The Continued Viability of Foreign Sales Corporations (FSCs): An Analysis of the WTO Decision Declaring FSCs Incompatible with GATT Trading Rules

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I. INTRODUCTION

Most major trading nations have features in their income tax laws that

favor exports. The United States has adopted such a scheme of preferential treatment of foreign income in order to provide incentives for the export of U.S.-produced goods.[1] However, such devices that reduce income taxes for U.S. exporters have been openly criticized by the international community as illegal export subsidies which are incompatible with the General Agreement on Tariffs and Trade (GATT).[2] In fact, the U.S. enacted its current Foreign Sales Corporation (FSC) legislation in the Tax Reform Act of 1984 to conform the Domestic International Sales Corporation (DISC) (the predecessor to the FSC) to the GATT understanding of export tax incentives.[3]

The latest pronouncement on this issue came on October 8, 1999, when the World Trade Organization (WTO) issued a report condemning the U.S. FSC tax regime and calling for its abolition by October 1, 2000.[4] The Dispute Settlement Panel's investigation originated with a complaint by the European Communities (EC) that the U.S. statutory scheme violated provisions of WTO agreements, including GATT, the Agreement on Subsidies and Countervailing Measures (SCM Agreement), and the Agreement on Agriculture (AA).[5] The Panel's final report backed the EC complaint, and both the United States and the European Communities appealed. However, on February 24, 2000, the Appellate Body upheld the Panel's decision, concluding that the FSC provisions did constitute an illegal export subsidy.[6]

Part II of this Comment will discuss the evolution of U.S. FSC legislation as well as the current organizational requirements for FSC status. Part III will analyze the WTO's decision declaring the U.S. FSC provisions incompatible with GATT. Finally, Part IV will address the problems with the current U.S. system as well as the potential options available to the United States in light of the WTO decision.

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1. *See* PAUL R. MCDANIEL & HUGH J. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 155 (4th ed. 1998). The Foreign Sales Corporation (FSC) provisions in the U.S. tax code allow U.S. companies to exempt earnings generated by economic activities outside the U.S. from income taxes if they are related to the sale or lease of an export product. *See generally* I.R.C. §§ 921-927 (1994).

2. Harmful tax competition has become an important issue in international tax law. *See* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998).

3. *See* STAFF OF THE JOINT COMM. ON TAXATION, 98th CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 1041-42 (Comm. Print 1985) [hereinafter GENERAL EXPLANATION].

4. *See* WTO Dispute Panel Report, United States – Tax Treatment for "Foreign Sales Corporations," WT/DS108/R ¶¶ 8.1-8.4, 8.8 (Oct. 8, 1999), *reprinted in* 38 I.L.M. 173 (2000) [hereinafter FSC Report].

5. *See id.* ¶¶ 1.1-1.4.

6. *See* Report of the Appellate Body, United States – Tax Treatment for "Foreign Sales Corporations," WT/DS108/AB/R ¶ 177 (Feb. 24, 2000) [hereinafter FSC Appellate Report].

II. EVOLUTION OF U.S. FSC LEGISLATION AND CURRENT ORGANIZATIONAL REQUIREMENTS FOR FSC STATUS

A. Different Types of Taxation Systems

There are essentially two grounds for nations to tax income: jurisdiction over the recipient based on the residence of the taxpayer (the residence principle or the worldwide system) and jurisdiction over the activity or source that produces the income (the source principle or the territorial system).[7] Under the residence principle or worldwide system, a country taxes the worldwide income of persons subject to its jurisdiction regardless of the income's source.[8] Under the source principle or territorial system, a country taxes income earned within its borders,[9] or in other words, residents of the home country are not taxed on their foreign source income.

Countries may adopt a mixture of these two jurisdictional grounds (e.g., a country may choose to apply the residence principle to individual income but the source principle to corporate income).[10] If all countries adhered to the same principle (either residence or source), there would not be a double taxation problem.[11] However, a mixture of these two principles can lead to double taxation of the same income. Because of the potential that one country's tax on residence income may be duplicated by another country's tax on the source of that income, many countries have developed principles to avoid or mitigate double taxation.[12] Relief from this double tax can take the form of a credit for foreign taxes paid, a deduction of foreign taxes from the domestic tax base, or the exemption of foreign source income from the domestic tax base.[13] However, while companies with international operations may be exposed to the risk of double taxation, there may also be opportunities for tax avoidance or evasion.

The U.S. generally taxes under the worldwide system. U.S. persons

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7. *See* JACOB A. FRENKEL, ET AL., INTERNATIONAL TAXATION IN AN INTEGRATED WORLD 22 (1991).
8. *See id.*
9. *See id.*
10. *See id.*
11. *See id.*
12. *See id.; see also* FSC Report, *supra* note 4, at ¶ 4.313.
13. *See id.*

are taxed on all income, whether derived in the United States or abroad.[14] However, the U.S. yields the right to tax income from sources outside its borders to the country where such income is derived, and a credit is typically allowed against the U.S. tax for foreign taxes paid on that income.[15] Within this basic framework, there are a variety of complex rules that govern the determination of the source of income (as either U.S. or foreign) as well as the allocation of expenses between U.S. and foreign source income.[16]

B. From DISCs to FSCs

In 1971, Congress enacted the Domestic International Sales Corporation (DISC) provisions as an incentive for U.S. companies to engage in export activities.[17] The DISC legislation invited exporters to create a separate domestic corporation, which had no assets, no employees, and no function other than to reduce taxes.[18] The DISC provisions allowed companies to run exports through the DISC, by selling goods to the DISC and then having the DISC resell them to the ultimate foreign buyer.[19] Profits were then divided between the DISC and its parent according to a statutory formula.[20] While one half of the profits attributed to the DISC would be distributed back to the parent and would be taxed as ordinary income, no tax would be paid on the other half of the DISC's profits.[21] This benefit actually operated as a long-term deferral; as long as a company qualified as a DISC, it was entitled to defer the tax on a major portion of its export profits.[22]

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14. *See* STAFF OF JOINT COMMITTEE ON TAXATION, U.S. JOINT COMMITTEE ON TAXATION REPORTS ON INTERNATIONAL TAXATION LAW AND RULES ¶ 15 (Comm. Print 1999) [hereinafter JOINT COMMITTEE REPORT]. The term "U.S. person" includes U.S. citizens, residents, and corporations. *Id.*

15. *See id.* at 3. "Foreign persons are subject to U.S. tax only on income that has a sufficient connection to the United States." *Id.*

16. *See id.* at 4.

