INCOME TAXATION, INTERNATIONAL COMPETITIVENESS AND THE WORLD TRADE ORGANIZATION'S RULES ON SUBSIDIES: LESSONS TO THE U.S. AND TO THE WORLD FROM THE FSC DISPUTE

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I. INTRODUCTION

In a February 2000 ruling, the World Trade Organization's Dispute Settlement Body adopted the report[1] on the complaint brought by the European Communities with respect to the United States tax regime known as the Foreign Sales Corporations ("FSC").[2] The report characterized the FSC as a "prohibited export subsidy" inconsistent with the World Trade Organization's ("WTO") rules on subsidies.

In response to the WTO ruling, the U.S. Congress enacted the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000"[3] ("Income Exclusion Act") which repealed the FSC and replaced it with a tax exclusion regime for certain extraterritorial income. In general, the new regime excludes from taxation any foreign sales income regardless of the place where the products are manufactured. From the United States' standpoint, the new statutory provisions are consistent with the WTO rules on subsidies. The WTO ruling affected a considerable number of U.S. exporting companies operating under the FSC regime, forcing

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Editor's Note: As this issue was about to go to press, the WTO handed down the report of the panel on *United States—Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities* (WT/DS108/RW, 20 August 2001). The WTO panel determined that the replacement legislation of the Foreign Sales Corporation regime is inconsistent with the SCM Agreement. The following article does not take that new development into account, but the outcome does not affect the author's analysis and conclusions. Indeed, the author essentially predicted the WTO panel's result.

[1]The referred report is the February 24, 2000 report rendered by the World Trade Organization's Appellate Body ("WTO Appellate Body") on the appeal brought by the U.S. against the Panel's report on the "*United States—Tax Treatment for "Foreign Sales Corporations"* dispute. The WTO Appellate Body's report can be found under WT/DS108/AB/R, February 24, 2000. The Panel's report, which was the subject matter of the appeal, can be found under WT/DS108/R, October 8, 1999. In general, the WTO Appellate Body's report upheld the report issued by the panel established by the World Trade Organization. ("WTO Panel").

[2]The complaint against the FSC was brought by the European Union ("EU") with respect to sections 921 through 927 of the United States Internal Revenue Code and related measures.

[3]FSC Repeal and Extraterritorial Income Exclusion Act of 2000, United States Congress H.R. 4986, 106th Cong. (2000) (enacted) ("Income Exclusion Act"). The FSC replacement legislation was signed into law by President Clinton on 15 November, 2000.

them to restructure their export operations in order to obtain the tax benefits arising from the new regime.[4] It should be noted that the rationale of the U.S. Congress in enacting the Income Exclusion Act was to preserve the economic benefits that U.S. exporters received under the prior regime.[5]

The European Union ("EU") has already requested authorization from the WTO to impose countermeasures against the U.S. alleging that the Income Exclusion Act is not in conformance with the WTO rules on subsidies. Thus, unless the parties to the FSC dispute reach an agreement, a WTO compliance panel will have to decide whether the new U.S. exclusion regime is consistent with the WTO rules on subsidies.

Regardless of the final outcome of the FSC dispute, this case provides some evidence that income taxation has a significant role in international economic relations as a means of enhancing the international competitiveness of domestic industries. However, to the extent that countries resort to different forms of income tax relief, as a means of providing indirect subsidies to domestic industries, they may affect not only the world trading system but also national income tax systems. In effect, indirect subsidies in the form of income tax relief measures are generally considered an unfair trade practice, which cause disruption or distortion of international trade. Likewise, the grant of indirect subsidies in the form described tends to erode the foundations of income taxation.[6]

This paper first analyzes the application of the WTO's discipline on subsidies to income tax relief measures that affect the world trading system as illustrated by the WTO's ruling in the FSC dispute. Secondly, it examines whether the WTO's discipline on subsidies is comprehensive enough to cope with income tax-related subsidies. Thirdly, this paper outlines the boundaries of international competitiveness policies that are based on income tax relief measures. Finally, from an international tax policy standpoint, this paper discusses the lessons to the U.S. and to the world arising from the FSC dispute.

II. BACKGROUND

The rising acceptance of trade liberalization policies has forced national governments to dismantle import-restraining policies and adopt international com-

[4]For instance, U.S. exporters do not need to establish a foreign base company in an off-shore jurisdiction to carry out their export operations any more.

[5]Under the Income Exclusion Act, the tax benefit is available even to U.S. companies that, prior to the new regime, did not fit into the FSC regime. In effect, the removal of the exports requirement existing under the FSC regime will, in principle, allow more companies to obtain the benefits only formerly available to exporters.

[6]This is so because certain tax exemption regimes and tax exclusion regimes both erode national tax bases and undermine the progressiveness of income taxation. The progressive principle is the cornerstone of most income tax systems. This principle is also known as the "ability to pay" principle.

petitiveness-oriented policies.[7] In an integrating world economy, national economic growth will depend to a certain extent upon the degree of access to, or influence on, international markets.[8]

A key factor to achieving economic growth in a liberalized world trading system is the enhancement of the international competitiveness of domestic industries. In effect, with the gradual reduction of import-restraining practices, domestic industries no longer can rely on tariff or non-tariff trade barriers on imports to protect their home-country markets. Therefore, the decision whether to "go international" is increasingly becoming one of survival rather than a logical step in the business expansion cycle of a company. National governments have responded to this situation, with varying degrees of success, by designing a wide array of fiscal and non-fiscal export incentives to support the international expansion of domestic industries. Some of these incentives constitute a direct violation of typical anti-subsidy rules that can be found in existing bilateral or multilateral trade agreements and are relatively easy to identify. However, there are other exports incentives that violate such rules in indirect ways, and thus are more difficult to identify. Lastly, there are incentives that either conform to trade agreements or are not regulated at all.

The creativity of national governments regarding the design of export incentives in some cases resembles the creativity of individual tax planners. Even though they pursue different objectives, both try to find the loopholes in the system and attempt to avoid anti-subsidies rules or taxes, respectively.

Subsidization of exports through income tax relief measures is not a new practice. Since 1980 the Tokyo Round Subsidies Code has proscribed the exemption, remission, or deferral of "direct taxes" in order to subsidize exports. However, as we will see, neither the Tokyo Round Subsidies Code nor the WTO rules on subsidies have provided an appropriate regulatory framework for the treatment of income tax-related subsidies.

The increasing complexity and sophistication of income tax law, particularly in the area of international taxation, has arguably opened up a host of opportunities to design tax relief measures which, in the event of a trade dispute, are generally easier to justify than other kinds of export incentives.[9] Tax-related subsidies might be more appealing to national governments as these can be

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[7]In the decades preceding the 1990's, many countries followed a protectionist pattern, trying to insulate their markets from foreign competition. Whole regions, such as Latin America in the 1960's and the 1970's, widely adopted import-substitution models that depended upon trade barriers to protect domestic industries, until they had matured and were able to face foreign competition. With the past decade's ascendancy of trade liberalization, protectionism is now rejected as an unsound policy. In the near future we will likely see governments focusing on exports and, thus, trying to enhance the international competitiveness of their domestic industries, rather than closing their markets to imports.

[8]As an illustration, consider the case of China, one of the few remaining countries in the world with a non-market economy, which has accepted significant economic reform commitments in order to gain membership to the World Trade Organization.

[9]An example is provision by the governments of export credits at below-market interest rates.

justified on sovereignty grounds. In other words, countries will most likely rely heavily on the concept of sovereign authority in tax matters as their first line of defense in trade disputes involving income tax-related subsidies.

The issue of income tax-related subsidies turns even more perplexing when an alleged subsidy does not derive from a specific tax relief measure but instead derives from the overall tax system. In fact, it is generally understood that territorial systems of taxation are, taxwise, more favorable to exporters than worldwide systems of taxation. In the FSC dispute this was a crucial issue since the U.S has a tax system unfavorable to exporters compared to the tax system of other countries (*e.g.*, countries with a territorial system of taxation or countries with weak anti-tax haven rules).

This paper addresses those issues in six parts. The first part overviews the existing WTO regulatory framework regarding export subsidies, with an emphasis on the rules applicable to income tax-related subsidies. The second part focuses on U.S. taxation of international transactions, particularly on the tax rules applicable to export operations. The third part analyzes U.S. export tax incentives that preceded the FSC and the first anti-subsidy action brought against a U.S. export incentive tax regime. In the fourth part, the FSC regime itself, the FSC dispute and the relevant issues arising from the WTO Appellate Body Report are considered. In the fifth part, the recently enacted Income Exclusion Act vis-à-vis the WTO rules on subsidies is examined. The last part draws several conclusions about the lessons to be learned from this long-running controversy.

III. DISCUSSION

A. *First Part: Export Subsidies and the World Trade Organization's Agreement on Subsidies and Countervailing Measures*

In general, governments utilize tariff and non-tariff measures to influence international trade.[10] Subsidies are non-tariff measures utilized by governments either to inhibit imports (so called "domestic subsidies") or to enhance exports (so called "export subsidies").[11] Subsidies typically constitute direct or indirect economic benefits granted by governments to an industry or group of industries.

The WTO rules on subsidies that affect trade in goods are contained in the Agreement on Subsidies and Countervailing Measures ("SCM Agreement").[12]

[10]See JOHN H. JACKSON, LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS 440-441 (1977).

[11]Export subsidies are specifically linked with exports whereas domestic subsidies are granted to industries regardless of whether those products are exported or not. See JOHN H. JACKSON, THE WORLD TRADING SYSTEM 249-250 (1989). There are other non-tariff measures designed to protect or increase the international competitiveness of domestic industries such as, for example, export controls, whose importance is increasing in the international economy. As the international economic relations become more complex so does the catalogue of non-tariff measures. See JACKSON, *supra* note 10, at 911.

[12]Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of the Uruguay Round vol. 1 (1994).

The General Agreement on Trade in Services has its own rules on subsidies. Likewise the WTO Agreement on Agriculture contains a separate subsidies discipline applicable to agricultural products. The three agreements are a result of the Uruguay Round of Multilateral Trade Negotiations (1986-1994).[13]

In various aspects, the SCM Agreement represents a major departure from its two predecessors, Article XVI of the original General Agreement on Trade and Tariffs ("GATT 1947")[14] and the Tokyo Round Subsidies Code ("Tokyo Subsidies Code").[15]

The first departure regards the definition of subsidies. Whereas GATT 1947 did not provide a definition of subsidies, the SCM Agreement does. Naturally, the lack of a definition allowed governments greater discretion in determining the existence of a subsidy. In regard to the absence of a definition in GATT 1947, John H. Jackson noted, "The issue is particularly murky in relation to tax practices, especially 'income taxes' on firms, often termed 'direct taxes'. This is because almost any tax advantage (interest deduction, accelerated depreciation, or, indeed, even low taxes) could be arguably a subsidy."[16] The Tokyo Subsidies Code, though it lacked a definition of subsidies, contained an illustrative list of practices that could be deemed to be export subsidies.

A second feature of the SCM Agreement is the introduction of the "specificity" concept. Following the terms of this concept, the cases which may be disputed under the SCM Agreement were narrowed to those where an alleged subsidy was intended to benefit a specific industry or group of industries. Economic benefits granted by a government that are generally available to everyone cannot be claimed as subsidies. Consequently, only those benefits granted by a government that target a specific industry or group of industries are generally actionable under the SCM Agreement.[17]

A third feature is that the injury test previously required for subsidies actions is no longer required for certain kind of subsidies under the SCM Agreement. The rationale underlying this change is that prohibited subsidies are particularly

[13]The Uruguay Round's Agreement on Agriculture contains special rules on subsidies, and constitutes a provisional and partial exemption of the SCM Agreement with respect to certain agricultural products.

[14]By the "original" General Agreement on Trade and Tariffs (GATT), I mean the one negotiated in 1947 and the amendments made thereafter, but before the Uruguay Round. It should be pointed out that whereas the original GATT rules referred only to trade in goods, the scope of the agreements arising out of the Uruguay Round is much broader, comprising trade in services, trade related intellectual property matters (so called "TRIPS") and trade related investment matters (so called "TRIMS").

[15]The GATT's Tokyo Round of negotiations took place from 1973 to 1979. The agreements arising from this round are called the Tokyo Round "Codes". An important feature of these agreements is that they were negotiated and signed just by a few countries (*i.e.*, industrialized countries). The official name for the Tokyo Subsidies Code is *Agreement on Interpretation and Application of Article VI, XVI and XXIII of the General Agreement on Trade and Tariffs*, GATT, BISD 26 Supp. 56 (1980). 31 UST 513 and T.I.A.S. No. 9619.

[16]John H. Jackson, World Trade and the Law of GATT § 8 (1969).

[17]It appears that the specificity concept was imported into the SCM Agreement from U.S. legislation and legal practice, where specificity is one of the tests for the application of countervailing duties against other countries. John H. Jackson, *supra* note 11, at 267.

harmful to international trade. Thus, if a prohibited subsidy were disputed, the traditionally required injury test would be waived under the SCM Agreement, avoiding the hassle of getting into the intricacies of an economic impact analysis. In the FSC dispute the WTO Appellate Body ruled that the FSC regime was a prohibited subsidy. Therefore, the EU did not have to address the injury test in this case.

Under the SCM Agreement, a subsidy finding is made whenever two tests are met.[18] The first test is the "subsidy existence" test. A subsidy is deemed to exist when a government or public body makes a financial contribution to a person and a benefit is thereby conferred. The SCM Agreement sets forth criteria to establish in which cases a financial contribution may be found to exist.[19]

The second test is the "specificity" test. A subsidy meets this criterion when only certain enterprises or industries can benefit from it. Several factors are set forth to determine whether a subsidy is specific.[20] Under the SCM Agreement, remedies are only available against specific subsidies.

