Special Reports

The Thirty-Years Tax War

by William M. Funk

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Again the World Trade Organization has gonged U.S. tax law after the United States enacted legislation providing export subsidies for U.S. corporations.[1] For nearly 30 years the United States has sought to provide tax benefits to U.S. exporters through the Internal Revenue Code, and at each step of the way has bumped up against its obligations under the international trade regimes established by the General Agreement on Tariffs and Trade and the WTO.

In the latest round of controversy, the United States enacted the FSC Repeal and Extraterritorial Income Exclusion Act (the "FSC Repeal Act") that attempted technical compliance with WTO obligations while preserving, in substance, the export benefits of prior legislation. A WTO dispute panel recently ruled that the FSC Repeal Act was an export subsidy and, thus, inconsistent with the United States' WTO obligations.

Neither the WTO nor the European Union were amused by the FSC Repeal Act signed into law in November 2000. Their chagrin was entirely justified: the replacement legislation almost precisely replicated the benefits of the Foreign Sales Corporation (FSC) regime, which was found to have run afoul of WTO rules. Small wonder, then, that within two days of President Clinton's signing the FSC Repeal Act into law, the European Union requested WTO authorization to impose up to US $4.4 billion in annual trade sanctions against the United States.[2] Now that the WTO has exercised its authority to strike at the substance of the law, the question is what the consequences of this action will be.

This article will trace the origins of this dispute from its beginnings through the current controversy. First, it will present an overview of the U.S. worldwide taxation regime; then it will examine the Domestic International Sales Corporation (DISC) regime and the replacement of DISCs by the FSC regime. The article will then describe the new legislation and the impact of the latest WTO ruling.

Overview of U.S. International Taxation

Although much of the world taxes its residents using a mix of territorial and worldwide systems, the United States has been unique in the sweep of its worldwide taxation. Generally, the United States taxes its citizens and resident aliens on all income regardless of where it is earned. As part of that system, the United States taxes controlled foreign corporations (CFCs), entities that have over 50 percent of their total value or 50 percent of the total

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[1]WTO Report of the Panel: "United States – Tax Treatment for Foreign Sales Corporations," WT/DS108/RW (20 August 2001).

[2]*EU Requests WTO Compliance Panel and Authorisation to Impose Sanctions against the US in Foreign Sales Corporation Trade Dispute* (visited 20 January 2001) http://www.eurunion.org/news/press/2000/2000073.htm.

voting power owned by U.S. shareholders (defined as U.S. persons owning more than 10 percent of the CFC under subpart F).[3] When a CFC earns income defined as "subpart F income," that income is taxed as a constructive dividend to U.S. shareholders.[4]

The subpart F provision was enacted to attack income deferral practices. Prior to the enactment of subpart F, U.S. corporations could achieve significant tax savings (especially in the mid-twentieth century when marginal tax rates were significantly higher than today) by deferring income from foreign operations.[5] They accomplished this by establishing subsidiaries in low-tax jurisdictions or "tax havens."[6] Those entities would typically receive income from foreign investments and operations. Because they were non-U.S. entities, they avoided any jurisdictional connection to U.S. taxing authority. Although U.S. residents were always required to pay tax on dividends received, by having the foreign entity receive and hold earnings they achieved a deferral of U.S. taxation. With the enactment of subpart F, however, it became more difficult for U.S. taxpayers to defer income by using a foreign corporation.

U.S. taxpayers that are shareholders of a CFC are taxed currently on their allocable subpart F income, of which the crucial component for this discussion is "foreign base company income."[7] This income includes: (1) foreign personal holding company income, (2) foreign base company sales income, (3) foreign base company services income, (4) foreign base company shipping income, and (5) foreign base company oil income.[8]

Legislation enacted at the time of subpart F's creation also included provisions that authorized the U.S. Internal Revenue Service to allocate income between a CFC and its U.S. parent, beginning an approach that eventually became embodied in the transfer pricing rules (section 482) that attempted to approximate arm's-length pricing.[9] Under the arm's-length approach, pricing in a transaction between related entities is recast so that the price of goods sold in such transactions is that which would emerge from two unrelated parties bargaining at arm's length. In doing so, the subpart F rules regulate deferral of income recognition by allocating income between the CFC and its shareholders.

