Fishing for Rainbows, the FSC Repeal and Extraterritorial Income Exclusion Act[†*]

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† FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000).

* J.D. candidate May 2004, University of San Diego School of Law.

"No nation was ever ruined by trade,"

Benjamin Franklin (1774)[1]

I. INTRODUCTION

On August 30, 2002, the final decision was released in the case of *United States-Tax Treatment for "Foreign Sales Corporations"*.[2] The World Trade Organization arbitration panel report authorizes the European Communities to levy $4.043[3] billion in annual trade sanctions against imports from the United States because of a provision in the U.S. tax code.[4] "The FSC Repeal and Extraterritorial Income Exclusion Act of 2000",[5] the most recent of 40 years worth of half-hearted attempts by the United States to comply with world trading body regulations, is the current offender. According to the arbitration panel, the act subsidizes foreign sales by U.S. corporations by relying upon export-based contingencies, and is inconsistent with the obligations of the United States under both the Agreements on Subsidies and Countervailing Measures ("SCM Agreement")[6] and the Agreement on Agriculture.[7]

The August 30, 2002 decision was the final determination of a January 14, 2002, WTO Appellate Panel report finding the United States' extraterritorial income exclusion rules to be a prohibited export subsidy. "This marks the fourth time in the past two and one-half years that the United States has lost this issue, twice in the Foreign Sales Corporation case and now twice in the ETI case."[8] "There is no opportunity for the

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1. DOUGLAS A. IRWIN, FREE TRADE UNDER FIRE 225 (2002).

2. *United States—Tax Treatment for "Foreign Sales Corporations" Recourse to Arbitration by the United States under Article 22.6 of the* DSU *and Article 4.11 of the* SCM Agreement, WT/DS108/ARB (Aug. 30, 2002), *available at* http://docsonline.wto.org/gen_search.asp?searchmode=advanced [hereinafter Arbitrator Decision]. The foreign sales corporation is hereinafter referred to throughout the comment and footnotes as an "FSC."

3. All references to $ herein refer to United States dollars unless otherwise noted.

4. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, 114 Stat. 2423.

5. *Id.*

6. Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization [hereinafter WTO Agreement]; Annex 1A, MULTILATERAL AGREEMENTS ON TRADE IN GOODS, 33 I.L.M. 1154 (1994) [hereinafter SCM Agreement].

7. Agreement on Agriculture, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, MULTILATERAL AGREEMENTS ON TRADE IN GOODS, 33 I.L.M. 1154 (1994) [hereinafter Agreement on Agriculture].

8. HOUSE COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON SELECT

United States to appeal this latest determination."[9]

President Bush is said to be in favor of complying with the ruling. Kenneth Dam, Deputy Treasury Secretary, in testimony to the Senate Finance Committee stated:

> The President has spoken on this and his message is clear. The United States will honor its WTO obligations and will come into compliance with the recent WTO decision. To do so will require legislation to change our tax law. The Administration is committed to working closely with the Congress in the development and enactment of the legislation necessary to bring the United States into compliance with WTO rules.[10]

Just two years before, a WTO appellate panel held that the foreign sales corporation ("FSC") provisions repealed in the 2000 Act constituted a similar, prohibited subsidy.[11] The Extraterritorial Income Exclusion Act ("ETI") was promulgated by the Clinton administration as a response to the FSC ruling under the guise of correcting the shortcomings of the FSC legislation, and bringing the U.S. into compliance with its WTO treaty obligations.[12] The expectation of success was short lived as just two days after President Clinton signed the ETI Act into law, the European Communities filed a request for consultations on the matter with the WTO.[13] Believing the ETI Act to be just as bad as its predecessor, the European Communities determined the Act merely replicated the offending provisions of the FSC rather than removing them.[14]

REVENUE MEASURES, Press Release (Apr. 9, 2002), *available at* http://www.waysandmeans.house.gov/legacy/press/2002/bodydocs/4-9-02body.htm.

9. *Id.*

10. *Hearing on the WTO Decision on the Extraterritorial Income Exclusion Provisions and International Competitiveness Before the Senate Committee on Finance*, 107th Cong. (2002) (testimony of Kenneth W. Dam Deputy Treasury Secretary), *available at* www.senate.gov/~finance/hearings/testimony/073002kdtest.pdf (last visited Feb. 20, 2004) [hereinafter Dam].

11. World Trade Organization, *United States—Tax Treatment for "Foreign Sales Corporations,"* WT/DS108/AB/R (Feb. 24, 2000), [hereinafter FSC Appellate Report].

12. 2001 Trade Policy Agenda and 2000 Annual report of the President of the United States on the Trade Agreements Program, U.S.T.R. (Mar. 2001), *available at* http://www.USTR.gov/reports2001.html. "The United States lost this case on appeal in spring 2000, but repealed the FSC and enacted new legislation in November which correct the shortcomings identified in the dispute."

13. United States-Tax Treatment for "Foreign Sales Corporations," Recourse by the European Communities to Article 4.10 of the SCM Agreement and Article 22.2 of the DSU, WT/DS108/13 (Nov. 17, 2000), *available at* http://www.wto.org.

14. United States-Tax Treatment for "Foreign Sales Corporations," Recourse by the European Communities to Article 21.5 of the DSU, WT/DS108/14 (Nov. 21,2000).

II. HISTORICAL BACKGROUND

As early as 1776, Adam Smith is on record for "condemning export bounties as just another wasteful expedient of the mercantile system."[15] While import tariffs have been imposed for centuries, the actual exercise of defining and limiting "export subsidies," namely government incentive programs that favor export sales over domestic sales, did not begin until the nineteenth century.[16] "This task was originally inspired not by high-minded notions of comparative advantage but by the mercantile notion that subsidies might undercut 'legitimate' tariffs."[17]

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15. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 80, (J. Rogers ed., vol. 2 1869) *quoted in* GARY CLYDE HUFBAUER & JOANNA SHELTON ERB, SUBSIDIES IN INTERNATIONAL TRADE 45 (1984).

16. A general definition of a subsidy is "an act by a government unit involving either (1) a payment, (2) a remission of charges, or (3) supplying commodities or services at less than cost or market price, with the intent of achieving a particular economic objective, most usually the supplying to a general market a product or service which would be supplied in as great quantity only at a higher price in the absence of the payment or remission of charges." UNITED NATIONS, A SYSTEM OF NATIONAL ACCOUNTS 124 (1982), *quoted in* HUFBAUER & ERB, *supra* note 15, at 9.

17. HUFBAUER & ERB, *supra* note 15, at 45.

> As a simplified illustration of the case for free trade, assume that Country A decides it wants to stimulate exports by providing a subsidy of $25 per spool for each spool of copper wire that is exported, provided that the exporter demonstrates that it lowered the price of copper wire in the foreign market by the full amount of the subsidy. XCo manufactures wire in Country A. It takes advantage of the subsidy to lower the unit price of its wire in foreign markets by $ 25, resulting in an increase in its exports. To meet the new demand, it hires some additional employees in Country A. So far, the subsidy seems to be working.
>
> A trade subsidy, however, is unlikely to have just one effect. Assume that YCo is a domestic company that manufactures electric motors in Country A and sells them domestically and abroad. Copper wire is a major component of an electric motor. YCo's price for wire, which it buys from XCo, is not changed by the export subsidy. Its foreign competitors, however, can now buy copper wire at the subsidized price. As a result, they are able to reduce their price for electric motors in Country A and in foreign markets, creating competitive problems for YCo. As a result of the new competition, YCo experiences a reduction in its domestic and foreign sales of motors and is forced to reduce the number of employees at its production plant in Country A. Whatever jobs were gained from the expansion of XCo's business might be lost from the contraction of YCo's business. In addition, Country A is now paying the bill for an export subsidy that probably has added no new jobs and certainly has distorted normal trade patterns.
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> The above example may appear to be something of a special case. In a world of floating exchange rates, however, an export subsidy is likely to have negative effects on domestic production of unsubsidized products. The reason is that an export subsidy is likely to cause an increase in the relative value of a country's currency when currency exchange rates are set by the market. That increase obviously would affect trade flows. In general, the changes in trades flows would tend to wash out any economic benefits that a country would hope to obtain from pursuing a beggar-thy-neighbor trade policy.
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> To illustrate the above point, assume that no companies in Country A

> [U]nbridled and competing national subsidies can undermine world prosperity. Whatever the analytical merits of a purist free trade, turn-the-other-cheek approach, the Great Depression taught the world that protective policies can quickly and destructively spread from nation to nation. Because the concentrated interests of producers command greater political support than the diffuse interests of consumers, national governments find it much easier to emulate the vices of protection than the virtues of free trade. This lesson has prompted the international community to fashion guidelines that distinguish between acceptable and unacceptable national subsidy measures and to codify those guidelines both in bilateral treaties and in multilateral agreements. In fact, a major purpose of the General Agreement on Tariffs and Trade (GATT) is to

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manufacture electrical motors or anything else using copper wire. In that case, Country A would not have to be concerned that the export subsidy for wire would harm its domestic industries directly. Because of the currency-exchange effect, however, Country A almost certainly would be harmed by the export subsidy. The subsidy, by increasing the demand for the products of Country A in foreign markets, almost certainly would increase the value of Country A's currency relative to other currencies. As the following example illustrates, the expected result of the higher exchange rate would be an increase in imports into Country A and a loss of jobs in the businesses in Country A that make products in competition with the new imports,

The facts of this example are similar to the facts in the example above, with the additional facts that Country A uses the dollar as its currency, and Country B uses the franc. The exchange rate before the export subsidy for copper wire was one dollar for two francs. After the subsidy was granted and exports of wire increased, the value of a Country A dollar rose so that it now commands three francs. Country B produces apples, which it sells for 30 francs a crate. The price of apples in Country A is 14 dollars (28 francs at the presubsidy exchange rate). Before the export subsidy caused the exchange rate to change, apples produced in Country B were not competitive with apples produced in Country A. After the exchange rate adjustment, however, a producer in Country B that sold apples in Country A for 10 dollars a crate could convert the proceeds into 30 francs. As a result, apples produced in Country B are now competitive in Country A, and exports of apples from Country B should be expected to go up. Producers of apples in Country A would lose sales, and jobs in the apple business in Country A would be lost.

In the above examples, the violation of free trade by Country A produced a bad result, for it and the rest of the world, even without any retaliation by Country A's trading partners. The worldwide economic costs of Country A's conduct would be magnified many times if other countries responded by erecting barriers to trade or by adopting their own export subsidies. One of the major purposes of the United States in helping to establish the WTO was to keep countries from making themselves poorer by behaving like Country A. Another major purpose was to prevent the almost inevitable disputes over trade practices from escalating out of control."