17. *See* Robert E. Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN. L. REV. 1443, 1446 (1988) (explaining that the DISC legislation was a response to the United States' deteriorating trade and payment position in the late 1960s and early 1970s); *see also* JON E. BISCHEL & ROBERT FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 136 (Practising Law Institute 2d ed., 1985) (noting that the DISC rules provided a tax benefit to companies that exported their goods from the U.S. rather than selling these goods in the domestic market).

18. *See* Hudec, *supra* note 17, at 1446.

19. *See id.*

20. *See id.*

21. *See id.*

22. *See* BISCHEL & FEINSCHREIBER, *supra* note 17, at 134; *see also* MCDANIEL & AULT, *supra* note 1, at 155 ("The subsidy took the form of a deferral of U.S. tax on a portion of export income channeled through a DISC, in effect an interest-free loan from the Treasury to U.S. exporters.").

From the time of its enactment, the DISC was the subject of a dispute between the U.S. and other signatories of GATT.[23] The U.S. claimed that the DISC provisions were necessary to correct competitive disadvantages faced by U.S. exporters due to the differences between U.S. and foreign tax laws.[24] Ultimately, the GATT council found that both the DISC provisions as well as the European tax systems had characteristics of an export subsidy.[25] After much debate, the GATT council adopted the reports together with an understanding which read:

> 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 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 income.[26]

In the interest of resolving the dispute, Congress enacted sections 921-927 of the Internal Revenue Code (I.R.C.) in the Tax Reform Act of 1984, replacing the DISC with the FSC.[27] The law's primary purpose was to bring the United States into conformity with GATT's legal obligations.[28] Under GATT rules, an exemption from tax on export income was understood as permissible only if the economic processes that gave rise to the income took place outside of the United States.[29] In order to comply with GATT, the FSC statute used a foreign-chartered

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23. *See generally* Hudec, *supra* note 17, at 1457. In 1972, the European Community filed a complaint charging that the DISC was an export subsidy in violation of GATT. The U.S. responded by filing counterclaims against France, Belgium, and the Netherlands claiming that the territoriality features of their income tax laws resulted in a similar subsidy to exporters. *See id.*
24. *See id.* at 1447.
25. *See* United States - Tax Legislation (DISC), Dec. 8, 1981, GATT B.I.S.D. 23S/98, 114 [hereinafter DISC Report]. The panel's report on DISCs stated that "the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI:4." *Id.* at 113.
26. *See id.* at 114. The United States stated that it was willing to accept the panel's ruling that DISC violated Article XVI:4 provided that the panel reports finding the French, Belgian, and Netherlands tax systems in violation were also accepted. *See* Hudec, *supra* note 17, at 1481.
27. *See* Hudec, *supra* note 17, at 1500.
28. *See* GENERAL EXPLANATION, *supra* note 3, at 1041.
29. *See id.* at 1042.

corporation, rather than a domestic corporation.[30] Further, a FSC filed a separate tax return and paid taxes on its income, unlike a DISC, which was not a taxable entity.[31] Finally, the tax incentive provided in the FSC provisions was in the form of a permanent exemption from tax, rather than a deferral.

C. Current FSC Provisions

Sections 921-927 of the I.R.C. provide that a portion of the export income of an eligible FSC will be exempt from federal income tax.[32] Furthermore, a U.S. corporation is not subject to tax on dividends distributed from the FSC out of earnings attributable to certain export income.[33] As a result, there is generally no corporate tax on the portion of export earnings that constitute foreign trade income.[34]

A FSC is typically owned by a U.S corporation that produces goods in the United States.[35] The U.S. corporation then supplies those goods to the FSC for resale abroad or pays the FSC a commission in connection with its sales overseas.[36] The FSC's income is equal to the FSC's gross markup or gross commission minus any expenses incurred.[37]

In order to qualify as a FSC, a corporation must meet the requirements set forth in I.R.C. section 922(a). First, the FSC must be created or organized under the laws of a qualified foreign country under § 927(e)(3) or of any U.S possession. Second, the FSC may not have more than twenty-five shareholders and may not issue preferred stock. Third, the FSC must maintain an office outside of the U.S. in a qualified foreign country and must maintain its permanent books at that office. In addition, the FSC must maintain specified tax records at a location within the U.S. Fourth, the Board of Directors must include at least one person who is not a U.S. resident. Fifth, the FSC cannot be a member of any controlled group of corporations of which a DISC is a member.[38]

Once a corporation qualifies as a FSC, the corporation obtains a tax exemption on the portion of its earnings that constitute "foreign trade

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30. *See id.* at 1043.
31. *See* FSC Report, *supra* note 4, ¶ 4.338.
32. *See generally* I.R.C. §§ 921-927. Under section 921 of the Internal Revenue Code, "[e]xempt foreign trade income of a FSC shall be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States." *Id.* As such, a FSC is not subject to U.S. tax on this income. *See id.*
33. *See* GENERAL EXPLANATION, *supra* note 3, at 1042.
34. *See id.*
35. *See* JOINT COMMITTEE REPORT, *supra* note 14, ¶117.
36. *See id.*
37. *See id.*
38. *See* I.R.C. § 922(a).

income," which means the gross income of an FSC attributable to "foreign trading gross receipts."[39] However, in order for a corporation to have "foreign trading gross receipts," it must satisfy two further requirements: the corporation's management must be from outside the U.S. and its economic processes must take place outside of the U.S.[40]

The first requirement is met if: 1) all meetings of the Board of Directors and shareholders are held outside of the U.S., 2) the principal bank account is maintained in a qualified foreign country under I.R.C. section 927(e)(3) or in a U.S. possession, and 3) all dividends, legal and accounting fees, and salaries are paid out of the main foreign bank account.[41] This foreign management requirement is one main difference between the DISC and the FSC. Because the DISC was a domestic entity, there was no requirement that its management be handled outside the U.S.[42]

