Boston University International Law Journal

Spring, 2002

20 B.U. Int'l L.J. 1

ARTICLE: HOW A TAXING PROBLEM HAS TAKEN ITS TOLL: A COMMON PERSON'S GUIDE TO AN INTERNATIONAL TAXATION DISPUTE

NAME: Marc Rosenberg*

I. Introduction

A. The General Agreement on Tariffs and Trade

Even before the end of World War II, allied officials led by the British and Americans were laying plans for a postwar international economic order that would avoid the disasters of the previous inter-war period. n1 These visionary creators of the Bretton Woods new economic order, which included the IMF, the World Bank, and the GATT, were inspired by the lesson of the inadequacies of existing institutions. n2 The allies desired an economy free of both blatant and hidden types of protectionism that hinder the efficient production and distribution of goods to the people. Therefore, when they drafted the General Agreement on Tariffs and Trade ("GATT"), n3 Article I expressly provided:

Any advantage, favor, privilege or immunity granted by any Contracting Party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other Contracting Parties. n4

In other words, similar foreign and domestic products must be treated equally in the market by each country. A country cannot tax a foreign product without taxing their own similar product; nor can they exempt their own country's products from taxes while not exempting another country's similar product. n5

The GATT also forbids a government from using subsidies to bolster exports. Under Article XVI:4, contracting parties cannot grant any form of subsidy on the export of any product that results in the product selling at a lower price than the comparable price charged for the like product to [*3] buyers in the domestic market. These rules were created in order to assure fair and impartial trading among nations.

Over time, the GATT evolved into more than a body of substantive international law governing the trade of goods. GATT also became an institution for multinational trade negotiations, the study of trade problems, the formulation of principles to guide members in the resolution of those problems, and for dispute adjudication. n6

In 1994, the Agreement Establishing the World Trade Organization was signed in Morocco as a result of the Uruguay Round of Multilateral Trade Negotiations. n7 The Agreement established the World Trade Organization ("WTO") to administer the new multilateral trading system. The WTO administers trade agreements, acts as a forum for trade negotiations, settles trade disputes, and reviews national trade policies. n8 The WTO has over 140 members that negotiate and sign agreements that form the basis for this trade system. n9 These agreements provide the legal ground rules for international commerce, guarantee member countries important trade rights, and require governments to keep trade policies within agreed upon limits. n10

The Agreement also conferred upon the WTO a form of juridicial status. n11 GATT disputes were originally settled in a relatively informal manner. With the creation of the WTO, however, a new dispute settlement procedure was implemented and set out in a detailed agreement known as the "Understanding on Rules and Procedures Governing the Settlement of Disputes" ("DSU"). n12 The dispute settlement process focuses on interpreting agreements and ensuring that the various countries' trade policies conform to these agreements. n13 The DSU made rulings 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 ruling. n14

[*4] Understanding the dispute resolution mechanism of the WTO is important in reviewing a dispute that arose between the United States and other parties as a result of development in the United States of an international taxation system. The European Union ("EU"), believing portions of the U.S. international taxation system violated the GATT, brought their grievances before the WTO. This dispute has continued for decades as the United States has repeatedly revised its tax legislation in an attempt to both comply with the GATT and keep U.S. business from being disadvantaged in the global economy.

B. Methods of Taxation

There are basically two methods by which nations tax income. The first is the residence principle, or the worldwide system, in which the government claims jurisdiction over the individual based on the taxpayer's residence. Under the residence principle, a country taxes the worldwide income of persons subject to its jurisdiction regardless of the income's source. n15 The second method is the source principle, or the territorial system, in which the government claims jurisdiction over the activity or source that produces the income. n16 Under the source principle, a country taxes income earned within its borders. n17 In other words, residents of the home country are not taxed on their foreign source income. n18

If all countries adhered to the same principle, there would be no double taxation problem. n19 But countries may adopt a mixture of these two jurisdictional grounds, n20 and this can lead to double taxation of the same income. Many countries have developed specific methods in an attempt to avoid or mitigate the double taxation that arises when one country's tax on residence income is duplicated by another country's tax on the source of that income. n21 The effects of double taxation may be mitigated by 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. n22 Unfortunately, as we shall later see, these same circumstances may also provide opportunities for tax avoidance or evasion.

[*5]

1. The Value-Added Tax

One taxation system used in various parts of the world is the value-added tax ("VAT"). The VAT is an indirect tax based upon the value added to a product at each stage of production. n23 Ronald Sernau explains the VAT through a simple illustration similar to the following example. n24 Suppose A Corp. sells its product, widget material, to B Corp. at a price of $ 2. Then B Corp. manufactures and sells its product, widgets, to C Corp. for $ 10. Finally, C Corp. packages and sells the finished product, box-o'-widgets, to the ultimate consumer for $ 20. The government would impose the following VAT:

[tdm'Stage of Production',ql [tcg1m,m'Selling Price',qc [tcg1m,m'Cost of Purchases',qc [tcg1m,m'Value Added',qc] Stage of Production Selling Price Cost of Purchases Value Added [tu3;4] A Corp. $ 2 $ 0 $ 2 B Corp. $ 10 $ 2 $ 8 C Corp. $ 20 $ 10 $ 10 [tu3;4] Total Value Added $ 20

At a VAT rate of 10%, A, B, and C will pay $ 0.20, $ 0.80, and $ 1.00, respectively, as VAT to the government. Then A will bill B $ 0.20 for the VAT, B will bill C $ 1.00 ($ 0.80 for which B is liable plus $ 0.20 paid to A), and C will bill the ultimate consumer $ 2.00 ($ 1.00 for which C is taxed plus $ 1.00 paid to B). Each seller expressly indicates the amount of VAT; the tax is not hidden in the product's sales price. n25

"The GATT rules do not prohibit encouraging exports by exempting exporters from indirect tax or by remitting previously paid indirect tax." n26 The government may exempt an exporting company subject to VAT from the tax on the value the exporter added to the product. In addition, the company may rebate the VAT that the exporter paid to its supplier. Organizations that currently interpret the GATT maintain the position that an indirect tax does not have an impact on export prices because the exporter shifts the tax benefit forward to the foreign consumer by a reduction in the export price. n27

[*6]

2. United States Taxation, and Some Early History

A tax on a person or a corporation, rather than a product or item, is called a direct tax. n28 The U.S. taxation system is based on direct taxation of persons and corporations. In fact, the United States taxes all of its citizens on their worldwide income. n29 Even if a U.S. taxpayer is not physically present in the United States, and all of his income is from foreign sources, that citizen must still pay tax on this income. n30 Nevertheless, the United States will often forgo the right to tax income from sources outside its borders in favor of the country where such income is earned by allowing a credit against the U.S. tax for foreign taxes paid on that income. n31

Prior to the Revenue Act of 1962, the income of a foreign subsidiary of a U.S. parent company was never subject to U.S. tax. n32 The U.S. parent company was able to defer payment of U.S. tax on any profits derived by the foreign subsidiary until it received these profits as dividends or it sold the stock of the subsidiary. n33 This system of deferral was based on the view that the foreign income of the foreign subsidiary of a U.S. parent, earned by the efforts of that subsidiary and not those of the U.S. parent, was foreign source income of a foreign entity and, theoretically, not within U.S. tax jurisdiction. n34

At that time, corporations could exploit the lack of clear rules regarding how much of the profits were attributable to the parent company and how much were attributable to the subsidiary, and some companies used this method to accumulate income in the foreign subsidiary that was properly the subject of U.S. taxation. n35 For example, a U.S. parent company could incorporate a subsidiary in a country with a tax rate lower than the U.S. without the intent of conducting active business in that country. The subsidiary could handle the export business of the U.S. parent company through a branch of the subsidiary in the country where the goods were destined. The parent company could manipulate the price of the goods charged in the transfer to the subsidiary, allowing the parent company to maximize profits in the subsidiary. The enterprise would [*7] benefit from the local tax rates abroad until the subsidiary repatriated the profits in the form of dividends to the parent company. n36

The Internal Revenue Service Tax Code ("IRC") contains anti-abuse sections that prevent actions such as moving to tax havens or permanently deferring repatriation. n37 In 1962, Congress enacted Subpart F of the Internal Revenue Code in an attempt to curtail provisions that provided companies with the opportunity to create tax havens to reduce their tax liabilities. Subpart F established the concept of a controlled foreign corporation ("CFC"). n38 A CFC is a foreign corporation in which U.S. shareholders own or control more than 50% of the voting stock. n39 Under Subpart F, the U.S. shareholders of a CFC are subject to current taxation on their proportionate shares of the CFC's Subpart F income n40 and of the increase in the CFC's corporate earnings invested in U.S. property. n41 Subpart F attempts to address the tax haven problem by attributing the income of the CFC to the U.S. shareholders. n42 One problem, however, is that the elimination of deferral in these cases is arbitrary and the tax avoidance it seeks to prevent is often avoidance of foreign, not U.S., taxes. n43

For example, suppose Company A manufactures widgets for use in Zimbabwe. Company A is a French corporation owned 75% by U.S. shareholders and 25% by French citizens. Company B also manufactures widgets for use in Zimbabwe, but the French corporation is wholly owned by French citizens. A and B both sell widgets to their subsidiaries at the same cost. The subsidiaries resell the widgets and reinvest their profits. Under Subpart F, because both Company A and its sales subsidiary are CFC's, the U.S. shareholders of A would be taxed on 75% of the profits of the sales subsidiary. The shareholders of B would not be subject to a similar tax. The result imposes a substantial tax burden on the American-controlled company because only French, and not American, tax is avoided by the American shareholders.