Subcommittee on Select Revenue Measures, Committee on Ways and Means, 107th Cong. 2nd Session (2002) (statement of Michael J. McIntyre, Professor of Law, Wayne State University), *available at* http://www.waysandmeans.house.gov/legacy/srm/107cong/4-10-02/4-10mcin.htm.

discipline protective import policies.[18]

The existence of two basic systems of taxation around the world is not addressed by the rules of the WTO,[19] and some believe this omission leaves U.S. corporations at a comparative disadvantage. The U.S. tax system is different from the tax systems of the European countries; in addition, the tax systems of the European countries differ markedly among themselves. Across systems, two generally recognized grounds exist for a nation to tax income. Firstly, the *worldwide system* provides for jurisdiction over the recipient of the income based on the residence of the taxpayer, allowing a country to tax the worldwide income of persons subject to its jurisdiction. Secondly, the *territorial system* provides for jurisdiction over the activity that produces the income, where tax is due on income produced within the country's borders.

No country uses a pure form of either system; rather, all mix the principles to varying degrees. The United States and approximately half of the members of the Organization for Economic Cooperation and Development tax individuals and corporations within their jurisdiction under some variation of a worldwide theory of taxation. To a U.S. citizen or business, this means that all earnings are subject to taxation, regardless of the location of the source of the earnings. Thus, an American citizen living in the "tax free" Cayman Islands pays U.S. income tax on most of his earnings just as if he were still domiciled in the United States, and that same citizen, if living in Utah, would owe U.S. tax on his dividend income from a company in Sweden.[20]

The territorial system taxes, in addition to home country earnings,

18. HUFBAUER & ERB, *supra* note 15, at 8.

19. FSC Appellate Report, *supra* note 11, at para. 6.

> For United States citizens and residents, the tax laws of the United States generally operate "on a worldwide basis." This means that, generally, the United States asserts the right to tax all income earned "worldwide" by its citizens and residents. A corporation organized under the laws of one of the fifty American states or the District of Columbia is a "domestic", or United States, corporation, and is "resident" in the United States for purposes of this "worldwide" taxation system.
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> The United States generally taxes any income earned by foreign corporations within the territory of the United States. The United States generally does not tax income that is earned by foreign corporations outside the United States. However, [under Section 882(a) IRC], such "foreign-source" income of a foreign corporation generally will be subject to United States taxation when such income is "effectively connected with the conduct of a trade or business within the United States."

Id. at para. 6-7.

20. Some additional tax breaks are available to American citizens domiciled outside of the U.S. but the basic rules of taxation do not change based on domicile. Similarly, a foreign tax credit may offset U.S. tax due on foreign dividends, but the payment of the dividend itself remains a taxable event. *See* I.R.C. § 901 *et seq.* (West 2003).

certain income, such as rent, earned outside of the home country (passive income), and exempts actively produced foreign income.[21] Under a territorial system, an individual or business only owes tax to the place where the taxable event occurs, and the amount of tax owed is not based on the taxpayers domicile.

Unlike other worldwide tax systems, the details of the U.S. system are such that U.S. multinationals may be disadvantaged when competing abroad against multinational companies established in other countries using a worldwide tax system. "This is because the United States employs a worldwide tax system that, unlike other worldwide systems, taxes active forms of business income earned abroad before it has been repatriated and more strictly limits the use of the foreign tax credits that prevent double taxation of income earned abroad."[22]

When a U.S. person pays income tax in a foreign country, a U.S. tax credit is generally available to offset the foreign taxes paid, reducing the amount of double taxation.[23] With exceptions, the United States essentially taxes that foreign income only to the extent that the U.S. tax rate is higher than the foreign rate.

The United States defines the residence of corporations for tax purposes purely on the basis of place of incorporation.[24] The U.S. system taxes all income earned by U.S. corporations, regardless of where that income has been earned or whether it was earned by a foreign branch office.

On the other hand, the United States generally exempts from direct taxation all income of foreign corporations that has been earned outside the United States. Foreign corporations are defined as all corporations that do not fit the criteria of U.S. corporations; *i.e.*, corporations organized outside the 50 states and the District of Columbia.[25]

21. In the corporate arena, this thinking is often reflected in the idea of taxing corporations on the basis of where they are managed, not merely on where they are incorporated. As business structures become more complex in a global economy, determination of the place of effective management of a company can become more difficult and can tax ambiguities, regarding tax treaty benefits or consolidated tax returns, especially in countries like France with a territorial tax system. *See* Herve Leherissel, *The Tax Residence of Companies,* 39 INT'L BUREAU OF FISCAL DOCUMENTATION, No. 4/5 (Apr. 1, 1999).

22. *See* Dam, *supra* note 10.

23. *See* I.R.C. § 901 *et seq.*

24. A U.S. corporation is defined in the tax code as one that is organized under the laws of one of the 50 states within the United States, or the District of Columbia. *Id.* § 7701(a)(4).

25. *Id.* §§ 7701(a)(4), 7701(a)(9).

The exemption of foreign corporations from direct U.S. income tax on their foreign-source income applies even to foreign subsidiaries of U.S. corporations. The United States generally taxes income of such subsidiaries only at the time it is transferred to the U.S. parent company in the form of dividends. This period of exemption is termed "deferral" under the U.S. tax system and theoretically can last indefinitely. Because of the potential for tax avoidance, the United States has adopted a series of "anti-deferral" rules that constitute targeted exceptions to the general norm of deferral and respond to specific concerns. One of these rules is Subpart F of the Internal Revenue Code, which limits the benefits of deferral for specific types of income earned by certain controlled foreign subsidiaries of U.S. companies.

III. SUBPART F

In 1962, the United States Congress passed Subpart F of the United States Tax Code.[26] In part, the rule was created as a way to deal with the distinctions created in the 1950s under the recently enacted General Agreement on Tariffs and Trade ("GATT") rules between direct taxes such as the income tax, and indirect taxes such as value-added taxes.

> Under the WTO agreements, direct taxes are not permitted to be border-adjustable. Therefore, the U.S. income tax is not rebatable on exports under these rules. In contrast, indirect taxes are permitted to be border adjustable under the WTO rules. Accordingly, the European value added taxes (VAT) may be, and are, rebated at the border consistent with WTO rules.[27]

This distinction matters partly because countries that use a VAT depend on it for a significant portion of government revenue.[28] Again, under WTO rules, the VAT is border-adjustable while other forms of taxation (upon which the United States is heavily dependent) are not.

As an overly simplified example, assume Germany only taxes consumption (through a VAT) and the United States only taxes income (through a corporate income tax). In such a case, neither the German nor the U.S. Treasury would receive revenue when a German manufacturer exports a car for sale to the United States.[29] When a U.S. manufacturer

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26. *Id.* § 952.
27. Dam, *supra* note 10.
28. In the United States, consumption taxes, mostly in the form of state and local sales taxes, account for approximately 2% of the gross domestic product (GDP). By contrast, European Countries are much more heavily dependent on consumption tax income ranging from a low of 6% of GDP in Italy to 11% in Iceland. Staff of the Joint Committee on Taxation, *Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series*, 23 (Apr. 4, 2002), *available at* http://www.house.gov/jct/x-23-02.pdf.
29. Joint Committee on Taxation, *Impact on International competitiveness of*

exports to Germany, both governments would receive revenue. In the example of the German company, VAT paid up until the time the car is exported from Germany is rebated at the time of export. Upon import into the United States, no income tax is due as the car left Germany at its full retail value and thus no profit was made in the United States. The American manufacturer pays income tax to the U.S. when it sells the car, and VAT to Germany when it is imported. The income/VAT tax cost for the American company to compete in Germany is higher than for the German company to sell in the United States. This is true regardless of any preference whether taxes should be paid by the ultimate consumer or by a corporation's shareholder. The American company always pays income tax while the German company pays VAT only for cars sold at home.

The primary reason for subpart F's implementation was, according to President Kennedy, to respond to what were perceived to be abuses by American companies using entities in low tax jurisdictions to minimize their current U.S. tax bills.[30] Congress was concerned that U.S. companies were using offshore subsidiaries to shelter earnings of their foreign operations from U.S taxes by selling goods to the offshore subsidiary at prices generative of no income to the U.S. parent. Issues of international competitiveness were not part of the debate.

Although proposals were advanced to eliminate deferral entirely, subpart F was enacted instead, as part of the Revenue Act of 1962.[31] The complexities of subpart F continue to haunt the United States today.[32]

The general principle of U.S. taxation prior to subpart F was that no U.S. tax was due on foreign-sourced earnings of a foreign corporation organized outside of the U.S. *until the earnings were repatriated into the United States.*[33] By basing foreign subsidiaries in low or no tax jurisdictions this tax could be deferred indefinitely. Subpart F partly closed this option by requiring corporations with at least one U.S.

Replacing the Federal Income Tax 98 (July 17, 1996), *available at* http://www.house.gov/jct/s-5-96.pdf.

30. *See* Franchise Tax Board of the State of California, *Water's Edge Manual,* § 9.1(b), *available at* http://www.ftb.ca.gov/manuals/audit/water/WEMSec9_1b.html (last visited Feb. 1, 2004).

31. Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962).

32. *See generally* Ned Maguire & Stuart Anolik, *Subpart F and Source of Income Issues in E-Commerce,* TAX NOTES INT'L, Oct. 23, 2000, at 1935.

33. *See generally* Richard A. Westin & Stephen Vasek, *The Extraterritorial Income Exclusion: Where Do Matters Stand Following the WTO Panel Report?,* TAX NOTES INT'L, July 16, 2001, at 337.

shareholder and 50 percent or more U.S. ownership to pay tax each year on the passive investment income, as well as some active investment income of their foreign subsidiaries, even if that income was not repatriated.

Subpart F puts U.S. corporations further behind their foreign competitors, by requiring immediate, instead of deferred, taxation on significant amounts of foreign-sourced income before it is "repatriated and more strictly limits the use of the foreign tax credits that prevent the double taxation of income earned abroad."[34] No other country requires its corporations to comply with such rules.

IV. THE DISC

Even before the creation of Subpart F, Congress subsidized exports through the Western Hemisphere Trade Corporation as a way to promote U.S. exports after World War II by excluding exempt foreign trade income from gross income.[35] In 1971, Congress expanded the subsidy by creating the Domestic International Sales Corporation ("DISC")[36] as part of a package of economic and fiscal measures proposed by the Nixon Administration to address the deteriorating U.S. balance of payments.[37] The DISC provided special tax treatment for exports by deferring a portion of the income generated by the export activity.

To qualify as a DISC, a United States corporation had to meet specific requirements, including that it be a domestic corporation, that 95 percent of the corporation's gross receipts for each taxable year consist of "qualified export receipts," and that 95 percent of the corporation's assets at the close of the taxable year be "qualified export assets." A U.S. corporation qualifying as a DISC is not subject to U.S. federal income tax on its current or retained export earnings. However, one half of a DISC's earnings is deemed distributed to the shareholders of the DISC and is taxable to those shareholders as a dividend.[38] This essentially created a permanent tax deferral on one half of the DISC's earnings for as long as the company complied with the rules.[39]

34. Herman P. Ayayo, *Global Economy Heightens Need for U.S. International Tax Reforms, Treasury Official Says*, TAX NOTES INT'L, Dec. 23, 2002, at 1194 (2002).

35. I.R.C. §§ 921, 922 (1954) (repealed 1976).

36. *Id.* §§ 991–97.