An exception to the specificity test is set forth in Article 2 paragraph 2.3 of the SCM Agreement. Under this provision a subsidy that is characterized as a "prohibited subsidy" shall be deemed to be specific. The rationale underlying this exception is the same as the one mentioned above regarding the injury test, namely, prohibited subsidies (*e.g.*, export subsidies) are particularly harmful to international trade and should be discouraged through hard-line measures. As mentioned earlier, the WTO Appellate Body ruled that the FSC regime was a prohibited subsidy. Consequently, the EU did not have to meet the specificity test in the FSC dispute.

Once the subsidy existence test and the specificity test have been met, the next step in a subsidy dispute is characterization of the subsidy. It is said that the SCM Agreement follows a "traffic light" approach[21] in its characterization of

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[18]The WTO discipline on subsidies is based on an elaborate system of rules that follow a stepped approach. This apparently mechanical approach may be explained as an attempt to achieve a greater degree of certainty than the one provided under GATT 1947 rules.

[19]Article 1 of the SCM Agreement reads "*Definition of a Subsidy:* 1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if: (a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), *i.e.*, where: (i) a government practice involves a direct transfer of funds (*e.g.*, grants, loans, and equity infusion), potential direct transfers of funds or liabilities (*e.g.*, loan guarantees); (ii) government revenue that is otherwise due is foregone or not collected (*e.g.*, fiscal incentives such as tax credits); (iii) a government provides goods or services other than general infrastructure, or purchases goods; (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments; or (a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994; and (b) a benefit is thereby conferred. 1.2 A subsidy as defined in paragraph 1 shall be subject to the provisions of Part II or shall be subject to the provisions of Part III or V only if such a subsidy is specific in accordance with the provisions of Article 2."

[20]SCM Agreement, Article 2.

[21]The World Trade Organization Secretariat, Guide to the Uruguay Round Agreements 91 (John Croome coordinator, Kluwer Law International 1999).

subsidies because, depending upon their harmful effects, they are divided into three categories. The most harmful subsidies are characterized as "prohibited subsidies," less harmful subsidies are characterized as "actionable subsidies," and harmless subsidies are characterized as "non-actionable subsidies." The SCM Agreement provides for different remedies for each category of subsidies.

Prohibited subsidies, the first category of subsidies, are those that are contingent either upon export performance or upon the use of domestic inputs over imported goods.[22] The SCM Agreement makes a distinction between *de jure* export subsidies and *de facto* export subsidies. The former are subsidies that legally have been made contingent upon export performance. The latter are subsidies that have not been legally made contingent upon export performance, but they have *de facto* been linked "to actual or anticipated exportation or export earnings."[23] This distinction will be particularly important to the determination of whether the tax benefits granted under the Income Exclusion Act are consistent with the SCM Agreement.

Prohibited subsidies are not subject either to the specificity test or to the injury test. Thus, under the SCM Agreement a prohibited subsidies claim is the simplest way to obtain relief against subsidized exports, in comparison with claims based upon other kinds of subsidies which would need to meet both the specificity test and the injury test. Regarding the FSC dispute, the WTO Appellate Body found that the FSC regime constituted a prohibited subsidy because it was a subsidy contingent upon export performance.

The second category of subsidies is actionable subsidies. These subsidies are those that cause injury to the domestic industry of another member, a detriment to benefits pertaining to another member under the General Agreement on Tariffs and Trade of 1994 ("GATT 1994")[24], or *"serious prejudice"* to the interests of another member.[25]

The third category of subsidies is non-actionable subsidies. These are either subsidies that are not specific or subsidies that are specific but meet the criteria set forth in paragraph 8.2 of Article 8 of the SCM Agreement (for example, research assistance). A non-actionable subsidy cannot be referred to the Dispute Settlement Body[26] for the establishment of a panel to consider the matter.[27]

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[22]Article 3.1 of the SCM Agreement provides: "3.1 Except 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; (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods. 3.2 A Member shall neither grant nor maintain subsidies referred to in paragraph 1."

[23]Footnote 4 to Article 3.1 (a) of the SCM Agreement.

[24]Multilateral Agreement on the Trade of Goods, Apr. 15, 1994, Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Annex 1A, Legal Instruments—Results of the Uruguay Round (1994), 33 I.L.M. 1154 (1994).

[25]Criteria to determine the existence of serious prejudice are set forth in Article 6.

[26]The Dispute Settlement Body is the body that administers the dispute settlement mechanism under WTO's Understanding on Rules and Procedures Governing the Settlement of Disputes.

[27]However, if such a subsidy has a serious adverse effect on the domestic industry of a WTO member, the SCM Agreement authorizes certain countermeasures against the subsidy. Paragraph 9.4 of Article 9 of the SCM Agreement.

An affected WTO member may refer a prohibited subsidy case or an actionable subsidy case to the Dispute Settlement Body for the establishment of a panel. Once a subsidy determination becomes binding, the Dispute Settlement Body can authorize countermeasures to be taken against a non-compliant subsidizing country.[28] In addition, under Part V of the SCM Agreement, a WTO member can launch an investigation against a prohibited subsidy or an actionable subsidy, to determine its existence and the imposition of a countervailing duty. A WTO panel dispute procedure and a "Part V" investigation can be conducted in parallel fashion. However, only one remedy arising from either mechanism would be available to the complaining member.[29]

Of particular relevance to the FSC dispute was Annex I "Illustrative List of Export Subsidies" to the SCM Agreement (the "Annex"). The Annex describes twelve practices that constitute export subsidies. The EU alleged that the FSC fell under paragraph (e) of the Annex which describes an export subsidy as the "full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises."

Footnote 58 to paragraph (e) of the Annex states that the term "direct taxes" means "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property."

In its defense, the U.S. alleged that the FSC was consistent with the following highlighted language of footnote 59 to paragraph (e) of the Annex[30] ("Footnote 59"), which reads:

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

[28]Article 4 sets forth the rules for prohibited subsidies and Article 7 for actionable subsidies.

[29]Footnote 35 of the SCM Agreement.

[30]Footnote 59 of the SCM Agreement. It is noteworthy to mention that some parts of this footnote closely resemble the 1981 GATT Council's decision described in a following section of the main text.

This brief survey of the SCM Agreement rules applicable to the FSC dispute shows that there are basically only two provisions available to resolve disputes involving income tax-related subsidies: paragraph (e) of the Annex and footnote 59 to paragraph (e) of the Annex. An issue that arises from the analysis of these two provisions is whether the guidelines embedded therein are sound both from an international trade policy standpoint and an international tax policy standpoint. It is argued below that the referred provisions fall short of providing a balanced solution to income tax-related subsidies. Moreover, the argument is made that these provisions provide for an oversimplified solution to certain complex income tax matters, such as transfer pricing, that cannot be resolved through a one-size-fits-all solution.[31]

B. *Second Part: U.S. Tax Rules Applicable to Export Operations*

1. *Systems of International Taxation*

In general, there are two systems used by countries to tax international transactions, namely, the territorial taxation system and the worldwide taxation system.[32] Few countries have embraced either of these systems in a pure form.[33] More often, countries have hybrid taxation systems—that is, systems that combine elements of the territorial taxation system and of the worldwide taxation system, though a particular system is generally favored.

Under a worldwide taxation system a country asserts taxing jurisdiction over both the foreign source income and the domestic source income earned by its residents. The U.S. system of international taxation can be characterized as a worldwide taxation system.[34] In contrast, under a territorial taxation system a country asserts taxing jurisdiction only over the domestic source income earned

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[31]The SCM Agreement provides for the arm's length principle as the sole solution to transfer pricing issues arising from international trade.

[32]Countries with worldwide taxation systems assert tax jurisdiction on the basis of citizenship, or residence, or a combination of the two. Territorial systems tax on the basis of the source of income. Territorial taxation systems and worldwide taxation systems are built upon, respectively, two fundamental policies known as the capital import neutrality principle ("CIN") and the capital export neutrality principle ("CEN"). However, it is not so easy to find countries with tax systems purely based either on a CEN policy or on a CIN policy. These principles represent two different approaches to the concept of fiscal neutrality. Neutrality is a term used by economists based on the widely accepted idea that economic decisions should be made without regard to tax consequences. Thus, a tax regime can be characterized as neutral when it does not influence business or investment decisions (*e.g.*, location of a manufacturing operation). Fiscal neutrality is given a considerable amount of importance in international tax law design. The objective of the CIN principle is to provide to foreign and local investors, in any given country, the same after-tax rate of return on similar investments in that country, taking into account the corporate and personal taxes paid in the source country and the country of residence. The objective of the CEN principle would be to have a tax system that does not influence investors decisions of where to locate an investment, since investors face the same marginal effective tax rate on income from similar investments, whether they invest locally or abroad.

[33]Hong Kong assesses tax on a territorial basis only. Years ago, South Africa had a regime very close to a pure territorial taxation system.

[34]The U.S. worldwide taxation system is even applicable to U.S. citizens who are not residing in the U.S.

by its residents.[35]

Domestic source income is income derived from sources deemed to be located within the territory of the country asserting tax jurisdiction. Foreign source income is income from sources deemed to be located outside the territory of the country asserting tax jurisdiction. Each country has rules that determine the source of different items of income, and those rules vary to a considerable extent.

Depending on the focus of analysis, either system might be considered as more favorable than the other. For instance, from a tax collection standpoint it could be said that a worldwide taxation system is better than a territorial taxation system as a tax revenue source.[36] However, if the focus of analysis were the enhancement of international trade competitiveness, the territorial taxation system would be more favorable.[37] Unlike a worldwide taxation system which exposes its taxpayers to double taxation, taxpayers in a territorial taxation system generally do not face this problem. In effect, foreign source income derived by a taxpayer subject to a worldwide taxation system would normally be subject to taxation both by the taxpayer's country of residence and by the country where the foreign source is located.[38] A taxpayer residing in a jurisdiction with a territorial taxation system would not be exposed to double taxation because he would only be subject to taxation on his domestic source income.[39]

In order to cope with double taxation, countries provide different kinds of relief to their taxpayers. Typical relief mechanisms consist of tax credits, tax exemptions, tax reductions or specific methods of calculating income. Countries also enter into tax treaties in order to mitigate double taxation. Still, even with all these relief measures, territorial taxation systems are more attractive to businessmen and investors. As a response to the competitive disadvantage created by its tax system the U.S. has enacted several exports incentive regimes specifically designed to offer certain U.S. taxpayers (*i.e.*, exporting companies) some of the tax benefits enjoyed by taxpayers residing either in territorial taxation systems or in worldwide taxation systems with weak anti-tax haven rules.[40] The FSC regime and the recently enacted Income Exclusion Act are part of a series of long-standing efforts of the U.S. to place its exporters on an equal footing with exporters based in countries with more favorable taxation systems.

[35]France applies a territorial principle of taxation with respect to entities doing business abroad.

[36]A country with a worldwide system collects more taxes because the income tax base is larger. A possible downside for a taxpayer resident in a territorial tax system would be to pay taxes at a higher rate. This seems to be the case in some European countries.

[37]*See* U.S. Treas. Dept', *International Tax Reform: An Interim Report,* 18 (Jan. 1993). *See also* Staff of Joint Comm. on Tax'n, *Factors Affecting the International Competitiveness of the United States*, 102d Cong., 1st Sess., at 23-24 (1991).

[38]Unless the taxpayer structures his business or investments activities through a tax haven jurisdiction.

[39]It should be noted that in order to prevent abuses, countries with territorial taxation systems have designed anti-abuse measures.

[40]The U.S. also has several anti-deferral regimes designed to eliminate abuse of tax havens.

2. *Relevant U.S. International Tax Law Provisions*

The WTO Appellate Body determined that the FSC regime was an income tax subsidy dependent upon export performance. Thus, this section analyzes the U.S. taxation of indirect export operations.

Export operations can be divided into direct export operations and indirect export operations, based on a company's reliance on a foreign subsidiary to carry out export-related activities. In direct export operations, products are manufactured, in part or in whole, in the U.S., and are sold to an unrelated business entity based in a foreign jurisdiction for consumption or use outside the U.S. In indirect export operations, products are manufactured, in part or in whole, in the U.S., and typically sold to a wholly owned foreign subsidiary that in turn resells them for consumption or use outside the U.S. This wholly owned foreign subsidiary may be located either in a low-tax jurisdiction (*e.g.*, Ireland) or a tax haven jurisdiction (*e.g.*, Barbados) in order to reduce or eliminate exposure to double taxation.

The taxation of income arising from U.S. direct export operations is generally governed only by the Internal Revenue Code's ("Code") rules for determining the source of income.[41] The taxation of income arising from U.S. indirect export operations is additionally governed by the IRC subpart F rules which apply to controlled foreign corporations, and the Treasury Regulations on transfer pricing discussed below.[42]

3. *Exports and the Determination of Source of Income Rules*

As mentioned above, most countries have their own source of income rules that are used to determine whether an item of income is foreign-source income or domestic-source income. In indirect export operations, two sets of source rules come into play—namely, the source rules applicable to the U.S. parent corporation, which exports the products, and the source rules applicable to the foreign subsidiary, which purchases and resells the products.

a. *Source Rules Applicable to the U.S. Parent Corporation.* One of the most complex aspects of the tax treatment of income derived from exports is the determination of the source of such income. This is so because export income is mixed-source income, that is, a blend of domestic source income (*e.g.*, earnings corresponding to local manufacturing of the products) and foreign source income (*e.g.*, earnings corresponding to marketing and sales-related expenses of the products abroad).[43] Thus, since the "economic processes"[44] encompassed by an export operation typically are located in more than one country, each taxing

[41]I.R.C. § 861.