A second taxation problem also arose in the post-World War II corporate context. There had been a large increase in the number of foreign manufacturing and marketing subsidiaries as part of the post-World War II international economic growth. The creation of these foreign subsidiaries [*8] placed income derived from foreign operations outside of U.S. tax jurisdiction. The IRS reacted by using section 482, a long dormant section of the tax code that authorized the IRS to consolidate accounts of related businesses and apportion income among them. n44

A new office, the Office of International Operations, was formed to encourage compliance with the international tax rules through an intensive audit procedure. n45 Through the Office of International Operations, the U.S. government quickly became active in using section 482 to make international pricing adjustments; n46 however, the lack of any concrete guidelines left the IRS without a means by which to determine objectively the allocation of income. n47 The somewhat arbitrary reallocation of income by the IRS resulted in a threat of double taxation.

By way of illustration, assume U.S. company A sells widgets which it manufactured to its wholly owned sales subsidiary in France, company B. If a section 482 allocation increases A's income by $ 1000, that income will be taxed twice, once to B by France, and once to A by the United States, unless B's income for France tax purposes is correspondingly decreased by $ 1000. Although the United States had signed agreements with many of its major trading partners to prevent double taxation, they were not effective in relieving the double taxation arising out of a section 482 allocation for several reasons. n48

First, under the income allocation rules of the foreign country, the taxpayer's original allocation may be perceived as correct. One commentator has stated that "it is almost an axiom of international taxation that no taxing jurisdiction will agree to reduce the amount of income subject to its tax merely because another taxing jurisdiction has allocated additional income to a related entity." n49 Second, because the IRS audits often are conducted several years after the foreign subsidiary has paid its local income tax, any recovery from the foreign country may be barred by that country's statute of limitations. n50 Third, the taxpayer also may be discouraged from seeking a refund in the foreign country by foreign language and currency complexities and physical distance problems that complicate the problems of proof. n51

Until 1971, U.S.-based exporters paid taxes on their income on a worldwide basis while the territorial tax systems of a number of European countries, including Belgium, France, and the Netherlands, [*9] exempted income earned outside the country's territorial limits. n52 The United States believed that the indirect taxing systems of these European countries put the United States at a disadvantage in international trade by allowing these countries to sell products at artificially lower prices than the United States, thereby discouraging U.S. exports. The United States subsequently enacted a series of tax legislation in an attempt to level the playing field.

II. Domestic International Sales Corporations ("DISC")

In 1969, Congress enacted the Domestic International Sales Corporation ("DISC") legislation. This legislation allowed domestic international sales corporations to enjoy some tax deferral on export sales. n53 The DISC legislation attempted to create a partially territorial approach to taxation, similar to those used in Europe, where the availability of VAT rebates along with territorial taxing schemes make non-U.S. goods cheaper than those manufactured in the U.S. n54 Put simply, Congress intended to reproduce the tax incentives for export sales under the territorial tax systems without enacting the system itself n55 in order to put U.S. corporations on an equal footing with their European counterparts and to promote the export of U.S. goods. n56

A DISC is a domestic corporation, a substantial portion of whose gross receipts arise from, and whose assets relate to, exporting activities. n57 The DISC legislation generally provides that U.S. corporate tax is deferred on a portion of a DISC's export related income, and that the profits of a DISC are not taxed to the DISC, but are instead taxed to the shareholders of the DISC when the profits are distributed or deemed to be distributed to them. n58 Generally, most of the tax on a DISC can be deferred indefinitely until either (1) the income is actually distributed to the DISC shareholders, (2) a shareholder disposes of a DISC stock, (3) the DISC is liquidated, (4) the stock of the DISC is distributed, exchanged or sold, (5) [*10] the corporation ceases to qualify as a DISC, or (6) the DISC election is terminated or revoked. n59

Upon enactment of the DISC legislation, a dispute arose immediately between the United States and certain countries in the EU. n60 The EU regarded the DISC legislation as an illegal export subsidy in violation of the GATT. n61 The EU alleged that the DISC was illegal because "it allowed indefinite deferral of direct taxes on income from exports earned through business activity conducted in the United States." n62

The United States responded that the DISC regime resulted in similar incentives for exports as those achieved by the portions of the VAT systems of Belgium, France, and The Netherlands that had been found to be consistent with the GATT in the Panel's 1981 Decision. n63 In 1976, a GATT Panel determined that both the DISC legislation and certain export tax practices of Belgium, France and The Netherlands had some characteristics of an illegal export subsidy. n64 The United States resisted adoption of the panel report until 1981, when the GATT Council also made a declaration that included the following language: n65

The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes <elip> 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. n66

Believing this was a binding interpretation of the GATT, the United States began the process of revising its tax system in conformity with these guidelines. n67

[*11]

III. Foreign Service Corporations

A. Enactment of Foreign Service Corporation Legislation

The United States never conceded that the DISC regime violated the GATT; however, it did adopt the GATT Panel's 1981 report on the DISC and attempted to comply with the findings of the report. Basically, the report provided that GATT signatories were not required to tax export income attributable to economic processes located outside of their territorial limits, as long as "arms length" pricing principles are observed in transactions involving domestic exporters and foreign buyers under common control. n68 In addition, the Panel's 1981 decision held that the GATT does not prohibit the adoption of measures in order to avoid double taxation of foreign source income. n69

The United States believed that, if legislation were to be enacted regarding tax exemptions for U.S. exports, the legislation would have to contain certain basic protections in order to avoid any violation of the GATT as it was interpreted in the 1981 GATT ruling. Thus, any legislation would have to: (1) be income attributable to economic processes located outside of the U.S. limits, (2) observe "arms length" pricing principles in transactions involving domestic exporters and foreign buyers under common control, and (3) adopt specific measures to avoid double taxation of foreign source income. The United States took great care in revising the tax code and replaced the DISC legislation during the mid-1980s. The DISC legislation was not completely repealed, but it was modified to eliminate certain aspects that the Panel had found to be objectionable under the GATT. After much review, the United States enacted the legislation creating Foreign Service Corporations ("FSC"). The United States felt that the FSC legislation promoted U.S. exports while at the same time complying closely with its treaty obligations under the GATT. n70 A FSC is a foreign corporation set up by a U.S. parent corporation in order to handle export activities. n71 Generally, a FSC is a wholly owned subsidiary of a U.S. producer and sells the products supplied by its U.S. parent corporation. n72

If a corporation qualifies as a FSC, a portion of the corporation's foreign trade income is exempt from U.S. taxation. n73 The IRS treats the exempt foreign trade income as not connected with the conduct of a U.S. trade or business and, therefore, not taxable in the United States. n74 The [*12] exempted portion of the foreign trade income can then be distributed as a tax-free dividend to the U.S. parent corporation. n75

According to U.S. taxation principles, domestic corporations are generally taxed on their worldwide income regardless of whether the income is derived from domestic or import activities. On the other hand, foreign corporations are sometimes exempt from tax on income derived from their export earnings when the foreign corporation is located in a foreign country. It is easy to see the benefits of organizing a FSC when domestic corporations are taxed on a world-wide basis and foreign corporations are exempt from taxation on certain of the same types of income.

B. The Formal Requirements for FSC Status

Before being permitted to qualify as a FSC, the corporation must meet the exacting requirements laid out in Internal Revenue Code ("IRC") sections 921 - 927. The first step in making the FSC compliant with the 1981 GATT Council ruling was to assure that any income was attributable to economic processes located outside of the United States. Unlike a DISC, a FSC must have an adequate foreign presence as defined in IRC section 922. n76 This meant that U.S. corporations wishing to avail themselves of FSC tax incentives would need to set up actual offices in foreign countries, under foreign laws, that were managed by foreign representatives, and which kept the money in a foreign account.

