about the trade dispute.[35] If the countries are having difficulty reaching an agreement, they can request a WTO mediator to facilitate the discussion.[36]

The majority of disputes that reach the consultation stage are resolved within a couple of months.[37] Some are settled for practical reasons, while others are settled on the merits of the case.[38] If the parties cannot settle the disagreement within sixty days of the consultation, the complaining party has the right to request a Panel from the Dispute Settlement Body to resolve the dispute.[39]

The Panel is comprised of three to five experts in the field of the dispute.[40] Independent from the countries in disagreement, the Panel's members are well-qualified government and/or non-government individuals. Many of these individuals have taught or published in the field of international trade law or policy, or served as senior trade policy officials for a WTO member.[41]

The Panel first hears the dispute between the disagreeing countries, making an objective assessment of the matter before it.[42] This includes receiving briefs from

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http://www.wto.org/english/docs_e/legal_e/28-dsu.pdf [hereinafter DSU]. *See also supra* note 3.

32. These parts include: 1) formal consultations; 2) hearings before a Panel; 3) passage or failure of the Panel's recommendations by the Dispute Settlement Body; 4) appeal of the Dispute Settlement Body's holding; and 5) implementation of the Dispute Settlement Body's decision. *See* WTO, Trading into the Future, Settling Disputes, The Panel Process, *at* http://www.wto.org/english/thewto_e/whatis_e/tif_e/disp2_e.htm.

33. *See* DSU, *supra* note 31, at art. 4.

34. *See* Mark Clough, *The WTO Dispute Settlement System—A Practitioner Perspective*, 24 FORDHAM INT'L L.J. 252, 254 (2000).

35. *See* DSU, *supra* note 3129, at art. 4(6) (stating that consultations shall be confidential, and without prejudice to the rights of any member in any further proceeding).

36. *See generally id.* at art. 5.

37. *See* Clough, *supra* note 34, at 264.

38. *See id.*

39. *See* DSU, *supra* note 31, at art. 4(7). The Dispute Settlement Body is comprised of all WTO members, and enforces all decisions made under the auspices of the DSU. *See id.* at art. 2(1).

40. *See id.* at art. 8(5). The disputing parties do not pick these Panel members; rather they are appointed by the Secretariat of the Dispute Settlement Body. *See id.* at art. 8(4).

41. *See id.* at art. 8(1).

42. *See* DSU, *supra* note 31, at art. 11:

> The function of a panel is to assist the DSB in discharging its responsibilities under this Understanding and the covered agreements. Accordingly, a panel should make an

each party, and also hearing oral arguments, similar to opponents in an American court. The Panel concludes its debate, and issues a preliminary report within six months.[43]

The Panel then files its preliminary report with findings and recommendations with the Dispute Settlement Body for approval.[44] This report is privately circulated among the body's members for review.[45] Eventually, the Panel will publicly release its report. In the interim period between private circulation and public release, the Panel does have the right to reconsider its findings and decision on the matter.[46]

Once the report is made public, the report is given to the Dispute Settlement Body for approval. After a brief discussion, the body then votes on the Panel's recommendations by a one-member, one-vote format.[47] The Dispute Settlement Body in the past has always accepted the decision of the Panel because the only way to override the Panel's recommendation is by majority vote.[48] This means that in order to override the Panel's decision, the losing party has to persuade one-half of the members of the body, or seventy-three other countries, to agree with its argument. This is a nearly impossible task, considering the diverse views and backgrounds of the body's members.

Once the Dispute Settlement Body has placed its approval on the Panel's recommendation, it is binding on the losing party.[49] The losing party, however, does have the right to appeal this decision to a higher authority: the Appellate Body.[50]

B. Appeal and Compliance by the Losing Party

As previously stated, the losing party does have the right to appeal the Panel's decision. In fact, the majority of the disputes that have reached the Panel have been appealed.[51] Made up of seven members,[52] the Appellate Body is charged with addressing each of the Panel's findings, and may uphold, modify or reverse

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> objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements, and make such other findings as will assist the DSB in making the recommendations or in giving the rulings provided for in the covered agreements. Panels should consult regularly with the parties to the dispute and give them adequate opportunity to develop a mutually satisfactory solution.

43. *See* id. at art. 12(8).

44. *See* Joost Pauwelyn, *Enforcement and Countermeasures in the WTO: Rules Toward a More Collective Approach*, 94 AM. J. INT'L L. 335, 336 (2000).

45. *See* Scott McBride, *Dispute Settlement in the WTO: Backbone of the Global Trading System or Delegation of Awesome Power?*, 32 LAW & POL'Y INT'L BUS. 643, 647 (2001).

46. This is a moot point, though, because no Panel has ever reversed itself during the interim period. *See Extraterritorial Income: WTO Issues Final Ruling Maintaining Interim Findings Against U.S. FSC/ETI*, 141 DAILY TAX REP., July 24, 2001 at GG-1.

47. *See* Pauwelyn, *supra* note 44, at 336.

48. *See* DSU, *supra* note 31, at art. 16(4).

49. *See* Clough, *supra* note 34, at 259.

50. *See* DSU, *supra* note 31, at art. 16(4).

51. *See* Clough, *supra* note 34, at 264.

52. *See* DSU, *supra* note 31, at art. 17(1).

any of the legal findings and conclusions of the Panel.[53] The Dispute Settlement Body will adopt the Appellate Body's ultimate conclusion, absent consensus to the contrary.[54]

Once the Appellate Body adopts the Panel's report, the losing party has to inform the Dispute Settlement Body of its plan of implementation.[55] If the losing party cannot immediately comply, a reasonable time period will be established for compliance. This is determined by a time period (a) approved by the Dispute Settlement Body; (b) approved by the parties in dispute within forty-five days; or (c) approved by an arbitrator within ninety days from the adoption of the Panel's recommendation by the Dispute Settlement Body.[56] The DSU also states that a reasonable time cannot exceed eighteen months.[57]

If the losing party does not implement a plan to cure the violation, the complaining party has the right to request compensation twenty days after the end of a reasonable time period.[58] Generally, compensation involves the lifting of trade barriers by the losing party. This may include tariff reductions or increases in the losing party's import quotas.[59] It is generally understood that compensation is to be offered to all WTO members.[60]

This compensation can also come in the form of retaliation. Unlike general compensation, "[r]etaliatory measures are directed primarily at concessions or other obligations applicable to the same sector as that in which the Panel or Appellate Body found an infringement."[61] This in essence means that retaliation is more specific than general compensation. The Dispute Settlement Body will authorize this retaliation unless there is a consensus against it.[62] The losing party does have the opportunity to dispute the amount of retaliation or compensation by requesting an arbitrator.[63]

To protect the Panel's decision, the Dispute Settlement Body continuously monitors the implementation process used by the losing party.[64] If the body and the losing party disagree on whether it is implementing a process to cure the violation, the losing party has the right to remand the disagreement back to the Panel for verification of its implementation process.[65]

53. *See id.* at art. 17(13).

54. *See id.* at art. 17(14).

55. *See id.* at art. 21(3). The DSU specifically calls for prompt implementation and compliance with the body's decision. *See id.* at art. 21(1).

56. *See id.* at art. 21(3).

57. *See id.* at art. 21(4). This eighteen month time period is important because current legislation will replace ETI over a five-year phase-in period. For a discussion on H.R. 1769, *see infra*, notes 314-332 and accompanying text.

58. *See id.* at art. 22(2).

59. *See* Pauwelyn, *supra* note 44, at 337.

60. *See id.*

61. Clough, *supra* note 3432, at 262.

62. *See* DSU, *supra* note 31, at art. 22(6).

63. *See* DSU, *supra* note 31, at art. 22(6).

64. *See id.* at art. 21(6).

65. *See* DSU, *supra* note 31, at art. 21(5). For a flow chart of the entire WTO dispute resolution

III. GATT, THE WTO, AND THE DEFINITION OF SUBSIDY

By way of background, this section will discuss the evolution of the WTO as an international organization. Because this article focuses specifically on a dispute between the European Communities and the United States regarding the definition of a subsidy, this section will also examine specific WTO agreements signed by the United States that define the term subsidy within the context of trade matters.

A. *GATT: 1947*

Established in 1947, and ratified in 1948, GATT was essentially a series of multilateral trade concession agreements, written to help regulate an expanding international marketplace.[66] Signed by a majority of the leading industrial powers at the time,[67] it was the framework used in building what is now the WTO.[68]

In order to aid the regulation of international trade, GATT's drafters included various articles specifically regulating certain business practices. Ranging from Cinematographic Films[69] to Exchange Arrangements,[70] these articles helped to define GATT members' obligations to one another. In their complaint against the United States, the European Communities base some of their argument on Article XVI of GATT, dealing with subsidies.

Specifically, Article XVI prohibits export subsidies of non-agricultural products because they hinder the objectives of GATT and affect international trade in general.[71] This means that a GATT member cannot cause the sale of an export

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process, *see* WTO, Trading into the Future, Settling Disputes, The Panel Process, *at* http://www.wto.org/english/ thewto_e/whatis_e/tif_e/disp2_e.htm.

66. *See* Ricardo Corona, *The Continuing Viability of the Banking and Financial DISC: A Tool Sheltering Export Finance Income*, 27 U. MIAMI INTER-AM. L. REV. 361, 366 (1995).

67. These nations included the United States, France, Australia, Canada and Great Britain. For a complete list of signatories, *see* GATT, *supra* note 16, at preamble.

68. In the establishment of the WTO, the final act of the Uruguay Round was to make binding on all WTO members all prior GATT agreements and legal instruments. *See* Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, Annex 1A, at preface, LEGAL INSTRUMENTS — RESULTS OF THE URUGUAY ROUND vol. 1, 33 I.L.M. 1125 (1994) [hereinafter Final Act], *available at* http://www.wto.org/english/docs_e/legal_e/06-gatt.pdf. *See also* Corona, *supra* note 66, at 366 n.27.

69. *See* GATT, *supra* note 16, at art. IV.

70. *See id.* at art. XV.

71. *See* GATT, *supra* note 16, at art. XVI, Section A - Subsidies in General:

> 1. If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory, it shall notify the CONTRACTING PARTIES in writing of the extent and nature of the subsidization, of the estimated effect of the subsidization on the quantity of the affected product or products imported into or exported from its territory and of the circumstances making the subsidization necessary. In any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the CONTRACTING PARTIES, the possibility of limiting the subsidization.

product to be made at a lower price than that charged for a similar product in the domestic market because it violates GATT obligations.[72] These types of subsidies can affect international trade in two respects.

First, hypothetically, if the United States is subsidizing its exports, this subsidy reduces the price of export goods by foregoing taxation on international transactions. This allows the American exporter to lower the price of its goods due to less tax liability to the United States. In a hypothetical export transaction in France, if this tax liability is less than the tax liability of a French company, the American exporter can sell a widget in France at a lower price than the domestic producer.

Due to lower taxes on the American exporter, other foreign exporters will be discouraged from competing with the United States in France's widget market.[73] This is because the foreign producer is in fact paying more taxes on its widget than the American exporter. The foreign exporter's government may be forcing its exporters to pay taxes on the sale, whereas the United States is foregoing the tax due on the transaction.

Second, because the American widget is cheaper than the French widget, and there is no foreign competition in the French widget market, sales for the American widget will rise.[74] This is basic economics: barring any outside factors such as quality or advertising, if the American widget is the cheapest on the French widget market, it should sell more rapidly than any other country's widget.

Article XVI's basic assumption is that it is illegal to subsidize exports to foreign markets. There is a problem though, because the term subsidy is not specifically defined within GATT.[75]

B. The Tokyo Subsidies Code of 1980[76]

To alleviate some of the confusion regarding the exact definition of subsidy, the Tokyo Subsidies Code first restated GATT's rule prohibiting the subsidizing of

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> 2. The 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.

72. *See id.* at art. XVI, Section B - Additional Provisions on Export Subsidies:

> 4. Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly *any form of subsidy on the export of any product other than a primary product which subsidy 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.* Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing, subsidies. (emphasis added).

73. *See* Phillip L. Jelsma, *The Making of a Subsidy, 1984: The Tax and International Trade Implications of the Foreign Sales Corporation Legislation*, 38 STAN. L. REV. 1327, 1329 (1986).

74. *See id.*

75. *See generally*, GATT, *supra* note 16, at art. XVI.

76. Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, Apr. 12, 1979, *available at* http://www.worldtradelaw.net/tokyoround/subsidiescode.pdf [hereinafter Tokyo Round Subsidies Code].

exports.[77] It then added an illustrative list of practices that GATT considered to constitute subsidizing activities.[78]

Within this illustrative list, paragraph (e) prohibited subsidies that were in essence tax deferral regimes, unless they charged interest on the deferral. In its text, paragraph (e) states that "the full or partial exemption, remission, or *deferral* specifically related to exports. . ." is considered a subsidy.[79] This is very important because if the United States would chose to use a deferral method of taxation, it would need to charge interest to be in agreement with its GATT obligations, or make sure that the deferral is not export contingent.[80] As is the case with the original GATT-1947 agreement, the Tokyo Round Subsidies Code did not specifically define subsidy; it simply provided a list of activities that were considered by GATT to be subsidies.

C. *The Uruguay Round of Multilateral Trade Negotiations (1986-1994)*

The main focus of the Uruguay Round was to create the WTO as an international organization.[81] This, in effect, created binding legal obligations between its members to adhere to WTO rules, and bound members to the dispute resolution process, previous GATT agreements, and any future WTO agreements.[82] The United States accepted the terms of this agreement in 1994.[83]

One of these WTO agreements was the Agreement on Subsidies and Countervailing Measures.[84] Part of the Uruguay Round, this agreement actually defined the term subsidy and expanded on the concept of a prohibited subsidy. According to this agreement, a subsidy must satisfy a two-part test. The first part of the test, deemed the subsidy existence test,[85] states that a subsidy exists where there is a financial contribution by a government.[86] This financial contribution can come

77. *See id.* at art. 19(1).
78. *See id.* at Annex.
79. *Id.* at Annex, para. (e) (emphasis added).
80. For a discussion of the DISC regime, *see infra* notes 129-153 and accompanying text.
81. *See generally* Uruguay Round Agreement, *supra* note 3.
82. *See* McBride, *supra* note 45, at 644.
83. *See generally* Uruguay Rounds Agreement Act, Pub. Law 103-465, 108 Stat. 4809 (1994).
84. *See supra* note 18.
85. *See* Lopez-Mata, *supra* note 13, at 582.
86. *See* Agreement on Subsidies and Countervailing Measures, *supra* note 18, at art. 1 — Definition of a Subsidy:

> For the purpose of this Agreement, a subsidy shall be deemed to exist if:
> (a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:
> a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);
> government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);
> (iii) a government provides goods or services other than general infrastructure, or purchases goods;
> (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii)

from a variety of sources, including a government foregoing taxation on certain transactions.[87] An example of this would be the United States foregoing taxation on FSCs.[88] This was done by allowing a FSC to defer tax liability on a portion of its income.

The second part of the test, deemed the specificity test,[89] states that a subsidy exists only when a certain portion of an enterprise or industry can meet it.[90] Under this test, remedies are "only available against *specific* subsidies."[91] An example of

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above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments; or

(a)(2)there is any form of income or price support in the sense of Article XVI of GATT 1994; and

(b) a benefit is thereby conferred.

87. *See* Agreement on Subsidies and Countervailing Measures, *supra* note 18, at art. 1.

88. For a complete discussion on FSCs and the foregoing of taxation, *see infra* notes 151-209 and accompanying text.

89. *See* Lopez-Mata, *supra* note 13, at 582.

90. *See* Agreement on Subsidies and Countervailing Measures, *supra* note 18, at art. 2 — Specificity:

2.1 In order to determine whether a subsidy, as defined in paragraph 1 of Article 1, is specific to an enterprise or industry or group of enterprises or industries (referred to in this Agreement as "certain enterprises") within the jurisdiction of the granting authority, the following principles shall apply:

a) Where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such subsidy shall be specific.

b) Where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions90. governing the eligibility for, and the amount of, a subsidy, specificity shall not exist, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. The criteria or conditions must be clearly spelled out in law, regulation, or other official document, so as to be capable of verification.

c) If, notwithstanding any appearance of non-specificity resulting from the application of the principles laid down in subparagraphs (a) and (b), there are reasons to believe that the subsidy may in fact be specific, other factors may be considered. Such factors are: use of a subsidy programme by a limited number of certain enterprises, predominant use by certain enterprises, the granting of disproportionately large amounts of subsidy to certain enterprises, and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy. In applying this subparagraph, account shall be taken of the extent of diversification of economic activities within the jurisdiction of the granting authority, as well as of the length of time during which the subsidy programme has been in operation.

2.2 A subsidy which is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority shall be specific. It is understood that the setting or change of generally applicable tax rates by all levels of government entitled to do so shall not be deemed to be a specific subsidy for the purposes of this Agreement.

2.3 Any subsidy falling under the provisions of Article 3 shall be deemed to be specific.

2.4 Any determination of specificity under the provisions of this Article shall be clearly substantiated on the basis of positive evidence.

91. *See* Lopez-Mata, *supra* note 13, at 582 (emphasis added).

this would be ETI because the United States agreed to forego taxation because the transaction was export-related.[92]

As this test insinuates, the next step, once a subsidy is found, is to characterize it as either a prohibited, actionable, or non-actionable subsidy. Prohibited subsidies, as defined in the Agreement on Subsidies and Countervailing Measures, are those that are "contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."[93] This means that a country is somehow granting a subsidy to a domestic producer to lower the cost of its goods, making them cheaper than imported equivalents.

Actionable subsidies are those "that cause injury to the domestic industry of another member, a detriment to benefits pertaining to another member under GATT-1994, or serious prejudice to the interests of another member."[94] This type of subsidy can be considered export-contingent because, due to the subsidy, the exporter can charge a lower price than a target country's domestic producers.

Finally, non-actionable subsidies are those that are not serious enough to be considered actionable, but still meet the requirements of the Agreement on Subsidies and Countervailing Measures, Article 8.1.[95] A non-actionable subsidy cannot be referred to the Dispute Settlement Body for consideration.[96]

These three terms define subsidies generally. In order to clarify the use of subsidies in different industries, the Agreement on Subsidies and Countervailing Measures, like the Tokyo Round before it, added an annex with footnote examples of subsidies in various capacities.[97] Under Annex I, paragraph (e), the agreement described 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."[98]

To clarify further the meaning of an export subsidy, Footnote 59 to paragraph (e) goes on to state that "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 the prices which would be charges between independent enterprises acting at arm's length.[99] This definition and clarification of paragraph (e) are central components of the disagreement between the United States and the European Communities. The European Communities state that the United States tax legislation fits within the meaning of Footnote 59 because its

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92. For a complete discussion on ETI and their export nature, *see infra* notes 214-294 and accompanying text.

93. Agreement on Subsidies and Countervailing Measures, *supra* note 18, at art. 3(1)(b).

94. Lopez-Mata, *supra* note 13, at 583.

95. *See* Agreement on Subsidies and Countervailing Measures, *supra* note 18, at art. 8.

96. *See* Lopez-Mata, *supra* note 13, at 583.

97. *See* Agreement on Subsidies and Countervailing Measures, *supra* note 18, at Annex I.

98. Agreement on Subsidies and Countervailing Measures, *supra* note 18, at Annex I, para. (e). Within this description of an export subsidy, direct taxes means "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property." *Id.* at Annex I, para. (e) n.58.

99. Agreement on Subsidies and Countervailing Measures, *supra* note 18, Annex I, para. (e) n.59.

legislation is a deferral of taxation specifically related to exports.[100] The United States counters that its legislation fit within the arm's length language of Footnote 59.[101]

The views of the two members are very different in the interpretation of subsidy, partly because of their fundamental beliefs of taxation. Part IV will discuss the different systems of taxation throughout the world, and outline the taxation of individuals versus territories.

IV. DIFFERENCE BETWEEN TAXATION SYSTEMS

Within international trade, there are two very different types of taxation: a worldwide system that bases taxation on individual citizens wherever they earn their income, and a territorial system that bases taxation on individuals and entities that earn income within the taxing entity's physical territory. This is important because the worldwide system can lead to double taxation on an overseas transaction without governmental assistance, while the territorial system only taxes the overseas transaction once.

The following sections will explain the differences between the two systems, and apply them to a hypothetical situation involving the United States (a worldwide tax system) and France (a territorial tax system). This hypothetical situation will conclude that in order to compete on the international market, worldwide systems of taxation should be allowed some sort of governmental assistance to compete with territorial taxation system exporters in order to avoid double taxation that is inherent in a worldwide taxation system.

A. *The Worldwide System of Taxation*

The United States is the leading country that uses a worldwide system of taxation. This system is deemed worldwide because the United States taxes its citizens on all of their income, irrespective of where they earn it. By focusing taxation on the individual, this means that the worldwide income of its citizens becomes subject to United States income tax, even when the income was not earned in the United States.[102] Relating this theory to export taxation, this means that a corporation must include the income or losses of a foreign branch on its tax return.[103]

Because the United States places tax liability on income regardless of where it is earned, it leads to double taxation of export goods. For example, by exporting widgets to France, a territorial taxation system, an American manufacturer pays tax to the United States on the sale because of the worldwide taxation system. As

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100. *See generally infra* notes 186-187 and accompanying text.

101. *See generally id.*

102. *See* Cecelia B. Skeen, *Knick-Knack Paddy Whack Leave the FSC Alone: An Analysis of the WTO Panel Ruling that the U.S. Foreign Sales Corporation Program is an Illegal Export Subsidy under GATT*, 35 NEW ENG. L. REV. 69, 97 (2000).

103. See Engel, *supra* note 27, at 1529.

discussed below, it also pays French tax on the sale because it is earning income within French territory. This makes competition difficult for the American manufacturer because with more expenses involved in the sale of the widget, in the form of higher taxes, the American product will be more expensive than that of the French competitor.

In order to overcome this double taxation problem, the United States offers various tax relief mechanisms to ease the tax burden on exports. These mechanisms include tax credits, tax exemptions, tax reductions, or specific methods of calculating income.[104] In other words, an American corporation can use these to offset any income tax liability on the foreign subsidiary's income from the sale of widgets.[105]

The point of these mechanisms is to relieve some of the income tax burden on American exporters, and place them on equal footing with other international exporters. The United States has also attempted to do this through various methods of taxation, including Domestic International Sales Corporations (DISCs), Foreign Sales Corporations (FSCs), and Extraterritorial Income (ETI). These tax methods are at the heart of the European Communities' argument stating that the United States is illegally subsidizing its exports.[106]

B. *Territorial System of Taxation*

Unlike the worldwide system of taxation, a territorial system of taxation only taxes income earned within its physical territory. This means that a territorial tax country is asserting tax jurisdiction only over the domestic source income earned by its citizens and residents.[107] Examples of countries using this type of taxation are Hong Kong, South Africa, and France.[108]

Because these countries only tax domestic income, there is no risk of double taxation because they do not tax foreign source income.[109] For example, if France is exporting widgets to Hong Kong, the French taxation system does not require the French exporter to pay taxes on the sale. This is because the income earned on the transaction is outside of France's physical territory. The exporter may have to pay tax to the foreign country where the sale took place, but that depends on the taxation system used in that country. Here, because Hong Kong uses a territorial taxation system, the French exporter would owe tax to Hong Kong on the income earned from the sale of the widget there.

Along with using a territorial taxation system, many European countries also base their taxation on consumption rather than on income. This taxation method,

104. *See* Lopez-Mata, *supra* note 13, at 586.

105. *See* Engel, *supra* note 27, at 1529.

106. The United States also uses other theories of taxation. It should also be pointed out that American taxation is income-based, and not consumption-based. *See id.* This is very different than European taxation, which allows the rebate of the value added tax upon exportation.

107. *See* Lopez-Mata, *supra* note 13, at 585-86.

108. *See id.* at 585 n.33, 35.

109. *See id.* at 586.

known as value added taxation, is usually applied to all goods and services.[110] In the production of taxable goods, the value added tax is usually applied at a flat rate to the value added to the good at each stage of production.[111] On average, this rate is approximately twenty percent of the value of the good.[112]

For example, in making a television, a value added tax of twenty-percent would be imposed on the market value of all electrical components made by Company 1. This would, for analysis purposes, be a tax of twenty dollars on Company 1 ($100 value of the electrical components times twenty percent). Company 1 then sells the electrical components to Company 2. Company 2 places the components inside its housing for assembly. A different value added tax is added at this step in the television process. Company 2, for argument's sake, would be responsible for a forty dollar tax on the item (value of the television is now $200 (electrical components plus the television housing and assembly) times twenty-percent). This type of value added tax is present throughout the assembly process until the television is in the hands of the consumer.