Subpart F income was designed to exclude active business income from transactions in which the CFC performs substantial business activities within the country of residence. The problem with this exception was that it required corporations to manufacture goods overseas to be exempt from U.S. taxation.[10] This created a perverse incentive for U.S. corporations to locate business activities and jobs overseas. The United States, under the administration of President Richard Nixon, attempted to redirect this incentive by encouraging exports without requiring that U.S. corporations organize foreign subsidiaries.

For nearly 30 years the United States has sought to provide tax benefits to U.S. exporters through the Internal Revenue Code, and at each step of the way has bumped up against its obligations under the international trade regimes established by the General Agreement on Tariffs and Trade and the WTO.

Round One: The DISC Regime

The forerunner of the FSC legislation was the DISC regime, enacted in 1971. This regime authorized U.S. entities to organize subsidiaries through which export sales could be conducted and a percentage of the profits on such sales would be exempt, at the DISC level, from U.S. taxation as foreign base company income. Shareholders of DISCs were partially exempt from current taxation from profits on sales of "export property."[11] Export property, under DISC rules, was defined as property manufactured in the United States and held primarily for export, of which not more than 50 percent of the value was attributable to imports brought into the United States.[12]

Thus, taxation of a portion of the profits from exports is deferred until earnings and profits are distributed as a dividend, the DISC stock is disposed of, or the DISC entity is liquidated or terminated.[13] Parent entities of DISCs could assign export profits to the

[3] I.R.C. section 957(a).

[4] I.R.C. section 951(a).

[5] Charles M. Bruce, et al., "Foreign Sales Corporations," 934 *Tax Management* at A-1 (1998).

[6] President John F. Kennedy's Tax Message to Congress, at 107 Cong. Rec. 6458 (1961).

[7] I.R.C. section 957(a)(1)(A)(i).

[8] I.R.C. section 954(a).

[9] Bruce, 934 *Tax Management* at A-1.

[10] Treas. Reg. section 1.954-3(a)(4).

[11] *See* United States Mission to the European Union, *Report of the WTO Panel on DISC Legislation: Report of the Panel presented to the Council of Representatives on 12 November 1976*, Doc. L/4422-23S/98, paragraph 12.

[12] I.R.C. section 993(c).

[13] Report of the Panel, paragraph 12.

DISC in the form of: (1) 50 percent of export profits, (2) 4 percent of gross export sales, or (3) a percentage that could be reasonably allocated based on arm's-length pricing.[14]

With these provisions, the use of DISCs became popular quickly, with 1,136 DISCs being formed within three months of the creation of the regime and 3,439 created by the end of 1972.[15] By 1974, DISC exports accounted for US $43.5 billion in U.S. exports and US $105 million of foregone tax collections.[16]

In 1972, some of the United States' European trading partners realized the potential advantage to U.S. exporters under the DISC regime and lodged complaints. Belgium, France, and the Netherlands — with other nations, styled as the European Communities (EC) — argued that the DISC regime constituted an export subsidy and violated principles of GATT.[17] Article XVI:4 of GATT provided that "the exemption, in respect of exported goods, of charges of taxes, other than charges in connection with importation or indirect taxes levied on one or several stages on the same goods if sold for internal consumption" constitutes an export subsidy.[18] EC officials argued that provision applied to the DISC regime.[19] The United States responded with complaints that European tax regimes were similarly structured to provide export subsidies.[20] After attempts to negotiate a resolution failed, a GATT panel was established in 1976 to examine the DISC issue.

The United States took the position that the DISC regime did not constitute an export subsidy, arguing that DISCs provided for mere income deferral, not an exemption from taxation.[21] The United States conceded that a deferral of taxes could be tantamount to an exemption from taxation if the deferral lasted for a significant length of time.[22] However, U.S. officials maintained that the ability of a taxpayer to comply with the DISC technical requirements, and so extend such deferral, was too uncertain to justify equating deferral with exemption.[23]

The United States noted that the DISC regime set stringent technical requirements with which taxpayers would find maintaining compliance difficult, and so taxpayers would not be able to maintain DISC status indefinitely.[24] When those taxpayers lost their DISC status, the deferral would then end. The United States noted that accounting firms required that DISC taxpayers account for the full deferred tax on a current basis for financial reporting purposes.[25] The United States contended that because the DISC legislation was controversial, statutory repeal was always a possibility and, therefore, the deferral was insufficiently reliable to constitute an outright exemption.[26]