The foreign economic processes requirement is met if: 1) the corporation has participated outside the U.S. in the solicitation, negotiation, or making of a contract relating to such an export transaction, and 2) "the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed fifty percent of total direct costs."[43] The first part of the foreign economic processes requirement can be satisfied by a contract between the FSC and its U.S. parent (or other domestic or foreign subsidiary) pursuant to which all of the export activities are performed by the related party and not by the FSC.[44] Generally, the FSC must participate in only one of these three activities (solicitation, negotiation, or making of a contract) to obtain the FSC tax exemption. However, if the FSC wants to use one of the administrative pricing rules, then the FSC (or its agent) must perform all of the activities attributed to that sale.[45] The second part of the foreign

39. I.R.C. § 923(b). These receipts include amounts from the sale or exchange of export property, from the lease or rental of export property for use outside of the U.S., or from the performance of services related to either a sale or lease. *See* I.R.C. § 924(a). The types of property that qualify as export property are defined in section 927(a). I.R.C. § 927(a).

40. I.R.C. § 924(b); *see also* MCDANIEL & AULT, *supra* note 1, at 159 n.14 ("The two requirements are intended to satisfy EU objections to the DISC provisions under GATT.").

41. I.R.C. § 924(c).

42. *See* Blake A. Bernet, *The Foreign Sales Corporation Act: Export Incentive for U.S. Business*, 25 INT'L LAW. 223, 227 (1991).

43. I.R.C. § 924(d).

44. *See* MCDANIEL & AULT, *supra* note 1, at 160.

45. *See Foreign Sales Corporations: a Tax Incentive for U.S. Exporters*, published

economic processes requirement can be satisfied if the FSC pays its agent (such as a parent or affiliate) for performing the activities which generate the direct costs.[46]

The portion of income from which an FSC is entitled to an exemption is its foreign trade income (FTI).[47] The amount of exempt income depends on the transfer pricing rule used to determine the FSC's FTI.[48] Income from qualified export transactions may be earned by the FSC in arm's length dealings between unrelated parties or may be allocated to the FSC under administrative pricing rules, which are intended to approximate arm's length pricing.[49] Under the arm's length method, taxable income is equal to the profit that results from buying goods from the U.S. parent and then selling the goods to a foreign buyer.[50] The exempt portion of FTI, under arm's length pricing, is thirty percent of the income the FSC derives from the transaction.[51]

In order for an FSC to take advantage of the administrative pricing rules, the FSC must perform the same economic processes that would satisfy the foreign economic processes requirement of section 924(d) and all activities relating to the solicitation, negotiation, and making of the sales contract.[52] Under the administrative pricing rules, income is to be allocated to the FSC under one of two methods.[53] The first method allows the FSC to take 1.83 percent of the total foreign trading gross receipts from the sale of export property as foreign trade income (not to exceed twice the amount allowed under the second method or forty-six percent of the total combined income).[54] Then, under section 923(a)(3), 15/23 (approximately sixty-five percent) of this foreign trade income is exempt from U.S. taxation.[55] The second method apportions twenty-three

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by the U.S. Office of the Chief Counsel for International Commerce, U.S. Department of Commerce 3 (1996) [hereinafter DOC Report].

46. *See id.*

47. *See id.*

48. *See id.*

49. *See id.* In theory, the administrative pricing rules are supposed to approximate the results under § 482. *Id.*; *see also* Bernet, *supra* note 42, at n.44 ("These measures were designed to comply with the GATT mandate, which provides that sales among related parties must meet arm's-length pricing standards. These pricing standards may be met by related parties by utilizing a transfer price which is determine by (1) a true arm's length price, or (2) one of two formulae that are designed to approximate an arm's length price.").

50. *See* Bernet, *supra* note 42, at 230 (noting that the price paid by the FSC to the exporter must be market price; it cannot be artificially inflated so as to create a large amount of taxable income which thereby results in a larger tax deduction).

51. I.R.C. § 923(a)(2).

52. *See* I.R.C. § 925(c).

53. *See* I.R.C. § 925(a)(1)-(2).

54. *See* I.R.C. § 925(a), (d).

55. I.R.C. § 923(a)(3). This rule provides an exemption for up to 30 percent (46% multiplied by 15/23) of the total income earned in the transaction. *See id.*

percent of the total combined taxable income derived from the sale of export property by the FSC and the remaining seventy-seven percent to its related supplier.[56] Then, 15/23 (approximately sixty-five percent) of the FSC's FTI is exempt from U.S. taxation.[57] Under I.R.C. section 921, this exempt foreign trade income (EFTI) is considered to be foreign source income not effectively connected with a U.S. trade or business. The nonexempt foreign trade income is treated differently depending on the transfer pricing method employed.[58]

III. WTO DECISION THAT FSC PROVISIONS ARE INCOMPATIBLE WITH GATT

A. The WTO's Role in Resolving Trade Disputes

The WTO, successor to GATT, is currently the primary international organization dealing with rules of trade between nations.[59] The WTO administers trade agreements, acts as a forum for trade negotiations, settles trade disputes, and reviews national trade policies.[60] The WTO Agreements, which are negotiated and signed by a majority of the world's trading nations, are at the center of this trade system.[61] These agreements provide the legal ground rules for international commerce, guarantee member countries important trade rights, and require governments to keep their trade policies within agreed upon limits.[62]

One of the most important features of the new WTO was the creation of a new dispute settlement procedure.[63] In contrast to the relatively informal GATT dispute settlement process, this new procedure was set out in a detailed agreement known as the "Understanding on Rules and Procedures Governing the Settlement of Disputes" (DSU), which

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56. *See* I.R.C. § 925(a)(2).
57. *See* I.R.C. § 923(a)(3).
58. *See* MCDANIEL & AULT, *supra* note 1, at 158. If an administrative pricing method is used, the FSC is taxed currently in the U.S. However, if the arm's length pricing method is used, the taxation is determined apart from the FSC rules. *See id.*
59. *See The WTO in Brief* (visited Feb. 13, 2000), *available at* http://www.wto.org/wto/inbrief/inbr00.htm.
60. *See id.*
61. *See id.*
62. *See id.*
63. *See* Robert E. Hudec, *The New WTO Dispute Settlement Procedure: An Overview of the First Three Years*, 8 MINN. J. GLOBAL TRADE 1, 2 (1999).