In this scenario, double taxation is avoided by allowing each subsequent seller a credit in the amount of the value added tax previously paid.[113] In this hypothetical, this means that Company 2 would be able to take a twenty dollar credit because Company 1 already paid twenty dollars on the value of the television at the time that Company 2 received the electrical components.

There are also products that are completely exempt from the value added tax. Goods that are basic or essential are not taxed by the value added tax. These are considered true exemptions.[114]

Another type of exemption is the zero-rate exemption. Zero-rate exemptions apply "to articles on which the value added tax is collected and allows the seller a credit for the tax the seller previously paid."[115] Thus, a company can receive a credit for *all* value added tax that it has paid throughout the manufacturing process. In terms of exportation, this potentially means that value added tax goods are cheaper than non-value added tax goods because exports are considered zero-rate exemptions.[116] In essence, the company under a value added tax regime receives a credit for all taxes previously paid on the good, requiring it to only pay territorial income tax to the foreign country, if applicable.

In general, the value added tax has been considered an indirect tax by GATT.[117] This is because the price of the good "remains constant because the tax

110. An exception is made for basic or essential goods such as food, children's clothing, and rent. *See* Hunter R. Clark et. al., *The WTO Ruling on Foreign Sales Corporations: Costliest Battle Yet in an Escalating Trade War Between the United States and the European Union?*, 10 MINN. J. GLOBAL TRADE 291, 311 (2001).

111. *See* Skeen, *supra* note 102, at 98.

112. *See* Clark, *supra* note 110, at 312.

113. *See* Clark, *supra* note 110 at 311.

114. *See id.*

115. *Id.*

116. *See* Clark, *supra* note 110, at 312.

117. *See* Skeen, *supra* note 102, at 99.

is really only paid when the consumer purchases the product."[118] GATT also supports the value added tax method because it does not distinguish between domestic and export goods and their ultimate price to consumers.[119]

Accordingly, countries with this type of tax are allowed broader exemptions on exports than non-value added tax countries. These exemptions amount to a full rebate of taxes paid on the goods up to the time that the goods are exported.[120] Once exported, exporters are only liable for any tax incurred on the actual sale of the goods. Because this system allows value added tax countries a distinct advantage on the sale of exports, the United States argues that it is an illegal subsidy under the reasoning of the WTO in its conclusions regarding United States tax methods.[121]

For example, assume that both the United States and France are exporting widgets to Hong Kong, a territorial tax country. Also assume that Hong Kong has a ten-percent territorial tax on any transactions within its physical territory. Both widgets cost $100 to manufacture. Both companies want to make a twenty-percent profit, so both will theoretically charge the Hong Kong consumer $120 (($100 times twenty-percent) plus $100).

Due to the value added tax, the French company has to pay a twenty-percent tax on the $100 widget before export, which equals a twenty dollar tax ($100 times twenty-percent). Remember, however, that because the widget is an exported good, the value added tax is credited to the French company because it is considered a zero-rate tax exemption due to its export status. This essentially means that the French company has yet to pay taxes on the widget. The American company also has not paid taxes on the widget because it does not have a value added tax; rather it bases taxation on income from the sale of the widget, not on its production.

Now that the goods are in Hong Kong, the consumer can purchase each widget for $120. Because this income is earned in Hong Kong's physical territory, both companies will have to pay the additional ten-percent territorial income tax on the sale to Hong Kong. This requires a twelve-dollar tax from each company ($120 sale times ten-percent tax on the sale).

In addition to the tax due to Hong Kong, remember that the American company must also pay taxes to the American government on the sale (barring any credit or tax deferral) because it is subject to worldwide taxation on its income as a company residing in the United States. If the tax is also ten-percent, the American company will be charged twenty-four dollars in taxes (twelve dollars to Hong Kong and twelve dollars to the United States). The French company, on the other hand, is not subject to French taxation because the sale took place *outside* the French taxing jurisdiction. Therefore the company is only required to pay Hong

118. Skeen, *supra* note 102, at 99.

119. *See id.*

120. *See id.* at 100.

121. For a discussion on the value added tax as an illegal subsidy, *see infra* notes 175-182 and accompanying text.

Kong tax of twelve dollars.

Because both companies want to maintain a twenty-percent profit margin on the cost of goods sold, the French company will add its tax liability, or twelve dollars, to its base price. The American company will also add its tax liability to its base price. Because of the increased tax liability on the American company, it will be required to raise its price twenty-four dollars, rather than twelve dollars, to maintain its profit margin. Barring any other outside factors, the French widget will be twelve dollars cheaper than the American widget, giving the French company an advantage in the Hong Kong widget market.

In order to combat this inequitable tax treatment on its exporters, the United States has implemented various tax-saving methods throughout the decades. The European Communities have argued that these tax methods are subsidies under various GATT and WTO agreements. The following section will analyze these tax-saving methods, examine the validity of the European Communities' arguments, and conclude with the WTO's judgments in each case.

V. EVOLUTION OF THE FSC

Starting in the Kennedy administration,[122] the United States attempted to level the playing field for American exporters by implementing various tax-saving mechanisms. All of these methods, in one way or another, allowed the deferral of any tax incurred in foreign transactions, sometimes for an indefinite period of time. The following sections will introduce three of these tax methods: Domestic International Sales Corporations (DISCs), Foreign Sales Corporations (FSCs), and Extra Territorial Income (ETI). It will then analyze their structures and how they affected international trade. Finally, it will discuss the WTO's stance on the method, and how the United States allegedly violated its WTO obligations by using these tax mechanisms.

A. Pre-DISC

Prior to the 1960's, foreign source income was not treated in the same fashion as it was in the previous hypothetical. In fact, the only way a corporation would be taxed on exports prior to 1960 was if it repatriated the foreign source income back to the United States.[123] Due to this indefinite deferral of income, many exporters started to move their operations overseas to take advantage of this tax haven.[124] This move allowed domestic exporters to earn unlimited tax-free income overseas. The only tax liability on this income occurred when it was repatriated to the United States, usually done on an as needed basis by the exporter.

To combat this movement overseas, the Kennedy Administration introduced legislation to tax foreign source income while still in the hands of a foreign

122. *See generally* Engel, *supra* note 27, at 1527.

123. *See id.*

124. *See* Engel, *supra* note 27, at 1527.

subsidiary. Entitled Subpart F, this legislation taxed certain transactions between a foreign subsidiary, known as a Controlled Foreign Corporation,[125] and its parent company, a United States corporation.[126] Subpart F taxed the CFC's foreign-based income, and attributed this tax to the domestic parent company.[127] In other words, shareholders of CFCs were now required to include as income any pro rata portion of CFC's undistributed income, thus removing any tax benefits of owning a foreign-based company.[128]

Subpart F worked to equalize taxation between domestic parent companies and their foreign subsidiaries. By doing this, however, the United States now subjected the domestic parent corporations to double taxation, similar to the previous hypothetical. In order to allow American exporters to compete in foreign markets, and to avoid double taxation, the United States implemented various tax methods to allow exporters to avoid this harsh double taxation. One of these methods was the DISC.

B. Domestic International Sales Corporations

Adopted in 1971,[129] Congress enacted the DISC to enhance the competitiveness of American exporters.[130] DISCs were intended to produce tax effects similar to tax methods used in Europe.[131] Specifically tailored to emulate territorial tax systems, DISCs only taxed income produced by the domestic parent corporation, similar to a territorial tax system.

As in the previous hypothetical, a French company that sold a widget in France would have tax liability because the sale took place within France's physical boundaries. Similarly, if the French company sold the same widget in Hong Kong, it would not have any French tax liability on the sale because the sale took place outside France's physical territory.[132] The United States felt that American exporters should receive the same tax treatment as foreign corporations.

This emulation of a territorial tax system by a DISC had a two-fold effect: it enabled exporters to lower their prices due to the reduction of their domestic tax

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125. *See* Lopez-Mata, *supra* note 13, at 589-90. In this article, the Controlled Foreign Corporation will be referred to as the CFC.

126. As defined, a CFC is a foreign corporation whose majority stockholder is an American shareholder. *See* I.R.C. § 957(a) (1962).

127. *See* I.R.C. § 954(d) (1962).

128. *See* Clark et. al., *supra* note 110, at 307. As with other taxation methods, there were ways that a domestic parent company could avoid paying taxes on its foreign subsidiary's income. These methods included tax credits, tax exemptions, tax reductions, or specific methods of calculating income. *See* Lopez-Mata, *supra* note 13, at 586. Essentially, a domestic parent company could offset any income tax due on its foreign subsidiary's income by using one of these credits or exemptions.

129. DISC was included in § 501of the Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497 (1971) (codified as amended in I.R.C. §§ 991-997 (1971)).

130. *See* Lopez-Mata, *supra* note 13, at 590.

131. *See* Skeen, *supra* note 102, at 72.

132. Since Hong Kong is also a territorial tax system, it would be able to tax the transaction. This point is ignored here for argument's sake.

burden, and increased the profitability of exporting.[133] This, in turn, drew a greater number of American exporters into the exportation market.[134]

Regarding the actual taxation effects of the legislation, DISCs were engineered to provide partial relief from Subpart F treatment.[135] In order to be qualified as a DISC, a company had to be incorporated in any State, and have:

> A. 95 percent or more of their gross receipts were qualified export receipts;
>
> B. the adjusted basis of the qualified export assets of the corporation equals or exceeds 95 percent of all assets of the corporation at the close of the taxable year;
>
> C. the corporation does not have more than one class of stock and the par or stated value of its outstanding stock is at least $2,500 on each day of the taxable year; and
>
> D. the corporation has made an election to be treated as a DISC.[136]

In this system, a DISC was established to do all exportation on behalf of the parent company. Without any further legislation, however, the parent corporation would still be liable for any income earned by the DISC due to Subpart F treatment.[137]

To avoid this treatment, the DISC was allowed to take a commission on any foreign sales it made on behalf of the parent corporation. These commissions were treated as 100% deductible to the parent corporation, and partially deductible to the DISC.[138] In other words, the DISC would sell the widgets on behalf of the parent corporation. At certain times of the year, it would repatriate the income to the parent corporation. The parent would then pay the DISC its commission.[139]

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133. *See* Clark et. al., *supra* note 110, at 298.

134. *See id.* at 298.

135. *See* Lopez-Mata, *supra* note 13, at 591.

136. I.R.C. § 992 (1971). In general, export receipts are "gross receipts from the sale, exchange, or other disposition of export property." I.R.C. § 993(a) (1971).

137. For a discussion on the different systems of taxation, *see supra* notes 107-121 and accompanying text.

138. *See* Jelsma, *supra* note 7371, at 1332.

139. To calculate the amount of the commission, the DISC used one of three methods stated in I.R.C. § 994 (1971):

> 1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,
>
> 2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or
>
> 3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482)

After the commission was distributed, both the parent corporation and the DISC owed tax on the commission. For the DISC, 57.5% of its export profits were considered income attributable to the DISC for the current year.[140] Regarding the other 42.5%, it could be deferred until the DISC's profits were distributed or the DISC ceased to exist.[141] Because actual distributions were rarely necessary, this 42.5% profit could be deferred indefinitely, thus saving millions of dollars in yearly taxation for American exporters.[142]

This method of taxation gave a distinct advantage to DISCs on the international exportation market. As expected, many European GATT members felt that the United States was illegally subsidizing DISCs. Specifically, France, Belgium, and the Netherlands, all of which were members of GATT, stated that DISCs violated GATT Article XVI:4.[143] Essentially, these European countries argued that DISCs resulted "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."[144] This was a clear violation of GATT Article XVI.

The United States countered this argument by stating that DISCs were similar to territorial taxation used throughout Europe.[145] The Unites States argued that, by taxing only income earned by the parent in the domestic market, DISCs were in effect a type of territorial taxation system. Because GATT implicitly endorsed territorial taxation, it should also endorse DISCs.

To settle this dispute, GATT established a Panel to examine the effects of DISCs on United States taxation.[146] The GATT Panel concluded its study by stating that this lack of taxation on DISCs was not a mere deferral on income, but instead constituted "remissions or exemptions."[147] In reaching its conclusion, the Panel looked to the fact that the United States did not charge interest on the deferred income,[148] and also to the fact that the United States could not state when the deferred 42.5% profit would ever be subjected to income tax.[149] This conclusion meant that the United States was not in accord with its GATT obligations under Article XVI.

The United States vehemently denied that it was in violation of Article XVI, and restated its position that the DISCs were similar to territorial taxation systems. The United States also criticized the GATT Panel because it did not establish the

140. *See* Jelsma, *supra* note 73, at 1333 (citing Treas. Reg. §1.861-8 and I.R.C. § 995(b) (1971)).