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The United States also argued that the DISC regime was necessary to alleviate the trade disadvantage incurred by the U.S. worldwide taxation regime, including the risk that U.S. manufacturers would export manufacturing facilities to other nations to avoid U.S. taxation.[27] Because the more territorial regimes of European countries were beneficial to European exporters, U.S. businesses required the DISC regime to level the playing field.[28]

The panel found that the DISC was an export subsidy subject to GATT notification requirements.[29] It concluded that the DISC provisions that contained income deferral provisions without a corresponding interest charge constituted a partial exemption from taxation.[30] This partial exemption was found to have met the GATT definition of a subsidy.[31] Under Article XVI:4 of GATT, remissions of tax or exemptions from taxation were listed as subsidy measures. A deferral of tax with an interest charge would have passed muster, but none was then applied by the DISC regime. Because the benefit of the DISC regime resulted in increased U.S. exports, the panel concluded that the DISC benefit was an export subsidy subject to GATT notification requirements.[32] The panel presumed that the export subsidy would lead to a lowering of prices for U.S. exports and a concomitant

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[14] *Id.*

[15] *Id.* at paragraph 16.

[16] *Id.* at paragraphs 17-18.

[17] Bruce, 934 *Tax Management*, at A-2.

[18] Article XVI:4 (BISD, 9 Supp., p. 186).

[19] Report of the Panel, paragraph 28.

[20] Bruce, 934 *Tax Management* at A-2.

[21] Report of the Panel, paragraph 32-35.

[22] *Id.*

[23] *Id.*, at paragraph 33.

[24] *Id.*

[25] *Id.*

[26] *Id.*, at paragraph 34.

[27] *Id.*, at paragraph 40.

[28] *Id.*, at paragraphs 40-42.

[29] *Id.*, at paragraph 68.

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

[31] *Id.*

[32] *Id.* at paragraph 69.

rise in exports of U.S. manufactured goods. Thus, the DISC regime resulted in a significant trade benefit.

In 1981, the panel's findings were accepted by the GATT Council, subject to a prior understanding.[33] Pursuant to that understanding (the "1981 Council Decision"), which did not affect the rights and obligations of other GATT contracting parties, parties to the DISC and other cases involving the tax regimes of EC states need not tax export income attributable to economic processes located outside their territory.[34]

Although the United States never conceded that the DISC regime violated GATT, the U.S. Congress enacted legislation in 1984 amending the DISC regime to mollify European trading partners. Corporate DISC shareholders were still permitted to defer taxation on 16/17ths of their taxable income attributable to no more than US $10 million in qualified export receipts, while individual DISC shareholders could defer all taxation.[35] DISCs were also required to pay an interest charge on deferred income (hence the term "Interest Charge DISCs") so that the deferral regime complied with the GATT panel decision.[36] Finally, the U.S. Congress enacted the FSC regime.

Round Two: The FSC Regime

Under the FSC statutes, the DISC regime was virtually replicated, except that to make use of the regime exporters had to meet a more technical set of requirements. The subsidiary now had to be "foreign," although not necessarily in the sense anticipated by international law. A FSC had to be a corporation incorporated under the laws of four designated U.S. possessions (American Samoa, the North Mariana Islands, Guam, or the U.S. Virgin Islands) or a qualified foreign country, and have elected FSC status.[37] To be a qualified foreign country, a jurisdiction had to be a party to an information exchange agreement under the Caribbean Basin Economic Recovery Act of 1983 or a party to a U.S. tax treaty and have been certified to meet FSC information exchange requirements.[38]

FSCs could have no more than 25 shareholders,[39] and only common stock was permitted.[40] FSCs had to maintain an office in a foreign jurisdiction, as qualified above, but not necessarily in the jurisdiction of incorporation. That is, the FSC could be incorporated under Guam law but maintain its office in American Samoa.[41] It was required to keep a set of permanent books of account at such office and maintain financial records within the United States.[42] At least one director of a FSC had to be a nonresident of the United States,[43] and FSCs were not [illegible] ber of an [illegible] lso has a [illegible] — in form, [illegible] — met the [illegible] ATT panel. [illegible] TT decisions [illegible] tracting party need not tax income of foreign subsidiaries, the new system was set up to channel trade through foreign subsidiaries to take advantage of this compromise.[45] Consistent with that rule, the U.S. parent typically sold goods to the FSC or paid a commission to the FSC for its sales of goods.[46]