significantly expanded the procedure's legal powers.[64] The dispute settlement process focuses on interpreting agreements and ensuring that the various countries' trade policies conform to these agreements.[65] The DSU made rulings by tribunals automatically binding on the parties, introduced appellate review and gave complaining parties an automatic right to impose retaliatory trade sanctions when a government refuses to comply with a legal ruling.[66]

B. Dispute Over FSC Provisions

On November 18, 1997, the European Communities (EC) requested consultations with the U.S. under Article 4 of the DSU, with respect to the tax exemptions and special administrative pricing rules contained in the FSC provisions of the I.R.C.[67] After the EC and the U.S. failed to reach a satisfactory solution, the Dispute Settlement Body (DSB) established a panel to examine the following issues:

1) Whether FSC provisions are subsidies contingent upon export performance within the meaning of Article 3.1(a) of the Agreement on Subsidies and Countervailing Measures (SCM Agreement)?
2) Whether FSC provisions are subsidies contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the SCM Agreement?
3) Whether the FSC provisions are in violation of the Agreement on Agriculture (AA) by granting subsidies in excess of its reduction commitments?[68]

C. Claims under Article 3.1(a) of the SCM Agreement

The EC alleged that the FSC regime involved two distinct subsidies:

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64. *See id.*
65. *See id.*
66. *See id.* at 3.
67. *See* FSC Report, *supra* note 4, ¶ 1.11. On November 18, 1997, the EC requested consultations under Article 4 of the DSU, Article XXIII:1 of GATT 1994, and Article 4 of the SCM Agreement. *See id.* On March 4, 1998, the EC requested that consultations be extended to include Article 19 of the AA. *See id.* ¶ 1.2. The EC claims it has opposed FSCs since their enactment, but that it had refrained from making formal objections because of the onset of the Uruguay Round of GATT negotiations. *See* Robert Goulder, *WTO Panel Blasts U.S. FSC Tax Regime*, WORLDWIDE TAX DAILY 2 (July 28, 1999). Other commentators have suggested the EC may have chosen to raise the FSC issue at this time in retaliation for recent losses at the WTO or because of the increase in FSC activity, especially in the software area. *See id.*
68. The U.S. also raised several procedural problems with the EC complaint; however, the Panel sided with the EC on these issues.

1) tax exemptions and 2) the availability of special administrative pricing rules for calculating exempt foreign trade income.[69] The Panel concluded that the FSC exemptions constituted an illegal export subsidy within the meaning of Article 3.1(a) of the SCM Agreement, which prohibits subsidies that are contingent upon export performance.[70] However, the Panel concluded that it was neither necessary nor appropriate to make findings with respect to the administrative pricing rules.[71]

The Panel began its analysis by looking at whether the exemptions identified by the EC were subsidies within the meaning of Article 1.1 of the SCM Agreement.[72] Two elements must be satisfied in order for a subsidy to exist under Article 1.1: there must be a financial contribution by a government,[73] and a benefit must be conferred.[74] The Panel ultimately concluded that whether revenue forgone is otherwise due, should be determined by examining the fiscal treatment that would be applicable "but for" the measures in question.[75]

69. FSC Report, *supra* note 4, ¶¶ 4.270-4.272. The EC made the distinction between these two aspects of the FSC scheme because, in their view, each subsidy could not exist without the other. The EC felt it was important that both aspects be held to be prohibited subsidies so that both would have to be withdrawn. *Id.* ¶ 4.273.

70. *Id.* ¶ 7.130.

71. *Id.* ¶ 7.127.

72. *Id.* ¶ 7.39. According to Article 3.1(a) of the SCM Agreement, subsidies, within the meaning of Article 1, that are contingent upon export performance are prohibited.

73. *See id.* ¶ 7.40. A financial contribution by a government arises only when government revenue that is otherwise due is forgone or not collected. According to the Panel, the term "otherwise due" refers to the situation that would occur but for the measures in question. Thus, the question presented in this case was whether, "if the FSC scheme did not exist, revenue would be due which is foregone by reason of that scheme." *Id.* ¶ 7.45.

74. *See id.* ¶ 7.40.

75. *Id.* ¶ 7.93. The United States argued that the term "otherwise due" should be interpreted in light of the 1981 Understanding adopted in conjunction with the DISC case. *Id.* ¶ 7.50. According to the U.S., the 1981 Understanding made it clear that the exemption of foreign source income from taxation did not constitute the forgoing of revenue that is otherwise due. *See id.* The U.S. considered the 1981 Understanding to be an interpretation of GATT 1947, which was incorporated into GATT 1994. *See id.* The U.S. also argued that the 1981 Understanding represented a subsequent practice within the meaning of the Vienna Convention on the Law of Treaties or constituted a decision within the meaning of the WTO Agreement that should "guide" the WTO. *Id.* The Panel concluded that the 1981 Understanding was not part of GATT 1994 and was not a subsequent practice. *Id.* ¶ 7.85. Although the Panel stated that the 1981 Understanding was a decision that should guide the WTO to the extent relevant, it ultimately concluded that the Understanding could not provide guidance in interpreting the SCM Agreement because that Agreement did not exist at the time the 1981

The EC alleged several exemptions were provided for by the FSC regime. The first exemption related to the application of formulaic rules for determining whether an FSC's income is domestic or foreign source.[76] Under section 882 (a) of the I.R.C., only income "effectively connected with a trade or business in the United States" is taxable to a foreign corporation.[77] However section 921 provides that "[e]xempt foreign trade income of an FSC shall be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States," and section 923 provides the rules for determining exempt foreign trade income.[78] The EC argued that were it not for the FSC provisions, this income would be taxable by the United States.