37. Eric Dorkin, *Symposium: Part Three: Private Capital and Development: Challenges Facing International Financial Institutions in a Globalized Economy*, 9 TRANSNAT'L L. & CONTEMP. PROBS. 247, 250 (1999).

38. A liability of shareholders to taxation on the retained earnings arises when one of the following events occur: (a) there is an actual distribution of untaxed DISC earnings, (b) the DISC is liquidated, (c) a shareholder disposes of the DISC's stock, or (d) the corporation fails to qualify as a DISC for the taxable year. I.R.C. §§991-97.

39. *Id.*

V. THE FIRST GATT COMPLAINT

Use of the DISC grew significantly to the point where in 1975, 70 percent of exports from the U.S. went through DISCs, and by 1977 it was being projected that foregone taxes would amount to $1.580 billion.[40] The European Community objected to the DISC and initiated the first GATT complaint in February of 1972.[41]

The European Communities ("E.C.") claimed that the DISC violated GATT Article XVI:4 of GATT 1947[42] which disciplines export subsidies.[43] As part of its response, the United States lodged three cases against European tax laws[44] claiming that they implicitly subsidized exports by failing to tax certain foreign-source income. All of these complaints were assigned to one panel that issued rulings in 1976 declaring the tax provisions of all four countries to be export subsidies.[45]

It was not until 1981 that the dispute was finally resolved with a GATT Council Understanding worked out by the parties.[46] It allowed for the replacement of the DISC and stated that foreign economic processes did not need to be taxed.[47] The essence of the understanding is that "[e]conomic processes located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of

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40. International Economic Report of the President, *quoted in* Report of the WTO Panel on DISC Legislation, at para. 17 (Nov. 12, 1976), *available at* http://www.useu.be/ISSUES/disc1176.html.

41. *See* Unpublished GATT Panel Report, United States Tax Legislation (DISC), L/4422-23S/98, 1976 GATTPD Lexis 2.

42.
> 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.

THE GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT), art. XVI(4), enacted 1947, 55 U.N.T.S. 187, *in* DOCUMENTS FOR EUROPEAN COMMUNITY LAW AND INSTITUTIONS IN PERSPECTIVE 400 (The Bobbd-Merrill Co., Inc. 1976).

43. International Economic Report of the President, *supra* note 40.

44. The complaints by the United States were against France, Belgium and Italy contending that if the DISC were an export subsidy, then the tax exemptions provided by these countries for foreign-source income were export subsidies.

45. *See* FSC Appellate Report, *supra* note 11, at para. 20.

46. *Id.* at para. 22.

47. *Id.* at para. 95.

GATT Article XVI:4 [which disciplines export subsidies]."[48]

In other words, the GATT Council adopted an interpretation clarifying that non-taxation of income generated by foreign economic processes was not a violation of trade rules. Although not actually vindicating the DISC, it provided a guideline for how the United States could replace the DISC with a new tax measure that would be legal under GATT.[49]

In 1984, Congress replaced the DISC with the Foreign Sales Corporation ("FSC") provisions.[50] The legislative history shows that both the Reagan Administration and Congress read the 1981 Understanding as enabling the United States to employ the FSC. The FSC was understood to meet the terms of the Understanding because it exempts from taxation income generated by foreign economic processes. Accompanying legislative materials explicitly confirmed this intention.

> Under GATT rules, a country need not tax income from economic processes occurring outside its territory. Accordingly, Congress believed that certain income attributed to economic activities occurring outside the United States should be exempt from U.S. tax in order to afford U.S. exporters treatment comparable to what exporters customarily obtain under territorial systems of taxation.[51]

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48. The full text of the understanding is as follows:

> The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, *i.e.*, prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign-source income.

Id. at para. 94.

49. The Tokyo Round Code on Subsidies & Countervailing Duties settled the four tax cases, based on four principles: (a) the distinction between direct and indirect taxes was preserved; (b) The United States agreed to repeal DISC (tax deferral was conceded to be an export subsidy, like tax exemption); (c) however, methods of avoiding double taxation—both the exemption method associated with territorial systems of taxation and the foreign tax credit method associated with worldwide systems of taxation—are defined not to be subsidies; (d) the arm's length pricing standard is to be observed in transactions between parent exporting companies and their foreign sales subsidiaries.

Gary Hufbauer, *The FSC Case: Background and Implications* (Feb. 27, 2002), *available at* http://www.iie.com/papers/hufbauer0102.htm.

50. Deficit Reduction Act of 1984, Pub. L. 98-369, §801(a) (1984).

51. *See* FSC Panel Report, *supra* note 11, at para. 333 (quoting from Staff Comm. On Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1042 (1985). The FSC was designed to cure the alleged defects in the DISC by instituting an entirely different system, using a foreign, rather

VI. COMPLAINT AGAINST THE FSC

In October 1999, 15 years after the FSC was enacted, a WTO panel ruled that the 1981 Understanding was not brought forward into the WTO and that, in any event, the FSC did not qualify under its provisions.[52] The U.S. Government maintained that the United States, the European Community, and the GATT Council meant the 1981 Understanding to have continuing force. The United States also argued that the FSC fit perfectly within the parameters of the Understanding.[53] The United States contended the drafters of the WTO did not intend to discard the old rulings and precedents, and that the trade law status of offshore income was determined in 1981 and was embedded in the new WTO rules written in the 1990s.[54]

The FSC scheme was not challenged for 15 years after its enactment even though it accomplished essentially the same thing as its predecessor, the DISC. A panel of the U.S. House of Representatives found no complaints by European companies to prompt the dispute.[55] Comments were made in the U.S. Congress, when debating how to comply with the WTO ruling, indicating that if the FSC regime were as anticompetitive as it was made out to be that there should have been an outcry against it by European manufacturers. However, there was not. Congress also noted that the European Communities brought the action against the FSC at a time when the European Communities had lost several rounds of the "Banana" and "Beef" disputes in the WTO.[56]

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than a domestic company, that would be compatible with all applicable GATT standards.

52. *Id.*

53. *Id.*

54. One the United States chief complaints in the DSC case was that the WTO panel erred in abandoning the 1981 understanding. *Id.* at para. 7.36. "Although the United States argued forcefully that the FSC provisions were blessed by the 1981 Understanding, the WTO panel disagreed, concluding that the 1981 Understanding had no continuing relevance in the interpretation of current WTO rules." Dam, *supra* note 10.

55. H.R. Rep. No. 106-845, at 14 (2000).

56. *Id.*

> Turning to the actions of the European Union in this dispute, it is the Committee's understanding that this dispute did not arise out of private sector complaints, but instead was initiated by the European Union primarily as a response to its losses in the so-called 'bananas' and 'beef' disputes. Indeed, it is the Committee's understanding that during the course of this dispute, European Union officials failed, when asked, to provide a single example of actual commercial harm suffered by a European firm as a result of the FSC provisions. In light of this, the Committee finds the European Union's decision

VII. ENTER THE WTO

In 1994, as part of the founding of the World Trade Organization, a new set of rules regarding subsidies was created– the Agreement on Subsidies and Countervailing Measures[57] ("SCM Agreement") of which the United States was the major proponent. The WTO also introduced, with U.S. encouragement, an enforcement mechanism that did not exist under the GATT.

> Frustrated with the GATT system, Congress wanted to improve the speed and effectiveness of the dispute settlement mechanisms and procedures. Congress insisted on the opening of foreign markets, the elimination of trade-distorting policies, and the establishment of a more effective system of international trading disciplines and procedures. The dispute settlement mechanism was established simply to ensure that the rules that countries agreed upon together and pledged to abide by are actually enforced. But even when the U.S. loses a case, the WTO cannot force change in U.S. laws, regulations or policies. The WTO cannot strike down any U.S. law, as an American court can. WTO panels merely determine whether disputed policies conflict with WTO rules and, if they do, recommend that members bring those policies into conformity. The disputing countries must still resolve the matter themselves, often through a negotiated settlement.[58]

Unlike the cases in the 1970s and 1980s where the United States could stall for years, under the new WTO rules the United States had to

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> to walk away from the 1981 Understanding deeply troubling and provocative as well as threatening to the international trading system.

Id.

57. Article 1 1.1 of The Agreement on Subsidies and Countervailing Measures Defines subsidy as follows:

> 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:
>
> (i) 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);
>
> (ii) 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) 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.

SCM Agreement, *supra* note 6.

58. DOUGLAS A. IRWIN, FREE TRADE UNDER FIRE 189 (2002) (quoting from the Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 1011 (1988)).

respond within a limited period of time or be liable for possible sanctions.

VIII. U.S. RESPONSE

In response to the WTO findings, the United States enacted the FSC Repeal and Extraterritorial Income Exclusion Act of 2000[59] on November 15, 2000. The legislation fully repealed the FSC provisions and adopted in their place the extraterritorial income exclusion ("ETI") scheme. The legislation was an attempt to bring the United States into compliance with WTO rules by addressing the analysis reflected in the WTO decision. At the same time, the legislation also was intended to ensure that U.S. businesses not be foreclosed from opportunities in the global marketplace because of differences in the U.S. tax laws as compared to the laws of other countries.[60]

IX. ETI BASICS

Along with repealing the FSC provisions of the tax code,[61] the ETI Act attempted to change the code in what was claimed to be a novel and fundamental way by redefining gross income. Prior to the change, all income was assumed to be included in gross income unless specifically excluded by a tax code provision.[62] Under the Act, the definition of gross income no longer includes extraterritorial income, and "becomes the new normative benchmark for taxing income derived in connection with certain activities performed outside the U.S."[63] Congress assumed that once income was no longer included in the definition of gross income, omitting that income from the tax base would not be a "prohibited subsidy." The Senate Finance Committee report explains the U.S. view:

> The Committee believes that, in order to ensure WTO compatibility, it is important that the new regime not confer export-contingent benefits. Accordingly, the Committee has determined that it is appropriate to treat all foreign sales alike. The general exclusion, therefore, applies to foreign trade income, whether the goods are manufactured in the United States or abroad, a

59. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 16-519, 114 Stat. 2423 (2000).
60. Dam, *supra* note 10.
61. I.R.C. §§ 921-27 (repealed 2000).
62. *Id.* § 61 ("Unless otherwise provided in this subtitle, gross income means all income from whatever source derived. . . ").
63. S. Rep. 106-416 (2000).

substantially broader category of income than that which was exempted from tax under the FSC provisions. A taxpayer would receive the same U.S. tax treatment with respect to its foreign sales regardless of whether it exports.

The Committee notes that the extraterritorial income excluded by this legislation from the scope of U.S. income taxation parallels the foreign-source income excluded under most territorial tax systems, particularly those employed by European Union member states. Under neither the U.S. tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign-source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems.