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If a FSC met all of the technical requirements, the U.S. parents and other shareholders were exempt from subpart F on income that would otherwise be deemed foreign base company income and result in a constructive dividend. The FSC had its income on sales classified as Foreign Trade Income (FTI) and the exempt portion thereof classified as Exempt Foreign Trade Income (EFTI).[47] FTI was the gross income from Foreign Trade Gross Receipts (FTGR). FTGR consisted of gross receipts from sale or disposition of export property, lease of export property for use outside the United States, services that are related to either of the aforementioned activities, engineering or architectural services for construction projects located outside the United States, or for performance of managerial services for unrelated FSCs or DISCs.[48]

The exempt portion of FTI was determined by reference to transfer pricing rules — the deemed price of the sale of export property by the parent corporation

[33] BISD 28S/114.

[34] *Id.*

[35] I.R.C. section 995(b)(1)(F).

[36] I.R.C. section 995(f).

[37] Treas. Reg. section 1.922-1(e) Q/A 5.

[38] Treas. Reg. section 1.921-2(a) Q/A 1.

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] I.R.C. section 923(a).

[45] BISD 28S/114.

[46] I.R.C. section 921(b).

[47] I.R.C. section 923(b).

[48] I.R.C. section 927(a)(1).

to the FSC — which allowed income to be allocated among the FSC and its parent entities.[49] The FSC could choose among two categories of methods to allocate income: either administrative pricing (which allowed a choice of 1.83 percent of FTGR or 23 percent of the combined taxable income of the FSC and the parent from the sale of the export property to be attributed to the FSC) or the price actually charged to the FSC, subject to section 482 and its arm's-length pricing rules.[50]

If the FSC determined its income by reference to administrative pricing, then 15/23rds of its income was exempt from deemed dividend treatment by corporate shareholders and 16/23rds was exempt from deemed dividend treatment by individual shareholders.[51] But, if the arm's-length pricing rules of section 482 were used, 30 percent of FTI would be exempt from deemed dividend treatment by corporate shareholders and 32 percent of FTI would be exempt from deemed dividend treatment by individual shareholders.[52] FSCs, then, paid a corporate level tax on the non-exempt portion of FTI. A dividends-received deduction was available to the recipient corporation for not just the earnings and profits that were EFTI, but also for the non-exempt portion of earnings and profits, if the FSC used the administrative pricing rules to determine transfer price on sales of export property.[53]

For FSCs to have EFTI and avail themselves of administrative pricing, they were also required to evince foreign management and to perform "foreign economic processes."[54] To meet this foreign management requirement, all corporate meetings (such as meetings of the board of directors or shareholder meetings) had to occur outside the United States and meet the requirements of the laws of the jurisdiction of incorporation.[55] The FSC had to maintain its principal bank accounts in a jurisdiction in which it could be incorporated and disburse its dividends, fees, and salaries from such accounts.[56]

To meet the foreign economic processes requirement, the FSC's sales participation activities (solicitation, negotiation, and contracting) had to be performed by the FSC or its agent,[*] and the FSC had to meet one of two foreign direct cost (FDC) tests: the 50 percent test or the 85 percent test.[57] Under the 50 percent test, at least 50 percent of the total direct costs (TDC) had to be FDCs attributable to any of the following expenses: (1) advertising and

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promotion, (2) processing of customer orders and arranging for delivery of export property, (3) transporting the export property to the customer, (4) issuing invoices, and (5) assumptions of credit risk.[58] Under the 85 percent test, FDCs had to exceed 85 percent of the TDCs attributable to at least two of the aforementioned activities.[59]

The FSC exemptions from taxation only applied to transactions involving export property. Like the DISC regime, export property could not be manufactured, grown, or extracted by the FSC, but had to be held for sale, lease, rental, or other disposition outside the United States; and could not have more than 50 percent of its value attributable to goods imported into the United States.[60] Export property did not include property used by a corporation related to the FSC, intellectual property (such as patents, inventions, models, designs, formulas, processes, copyrights, good will, or trademarks), oil or gas, unprocessed timber from softwood, or products subject to export controls or executive orders.[61]

Against a backdrop of U.S. protests against European restrictions on imports of certain U.S. goods, the European Communities in 1997 requested the establishment of a new dispute panel to determine whether the FSC regime complied with the WTO agreement. EC officials alleged that the FSC regime constituted an illegal export-contingent tax subsidy.[62] Under the WTO Agreement on Subsidies and

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[49] I.R.C. section 925(a)

[50] *Id.* However, where the FTGR method of administrative pricing is used, in no event may EFTI with respect to a transaction exceed the amount the combined taxable income method would yield. I.R.C. section 925(d).