[42]I.R.C. § 951. Section 951 and transfer pricing rules would not apply to export operations where a U.S. manufacturer sells abroad all or part of its production to an unrelated foreign purchaser.

[43]*See* PAUL B. STEPHAN ET AL., INTERNATIONAL BUSINESS AND ECONOMICS, LAW AND POLICY 843 (The Michie Company, 1993).

[44]The term "economic processes," an important term for purposes of this paper, was first used in the 1981 GATT Council's decision mentioned below in the main text. *See infra* note 68.

jurisdiction has to decide how to allocate the income derived from those economic processes.

The U.S. source determination rules regarding tangible-goods exports provide that income "from the sale or exchange of inventory property . . . produced (in whole or in part) by the taxpayer within and sold or exchanged without the United States . . . shall be treated as derived partly from sources within and partly from sources without the United States."[45]

The Internal Revenue Code authorizes source determination "by processes or formulas of general apportionment prescribed by the Secretary."[46] Based on this authorization, the Treasury issued regulations that provide a two-step approach for the source determination of export income.

Under this two-step approach, the first step is an "apportionment" of the overall income derived from an export operation. Apportionment entails the determination of which shares of the export-related income are attributable either to production activity or to sales activity.[47] Apportionment can be effected through three alternative methods. One method, for example, is the "50/50 method." Under this method, fifty percent of the U.S. exporter's gross income would be deemed to be from a production activity (*i.e.*, manufacturing income) and the other fifty percent as sales activity (*i.e.*, non-manufacturing) income. A question that could arise from the application of this general apportionment formula to transactions involving related parties (*i.e.*, parent-subsidiary structures) is whether this formula is consistent with the arm's length principle set forth by footnote 59 of the SCM Agreement quoted above.[48]

The second step is the foreign source or domestic source "allocation" of the manufacturing income and non-manufacturing income.[49]

b. *Source Rules Applicable to a Foreign Subsidiary*. An indirect export operation requires the organization of a foreign corporate subsidiary which will resell the products purchased from the parent corporation. Under U.S. tax law a foreign corporation is generally considered a separate entity from its shareholders, even in those cases where the foreign corporation is a wholly owned subsidiary.

Income derived from sources outside the U.S. by a foreign corporation is generally excluded from U.S. taxation unless it is income "effectively connected with the conduct of a trade or business within the United States."[50] Thus, under certain conditions, the foreign source income earned by a foreign subsidiary from an indirect export operation might be treated as income effectively con-

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[45]I.R.C. § 863(b).

[46]*Id.*

[47]Reg. § 1.863-3(b)(1). The rules for source allocation are set forth in Regulation section 1.863-3(c).

[48]In the Conclusion section of this paper, I argue that this apportionment formula might be considered inconsistent with the language of footnote 59 to paragraph (e) of the Annex (to the extent that it does not reflect an arm's length price).

[49]*See* Reg. § 1.863-3.

[50]I.R.C. § 864(c).

nected with a U.S. trade or business, and thereby subject to U.S. taxation.

The conditions under which foreign source income arising from an indirect export operation will generally be subject to U.S. taxation are: (i) when the foreign corporation has an office or other fixed place of business within the U.S. ("permanent establishment");[51] (ii) the foreign source income is attributable to that permanent establishment; *and* (iii) the foreign source income is derived from the sale of products through that permanent establishment.[52] There is an important exception. In effect, even if the outlined conditions are met, foreign source income will not be considered "effectively connected" with a U.S. trade or business if the products are sold for use, consumption, or disposition outside the U.S. and a permanent establishment of the foreign subsidiary in a foreign country "participated materially in such sale."[53] Accordingly, depending on how the indirect export operation is structured, a foreign subsidiary can avoid the effectively connected income treatment.

4. *Subpart F and the Treasury Regulations on Transfer Pricing as Anti-Deferral Measures*

U.S. corporations can arrange their business activities in a foreign country either under a subsidiary or under a branch structure. In some instances, subsidiaries have a tax advantage over branches because, under certain circumstances, they can provide investors with the benefit of tax deferral. In effect, under U.S. tax law the foreign earnings of a foreign corporation are not taxable until such earnings are distributed to the U.S. shareholders. Thus, to the extent a foreign subsidiary does not repatriate the foreign earnings to the U.S., it might enjoy a financial benefit not available to a foreign branch.[54] Accordingly, before the enactment of the anti-deferral rules described below, U.S. companies that carried on their international operations through foreign subsidiaries incorporated in low-tax or tax haven jurisdictions enjoyed the benefit of tax deferral. This benefit was generally available to exporters and non-exporters. Years later, as explained in the third part, the tax deferral benefit was made available mostly to exporters.

To avoid abuses of the tax deferral benefit through the organization of foreign subsidiaries in low-tax or tax haven jurisdictions, Congress enacted the Internal Revenue Code's Subpart F rules ("Subpart F") in 1962. The Subpart F regime revolves around the concept of controlled foreign corporation ("CFC"), which is

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[51]The term of permanent establishment is not used in U.S. statutory tax law, but it is widely used in tax treaties and statutory tax laws of other countries. The term basically refers to the notion of an office or other fixed place of business.

[52]I.R.C. § 864(c)(4)(B)(iii).

[53]I.R.C. § 864(c)(4)(B)(iii).

[54]Foreign branch earnings are included in the tax base of the U.S. corporation and so are subject to current tax. *See* GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT AND PROBLEMS ch. 6 (West 1997), for an extensive treatment of this topic.

defined by reference to a stock ownership test.[55] The technique provided by Subpart F for the taxation of certain income derived by a CFC is a deemed or constructive dividend.[56] Thus, a CFC's U.S. shareholders are taxed on certain earnings accumulated by the CFC as if they had been distributed to those shareholders.[57]

Subpart F treatment applies, *inter alia*, to export-related income that constitutes "foreign base company sales income" under Code section 954(d).[58] Such income is treated as Subpart F income and can be taxed as a constructive dividend to the U.S. parent corporation under Code section 952(a)(2).[59] Foreign base company sales income generally arises when a U.S. exporter structures its foreign operation under a parent-subsidiary scheme, the subsidiary is incorporated in a low-tax or no-tax jurisdiction, and has no business purpose other than reselling products purchased from its parent company or a related company, to the extent those sales occur outside its country of incorporation.

The possible benefits of tax deferral may act as an inducement to a U.S. corporation to engage in aggressive transfer pricing for inter-company transactions with related parties. The aim is to manipulate artificially the price of goods, services or intangibles in order to switch income from a high-tax jurisdiction to a low-tax jurisdiction. Through the regulations under Code section 482, the Treasury has attempted to regulate transfer pricing in order to eliminate the perceived abuses.[60]

The legislation which set the stage for the FSC and its predecessor, the Domestic International Sales Corporation ("DISC"), was enacted by the U.S. Congress to enhance the international competitiveness of U.S. exporters. To achieve

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[55]To characterize a foreign corporation as a CFC, more than fifty percent of the corporation's voting power or stock value must be owned by U.S. shareholders. I.R.C. § 957(a) U.S. shareholders are defined in section 951(b).

[56]Under section 952, this technique is applicable to certain income accumulated in a foreign corporation.

[57]Section 951(b) defines U.S. shareholders for purposes of Subpart F treatment.

[58]Section 954(d)(1) reads in part: "For purposes of subsection (a)(2), the term "foreign base company sales income" means income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where- (A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and (B) the property is sold for use, consumption, or disposition outside such foreign country, or in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country."

[59]See GUSTAFSON ET AL., *supra* note 52, at 641.

[60]The Treasury's administration of the Treasury Regulations relating to transfer pricing followed a hard-line approach that was a source of constant disputes between U.S. exporters and the Treasury. To avoid such disputes the Congress enacted several tax regimes, such as the DISC and the FSC. Edwin S. Cohen et al., *A Decade of DISC: Genesis and Analysis*, 2 VA. TAX REV. 7, 24-25 (1982). The apportionment rules referred to in the main text have the objective of mitigating the administrative problems arising from the regulation and inspection of transfer pricing practices.

this goal, both regimes provided partial relief to U.S. exporters from Subpart F treatment and the regulations on transfer pricing. Thus, the DISC and the FSC represented a partial departure from the general anti-deferral mechanisms otherwise applicable to U.S. companies that carried on export operations.

C. *Third Part: Pre-FSC U.S. Export Incentives*

1. *U.S.'s Export Tax Incentives and the First Anti-Subsidy Dispute*

Since the enactment of Subpart F the U.S. has attempted to provide U.S. exporters some relief from Subpart F's anti-deferral treatment through four consecutive special tax regimes, namely the "export trade corporations" regime,[61] the DISC regime, the FSC regime and the current regime arising from the Income Exclusion Act. In addition, those special tax regimes have simplified the application of, and provided some relief from, the regulations on transfer pricing otherwise applicable to U.S. exporters.

European countries have successfully challenged the DISC regime and the FSC regime before the GATT and the WTO, respectively. In light of the failure of the U.S. to overcome two consecutive anti-subsidies actions against its export incentives tax regimes, a question is whether the U.S. Congress will ever be able to enact export incentives consistent with the SCM Agreement. In connection with the recent EU challenge against the recently enacted Income Exclusion Act, the conformity of the Income Exclusion Act with the WTO rules is not so clear. To evaluate that argument, some background information is useful.

2. *The Domestic International Sales Corporation*

The DISC regime was a tax deferral scheme enacted in 1971 as a partial relief measure for the unfavorable tax treatment applicable at that time to U.S. exporters, vis-à-vis the tax treatment applicable to exporters based in other countries.[62] This unfavorable treatment resulted both from the operation of Subpart F[63], and the implementation and administration of transfer pricing regulations by the U.S. Treasury. Indeed, commentators agreed that U.S. exporters' complaints about the administration of the regulations on transfer pricing were justified.[64] Conse-

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[61]See PAUL STEPHAN ET AL., *supra* note 41, at 828.

[62]According to Edwin S. Cohen and others, the disadvantaged situation of U.S. exporters was recognized by the U.S. Treasury in separate congressional hearings, where Treasury acknowledged the "complexity of the existing law, unfair treatment under U.S. tax laws of U.S. manufacturing for export, ambiguous intercompany pricing rules, and the need for certainty in the tax law." Edwin S. Cohen et al., *supra* note 58, at 24, 27.

[63]As noted above, Subpart F sets forth the concept of a "controlled foreign corporation" (CFC). Pursuant to the provisions contained therein the U.S. shareholders of a CFC are taxed on their proportional shares of the CFC's Subpart F income. In Cohen's view, the congressional purpose of the CFC concept was to curb the use of tax haven devices by U.S. exporters. See Edwin S. Cohen et al., *supra* note 58, at 12.

[64]See Edwin S. Cohen et al., *supra* note 58, at 24. U.S. exporters alleged that "the combination of vague regulations, lack of precedent, and innovative agents [left] them in doubt regarding the tax consequences of their international marketing plans until years after the fact." Edwin S. Cohen et al., *supra* note 58, at 24-25.

quently, the DISC regime was specifically designed to neutralize this unfavorable treatment for the benefit of U.S. exporters.

In order to cope with the problems arising from the administration of the regulations on transfer pricing, a specific rule was enacted for the allocation of income between a U.S. manufacturer and a DISC (*i.e.*, fifty percent to each).[65] The combined effect of this allocation rule and the deferral of fifty percent of export-related income, also provided for under the DISC regime, resulted in the current taxation of seventy-five percent of the income derived from the overall export operation and a tax deferral of the remaining twenty-five percent.[66]

3. *The GATT Dispute on the Domestic International Sales Corporation*

In February 1972, the EU requested consultations with the U.S. regarding the inconsistency of the DISC regime with the exports-related subsidies rules provided by Article XVI:4 of GATT 1947.[67] As mentioned above, the GATT 1947 rules were imprecise and did not provide any definition of subsidies.

The U.S. denied any violation of these rules and filed a counterclaim on similar grounds against the income tax regimes of France, Belgium and the Netherlands.[68] The U.S. defended the DISC regime on the grounds that the tax benefits arising thereunder were similar to the tax benefits arising under the territorial system of taxation used by these three countries. Since consultations failed to settle the dispute, four separate panels ("Panels") were established to deal with these complaints, initiating the so-called "Tax Legislation Cases."[69] On November 2, 1976, the Panels issued their respective reports in which it was determined that each country had violated GATT 1947's anti-subsidies rules.

With respect to the three European countries, the Panels found that each country had "allowed some part of the export activities belonging to an economic process originating in the country, to be outside the scope of [applicable

[65] I.R.C. § 994(a).

[66] This favorable treatment was enhanced by the Tax Reform Act of 1976, which amended the original DISC regime. See Edwin S. Cohen et al., *supra* note 58, at 31.

[67] Article XVI:4 set forth "4. Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing, subsidies." General Agreement on Tariffs and Trade, 55 UNTS 194; BISD IV (1969).

[68] The tax systems in these three countries, at the time of the DISC dispute, were based on a territorial principle, under which income deriving from exports generally was considered foreign source income not subject to taxation. In addition, these tax systems generally allowed a generous dividend received deduction (*i.e.*, up to 95 percent) to a parent corporation on the dividends distributed by its foreign subsidiary.