The Committee believes that this legislation, which fundamentally changes the U.S. tax treatment of extraterritorial income, complies with the WTO decisions and honors U.S. obligations under the WTO.[64]

X. THE FINDINGS

On March 20, 2000, the WTO's Dispute Settlement Body ("DSB") recommended that the United States bring into conformity the measures it found to be inconsistent with its obligations under the SCM Agreement and the Agreement on Agriculture and to withdraw the FSC subsidies by October 1, 2000. The United States requested an extension until November 1, 2000 and on November 15, 2000 signed into law the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. As stated previously, the United States believed that this resolution was consistent with the United States' WTO obligations.

The European Communities immediately disputed the United States' conclusion.[65] Pascal Lamy, the E.U. trade commissioner, called the ETI "even worse" than the FSC and stated that it continued to make income

64. *Id.*

65. The European Communities considered that the ETI Act did not comply with the recommendations and rulings of the DSB and that it was not consistent with the United States' obligations under the SCM Agreement, the Agreement on Agriculture, and the GATT 1994. The European Communities therefore requested that the matter be referred to the original panel pursuant to Article 21.5 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (the "DSU"). On 20 December 2000, in accordance with Article 21.5 of the DSU, the DSB referred the matter to the original panel. The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 20 August 2001.

Report of the Appellate Body, United States—Tax Treatment for "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/AB/RW (Jan. 14, 2002) at 1.4 [hereinafter ETI Appellate report]; Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, 33 I.L.M. 1154 (1994) [hereinafter DSU].

tax relief contingent on exports, contrary to WTO rules.[66] The WTO Panel established to review the matter agreed with the European Communities as did the Appellate Body on appeal. These reports were adopted by the DSB on January 29, 2002.[67]

In fact, the United States knew the ETI scheme would be challenged by the European Communities before it was adopted. An agreement between the United States and the E.C. was in place that specifically spelled out the procedures that would be followed to challenge the ETI once the FSC repeal bill had been enacted, and prevented the European Communities from instituting sanctions until the challenge was resolved.[68] The agreement provided that the European Communities would challenge the FSC replacement and argue that it was not WTO-compliant. Stuart Eizenstat, U.S. Deputy Treasury Secretary, said the agreement was only a "procedural technicality. . .to protect their procedural rights" and "does not signal the start of any trade war."[69] President Clinton stated that he believed that the WTO would find the new regime compliant.[70]

Trade officials for the European Communities were just as adamant that the new scheme not pass muster. One stated: "we believe the new legislation is just as bad as its predecessor."[71] The FSC repeal bill was finally enacted on November 14, 2000, during a lame duck session of Congress after the November elections.

One reason that the new scheme is stated to be as "bad" as the old one is because it is estimated that exporters will be able to obtain precisely the same net reduction in tax under the new rules as they did under the old system.[72] The European Communities stated the new rules arithmetically correspond to the exempt foreign trade income of the FSC.[73]

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66. Frances Williams, *International Economy: WTO to Assess Sanctions U.S. Tax Breaks European Union's Pounds 2.8bn Claim Over Exports*, FIN. TIMES (London) International Economy, Nov. 29, 2000 at 19.

67. Arbitrator Decision, *supra* note 2, at para. 1.2.

68. *U.S.-E.U. Agreement on Extension of FSC Deadline*, 2000 WORLDWIDE TAX DAILY 194-20 (2000).

69. Robert Goulder et al., *U.S. President Signs FSC Repeal Bill; European Union Seeks Trade Sanctions*, TAX NOTES INT'L, Nov. 27, 2000, at 2541.

70. *Id.*

71. *Id.*

72. See David Benson et al., *New Law Repeals FSC, Implements New U.S. Tax Scheme for Extraterritorial Income*, TAX NOTES INT'L, Nov. 27, 2000, at 2457.

73. First Written Submission of the European Communities, United States — Tax Treatment for "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities, at para. 19, WT/DS108/RW Annex A-1, (Jan. 17, 2001) [hereinafter EC Submission].

In fact, the new rules actually expand the tax benefits to more entities than were previously eligible. In enacting the new legislation, the U.S. Congress extended its economic benefits to S corporations, individuals, and partnerships that previously did not qualify for FSC benefits, and it broadened the range of products that qualify for a tax subsidy by reducing U.S. origin requirements. Foreign corporations can also claim the ETI benefit. These additional benefits make the new ETI system more expensive than the old FSC system. The U.S. Joint Committee on Taxation estimated that the new legislation would provide $4.5 billion in tax savings to taxpayers between 2001 and 2010.[74]

> A significant complicating factor in drafting the FSC replacement was the insistence on the part of the large multinational beneficiaries of the FSC that the distribution of the replacement subsidy mirror that of the FSC subsidy, to the penny, lest their share prices suffer. So the new regime had to look a whole lot like the old regime.[75]

The ETI was one of the most heavily lobbied issues on Capitol Hill during the period immediately preceding the legislation's passage in November of 2000. In addition to lobbying activities conducted individually, large U.S. corporations worked in groups. In 2000, FSC extension was the number one tax issue for the Business Round Table, a lobbying group with an annual budget in excess of $30 million.[76] The Business Round Table declared: "It is important that any replacement in fact replicates the results of the current regime and does not create winners and losers among the current beneficiaries."[77]

PricewaterhouseCoopers (PwC) and the National Foreign Trade Council formed the FSC/ETI Coalition and got exporters to collectively contribute $1 million for 2000 alone. Leading the PwC lobbying effort was Ken Kies, former chief of staff of the Joint Committee on Taxation, and Barbara Angus, who currently heads the Treasury Department's international tax staff.[78]

Most of the FSC benefits are received by a small number of large corporations that account for most U.S. exports.[79] The top 50 companies

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74. *See* Joint Committee on Taxation, 106th Cong., General Explanation of Tax Legislation Enacted in the 106th Congress, 113 JCS-2-01 (Apr. 2001).

75. Lee A. Sheppard, *Eye-Poking Over the FSC Replacement*, TAX NOTES INT'L, Mar. 12, 2001, at 1216-17(2001).

76. Martin A. Sullivan, *20 Talking Points on U.S. Export Tax Incentives*, TAX NOTES, Apr. 29, 2002, at 660.

77. Business Roundtable, Key Economic Policy Initiatives — An Agenda for Early Action, (Jul. 21, 2000) *available at* http://www.businessroundtable.org/publications/publication.aspx?qs=2426BF807822B0F1AD4

78. Sullivan, *supra* note 76.

79. Jose Oyola, *Foreign Sales Corporation Beneficiaries: A Profile*, TAX NOTES, Aug. 14, 2000, at 936 n.4 (estimating that "U.S. firms with more than 500 employees accounted for only three percent of all US exporters in 1997, but the exports of these

received 86.8 percent of the total benefits.[80] The Boeing Company alone accounted for over 10 percent of the total FSC benefits from 1991 to 1998, representing 10 percent of Boeing's income for that period.[81] General Electric Company, Motorola, Inc., Caterpillar Inc., Allied Signal Inc., and Cisco Systems, Inc. individually received more than five percent of the total benefits during this same period.[82] Such percentages make it no wonder that a heavy lobbying push was made to retain these tax breaks.[83]

XI. THE ETI ACT IN DETAIL

In response to the WTO findings and a threat of EU trade sanctions, the U.S. Congress passed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. The legislation repealed the FSC provisions and created similar provisions elsewhere in the code. The FSC Repeal Act offers some administrative simplification by removing both the requirements for a subsidiary and the highly technical compliance rules of the FSC.[84]

The ETI Act consists of changes to five sections of the U.S. tax code.[85] The overall effect of the rules is to reduce the tax on profits from

firms represented almost 70 percent of all U.S. exports.").

80. *Id* at 934.

81. *Id.* at 936.

82. *Id.*

83. What exactly is meant by "rent" and "seeking"? "Seeking" is more than wanting, because it involves expending resources to obtain the favor of government. . ."[R]ents" simply refer to excess returns to private parties due to special privileges or protections accorded them by government (whether they be the first Queen Elizabeth's monopolies or present day tariffs and import quotas). The "excess" is the additional profit above and beyond the profit that would be enjoyed in the absence of favorable government action. In the context of international economic policy, rents are therefore simply the additional profit above and beyond what could be made by companies with intervention on their side. Some of these rents flow through to stockholders, workers, and in some countries to the politicians who provide the favorable treatment. In actual practice, rent seeking operates partly through the electoral process and partly through interest group influence on legislative and administrative processes.

KENNETH W. DAM, THE RULES OF THE GLOBAL GAME 6-7 (2001).

84. William M Funk, *The Thirty-Years Tax War*, TAX NOTES INT'L, Oct. 1, 2001, at 65, 71.

85. ETI Appellate Report, *supra* note 65, at para. 16. Certain parts of Sections 2 and 5 relate to foreign sales corporations and part of Section 3, entitled "Treatment of Extraterritorial Income," amends the United States Internal Revenue Code by inserting into it a new Section 114, as well as a new Subpart E, which is in turn composed of new

exports by about 15 percent. A 35 percent effective tax rate would be reduced to about 30 percent. For example, if an exporter generated $1 of export income on sales of $10, its tax bill would be reduced from $0.35 to $0.30 under the ETI regime.[86]

The ETI provisions apply to foreign corporations which elect to be treated, for tax purposes, as U.S. corporations[87] as well as any other U.S. taxpayer. The ETI measure permits all these taxpayers to elect on a transaction-by-transaction basis to have qualifying income taxed in accordance with the provisions of the ETI Act.

> With the new regime based on transactions and not on separate entities, FSCs can be discarded and trade can be carried out directly by the parent or other manufacturing entity. This may not necessarily end the need for a separate subsidiary to utilize other benefits. With the continuing importance of meeting mathematical tests, administrative and accounting convenience may still favor having export operations in a specially established subsidiary.[88]

The FSC Repeal Act states that "extraterritorial income" is exempt from U.S. taxation and it partially converts the U.S. tax code from a worldwide system to a territorial one. However, the legislation defines extraterritorial income as gross income attributable to foreign trading gross receipts ("FTGR") and defines FTGR in essentially the same manner as it was defined under the FSC system. "All income that is not attributable to FTGR is taxed on the same basis as prior to passage of the FSC Repeal Act."[89]

The complex set of transfer pricing rules previously in place were eliminated along with the foreign subsidiary requirement. "However,

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Sections 941, 942 and 943.

86. *See* Sullivan, *supra* note 76, at 661.

87. I.R.C. § 943(e)(3).

88. Funk, *supra* note 84, at 71.

89. Taxpayers who have income attributable to FTGR can save tax. The reduction is equal to either 1.2 percent of FTGR, 15 percent of qualifying foreign trade income or 30 percent of foreign sale and leasing income. Although, superficially, the calculations for determining exempt income seem different from the FSC regime, the numbers work out to be exactly the same: the new percentages (1.2 percent and 15 percent) are equal to the old administrative pricing percentages (1.83 percent and 23 percent) multiplied by 15/23rds and the 30 percent FSLI exclusion corresponds to the exclusion when section 482 arm's-length pricing rules were utilized. For the foreign direct costs tests, foreign direct costs must meet either the 50 percent or the 85 percent test: either foreign direct costs must be equivalent to or greater than 50 percent of total direct costs attributable to the transaction[s], or foreign direct costs must be equivalent to or greater than 85 percent of total direct costs in two of five types of enumerated activities. The activities are the following: advertising and sales promotion, processing of customer orders and arranging for delivery, transportation outside the United States, determination and transmittal of a final invoice, and assumption of credit risks.