In addition, the property sold must satisfy various tests designed to ensure that the FSC tax incentive is only for property that is manufactured in the U.S., using primarily U.S. content, and then sold to customers outside the U.S. n77 "After all, Congressional intent was to encourage (and not discourage), through this tax incentive, the export of U.S.-manufactured goods, not the export of foreign-manufactured goods or goods with substantial foreign content." n78

1. Definition of FSC & Foreign Trading Gross Receipts

According to IRC section 922, a FSC is a corporation organized under the laws of a qualifying foreign country or possession of the United States, with a board of directors that must include at least one individual who is not a resident of the United States, and that has elected to be treated as a FSC for the tax year. n79 The FSC must not be a member of any controlled group of corporations of which a DISC is a member. n80 At no time in the taxable year may the FSC have more than 25 shareholders [*13] or outstanding preferred stock. n81 The FSC must maintain a set of permanent books of account, including invoices, in the country of its organization, as well as maintain required records at a location within the United States. n82

To be exempt, the income of the FSC must be "foreign trade income," meaning that the income must be attributable to "foreign trading gross receipts." n83 Under IRC section 924(a), foreign trading gross receipts includes income:

(1) from the sale, exchange, or other disposition of export property,

(2) from the lease or rental of export property for use by the lessee outside the United States,

(3) for services related and subsidiary to any sale, exchange, or other disposition of export property, or any lease or rental of export property by such corporation,

(4) for engineering or architectural services for construction projects located outside the United States, or

(5) for the performance of managerial services for an unrelated FSC or DISC in furtherance of the production of foreign trading gross receipts described in paragraphs (1) - (3). n84

Also, in order for income to be considered from foreign trading gross receipts, the management of the FSC and the transactions from which the income is earned must take place outside of the United States. n85 The management of a FSC meets these requirements if: (1) all meetings of the board of directors and shareholders of the corporation are outside the United States, (2) the principal bank account of the corporation is maintained in a foreign country which meets the proper requirements, and (3) all dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the corporation disbursed during the taxable year are disbursed out of bank accounts of the corporation maintained outside the United States. n86

There are two alternative methods available to determine whether the transactions from which the income is earned are considered to take place outside of the United States. To be exempt from taxation under either alternative, the expenditure of money must be attributable to activities performed outside the U.S. (foreign direct costs), n87 and must fall into one of the categories of activities relating to the disposition of export property. There are detailed lists regarding what can and cannot be included under each broad category, but in general the categories of [*14] activities relating to the disposition of export property include: (1) advertising and sales promotion, (2) processing customer orders and arranging for delivery of the export property, (3) transportation from the time of acquisition by the FSC to the delivery to the customer, (4) determination and transmittal of a final invoice or statement of account and the receipt of payment, and (5) the assumption of credit risk. n88

The first alternative is met if the corporation or its agent has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction, and the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50% of the total direct costs attributable to the transaction. n89

The second alternative is the 85% test. A corporation is treated as satisfying the requirements with respect to any transaction if, with respect to each of at least two of the five categories listed above, the foreign direct costs incurred by such corporation attributable to activities described in such paragraph equal or exceed 85% of the total direct costs attributable to activities described in that paragraph. n90

Several transactions are not considered foreign trading gross receipts, even if they meet all of the above stated requirements. Under IRC section 924(f), the term "foreign trading gross receipts" does not include receipts of a FSC from a transaction if:

(A) The export property or services are either for ultimate use in the United States, or are for use by the United States or a U.S. instrumentality, and such use of export property or services is required by law or regulation;

(B) The transaction is accomplished by a subsidy granted by the United States or any U.S. instrumentality;

(C) Such receipts are from another FSC which is a member of the same controlled group of corporations of which such corporation is a member; or

(D) The term "foreign trading gross receipts" shall not include any investment income or carrying charges.

If a FSC satisfies the transaction requirements provided in IRC section 924 by "<elip>engaging in export related activities, under foreign management, with foreign economic processes, [a] portion of the foreign trade income is 'exempt foreign trade income' and not subject to U.S. taxation." n91 The income is exempt because, if it satisfies all of the conditions of compliance with the statute, the income is considered foreign source [*15] income that is not effectively connected with the conduct of a trade or business in the United States. n92

2. Pricing Rules

A second requirement for FSC status is that the U.S. corporation must make sure that the "transfer price" of its products meets certain standards of fairness. In other words, the domestic corporation cannot sell the export products at a vastly under-or over-priced cost to the foreign corporation, but must instead price the goods at a reasonable rate. This is accomplished by either of two methods.

The first method available to the FSC in determining the foreign trade income is the "arm's length pricing" method. In the arm's length method, the method of determining the foreign trade income of the FSC is to treat the FSC as if it were an independent party buying the exported goods from the U.S. producer at a price that other independent parties might have agreed to in dealing at arm's length. n93 In this case, the foreign trade income is determined by reducing the foreign trade gross receipts by the amount of the arm's length transfer price.

The second method available to the FSC in determining the foreign trade income is the "administrative pricing rules" method. n94 The code provides several different rules to choose from, and the FSC is allowed to choose the most beneficial method. The choice of one of the administrative pricing formulas will often permit more foreign trade income to be put into the FSC than the arm's length method. n95 The foreign trade income for the administrative rules method is determined by reducing the foreign trading gross receipts by the administrative transfer price that the FSC has chosen. n96

After the foreign trade income for the FSC has been determined, a calculation is made to ascertain what portion of this income is exempt from U.S. taxation. n97 When using the arm's length pricing method, if the shareholder of the FSC is a U.S. corporation, 30% of the FSC's gross foreign trade income is exempt foreign trade income; otherwise 32% is exempt. n98 When using the administrative rules method, if the shareholder of the FSC is a U.S. corporation, then 15/<23> of the foreign trade income derived from the transaction is exempt from U.S. taxation; otherwise, 16/<23> qualifies for exemption if the shareholder is not a U.S. corporation. n99

[*16] Domestic corporations are entitled to a 100% dividends-received deduction for distributions out of earnings and profits attributable to foreign trade income, other than Section 923(a)(2) non-exempt income. n100 U.S. corporations that own less than 20% of the FSC in both vote and value of the stock are entitled to a 70% dividends-received deduction on dividends attributable to a FSC's "effectively connected income." n101 Individual shareholders, however, are not entitled to a dividends-received deduction. n102

IV. The EU Lodges a Complaint Against FSC Legislation

A. The EU Argument

The EU has opposed the FSC regime since it was first enacted in the mid-1980s. n103 The original complaint lodged by the EU alleged that the FSC legislation violated the GATT 1994, the WTO Agreement of Subsidies and Countervailing Measures ("ASCM"), and the WTO Agreement on Agriculture ("AA"). On November 18, 1997, the EU requested consultations with the United States pursuant to Article IV of the DSU. n104

The EU and the United States held consultations in December 1997 and February and April of 1998, but failed to reach a mutually satisfactory solution. On July 1, 1998, the EU requested the establishment of a panel under Article VI of the DSU, Article IV of the ASCM, Article XIX of the AA, and Article XXIII of GATT 1994. n105 The Dispute Settlement Body ("DSB") granted the request and established a panel to examine the following issues:

(1) Were FSC provisions subsidies contingent upon export performance within the meaning of Article 3.1(a) of the Agreement on Subsidies and Countervailing Measures (ASCM)?

(2) Were FSC provisions subsidies contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the ASCM?

(3) Were the FSC provisions in violation of the Agreement on Agriculture (AA) by granting subsidies in excess of its reduction commitments? n106

[*17]

1. Claims under Article III:1(a) of the ASCM

In the first argument presented to the WTO Panel, the EU alleged that FSC subsidies included both tax exemptions and the availability of special administrative pricing rules for calculating exempt foreign trade income. n107 The first exemption related to the application of formulaic rules for determining whether a FSC's income came from a domestic or foreign source. n108 Under section 882(a) of the IRC, only income "effectively connected with a trade or business in the United States" is taxable to a foreign corporation. However, section 921 provides that "exempt 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," and section 923 provides the rules for determining exempt foreign trade income. The EU argued that this income would be taxable by the United States if not for the FSC provisions.