141. *See* I.R.C. § 995 (1971).

142. *See* Jelsma, *supra* note 73, at 1333.

143. For discussion on GATT Art. XVI, *see supra* notes 71-72 and accompanying text.

144. GATT, *supra* note 16, at art. XVI(4).

145. *See* Lopez-Mata, *supra* note 13, at 592.

146. Although similar, remember that this dispute took place within GATT dispute resolution procedure, not WTO.

147. Jelsma, *supra* note 73, at 1333 (citing Report on United States Tax Legislation (DISC), 23 BISD (Supp. 1977)).

148. This requirement was not officially codified under GATT until the Tokyo Round. *See* Tokyo Round Subsidies Code, *supra* note 74, at Annex, para. (e).

149. *See* Jelsma, *supra* note 73, at 1334 n.47.

exact meaning of a subsidy,[150] nor did it discuss which parts of DISCs the Panel considered to be a subsidy.[151]

In the end, after increasing pressures from GATT and its European members, the United States complied with the Panel's decisions on DISCs by implementing an interest charge on the deferred 42.5% of income.[152] By doing this, the United States felt that it had appeased one of their arguments against DISCs. The United States also adopted new tax legislation that created an entity that would overcome any future GATT arguments: the Foreign Sales Corporation (FSC).[153]

C. *Foreign Sales Corporations*

Enacted as part of the Deficit Reduction Act of 1984,[154] FSCs were designed to provide American exporters with a substitute for DISCs. At the time of its enactment, Congress felt that FSCs would be compliant with GATT obligations, and would appease any European argument that they could be considered an illegal subsidy.[155]

Unlike DISCs, FSCs were incorporated outside the United States,[156] specifically in a jurisdiction considered to be a tax haven.[157] This allowed a foreign subsidiary to pay minimal tax on any income earned in that country. Besides the requirement of international incorporation, a FSC also had to have (1) no more than twenty-five shareholders; (2) no preferred class of stock; and (3) economic substance.[158]

In addition to meeting all of these requirements, a FSC also had to meet the "foreign management and economic process test."[159] This test required FSCs (1) to have all board of director meetings outside the United States; (2) to maintain their principal bank account outside the United States; and (3) to disburse all dividends, legal and accounting fees, and salaries of officers and directors from a bank account outside the United States.[160] The point of the test was to ensure that

150. The exact definition of a subsidy was not codified until the Uruguay Round in 1994 under the Agreement on Subsidies and Countervailing Measures, a full 16 years after this decision. Even today, there is dispute as to the exact definition of a subsidy. For discussion on the Agreement on Subsidies and Countervailing Measures and its definition of a subsidy, *see supra* notes 84-100 and accompanying text.

151. *See* Lopez-Mata, *supra* note 13, at 593.

152. *See* I.R.C. § 995(f)(1) (1984).

153. This does not mean that DISCs dissolved entirely. DISCs are still used today, but with much less tax savings due to the interest charge on deferred income. In fact, DISCs are used solely as a tax incentive for small exporters. *See* Lopez-Mata, *supra* note 13, at 596.

154. Pub. L. 98-369, 98 Stat. 494 (1984). The parts relating to FSCs were codified in I.R.C. §§ 921-927 (1984).

155. *See* Lopez-Mata, *supra* note 13, at 595, 598.

156. *See id.* at 597.

157. A tax haven is a country that has a nominal tax rate. Well-known examples of tax havens are the U.S. Virgin Islands, Barbados, and Guam. *See* Clough, *supra* note 34, at 265.

158. *See* I.R.C. § 922 (Supp. 1985).

159. *See* Corona, *supra* note 66, at 369.

160. *Id.*

FSCs were, in fact, international corporations.[161]

Similar to DISCs in practice, FSCs were foreign subsidiaries of an American parent corporation that operated on a commission. Basically, the FSC would purchase goods from the domestic parent corporation, resell them abroad, and then repatriate a portion of this earned income back to the domestic parent corporation through the use of a dividend.[162] This dividend was then subject to a one hundred-percent dividends-received deduction by the parent corporation.[163] The income not returned to the parent (the FSCs commission) was treated as foreign trade income.[164] Because foreign trade income was treated as foreign source income not effectively connected to the parent corporation, it was not subjected to United States taxation.[165]

The export sales commission retained by the FSC was determined by using one of two different methods. The first was arm's length pricing under Section 482 of the Code.[166] In practice, this meant that thirty-two percent of the FSC's income could be withheld for taxation purposes.[167] The other way to determine taxation was by using an administrative price method.[168] This method limited taxation to the greater of 1.83% of the foreign trade gross receipts[169] from the transaction, or twenty-three percent of the combined taxable income of the transaction. These methods, in conjunction with Section 951(e) of the Code, allowed the FSC to use a different method of taxation than its parent corporation. This different method was used in order to avoid Subpart F treatment, thereby

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161. This will become important because in fact, FSCs were not international corporations. *See infra* note 203-204 and accompanying text.

162. *See* I.R.C. § 245(c) (Supp. 1985).

163. *See id. See also* Jelsma, *supra* note 73, at 1341.

164. *See* I.R.C. § 245(c) (Supp. 1985).

165. *See* I.R.C. § 882 (Supp. 1985).

166. *See* I.R.C. § 482 (1985).

167. *See* Jelsma, *supra* note 73, at 1342.

168. *See* I.R.C. § 925 (Supp. 1985).

169. For a definition of Foreign Trading Gross Receipts, *see* I.R.C. § 924 (Supp. 1985):

> (a) In general-Except as otherwise provided in this section, for purposes of this subpart, the term 'foreign trading gross receipts' means the gross receipts of any FSC which are-
>
> 1. from the sale, exchange, or other disposition of export property,
> 2. from the lease or rental of export property for use by the lessee outside the United States,
> 3. for services which are related and subsidiary to-
>
>   (A) any sale, exchange, or other disposition of export property by such corporation, or
>
>   (B) any lease or rental of export property described in paragraph (2) by such corporation,
> 4. for engineering or architectural services for construction projects located (or proposed for location) outside the United States, or
> 5. for the performance of managerial services for an unrelated FSC or DISC in furtherance of the production of foreign trading gross receipts described in paragraph (1), (2), or (3). Paragraph (5) shall not apply to a FSC for any taxable year unless at least 50 percent of its gross receipts for such taxable year is derived from activities described in paragraph (1), (2), or (3).

avoiding double taxation.[170]

The FSC was different from a DISC because it was internationally based, not a domestic corporation. By making it an international entity, the FSC moved closer to a territorial taxation system because the United States was not taxing any income earned by an American corporation overseas. As compared to the previous hypothetical, France used its territorial taxation system to tax French corporations only on income earned within France's physical boundaries. FSCs were effectively doing the same thing.

FSCs were very successful with American corporations that exported many of their goods internationally. It was estimated that 6,000 American corporations benefited from FSC tax breaks, including such businesses as Boeing, General Electric, and Motorola.[171] In 1998, Boeing alone saved approximately $130 million, or twelve percent of its earnings for the year, in U.S. taxes as a result of its FSC.[172] This success was not limited to industrial giants. It was estimated that small and medium-sized manufacturers saved on average $124,000 annually due to FSC benefits.[173] Overall, it was estimated that FSCs provided over four billion dollars per year in tax breaks to domestic corporations.[174]

Although this tax method seemed very similar to territorial taxation, the European Communities still argued that the FSC constituted an illegal subsidy under GATT.[175] In general, the European Communities felt that because FSC benefits were available only to American exporters, they amounted to a subsidy.[176] This subsidy, it argued, put European businesses at a distinct disadvantage because, through the use of FSCs, American exporters could lower the price of their goods in comparison to their European competition.[177]

The United States countered this argument by stating that FSCs were being treated similarly to exporters under European territorial taxation systems.[178] In comparing FSCs to territorial taxation systems, the United States stated that both methods of taxation provided the domestic parent corporation with a partial exemption for income attributable to a foreign subsidiary.[179] Both of these methods resulted in reductions in tax from a domestic corporation's export activities.[180] The United States further argued that if the FSC was considered a tax

170. *See* Lopez-Mata, *supra* note 13, at 598.

171. *See Extraterritorial Income: WTO Panel Issues Preliminary Ruling Against United States in FSC Dispute-U.S. Businesses Look Ahead*, 121 DAILY TAX REP., June 25, 2001, at GG-1.

172. *See id.*

173. *See Diplomacy Along With Tax Law Change Needed to Resolve Dispute With European Union Over U.S. Export Tax Breaks*, 130 DAILY TAX REP., July 9, 2001, at J-1.

174. *See* Sean D. Murphy, *Contemporary Practice of the United States Relating to International Economic Law, U.S. Position on Foreign Sales Corporation*, 94 AM. J. INT'L L. 516, 531 (2000).

175. *See* Skeen, *supra* note 102, at 75.

176. *See id.*

177. *See* Clark et. al., *supra* note 110, at 308.

178. *See* WTO Doc. WT/DS108/AB/R, at para. 4.336.

179. *See* WTO Doc. WT/DS108/AB/R, at para. 4.336.

180. *See id.*

subsidy, so too was the European territorial taxation system.[181] As previously stated, the FSC deferred tax due on export income, very similar to the territorial taxation system prevalent in Europe. Because both systems exempted export taxation in one way or another, and the FSC was somewhat based on a territorial taxation idea, both tax systems should be held to the same standard of subsidization.[182]

To clarify their argument, the European Communities specifically stated that they considered the FSC an illegal subsidy under the Agreement on Subsidies and Countervailing Measures and the Agreement on Agriculture.[183] The European Communities first argued that FSC legislation violated the Agreement on Subsidies and Countervailing Measures, Article I:1 because the United States was foregoing taxes owed by the FSC.[184] This illegal deferral of taxation was done by granting tax subsidies specifically contingent upon the exportation of goods.[185]

The European Communities also argued that FSCs violated the Agreement on Subsidies and Countervailing Measures, Footnote 59 to paragraph (e), because FSCs were a deferral of direct taxes related to exports.[186] As paragraph (e) states, a subsidy is prohibited if it gives "(1) exemptions (2) specifically related to exports (3) of direct taxes (4) payable by industrial or commercial enterprises."[187]

Finally, the European Communities argued that FSCs violated the Agreement on Agriculture Article III:3[188] by providing subsidies in excess of their reduction commitments.[189] This meant that the United States was granting agricultural tax subsidies in excess of the levels it committed to by endorsing the Agreement on Agriculture.[190]

The United States attacked these arguments, stating that FSCs were consistent with the language of Footnote 59 because "income generated from economic activity outside the territory of the taxing authority need not be taxed, and that a decision not to tax such income is not a prohibited subsidy."[191] Specifically, Footnote 59's second sentence insinuated that a WTO member had the right not to tax a domestic corporation's foreign subsidiary as it saw fit.[192] The second

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181. *See id.* at para. 4.310.

182. *See id.* at paras. 4.320, 4.321.

183. *See id.* at para. 3.2.

184. *See* WTO Doc. WT/DS108/R, at para. 4.275.

185. *See id.* at para. 4.277. *See also* Julie Elizabeth McGuire, *World Trade Organization Find U.S. Foreign Sales Corporation Violates EU Trade Agreements*, 2 LAW. J. 5 (2000).

186. *See* WTO Doc. WT/DS108/R, at para. 4.307.

187. *See id.* at para. 4.302.

188. *See* Agreement on Agriculture, *supra* note 19, at art. 3(3) - Incorporation of Concessions and Commitments:

Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agricultural product not specified in that Section of its Schedule.

189. *See* WTO Doc. WT/DS108/R, at para. 4.1332.

190. *See* McGuire, *supra* note 183, at 5.

191. *See* WTO Doc. WT/DS108/R, at para. 4.352.