The second exemption related to the fact that the foreign trade income of an FSC is excluded from the controlled foreign corporations provisions of Subpart F of the I.R.C.[79] Generally, a U.S. corporation conducting business abroad through a separate foreign corporation does not pay U.S. tax on the foreign corporation's foreign source income (defined as earnings which are not effectively connected with a U.S. trade or business) until that income is repatriated back to the U.S. through a dividend or otherwise.[80] However, to prevent taxpayers from shifting their investments to low-taxing jurisdictions, a number of anti-deferral mechanisms, including the controlled foreign corporation provisions of Subpart F, have been enacted.[81] These provisions require that U.S. shareholders holding stock in controlled foreign corporations include in their gross income their pro rata share of the foreign corporations undistributed income.[82] However, foreign trade income of an FSC is exempt from the Subpart F regime, and thus, the parent of an FSC need not report undistributed income from the FSC that would otherwise be subject to immediate taxation.[83]

Understanding was adopted. *Id.*

76. *See id.* ¶ 7.95.

77. I.R.C. § 882(a); *see also* I.R.C. § 864 *amended by* I.R.C. § 864(b)(2)(A)(ii) (Supp. IV 1999) (setting forth the rules for determining whether the income of a foreign corporation is connected with a trade or business in the United States).

78. I.R.C. §§ 921(a), 923.

79. *See* FSC Report, *supra* note 4, ¶ 7.96.

80. *See id.* ¶ 4.165.

81. *See id.*

82. *See id.*

83. *See id.* ¶ 7.96. Under I.R.C. § 951(e), if an FSC uses the administrative pricing rules to determine its foreign trade income (FTI), both the exempt and non-exempt portions are not subject to the Subpart F provisions. I.R.C. § 951(e). However if the FSC uses the arm's length pricing rules in I.R.C. § 482, then the shareholder must declare its pro rata share of the non-exempt portion of the FSC's FTI. I.R.C. § 482.

The third exemption relates to the tax treatment of dividends paid by an FSC to its parent.[84] Under section 245(c) of the I.R.C., shareholders of an FSC receive a one hundred percent deduction for the dividends distributed out of earnings from foreign trade income.[85] Thus, the parent of an FSC is not required to pay taxes on dividends attributable to the foreign trade income of an FSC. Generally, however, dividends received by a U.S. corporation, derived from the foreign source income of a foreign corporation, are taxable.[86]

The Panel found it unnecessary to evaluate each of the previously mentioned exemptions separately to determine whether revenue forgone was otherwise due.[87] Instead, the Panel stated that "[v]iewed as an integrated whole, the exemptions provided by the FSC scheme represent a systematic effort by the United States to exempt certain types of income which would be taxable in the absence of the FSC scheme."[88] After concluding that the various exemptions, as a whole, result in a financial contribution by a government within the meaning of Article 1.1(a)(2)(ii) of the SCM Agreement,[89] the Panel found that a benefit was clearly conferred (as FSCs and their parents need not pay taxes that would otherwise be due).[90]

Having found that the exemptions represented a subsidy, the Panel then considered whether that subsidy was contingent upon export performance within the meaning of Article 3.1(a).[91] Under section 924 of the I.R.C., the income of an FSC that constitutes foreign trading gross receipts only arises from the sale or lease of "export property" or from

84. *See* FSC Report, *supra* note 4, ¶ 7.97.
85. I.R.C. § 245(c); *see also id.*
86. *Id.*
87. *Id.* ¶ 7.99. The Panel stated that, "[i]t is conceivable that a particular exemption may not in every case individually result in the foregoing of revenue that is otherwise due. . .given that the European Communities has alleged that the various exemptions are interconnected and that together they represent a single subsidy, we consider that our task is to look at the various exemptions provided by the FSC scheme as a totality, and to asses whether taken together they involve a financial contribution in the form of the foregoing of revenue otherwise due." *Id.*
88. *Id.* ¶ 7.100.
89. *Id.* ¶ 7.102.
90. *Id.* ¶ 7.103.
91. *Id.* ¶ 7.105(a). Article 3.1 of the SCM Agreement provides that "[e]xcept as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited: (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I."

the sale or lease of services relating to such property.[92] According to the Panel, the various exemptions under the FSC regime confer a subsidy that is contingent upon export performance for the following reasons: 1) the subsidy is only available with respect to foreign trading income, 2) foreign trading income arises from the sale or lease of export property or the provision of services relating to the sale or lease of export property, and 3) export property is limited to goods manufactured, produced, grown, or extracted in the United States which are held for use or consumption outside of the United States.[93]

D. Claims under Article 3.1(b) of the SCM Agreement

The EC also argued that the FSC regime was a subsidy contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the SCM Agreement.[94] This argument was based on the fact that the tax exemptions under the FSC provisions are limited to income from the export of products not more than fifty percent of the fair market value of which is attributable to articles imported into the United States.[95] The Panel declined to make findings with respect to this issue and concluded that the legal issues relating to this claim were not really explored by either party.[96]

E. Claims under the Agreement on Agriculture

Finally, the EC claimed that the FSC regime constituted an export subsidy under Article 9.1(d) of the Agreement on Agriculture by providing exports in excess of the U.S. export reduction commitments.[97] The Panel determined that in order for the FSC provisions to fall within the scope of Article 9.1(d), there must be subsidies, and the provision of those subsidies must be to reduce the costs of marketing exports of

92. I.R.C. § 924; *see also* FSC Report, *supra* note 4, ¶ 7.107.

93. FSC Report, *supra* note 4, ¶ 7.108. The Panel further stated that, "the status of the FSC exemptions as an export subsidy within the meaning of Article 3.1(a) of the SCM Agreement is confirmed by item (e) of the Illustrative List." *Id.* Under this provision, an export subsidy includes: "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." *Id.* The Panel concluded that the FSC exemptions did constitute the "full or partial exemption, remission, or deferral. . .of direct taxes. . .paid or payable by industrial or commercial enterprises." *Id.* ¶¶ 7.109-7.110.

94. *See id.* ¶ 7.131.

95. *See id.*

96. *Id.* ¶ 7.132.