Id.

the calculations for determining exempt income have been adjusted in such a way that ensures that substantially the same benefits are provided to exporters."[90] The income from foreign trade under the FSC Repeal Act that is exempt is "qualifying foreign trade income" ("QFTI").

QFTI is an amount, which, if excluded from the taxpayer's gross income, will result in a reduction of the taxable income of the taxpayer from the qualifying transaction.[91] QFTI is calculated as the greater of (1) 1.2 percent of FTGR, (2) 15 percent of FTI (defined as taxable income attributable to FTGR, as previously defined under FSC law), or (3) 30 percent of "foreign sale and leasing income" ("FSLI"), a new

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90. *Id.* at 72.

91. Section 2 of the ETI Act repeals the foreign sales corporation rules by repealing I.R.C. sections 921-27 entirely. Section 3 of the ETI Act inserted sections 114, 941, 942 and 943 into the I.R.C., and created new rules under which certain income is excluded from United States taxation.

Section 114(a) provides a specific exclusion from gross income by stating that gross income "does not include extraterritorial income." Section 114(b) excludes from 114(a) "extraterritorial income which is not qualifying foreign trade income as determined under subpart E of part III of subchapter N." Therefore, in order for income to be excluded under these rules it must be QFTI. § 941(a) defines QFTI as follows:

> Qualifying Foreign Trade Income.— For purposes of this subpart and section 114:
>
> (1) In general.— The term 'qualifying foreign trade income' means, with respect to any transaction, the amount of gross income which, *IF EXCLUDED* (emphasis added), will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of—
>
> (A) 30 percent of the foreign sale and leasing income (defined in § 941(c)(1)) derived by the taxpayer from such transaction,
>
> (B) 1.2 percent of the foreign trading gross receipts (defined in § 942(a)) derived by the taxpayer from the transaction, or
>
> (C) 15 percent of the foreign trade income (defined in § 941(b)) derived by the taxpayer from the transaction.

Section 941 is the first step in defining QFTI. The WTO found Section 941 to be a permissive section of the code, not mandatory. Use of the words "if excluded" allows a taxpayer who otherwise qualifies to be treated under the act to instead use a foreign tax credit if it would result in a lower overall tax.

Section 5(b) prohibits foreign corporations from electing to be treated as FSCs after 30 September 2000 and provides for the termination of inactive FSCs. Section 5(c) also creates a "transition period" for certain transactions of existing FSCs. Specifically, under section 5(c)(1) of the ETI Act, the repeal of the provisions of the I.R.C. relating to FSCs "shall not apply" to transactions of existing FSCs which occur before 1 January 2002 or to any other transactions of such FSCs which occur after 31 December 2001, pursuant to a binding contract between the FSC and an unrelated person which is in effect on 30 September 2000. These provisions are the subject of the European Communities' claim that the United States has not fully withdrawn the FSC subsidies, in accordance with Article 4.7 of the SCM Agreement. ETI Appellate Report, *supra* note 65, at para. 17.

term. FSLI is FTI that is allocable to foreign economic processes or which is derived from lease or rental of "qualifying foreign trade property" ("QFTP") outside the United States.[92]

Generally, income from specific transactions will qualify for treatment in accordance with the provisions of the ETI measure if it is income attributable to gross receipts: (i) from specific types of transaction;[93] (ii) involving QFTP;[94] and (iii) if the "foreign economic process requirement" is fulfilled with respect to each such transaction.[95]

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92. Even the new FSLI replicates the old regime. FSLI is limited to property manufactured, produced, grown, or extracted by the taxpayer, or acquired by the taxpayer for arm's-length prices as determined according to section 482 transfer pricing rules. Just as it was under the old regime, 30 percent of profits from transactions in export property are exempt where pricing is determined by reference to section 482 rules.

ETI Appellate Report, *supra* note 65, at para. 17.

93. Turning to the first of these conditions, the rules contained in the ETI measure apply, in particular, to income arising from sale, lease or rental transactions. The ETI measure also applies to income earned from the performance of services "related or subsidiary to" qualifying sales or lease transactions, as well as to income earned from the performance of certain other services. I.R.C. § 942(a)(3).

94. The second condition is that these transactions involve QFTP. Section 943(a)(1) defines QFTP as property:

> (A) manufactured, produced, grown or extracted within or outside the United States, (B) held primarily for sale, lease or rental, in the ordinary course of business, for direct use, consumption, or disposition outside the United States, and (C) not more than 50 percent of the fair market value of which is attributable to (i) articles manufactured, produced, grown, or extracted outside the United States, and (ii) direct costs for labor performed outside the United States.

I.R.C. §§ 943(a)(3) and (4) set forth specific exclusions from this general definition.

95. This requirement is fulfilled "if the taxpayer (or any person acting under contract with such taxpayer) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction." *Id.* § 942(b). Under the ETI Act, the need to satisfy these three conditions is subject to a number of exceptions.

The detailed rules of the ETI measure provide that foreign trading gross receipts may be earned through (i) any sale, exchange, or other disposition of qualifying foreign trade property; (ii) any lease or rental of qualifying foreign trade property; (iii) any services which are related and subsidiary to (i) and (ii); (iv) for engineering or architectural services for construction projects located (or proposed for location) outside the United States; and (v) for the performance of managerial services for a person other than a related person in furtherance of activities under (i), (ii) or (iii). *Id.* § 942(a)(3).

A certain portion of the "direct costs" of the transaction must be attributable to activities performed outside the United States The relevant activities are: (A) advertising and sales promotion; (B) the processing of customer orders and the arranging for delivery; (C) transportation outside the United States in connection with delivery to the customer; (D) the determination and transmittal of final invoice or statement of account or the receipt of payment, and (E) the assumption of credit risk. A taxpayer will be treated as having satisfied the foreign economic process requirement when at least 50 percent of the total costs attributable to such activities is attributable to activities performed outside the United States, or, for at least two of these five categories of activity, when at least 85 percent of the total costs attributable to such category of activity is attributable to activities performed outside the United States. §§ 942(b)(2)(A)(ii), In general, U.S. exporters will be able to obtain the same net reduction in U.S. tax under the ETI Act as under the previous FSC scheme.[96]

XII. DETAILED FINDINGS OF THE APPELLATE PANEL

The first issue addressed by the appellate panel in its decision released on January 14, 2002,[97] regarding the report of the original panel decision of August 20, 2001,[98] is as follows:

(b)(2)(B) and (b)(3).

Section 942(a) designates as "foreign trading gross receipts" the receipts generated in transactions satisfying all three of these conditions. Under Section 114(e), "extraterritorial income" is the gross income attributable to foreign trading gross receipts and, under Section 941(b) "foreign trade income" is the taxable income attributable to foreign trading gross receipts.

96. The following examples show that the same net reduction in U.S. tax is obtained from either the ETI or FSC schemes. Benson, *supra* note 72.

Example 1

X, a U.S. corporation, has foreign trading gross receipts (FTGR) of $10 million that generate combined taxable income (CTI) for FSC purposes of $1 million after the allocation of the cost of goods sold and expenses. Under the FSC administrative pricing rules, X would be entitled to pay a tax deductible FSC commission of $230,000 that is equal to the higher of 1.83 percent of FTGR ($183,000) or 23 percent of CTI. The FSC will be tax exempt on 15/23rds, or $150,000, of its commission income, resulting in a net U.S. tax benefit to X (which obtains a dividends-received deduction for FSC dividends) of $52,500 ($150,000 x 35 percent). Under the act, X will be able to exclude $150,000 as qualifying foreign trade taxable income, based on the higher of 1.2 percent of FTGR ($120,000) or 15 percent of foreign trade income. The exclusion will result in a net tax benefit to X of $52,500.

Example 2

Assume the same facts as Example 1, except that the CTI is $500,000. In this case, X would use the 1.83 percent method to claim the maximum FSC commission deduction of $183,000 (versus 23 percent of CTI or $115,000). This would result in a net federal tax benefit to X of $ 41,772 ($183,000 x 15/23rds x 35 percent). Under the act, X could exclude $120,000 as QFTI, which results in a net federal tax benefit of $42,000.

Example 3

Assume the same facts as Example 1, except that the CTI is $300,000. X would initially use the 1.83 percent method to claim the maximum FSC deduction of $183,000, but the FSC commission would be limited to $138,000 (CTI x 46 percent), resulting in a net federal tax benefit to X of $31,500. Under the act, X could initially exclude $120,000, but X could exclude only $90,000 (30 percent x $300,000), which results in a net tax benefit of $31,500.

97. ETI Appellate Report, *supra* note 65.

98. Report of the Panel, United States—Tax Treatment for "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW (Jan. 17, 2001), *in* 34 WTO Dispute Settlement Decisions, Bernan's Annotated Reporter (Aug. 2001) [hereinafter ETI Panel Report].

[W]hether the Panel erred in finding, in paragraphs 8.30 and 8.43 of the Panel Report, that the ETI measure. . .involves the foregoing of revenue which is "otherwise due" and thus gives rise to a "financial contribution" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement;[99]

The Panel found that the ETI measure "results in the foregoing of revenue which is 'otherwise due' and thus gives rise to a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement."[100]

Article 1.1(a)(1)(ii) of the SCM Agreement sets out to define "subsidy" and deems it to exist when: "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits). . .and (b) a benefit is thereby conferred." Although Article 1 defines a subsidy, it does not impose any obligations regarding the subsidies defined. It does however create an initial threshold inquiry that must be satisfied. "[T]he granting of a subsidy is not, in and of itself, prohibited under the SCM Agreement. Nor does granting a "subsidy," without more, constitute an inconsistency with that Agreement. The universe of subsidies is vast. Not all subsidies are inconsistent with the SCM Agreement."[101]

In its appeal of the dispute settlement panel's ruling, the United States essentially repeated the arguments it had made in the original case, and argued that the FSC replacement actually did make a territorial exception to the general rule of taxing worldwide income. The United States contended the Panel ignored the fact that the definition of "gross income" is not contained in Section 61 of the Internal Revenue Code ("IRC") alone, but depends also on other sections of the IRC and, more particularly, on sections 114(a) and (b).[102]

Second, the U.S. argued that the Panel erroneously created a distinction between a "specific" and a "general" tax exclusion. The Panel stated that a Member may exclude a category of income from taxation only if it excludes "all of the income" in that category. The United States contends that such an analysis improperly incorporates the concept of specificity, found in Article 2 of the *SCM Agreement*, into the definition of "subsidy" in Article 1. Third, the Panel created another erroneous standard by stating that a tax exclusion must have "some kind of overall rationale and coherence" if it is to avoid foregoing revenue that is otherwise due. Such a proposition is inconsistent with the Appellate Body's prior statement that a Member is free to tax or not tax the categories of revenues that it chooses. Fourth, the United States appeals what it considers to be a failure by the Panel to apply the original panel's "but for" test, a test which the Appellate Body had upheld. The United States submits that "but for" the exclusion of qualifying foreign trade income, *all* extraterritorial

99. ETI Appellate Report, *supra* note 65, at para. 80(a).
100. *Id.* at para. 8.43 (footnote omitted).
101. *Id.* at para. 47.
102. *Id.* at para. 27.