192. *See* Lopez-Mata, *supra* note 13, at 601.

sentence states that "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 the prices which would be charged between independent enterprises acting at arm's length."[193] This meant that because this tax exemption did not violate Article III:1(a) of the Agreement on Subsidies and Countervailing Measures and Footnote 59 to paragraph (e), FSCs did not violate any United States obligations to GATT and the WTO.[194]

Eventually, the European Communities and the United States placed this disagreement before a WTO Panel. The Panel, chaired by Crawford Falconer (New Zealand), and assisted by Seung Wha Chang (South Korea) and Didier Chambovey (Switzerland),[195] agreed with the European Communities, and ruled against the United States.[196]

The Panel first looked at the specific language of a FSC to determine whether it was a subsidy. In doing so, it used a "but for" test, and explained that if the scheme did not exist, and revenue would be due but for the scheme, the scheme should be considered a subsidy.[197] The Panel added weight to this reasoning because the United States also uses a "but for" test to determine whether a subsidy exists.[198]

It also found that a FSC was a subsidy under the Agreement on Subsidies and Countervailing Measures, Article III:1. The Panel first looked at Section 924 of the Code for the definition of export property. Applying this definition, the Panel concluded that because the subsidy was contingent upon export performance, and not available to domestic performers, it was an illegal subsidy.[199]

Regarding the Agreement on Agriculture violations, the Panel felt that because the agreement did not have an official definition of subsidy, both parties must have relied on the definition used in the Agreement on Subsidies and Countervailing Measures.[200] Because the Panel already found that the FSC was an illegal subsidy under this agreement, it therefore must also be a subsidy under the Agreement on

193. Agreement on Subsidies and Countervailing Measures, *supra* note 18, at Annex 1, para. (e) n.59.

194. *See* WTO Doc. WT/DS108/R, at para. 4.352.

195. *See Extraterritorial Income: Third Parties Line Up Against U.S. in WTO FSC Replacement Hearings*, 51 DAILY TAX REP., Mar. 15, 2001 at G-3.

196. *See* WTO Doc. WT/DS108/R, at para. 8.1. Regarding this or any other decision made by a WTO Panel, it will be very difficult for the United States to overcome any decision by the WTO, specifically those made by the Panel and the Appellate Body. As previously stated, the Dispute Settlement Body will accept their holdings *absent consensus to the contrary*. This means that unless the United States can persuade seventy-one other countries to agree with its argument, it has to abide by the WTO's decision.

197. *See id.* at para. 7.45.

198. *See id.* at para. 7.47. The United States Department of Commerce uses a "but for" test to identify and determine countervailable subsidies. As stated in 19 C.F.R. § 351.509:
Benefit
(1) Exemption or remission of taxes. In the case of a program that provides for a full or partial exemption or remission of a direct tax (e.g., an income tax), or a reduction in the base used to calculate a direct tax, a benefit exists to the extent that the tax paid by a firm as a result of the program is less than the tax the firm would have paid in the absence of the program.

199. *See* WTO Doc. WT/DS108/R, at para. 7.108.

200. *See* WTO Doc. WT/DS108/R, at para. 7.149.

Agriculture. The Panel also found that the FSC was a subsidy to reduce the costs of marketing exports of agricultural products under the Agreement on Agriculture Article IX:1(d).[201] Because FSC subsidies reduced an exporter's income tax liability with respect to marketing activities, the Panel held that they effectively reduced the cost of marketing agricultural products.[202]

Finally, the Panel stated that, although named as a foreign corporation, FSCs were not foreign in practice. In fact, over seventy-four percent of FSCs were located in American possessions, with the U.S. Virgin Islands accounting for sixty-six percent of FSC locations.[203] The Panel also looked to the fact that citizens of the U.S. Virgin Islands were considered United States citizens for taxation purposes, yet FSCs located there were not.[204]

After the Panel's final decision, the European Communities threatened the United States with countermeasures aimed at American exports. These countermeasures would impose an additional one hundred-percent ad valorem duty above the duty already paid.[205] This would translate into the price of American exports suddenly doubling overnight, which obviously would hurt American exporters in European markets.

Before the European Communities were able to implement these countermeasures, the United States appealed the Panel's decision to the WTO's Appellate Body. Its primary argument was that the original Panel did not read the meaning of Footnote 59 in conjunction with the rest of the Agreement on Subsidies and Countervailing Measures.[206] This led the Panel to misinterpret the meaning of subsidy within this agreement, thus wrongly ruling against the United States.

The Appellate Body disagreed, stating that the Panel correctly applied the "but for" analysis of the American export taxation system.[207] It found that, to determine the definition of subsidy, the Panel did not need to read Footnote 59 in conjunction with the rest of the Agreement on Subsidies and Countervailing Measures.[208] Therefore, on February 24, 2000, the Appellate Body upheld the Panel's ruling that a FSC was a subsidy under the Agreement on Subsidies and Countervailing Measures,

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201. *See id.* at para. 7.159.

202. *See id.* at para. 7.155.

203. *See* WTO Doc. WT/DS108/R, at para. 4.199.

204. *See* I.R.C. § 932 (1986) - Coordination of United States and Virgin Islands income taxes: (B)(3) Extent of income tax liability. In the case of an individual to whom this subsection applies in a taxable year for purposes of so much of this title (other than this section and section 7654) as relates to the taxes imposed by this chapter, the United States shall be treated as including the Virgin Islands.

205. *See* WTO, *Communication from the Permanent Delegation of the European Commission*, WT/DS108/13 (Nov. 17, 2000). The Annex of this communication also listed American industries and products that would be targeted.

206. *See generally*, WTO, *Report of the Appellate Body*, WT/DS108/AB/R (Feb. 24, 2000), at Section III A: Claims of the United States–Appellant [hereinafter *Report of the Appellate Body*]. *See also* WTO, *Report of the Panel*, WT/DS141/R (Oct. 30, 2000), at Annex 3-3: Third-Party Submission of the United States.

207. *See Report of the Appellate Body*, *supra* note 206, at para. 91.

208. *See Report of the Appellate Body*, *supra* note 206, at paras. 93-94.

Article III:1.[209] Regarding the actual taxation of export income, the Appellate Body stated that the United States could not carve out any exemptions that were export contingent.[210] This, by nature, would be a violation of its Agreement on Subsidies and Countervailing Measures obligations.[211]

The Appellate Body, however, did reverse part of the Panel's decision.[212] It stated that the United States was acting consistently with its obligations under Agreement on Agriculture because FSC taxation did not relate to the marketing of an export product.[213]

The WTO's final decision on FSCs dealt a serious blow to American exporters. Because of the WTO decision, exporters could no longer take advantage of the FSC, and thus reverted back to the harsh tax treatment of Subpart F. This reversion would weigh heavily on their opportunities in European markets because they would again be subjected to double taxation.

To remedy this situation, Congress enacted a new tax mechanism that applied to both domestic and export corporations. Because it was not export contingent, Congress felt that it should be WTO compliant. The next section of this article will analyze this new method of taxation, and discuss the WTO problems involved with its implementation.

D. *Extraterritorial Income*

In order to appease the European Communities' and WTO's concerns, Congress enacted legislation that was not export contingent, yet allowed for certain tax benefits for corporations to compete with the Europeans. Entitled the FSC Repeal and Extraterritorial Income Exclusion Act of 2000,[214] it was considered the newest American taxation scheme in the long battle between the United States and the European Communities.

As the name insinuates, the FSC Repeal Act terminated all FSC legislation, and replaced it with Extraterritorial Income.[215] Codified in Section 114 of the Code, ETI is defined as "the gross income of the taxpayer attributable to foreign trading gross receipts[216] of the taxpayer."[217] Any income considered ETI is

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209. *See id.* at para. 121.

210. *See id.* at para. 153.

211. *See id.* at para. 154.

212. *See id.* Specifically, the Appellate Body only reversed the Panel's discussion on the Agreement on Agriculture Art. IX:1(d).

213. *See Report of the Appellate Body*, *supra* note 206, at para. 111.

214. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (codified in scattered sections of the Code). In this article, this Act will be referred to as ETI.

215. This is different than the transition between DISCs and FSCs. DISCs still exist, but the deferred income now has an interest charge in place. *See supra* note 153. As this act states, FSCs are no longer in existence.

216. ETI replaced FSC, which made I.R.C. §§ 921-927 void. Originally, foreign trade gross receipts were defined in I.R.C. § 924 (Supp. 1985). This section was replaced by I.R.C. § 942 (2000). The only language that was different between the sections was "gross receipts of any FSC which are" was changed to "gross receipts of the taxpayer which are."

excluded from gross income, thus avoiding United States taxation.[218]

Foreign trading gross receipts are based on the sale of qualified foreign trade property.[219] As defined, qualified foreign trade property is property that can be (1) manufactured *within or outside* the United States;[220] (2) held primarily for sale *outside* the United States;[221] and (3) not more than fifty percent of the fair market value can be attributable to foreign content.[222] This means that American exporters are no longer required to set-up foreign subsidiaries such as FSCs to route their exports for sale. By doing this, Congress hoped to avoid any subsidization arguments from the WTO.[223]

Another principle feature of ETI is that it is an exclusionary taxation method, and not a deferral taxation method, like FSC.[224] In other words, unlike previous taxation methods, ETI does not count at all towards gross income. Instead, its income is characterized separately.

There are two ways of characterizing ETI income: qualifying foreign trade income and non-qualifying foreign trade income.[225] Qualifying foreign trade income means the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction "equal to the greatest of: (A) thirty-percent of the foreign sale and leasing income . . . ; (B) 1.2 percent of the foreign trading gross receipts . . . ; or (C) fifteen-percent of the foreign trade income . . . ."[226] "Non-qualifying foreign trade income is not excludable from gross income."[227]

By making ETI a taxation exclusion method, and making sure that it was not export-contingent, Congress felt that it should be fully compliant with the WTO decision on FSCs. As stated by one United States official, "our proposal directly addresses the WTO Panel decision and it is both in fact and in law WTO compatible."[228]

Remembering the past three decades of debate over the issue, United States officials anticipated a negative reaction from the European Communities over the ETI. In public remarks, United States officials preempted this reaction by openly criticizing the European Communities' previous information given to the United States. In one instance, the United States Legal Counselor in Geneva, Daniel

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217. I.R.C. § 114(e) (2000).

218. *See* I.R.C. § 114(a) (2000).

219. *See* I.R.C. § 942(a)(1)(A) (2000).

220. *See* I.R.C. § 943(a)(1)(A) (2000) (emphasis added).

221. *See* I.R.C. § 943(a)(1)(B) (2000) (emphasis added).

222. *See* §943(a)(1)(C). *See also* Lopez-Mata, *supra* note 13, at 604.

223. *See* I.R.C. § 942 (2000). *See generally* Lopez-Mata, supra note 13. Instead of being export-contingent (FSC), ETI allows both domestic and foreign manufacturers to take advantage of this method of taxation.

224. *See* Lopez-Mata, *supra* note 13, at 603 (citing I.R.C. § 114).

225. *See id.* at 604.

226. *See* I.R.C. § 941 (2000).

227. *See* Lopez-Mata, *supra* note 13, at 604.

228. Murphy, *supra* note 174, at 533 (quoting comments made by Department of the Treasury Deputy Secretary Stuart E. Eisenstat).

Brinza, accused the European Communities of failing to offer any views on what precise steps the United States could make to satisfy their concerns.[229] This lack of precise information, he stated, led to the past disagreements over the FSC, now being drawn out into its third decade.[230]

Brinza also criticized the European Communities and the WTO for not seeing the similarities between European territorial taxation and American attempts to mimic this system. In an interview, Brinza stated that "the European Union refuses to recognize the indisputable fact that tax treatment of exports under the FSC Replacement Act is similar to the tax treatment of exports under existing European territorial systems."[231] This criticism seems justified because both the United States and the European Communities use non-taxation of exports to gain an advantage in pricing their exports. In fact, the European Communities have admitted to American officials that "exempting foreign income from taxation is a widely accepted tax practice that does not constitute a prohibited export subsidy."[232]

As expected, the European Communities nevertheless filed a grievance against the United States, claiming that ETI constituted an illegal subsidy because it was export-contingent, similar to its previous grievance with FSCs.[233] Because ETI legislation states that property has to be held primarily for sale *outside* the United States,[234] the European Communities argued that qualified foreign trade property was export-contingent. This would become the primary focus in the European Communities' argument that the United States was still illegally subsidizing its exports.[235]

In fact, some European Communities officials publicly stated that ETI is even worse than FSCs. At one point, the European Commission[236] declared that the law "not only maintains the violations found by the WTO in the FSC case, but may even aggravate them."[237] The Commission went on to state that "the new legislation continues to provide a significant illegal export subsidy to more than

229. *See FSCs: U.S. Defends FSC Replacement at WTO, Advances Points of Agreement With EU*, 246 DAILY TAX REP., Dec. 21, 2000 at G-4 [hereinafter *U.S. Defends FSC*].

230. *See id.*

231. *U.S. Defends FSC, supra* note 229.

232. *Id.*

233. *See generally* WTO Doc. WT/DS108/RW.

234. *See* I.R.C. § 943 (2000) (emphasis added).