[51] I.R.C. section 923(a).

[52] *Id.*

[53] I.R.C. section 245(c).

[54] Treas. Reg. sections 1.924(c)-1(b).

[55] Treas. Reg. sections 1.924(c)-1(c)(1).

[56] I.R.C. section 924(e).

[*] A provision easily met under Treas. Reg. section 1.924-1.

[57] I.R.C. section 924(d)(direct costs are costs of materials and labor directly associated with performance of the activity).

[58] Treas. Reg. sections 1.924(d)-1(d)(1).

[59] Treas. Reg. sections 1.921-2(a) Q/A 1.

[60] I.R.C. section 927(a)(2).

[61] I.R.C. section 924(b).

[62] WTO Report of the Panel: United States – Tax Treatment for "Foreign Sales Corporations," WT/DS108/R (8 October 1999) at paragraph 3.2.

Countervailing Measures (SCM Agreement), a subsidy is defined, *inter alia*, as "government revenue that is otherwise due, is foregone or not collected (e.g., fiscal incentives such as tax credits)."[63] Export subsidies are prohibited under the SCM Agreement if they meet one of several definitions listed in Annex I to the SCM Agreement. Annex I lists as an illegal export subsidy "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."[64]

Although the United States conceded that the FSC regime was a departure from its usual taxation rules, it argued that the FSC regime was permissible under prior GATT rulings.[65] U.S. officials argued that, based on the 1981 Council Decision and the GATT tax cases regarding the DISC regime and several European tax regimes, three principles should decide the FSC case.[66] First, foreign economic processes need not be taxed and a decision not to tax profits resulting from such activities is not a subsidy.[67] Second, arm's-length pricing should be observed.[68] Third, measures to avoid double taxation of income may be adopted.[69] The United States also argued that the GATT tax cases, taken together, state that territorial taxation does not violate WTO rules. Because the FSC regime incorporated features of territorial taxation as permitted by prior decisions, the United States argued that the FSC regime should not be regarded as an illegal export subsidy.[70]

In October 1999 a WTO panel issued a report holding that the FSC regime was inconsistent with the SCM Agreement and recommended that the U.S. government bring the FSC regime "into conformity with [U.S.] obligations."[71] The WTO panel found that the crucial inquiry was whether taxes that were "otherwise due" were made exempt by a law specifically relating to exports.[72] The panel made the determination of whether income was otherwise due based on a "but for" test: but for the exemption specifically relating to export income, was the income taxable?[73] In making this determination, the panel stated that it would not examine each provision of a tax regime in isolation, but rather view it as part of an integrated whole.[74]

The United States appealed the panel's decision to the WTO Appellate Body. On appeal, U.S. officials attempted to clarify its arguments. They argued that activities specifically listed as

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permitted by prior GATT decisions should not be subject to the "otherwise due" test and instead be regarded as protected by a safe harbor.[75] Because the 1981 Council Decision specifically permitted exemption from taxation of profits from foreign economic processes, the United States argued that this should be treated as a safe harbor.[76]

In February 2000 the WTO Appellate Body rejected the U.S. arguments and upheld the panel's finding that the FSC regime was a "prohibited export subsidy."[77] The Appellate Body ruled that the 1981 Council Decision was not a binding decision by its own terms and therefore was not incorporated into WTO law.[78] The 1981 Council Decision had stated that such decision was not intended to have general application, and, therefore, could not set forth a broadly applicable principle.

Having disposed of the safe harbor issue, the Appellate Body noted that no particular tax system is mandated by WTO rules, but that any tax regime must comply with WTO obligations.[79] The United States never seriously challenged the assertion that the FSC regime exempted taxes otherwise due. Because the FSC laws excluded revenue otherwise due and made such exclusion contingent on exports, the regime violated the SCM Agreement.[80] The Appellate Body also noted, in *dicta*, that it was theoretically possible to create a tax regime that

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[63]SCM Agreement, at 1.1.

[64]Annex I to the SCM Agreement, at I(e).

[65]WTO Report of the Panel, at paragraph 4.330.