97. *See id.* ¶ 7.133.

agricultural products.[98] The Panel concluded that the FSC provisions conferred a subsidy within the meaning of the Agreement on Agriculture because they involved the provision of a subsidy to reduce the costs of marketing exports of agricultural products.[99]

F. Report of the Appellate Body

The Dispute Settlement Body (DSB) "automatically" adopts reports of the Panel unless there is a unanimous decision to the contrary.[100] The losing party is then required to notify the DSB of its intentions to comply with the Panel's results within 30 days after the report's adoption.[101] Alternatively, parties may file an appeal with the Appellate Body, which was established to review issues of law and legal interpretations by the Panel.[102]

The U.S. notified the DSB of its intention to appeal certain issues in the Panel report on November 26, 1999, and the EC filed a cross-appeal on December 7, 1999.[103] The Appellate Body issued its final report on February 24, 2000, concluding that the FSC measures did indeed constitute an export subsidy.[104] The Appellate Report upheld the Panel's findings that the FSC measures constituted an illegal export subsidy under Article 3.1(a) of the SCM Agreement, but reversed the Panel's findings that the U.S. had acted inconsistently with its obligations under Article 3.3 of the AA through the provision of subsidies to reduce the costs of marketing exports.[105] However, the Appellate Body did find that the U.S. had acted inconsistently with its obligations under Articles 10.1 and 8 of the AA by applying export subsidies that lead to the circumvention of its export subsidy commitments, with respect to agricultural products.[106]

98. *Id.* ¶ 7.148.
99. *Id.* ¶ 7.159.
100. *See* JAMES CAMERON & KAREN CAMPBELL, DISPUTE RESOLUTION IN THE WTO 31 (1998).
101. *See id.*
102. *See id.* "The Appellate Body has the authority to uphold, modify, or reverse the findings of the Panel." *Id.* at 37.
103. *See* FSC Appellate Report, *supra* note 6.
104. *Id.* ¶ 180.
105. *Id.* ¶ 177.
106. *Id.*

IV. OPTIONS FOR THE U.S. IN LIGHT OF THE WTO DECISION

After a final report is issued, the losing country must follow the recommendations of the DSB within a reasonable period of time.[107] If the country fails to act within this period, it must enter into negotiations with the complaining country to determine mutually-acceptable compensation.[108] If no satisfactory compensation can be agreed upon, the complaining country may ask the DSB for permission to impose limited trade sanctions against the losing party.[109] The DSB will grant this authorization within thirty days unless there is consensus against the request.[110]

In this case, the Appellate Body recommended that the DSB request the U.S. to withdraw the FSC subsidies without delay and conform its FSC regime to its obligations under the Agreement on Agriculture.[111] The U.S. has yet to announce how it plans to implement the Panel's decision. However, the U.S. appears to have several potential options available.

A. Modify FSC Provisions to Comply with WTO Agreements

As it did in the DISC case, the U.S. may attempt to repeal the FSC provisions that were deemed incompatible with GATT and modify its tax rules in accordance with the Panel's findings in order to continue to provide some type of export assistance. However, this is likely to be a costly and time-consuming process. To complicate matters, the Panel's decision was very broad, making it difficult for lawmakers to come up with a replacement. If the United States wants to keep some form of the FSC provisions in the I.R.C., it might begin by modifying each of the three exemptions found by the Panel to be inconsistent with its responsibilities under GATT.[112]

The first exemption related to the application of formulaic rules to determine the amount of foreign source income attributable to the

107. *See WTO "Trading into the Future": An Interactive Guide to the World Trade Organization* (last modified Feb. 3, 2000), *available at* http://www.wto.org.

108. *See id.*

109. *See id.* In theory, the sanctions should be imposed in the same sector as the dispute. *See id.* If this is not practical or would not be effective, the sanctions can be imposed in a different sector of the same agreement. *See id.* The objective is to minimize the chances of actions spilling over into unrelated sectors. *See id.*

110. *See id.*

111. FSC Appellate Report, *supra* note 6, ¶ 177.

112. *See generally supra* Part III. As mentioned, the Panel found that the three exemptions, as a whole, constituted the subsidy (it did not consider each item individually).

FSC.[113] As such, the U.S. might first attempt to modify its pricing rules so that they increase the amount of foreign trade income attributed to the FSC. Under the previous rules, U.S. exporters were able to select either arm's length pricing or the administrative pricing rules after the close of the year.[114] This created a situation where exporters using an FSC could wait and see which rule would produce the least amount of tax.[115] The obvious answer to this problem would be to require GATT-mandated arm's length pricing in all transactions between an FSC and its suppliers.[116] However this solution, by itself, is not likely to satisfy the Panel as their real objection seemed to be that a portion of the FSC's income is completely exempt from tax.

In order to deal with the second exemption, I.R.C. section 951(e) would need to be modified, so that an FSC's foreign trade income is included in the Subpart F provisions.[117] The typical foreign export corporation is organized in a tax haven country as a wholly owned subsidiary of a U.S. corporation.[118] As a result, it falls within the "controlled foreign corporation" definition of section 957(a).[119] Under most circumstances, earnings from such a corporation fall within the Subpart F income taxed to the U.S. parent as a constructive dividend.[120] According to one commentator, because of Subpart F, "U.S. exporters were required to pay income taxes on the export income of tax-haven subsidiaries that conducted no manufacturing in the tax-haven country."[121] As such, most U.S. exporters were paying greater income taxes on their export income than other tax-haven exporters.[122] The original DISC legislation was enacted partially to correct the disadvantage U.S. exporters faced because of the Subpart F provisions.[123] Currently, under section 951(e), exempt foreign trade income of a FSC is not subject to constructive dividend treatment under Subpart F.

113. *See generally id.*
114. *See* Jeffrey Ryan, *An Analysis of the GATT-Compatibility of the New Foreign Sales Corporation*, 26 SANTA CLARA L. REV. 693, 715 (1986).
115. *See id.*
116. *See id.*
117. *See supra* Part III.
118. *See* CHARLES H. GUSTAFSON, ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS, 641 (1997).
119. I.R.C. § 957 (a).
120. *See* GUSTAFSON, ET AL., *supra* note 118, at 641.
121. *See* Hudec, *supra* note 17, at 1448.
122. *See id.*
123. *See id.*

However, if arm's length pricing were required in all transactions between the FSC and its suppliers (as previously discussed), then a U.S. shareholder would be required to declare a pro rata share of the FSC's foreign trade income under section 951(e).