235. For a discussion of the European Communities' arguments, *see infra* notes 239-248 and accompanying text.

236. The European Commission is not the same entity as the European Communities. The European Communities, synonymous with the European Union, is a formal group of countries bound by treatises and agreements. For more information on the European Communities, *see generally* http://www.europa.eu.int/index_en.htm. The European Commission, on the other hand, is actually a commission within the European Union, preparing legislation and representing the EU on various international issues. For more information on the European Commission, *see generally* http://www.europa.eu.int/comm/index_en.htm.

237. *Extraterritorial Income: WTO Panel Issues Preliminary Ruling Against United States in FSC Dispute*, 121 DAILY TAX REP., June 25, 2001 at GG-1.

half of total American exports, to the direct detriment of European companies."[238]

Similar to the original FSC dispute, the European Communities argued that the FSC Replacement Act (ETI) resulted in the foregoing of tax revenue that is otherwise due.[239] This is because ETI is a tax exemption scheme, and but for the scheme, the United States would be taxing this income.[240] It argued that by foregoing this taxation of income, the United States gave exporters a financial contribution, in direct violation of the Agreement on Subsidies and Countervailing Measures, Article I:1.[241] As previously discussed, qualified foreign trade property is held for sale *outside* the United States.[242] This seems to make the subsidy export-contingent. In fact, the Panel even noted that according to the European Communities, "there would no longer be a prohibited subsidy within the meaning of Article III of the Agreement on Subsidies and Countervailing Measures if the United States eliminated the requirements that the property be held for use outside the United States and the fifty percent foreign content limitation."[243]

To expand the breadth of their argument, the European Communities also argued that ETI violated the Agreement on Subsidies and Countervailing Measures, Article III:1(a) "because it is only applicable to profits arising from export transactions."[244] Therefore, because the ETI is conditioned upon exportation, the European Communities asserted that the subsidy is export-contingent in respect to American-produced goods.[245]

The European Communities also argued that ETI accords more favorable treatment to American domestic products than imported foreign products.[246] They claimed that because qualified foreign trade property's fair market value cannot contain more than fifty-percent foreign content, ETI is not available to foreign corporations whose goods have one hundred percent foreign content.[247] In essence, the European Communities argued that by discriminating against products with foreign content, ETI afforded domestic products favorable treatment, thus violating GATT-1994, Article III:4.[248]

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238. *See id.*

239. *See* WTO Doc. WT/DS108/14/Corr.1.

240. *See* WTO Doc. WT/DS108/RW, at para. 8.43.

241. *See* WTO Doc. WT/DS108/RW, at para. 8.30.

242. For a discussion on qualified foreign trade property, *see supra* notes 219-223 and accompanying text.

243. WTO Doc. WT/DS108/RW, at para. 8.1.

244. *See id.* at para. 8.50.

245. *See id.* at paras. 8.59-60.

246. *See id.* at para. 3.1(e).

247. *See* WTO Doc. WT/DS108/RW, at para. 8.160.

248. *See* GATT, *supra* note 16, at art. III - National Treatment on Internal Taxation and Regulation:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.

As previously discussed, the United States countered by stating that ETI is not export-contingent, and is in complete accord with the Agreement on Subsidies and Countervailing Measures and other WTO obligations.[249] Because Section 114 of the Code is available to both domestic and foreign manufacturers, the United States argued that by definition, it could not be considered export-contingent under the Agreement on Subsidies and Countervailing Measures Article I:1.[250]

In addition, the United States commented that ETI "does not require the use of domestic rather than imported goods."[251] Within the language of ETI, the United States stated that goods could meet the foreign articles and labor limitation imposed by GATT Article III:4 "*even if* one hundred percent of the fair market value of their inputs is foreign."[252] Because ETI did not violate Article III:4 on its face, the United States argued that it did not constitute an illegal export subsidy.

Finally, the United States asserted that if legislation provided that "gross income does not include income generated from export activities," as ETI does, the ordinary meaning of Article I:1(a) suggests that there would not be a financial contribution within the meaning of the Article.[253] This is because the "tax revenue on export activities would not be 'otherwise due' under the law of the Member, which is the normative benchmark for an Article I analysis."[254]

Along with filing a grievance in the WTO, the European Communities criticized the United States defenses in the matter. European Communities officials publicly stated that the United States appeared to be basing its defense on a narrow definition of subsidy "that assumes that whatever is not specifically prohibited by the Agreement on Subsidies and Countervailing Measures is permitted."[255] This defensive strategy, they argued, was very similar to the original strategy in the FSC debate.

On August 20, 2001, the Panel decided against the United States, and found that the ETI is in fact an illegal subsidy.[256] In looking at both arguments, the Panel first addressed whether ETI is export-contingent. Applying a "but for" analysis, similar to the reasoning in its FSC decision, the Panel concluded that the ETI exclusion foregoes revenue that is otherwise due within the meaning of Article I:1.[257] This conclusion meant that only exporters are entitled to take the exemption, and thus, the United States government is not taxing income that it would normally tax *but for* the exemption.

The Panel also found that the United States was in violation of the Agreement

249. *See* GATT, *supra* note 16, at para. 3.3.

250. *See* GATT, *supra* note 16, at para. 8.51.

251. *Id.* at para. 8.125.

252. *Id.* (emphasis added).

253. *Id.* at para. 8.39.

254. *Id.*

255. *Extraterritorial Income: U.S. Outlines FSC Replacement Defense, Urges WTO to Reject EU's Argument*, 50 DAILY TAX REP., Mar. 14, 2001 at G-5.

256. *See generally*, WTO Doc. WT/DS108/RW. As a note, the ETI Panel was the same as in the original FSC dispute.

257. *See id.* at para. 8.37.

on Subsidies and Countervailing Measures, Article III:1(a). Because qualifying foreign trade property had to be held a for ultimate use *outside the United States*, ETI is therefore only available in respect of income derived from transactions relating to that property.[258] This meant that ETI was export-contingent because only exports could take advantage of the exemption, in clear violation of Article III:1(a).

Finally, the Panel found that ETI also violated GATT Article III:4 because American products would be more likely to take advantage of the exclusion than imported products.[259] Although Section 114 of the Code states that products may be manufactured inside or outside the United States, the Panel concluded that an illegal subsidy existed even if only a small percentage of corporations using the exemptions had one hundred percent American content products.[260] This meant that there was no possible way for foreign products to take advantage of ETI, thus violating Article III:4 by providing less favorable treatment to imported products.

This decision seemed to puzzle many American trade experts. For example, Fred Murray, Vice President for Tax Policy of the National Foreign Trade Council, Inc., told reporters that "the Panel's decisions appears to ignore the fact that the United States fundamentally alters its tax system specifically to comply with the WTO's rules and to move the United States system closer to territorial tax systems that are common in Europe and around the world."[261] This sentiment echoed the United States' argument throughout the disagreement: DISCs, FSCs and ETI all, in one way or another, deferred or exempted export income, just like territorial taxation systems in Europe. Unfortunately, the WTO did not analyze these tax methods in the same manner.

On October 15, 2001, the United States filed an appeal of ETI Panel's decision with the WTO Appellate Body.[262] This was done in part because of pressure placed on United States Trade Representative, Robert Zoellick, by various congressmen. In a letter dated September 6, 2001, eleven House Democrats, led by Representatives Charles Rangel of New York and Sander Levin of Michigan, urged Zoellick to appeal the ETI decision because it was "deeply flawed."[263]

President Bush received pressures from the private sector as well. In a letter dated August 8, 2001, chief executives of seventy-four leading American companies wrote him, urging an appeal of the ETI decision.[264] These chief executives stated that an appeal "could serve to clarify the meaning of WTO rules and provide greater certainty about what needs to be done to resolve this 'volatile

258. *See* WTO Doc. WT/DS108/RW, at para. 8.74.

259. *See* WTO Doc. WT/DS108/RW, at para. 8.158.

260. *See id.* at para. 8.123.

261. *Extraterritorial Income: WTO Panel Issues Preliminary Ruling Against United States in FSC Dispute*, 246 DAILY TAX REP., Dec. 21, 2000, at G-4. *See also supra* note 227.

262. *See International Taxes: U.S. Files Notice of Appeal of WTO Ruling on Extraterritorial Income*, 201 DAILY TAX REP., Oct. 19, 2001, at G-6.

263. *Extraterritorial Income: EU Presses U.S. to Announce Decision on Whether it Will Appeal FSC Ruling*, 193 DAILY TAX REP., Oct. 9, 2001, at G-6 [hereinafter *EU Presses U.S.*].

264. *See id.*

conflict.'"[265]

On November 26, 2001, the United States' appeal was argued by Deputy Treasury Secretary Kenneth Dam.[266] By having a high-ranking official take part, the Bush administration hoped that the WTO would realize how serious the United States was taking the appeal.[267] While before the Appellate Body, Dam argued that ETI is not export-contingent because both foreign and domestic corporations can take advantage of its tax benefits.[268]

Dam also stated that the Panel's decision on ETI was so broad and subjective that it "calls into question measures incorporated in the tax systems of every (WTO) member."[269] This decision, he continued, not only undermined ETI, but "could place at risk other tax systems in Europe and the rest of the world."[270] In order to emphasize this point, Dam cited specific examples of European countries that give incentives to their exporters, similar to the United States and its use of ETI. These examples, particularly tax systems in Belgium, France, Germany, and Italy, exclude resident corporations from paying corporate tax on foreign income or are not taxed on foreign source dividend income. These examples are so similar to ETI that they can be considered one in the same.[271]

In its appeal, the United States seems to be rehashing the same argument that has been the focus of American policy since the advent of DISCs in 1971: the system is not export-contingent, and therefore is not an illegal subsidy. As previously stated, Section 114 of the Code specifically provides that qualified foreign trade property must be sold *outside* the United States. This was one of the main points of the Panel's decision.

On January 14, 2002, the WTO's Appellate Body enforced this main point by affirming the Panel's decision on ETI.[272] As with previous decisions, this decision held that the United States was illegally subsidizing its exporters through the use of ETI. Specifically, the Appellate Body looked to previous decisions and their interpretation of "contingent." As stated in the Canada-Aircraft decision in 1999, contingent means "'conditional' or 'dependent' for its existence upon something else."[273] In other words, the grant of a subsidy must be conditional or dependent upon export performance.

The Appellate Body then applied this definition to ETI. Because ETI requires qualified foreign trade property to be sold outside the United States, it is export

265. *See id.*

266. *See Extraterritorial Income: Deputy Treasury Secretary Dam to Make Opening Argument in FSC Appeal at WTO*, 213 DAILY TAX REP., Nov. 6, 2001, at G-1.

267. *See id.*

268. *See Extraterritorial Income: World's Tax Systems "At Risk" Because of WTO Ruling, U.S. Warns*, 226 DAILY TAX REP., Nov. 27, 2001, at G-1.

269. *Id.*

270. *Id.*

271. *See id.*

272. *See generally* WTO Doc. WT/DS108/AB/RW.

273. Canada - Measures Affecting the Export of Civilian Aircraft, WTO Doc. WT/DS70/AB/R (Aug. 2, 1999), at para. 166.

contingent even though foreign-based corporations can take advantage of its provisions.[274] The Appellate Body concluded that just because the "subsidies granted [to foreign-based corporations] might not be export contingent, [it] does not dissolve the export contingency arising in the first set of circumstances."[275]

The Appellate Body also looked to the fact that the United States was foregoing taxation due on the overseas transactions.[276] As stated in SCM Article 1.1(a)(1)(ii), "the normative benchmark for determining whether revenue foregone is otherwise due must allow a comparison of the fiscal treatment of comparable income, in the hands of taxpayers in similar situations."[277]

Examining the Code, the Appellate Body first looked to Section 61(a), where gross income means "all income from whatever source derived."[278] In determining a taxpayer's tax liability, gross income is then reduced by a credit, subject to limitations, with the amount of foreign taxes paid or deemed to have been paid by that taxpayer.[279] These rules on the taxation of gross income, however, do not apply to any income received on the sale of qualified foreign trade property.

This income, known as qualified foreign trade income, is excluded from taxation altogether.[280] Because of this, "the amount of tax paid by the taxpayer will very likely be less than the tax which the taxpayer would have paid, on that income, under the rules "otherwise" applicable to foreign-source income, if the taxpayer did not elect to use the ETI measure.[281]

The Appellate Body concluded, "This, too, confirms that the United States will forego revenue under the ETI measure that would be 'otherwise due'," violating SCM Article I.1(a)(1)(ii).[282]

Unlike previous decisions by a WTO dispute resolution body, this part of the Appellate Body's decision was actually applauded by some United States officials. For example, Linnett Deily, the United States Ambassador to the WTO, applauded this part of the decision by stating that the Appellate Body "clarified the normative benchmark for determining whether revenue foregone is otherwise due."[283] This, he went on to say, "has made its standard clearer and more understandable."[284]

Like previous WTO decisions, Deily stated that the majority of the opinion lacks guidance, making it difficult for WTO members to avail themselves of a WTO subsidy exemption.[285] This vagueness in WTO opinions, it seems, is making

274. *See* WTO Doc. WT/DS108/AB/RW, at para. 119.