[69] *Tax Legislation - United States Tax Legislation (DISC)*, L/4422, BISD 23S/98, Report of the panel adopted 7-8 December 1981; *Tax Legislation - Income Tax Practice Maintained By France*, L/4423, BISD 23S/114, Report of the panel adopted 7-8 December 1981; *Tax Legislation - Income Tax Practice Maintained By Belgium*, L/4424, BISD 23S/127, Report of the panel adopted 7-8 December 1981; *Tax Legislation - Income Tax Practice Maintained By The Netherlands*, L/4425, BISD 23S/137, Report of the panel adopted 7-8 December 1981.

income] taxes. In this way [the country] has foregone revenue from this source and created a possibility of pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries."[70]

The Panel constituted for the DISC regime concluded that "the DISC legislation in some cases had effects which were not in accordance with the United States obligations under Article XVI:4 [of GATT]."[71] The Panel also observed that "the [income tax] deferral did not attract the interest component of the tax normally levied for late or deferred payment and therefore . . . to this extent, the DISC legislation constituted a partial exemption which was covered by . . . the illustrative list."[72]

U.S. commentators criticized the Panel's report on several grounds.[73] First, many noted that the report did not establish the meaning of a subsidy or explain which aspect of the DISC regime was characterized as a subsidy.[74] Second, many said that the report failed to recognize that the DISC did not constitute an export incentive, but rather a means to place U.S. exporters on an equal footing with exporters of other countries.[75]

The four countries involved refused to accept the Panels' reports.[76] However, without recognizing any violation to GATT 1947, the parties settled the dispute with an agreement that was adopted by a GATT Council decision rendered in December 1981, which in substance reversed the Panels' reports. The Council's decision provided:

> "The Council adopts these reports on the understanding that with respect to these cases, and in general, *economic processes* (including transactions involv-

[70]BISD 23S/114, paragraph 47; BISD 23S/127, paragraph 34; and BISD 23S/137, paragraph 34.

[71]BISD 23S/98, paragraph 74.

[72]*Id.*, at paragraph 71.

[73]See, for instance, Professor Jackson commentary, stating, "[A]lthough the Panel's statements of facts and the parties' argumentation is thorough, the reasoning expressed in the conclusions of the Panel is opaque, questionable and incomplete." Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 Am. J. Int'l. 747, 764 (1978). See also a criticism of these reports in Edwin S. Cohen et al., *supra* note 58, at 45.

[74]"Foremost, the reports fail to state clearly the meaning of the term 'subsidy'. In the case of the DISC, it is not clear whether the definition of 'subsidy' is limited to the excused interest on the deferral or whether the Panel´s economic benefit analysis should be interpreted to mean that any benefit conferred by a member government upon its exporters is violative of Article XVI(4). The DISC Panel seems to have adopted only the more narrow interpretation as its formal conclusion. If the extent of the benefits is limited to the excused interest, then quite an international storm has been raised about a relatively minor sum." Edwin S. Cohen et al., *supra* note 58, at 45.

[75]Cohen defends the position that the DISC was never designed to be an export incentive but a formula to address the obstacles to U.S. exports created by the operation of Subpart F and the administration of the transfer pricing rules under section 482. See Edwin S. Cohen et al., *supra* note 58, at 46. In this author's opinion, the positions of these other authors might be regarded as somewhat artificial because whether you consider the DISC as an export incentive or a formula to remove a disincentive to exporters the end result would be the same.

[76]GATT operated under a contractual approach, whereas the WTO operates under an institutional framework. In a contractual framework, any country could block a Panel decision. In other words each country involved in a dispute had to agree on the Panel's decision in order to make the decision binding.

> ing exported goods) *located outside the territorial limits of the exporting country* need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. *It is further understood that Article XVI:4 requires that arm's-length pricing be observed*, *i.e.*, prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign income."[77] [*emphasis added*]

At first glance, it appears that the GATT Council's decision intended to vindicate both territorial taxation systems and worldwide taxation systems. In essence, however, commentators agreed that the Council's decision constituted a tacit recognition that territorial systems of taxation were consistent with GATT rules.[78] In connection with countries with a worldwide system of taxation, the GATT Council's decision established a safe harbor rule that could be adopted by such countries in order to prevent future anti-subsidies claims.[79] The safe harbor rule held that any country need not tax income connected with economic processes occurring outside its territory, provided they were consistent with the

[77]*Tax Legislation*, BISD 28S/114 (December 7-8, 1981).

[78]Professor Stephan comments, "The Council essentially legitimated the 'territorial' system of taxation utilized by exemption-method countries. Reasoning that GATT was not intended to interfere with traditionally accepted measures for the avoidance of double taxation of foreign income, it concluded that a country need not tax income derived from economic processes carried on outside its borders. However, it also warned that the arm's length principle had to be used when determining the amount of income so derived ..." Paul B. Stephan et al., *supra* note 41, at 828-29. See also Edwin S. Cohen et al., *supra* note 58, at 54-55.

[79]This interpretation of the GATT Council decision was indeed used as an argument by the U.S. government in the later FSC dispute: "The 1981 Council Decision effectively overruled the panel's decisions with respect to France, Belgium, and the Netherlands, and established a clear-cut territorial test for determining whether a particular income tax measure constitutes an export subsidy; namely, that income attributable to activities taking place outside the territory of the taxing country need not be taxed, and that a decision not to tax such income does not give rise to an export subsidy. This test permitted France, Belgium and the Netherlands to retain their export-favoring territorial-type systems, while at the same time providing the United States with clear rules for how it might modify its tax laws so as to provide, in a GATT-consistent manner, the same treatment provided by European governments to their exporters. The rules contained in the 1981 Council Decision built upon the rules contained in the Subsidies Code, and those rules were not altered during the Uruguay Round negotiations that resulted in the SCM Agreement." WT/DS108/R, October 8, 1999**,** paragraph 4.331. Consider also the comments of Edwin S. Cohen: "Thus, the GATT resolution may be interpreted to condemn the DISC while sanctioning the territorial tax systems of France, Belgium and the Netherlands." Edwin S. Cohen et al., *supra* note 58, at p. 54. Consider also the comment made by Field: "The GATT Council's decisions on December 1 appear to have ratified the basic conclusions of the panel report that condemned the DISC legislation. Indeed, the first two of the three criteria adopted by the GATT Council arguably strengthen that condemnation, since DISC defers taxes on some portion of the 'economic processes' taking place *within* the United States. This is in apparent violation of the first criterion. In addition, the 'four percent' and 'fifty-fifty' rules in section 994 of the Code depart from the arm's-length pricing standard and appear to violate the second criterion." Field, *GATT Acts on Export Tax and Panel Reports*, 13 Tax Notes (TA) 1485, (1981). Finally consider the comment made by Paul B. Stephan et al: "As explained . . . the GATT Council

arm's length principle.[80]

4. *The Tokyo Subsidies Code and Income Tax-Related Subsidies*

Before considering the FSC case, it is useful to review some provisions of the Tokyo Subsidies Code, which was agreed upon by the U.S. and certain other countries in April 1979 as part of the GATT's Tokyo round of negotiations.[81] The Tokyo Subsidies Code was signed three years later, after the GATT Panels issued their reports on the Tax Legislation Cases and two years before the GATT's Council final decision on the Tax Legislation Cases described above.

The Tokyo Subsidies Code attempted to implement Article XVI:4 of GATT. At the time the FSC legislation was enacted by the U.S., the Tokyo Subsidies Code set forth the general standard on subsidies. Thus, it may be argued that when the U.S. designed the FSC, it had the Tokyo Subsidies Code in mind.

Article 9 of the Tokyo Subsidies Code restated the GATT 1947's rule prohibiting subsidies on exports[82] and introduced an illustrative list of practices considered to be export subsidies.[83] This list was included as an Annex to the Tokyo Subsidies Code. The most relevant provision for the analysis of the genesis of the FSC regime is paragraph (e) of the illustrative list:

> "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."[84] [*emphasis added*]

With respect to deferral, footnote 2 to paragraph (e) of the Annex further provided:

> "The signatories recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The signatories further recognize that nothing in this text prejudges the disposition by the CONTRACTING PARTIES of the specific issues raised in GATT document L/4422."[85]

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eventually condemned the DISC rules as a violation of the GATT's prohibition of export subsidies. Though this condemnation was obviously significant, perhaps even more important was the Council's explanation of acceptable tax measures. . . . The Council essentially legitimated the 'territorial' system of taxation utilized by exemption-method countries." STEPHAN ET AL., *supra* note 41, at 828-829.

[80]For an explanation of the arm's length principle and its implications to WTO members see the Conclusion of this paper.

[81]The Subsidies Code was signed mostly by industrialized countries which were members of GATT. Other members of GATT did not sign this Code because, at the time of its signature, many developing countries justified the use of subsidies as a means to foster or protect their infant industries.

[82]"1. Signatories shall not grant export subsidies on products other than certain primary products." Tokyo Subsidies Code, article 9, para. 1.

[83]Tokyo Subsidies Code, article 9, para. 2.

[84]Tokyo Subsidies Code, Annex, para. (e).

[85]GATT document L/4422 contains the DISC Panel Report. The complete text of note 2 to the Tokyo Subsidies Code is the following: "The signatories recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The signatories further recognize that nothing in this text prejudges the disposition by the CONTRACTING PARTIES of the specific issues raised in GATT document L/4422. The signatories reaffirm the principle

Paragraph (e) of the illustrative list constituted a prohibition on tax deferral regimes, unless interest charges were included. However, it could arguably be said that the second sentence in the referred footnote 2 was meant to grant a *temporary* immunity to the DISC regime, while the U.S. repealed or modified it.[86] Indeed, footnote 2 to paragraph (e) of the Annex provided that GATT signatories with tax regimes incompatible with paragraph (e) should be granted a "reasonable period of time" to bring their tax regimes into compliance with this provision.[87] In this respect, a commentator noted that "at the time the Tokyo Round Agreements were adopted, the United States had major [political] difficulties ending the DISC and this had to wait until after the presidential elections in 1980."[88]

Until 1984, due to increasing political pressure exerted by the then European Economic Community, the U.S. amended the DISC regime and created a new export tax incentive regime, that is the FSC. The DISC was kept by Congress as a tax incentive for to small U.S. exporters, but it was transformed into an interest-charge DISC to make it consistent with the existing GATT discipline on subsidies, which prohibited interest-free tax deferrals. Congress introduced the FSC in order to provide for a tax incentive to larger U.S. exporters. The FSC was allegedly designed to overcome any future GATT anti-subsidy action.[89]

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that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any signatory may draw the attention of another signatory to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the signatories shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of signatories under the General Agreement, including the right of consultation created in the preceding sentence. Paragraph (e) is not intended to limit a signatory from taking measures to avoid the double taxation of foreign source income earned by its enterprises or the enterprises of another signatory. Where measures incompatible with the provisions of paragraph (e) exist, and where major practical difficulties stand in the way of the signatory concerned bringing such measures promptly into conformity with the Agreement, the signatory concerned shall, without prejudice to the rights of other signatories under the General Agreement or this Agreement, examine methods of bringing these measures into conformity within a reasonable period of time. In this connection the European Economic Community has declared that Ireland intends to withdraw by 1 January 1981 its system of preferential tax measures related to exports, provided for under the Corporation Tax Act of 1976, whilst continuing nevertheless to honor legally binding commitments entered into during the lifetime of this system."

[86]In the FSC case the European Communities alleged before the Panel that the second sentence in footnote 2 was "specifically designed to protect the U.S. DISC/FSC legislation." See WT/DS108/R, October 8, 1999, at para. 4.663.

[87]"Where measures incompatible with the provisions of paragraph (e) exist, and where major practical difficulties stand in the way of the signatory concerned bringing such measures promptly into conformity with the Agreement, the signatory concerned shall, without prejudice to the rights of other signatories under the General Agreement or this Agreement, examine methods of bringing these measures into conformity within a reasonable period of time." Tokyo Subsidies Code, Annex, note 2, fourth paragraph.

[88]Statement of the European Communities representative before the FSC Panel. See WT/DS108/R, October 8, 1999, at para. 4.663.

[89]GUSTAFSON ET AL., *supra* note 52, at 665.

D. *Fourth Part: The FSC Regime and the WTO Dispute*

1. *The Foreign Sales Corporation*

The FSC regime was enacted as part of the Deficit Reduction Act of 1984, to provide major U.S. exporters with a substitute for the DISC regime.[90] Unlike the DISC, the FSC required the incorporation of a company outside the U.S. The location of a sales subsidiary abroad, along with certain other measures,[91] arguably provided to the U.S. a legitimate basis to forego taxation on income attributable to economic processes taking place outside the U.S., under the safe harbor rule mentioned above. In most cases FSCs were incorporated in tax-haven jurisdictions in order to preserve the tax benefits arising under the FSC regime, which otherwise would have been reduced by any foreign taxes imposed on the FSC's income.

In accordance with the FSC regime, U.S. exporters structured their export operations under a parent-subsidiary scheme whereby the FSC purchased and resold the products manufactured in the U.S. by its parent corporation. A key concept to the FSC regime was "foreign trade income" which refers to income from export-related operations carried out by the FSC. These operations included, *inter alia*, the disposition or lease of "export property."[92] Export property generally consisted of property manufactured in the U.S. with a minimum of fifty percent U.S. contents value.[93] The export tax-incentive was only available for foreign trade income and consisted of tax benefits for the FSC at both the corporate and the shareholder levels.

At the corporate level there was a tax exemption for a certain portion of the foreign trade income derived by the FSC. The portion of the foreign trade income subject to the exemption was calculated using either arm's length pricing or special administrative pricing rules ("Administrative Pricing Rules").[94] To make effective this exemption the Code treated a portion of the foreign trade income as foreign source income not effectively connected with a U.S. trade or business.[95] This treatment arguably amounted to a departure from source principles otherwise applicable.[96]

[90]The DISC regime was amended in 1984 and has continued to exist as a vehicle for small size U.S. exporters. The amended DISC regime came with an interest charge on the amount of taxes deferred.