> income would be excluded from "gross income". Finally, the Panel erred in finding that extraterritorial income excluded by the ETI Act necessarily would be taxed if the ETI Act did not exist. The United States submits that merely classifying income as "gross income" does not *per se* mean that it would necessarily be taxed, since "gross income" may also be subject to deferral, deductions or foreign tax credits.[103]

New code section 114(a) states: "gross income does not include extraterritorial income." Technically, the new general rule applies to a much broader range of foreign income than the FSC regime exempted. The United States argued that this new broad general rule does not require that the taxpayer export, or that the goods it sells be domestically produced, or that it have a special foreign sales subsidiary, or that it be a U.S. citizen, so long as it is subject to U.S. tax jurisdiction. All of these contentions are true, except that the rest of the FSC replacement provisions remove almost all of the exemption. New code section 114(b) states that extraterritorial income does not include income that is not "qualified foreign trade income." The FSC replacement's success depends on the definition of this term.[104]

The European Communities argued that the FSC replacement is a subsidy according to Article 1 of the SCM Agreement. Article 1.1 of the SCM Agreement states that a subsidy is deemed to exist if there is a "financial contribution" by a government, and "a benefit is thereby conferred." Article 1.1(a)(2)(ii) states that a "financial contribution" includes "government revenue that is otherwise due [that] is forgone or not collected (e.g., fiscal incentives such as tax credits)."

The United States argued that the FSC replacement does not cause the government to forgo revenue otherwise due within the meaning of Article 1 of the SCM agreement because the FSC replacement's general extraterritorial income exclusion, section 114(a), constitutes a new normative benchmark, or prevailing standard, against which exclusions are to be judged and "does not create a tax-saving exception to an otherwise applicable revenue-raising general rule."[105] Thus, the United States argued, the ETI is not a subsidy. Revenue that was never due cannot be forgone.

According to the European Communities, the Panel's conclusion was not based on the idea that Section 61 of the IRC was the normative benchmark, nor that any exception to it would be a subsidy. Rather, in analyzing the ETI Act, the Panel looked at the "overall situation as an

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103. *Id.*
104. *See* Sheppard, *supra* note 75, at 1217.
105. EC Submission, *supra* note 73 Annex A-2 at para. 2, 61.

integrated whole." [106]

There is no specific WTO provision that states what a country's "tax system has to look like in the first place."[107] WTO members are free to tax or "not to tax certain types of income" as they choose.[108] "[I]n principle, a Member is free not to tax any particular category of income it wishes, even if this results in the grant of a 'subsidy' under Article 1.1 of the SCM Agreement, provided that the Member respects its WTO obligations with respect to the subsidy."[109]

"That is what the United States insists it is doing with the FSC replacement, which it argues 'does not constitute a subsidy because tax on the excluded income is not 'otherwise due.''[110] This brings U.S. tax provisions into compliance with the WTO's principles.

Article 1.1(a)(1)(ii) of the SCM Agreement states that there is a "financial contribution by a government" where "government revenue that is otherwise due is foregone or not collected." This was addressed in the WTO panel's report where it said:

> . . . the *"foregoing"* of revenue *"otherwise* due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise". We, therefore, agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question. . . . What is "otherwise due", therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself.[111]

From a fiscal perspective, when a government chooses not to tax certain income, no revenue is "due" on that income. "However, although a government might, in a sense, be said to "forego" revenue in this situation, this alone gives no indication as to whether the revenue foregone was "otherwise due." "In other words, the mere fact that revenues

106. ETI Panel Report, *supra* note 98, at para. 8.23.
107. *See* Sheppard, *supra* note 75, at 1218.
108. *Id.*
109. ETI Appellate Report, *supra* note 65, at para. 86. "[T]he granting of a subsidy is not, in and of itself, prohibited under the SCM Agreement. Nor does granting a "subsidy", without more, constitute an inconsistency with that Agreement. The universe of subsidies is vast. Not all subsidies are inconsistent with the SCM Agreement." *Id.* at para. 85.
110. *See* Sheppard, *supra* note 75, at 1218.
111. FSC Appellate Report, *supra* note 11, at para. 90.

are not 'due' from a fiscal perspective does not determine that the revenues are or are not 'otherwise due' within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*."[112]

The question essentially becomes defining what the normative benchmark is in order to distinguish between situations where revenue foregone is "otherwise due" and situations where revenue foregone is not "otherwise due."[113] The United States made a circular argument when attempting to win this point regarding what the normative benchmark should be. The United States argued that the panel misconstrued the concept of "gross income" and ignored other relevant provisions of the U.S. tax code.[114] "According to the United States, under the IRC, 'gross income' is the starting point for calculating taxable income, but 'gross income' by itself is *not* necessarily subject to tax because a taxpayer can make 'deductions' from it."[115] The United States went on to say that the Panel "erred in determining that the prevailing rule of taxation in the United States is that 'gross income' is taxable."[116]

"Whether revenue has been forgone requires a comparison of the whole U.S. [tax] system before the FSC replacement with the U.S. [tax] system [under the ETI scheme]."[117] The European Communities argued that the WTO should compare like with like—the U.S. treatment of export sales of goods with the U.S. treatment of domestic sales of goods. The WTO determined that due to the complexity and variances between tax codes, a "rational basis" was required to make the comparison.[118] Further, the WTO determined that it was virtually impossible to conclusively distinguish between those portions of a tax code that fall within a "general rule" and those that are part of the "exceptions" to it.[119] It also stated that under Article 1.1(a)(1)(ii) of the SCM Agreement there is no requirement to determine what the general rule of taxation is anyway.[120]

The answer was to treat like income similarly to like income.[121] The

112. ETI Appellate Report, *supra* note 65, at para. 88.
113. *Id.* at para. 89.
114. *Id.* at para. 84.
115. *Id.*
116. *Id.*
117. *See* Sheppard, *supra* note 75, at 1218.
118. ETI Appellate Report, *supra* note 65, at para. 90.
119. *Id.* at para. 91.
120. *Id.*
121. *Id.* at para. 91.

fiscal treatment of comparable income of taxpayers in comparable situations should be the same.[122] Due to the difficulty in defining like income, the appellate panel attempted to create a definition using examples of what would be inappropriate to consider "like income" including:

- Income earned in sales transactions compared to income earned from employment and
- Taxation of foreign-sourced income in the hands of a domestic corporation compared with the taxation of foreign-sourced income in the hands of a foreign corporation.[123]

To identify the normative benchmark for comparison, the appellate panel looked to the United States' other rules of taxation applicable to the foreign-source income of United States citizens and residents earned through the sale or lease of property, or through the performance of "related" services.[124] It did so to determine whether, and to what extent, the U.S. imposes tax on foreign-source income of U.S. citizens and residents, including the income covered by the measure at issue, which the United States considers to be foreign-source income.

In other words, our inquiry under Article 1.1(a)(1)(ii) is not simply ended at this stage of analysis because the measure involves an allocation of income between domestic- and foreign-source income. Rather, we must compare the way the United States taxes the portion of the income covered by the measure, which it treats as foreign-source, with the way it taxes other foreign-source income under its own rules of taxation.[125]

In the panel's "view, the normative benchmark for determining whether the ETI measure" results in the foregoing of income otherwise due is based on the definition of taxable income in the U.S. tax code.[126] Under the tax code, taxable income means "gross income minus the

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122. *Id.* at para. 98.
123. *Id.* at paras. 90, 92.
124. The panel added for clarification:

> We recall that the measure applies to certain foreign corporations that elect to be treated as United States corporations. For the purpose of United States taxation, these corporations are deemed to be United States corporations. Thus we do not examine the United States' fiscal treatment of the foreign-source income of *foreign* corporations including foreign subsidiaries of United States corporations — that do *not* elect to be treated as United States corporations. We do not, therefore, examine the rules of taxation for the foreign-source income of foreign subsidiaries of United States corporations.

Id. at n. 75.
125. ETI Appellate Report, *supra* note 65, at para. 98.
126. *Id.* at para. 101.

deductions allowed" under the IRC.[127] Gross income means "all income from whatever source derived."[128] Thus, these sections do not distinguish between income based on whether the income is treated by the United States as domestic- or foreign-source.[129] "Rather, these provisions treat 'all income from whatever source' in identical fashion so that, in principle, foreign-source gross income of United States citizens and residents, less allowable deductions, is subject to tax as taxable income."[130]

The other provisions of the U.S. tax code found by the panel to be part of the norm for comparison purposes were the provisions to provide tax credits against foreign taxes paid by U.S. taxpayers. Where a U.S. taxpayer pays tax in a foreign jurisdiction, he is normally allowed a credit up to the amount that would have been due to the United States.[131]

The comparison to be made is between taxation of foreign-sourced income under the normative rules outlined above with taxation of QFTI, which is also treated as foreign-source income.[132]

The panel found a significant contrast between the rules applicable to QFTI and the "other rules."[133]

> United States citizens and residents can *elect*, at their own discretion: *either* to have certain of their income treated as extraterritorial income under the ETI measure, with the result that a portion will be definitively excluded from taxation as QFTI; *or* these same taxpayers can elect to have the same income taxed under the "other" rules applicable to foreign-source income, with tax credits being recognized for, at least, a portion of foreign taxes paid. Where the taxpayer elects not to be taxed under the ETI measure, the United States taxes this income under the "other" rules of taxation applicable to foreign-source income. We see this as confirmation that, absent the ETI measure, the United States would tax the income under the "otherwise" applicable rules of taxation we have used as our benchmark.[134]

The U.S. tax code allows a taxpayer to choose whether to be taxed under the ETI rules. The only reason for a taxpayer to choose ETI is if a lower overall tax bill results.[135] As such, the amount of tax paid will

127. I.R.C. §63(a).
128. *Id.* §61(a).
129. *Id.* §§ 861—65 (providing the rules to determine whether income of United States citizens and residents is from sources within or outside the United States).
130. ETI Appellate Report, *supra* note 65, at para. 99.
131. *Id.* at para. 100.
132. *Id.* at para. 101.
133. *Id.* at para. 102.
134. *Id.* at para. 103.
135. We mentioned earlier that, where a taxpayer elects to use the ETI measure, it must give up any tax credits it has obtained through taxation in a foreign

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.

> This, too, confirms that the United States will forego revenue under the ETI measure that would be "otherwise due". In our view, the definitive exclusion from tax of QFTI, compared with the taxation of other foreign-source income, and coupled with the right of election for taxpayers to use the rules of taxation most favourable to them, means that, under the contested measure, the United States foregoes revenue on QFTI which is otherwise due.[136]

The European Communities offered as further proof "the congressional revenue estimates attached to the FSC replacement show that revenue has been forgone."[137] The final nail in the United States' coffin was provided by Manal Corwin, the U.S. Treasury Department's acting international tax council in a speech three weeks after the FSC Repeal bill was passed. Ms. Corwin called the new statute a "narrow exception" from the traditional U.S. tax model based on reaching the worldwide income of each U.S. taxpayer, regardless of where such income is derived.[138] The panel listened to her and agreed.