275. WTO Doc. WT/DS108/AB/RW, *supra* note 274, at para. 119

276. *See id.* at paras. 81-107.

277. *Id.* at para. 98.

278. *Id.* at para. 99.

279. *See id.* at para. 100.

280. *See id.* at para. 102.

281. *Id.* at para. 104.

282. *Id.*

283. *Extraterritorial Income: U.S. Official Cites 'Encouraging' Findings in WTO Appellate Body's Ruling on ETI Act*, 20 DAILY TAX REP., Jan. 30, 2002, at G-3 [hereinafter *Extraterritorial Income*].

284. *Id.*

285. *See Extraterritorial Income*, *supra* note 283.

it difficult for the United States to comply with its WTO obligations.

The European Communities, on the other hand, appear content with the Appellate Body's decision. At the time of the decision, it was unclear what the European Communities would do: they could have requested sanctions against American products, request direct retaliation against American exporters, or simply wait and see what the American Congress would do about ETI.

After waiting for fifteen months,[286] the European Communities finally asked the WTO for over four billion-dollars in direct retaliation against American exporters and their goods.[287] This retaliation is against everything from meatmeant and vegetables to paper and cotton.[288] In essence, the American products mentioned in the retaliation would be slapped with additional duties of up to 100 percent ad valorem above bound customs duties.[289]

Currently, there is no timeline when the European Communities will implement these sanctions. European Trade Commissioner Pascal Lamy, however, has said that the EU "will hold off imposing the sanctions as long as Congress appears to be making a good-faith effort to bring U.S. law into compliance with WTO rules."[290] Previously, though, he stated that "if there is 'no sign that compliance is on the way' by this fall, the Commission will begin the 'legislative procedure' leading to the adoption of retaliatory trade measures by January 1, 2004."[291]

Some officials in the U.S. have taken the pending retaliation as an escalation to the already-heightened tension between the U.S. and the European Communities. As stated by Senate Finance Committee Chairman Charles E. Grassley, "[s]anctions would needlessly elevate bilateral trade tensions in the targeted areas and derail our efforts to resolve this issue in a timely way."[292] He went on to say that "[s]anctions could also lead to a deeper economic slowdown when we need to do all we can to expand world trade and economic growth."[293]

Other officials, however, seem to look at the Appellate Body's decision and the following European Communities' retaliation as the U.S. being caught with its hand in the cookie jar. As stated by House Ways and Means Committee Chairman William Thomas:

> We're in violation [of our GATT responsibilities]. . .[s]ome of these people who make these uppity comments about why can't people give us a little bit of time—

286. The original Appeals decision was on January 14, 2002. For reference, *see* WTO Doc. WT/DS108/AB/RW.

287. *See* WTO Doc. WTO/DS108/26 (April 25, 2003).

288. *See id.*

289. *See id. See also EU Threatens to Impose Sanctions If NoNoif no U.S. Progress on Compliance by Fall*, 89 DAILY TAX REP., May 8, 2003, at G-10.

290. *Thomas May Post-Pone International Tax Bill; Crane-Rangel Measure Gets 100 Co-Sponsors*, 108 DAILY TAX REP., June 5, 2003, at G-10.

291. *Id.*

292. *EU Threatens to Impose Sanctions If No U.S. Progress on Compliance by Fall*, 89 DAILY TAX REP., May 8, 2003, at G-10. As a note, Senator Grassley is a Republican from Iowa.

293. *Id.*

> this was the fourth WTO decision against us. I know that the rest of the world is unfair to us but, at some point, when we're wrong and, if we are the major importer and exporter in the world, we have to look at our responsibility to maintain the world trading order. Frankly, we have won far more cases than we have lost using that structure.[294]

Due to the previous decision against the U.S., ETI is currently considered an illegal subsidy by the WTO. The following section will look at what the United States should do to become WTO-compliant. Specifically, it will discuss revamping the American taxation system, as well as diplomatic pressures the United States could exert over the European Communities.

VI. REMEDYING THE EXPORT SUBSIDIES PROBLEM

In order to become WTO-compliant, the United States could change the focus of its tax system to a territorial system. In doing this, it should not try to introduce legislation similar to the FSC or ETI. The previous three decades of struggle between the United States and the European Communities should be enough of an incentive not to repeat prior mistakes. As echoed by House Ways and Means Committee Chairman Thomas, "We should accept the message of the WTO ruling, roll up our sleeves, and get down to work immediately to design a tax system that will make Americans competitive both at home and as they trade abroad."[295]

One way to do this is to move the United States toward a value added tax-based system, reimbursing corporations throughout the manufacturing process. This would allow American exporters to take advantage of value added tax exemptions on taxation. Value added tax in the United States would also be WTO-compliant because, as stated previously, GATT has endorsed the value added tax as being compliant with the Agreement on Subsidies and Countervailing Measures and other GATT agreements.[296] In fact, consumption-based taxes such as the value added tax are followed by a majority of nations, including all members of the Organization for Economic Co-operation & Development, except for the United States.[297] Because the rest of the world uses a value added tax, there has been a major congressional effort to turn the American system of taxation from a worldwide system to one based on consumption, particularly one based on the value added tax.[298]

As previously discussed, consumption-based tax methods on exports such as

294. *Thomas Says He Soon Will Introduce ETI Bill, Criticizes Crane-Rangel Approach*, 90 DAILY TAX REP., May 9, 2003, at G-10. As a note, Congressman Thomas is a Republican from California.

295. *Extraterritorial Income: WTO Issues Final Ruling Maintaining Interim Findings Against US FSC/ETI*, 141 DAILY TAX REP., July 24, 2001 at GG-1.

296. *See supra* notes 142-143 and accompanying text.

297. *See* Laura Dale, *The Economic Impact of Replacing the Federal Income Tax with a Federal Consumption Tax: Leveling the International Playing Field*, 9 CURRENTS: INT'L TRADE L.J. 47, 47 (2000).

298. For a discussion on these congressional efforts, *see infra* notes 299-310 and accompanying text.

value added taxation allow a domestic corporation to sell its exports free of domestic taxes. This is allowed because under value added taxation, exports are considered zero-rate exemptions.[299] By the United States changing to a value added taxation system, American corporations, like the rest of the world, could use these exemptions to sell their exports free of domestic tax, thus lowering their overall prices and allowing them to be competitive in the international exportation market.[300]

In fact, there have been several proposals to implement various value added taxation systems in the United States. One of these proposals, introduced in 1994 by Congressman Sam Gibbons, repealed both the individual and corporate income tax, and replaced them with a value added tax.[301] This proposal was introduced because "[w]e cannot afford the current system. It costs too much to operate. It destroys Americans' confidence in their government and it hurts our economy by exporting American job opportunities."[302] Commonly referred to as the "business transfer tax,"[303] the bill placed a twenty-percent value added tax on all stages of production,[304] similar to value added taxes in Europe. The bill, however, died in the House Committee on Ways and Means, and was never re-introduced.

Other proposals have added a value added tax on top of already existing income tax liabilities. Introduced by Senator Ernest Hollings and Representative John Dingell, their proposal added a five-percent value added tax to each taxable transaction.[305] This tax would be used to fund a national health care system. As with European value added taxes, food, housing and medical care were considered zero-rate exemptions. Both bills died in committee and were never re-introduced.

These bills were either outright denounced or never re-introduced because of the intense congressional distaste for value added taxes. In fact, in 1994, a number of congressmen joined an anti-VAT caucus to combat proposals that introduced any form of value added taxation.[306] This distaste was due to the enormous administrative pressure placed on governments that imposed forms of value added

299. *See supra* notes 114-119 and accompanying text.

300. For a discussion on the repercussions of changing from a worldwide taxation system to one based on consumption, *see generally* Dale, *supra* note 297.

301. H.R. 4050, 104th Cong. § 101 (1996). As a note, Congressman Gibbons is a Democrat from Florida.

302. *Introductory Statement and Technical Description of Bill (H.R. 4050) by Rep. Sam Gibbons (D-Fla) for Single-Rate Subtraction-Method Value-Added Tax, Introduced September 11, 1996*, 177 DAILY TAX REP., Sept. 12, 1996, at D-45.

303. *See* Charles E. McClure, Jr., *The U.S. Debate on Consumption-Based Taxes: Implications for the Americas*, 29 U. MIAMI INTER-AM. L. REV. 143, 149 (2000).

304. *See* H.R. 4050, 104th Cong. § 10001 (1996).

305. *See* H.R. 16, 106th Cong. § 3901 (1999) (the Dingell bill to finance health care); S. 237, 104th Cong. § 101 (1995) (the Hollings bill to finance national health care and to fund reductions in the national debt). As a note, Senator Hollings is a Democrat from South Carolina and Representative Dingell is Democrat from Michigan. *See also* Alan Schenk, *Radical Tax Reform for the 21st Century: The Role for a Consumption Tax*, 2 CHAP. L. REV. 133, 139 n.39 (1999).

306. *See Tax Policy: White House Has no Plans to Move Towards Value-Added Tax, Bentsen Says*, 207 DAILY TAX REP., Oct. 28, 1994 at D-10. At the time, the anti-VAT caucus consisted of 17 Senators and 111 House members.

taxation. Many experts, including Daniel Mitchell, McKenna Senior Fellow in Political Economy at the Heritage Foundation, warn that a value added tax will increase the size and cost of government.[307] He came to this conclusion because countries with value added taxation have on average a forty-percent heavier tax burden than those without value added taxation.[308] These countries also consume about forty-two percent more national economic output to implement the tax than non-value added taxation countries.[309]

Moreover, replacing the Code with a value added tax system would be an enormous congressional task. In order to implement a value added tax, Congress would have to re-work the entire Code with respect to all relevant parts of taxation dealing with exports and their inclusion in gross income. Congress would also have to debate whether the value added tax would apply only to exports, or to all individuals and corporations under the Code. In the event that the value added tax would apply only to corporations, specifically those engaged in exportation, the United States would risk the possibility that the WTO would consider this system an illegal subsidy because of its export nature, thus in violation of GATT and other WTO obligations.

Finally, a value added tax would move away from a fundamental of American taxation; namely that the Code allows taxpayers to customize tax liabilities to their individual needs. As previously discussed, the Code allows taxpayers incentives such as tax credits and deduction to avoid tax liabilities. These incentives, in turn, allow the taxpayer to tailor their business practices to obtain the most beneficial tax status. A value added taxation system, on the other hand, places a flat rate on all products during the production stage.[310] This obviously does not allow for the same amount of tax planning as does a system with tax incentives.

Another way to become WTO-compliant is through the use of a pure territorial tax on foreign branches of domestic corporations. This could be achieved by not taxing any income earned outside the United States, exactly like the European Communities taxation system. This would allow American exporters to avoid double taxation because, unlike before, exporters are now only paying foreign tax in the country where the sale took place. It would also signal to the WTO that the United States is serious about becoming WTO-compliant and is ready, willing and able to work with the rest of the world on difficult and intricate problems.

This option, however, could possibly result in the mass exodus of American manufacturers overseas to low tax jurisdictions.[311] This would be very similar to

307. *See VAT: VAT Option in OMB Memo Denounced; Candidates Urged to Join Anti-VAT Caucus*, 206 DAILY TAX REP., Oct. 27, 1994 at D-5.

308. *See id.*

309. *See id.*

310. Some systems allow exemptions for needed items such as food (true exemption) and others allow items to be taxed at zero percent (zero-rate exemptions). For a discussion on true and zero-rate exemptions within value added taxation, *see supra* notes 113-117 and accompanying text.

311. For a discussion on territorial taxation and American corporate decisions, *see generally* Rosanne Altshuler & Harry Grubert, *Where Will They Go If We Go Territorial? Dividend Exemption*

the problem present in the 1950's, the pre-DISC era discussed above. This was the whole point behind the advent of Subpart F under the Kennedy Administration. Therefore, this too seems to be an implausible option to American lawmakers.