[91]For instance the foreign sales subsidiary had to have a substantial presence abroad.

[92]I.R.C. § 924(a). The concept also includes export-related services and certain other services performed abroad (*e.g.*, construction projects-related services).

[93]I.R.C. § 927(a)(1).

[94]The administrative pricing rules were part of the EU complaint filed before the WTO Dispute Settlement Body.

[95]I.R.C. § 921(a).

[96]Repealed I.R.C. section 921(d) read: "For purposes of this chapter [Foreign Sales Corporation] (1) all foreign trade income of a FSC other than- (A) exempt foreign trade income, ... shall be treated as income effectively connected with a trade or business conducted through a permanent establishment of such corporation within the United States. Income described in paragraph (1) shall be treated

At the shareholder level there was a one hundred percent dividends received deduction to the parent corporation for dividends distributed by the FSC "out of earnings and profits attributable to foreign trade income."[97] This was a major departure from applicable U.S. corporate taxation rules which deny any dividends received deduction to U.S. corporate shareholders of *foreign* corporations.

A third departure from U.S. international tax rules was the exemption granted to FSCs with regard to Subpart F treatment. In most cases FSCs were wholly owned subsidiaries, thus qualifying to be treated as a controlled foreign corporation, with income subject to Subpart F treatment. However, in order to give full economic effect to the tax benefit at the shareholder level, the Code had to exclude all or part of the FSC foreign trade income from Subpart F treatment. This goal was achieved through Code section 951(e) which exempted FSC income from Subpart F treatment.[98]

In short, absent the FSC regime, the overall foreign trade income derived by the foreign sales subsidiaries of U.S. exporters would have been subject both to the U.S. standard double taxation (*i.e.*, at the corporate level and at the shareholders level) and to constructive dividend treatment under Subpart F.

While the DISC was designed as a tax deferral scheme, the FSC was essentially designed to operate as a tax exemption scheme. The switch from a deferral formula to an exemption formula might be attributed to the U.S. desire to hold on to an export incentive for U.S. exporters that could be defended as consistent with the 1981 GATT Council Decision and the then applicable Tokyo Subsidies Code.[99]

Indeed, the general explanation of the FSC provisions provided by the staff of the Joint Committee on Taxation clearly indicates the intent of Congress to conform the new tax incentive to the 1981 GATT Council Decision.[100] Thus, in

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as derived from sources within the United States." Under generally applicable source rules foreign source income derived through a permanent establishment of a foreign corporation within the U.S. would constitute income effectively connected with a U.S. trade or business, and, thus, taxable as domestic source income. See I.R.C. § 864(c)(4)(B)(iii).

[97] I.R.C. § 245(c)(1)(A).

[98] As a controlled foreign corporation the income derived by a FSC generally constitutes foreign base company sales income. Under Subpart F this kind of income would be treated as income taxed to the U.S. parent-corporation as a constructive dividend under sections 952(a)(2) and 954(d). See Gustafson et al., *supra* note 52, at 641. The amount of the foreign trade income subject to exemption from Subpart F treatment would depend on the transfer pricing rules selected by the FSC.

[99] In the FSC dispute the U.S. government expressly mentioned: "Both the United States and the European Communities were parties to the *Tax Legislation Cases*. The United States enacted the FSC for the specific purpose of complying with the findings of the DISC panel, as interpreted by the Council Decision." Section 4.703 of the WTO Panel report (WT/DS108/R, 8 October 1999). During the FSC dispute some of the lines of defense of the U.S. were based upon the 1981 GATT Council Decision and provisions of the Tokyo Round Code. For an opinion of the non-compatibility of the FSC with GATT see Jeffrey F. Ryan, *An Analysis of the GATT-Compatibility of the New Foreign Sales Corporation*, Comment, 26 SANCLR 693 (1986).

[100] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 prepared by the Staff of the Joint Committee on Taxation (1985).

order to qualify as a FSC a sales subsidiary had to meet several requirements, such as being incorporated outside the U.S., have economic substance, and carry out export related activities outside the U.S. Satisfaction of these requirements allegedly constituted evidence, under the 1981 GATT Council Decision, that the untaxed FSC's income derived from "*economic processes . . . located outside the territorial limits of the exporting country.*"[101]

In addition to the foreign economic processes related requirements, Congress was careful to set forth transfer pricing provisions which were allegedly consistent with GATT's arm's length standard.[102] Under the FSC regime, a U.S. exporter could choose either an arm's length pricing methods or the application of special Administrative Pricing Rules. Under the arm's length pricing method, prices were determined as if two unrelated parties were involved, negotiating at "arm's length." Under the Administrative Pricing Rules, prices were determined pursuant to certain pricing formulas. Transfer prices determined under each of these methods could vary significantly for the same export operation. Naturally, U.S. exporters chose the pricing method which allowed them to maximize the tax benefits arising from the FSC regime. In connection with the actual application of these pricing methods, a commentator noted that: "Often, the choice of one of the administrative pricing formulas will permit more foreign trade income to be put into the FSC than will the arm's length pricing method."[103]

In practice, the operation of the FSC rendered artificial the economic processes taking place outside the U.S.[104] For instance, even though most FSCs were incorporated in tax haven jurisdictions the actual exports-generating activities remained located within the U.S. Some commentators even referred to the FSC as a "form-only [entity] designed to mask a tax subsidy."[105] The FSC's export contingency requirements (*i.e.*, "export property" concept) made the tax regime even more vulnerable to anti-subsidy challenges. Therefore, it is not surprising that from its enactment the European Community objected the FSC.[106] Once again the U.S. was exposed to another international trade dispute relating to its new export-incentive regime.

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[101]*See supra* note 77.

[102]I.R.C. § 925. The fact that the FSC regime had its own Administrative Pricing Rules rendered inapplicable the Treasury Regulations relating to transfer pricing.

[103]GUSTAFSON ET AL., *supra* note 52, at 675.

[104]In the absence of the FSC regime, the income derived by most FSCs would had been taxable as income "effectively connected" with a U.S. trade or business, due to the fact that the FSCs typically carried out its export operations through a U.S. permanent establishment. A permanent establishment would had been deemed to exist because most FSCs carried out its export related activities through an agent located in the U.S. *See* I.R.C. § 924(d)(1)(A), which authorized FSCs to contract with its U.S. parent or any person to act as its agent without incurring in a U.S. trade or business. It could be argued that recourse to an agent provided FSCs sort of a "cover up", enabling FSCs to formally meet the *foreign economic processes* test.

[105]Philip L. Jelsma, *The Making of a Subsidy, 1984: The Tax an International Trade Implications of the Foreign Sales Corporation Legislation*, Note, 38 STAN. L. REV. 1327, 1361 (1986).

[106]See PAUL B. STEPHAN ET AL., INTERNATIONAL BUSINESS AND ECONOMICS, LAW AND POLICY 986 (1999 Suppl.).

2. *The World Trade Organization Dispute*

The WTO's Appellate Body upheld the Panel Report ruling that the FSC regime met the requirements to be considered a prohibited subsidy pursuant to the SCM Agreement on the grounds that the tax benefits provided under the FSC regime were export contingent.[107] The three tax benefits that the Appellate Body found inconsistent with the SCM Agreement were:[108]

1. Exemption from source determination rules: The Appellate Body determined that the FSC regime constituted an exemption from the effectively connected income rules otherwise applicable to comparable export operations, because under the FSC regime a portion of the FSC foreign trade income was statutorily deemed foreign source income, regardless of any factual analysis of the export operation.[109]
2. Exemption from dividends received deduction rules: The Appellate Body determined that the FSC regime constituted an exemption from the dividends received rules, because under the FSC regime the U.S. parent corporation obtained a one hundred percent dividends received deduction on the earnings distributed by FSCs. This deduction was not available to U.S. corporate shareholders of other foreign corporations.
3. Exemption from Subpart F treatment: The Appellate Body determined that the FSC regime constituted an exemption from Subpart F treatment, because under the FSC regime the foreign trade income derived by a FSC would not be deemed to be constructive dividends, otherwise taxable to the U.S. parent corporation under Subpart F.

Pursuant to Article 1.1 (a)(1) (ii) of the SCM Agreement, the Appellate Body confirmed that the combination of the three exemptions resulted in foregone government revenue that would otherwise be due if the FSC regime were not in place. In other words, the three exemptions amounted to a financial contribution by the U.S. government, for the benefit of U.S. exporters. Under the referred SCM Agreement's provision a financial contribution is deemed to exist where "government revenue that is otherwise due is foregone or not collected."[110] In

[107]The complaint against the FSC was based upon the violation of the SCM Agreement and the WTO Agreement on Agriculture. The WTO Panel identified sections 245(c), 921 through 927, and 951(e) of the IRC as the primary provisions constituting the FSC regime. See paragraph 7.34 and footnote 602 of the Panel Report, supra footnote 1. Canada and Japan also adhered to the European Union complaint as Third Participants.

[108]WT/DS108/AB/R at paragraphs 16 through 18.

[109]In the absence of the FSC regime, the income derived by most FSCs would had been taxable as income effectively connected with a U.S. trade or business, due to the fact that the FSCs typically carried out their export operations through a U.S. permanent establishment. A permanent establishment would had been deemed to exist because most FSCs carried out its export related activities through an agent located in the U.S. *See* I.R.C. § 924(d)(1)(A), which provides that a FSC can contract with its U.S. parent or any person to act as its agent. It could be argued that recourse to an agent provides FSCs with a cover up, enabling the FSC to meet the foreign economic processes test.

[110]Article 1.1(a)(1)(ii) of the SCM Agreement.

connection with this crucial test the WTO Panel resolved that absent any standard set in the SCM Agreement to determine whether certain foregone revenue is otherwise due, such determination shall be made by reference to a "government's own tax regime."[111]

The WTO Appellate Body also found that the three tax exemptions conferred by the FSC regime were export contingent on the ground that the three benefits were only available with respect to foreign trade income.[112] As explained in an earlier section, the FSC's tax benefits were only available with respect to foreign trade income, which was income derived from the disposition or lease of *export property*. To qualify as export property goods had to be manufactured in the U.S. with a minimum of fifty percent U.S. content value.

During the FSC dispute proceedings the U.S. relied heavily on the 1981 GATT Council decision and on footnote 59, both quoted above[113]. The U.S. argued that the foreign economic processes language of the 1981 GATT Council decision and the second sentence of footnote 59 provided a controlling legal standard to the effect that a WTO member has a right not to tax foreign economic processes and may make non-taxation of these foreign economic processes contingent upon any condition it deems appropriate. Consequently, since the FSC was incorporated and operated outside the U.S., the U.S. could grant any tax exemption to it. Nevertheless, the WTO Appellate Body resolved that the 1981 GATT Council decision did not "provide useful interpretative guidance in resolving the legal issue" relating to the FSC dispute.[114] The WTO Appellate Body explained that the factual and legal issues that arose in the Tax Legislation Cases were rather different from the issues that arose in the FSC dispute.

With regard to footnote 59, the WTO Panel determined that it did not find anything that "would lead us to conclude that a Member that decides that it will tax income arising from foreign economic processes does not forego revenue 'otherwise due' if it decides in a selective manner to exclude certain limited categories of such income from taxation." [115] With respect to the same point, on

[111]WTO Panel's Report, *supra* note 2, at para. 7.42.

[112]See Article 3.1(a) of the SCM Agreement and paragraph (e) of Annex I thereof.

[113]Footnote 59 to paragraph (e) of the Illustrative List of Export Subsidies contained in Annex I of the SCM Agreement. See supra note 29 and accompanying text.

[114]*See* WTO Appellate Body's report, *supra* note 1, para. 120. As mentioned earlier, the *Tax Legislation Cases* were settled by the 1981 GATT Council decision. With respect to this decision the WTO Panel resolved: "In conclusion, we do not consider that the 1981 understanding is part of GATT 1994, nor that it represents subsequent practice in the application of GATT 1947 establishing the agreement of the contracting parties regarding its interpretation. The 1981 understanding is in our view a "decision" within the meaning of Article XVI:1 of the WTO Agreement which shall "guide" the WTO to the extent relevant. However, we consider that the 1981 understanding cannot provide guidance in understanding detailed provisions of the SCM Agreement which did not exist at the time the understanding was adopted." WTO Panel's report, *supra* note 2, para. 7.85.

[115] WT/DS108/R at paragraph 7.92.

appeal, the Appellate Body further stated that:

> [The issue] is not, as the United States suggests, whether a Member is or is not obliged to tax a particular category of foreign-source income. As we have said, a Member is not, in general, under any such obligation. Rather the issue in dispute is whether, *having decided to tax a particular category of foreign source-income*, namely foreign-source income that is "effectively connected with a trade or business within the United States," the United States is *permitted to carve out an export contingent exemption from the category of foreign-source income that is taxed under its other rules of taxation.*[116] [emphasis in original]

The quoted language synthesizes the rationale of the ruling rendered against the U.S. In effect, the test articulated by the WTO Appellate Body in the FSC dispute is that whenever a government has decided to tax a particular category of income it cannot grant an export-contingent exemption on income belonging to such category without violating its obligations under the SCM Agreement. Such a test constitutes a serious blow to the ability of the U.S. to comply with its obligations under the SCM Agreement. This is so because, the U.S. has embraced international tax rules (*e.g.*, Subpart F) that *intrinsically* constitute a competitive disadvantage to U.S. exporters, vis-à-vis international taxation principles adopted by other countries, which inherently foster exports. Accordingly, if the test articulated by the Appellate Body were broadly interpreted, it could be argued that any tax relief measure enacted by the U.S. for the benefit of exporters could be challenged as a departure from established U.S. international taxation principles.