XIII. IS THE SUBSIDY EXPORT-CONTINGENT?

The EC called the FSC replacement an illegal export subsidy under Article 3.1(a) of the SCM Agreement because qualification is contingent upon export performance.[139] The panel found that "the FSC Replacement

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> State that is attributable to the income excluded from taxation. Accordingly, the measure will be beneficial to taxpayers where the amount of tax otherwise due on excluded QFTI is greater than the amount of tax credits which the taxpayer must give up in relation to the excluded QFTI. For instance, this calculus is likely to result in taxpayers electing to use the measure where: (a) the amount of income actually taxed in a foreign jurisdiction is less than the amount of excluded QFTI and (b) where the rate of taxation applied to income taxed in a foreign jurisdiction is lower than the United States rate of taxation that would "otherwise" be applied to the excluded QFTI.

Id. at para. 104 n.80.

136. *Id.* at paras. 104—05.

137. *See* Sheppard, *supra* note 75, at 1218.

138. Robert Goulder, *U.S. Treasury Official Denies FSC Repeal Signals Move to Territoriality*, TAX NOTES INT'L, Dec. 18, 2000, at 2749.

139. In Appellate Body Report, Canada—Measures Affecting the Export of Civilian Aircraft ("Canada - Aircraft"), at paras. 162-80, WT/DS70/AB/R (Aug. 20, 1999), it was stated:

> [A] subsidy is contingent "in law" upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure.... [F]or a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfillment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.

Act provides subsidies which are contingent upon export performance contrary to Article 3.1(a) of the SCM Agreement[140] and specifically related to export contrary to item (e) of Annex 1 of the SCM Agreement."[141]

Export linkage is defined by Article 3.1(a), which prohibits "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance . . ." unless the Agreement on Agriculture holds to the contrary. Footnote 4 to this provision states that "in fact" means that the subsidy, though not legally tied to export performance, is illegal if it is in fact tied to anticipated export activity or export earnings.[142] This does not prohibit all export subsidies.

The European Communities drew a distinction between two different subsidies alleged to be granted under the ETI measure. The first related to property produced "within the United States"; the second to property produced "outside the United States". The European Communities argued that both these subsidies are *de jure* contingent upon export performance.[143] In relation to U.S. produced goods, the panel stated:

> [T]he words of the statute itself make it clear that exporting is a necessary precondition to qualify for the subsidy. *In respect of US-produced goods*, the existence and amount of the subsidy depends upon the existence of income arising from the exportation of such goods. *In relation to US-produced goods*, the existence of such income is clearly conditional, or dependent upon, the exportation of such goods from the United States. We are therefore of the view that by necessary implication the scheme is *de jure* dependent or contingent upon export in relation to US-produced goods.[144]

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140. Article 3.1(a) of the SCM Agreement, *supra* note 6, states:

> [S]ubsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I" are prohibited. Footnote 4 of article 3.1(a) explains: "This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

141. Annex I paragraph (e) of the SCM Agreement includes in its list of export subsidies "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." It then defines direct taxes in the footnote 58 of the Annex as: "wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property." *Id.*

142. SCM Agreement, *supra* note 6, at n.4.

143. E.C. Submission, *supra* note 73, at paras. 62—66. The European Communities also argued, in the alternative, that both the basic and the extended subsidies provided under the ETI Act are *de facto* export contingent. *Id.* at paras. 131—45.

144. ETI Panel Report, *supra* note 98, at para. 8.60 (emphasis added).

The United States claimed "that the ETI measure is export-neutral" since "the tax exclusion is available with respect to property that is *not* produced in the United States and, therefore, not exported from the United States."[145] Therefore, since "the tax exclusion can be obtained without exportation . . . export performance is not a condition that must be satisfied in order to obtain this exclusion."[146]

Under the ETI scheme, the United States excludes from tax a portion of the income earned by U.S. citizens and residents through certain transactions involving, or related to, QFTP. Section 943(a)(1)(A) of the IRC defines QFTP as property "manufactured, produced, grown, or extracted within or outside the United States." The appellate panel concluded that this "contemplates two different factual situations, one involving property produced within the [United States] and the other involving property produced outside the [United States,]"[147] each with its own tax provisions.[148] For property produced within the United States, the taxpayer can obtain the subsidy only by satisfying the conditions in the code relating to this property. In order to obtain the subsidy, the property must be "held primarily for sale, lease, or rental, in the ordinary course of trade or business for *direct use, consumption, or disposition outside* the United States . . . ."[149] The Appellate Panel concluded that "[f]or property produced within the United States, . . . the property must be exported [in order to obtain the subsidy]."[150] "In other words, use outside the United States necessarily implies exportation of the property from the United States (the place of production) to the place of use."[151] This is an "export contingency, under Article 3.1(a) of the SCM Agreement."[152] The fact that there is also a subsidy for products created outside of the United States does not stop the ones manufactured within the United States from being export contingent.[153]

XIV. The Footnote 59 Violation; Double Taxation of Foreign-Source Income

"'Double taxation' occurs when the same income, in the hands of the

145. ETI Appellate Report, *supra* note 65, at para. 110.
146. *Id.*
147. *Id.* at para. 113.
148. I.R.C. § 943(a)(2) contains rules that apply only to property produced "outside the United States," while I.R.C. § 943(c) has source rules that address only the case of property produced "within the United States."
149. I.R.C. § 943(a)(1)(B) (emphasis added).
150. ETI Appellate Report, *supra* note 65, at para. 116.
151. *Id.*
152. *Id.* at para. 118.
153. *Id.*

same taxpayer, is liable to tax in different States."[154] "The United States also argues that the FSC replacement is a permissible measure to prevent double taxation of foreign source income according to footnote 59 of paragraph (e) of Annex I of the SCM Agreement,[155] because non-taxation of foreign-source income is an established, accepted means of avoiding double taxation."[156] Annex 1 to the SCM Agreement provides an illustrative list of prohibited subsidies. Item (e) listed in Annex 1 states that "[t]he full or partial exemption, remission, or deferral specifically related to exports, or direct taxes. . ." is a prohibited export subsidy. The Appellate Panel set out to first determine whether the ETI Act is a measure to avoid double taxation within the meaning of footnote 59 and, if so found, then would determine whether footnote 59 creates an exception to the prohibition against export subsidies in accordance with footnote 5.[157] Because the Panel concluded that the ETI Act is not a measure to avoid double taxation under footnote 59, it did not reach the question of whether footnote 59 creates an exception under footnote 5.

The Appellate Panel examined the ETI Act's "design, structure and architecture" to determine whether or not it was created to serve the purpose of avoiding double taxation.[158] The Panel did not say that avoiding double taxation must be the sole or leading purpose underlying a measure, however it did state that if one of the purposes of the

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154. *Id.* at para. 137.

155. Footnote 59 of para. (e) of Annex I of the SCM Agreement, *supra* note 6, states:

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

156. *See* Sheppard, *supra* note 75, at 1219.

157. Footnote 5 of the SCM Agreement, *supra* note 6, provides that measures identified in Annex I of that agreement as not being export subsidies are not prohibited under any part of the agreement.

158. ETI Appellate Report, *supra* note 65, at para. 149.

provision is to avoid double taxation it must be "reasonably discernable."[159]

The Act was found to be both unusually broad and unusually narrow for a measure whose purpose is to avoid double taxation.[160] Further, the Act was found to:

> [overlap] with an extensive system of bilateral agreements designed to avoid double taxation through foreign tax credits, and its application [was] not designed to cover situations where such agreements did not exist. . . . No single one of these elements, taken separately, was sufficient to lead the Panel to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income; taken together, however, they lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income within the meaning of footnote 59."[161]

Finally, the Panel found that the Act was not designed to complement, or even take into account, U.S. bilateral tax treaties and preexisting U.S. tax credits that serve to avoid double taxation. The Panel did not preclude the use of alternative mechanisms to avoid double taxation. It only said that the Act was not properly structured within the present facts and in the context of the U.S. tax system to achieve the stated goal.[162]

XV. VIOLATION OF THE AGREEMENT ON AGRICULTURE

The Panel found that:

> the United States has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture* by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its export subsidy commitments under Article 3.3 of the *Agreement on Agriculture*.[163]

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159. ETI Panel Report, *supra* note 98, at para. 7.17.

160. [T]he Act includes as "extraterritorial income" that is excluded from taxation income which would, in our view, not necessarily be treated as taxable in other jurisdictions. In this respect, the Act is unusually broad for a measure whose purpose is *to avoid* double taxation. At the same time, the "extraterritorial income" excluded from taxation does not include a range of income which *is* potentially subject to taxation in other jurisdictions. It is thus, in certain respects, unusually narrow for a measure whose asserted purpose is *to avoid* double taxation. Finally, we note that the Act overlaps with an extensive system of bilateral agreements to avoid double taxation through foreign tax credits, and its application is not designed to cover situations where such agreements did not exist. No single one of these elements, taken separately, would necessarily lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income; taken together, however, they lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income within the meaning of footnote 59.

Id. at para. 8.97.

161. *Id.* at para. 7.17.

162. *Id.* at paras. 8.1-8.171, 9.1.

163. *Id.* at para. 8.122.

The panel reached this decision by determining the same reasoning used to find violations of the SCM Agreement applied in the instant case.[164] It was "also applicable as regards whether the Act gives rise to subsidies contingent upon export performance within the meaning of Article 1(e) of the Agreement on Agriculture for the purposes of Article 10.1 of the Agreement on Agriculture."[165] The subsidies provided by the FSC Replacement Act were found to be export subsidies within the meaning of Articles 1(e)[166] with respect to qualifying property produced within the United States and that the United States acted inconsistently with Articles 8[167], and 10.1[168] of the Agreement on Agriculture.[169]

XVI. ADDITIONAL VIOLATIONS

The panel found two additional violations upon which to report. First, that the FSC Replacement Act provides treatment less favorable to imported products than is accorded to like United States products, contrary to Article III:4 of GATT 1994,[170] and second, that the FSC Replacement Act contains transitional provisions which allow companies to continue to benefit from the WTO incompatible FSC scheme beyond the October 1, 2000, thus failing to withdraw the

164. ETI Appellate Report, *supra* note 65, at para. 188.
165. *Id.*
166. Agreement on Agriculture, *supra* note 7, art. 1(e) (defining "export subsidy as "subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this agreement").
167. "Each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule." *Id.* art. 8.
168. "Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments." *Id.* art. 10.1.
169. ETI Appellate Report, *supra* note 65, at para. 196.
170. 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.