A large-scale change to the Code, however, seems very improbable because such a change "will take more than six months-well beyond the end-of-April date when the European [Communities] will be authorized to retaliate against the United States over the dispute."[312] Senate Finance Committee Chairman Max Baucus, echoed this sentiment by stating that the Bush administration should seek a resolution to the dispute "other than a major overhaul of the United States tax code."[313]

Currently, there is legislation being generated to replace ETI with a deduction for American manufacturers.[314] Sponsored by Reps. Philip Crane and Charles Rangel, H.R. 1769 is intended to "help U.S. manufacturers and their workers maintain their international competitiveness."[315] This proposal currently has both widespread Congressional[316] and manufacturing[317] support.

If passed in its current form, H.R. 1769 would repeal ETI.[318] In its place, a newly-created Code Section 250 would allow a deduction of ten percent for "qualified production activities income."[319] As currently defined, qualified production activities income is "(1) the portion of the modified taxable income of the taxpayer which is attributable to domestic production activities, and (2) the domestic/foreign fraction."[320] In essence, this means that a domestic manufacturer will receive a deduction against itstheir gross income for making itsthere products domestically rather than abroad. This deduction, however, is further reduced by multiplying the deduction by a fraction.[321] Because a fraction is used to determine the final deduction allowed, some officials in the current administration think that

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and the Location Decisions of U.S. Multinational Corporations, 54 NAT'L TAX J. 787 (2001).

312. *Extraterritorial Income: Complying With WTO Tax Ruling Will Take Over Six Month, Thomas Says*, 27 DAILY TAX REP., Feb. 8, 2002 at G-8, citing comments made by House Ways and Means Committee Chairman Bill Thomas, a Republican from California.

313. *Id.* (citing 26 DAILY TAX REP., Feb. 7, 2002 at G-7). As a note, Senator Baucus is a Democrat from Montana.

314. *See generally* H.R. 1769, 108th Cong. § 3 (2003). Currently, there is a Senate companion bill to H.R. 1769 that was introduced May 1, 2003. *See generally* S.B. 970, 108th Cong. (2003).

315. *Rangel, Crane Introduce Export Tax Bill With Domestic Manufacturers Rate Deduction*, 71 DAILY TAX REP., Apr. 14, 2003 at G-9. As a note, Congressman Crane is a Republican from Illinois, and Congressman Rangel is a Democrat from New York.

316. Currently, there are 100 co-sponsors of the bill. *See Thomas May Post-Pone International Tax Bill; Crane-Rangel Measure Gets 100 Co-Sponsors*, 108 TAX REP., June 5, 2003 at G-10.

317. Some of the American companies in support of H.R. 1769 are Microsoft, Boeing, and Caterpillar. *See EU Threatens to Impose Sanctions if no US Progress on Compliance by Fall*, 89 TAX REP., May 8, 2003 at G-10.

318. H.R. 1769, 108th Cong. § 2 (2003).

319. *See id* at § 3(a).

320. *Id.*

321. *See id.* Within newly-created § 250(g), the ten percent deduction is multiplied by the value of domestic production/the value of worldwide production. Because the value of the worldwide production may be higher than the domestic production, it will then reduce the deduction allowed.

a newly-created Section 250 may be too difficult to administer.[322]

Although intended to replace ETI, the current legislation does not offer American exporters the same economic incentive to help off-set double taxation abroad. In the current ETI legislation, almost *any* American exporter can take advantage of the exclusion of extraterritorial income from gross income.[323] So long as the income is classified as extraterritorial income under Section 114, it is an exclusion from gross income. Under the current version of H.R. 1769, only a certain percent is deducted from gross income.[324] This percentage is further reduced to almost zero if the corporation does a significant portion of itstheir manufacturing overseas.[325]

Similarly, ETI can be used by both manufacturers and service-providers.[326] Under H.R. 1769, only domestic manufacturers can take advantage of the deduction.[327] As stated by an anonymous staffer close to the current legislation, "[a]bout 25 percent of the companies that now benefit from ETI are service corporations, which get no relief at all under the Crane-Rangel [H.R. 1769] approach."[328]

Finally, many legislators feel the bill in its current form should pass WTO scrutiny under the previous three decades of debate.[329] This is because H.R. 1769 does not differentiate between exporters and domestic corporations, unlike ETI,

322. *See Domestic Manufacturing ETI Replacement Raises Equity, Complexity Issues, Olson Says*, 97 TAX REP., May 20, 2003 at G-8, citing comments made by Assistant Treasury Secretary for Tax Policy Pamela Olson. This fraction may be difficult to administer because the corporation needs to clearly document all domestic production, including gross receipts, deductions and income attributable to domestic production. For reference, *see* H.R. 1769, 108th Cong. § 3 (2003), *specifically* newly-created §250(d).

323. *See* § 114, referring to § 942(a)(1), defining foreign trading gross receipts as receipts which are:

> (A) from the sale, exchange, or other disposition of qualifying foreign trade property
> (B) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States,
> (C) for services which are related and subsidiary to—
> (i) any sale, exchange, or other disposition of qualifying foreign trade property by such taxpayer, or
> (ii) any lease or rental of qualifying foreign trade property described in subparagraph (B) by such taxpayer,
> (D) for engineering or architectural services for construction projects located (or proposed for location) outside the United States, or
> (E) for the performance of managerial services for a person other than a related person in furtherance of the production of foreign trading gross receipts described in subparagraph (A), (B), or (C).

324. *See* H.R. 1769, 108th Cong. § 2 (2003).

325. *See id.* at § 3.

326. *See supra*, note 323

327. *Id.*

328. *Crane, Rangel Urge Lawmakers to Support Domestic Manufacturing ETI Replacement*, 94 TAX REP., May 15, 2003 at G-4.

329. *See Thomas Says He Soon Will Introduce ETI Bill, Criticizes Crane-Rangel Approach*, 90 TAX REP., May 8, 2003 at G-10, citing a legal analysis written by the Democratic Staff to the Senate Finance Committee.

FSC and the DISC regimes.

It will fail WTO scrutiny, however, on other grounds. Under the DSU, the losing party must comply with the Panel/Appellate Body's decision within eighteen months of the decision.[330] Currently, H.R. 1769 phases in over a five-year period,[331] in clear violation of the DSU's requirements. As stated by EC spokeswoman Arancha Gonzales, "EU legal experts believe the five-year transition period proposed in H.R. 1769 'is clearly WTO-incompatible and therefore unacceptable.'"[332]

As with any piece of legislation, what currently exists will not necessarily be the final result. In its current form, H.R. 1769 does not offer the same benefits to exporters as ETI, and should not be viewed as its replacement. Rather, H.R. 1769 should be viewed as an economic stimulus package to bring jobs back into the U.S. during a time of economic recession, and not as a means to help exporters. If that were the case, all exporters, including service providers, would be able to take advantage of the deduction offered in H.R. 1769. Similarly, the deduction would not be reduced by a fraction, and would generate roughly the same after-tax savings as ETI.

Instead of making changes to the Code or the United States system of taxation, there are other ways to combat this disagreement. As stated throughout this article, the United States has argued that FSCs and ETI are very similar to the European Communities' taxation systems because they both either defer or exempt export income from taxation. To settle this debate, the United States could bring an action against the European Communities, claiming that their taxation systems are illegally subsidizing their exports.

In bringing this action, the United States could argue that because value added taxation allows a zero-rate exemption for exports, these systems are in violation of GATT and WTO obligations because they are export contingent. Like the European Communities arguments against FSCs and ETI, the United States could argue that because value added taxation defers tax liability specifically related to exports, it fits within the meaning of Footnote 59 to the Agreement on Subsidies and Countervailing Measures. Because of this, value added taxation is an illegal subsidy.

This may not be the best approach, however, because of the reaction by the European Communities and a possible favorable WTO holding in the action. In bringing an action, the United States' actions may be viewed as vindictive rather than as an attempt to resolve the disagreement. The European Communities may interpret this action as a slap in the face, and that the United States is unwilling to progress towards a peaceful end to the thirty-year debate. Similarly, they could also see the action as an escalation to the disagreement, making future consultations more hostile than previous meetings.

330. *See supra*, note 57 and accompanying text.

331. *See* H.R. 1769, 108th Cong. at § 3 (2003).

332. *See Thomas Says He Soon Will Introduce ETI Bill, Criticizes Crane-Rangel Approach*, 90 TAX REP., May 8, 2003 at G-10

Bringing the action may not solve the disagreement because the WTO Panel, even if it finds in favor of the United States, may not clarify the situation. In its decisions on DISCs, FSCs, and ETI, the United States complained that the Panel's holding did not give any meaningful direction to the United States. These holdings did not explain which parts of the tax method were considered to be subsidies, nor did it identify how the United States could change its method of taxation to become compliant with its WTO obligations. Such a holding in an action against the European Communities would frustrate further the relations between Europe and the United States, making future cooperation very difficult.

In the end, the best way for the United States to become WTO-compliant is to continue meeting with representatives from both the European Communities and the WTO. These meetings should be cooperative in nature, and very specific as to how the United States can become WTO-compliant. In this way, the United States can better understand what the WTO is looking for in compliance, and how territorial and value added taxation are not in violation of GATT and WTO obligations.

Although they are not occurring on a worldwide basis, there are some meetings already taking place between representatives of the United States and the European Communities. In early January, 2002, with the Appellate Body's decision on ETI on the near horizon, United States Trade Representative Robert Zoellick began to meet with the European Trade Commissioner Pascal Lamy. These meetings, as characterized by Zoellick, were "a good faith effort to try to resolve the issue fairly and to put it to rest."[333]

These meetings, however, need to include the WTO and other nations such as India, Australia, and Japan.[334] In order to end the current subsidies debate properly, the United States needs to present its argument to all WTO members, not just to a WTO Panel or Appellate Body. These organizations by definition do not change or make trade policy; they simply enforce them. By not including other nations in the discussions, the United States is only going to get half of the picture. It will only receive advice on how future legislative changes to the Code are WTO-compliant *in the eyes of the European Communities*; not in the eyes of who matters most: the WTO.

To present its argument, I suggest that the United States request that the WTO include the current debate over subsidies on its calendar for the next Ministerial Conference, held in Mexico in 2003.[335] This will give the United States enough time to garner international support for its arguments. It will also allow the United States to consider its next move to become WTO-compliant. This Conference, known as the Fifth Ministerial Conference, will be similar to the Fourth Ministerial

333. *Extraterritorial Income: U.S. Vows to Comply With WTO Tax Ruling, Sets Plan For Working With Congress and EU*, 18 DAILY TAX REP., Jan. 28, 2002 at G-6.

334. These nations were involved in the ETI decision as third-party participants. *See generally* WTO Doc. WT/DS108/AB/RW.

335. This conference will take place in Cancun, Mexico on Sept. 10-14, 2003. *See* WTO, Current Negotiations and Implementation, Doha Development Agenda, http://www.wto.org/English/ tratop_e/ dda_e/dda_e.htm.

Conference, held last November in Doha, Qatar.[336] At the Fourth Conference, WTO members discussed the admission of two bitter rivals to the WTO: Taiwan and mainland China.[337] By admitting such members to the organization, the WTO's current members proved that they can work together on a very difficult issue. Such cooperation will be imperative to end the current subsidies debate.

Such a Conference would also provide the opportunity for the United States to present its ideas on value added taxation and GATT agreements in a non-adversarial manner. It can present ideas on future legislation, and obtain input from the European Communities and the WTO. It could even ask the WTO for a preliminary holding on whether the proposed method of taxation is WTO-compliant.

Finally, such a Conference would also provide the United States a forum to request change from the WTO and GATT. Specifically, it could ask to amend the Agreement on Subsidies and Countervailing Measures so ETI could be included, making it compliant with WTO obligations. If this tactic does not work, the United States could try to garner international support for amending the Agreement on Subsidies and Countervailing Measures from a majority of WTO member nations.

VII. CONCLUSION

The European Communities and the United States are entering their fourth decade of debate over the exact definition of the term subsidy. This disagreement has led the United States to implement various methods of taxation in order to allow its exporters to compete with foreign exporters. In abiding by its goal of fair and equitable trade between countries, the WTO has held each of these methods of taxation to be in violation of various WTO and GATT agreements.

These WTO decisions have led to mass confusion regarding the exact definition of the term subsidy. To clarify this confusion, the United States, along with the European Communities and the WTO, should enter into formal consultations to clarify the situation. Doing so will not only clarify exactly how the United States subsidizes its exports, but also explain how territorial taxation does not. This should give the United States a blueprint for successful completion of their WTO obligations, and still allow American exporters to compete in the international market.

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336. For more information on the Doha Conference, *see* Current Negotiations and Implementation, Doha Development Agenda, *supra* note 335.

337. *See generally id.*