The second exemption discussed the exclusion of foreign trade income of a FSC from the controlled foreign corporations provisions of Subpart F of the IRC. n109 U.S. corporations conducting business abroad through a separate foreign corporation generally do not pay U.S. tax on income that is not effectively connected with a U.S. trade or business until that income is repatriated back to the U.S. As discussed earlier, Subpart F was enacted in order to prevent taxpayers from shifting their investments to low-taxing jurisdictions. U.S. shareholders holding stock in controlled foreign corporations must include their pro rata share of the foreign corporations' undistributed income in their gross income; however, foreign trade income of a FSC is exempt from the Subpart F regime. Thus, the parent of a FSC does not need to report undistributed income from the FSC that would otherwise be subject to immediate taxation.

The third exemption related to the tax treatment of dividends paid by a FSC to its parent. n110 Under section 245(c) of the IRC, shareholders of a FSC received a 100% deduction for the dividends distributed out of earnings from foreign trade income. Generally, dividends received by a U.S. corporation, derived from the foreign source income of a foreign corporation, are taxable. However, the parent of a FSC is not required to pay taxes on dividends attributable to the foreign trade income of a FSC.

The Panel concluded that the FSC exemptions constituted an illegal export subsidy within the meaning of Article III:1(a) of the ASCM, which prohibits subsidies contingent upon export performance. n111 The Panel began by considering whether the exemptions identified by the EU were subsidies within the meaning of Article I:1 of the ASCM. For a subsidy to exist under Article I:1, there must be a financial contribution by a government [*18] and a benefit must be conferred.

The Panel determined that "viewed as an integrated whole, the exemptions provided by the FSC scheme represent a systematic effort by the U.S. to exempt certain types of income which would be taxable in the absence of the FSC scheme." n112

After concluding that the various exemptions, as a whole, resulted in a financial contribution by a government within the meaning of Article I:1(a)(2)(ii) of the ASCM, the Panel found that a benefit was clearly conferred, as FSCs and their parents would not need to pay taxes otherwise due. n113 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 III:1(a). Under section 924 of IRC, FSC foreign trading gross receipts only arise from the sale or lease of "export property" or from the sale or lease of services relating to such property. According to the Panel, the various exemptions under the FSC regime conferred a subsidy that is contingent upon export performance, because (1) the subsidy was only available with respect to foreign trading income; (2) foreign trading income arose 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 was limited to goods manufactured, produced, grown, or extracted in the U.S. that were held for use or consumption outside of the country. n114

2. Claims under Article III:1(b) of the ASCM

The EU also argued that the FSC was a subsidy contingent upon the use of domestic over imported goods within the meaning of Article III:1(b) of the ASCM, because the tax exemptions under the FSC provisions were limited to income from the export of products for which not more than 50% of the fair market value was attributable to imported articles. n115 The Panel declined to make findings with respect to this issue, concluding that neither party had explored the legal issues relating to this claim. n116

3. Claims under the Agreement on Agriculture

As its final argument, the EU claimed that the FSC constituted an export subsidy under Article IX:1(d) of the AA by providing exports in excess of the U.S. export reduction commitments. n117 The Panel determined that the FSC provisions fell within the scope of Article IX:1(d) [*19] because subsidies were provided for the purpose of reducing the costs of marketing exports of agricultural products. n118

4. Current EU Concerns: DISC Forgiveness and Further Considerations

FSCs are often incorporated in tax havens where no income tax is paid, so distributions from FSCs to parent corporations are often exempt from U.S. and local taxation. The EU believes that since the FSC is de facto exempt from all taxation, U.S. exports and companies that benefit from the FSC do not experience the same market forces faced by foreign competitors.

The EU agrees that the U.S. may grant a tax credit for income taxes paid abroad, but they argue that the FSC tax break is illegitimate because it is not contingent on any foreign income tax payments. The EU argues that the U.S. tax code provisions amount to an unfair export subsidy that favor exports over like products sold for domestic purposes because it grants a tax benefit only to exports. Therefore, the EU believes that FSCs violate GATT and the ASCM. n119

The EU is also concerned that "the FSC scheme subsidizes U.S. exports across the board, covering the entire manufacturing industry, computer software, and even agricultural products." n120 A wide range of manufactured products benefit from FSC tax treatment, including non-electrical machinery, chemicals, electrical machinery, and transportation equipment. However, the largest non-manufactured products or service to receive the benefits of the FSC regime are grains and soybeans. n121 Due to what the EU considers subsidies on these agricultural products, the EU also believes that the U.S. has violated the WTO AA.

The most contentious provisions of the FSC actually concern accumulated DISC income earned before January 1, 1985, as tax exempt, if the corporation distributed the income to its shareholders after December 31, 1984, and it had been a DISC on December, 31, 1984. n122 The EU feels that by forgiving the deferred taxes of DISCs, the U.S. enlarged the size of what the EU claims was already an illegal export subsidy. U.S. exporting companies stand to gain $ 10-13 billion from the forgiveness of these taxes. n123

Before passage of the legislation, exporters lobbied Congress heavily and argued that "the collection of DISC-deferred tax would overburden [*20] industry and result in fewer American exports." n124 The exporters argued that the DISC deferrals should be exempted because the funds had already been invested in capital assets, and their repayment would overburden industry. For example, the exporters argued to the House Ways and Means Committee that:

deferred taxes do not exist in separate bank accounts but in many instances in the form of bricks and mortar and other liquid assets. So a tax on DISC-deferred income would be nothing more than a tax on current U.S. production and employment in the U.S. and should be recognized as such. DISC-generated investments were made on the basis of assurances by successive Administrations that DISC deferrals were intended to continue so long as invested in export assets <elip> . To tax these deferrals retroactively would unjustifiably penalize U.S. exporters who in good faith have followed the requirements of the DISC statute over the years. n125

B. The United States Argument

"The U.S. position has consistently been that the FSC regime is not an illegal export subsidy." n126 The U.S. argument that the FSC legislation is consistent with the ASCM rested primarily on the second and fifth sentences of Annex I, footnote 59 of the ASCM. n127 The relevant provisions provide:

[2] The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their own or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length.

[5] 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. n128

The United States contended that Sentence 5 of footnote 59 acts as a limitation on the definitions of "subsidy" in Article I:1 and "export subsidy" in Article III:1 of the ASCM. n129 Therefore, the United States argued, a nation whose tax system employs a procedure providing for certain tax credits can provide an exemption with respect to income from [*21] export activities if it a measure whose purpose is to avoid double taxation. n130

To support its interpretation of the footnote 59 provisions, the United States relied on the GATT Council action of 1981 that had resolved the previous disputes between the United States and the EU involving the DISC legislation. n131 The Council's earlier ruling had provisions similar to the United States' interpretation of footnote 59. After all, the GATT Council had held that economic processes located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country, that such transactions must observe arm's-length pricing, and that Article XVI:4 does not prohibit the adoption of measures to avoid the double taxation of foreign source income. n132 In other words, where arm's-length pricing schemes have been observed, the exporting country can consider activity from economic processes outside of its borders as foreign source income and take steps to avoid double taxation.

C. The WTO Decisions

The WTO Panel issued its opinion on October 8, 1999. n133 The WTO Panel agreed with the EU that the FSC tax exemptions were an improper export subsidy under Article III:1(a) of ASCM and AA. n134 In its opinion, the WTO labeled the FSC legislation as an illegal export subsidy and "called for the FSC to be dismantled by October 1, 2000." n135 The DSB "automatically" adopts reports of the Panel unless there is a unanimous decision to the contrary. n136 Within 30 days after the report's adoption, the losing party is required to notify the DSB of its intentions to comply with the results or file an appeal with the Appellate Body, established to review issues of law and legal interpretations by the Panel. On November 26, 1999, the United States notified the DSB of its intention to appeal certain issues in the Panel Report. n137 The EU filed a cross-appeal on December

7, 1999. The appeal raised two issues included in the original [*22] complaint but not addressed by the WTO panel in its report: (1) administrative pricing and (2) the U.S. content requirement. n138

The Appellate Body issued its final report on February 24, 2000. Concluding that the FSC measures did indeed constitute an export subsidy, the Appellate Body of the WTO would not examine the strongest contention of the United States, that FSC activity was not a violation because it was protected under footnote 59, sentence 5's exclusion for purposes of avoidance of double taxation. n139 The Appellate Body felt that they were restrained from addressing questions raised by this argument by Article XVII:6 of the Understanding on Rules and Procedures Governing the Settlement of Disputes. n140

Article XVII:6 confines the Appellate Body to considering either "issues of law covered in the panel report" or "legal interpretations developed by the panel." The Appellate Body felt that the argument of the United States would require the examination of "whether the FSC legislation was intended to avoid double taxation and, if so, whether the legislation fell outside the general prohibition of export subsidies" - two legal questions which were not addressed by the WTO Panel that heard the initial case. n141