General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194, art. III [hereinafter GATT].

subsidy and implement the DSB recommendations and rulings.[171]

XVII. DETERMINATION OF THE LARGEST WTO PENALTY SO FAR

The panel's only task left at this point was to agree on the punishment to be meted out by the arbitrators of the DSU.[172]

The arbitrator's job under Article 4.11 of the SCM Agreement is to determine whether the countermeasures proposed by the complainant are appropriate. Footnote 10 of the article clarifies by saying: "This expression is not meant to allow countermeasures that would be disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited."[173] The arbitrator's decision at this stage is only to determine if the concessions requested are appropriate and equivalent to the level of "nullification or impairment."[174]

The United States took the position that the countermeasures proposed by the European Communities were not appropriate because they were disproportionate to the trade impact of the inconsistent measure on the European Communities.[175] The United States interpreted Article 4.10 of the SCM Agreement as requiring countermeasures not be disproportionate to the trade impact of the violating measure on the complaining Member.[176] The United States also considered that, in this instance, the

171. The United States argued that it is traditional to allow a transitional period of time for subsidies to be withdrawn in order that companies who have entered into contractual arrangements based on the existence of those subsidies not be unduly punished. The FSC repeal act gave an indefinite extension to contracts in existence as of January 1, 2002, and the U.S. agreed that as to those transactions, the FSC Repeal act did not apply. Article 4.7 of the SCM Agreement requires prohibited subsidies to be withdrawn "without delay", and provides that the panel will specify an appropriate time-period. The panel stated that the subsidies were to be withdrawn "without delay." *See* ETI Appellate Report, *supra* note 65, § X.

172. The United State initiated the proceedings under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement. Article 22.6 of the DSU provides in relevant part:

> When the situation described in paragraph 2 occurs, the DSB, upon request, shall grant authorization to suspend concessions or other obligations within 30 days of the expiry of the reasonable period of time unless the DSB decides by consensus to reject the request. However, if the Member concerned objects to the level of suspension proposed,. . . the matter shall be referred to [binding] arbitration.

DSU, *supra* note 65, at 1240.

173. Art. 4.10 of the SCM Agreement, *supra* note 6, states: "In the event the recommendation of the DSB is not followed within the time-period specified by the panel, which shall commence from the date of adoption of the panel's report or the Appellate Body's report, the DSB shall grant authorization to the complaining Member to take appropriate[9] countermeasures, unless the DSB decides by consensus to reject the request."

174. DSU, *supra* note 65, art. 22.7.

175. ETI Panel Report, *supra* note 98, at para. 15.

176. *Id.* at paras. 16—57.

amount of the subsidy can and should be used as a "proxy" for the trade impact of the measure.[177] The United States estimated the total value of the subsidy at $4,125 million for the year 2000, and suggested that, allocating to the European Communities its share of that amount, countermeasures in a maximum amount of $1,110 million would be appropriate.[178]

The European Communities countered that its proposed countermeasures corresponded to the value of the subsidy, and that this amount was "appropriate" within the meaning of Article 4.10 of the SCM Agreement. In the E.C.'s view, "Article 4.10 of the SCM Agreement sets out a unique benchmark for countermeasures in response to violations of a particular provision of the SCM Agreement—namely Article 3."[179] Further, the European Communities argued that "Article 4.10 of the SCM Agreement allows for countermeasures which will induce compliance, and in this instance, countermeasures in the amount of the value of the subsidy to be withdrawn are appropriate."[180] The European Communities requested an authorization to take countermeasures by suspending concessions in the amount of $4,043 million. This was the dollar amount believed by the European Communities to have been spent by the United States in support of the subsidy.

The Arbitration Panel determined that Article 4.10 of the SCM Agreement means that: "a Member is entitled to act with countermeasures that properly take into account the gravity of the breach and the nature of the upset in the balance of rights and obligations in question. This cannot be reduced to a requirement that constrains countermeasures to trade effects."[181] The parties were in agreement regarding the type

177. *Id.* at para. 62.

178. Second Written Submission of the European Communities, United States—Tax Treatment for "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities, at para. 19, WT/DS108/RW Annex C-2, at para. 4 (Feb. 27, 2001). In its first submission, the United States had initially estimated the actual value of the subsidy at a lower figure. However, it subsequently re-evaluated that amount to take account of certain E.C. arguments concerning the relevant elements for the calculation. The amount cited here is the U.S. figure for the amount of the subsidy as adjusted to take account of the coverage of the subsidy and the shift to the ETI Act. A more detailed analysis of the relevant factors and figures can be found in Annex 1.

179. Second Written Submission of the European Communities, United States—Tax Treatment for "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities, at para. 19, WT/DS108/RW Annex C-1, para. 22 (Feb. 27, 2001).

180. Arbitrator Decision, *supra* note 2, at para. 3.2.

181. *Id.* at para. 5.61.

of countermeasures to be instituted, it was only the amount that was in dispute.[182]

The Arbitration Panel stated in support of its decision that:

> Once such a measure is in operation, its real world effects cannot be separated from the inherent uncertainty that is created by the very existence of such an export subsidy. The measure is, by its very nature, inherently destabilizing. This is its essential character and it is reflected in the fact that the measure is *per se* prohibited. In this particular case, moreover, the subsidy at issue, the FSC/ETI scheme, is a measure which is extensive in its application and, indeed, is potentially available to a very wide range of goods for export. It is not at all like a product- or even a sector-specific measure with, e.g., a set rate or quantum of funds. It is a highly complex and comprehensive export subsidy being applied to a multiplicity of firms.[183]

In the Panel's view, each dollar of subsidy is as much a breach of U.S. obligations as any other dollar. "It is an *erga omnes* obligation owed in its entirety to each and every Member" and cannot be considered to be "allocatable" across the Membership.[184] Otherwise, the Member concerned would be only partially obliged in respect of each and every Member, which is manifestly inconsistent with an *erga omnes per se* obligation.[185] Therefore, "the United States has breached its obligation to the European Communities in respect of all the money that it has expended, because such expenditure in breach—the expense incurred—is the very essence of the wrongful act."[186]

The arbitration panel determined that the balance of the rights and obligations between Members of the WTO could only be properly redressed through full compliance with the DSB's recommendations, *i.e.*, in this case, a complete withdrawal of the unlawful subsidy. "Countermeasures merely offer a *temporary* and imperfect solution to the persisting violation, which in no way reduces the need to comply or substitutes for compliance."[187]

XVIII. CONCLUSION

The WTO was designed primarily to promote and safeguard free trade, and through free trade to increase peace in the world and the

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182. *Id.* at para. 6.1.
183. *Id.* at para. 6.8.
184. *Id.* at para. 6.10.
185. *Id.*
186. *Id.* "One of the arbitrators wishes to stress that this and the following paragraph should not be read to mean that, without regard to the particular circumstances of individual cases, the total amount of the subsidy would be a universally and generally applicable standard at all times." *Id.* at para. 6.10 n.74.
187. *Id.* at para. 6.10 n.72.

standards of living of the world's people.[188] The WTO is an organization based on rules that the United States played a major role in establishing. In playing a major role in the establishment of the WTO, the United States showed its commitment to free trade and the need for an international institution to limit the protectionist forces that benefit only a few in favor of a system of free markets for the benefit of everyone.

> In the ETI case, the WTO has operated exactly as it was designed to operate. It correctly labeled ETI as an export subsidy and determined that the continued operation of ETI was inconsistent with U.S. treaty obligations. Any other decision would have struck a blow for protectionism and undermined the credibility of a major international institution that serves America's long-term economic and political interests and the long-term interests of its trading partners.[189]

According to free trade theorists, "export subsidies benefit the recipients at the expense of the general population and the national economy."[190] "[U]nbridled and competing national subsidies can undermine world prosperity."[191] Since the concentrated interests of producers are politically more powerful than the diffuse interests of consumers, it is easier for governments to go along with and protect industry groups rather than to promote free trade. A major purpose of GATT was to discipline protective import policies because of this behavior.

> The 1930s experience with export subsidies as well as with competitive devaluation, which has the effect of a general export subsidy and import surcharge, apparently convinced the GATT founders that export subsidies exacerbate international political tensions and should be eliminated. Though consumers in the importing country gain from export subsidization by other nations, domestic-producer groups in the importing countries are forced to curtail output and incur a producer-surplus loss. . . . The view that domestic producers are somehow more entitled to domestic compared to foreign markets is still widely held by the general public. Thus, in the case of export subsidies, it was not necessary for the founders of the GATT to implement their international political objective with regard to this distortion only gradually (as with tariffs) and export subsidies were banned outright.[192]

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188. The World Trade Organization, *10 Benefits of the WTO Trading System, available at* http://www.wto.org/english/thewto_e/whatis_e/10ben_e/10b00_e.htm (last visited Feb. 4, 2004).

189. Michael, J. McIntyre, *How the United States Should Respond to the ETI Controversy*, TAX NOTES, May 20, 2002, at 1251, 1253.

190. *Id.*

191. HUFBAUER & ERB, *supra* note 15, at 8.

192. ROBERT E. BALDWIN, NONTARIFF DISTORTIONS OF INTERNATIONAL TRADE 86 (1980), *quoted in* HUFBAUER & ERB, *supra* note 15, at 8.

If this theory is correct, then the WTO decision against the U.S. government will actually advance the best interests of the American public and the American economy if it leads to the outright repeal of the ETI.

In October of 2003 the House Ways and Means Committee and the Senate Finance Committee each passed bills that would repeal the FSC/ETI scheme.[193] One of the few similarities in the bills, the House version called the American Jobs Creation Act of 2003, and the Senate's the Jumpstart our Business Strength (JOBS) Act, is the use of a three-year phase in for the repeal. The slow phase-in was immediately challenged by the European Union's Pascal Lamy. A firm date for sanctions to start was set for December 15, 2003, and then moved to March 1, 2004, if the FSC/ETI scheme is not repealed.[194] President Bush's recent repeal of tariffs on imported steel may buy Congress a little more time to come up with a solution that is palatable to the European Union.

Of the options available to Congress, only the full repeal of ETI without any replacement is consistent with free trade and offers Congress a complete and honest solution to the ETI problem. It is unlikely that a new drafter will be able to create a new export subsidy that will continue to provide the same benefits currently provided under the ETI scheme and still pass muster with the WTO's dispute settlement body. Given the political realities of instituting major tax reform legislation, it is unlikely that a complete overhaul of the U.S. system could be accomplished in the limited time left, and even then it would be subject to new challenges before the WTO by the Europeans. The ETI should be repealed in order for the United States to satisfy its obligations under international law and maintain its position as a leader of the free-trade movement. Any alternative mechanism for stimulating exports, even one that is acceptable to the WTO, will distort trade patterns without increasing U.S. jobs or strengthening the U.S. economy. The best course of action for Congress is to stay the free trade course that the United States charted more than a half-century ago.[195]

STUART SMITH

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193. H.R. 2896, 108th Cong., 1st Sess. (2003); S. 1637, 108th Cong., 1st Sess. (2003).

194. Edward Alden, *Tariff Deadline Looms as Lamy arrives in US*, FIN. TIMES (London), Feb. 26, 2004.

195. *See* McIntyre, *supra* note 189, at 1251.