During the FSC dispute proceedings, the U.S. raised a procedural defense based upon footnote 59, arguing that the WTO dispute settlement mechanism was not an appropriate forum to resolve the FSC dispute. Footnote 59 provides that ". . . Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms. . . ."[117] Accordingly, the U.S. asked to forward the FSC dispute to an appropriate forum such as the Organization for Economic Cooperation and Development ("OECD"). However, the WTO Panel resolved that footnote 59 could not be interpreted as restraining the right of a WTO Member to utilize the dispute settlement mechanism provided by the SCM Agreement.

Finally, it should be mentioned that the complaint filed by the EU before the WTO contained a claim that the FSC's Administrative Pricing Rules referred above were a separate subsidy. However, having found that the three FSC's tax benefits described above constituted a prohibited subsidy the Panel found it pointless to render a decision with respect to the Administrative Pricing Rules. Thus, the validity of non-arm's length pricing methods was left undecided.[118]

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[116]WT/DS108/AB/R at paragraph 99.
[117]See infra note 29 and accompanying text.
[118]WTO Panel´s report, *supra* note 1, para. 7.127.

E. *Fifth Part: The Income Exclusion Act and the WTO*

1. *The Income Exclusion Act*

The Income Exclusion Act constitutes the fourth attempt of the U.S. to place its exporters in a competitive advantage vis-à-vis the exporters of other countries without violating its obligations under a multilateral trade agreement. While the FSC was designed to operate as a tax *exemption* regime, the Income Exclusion Act is designed to operate as a tax *exclusion* regime.[119]

The shift from an exemption formula to an exclusion formula was presumably driven by the test articulated by the WTO Appellate Body in the FSC dispute, referred to in the prior section of this paper. The U.S. Congress may have concluded that if the Appellate Body had resolved that a country could not grant export-contingent *exemptions* with respect to categories of income it had decided to tax, then the Appellate Body could not object a country's decision to *exclude* from taxation *a particular category of income.*

Unlike the prior regimes (*i.e.,* DISC and FSC), under the Income Exclusion Act no conduit business entity, either domestic or foreign, is required to obtain the tax benefits deriving thereunder. The removal of a foreign conduit entity definitely narrows the range of subsidy related claims that could be made in the future by any WTO member against the Income Exclusion Act. This is so because all of the SCM Agreement violations found by the WTO Appellate Body (*e.g.*, exemption from "Subpart F" treatment) were related to the export operations carried on outside the U.S. by foreign subsidiaries of U.S. corporations.[120]

The cornerstone concept of the Income Exclusion Act is the concept of "extraterritorial income." Extraterritorial income is defined as the gross income of the taxpayer attributable to foreign trading gross receipts, which (for purposes of this paper) is a key concept of the new regime. "Foreign trading gross receipts" refers, *inter alia*, to gross receipts from the sale or exchange of "qualifying foreign trade property" or the lease of qualifying foreign trade property for use outside the United States. [121] Only those gross receipts that derive from *economic processes* that take place outside the U.S. are characterized as foreign trading gross receipts.[122]

In order to avoid export-contingency characterization the Income Exclusion Act provides that qualifying foreign trade property does not need to be manufactured, produced or grown in the U.S. At first glance the new regime appears to

[119]I.R.C. § 114.

[120]It should be noted, however, that some of the repealed FSC regime concepts have been kept under the new regime with slightly changed labels (*e.g.*, "qualifying foreign trade income" resembles the "foreign trade income" concept; or the "qualifying foreign trade property" resembles the "export property" concept).

[121]I.R.C. § 942. The concept also includes export-related services and certain other services performed abroad (*e.g.*, construction projects-related services).

[122]I.R.C. § 942 (b)(1).

be consistent with the SCM Agreement. However, there are two requirements that greatly reduce the kinds of property that can be characterized as qualifying foreign trade property. The first one is that qualifying foreign trade property has to be "held primarily for sale, lease, or rental, in the ordinary course of business, for direct use, consumption, or disposition *outside* the United States."[123] The second one is that not more than fifty percent of its fair market value can be attributable to foreign content. Consequently, when we consider how certain property can be characterized as qualifying foreign trade property it is difficult to avoid identifying property that meets such requirements as property that is generally subject to export transactions. In other words, even though the U.S. Congress formally removed the export requirement, in substance it appears that the new regime is mostly targeting export activities.

Extraterritorial income is divided into "qualifying foreign trade income" and "non-qualifying foreign trade income." Under the new regime qualifying foreign trade income should be excluded from gross income, thus resulting in a reduction of the taxpayer's taxable income determined according to one of three mathematical formulas. According to a commentator "the [gross income] exclusion would be automatic but the taxpayer may elect, on a transactional basis, whichever [mathematical] formula yielded the greatest tax benefit."[124] Non-qualifying foreign trade income is not excludable from gross income. [125]

A U.S. commentator has already noted that the whole picture arising from the new regime appears to be "a clear expectation of export." [126] The crucial issue for the U.S. is that if the new regime does constitute an *expectation of export*, it would place the new regime in a collision course with the SCM Agreement. Particularly since the new regime seems to be inconsistent with footnote 4 to Article 3.1(a) of the SCM Agreement which provides:[127]

> "This standard [export contingency "in fact"] is met when the facts demonstrate that the granting of a subsidy, *without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings*. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision." [emphasis added]

As mentioned earlier, the SCM Agreement makes a distinction between de jure export subsidies and de facto export subsidies. In light of this footnote the new regime could be interpreted as creating a subsidy contingent "in fact" upon export performance.

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[123]I.R.C. § 943(a)(1)(B).

[124]Lee A. Sheppard, *"An Export Subsidy Is an Export Subsidy"*, Tax Analysts, document number: Doc 2000-20325 (12 original pages), July 28, 2000. Paradoxically, in most situations, only a relatively modest proportion of the overall extraterritorial income of a U.S. corporation would be excluded from gross income. It has been calculated that approximately between 15 percent to 30 percent of the extraterritorial income would be excluded from taxation.

[125]I.R.C. § 114 (b).

[126]Lee A. Sheppard, *supra* note 122.

[127]Footnote 4 to Article 3.1(a) of the SCM Agreement.

Interestingly the Income Exclusion Act makes reference to the economic processes that "take place outside the U.S.,"[128] which resemble a portion of the language of the 1981 GATT Council decision. As explained above, the WTO Appellate Body ruled that such GATT Council decision was not a controlling legal principle in the FSC dispute. The use of that language in the Income Exclusion Act appears to indicate that, in the event of any challenge against the new regime, the U.S. will insist on the sovereign right of every country to tax foreign economic processes in any way it deems appropriate. If that was the case, it should be recalled that the WTO Appellate Body ruled that the crucial issue is not whether every WTO member has the right to tax foreign economic processes, but whether a WTO member has selectively excluded certain limited categories of export-related income from taxation.

2. *Is the Income Exclusion Act Consistent with the SCM Agreement?*

As explained above the new regime was designed to use a tax exclusion approach rather than a tax exemption approach. Under the new regime the U.S. Congress has inverted the equation by which taxpayers may claim the tax benefits arising thereunder. Thus, taxpayers do not need to worry about meeting the requirements of a tax exemption. This is so because the tax exemption has been transformed into the general rule, and every taxpayer is entitled to receive the tax benefit arising from the general rule, *provided* he meets certain stringent requirements. Even though in practice the end result appears to be almost the same as it was under the FSC regime, the U.S. is certain that having decided to exclude extraterritorial income from taxation there is no way that the new regime can be regarded as inconsistent with the SCM Agreement.

The EU has already contended that the Income Exclusion Act does not conform to the WTO Dispute Settlement Body ruling, which adopted the WTO Appellate Body Report. In a press release the EU Commission asserted that the Income Exclusion Act provides for "an exception to a general rule, as every transactions that does not match the criteria established by the law will be taxed, under the guise of a general principle." [129] In the same release the EU Commis-

[128]I.R.C. § 942 (b)(1).

[129]On November 17, 2000, the EU Commission released a document, providing several answers to frequently asked questions in connection with the FSC trade dispute and the new Income Exclusion Act. A partial text of the document concerning some answers related to the new regime reads:

"2. Questions on the FSC Scheme and the FSC Replacement legislation:

(11) Why is the EU challenging the FSC replacement legislation?

This new system is basically identical to the FSC scheme. It provides that US companies will not be taxed on part of the income obtained from export sales if they export goods which are manufactured with more then 50 percent of US inputs. If the products are sold within the US or if they are made with less than 50 percent of US inputs, then all the income generated by the sale will be taxed. A company's tax burden on income derived from these export activities will be reduced between 15 to 30 percent. Furthermore, the proposed legislation includes transitional provisions that extend the application of the condemned FSC scheme, perpetuating the existing violation of the WTO rules at least until 1 January 2002.

(12) But is it not true that the new US legislation is not a subsidy, as it excludes "extraterritorial income" from taxation, just as the European tax systems do?

sion provided the following illustrations:

> In other words, it is like a car dealer that advertises a 20 percent discount on all its sales but just below he indicates that this offer is only valid for model (A). The simplest way to write this would be to say: 20 percent discount for all sales of model (A). The result in both cases is the same, but the way to draft it is different. That is exactly what the US law does under the cover of benefiting everybody, only one model, in this case US exports, actually benefits from the discount (tax break). . .

This is a totally incorrect statement. Simply reading the text of the law it can be realised that the contrary is true. The US law first provides that "extraterritorial income" will not be taxed. Then that the previous provision will only apply to "extraterritorial income" from certain transactions that comply with the particular requirements established by the law (sales outside the US, with more than 50 percent US inputs, etc). Therefore it provides for an exception to a general rule, as every transactions that does not match the criteria established by the law will be taxed, under the guise of a general principle. In other words, it is like a car dealer that advertises a 20 percent discount on all its sales but just below he indicates that this offer is only valid for model (A). The simplest way to write this would be to say: 20 percent discount for all sales of model (A). The result in both cases is the same, but the way to draft it is different. That is exactly what the US law does under the cover of benefiting everybody, only one model, in this case US exports, actually benefits from the discount (tax break).

(13) Even if it is a subsidy, the fact that not only companies exporting from the US but also US companies located outside the US can benefit from it eliminates the export contingency element condemned in the FSC scheme?

Maybe the best way to illustrate the fallacy of this is also to use an example. If hunting elephants is prohibited by an international treaty, a national law which allows elephants to be hunted will not be brought in line with the treaty if a new law is passed saying that also giraffes can be hunted. The violation of the treaty continues and will not be remedied by adding giraffes to the law as elephants can continue to be hunted in breach of the treaty. The same situation is present in the FSC replacement act. The fact of adding US companies located abroad to the universe of beneficiaries of the new law does not remove the violation as for those companies located within the US the only way to benefit from the FSC replacement act is by exporting.

(14) Were not the FSC and its replacement legislation an attempt from the US to apply the territorial tax systems principle to its tax system?

There are several reasons why the FSC and its replacement legislation were not intended to replicate the effects of territorial systems. First, it provides for a tax break to export sales while territorial systems do not. Second, it exempts income that is generated in the US, while territorial systems only exempt income derived from activities carried out abroad. Third, it does not apply arms-length transfer price rules to properly allocate taxable income, allowing domestic income to escape taxation. Fourth, it is not intended to avoid double taxation as FSCs are established in tax havens while territorial systems provide for special anti-avoidance rules. Fifth, the inclusion of an obligation to use more than 50 percent US inputs has nothing to do with either territorial or worldwide systems.

(15) Don't US companies suffer a disadvantage vis-a-vis EU companies from the fact that US taxes are paid on income generated outside the US while EU companies only pay taxes for income generated within Europe?

The decision not to tax economic activities abroad is an internationally recognised method to avoid that companies are taxed twice. The application of this fundamental principle of fairness in international taxation should not surprise anybody. If the US considers that its tax regime is disadvantageous to its companies it is completely free to change it the way it wants. It can replicate the tax system of its competitor, improve it, create a completely different one, etc. The only thing it cannot do is to provide export subsidies, in particular as a response to an allegedly disadvantageous situation resulting from its own sovereign choice on tax matters." The official citation for that document is MEMO/00/84 (November 17, 2000). The document can be viewed at the EU Commission's Europa website http://europa.eu.int/index-en.htm (Dispute Settlement, Overview of cases, United States - Tax Treatment for "Foreign Sales Corporations"). The document can also be viewed at Tax Analysts, with Document Number: Doc 2000-29641 (5 original pages).

> Maybe the best way to illustrate the fallacy of this is also to use an example. If hunting elephants is prohibited by an international treaty, a national law which allows elephants to be hunted will not be brought in line with the treaty if a new law is passed saying that also giraffes can be hunted. The violation of the treaty continues and will not be remedied by adding giraffes to the law as elephants can continue to be hunted in breach of the treaty.

On November 17, 2000, the EU requested authorization to launch retaliatory trade sanctions against the U.S.[130] Thus, unless the parties reach an agreement, the referred WTO Dispute Settlement Body will have to determine whether the new exclusion regime complies with the SCM Agreement.[131]

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[130]In the same press release quoted in the prior footnote the EU Commission provided several answers to frequently asked questions in connection with the sanctions requested and the procedure launched by the EU before the WTO. Some of the answers provided by the EU Commission thereon are the following:

"1. Questions on WTO procedures: sanctions, list and amount.