As for the U.S. contentions regarding the interpretation and scope of the ASCM as determined by the 1981 GATT Council action involving the DISCs, the Appellate Body cited a previous decision that held that adopted panel reports are only binding upon parties to the dispute and do not constitute binding decisions for later cases involving different parties. n142

The Appellate Report upheld the Panel's findings that the FSC measures constituted an illegal export subsidy under Article III:1(a) of the ASCM Agreement, but reversed the Panel's findings that the U.S. had acted inconsistently with its obligations under Article III:3 of the AA through the provision of subsidies to reduce the costs of marketing exports. n143 However, the Appellate Body did find that the United States had acted inconsistently with its obligations under Articles X:1 and VIII of the AA by applying export subsidies that lead to the circumvention of its export subsidy commitments, with respect to agricultural products. n144

The issuance of this Appellate Body Report and the relevant WTO rules regarding resolution of disputes resulted in the U.S. government facing pressure to amend portions of the IRC or face punitive sanctions [*23] imposed by the EU. n145 After a final report is issued, the losing country must follow the recommendations of the DSB within a reasonable period of time. n146 Alternatively, a country may enter into negotiations with the complaining country to determine mutually acceptable compensation. 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, and the DSB will grant this authorization within thirty days unless there is consensus against the request. n147

In this case, the Appellate Body recommended that the DSB request the United States to withdraw the FSC subsidies without delay and to conform its FSC regime to its obligations under the AA. n148

D. Events Occurring Since the Appellate Body Decision

On February 24, 2000, the United States lost its appeal of the Panel Ruling. n149 On March 20, 2000, the Settlement Body held that the U.S. FSC provisions constituted an illegal export subsidy and violated the ASCM. n150 The U.S. was given until September 1, 2000 to repeal its FSC provisions or face trade sanctions from the EU. n151

On May 2, 2000, the United States presented the EU with a proposal to revise the FSC by exempting only a portion of all foreign-source income from branches of qualified U.S. firms from tax, not just exports. n152 The EU notified the United States in late May that it would not accept the proposal. On July 27, the House Ways and Means Committee approved a replacement for the FSC that would provide an export tax benefit similar in size to FSC, but that would also include a partial tax exemption for income from foreign operations. n153 The Administration and U.S. exporters support this measure; however, on August 31, the EU notified the United States that it considered the proposal not to be WTO-compliant. n154

In September 2000, American negotiators and their EU counterparts met and agreed to extend to November 1, 2000 the deadline for U.S. [*24] compliance. n155 In November 2000, Congress passed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ("FSC Repeal Act"). n156 The United States chose to repeal the FSC, n157 but did so by enacting new legislation that extended existing provisions by providing a broad exclusion for all "qualifying foreign trade income," whether the goods that give rise to such income are manufactured in or outside of the United States, and whether the taxpayer is an individual or a corporation. n158

President Clinton signed the FSC Repeal Act into law in November 2000. The President explained that, since the Appellate Body found the FSC provisions violated the ASCM and the AA, new legislation was necessary to bring the U.S. into compliance with WTO standards. n159 President Clinton also stated that the FSC Repeal Act specifically addressed the concerns raised by the WTO Appellate Body and would be found to be compliant with WTO standards. n160

The FSC Repeal Act repealed the FSC provisions in their entirety and changed the way the United States taxes income generated outside the country. n161 However, the bill's intended impact was overstated. n162 According to The Wall Street Journal, the legislation "rewrites the legal basis for the FSC program and eliminates the need to set up an offshore company. But it maintains roughly the same level of benefits for the same companies, even increasing them for arms exporters that previously only qualified for a partial benefit." n163

The EU went so far as to call the new law even worse than the old one. n164 The EU considered the FSC Repeal Act to be inconsistent with [*25] U.S. obligations under the ASCM, the AA, and the GATT 1994, n165 and requested that the matter be referred to the original panel pursuant to Article XXI:5 of the DSU. n166 On December 20, 2000, the DSB referred the matter to the original panel. n167

On August 20, 2001, the Panel Report circulated to the Members of the WTO. The Panel found that the FSC Repeal Act was inconsistent with the ASCM, AA, and GATT 1994; that the FSC Repeal Act fails to fall within the scope of footnote 59 of the ASCM because it is not a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59; that the U.S. has not fully withdrawn the FSC subsidies and so failed to implement the recommendations and rulings of the DSB made pursuant to the ASCM; n168 and that the U.S. had nullified or impaired benefits accruing to the European Communities under those agreements. n169 The Panel, therefore, concluded that the United States acted inconsistently with its obligation under the ASCM, the AA, and the GATT 1994. n170

On October 15, 2001, the United States notified the DSB of its intention to appeal certain issues of law covered in the Panel Report, and filed a Notice of Appeal. n171 The case went before the Appellate Body in November 2001. The United States assigned many errors to the Panel's reasoning; however, the Appellate Body upheld all rulings against the United States. n172

The United States again made an argument regarding footnote 59 of the ASCM. The United States requested the Appellate Body to set aside the Panel's findings that the FSC Repeal Act is not a measure to avoid double taxation under the fifth sentence of footnote 59. The Panel had begun its inquiry by holding that the United States bore the burden of proving that the contested measure fell within the scope of the fifth sentence of footnote 59. n173

According to the United States, "the last sentence of footnote 59 is inextricably linked to Article III:1(a) of the ASCM and it serves to define [*26] the scope of Article III:1(a)." n174 The United States contended that the EU bore the burden of proving that the measure does not fall within footnote 59 to the ASCM. n175 The United States argued that in finding that the FSC Repeal Act is not a measure to avoid double taxation, the Panel articulated four new principles not found in the fifth sentence of footnote 59. n176 The U.S. also argued that the Panel had erroneously created detailed criteria for a measure to qualify under the fifth sentence of footnote59 and, in so doing, improperly established "a new double taxation avoidance code." n177

The United States then stated that the FSC Repeal Act achieves avoidance of double taxation through the exclusion of extraterritorial income from gross income. n178 The FSC Repeal Act's legislative history expressly identifies double taxation avoidance as a primary objective of the FSC Repeal Act, and the FSC Repeal Act was designed to parallel certain aspects of the territorial systems of many member States of the EU. n179 Finally, the United States concluded that, should the Appellate Body reverse the Panel's finding and hold that the FSC Repeal Act is a measure to avoid double taxation within the meaning of footnote 59, the Appellate Body should then complete the analysis and find that, by virtue of footnote 5 to the ASCM, the FSC Repeal Act is not a prohibited export subsidy. n180

The Appellate Body rejected the U.S. argument. The Appellate Body began by citing an earlier case that stood for the principle that the burden of proof rests upon the party who asserts a particular claim or defense. n181 The Appellate Body stated that footnote 59 constitutes an affirmative defense that justifies a prohibited export subsidy when the measure in question is taken to avoid the double taxation of foreign-source income. n182 They then reasoned that the burden of proving that a measure is justified by falling within the scope of footnote 59 rests upon the responding party, and thus upheld the Panel's finding that the burden of proof under the fifth sentence of footnote 59 fell on the United States. n183

The United States also requested the Appellate Body set aside the Panel's finding that the FSC Repeal Act's transition rules are inconsistent [*27] with the full withdrawal of the FSC subsidies. n184 The United States argued that the FSC Repeal Act repeals the FSC provisions and provides that no corporation can elect to be treated as a FSC after September 30, 2000. n185 The United States also argued that the FSC Repeal Act also contains transitional rules that ensure taxpayers a degree of certainty in tax planning and that are essential to the orderly passage from one set of tax rules to another. n186

The Appellate Body, while recognizing the portion of the FSC Repeal Act that ended corporate elections of the FSC provisions on September 30, 2000, nevertheless noted that under the FSC Repeal Act:

Existing FSCs can continue to use the original FSC measure for transactions pursuant to a binding contract between the FSC and any unrelated person that was in effect on and after 30 September2000. n187 Thus, by the United States' own acknowledgement, the original FSC measure continues to apply, unmodified, to existing FSCs in respect of a defined set of transactions. n188

The success of the United States' appeal depends on the success of its argument that prohibited FSC subsidies can continue to be granted to protect the contractual interests of private parties and to ensure an orderly transition to the regime of the new measure. In short, on the basis of these arguments, the United States seeks to have the time-period for the full withdrawal of the prohibited FSC subsidies extended, in some circumstances, indefinitely. n189