The third and final exemption mentioned by the Panel was that the parent of an FSC is exempt from tax on dividends attributable to the FSC's foreign trade income.[124] The technique used to exempt part of the FSC's income is to deem it "foreign source income which is not effectively connected with the conduct of a trade or business in the United States."[125] Under I.R.C. section 245, a corporation is entitled to a one hundred percent dividends received deduction for distributions out of earnings and profits attributable to foreign trade income.[126] As for non-foreign trade income, the corporation is entitled to a seventy or eighty percent dividends received deduction, depending on the percentage of stock owned by the U.S. parent.[127] In effect, the exempt foreign trade income is not subject to U.S. tax, while the non-exempt foreign trade income is only subject to a single level of corporate tax at the FSC level.[128]

One solution would be to mandate the use of arm's-length pricing in all FSC transactions, to require the FSC's foreign trade income to be included in the Subpart F provisions, and to eliminate the one hundred percent dividends received deduction. However, modifying the tax provisions in this manner is not likely to preserve the tax benefits upon which U.S. corporations have come to rely. Further, it is not clear that such modifications would actually satisfy the Panel's objections to the FSC scheme. It appears that the Panel's major problem with the U.S. system is that it provides a complete exemption from taxation for certain income specifically related to exports. Although the U.S. generally taxes under the worldwide system, the U.S. has tried to incorporate principles of territoriality by not taxing the foreign source income of U.S. exporters. The rationale behind such a system is to alleviate the double tax and increase the competitiveness of U.S. exporters. However, double taxation only arises when the same income of the same taxpayer is subjected to taxes both in the source country and the residence country during the same period. The problem with the U.S. system is that a portion of an FSC's income is being completely exempt from tax by designating it as foreign source income not effectively connected with a U.S. trade or business. As a result, no U.S. or foreign

124. *See generally supra* Part III.
125. FSC Report, *supra* note 4, ¶ 4.169.
126. I.R.C. § 245.
127. *See* I.R.C. § 245.
128. GUSTAFSON, ET AL., *supra* note 118, at 679-80.

tax is being paid. The Panel seems to be implying that the U.S. cannot adopt a worldwide system of taxation for corporate income, and then selectively apply source principles to certain types of that income.

Another problem with the FSC rules is that they require insufficient foreign activity to be comparable to a territorial income tax system, and allow FSCs too much exempt income for the actual activities performed abroad.[129] However, the U.S. may be able to adhere to WTO rules and at the same time retain some of the benefits of its FSC scheme if the substance of the foreign management and economic process requirements were increased. One of the principal arguments made by the EC was that the FSC's foreign management and foreign economic process requirements were in reality a sham.[130] According to the EC, the foreign management requirements can be dealt with by holding meetings over the telephone and having service companies in the country of incorporation deal with the paperwork.[131] The EC argued that although the FSC must incur the costs of the foreign economic processes, the FSC does not need to perform these activities itself.[132] In addition, many states, trade associations, or private businesses sponsor "shared FSCs" for their companies, members or customers to reduce the costs of operating an FSC while still obtaining the full tax benefit.[133] The solution to these problems is to require the FSC to be more than just a paper corporation. In other words, the FSC should be required to maintain an actual office outside of the U.S., to hire local employees, and to conduct the export activities itself.

Further, the U.S. may be able to continue to encourage export activities by incorporating some territorial elements into its worldwide system of taxation. Such a system would not recognize the exempt status of income earned in tax havens, income earned in non-treaty countries, or passive income derived outside the U.S.[134] Also, the system would require that foreign branches be subject to income tax in the foreign

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129. *See* Phillip Jelsma, *The Making of a Subsidy, 1984: The Tax and International Trade Implications of the Foreign Sales Corporation Legislation*, 38 STAN. L. REV. 1327, 1356 (1986).

130. *See* FSC Report, *supra* note 4, ¶ 4.191.

131. *See id.* ¶ 4.192; *see also A US Loss at WTO*, JOURNAL OF COMMERCE, Aug. 5, 1999 (stating large banks that maintain offshore trust departments to shelter their clients' assets are among the principal FSC managers).

132. *See* FSC Report, *supra* note 4, ¶ 4.193. An agent (including a parent) can perform these activities on behalf of the FSC. *See id.*

133. *Id.* ¶ 4.197.

134. *See* Jelsma, *supra* note 127, at 1356.

country and foreign tax credits would not be available to offset the domestic taxes on non-exempt income.[135]

Any change in the U.S. provisions should be coordinated with the EU to avoid the situation that arose in the banana dispute.[136] In that case, the EU changed its banana trade regime only to find that the U.S. did not consider the changes acceptable.[137] According to EU Washington Chief of Mission, John Richardson, the EU would consider extending the deadline for the U.S. to comply with the WTO ruling "if the United States appears to be developing an acceptable replacement."[138]

B. Repeal the FSC Laws

Alternatively, the U.S. could repeal its entire FSC scheme. However, once Congress creates a tax benefit for one segment of society, it is nearly impossible to take that benefit away.[139] It is unlikely that U.S. corporations would be willing to give up the benefits from FSCs; according to congressional estimates, the tax breaks for U.S. companies would be more than $15 billion over the next five years.[140]

C. Accept Countervailing Duties by the European Communities

When the Dispute Settlement Body (DSB) confirms that a particular subsidy is prohibited, it must be withdrawn immediately.[141] However, if the offending subsidy is not withdrawn, the complaining country can take countermeasures.[142] If domestic producers are hurt by imports of