(1) What are the WTO procedural steps that the EU is required to take in order to protect its economic interests and its WTO rights?

Although the procedural agreements signed by the EU and the US on 29 September do not apply to the situation where the US has failed to adopt the FSC replacement legislation by 1 November, the EU will nevertheless agree to follow these procedures as the US has adopted the replacement legislation soon after the WTO deadline. The EU will therefore take the following steps in the WTO:

- on 17 November the EU has made a request for suspension of concessions to the WTO, indicating a list of products and an amount. This is so because, given the interpretation of the Dispute Settlement Understanding defended by the US during the banana dispute, failure to do so will result in the EU losing its rights.

- the EU will challenge the WTO compatibility of the US legislation by requesting a compliance panel in the WTO. The arbitration work will then be suspended until the compliance panel has ruled on the legality of the new US legislation.

(2) Why does the EU need to present a list of products to the WTO?

Failure to do so will put our WTO rights at risk. It has also been the consistent practice of WTO members, including the US in both the bananas and hormones cases, to present a list of products when requesting authorization to suspend concessions.

(3) How big is the list and what products are included on it?

The list of products that the EU has submitted to the WTO avoids premature and unnecessary effects on trade flows while at the same time complying with WTO obligations. At this stage the list includes chapters of the Common Customs Tariff without identifying individual products. The chapters selected are those where the EU has found that there are products that could be subject to sanctions without negatively affecting the EU industry and consumers as the degree of dependency from the US is low and there are alternative sources of supply available either within the EU or in third countries. This list constitutes the universe of products within which the EU will select products to be subject to sanctions if the new US legislation is again condemned by the WTO. The scope of the final list will depend on the WTO arbitrators' decision on the amount of sanctions the EU is entitled to apply. The Commission will consult with Member States and industry in selecting individual products that can be subject to sanctions.

. . .

(7) The latest press reports talk about a figure which is very high, between $4 and $26 billion, is this correct?

In accordance with the most recent WTO precedents, the EU can request authorisation to suspend concessions for the amount of the FSC subsidy. The EU has calculated the value of the subsidy at $4.043 million." EU Commission, *supra* note 117. With respect to the announced EU's request for sanctions see also statement made by U.S. Deputy Treasury Secretary Stuart Eizenstat, Tax Analysts, Document number 2000-29604 (4 original pages), November 16, 2000.

[131]Additionally the EU has noted that even though the FSC regime has been repealed, transactions involving an existing FSC will still be subject to the FSC regime for a certain transition period. The

The key provision that will likely determine the future of the new regime is footnote 4 to Article 3.1(a) of the SCM Agreement quoted in the prior section of this paper.[132]

How one resolves the consistency of the Income Exclusion Act with the provisions of the SCM Agreement depends on whether one applies a formalist or functionalist analysis to the interpretation of the Income Exclusion Act. Formalists would rely heavily on the Income Exclusion Act's text, while functionalists would look into the end result. A formalist analysis would likely give a long-awaited victory to the U.S. Under a functionalist analysis the chances of overcoming the EU's latest challenge would be less clear. Several news sources have already made public a confidential WTO compliance panel interim report that apparently favors the European Union.[133]

An innovative way of analyzing the new regime could be by application of the principles developed by the U.S. courts in tax law cases, such as the substance over form doctrine.[134] This particular doctrine is a tool widely used by the Internal Revenue Service to combat tax avoidance schemes designed by taxpayers. Consideration of this doctrine by a WTO compliance panel would be relevant in light of comments from U.S. analysts that in substance the new regime is not consistent with the SCM Agreement.[135]

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transition period elapses the day prior to January 1, 2002. Section 5(c) of the Income Exclusion Act. The European Union has argued that this transitional period constitutes an extension of the FSC regime, in violation of the WTO Dispute Settlement Body ruling.

[132]*See supra* Part E.1.

[133]*United States Apparent Loser in ETI Dispute,* Tax Analysts Document Number 2001-17523 (1 original page), 22 June 2001; *WTO Ruling on Tax Break Has Bush in Bind*, Helene Cooper, The Wall Street Journal page A2, June 25, 2001; *WTO Ruling Could Stoke EU-US Tension*, Edward Alden, The Financial Times (electronic version) June 22, 2001; *WTO Rejects US Tax Break*, Stephen Fidler, The Financial Times (electronic version) June 24, 2001; *EU-US Trade Dispute Simmering*, Guy de Jonquieres, The Financial Times (electronic version) June 26, 2001.

[134]For a discussion of, and application by US. Courts of, this doctrine see SAMUEL THOMPSON, TAXATION OF BUSINESS ENTITIES 59 (1994 West Publishing).

[135]Consider the following comment by Hank Gutman, former chief of staff for Congress' Joint Committee on Taxation, currently a partner in the Washington office of KPMG: "The question the WTO will have to answer is whether to look at the form of this law or the substance." *House Clears Tax Credit for Exporters*, The Wall Street Journal, November 15, 2000. During the legislative discussions that led to the enactment of the new regime U.S. Congressman Fortney Pete Stark, D-Calif., stated: "Finally, H.R. 4986 does not address the concerns of the WTO dispute panel. The new scheme attempts to allay the European Unions' concerns by allowing some foreign operations to also receive the subsidy. The new scheme eliminates the requirement on a firm to sell its exports through a separately chartered foreign corporation in order to receive the benefit. The only portion that is eliminated is the paper subsidiary. Instead of creating a tax haven, U.S. exporters will be able to receive the benefit outright. The new scheme doesn't prevent arms exporters or any other industry from receiving the entire benefit of the subsidy. The new scheme essentially leaves the export benefit in place but now the U.S. Treasury will forego an additional $300 million per year to subsidize U.S. exporters. The U.S. Treasury will forego more than $3 billion per year to help companies like Boeing and R.J. Reynolds peddle their products. Exporters will continue to receive a lower tax rate on income from export sales than from domestic sales. This is clearly prohibited under the WTO Agreement on Subsidies and Countervailing Measures." H7416-H7431; FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (September 12, 2000). Available also in Tax Analysts document number 2000-24267. *See also* Lee A. Sheppard, *supra* note 122.

IV. CONCLUSION

If one accepts the view that the past is prologue, the long-running controversy over export subsidies between the U.S. and several of its foreign trading partners provides lessons for all.

A. *Lessons For the U.S.*

While the DISC complaint was filed based upon Article XVI:4 of GATT 1947, as effective in 1973, [136] the FSC complaint was brought under the SCM Agreement which is quite different in content and scope. Article XVI:4 set forth the whole GATT discipline on subsidies in five paragraphs and was rather ambiguous and limited in scope. The SCM Agreement sets forth the WTO discipline on non-agricultural subsidies in thirty-two articles and seven annexes.[137] The SCM Agreement is broader in scope and constitutes a more technical approach to multilateral subsidies regulation.[138] The SCM Agreement is expected to bring certainty in a former obscure area of international trade regulation. However, even though the rules of the game became clearer the U.S. failed, for a second time, to defend its export incentive regime. Why so?

The second downfall of the U.S. in relation to export subsidies disputes raises a number of issues. The first one is whether the FSC regime was at any time consistent with U.S. obligations under succeeding multilateral agreements. In this regard two hypotheses can be formulated. The first hypothesis is that the FSC regime was consistent with GATT 1947, the Tokyo Subsidies Code and the 1981 GATT Council Decision, but became inconsistent with the SCM Agreement. The second hypothesis is that the FSC regime (which was enacted years before the SCM Agreement was negotiated at GATT's Uruguay Round) has never been consistent with any of those sets of multilateral rules. Earlier sections of this paper lead to the conclusion that the second is the correct hypothesis. In effect, in the briefs submitted by the U.S. during the FSC dispute, the U.S. relied heavily on the 1981 GATT Council Decision, which settled the dispute between the U.S. and three European countries.[139] However, the WTO Appellate Body decision made it clear that even assuming that the 1981 GATT Council Decision had not been superseded by the SCM Agreement, still its language was inapplicable to the FSC dispute. That means that even in the absence of the SCM Agreement the EU still would have had a good chance to defeat the U.S. based upon the anti-subsidy rules set forth in GATT 1947 and the Tokyo Subsidies Code.[140]

[136]The date the GATT Panels were established.

[137]The discipline on agricultural subsidies is contained in the WTO Agreement on Agriculture.

[138]With respect to the broader approach of the SCM Agreement see the Appellate Body Report p.42.

[139]The subject matter of such disputes was violations to GATT 1947 and the Tokyo Subsidies Code.

[140]The Tokyo Subsidies Code's Annex contained an illustrative list of practices that could be deemed to be export subsidies. Paragraph (e) of such Annex is identical to paragraph (e) of Annex I ("Illustrative List of Export Subsidies") to the SCM Agreement. The text of that paragraph is "the

A second issue concerns the absence in the SCM Agreement of a safe-harbor provision that would have helped the U.S. to overcome further challenges against its export incentives. This issue is particularly relevant if it is considered that since the time the FSC regime was enacted, U.S. and non-U.S. commentators questioned the conformity of the FSC regime with GATT 1947 and the Tokyo Subsidies Code. Furthermore, years before the FSC dispute was initiated the Europeans had denounced the FSC regime as a prohibited export subsidy.[141] Thus, with respect to the negotiation of the SCM Agreement the questions are: Why did not the U.S. trade representatives include any language therein that would have prevented a challenge to the FSC? Why did they not include any language that had affirmed the effectiveness of the 1981 GATT Council Decision?

Those issues are worthy of analysis, particularly if it is considered, first, that it is hard to find commentators who criticize the WTO ruling as an unsound decision,[142] and, second, that authoritative U.S. materials written before the FSC dispute was initiated explicitly referred to the FSC as a "subsidy to U.S. exports" or "export incentive."[143]

In connection with the negotiations that led to the Tokyo Subsidies Code and the 1981 GATT Council Decision, Professor Cohen suggested that the U.S. trade representatives failed to obtain appropriate expert advice on the treatment of income tax issues in multilateral trade negotiations.[144] As far as the Uruguay Round negotiations are concerned, it seems that the U.S. trade representatives missed for a second time to consult the international tax experts at the U.S. Treasury.

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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."

[141]In the press release quoted above the EU Commission stated "The FSC scheme is an across the board export subsidy that benefits all type of US companies and products. European companies have been complaining about FSC subsidies, either individually or as one of a number of subsidies granted to US firms, *for quite some time.* However, the factor that made the EU start this case was the rapidly increasing amount of FSC subsidies being granted in recent years and its global effect on EU companies' performance. The FSC gives a massive export subsidy, now worth over $4 billion dollars per year, which benefits around half of US exports, which compete directly with EU products. However, certain sources consider the real amount of the subsidies to be substantially higher. If we take into account that the FSC scheme has been in place since 1985, it is easy to understand the magnitude of subsidization being granted to US companies to the detriment of their world wide competitors, among them, EU companies." (emphasis added). EU Commission, *supra* note 127.

[142]It should be noted, however, that there are few authoritative comments that can be found with respect to the WTO Appellate Body's decision in the FSC dispute. Such scarcity of comments might be attributable to the fact that such decision is still a recent one, and also to the fact that the FSC dispute is not over yet. A critique of the WTO Appellate Body's decision can be found in Paul B. Stephan, *Sheriff or Prisoner? The United States and the World Trade Organization*, 1 Chicago Journal of International Law, 49, 61-65 (2000).

[143]*See* GUSTAFSON, et al., *supra* note 51, at 665. See also STEPHAN et al., *supra* note 41, at 827.

[144]*See* Edwin S. Cohen et al., *supra* note 58, at 21, 54. Professor Edwin S. Cohen was former Assistant Secretary of the Treasury for Tax Policy. He had a leading role in the design and implementation of the DISC. *See also* EDWIN S. COHEN, A LAWYER'S LIFE: DEEP IN THE HEART OF TAXES (Tax Analysts 1994).

The seeming failure of the U.S. trade negotiators to include a safe harbor provision in the SCM Agreement has driven the U.S. to engage in creative international tax planning, enacting several tax regimes in an attempt to conform to successive adverse international trade rulings. A safe harbor provision would have allowed the U.S. to place its exporters on an equal footing with exporters based either in territorial systems of taxation or in worldwide systems of taxation with weak anti-tax haven rules. Such failure might eventually drive the U.S. to consider either repealing some of the main features of its international taxation system or renegotiating the SCM Agreement.[145] Actually, a step in that first direction was the enactment of the Income Exclusion Act whose purpose is to set forth a regime that resembles as much as possible a territorial system of taxation. However, to the extent that the U.S. keeps untouched the fundamental principles of its international taxation system, any exclusionary regime created thereunder would prove rather artificial.

The essential issue is that U.S. export incentives are the result of a specific policy intention to favor exports rather than an incidental benefit arising from a tax system.[146] In contrast, the tax exclusion on foreign source income provided by territorial systems of taxation is more of a by-product of these systems than the result of an explicit policy decision. Thus, the U.S. has a serious structural obstacle to securing export incentives compatible with the SCM Agreement.[147] This point is illustrated by the fact that the U.S. Congress has classified every export incentive regime enacted so far as a tax *expenditure*, for federal budget purposes.[148] Indeed the U.S. Congress Joint Committee on Taxation has already calculated that the Income Exclusion Act will have a cost of $4.5 billion in lost revenue over ten years.[149] The budgetary treatment of export incentives as tax expenditures plays badly against the U.S. in future international trade disputes, since the revenue loss arising from the new regime could be regarded as prima facie evidence of a prohibited financial contribution under the SCM Agreement.[150] Under a territorial system of taxation it would prove rather difficult to find a government treating extraterritorial income as a tax expenditure.