On January 14, 2002, the WTO "handed the United States its biggest loss ever with a decision that opens the way for the EU to ask for billions of dollars in punitive tariffs on US imports." n190 As part of the agreement between the EU and the United States, the next step will be the automatic reactivation of the WTO Arbitration Procedure to decide on the amount of counter measures the EU would be entitled to request authorization to impose. n191 The Arbitrators' report is expected by the end of March, 2002. n192

The EU asked the WTO to approve approximately $ 4 billion in retaliatory trade sanctions against the United States shortly after the FSC [*28] Repeal Act was signed into law. n193 The EU then published a list of the American goods against which the penalty tariffs would be targeted, including "46 general categories of products ranging from live animals to spacecraft." n194 Although lower than the $ 26 billion claim that some American officials expected, the $ 4 billion claim is by far the largest in the WTO's brief history. n195 The $ 4 billion figure also matches the U.S. Treasury estimate of the annual dollar value of the FSC tax benefit to American corporations. n196

Reacting to the news, EU Trade Commissioner Pascal Lamy stated:

We now have a definitive legal ruling on the FSC case. Of course I'm pleased that the WTO has confirmed what we always believed. We have made a point of handling this dispute in a very reasonable manner. Now it is up to the US to comply with the WTO's findings and to settle this matter once and for all. As to how, we look forward to rapid US proposals. n197

U.S. Trade Representative Robert B. Zoellick was predictably less upbeat:

We are disappointed with the outcome. <elip> Given prior decisions, we knew this would be an uphill struggle, but we believed it was important to make our case for a level playing field on tax rules. The United States respects its WTO obligations, which serve America's interests, and we intend to continue to seek to cooperate with the EU in order to manage and resolve this dispute. n198

Zoellick added:

This is an especially sensitive dispute that, at its core, raises questions of a level playing field with regard to tax policy<elip> . We will be consulting closely with Congress and affected U.S. interests regarding next steps. n199

[*29]

E. Conclusion: U.S. Options Regarding the WTO Decisions

The United States has several options available to respond to the Appellate Body Report of January 14, 2002. These options, which can be employed individually or in combination, include:

(1) Start a trade war;

(2) Bear sanctions as part of the cost of business;

(3) Convert to a territorial system of taxation; and/or

(4) Seek a negotiated settlement with the EU.

1. Start a Trade War

If the EU puts $ 4 billion worth of sanctions on U.S. products, the United States could respond with sanctions of its own. In the past, U.S. officials have also raised the possibility that if the United States lost its case, the administration might bring retaliatory cases against European nations with tax laws that it thinks do not comply with WTO rules. n200 Two European nations concerned about protecting the business tax breaks are Belgium and Spain. n201

However, it is unlikely that the United States will start a trade war. Although the EU could ask the WTO for permission to start imposing sanctions almost immediately, trade experts believe the two sides will find another solution. n202 Few people who follow trade matters expect an all-out trade war. Trans-Atlantic trade is so vast and so beneficial that neither side can afford a breakdown.

n203 U.S. Trade Representative Robert Zoellick, who once warned that such a step would amount to "using a nuclear weapon" on the international trading system, promised that the United States would cooperate with Europe "in order to manage and resolve this dispute." n204

Neither side wants punitive tariffs that will effectively double the price of billions of dollars worth of U.S. imports. n205 In addition, retaliation would also damage some European businesses, as European companies have U.S. units that also take advantage of the tax system. n206

[*30]

2. Bear the Sanctions as Part of the Cost of Business

Another option is to let the proposed sanctions take effect and bear the sanctions as part of the cost of business. The EU sanctions would then become the price that the U.S. pays to maintain a FSC that the WTO considers illegal under global trading rules. n207 However, if the U.S. wishes to pursue the goal of global free trade, it should not simply ignore a rule that has gone through the proper international legal channels. Refusal to fulfill the obligations determined by the WTO will damage a still delicate legal system that the United States, as well as many other nations, has worked hard to establish. n208 The resulting high tariffs would also likely cause sales overseas to suffer, affecting an already slow economy. Therefore, it is also unlikely that the U.S. will simply follow this course.

3. Convert to a Territorial System of Taxation

One way for the United States to comply with its international agreements would be to convert to a territorial system of taxation. Kenneth Kies, a managing partner for Pricewaterhousecoopers LLP, has said that it is unrealistic to expect the United States to revise its law easily since this is a congressional election year. n209 However, several U.S. lawmakers, including California Republican

Bill Thomas, head of the tax-writing House Ways and Means Committee, have said they would prefer to move to a "territorial" system such as that found in Europe. n210

The WTO Appellate Body has already found that the territorial system is an acceptable means of exempting export profits from taxation. n211 The VAT is already being used by almost every competitor of the United States. n212 Because the majority of countries use the VAT system, any country that relies exclusively on income taxation puts itself at a competitive disadvantage. n213

Another benefit of using the VAT as either a supplement or an alternative to income taxation would be the reduction of international economic tensions by eliminating transfer pricing disputes. n214 One commentator has argued that "a VAT could raise the same revenue as either formulary apportionment or transfer pricing in a much less contentious way." n215 Other reasons cited for introducing a VAT system include: n216

[*31]

1. It will encourage savings,

2. It is neutral between (a) the production of capital and non-capital goods; (b) the production of goods and services; (c) single-stage and multi-stage production processes; and (d) the use of capital and labor,

3. After a transition period, it should be easier and cheaper to comply with and administer than the present income tax,

4. Apart from a one-time increase it is not inflationary,

5. It has advantages over a single-stage retail sales tax,

6. Greater reliance on border adjustable indirect taxes will help level the playing field for U.S. goods in the domestic market and make U.S. goods more internationally competitive abroad, and

7. Provision is generally made for a refund of excess tax paid (which is more advantageous for business than a carry-forward).

4. Seek a Negotiated Settlement with the EU

The most likely scenario is a negotiated settlement between the United States and the EU. Such an agreement could take the form of a narrow accord, limited in scope to the taxation of American exports, or a comprehensive settlement across the entire spectrum of trade disagreements that divide the EU and the United States. n217

The main issue now is what concessions Washington must make to satisfy the Europeans and comply with world trade rules. n218 As Keith Hendry, director of the trade law department of Clifford Chance Puender in Brussels said, "no one wants to start a major trade conflict. I'm pretty sure that they'll do a deal." n219 Trade analysts have suggested that the EU will use its victory to force the U.S. away from raising barriers on European steel, although the EU and U.S. officials rejected such a trade-off. n220

The EU has also suggested that the Bush administration could avoid setting off a trade war between the United States and Europe by lowering U.S. tariffs on an equivalent amount of European products. n221 According to the EU, the United States could thus prevent billions of dollars in sanctions. n222

An agreement could also come as a comprehensive settlement across the entire spectrum of trade disagreements that divide the EU and the United States. n223 Hoping to maintain the tax benefits of the current system, some business groups have urged that the U.S. and EU "roll the

[*32] dispute over the FSC into the new round of global trade talks that began in Doha, Qatar," in November 2000. n224 Officials could then change the WTO rules that prohibit the FSC system. n225

"Key Congressional leaders and the National Association of Manufacturers have urged the U.S. to seek a negotiated settlement," n226 and Treasury Secretary Lawrence Summers has indicated that the United States will attempt to negotiate a settlement that allows the overall FSC program to continue. n227 "How vigorously the United States will pursue such negotiations and whether the EU will be receptive to such overtures is uncertain." n228 The best hopes of the global economy, however, lie in agreement between these two great parties.