135. *See id.*
136. *See EU Offers to Extend Deadline for Eliminating FSCs*, CONGRESS DAILY (Feb. 25, 2000).
137. *See id.*
138. *See id.*
139. *See* Hudec, *supra* note 17, at 1504. The combined lobbying strength of the various industries makes it difficult to revoke a tax benefit. *See id.*
140. *See WTO Declares U.S. Tax Breaks on Exports Illegal*, NAT'L POST (Feb. 25, 2000).
141. *See generally Trading into the Future* ch. 3, Apr. 1999, *available at* http://www.wto.org; *see also,* JAMES CAMERON & KAREN CAMPBELL, DISPUTE RESOLUTION IN THE WORLD TRADE ORGANISATION 70 (1998). There is some debate as to the binding nature of a final ruling of the dispute settlement process. The question is whether the report creates an obligation to perform the recommendations of the Panel or whether complaining parties simply refuse to take action and accept retaliatory sanctions. At least one commentator has stated that the DS establishes a preference for an obligation to perform the recommendations of the Panel, and that compensation should be resorted to only if the immediate withdrawal of the offending measures is not practical. However, Article 22 does not expressly rule out compensation as a remedy for noncompliance.
142. *See Trading into the Future, supra* note 139, at ch. 3.

subsidized products, countervailing duties can be imposed.[143]

The FSC ruling follows several setbacks for the EC in the WTO. Since the EC did not modify its banana import rules or rescind its prohibition on the importation of hormone-treated beef, the U.S. has imposed retaliatory sanctions and punitive duties.[144] In retaliation for the EC's refusal to comply with the ruling against its ban on the import of hormone-treated beef, the U.S. imposed one hundred percent duties on $116.8 million of EC exports.[145] In April of 1999, the U.S. placed another $191 million in sanctions on EC goods after a favorable WTO ruling over the EC's banana-import rules.[146]

Assuming the U.S. can simply refuse to withdraw the offending subsides, the EC will have the right to levy additional countervailing customs duties against imports in an amount sufficient to offset the estimated damage of the subsidy (in this case the estimated subsidy provided by the FSC legislation). The stakes are much higher for the U.S. compared to previous disputes at the WTO, because the EC claims that FSCs are the largest export subsidy in the world trade system, costing approximately $2 billion annually.[147] The size of the FSC benefit could mean countervailing duties are widespread and big enough to considerably impact U.S. exports.

D. Negotiate a Settlement

It appears that the best solution for both parties would be to settle the FSC dispute as part of a broad deal that would take into account recent U.S. victories in the WTO. Given the importance of trade relations between the U.S. and the EU, it is in both parties' best interest to negotiate a mutually-beneficial settlement. According to U.S. Trade Representative Charlene Barshefsky, "[t]he European Union, as the world's largest economy outside the U.S., is in total America's largest trade and investment partner, the largest source of foreign direct

143. *Id.* Countervailing duties can only be charged after the importing country has conducted a detailed investigation. There are detailed rules for deciding whether a product is being subsidized, criteria for determining whether imports or subsidized products are hurting domestic industry, procedures for initiating and conducting investigations, and rules on the implementation and duration of countervailing measures. *Id.*

144. *See A Loss at WTO, supra* note 129, at 7.

145. *See id.*

146. *See id.*

147. *See* FSC Report, *supra* note 4, ¶ 4.283.

investment in the Unites States, and the largest destination for our own foreign direct investment."[148]

V. CONCLUSION

The U.S. has consistently maintained that the FSC regime merely places U.S. businesses on equal footing with their foreign competitors (by neutralizing the effect of territorial tax systems).[149] Under a territorial system that taxes according to the source principle, residents of a country are not taxed on their income from foreign sources and foreigners are taxed at the same rate as residents on income from domestic sources.[150] The U.S. contends that territorial tax systems provide more favorable treatment for exporters of goods and services than a worldwide system because income from export activities that occurs outside of the territory of the taxing jurisdiction is not taxed.[151] However, FSCs are usually subsidiaries of U.S. corporations that are based in tax havens with no or very low tax rates. Thus, it is difficult for the U.S. to continue to argue that the FSC regime is intended to incorporate principles of territoriality (as there is not really a double tax problem because the other country is not imposing a tax). Further, to the extent that there is a double tax, corporations have the availability of a foreign tax credit. In any event, the Panel essentially stated that the distinction between worldwide and territorial tax systems was irrelevant. The Panel agreed with the U.S. that it is not the business of the WTO to dictate the type of tax system that should be maintained by members.[152] Thus, the U.S. is free to maintain a worldwide tax system, a territorial tax system or any other system that it sees fit.[153] However, the Panel stated that the U.S. is not free "to establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim that it is entitled to provide such an export subsidy because it is necessary to eliminate a disadvantage to exporters created by the US tax system itself."[154] In other words, the U.S. would be

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148. Charlene Barshefsky, U.S. Trade Representative, American Trade Relations with the European Union Before the Trade Subcomm. of the House Ways and Means Comm. (Jul. 28, 1998). Barshefsky went on to state that in 1997, U.S. exports to the EU were $141 billion, while service exports to the EU were $77 billion. *See id.*

149. *See* FSC Report, *supra* note 4.

150. *See* FRENKEL, ET AL., *supra* note 7, at 28.

151. *See* FSC Report, *supra note* 4, ¶ 4.139.

152. *Id.* ¶ 7.122.

153. *See id.*

154. *Id.* Members are free to pursue their own domestic tax goals through international taxation, so long as they do so in a way that does not violate other commitments they have made in the WTO Agreements. *See id.*

permitted to tax corporate income under the source principle, but it cannot say that it is taxing worldwide income and then provide an exemption specifically related to exports. However, this is exactly what the U.S. has done with the FSC scheme.[155] The United States has consistently put the interests of U.S. exporters ahead of its responsibilities to other GATT members.

The U.S. has vigorously supported the WTO when decisions were in its favor. As U.S. Trade Representative Charlene Barshefsky stated in her testimony to Congress: "The WTO system was designed to help put. . .potentially explosive trade problems into a rules-based context . . . we will not tolerate non-compliance with trade agreements or WTO rules. . .and we will insist on timely and full implementation of these rulings."[156] Now that the WTO has ruled against the United States on the FSC issue, whether the United States chooses to abide by its vigorous defense of WTO rules remains to be seen.

BRENDA O'LEARY

155. *See* Hudec, *supra* note 17, at 1501. The announced purpose of the FSC was to change the DISC to make it GATT-compatible, while changing its substance as little as possible. *See id.*

156. Barshefsky, *supra* note 146.