[145]The U.S. could follow one of these courses of action: (i) return to the regime existent before the enactment of Subpart F in 1962 (before the enactment of Subpart F the foreign source income of a foreign corporation could not generally be taxed in the US), or (ii) substantially adopt a territorial tax system. With respect to a discussion of the U.S. alternatives in that regard see Edwin S. Cohen et al., *supra* note 58, at 53.

[146]*See* WTO Appellate Body comments on this regard. WT/DS108/AB/R at paragraph 99.

[147]It should be noted that the WTO Panel resolved in the FSC dispute that whether certain foregone revenue is “otherwise due”, such determination shall be made by reference to a “government’s own tax regime.”

[148]The WTO Panel in the FSC dispute analyzed the tax expenditure treatment afforded to the FSC regime in the U.S. federal budget. The DISC was also treated as tax expenditure in the U.S. federal budget. See Edwin S. Cohen et al., *supra* note 52, at 58.

[149]Robert Goulder, *House and Senate Reach Agreement on FSC Repeal Bill*, Tax Analysts document number Doc 2000-27756 (3 original pages) October 26, 2000. See also *U.S. Is Set to Clear Export-Tax Regime*, Wall Street Journal, November 13th 2000.

[150]“There is a financial contribution ... where: ...“Government revenue that is otherwise due is foregone or not collected.” Article 1.1 (a)(1) (ii) of the SCM Agreement.

In sum, for the U.S. the FSC dispute highlights the need to reexamine the virtues of its current international taxation system, vis-à-vis the international competitiveness of U.S. exporters. The long-standing effort of the U.S. to preserve a tax incentive for U.S. exporters arguably constitutes evidence in and of itself that some features of its international taxation system do affect the international competitiveness of U.S. exporters.[151]

B. *Lessons For the World*

For the rest of the world, the FSC dispute raises several cautionary yellow flags.

Even though the WTO Appellate Body emphasized that its report did not judge the merits of any system of taxation,[152] the FSC dispute constitutes a warning notice to other countries that have adopted worldwide systems of taxation along with strong anti-tax haven rules. In practice, countries with that kind of systems will likely struggle to achieve a balance between exports promotion and consistence with the WTO's subsidies discipline, in contrast to countries with territorial taxation systems or with worldwide taxation systems that have weak anti-tax haven rules.[153]

In general, reconciling income tax-based export incentives with international economic regulations has proven to be a complex task for many countries. Actually, the U.S. is not the only country struggling to find a way to harmonize tax relief measures with such kind of regulations. Across the Atlantic, the EU Court of Justice has tried disputes arising from claims against income tax provisions of individual EU's members that allegedly violated EU's competition law.[154] The comments with respect to the decisions rendered by the EU Court of Justice in those disputes indicate that the Europeans are also having a hard time dealing with income tax-related matters that fall under the scope of EU's competition law.[155] The EU Court of Justice has particularly been criticized in connection

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[151]Another issue is the fiscal cost of the exports incentives regimes enacted so far. For instance, the Income Exclusion Act's fiscal cost (*i.e.*, revenue foregone) has been calculated by the U.S. Congress in $4.5 billion.

[152]*See* WTO Appellate Body's report, *supra* note 1, at 60.

[153]Ultimately this paper should provide some assistance to tax policymakers over avoiding curtailing the international competitiveness of local exporters.

[154]"The *Tax advantages for newspaper publishers* case concerned a Frech tax measure allowing publishing firms publishing newspapers devoted to political news to form a tax-free reserve for the acquisition of equipment or buildings necessary for the publication of the newspaper, or to deduct from their taxable base any expenditure incurred for that purpose (apparently by allowing a current deduction rather than the normal depreciation over a number of years). French tax law also provided, however, that "publishing houses shall not benefit (from the tax relief) in respect of any part of their publications printed abroad". The drafter of this clause was probably not skilled in Community law. As was to be expected, the Court considered that the French measure caused French publishing houses to have their printing done in France rather than abroad, thus clearly resulting in an obstacle to intra-Community trade. Consequently, the contested French tax provision was regarded as a prohibited measure having an equivalent effect as a quantitative import restriction." BEN TERRA AND PETER WATTEL, EUROPEAN TAX LAW 25 (Second Edition, Kluwer Law International 1997).

[155]*Id.* at 54.

with its interpretation of international tax law in EU competition law cases. The Netherland's State Secretary of Finance, for instance, publicly complained that the EU Court case law on such kind of disputes was inconsistent and unconvincing. The Secretary of Finance also noted that "however simple the cases brought before the Court may appear at first sight, it would be wrong to underestimate the complexity of national direct taxation, and the difficulty for non-fiscal experts of understanding it."[156]

The FSC dispute and the comments made by the Netherlands' State Secretary of Finance provide some evidence that the time has come for international policymakers to close the existing gap between international economic regulation and international tax law, and to design a regulatory framework under which income tax matters affecting the world's economy can be resolved.

Closing that gap needs further attention. In contrast to the close interrelationship between certain legal disciplines and international economic regulation,[157] international tax law and economic regulation have followed divergent paths for a long time, with minimum interaction between them.[158] In addition, taxation has traditionally been considered a domestic issue with minor international repercussions except for double taxation issues.[159] Another factor that has probably led to the relative isolation of international tax law could be the lack of interest therein of the international business community, which has been the driving force behind the completion of several international economic arrangements and the establishment of international business organizations.[160] Interestingly, income

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[156]*Id.*

[157]Consider, for instance, the long standing efforts to protect intellectual property on an international basis which have led to the creation of international organizations (*e.g.*, the World Intellectual Property Organization founded in 1893.) and the negotiation of several international and regional agreements. It should also be noted that the legal literature on the interaction between international tax law and the regulation of economic relationships is scarce. One of the few books covering such interaction is PAUL STEPHAN et al., *supra* note 41.

[158]This situation should not be surprising if we consider that there are certain issues that have had more importance at different periods of the international economic agenda or involved strong political or business interests (*e.g.*, protection of intellectual property). At the outset of trade liberalization the removal of tariffs occupied most of the efforts of international trade policymakers. Currently the importance of tariffs as trade barriers has greatly diminished, switching the focus to non-tariff barriers such as environmental or technical standards issues. Likewise, the economic importance of trade in goods, which is regulated by the General Agreement on Trade and Tariffs has decreased as compared with trade on services securing for the General Agreement on Trade in Services a major future role in the world economy. On the political side, lobbying groups have been very active trying to include cultural industries protection issues in the international economic agenda.

[159]A major roadblock for the inclusion of international tax issues in the world's economic agenda is the issue of sovereignty. On the grounds of sovereignty countries tend to reject international tax cooperation or harmonization proposals. Consider, for instance, how tax harmonization proposals are generally regarded as an intrusion into a state's sovereignty. In connection with the EU's tax harmonization program, Denmark has recently refused to waive its veto right in connection with tax matters. The United Kingdom and Ireland have also opposed that result.

[160]The role of big business in strongly supporting NAFTA against other lobbying groups (*e.g.*, labor and environmental groups) is generally recognized. Consider also the success of the International Chamber of Commerce and its widely accepted rules in the areas of letters of credit, commercial arbitration and international commercial terms (*i.e.*, INCOTERMS). This organization largely

taxation has never been a serious negotiating issue in any of the bilateral or multilateral trade and investment arrangements entered into by the U.S. or other countries.[161] Recent events, such as the possible accession of China to the WTO (which was requested to change several features of its tax system in order to become a WTO member),[162] however, suggest the increasing role of taxation in the regulation of international economic relations.

One top international organization, namely the Organization for Economic Cooperation and Development ("OECD"), has recently launched an international effort to emphasize the harmful effects that tax policies can have in the international economy. The OECD report on harmful tax competition shows that the evolution of the world's economy has taken us to a point where taxation can increasingly have either a positive or negative impact in the international economic system.[163] The OECD report is directed mostly toward harmful tax practices engaged in by countries, such as the establishment and operation of tax haven regimes.[164]

The FSC dispute highlights the absence of an international tax architecture. The WTO Appellate Body correctly concluded that under the SCM Agreement it had jurisdiction to resolve the FSC question, notwithstanding the U.S. allegation, under footnote 59, that the WTO was not an appropriate forum to resolve tax-related matters. However, there is certainly a need for a multilateral forum to discuss international tax-related matters.[165] An important pending matter, for instance, which was left unresolved by the WTO Appellate Body, is the conformity of transfer pricing regulations and advance pricing rulings under the SCM Agreement.[166] Many countries have adopted transfer pricing regulations, which set forth transfer pricing methodologies in connection with international transac-

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owes its success to the wide support received from the international business community. Indeed any effort to enhance the international taxation framework would likely be resisted by the business community. Thus, governments would be left to their own devices, in a politically costly crusade to integrate international tax law into international economic regulation.

[161]NAFTA, for example, does not make any reference to tax related matters. The European Union does contemplate indirect tax harmonization as part of its economic integration program. And, harmonization in the area of direct taxation has not been given much importance. Recent tax harmonization efforts in the area of portfolio investment have actually faced considerable resistance from some member countries such as the United Kingdom.

[162]Z. Jun Lin, *Recent Developments of Tax System Reforms in China: Challenges and Responses*, 27 International Tax Journal 90 (2000).

[163]ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, HARMFUL TAX COMPETITION, AN EMERGING GLOBAL ISSUE (1998). The term "tax competition" refers to practices engaged by countries to attract mobile capital (*e.g.*, portfolio investment). The EU has also taken actions also in the area of tax competition, setting forth a Code of Conduct on Business Taxation.

[164]The OECD has recently blacklisted a large number of jurisdictions which offer tax haven regimes.

[165]*See* EDWIN S. COHEN, A LAWYER'S LIFE, DEEP IN THE HEART OF TAXES 497 (1994).

[166]As mentioned in an earlier section of this paper, the FSC complaint filed by the EU before the WTO contained a claim that the FSC's Administrative Pricing Rules were a separate subsidy. However, having found that the three FSC regime constituted on itself a prohibited subsidy, the WTO Appellate Body believed it pointless to render a decision with respect to the Administrative Pricing Rules.

tions carried on by taxpayers. In addition, tax authorities of an increasing number of countries enter into advance pricing agreements with taxpayers. These agreements allow any taxpayer to "lock-in," for a certain period of time, a specific transfer pricing methodology for the international transactions carried on by the taxpayer.[167] Advance pricing agreements are widely used in industrialized countries.[168]

To which extent are those transfer pricing regulations and advance pricing rulings compatible with the language of footnote 59?[169] The relevant language of that footnote reads "The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length." That footnote appears to use the arm's length price[170] as the sole standard upon which the administrative transfer pricing practices of WTO members shall be judged. Accordingly, to the extent that the transfer pricing methodologies set forth in a transfer pricing regulation (or repeatedly authorized through advance pricing rulings) do not reflect an arm's length price, such methodologies could be found inconsistent with the SCM Agreement. In this regard it should be borne in mind that in the *Tax Legislation Cases* the transfer pricing rules and practices of certain European countries were found inconsistent with GATT 1947. Transfer pricing issues, under the SCM Agreement, might prove to be a rich source of subsidy disputes in the future. Actually, the EU has already pointed out that the Income Exclusion Act "does not apply arms-length transfer price rules to properly allocate taxable income, allowing domestic income to escape taxation."[171]

The significant impact that transfer pricing issues have on international trade is illustrated by the following point made by a U.S. commentator with respect to the *Tax Legislation Cases*.

> "From the United States' viewpoint the most problematic factor faced by the taxing authority of each country was the method by which income from a particular transaction was identified as foreign source or domestic source. Under any system in which profits of a foreign subsidiary are not taxed directly, the intercompany pricing rules of the domestic country become vitally important. If the domestic country has a favorable rule, or alternatively, fails to enforce adequately the rule, then *the benefits accruing to exporters from untaxed foreign profits are enhanced even further.*"[172]

[167]Such methodologies are to be applied to any apportionment or allocation of income, credits, allowances or deductions in connection with international transaction carried on between *related parties*.

[168]*See* Susan C. Borkowski, *Transfer Pricing Advance Pricing Agreements: Current Status by Country*, 26 International Tax Journal 1 (2000).

[169]Footnote 59 to paragraph (e) of the SCM Agreement's Annex.

[170]An arm's length price is the price independent parties would have agreed upon under similar circumstances.

[171]*See* EU Commission, *supra* note 127, answer to question 14.

[172]Edwin S. Cohen et al., *supra* note 58, at 47 (emphasis added).

In light of these considerations one could fairly ask whether the WTO is an appropriate forum, or the SCM Agreement is comprehensive enough, to deal with notably complex tax issues, such as transfer pricing, as they affect international trade.

Finally, although the WTO Appellate Body ruling conforms to the SCM Agreement, still it does not appear to be sound policy. After all, why should not a country with a worldwide system of taxation be entitled to place its exporters on an equal footing with exporters operating under a different system of taxation? This kind of problems should be worked out in an *ad hoc* multilateral setting.[173] Likewise, the proposed global tax forum would deal with persistent problems, such as international tax evasion, with pressing problems, such as the so-called tax competition, and with emerging problems, such as international taxation of e-commerce. These matters do need a coordinated response from the international community.[174]

[173]The EU position on this regard is a harsh one. See EU Commission, *supra* note 127, answer to question 15.

[174]The OECD has played a pivotal role in the area of international taxation, however the OECD lacks the "moral authority" to undertake a larger role. This is so because the OECD only represents a relatively small number of countries (*i.e.*, mostly industrialized countries).