Legal Topics:

For related research and practice materials, see the following legal topics:
International Trade LawImports & ExportsDuties, Fees & TaxesGeneral OverviewTax LawInternational TaxesGeneral OverviewTransportation LawCarrier Duties & LiabilitiesGATT & NAFTA

FOOTNOTES:

n1. Alan C. Swan & John F. Murphy, Cases and Materials on the Regulations of International Business and Economic Relations 467 (2d ed. 1999) [hereinafter Swan & Murphy].

n2. John H. Jackson, William J. Davey & Alan O. Sykes, Legal Problems of International Economic Relations 278-284 (1994); James F. Smith, Symposium: Treaty Making in the

Next Millennium: International Agreements in the Post-Modern Era, 5 Sw. J. L. & Trade Am. 183 (1998).

n3. General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194 [hereinafter GATT].

n4. GATT art. I.

n5. See GATT art. III.

n6. Swan & Murphy, supra note 1, at 471.

n7. See Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, Legal Instruments-Results of the Uruguay Round vol. 1 (1994), 33 I.L.M. 1125 (1994) [hereinafter WTO Agreement].

n8. See WTO in Brief: Part 2, World Trade Organization, at http://www.wto.org/english/thewto e/whatis e/inbrief e/inbr02 e.htm (last visited Apr. 14, 2002).

n9. See id.

n10. See id.

n11. See Swan & Murphy, supra note 1, at 473.

n12. See Final Act Embodying the Results of the Uruguay Round of Negotiations, Apr. 15, 1994, Annex 2 - Understanding on Rules and Procedures Governing the Settlement of Disputes, 33 I.L.M. 1226 (1994) [hereinafter DSU]. See also Robert E. Hudec, The New WTO Dispute Settlement Procedure: An Overview of the First Three Years, 8 Minn. J. Global Trade 1, 2 (1999).

n13. See Hudec, supra note 12, at 2.

n14. See id.

n15. Brenda O'Leary, The Continued Viability of Foreign Sales Corporations (FSCs): An Analysis of the WTO Decision Declaring FSCs Incompatible with GATT Trading Rules, 2 San Diego Int'l L.J. 149, 151 (2001); Jacob A. Frenkel et al., International Taxation in an Integrated World 22 (1991).

n16. Id.

n17. Id.

n18. Id.

n19. Id.

n20. Id.

n21. Id.

n22. Id.

n23. Ronald D. Sernau, The Foreign Sales Corporation Legislation: A $ 10 Billion Boondoggle, 71 Cornell L. Rev. 1181, 1183 (1986).

n24. Id. at 1183 n.18.

n25. See William H. Morris, U.S. Lags Behind Even Undeveloped Nations in Implementing VAT, 5 J. Int'l Tax'n 218 (1994).

n26. Sernau, supra note 23, at 1183.

n27. Id.

n28. Id. (referring to R. Lipsey, An Introduction to Positive Economics 433 (5th ed. 1979)).

n29. 26 U.S.C. 61 (1994); 26 CFR 1.1-1(b) (2001); Treas. Reg. 1.1-1(b) (2000).

n30. See Mitchell B. Weiss, International Tax Competition: An Efficient or Inefficient Phenomenon?, 16 Akron Tax J. 99, 109 (2001).

n31. See O'Leary, supra note 15, at 153.

n32. See Our Federal Tax System, Message from the President of the United States Relative to our Federal Tax System, H.R. Doc. No. 87-140, at 6 (1961) (statement by Secretary Dillon).

n33. See id.

n34. See Edwin S. Cohen & Michael D. Hankin, A Decade of DISC: Genesis and Analysis, 2 Va. Tax Rev. 7, 10 (1982).

n35. See id.

n36. See Lawrence B. Krause & Kenneth W. Dam, Federal Tax Treatment of Foreign Income 13-15 (1964).

n37. Hunter R. Clark, Amy Bogran & Hayley Hanson, The WTO Ruling on Foreign Sales Corporations: Costliest Battle Yet in an Escalating Trade War Between the United States and the European Union?, 10 Minn. J. Global Trade 291, 307 (2001).

n38. See IRC 957(a) (2001).

n39. IRC 951(b).

n40. IRC 951(a)(1)(A)(i), 952.

n41. IRC 951(a)(1)(B), 956(a).

n42. See Cohen & Hankin, supra note 34, at 14.

n43. See id.

n44. See S. Rep. No. 67-275, pt. 2 (1921).

n45. See Donald W. Bacon, Compliance Problems in Taxation of International Operations, in Taxation of Foreign Income 160-61 (Tax Inst. of Am. ed., 1966).

n46. Cohen & Hankin, supra note 34, at 18.

n47. Id.

n48. Id. at 21.

n49. Id.

n50. Id.

n51. Id.

n52. See 129 Cong. Rec. S11,761 (daily ed. Aug. 4, 1983) (statement in introduction of S. 1804 by Sen. Dole).

n53. Paul B. Stephan, Sheriff or Prisoner? The United States and the World Trade Organization, 1 Chi J. Int'l L. 49, 62 (2000).

n54. Julie Elizabeth McGuire, World Trade Organization Finds U.S. Foreign Sales Corporation Violates EU Trade Agreements, 7 Lawyers J. 5, 5 (2000).

n55. See 129 Cong. Rec. S11,761, supra note 52.

n56. John M. Gray, Taxation: Foreign Sales Corporations Replace Domestic International Sales Corporations, 26 Harv. Int'l L.J. 293, 294 (1985).

n57. See IRC 991-994.

n58. See Charles H. Gustafson, Robert J. Peroni & Richard Crawford Pugh, Taxation of International Transactions P 11,125, at 663 (1997) [hereinafter Gustafson et al.].

n59. Id.

n60. Id.

n61. Id. P 11,130, at 664.

n62. Id.

n63. Id.

n64. See United States Tax Legislation (DISC), Dec. 7-8, 1981, GATT B.I.S.D. (28th Supp.) at 114 (1981).

n65. Stephan, supra note 53, at 62.

n66. United States Tax Legislation (DISC), supra note 64, at 114.

n67. See Stephan, supra note 53, at 62.

n68. See Gustafson et al., supra note 58, P 11,130, at 664.

n69. Id.

n70. See McGuire, supra note 54, at 5.

n71. See Richard L. Doernberg, International Taxation In a Nutshell 14.01, at 396 (West 1999).

n72. Gustafson et al., supra note 58, P 11,137, at 665.

n73. Id. P 11,145, at 667.

n74. See IRC 921(a).

n75. See Gustafson et al., supra note 58, P 11,137, at 665.

n76. See Stephan, supra note 53, at 62.

n77. William Lee Andrews, III, No Bull's Eye for "Targeted" International Tax Rules, 18 Va. Tax Rev. 781, 830 (1999).

n78. Id.

n79. See IRC 922.

n80. IRC 922(b)(2).

n81. IRC 922(a)(1)(B).

n82. IRC 922(a)(1)(D)(ii)-(iii).

n83. IRC 923(b).

n84. Id.

n85. See IRC 924(b); see also Gustafson et al., supra note 58, P 11,145, at 667.

n86. See IRC 924(c).

n87. See IRC 924(d)(3)(B).

n88. See IRC 924(e).

n89. See IRC 924(d)(1).

n90. See IRC 924(d)(2).

n91. IRC 923, 921(a).

n92. See Doernberg, supra note 71, 14.04, at 434.

n93. See Gustafson et al., supra note 58, P 11,210, at 675.

n94. See IRC 925.

n95. See Gustafson et al., supra note 58, P 11,212, at 675.

n96. See id. P 11,214, at 676.

n97. See id. P 11,215, at 676.

n98. See IRC 923(a)(2), 291(a)(4)(A).

n99. See IRC 923(a)(3), 291(a)(4)(B).

n100. See IRC 245(c)(1)(A).

n101. See IRC 245(c)(1)(B).

n102. See id.

n103. See McGuire, supra note 54, at 5.

n104. See WTO Panel Report: United States - Tax Treatment for "Foreign Sales Corporations" (Findings and Conclusions), 38 I.L.M. 173, P 1.1 (Oct. 8, 1999).

n105. Id. P 1.3.

n106. Id. P 1.4.

n107. Id. P 7.35, at 184.

n108. Id. P 7.95, at 199.

n109. Id. P 7.96, at 199.

n110. Id. P 7.97, at 199.

n111. Id. P 7.130, at 207.

n112. Id. P 7.100, at 200.

n113. Id. P 7.103, at 200.

n114. Id. P 7.108, at 201.

n115. Id. P 7.131, at 207.

n116. Id. P 7.132, at 207.

n117. Id. P 7.133, at 207.

n118. Id. P 7.148, at 210.

n119. See Kevin D'Amour, U.S. Tax Break Under Seige, Legal Times, Mar. 8, 1999, at S44.

n120. See id.

n121. See id.

n122. See Gray, supra note 56, at 293.

n123. See Sernau, supra note 23, at 1184; see also Europeans Announce Plans to Force GATT Review of DISC and FSC, 24 Tax Notes 228 (1984).

n124. See Sernau, supra note 23, at 1193.

n125. See id. at 1193 n.96.

n126. See McGuire, supra note 54, at 5.

n127. See Stanley I. Langbein, United States - Tax Treatment For Foreign Sales Corporations, 95 Am. J. Int'l L. 546, 547-48 (2000).

n128. Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, WTO Agreement, Annex 1A, at Annex 1 n.59 (1994), available at http://www.wto.org/english/docs e/legal e/24-scm.pdf (last visited Mar. 10, 2002).

n129. See Langbein, supra note 127, at 547.

n130. See id.

n131. See id. at 548.

n132. See United States Tax Legislation (DISC), supra note 64, at 114.

n133. See WTO Panel Report: United States - Tax Treatment for "Foreign Sales Corporations" (Findings and Conclusions), supra note 104; see also WTO Panel Finds U.S. FSC Regime Grants Illegal Subsidies, 10 J. Int'l Tax'n 6 (1999).

n134. See McGuire, supra note 54, at 5.

n135. See Ernest R. Larkins, WTO Ruling: Beginning of the End for FSCs?, 11 J. Int'l Tax'n 6 (1999).

n136. See James Cameron & Karen Campbell, Dispute Resolution in the WTO 31 (1998).

n137. See WTO Report of the Appellate Body: United States - Tax Treatment for "Foreign Sales Corporations," WT/DS108/AB/R, P 4 (Feb. 24, 2000) [hereinafter U.S. - Tax Treatment for FSCs].

n138. Julie Elizabeth McGuire, WTO Rules U.S. In Violation of EU Trade Agreements; Appeals Filed, 222 The Legal Intelligencer 11 (2000).

n139. See Langbein, supra note 127, at 548.

n140. See U.S. - Tax Treatment for FSCs, supra note 137, P 103.

n141. See id.

n142. See id. P 108.

n143. See id. P 177.

n144. See id.

n145. See Settling Disputes, World Trade Organization, at http://www.wto.org/english/thewto e/whatis e/tif e/disp0 e.htm (last visited Apr. 14, 2002).

n146. See id.

n147. See id.

n148. See U.S. - Tax Treatment for FSCs, supra note 137, P 177.

n149. See id.

n150. See Weiss, supra note 30, at 111 (citing WTO Appellate Body Report Rejecting U.S. Appeal on FSC Tax Incentives, 2000 Tax Notes 38-12 (2000)).

n151. See Weiss, supra note 30, at 111.

n152. See David L. Brumbaugh, U.S. Congressional Research Service Updates Report on FSCs, 2000 Worldwide Tax Daily 194-19, P 9 (2000).

n153. See id. P 2.

n154. See id.

n155. See EU/US: Americans Contest EU Demand for USD 4 Billion Sanctions, Eur. Rep., Dec. 2, 2000, at 508, available at 2000 WL 24320190 (last visited Mar. 10, 2002).

n156. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (codified as amended in scattered sections of 26 U.S.C.) [hereinafter FSC Repeal Act].

n157. See id.

n158. See 26 U.S.C. 114 (2000); H.R. Conf. Rep. No. 106-2614 (2000).

n159. See President's Statement on Signing the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, 36 Weekly Comp. Pres. Doc. 2885 (Nov. 15, 2000).

n160. See id.

n161. See George G. Jones & Mark A. Luscombe, The New Extraterritorial Income Exclusion, 14 Accounting Today 22 (2000), available at 2000 WL 11748592 (last visited Mar. 10, 2002).

n162. See Clark et al., supra note 37, at 294.

n163. See Geoff Winestock, EU Aims for Huge Sanctions on the U.S., Wall St. J., Nov. 20, 2000, at A2; see also Paul Meller, Europeans Seek $ 4 Billion in Sanctions Against U.S., N.Y. Times, Nov. 18, 2000, at C1.

n164. EU/US: Americans Contest EU Demand for USD 4 Billion Sanctions, supra note 155, at 508.

n165. See WTO Report of the Appellate Body: United States - Tax Treatment for "Foreign Sales Corporations," WT/DS108/AB/RW, P 4 (Jan. 14, 2002) [hereinafter U.S. - Tax Treatment for FSCs II].

n166. See WTO Request for the Establishment of a Panel: United States - Tax Treatment for "Foreign Sales Corporations," WT/DS108/16 (Dec. 8, 2000).

n167. See WTO Constitution of the Panel: United States - Tax Treatment for "Foreign Sales Corporations," WT/DS108/19 (Jan. 5, 2001).

n168. See U.S. - Tax Treatment for FSCs II, supra note 165, P 9.1.

n169. See id. P 9.2.

n170. See id.

n171. See WTO Notification of Appeal by the United States: United States - Tax Treatment for "Foreign Sales Corporations," WT/DS108/21 (Oct. 15, 2001).

n172. See U.S. - Tax Treatment for FSCs II, supra note 165, P 256.

n173. See id. P 122.

n174. Id. P 204.

n175. Id. P 124.

n176. Id. P 34.

n177. Id. PP 32; 173.

n178. Id. P 37.

n179. Id.

n180. Id. P 38.

n181. See WTO Report of the Appellate Body: United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India, WT/DS33/AB/R (May 23, 1997).

n182. See U.S. - Tax Treatment for FSCs II, supra note 165, P 101 n.3.

n183. See id. PP 133-34.

n184. See id. P 45.

n185. See id. P 224.

n186. See id. P 224.

n187. See FSC Repeal Act, supra note 156, 5(c)(1)(B)(ii).

n188. See U.S. - Tax Treatment for FSCs II, supra note 165, P 228.

n189. See id.

n190. Paul Geitner, WTO Appeals Panel Rules Against U.S. Again on Tax Breaks Case, Associated Press, available at 2002 WL 3704118 (Jan. 14, 2002).

n191. EU Welcomes WTO Definitive Confirmation That US Export Subsidies (Foreign Sales Corporations) Are Illegal, European Union in the United States, available at http://www.eurunion.org/news/press/2002/2002001.htm (last visited Apr. 14, 2002).

n192. See id.

n193. See EU/US: Americans Contest EU Demand for USD 4 Billion Sanctions, supra note 155, at 508; Glenn Hess, US Shrugs Off EU Threat to Start FSC Tax-Related Trade Sanctions, Chemical Mkt. Rep., available at 2000 WL 24156581 (Nov. 20, 2000).

n194. Winestock, supra note 163, at A2.

n195. See Clark et al., supra note 37, at 294.

n196. See id.

n197. EU Welcomes WTO Definitive Confirmation That US Export Subsidies (Foreign Sales Corporations) Are Illegal, supra note 191.

n198. Press Release, Office of the United States Trade Representative, WTO Upholds Adverse Ruling on Foreign Sales Corporation (FSC) Tax (Jan. 14, 2002), available at http://www.ustr.gov/releases/2002/01/02-05.htm (last visited Apr. 14, 2002); see also David E. Rosenbaum & Elizabeth Olson, U.S. Loses Trade Case to Europeans on Offshore Tax Havens, N.Y. Times, Jan. 15, 2002, available at http:// www.nytimes.com/2002/01/15/business/worldbusiness/15TRAD.html (last visited March 14, 2002).

n199. Press Release, supra note 198.

n200. See Associated Press, Administration Leaves All Options Open to Avoid Trade War With EU (Jan. 16, 2002), available at http://www.montanaforum.com/rednews/2002/01/15/build/taxes/wto.php?nnn=2 (last visited Apr. 14, 2002).

n201. See id.

n202. See Geitner, supra note 190.

n203. See Rosenbaum & Olson, supra note 198.

n204. See Carter Dougherty, WTO Nullifies U.S. Tax Break in Trade Dispute With EU, Washington Times, Jan. 15, 2002, available at 2002 WL 2902746.

n205. See Geitner, supra note 190.

n206. See Seattle Post-Intelligencer Staff and News Services, WTO Rejects U.S. Tax Law (Jan. 15, 2002), available at http://seattlepi.nwsource.com/business/54477 wtotax 15.shtml (last visited Apr. 14, 2002).

n207. See Clark et al., supra note 37, at 316.

n208. See Larkins, supra note 135, at 6-7.

n209. See Seattle Post-Intelligencer Staff and News Services, supra note 206.

n210. See id.

n211. See U.S. - Tax Treatment for FSCs, supra note 137, P 179.

n212. See Morris, supra note 25, at 219.

n213. Id. at 221.

n214. Id. at 223.

n215. Id.

n216. Id. at 219.

n217. See Archer Urges Cautious Approach on Foreign Sales Corp.s, Congress Daily/AM, Mar. 9, 2000, available at 2000 WL 11085952.

n218. See Rosenbaum & Olson, supra note 198.

n219. Geitner, supra note 190.

n220. See Associated Press, supra note 200.

n221. See id.

n222. See id.

n223. See Archer Urges Cautious Approach on Foreign Sales Corp.s, supra note 217.

n224. Dougherty, supra note 204.

n225. Id.

n226. Id.

n227. See Treasury Department, U.S. Treasury Secretary, Trade Rep. Express Disappointment With Latest WTO Ruling on FSC Regime, 2000 WTD 38-29 (2000).

n228. Larkins, supra note 135, at 6-7.