[66]*Id.*

[67]*Id.*

[68]*Id.*

[69]*Id.*

[70]*Id.*, at paragraph 4.349.

[71]WTO Report of the Panel, at paragraph 8.4.

[72]*Id.*, at paragraph 7.110-14.

[73]*Id.*, at paragraphs 7.45, 7.93.

[74]*Id.*, at paragraph 7.99.

[75]*Id.*, at paragraph 4.379-82.

[76]*Id.*

[77]WTO Report of the Appellate Body: United States – Tax Treatment for "Foreign Sales Corporations," WT/DS108/AB/R (24 February 2000) at paragraph 177(a).

[78]*Id.*, at paragraph 112-14.

[79]WTO Report of the Appellate Body, at paragraph 179.

[80]*Id.*, at paragraph 180.

has no general rule with regard to taxation of foreign income.[81] Under such a system, the "otherwise due" or "but for" test would not apply to such a system. In the absence of such a regime, the "otherwise due" test applies.

The WTO Appellate Body gave the U.S. government until 1 October 2000 to bring its tax laws into compliance with the FSC decision; a deadline that was later extended as a result of negotiations between U.S. and EC officials.

Round Three: The FSC Repeal

In response to the WTO findings and the threat of EU trade sanctions, the U.S. Congress passed the FSC Repeal and Extraterritorial Income Exclusion Act. The legislation repealed the FSC provisions while creating similar provisions elsewhere in the code.

The FSC Repeal Act is an improvement over the FSC regime in one respect: it is simpler administratively. Gone are the requirements for a subsidiary and its technical compliance rules. With the new regime based on transactions and not on separate entities, FSCs can be discarded and trade can be carried out directly by the parent or other manufacturing entity. This may not necessarily end the need for a separate subsidiary to utilize other benefits. With the continuing importance of meeting mathematical tests, administrative and accounting convenience may still favor having export operations in a specially established subsidiary.

The FSC Repeal Act provides that "extraterritorial income" is exempt from U.S. taxation, ostensibly converting the U.S. tax regime from a worldwide regime to a territorial regime. However, the legislation defines extraterritorial income as gross income attributable to FTGR (substantially the same as previously defined under FSC law). All income that is not attributable to FTGR is taxed on the same basis as prior to passage of the FSC Repeal Act.

Taxpayers who have income attributable to FTGR can save tax. The reduction is equal to either 1.2 percent of FTGR, 15 percent of qualifying foreign trade income or 30 percent of foreign sale and leasing income. Although, superficially, the calculations for determining exempt income seem different from the FSC regime, the numbers work out to be exactly the same: the new percentages (1.2 percent and 15 percent) are equal to the old administrative pricing percentages (1.83 percent and 23 percent) multiplied by 15/23rds and the 30 percent FSLI exclusion corresponds to the exclusion when section 482 arm's-length pricing rules were utilized.

The Appellate Body ruled that the 1981 Council Decision was not a binding decision by its own terms and therefore was not incorporated into WTO law.

FTGR, crucial to determining exempt income, is defined as gross receipts from: (1) the sale, exchange, or disposition of qualified foreign trade property; (2) the lease or rental of qualified foreign trade property for use by a lessee outside the United States; (3) services related and subsidiary to either of (1) or (2); (4) engineering or architectural services for construction projects located outside the United States; or (5) performance of management services for unrelated persons.[82] For such receipts to be FTGR, as in the prior FSC regime, the requirements of foreign direct costs and of foreign economic processes must be met.[83]

For the foreign direct costs tests, foreign direct costs must meet either the 50 percent or the 85 percent test: either foreign direct costs must be equivalent to or greater than 50 percent of total direct costs attributable to the transaction[s], or foreign direct costs must be equivalent to or greater than 85 percent of total direct costs in two of five types of enumerated activities.[84] The activities are the following: advertising and sales promotion, processing of customer orders and arranging for delivery, transportation outside the United States, determination and transmittal of a final invoice, and assumption of credit risks.[85]

The definition of foreign economic processes is the same in the new regime as in the FSC regime: solicitation, negotiation, and making the contract.[86] Although these terms have yet to be defined by regulations, it is not unreasonable to expect that, if regulations are ever issued, the definitions will resemble those definitions from the prior FSC regime.

The definition of "export property," now qualifying foreign

[81] *Id.*, at paragraph 91 ("It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures. We observe, therefore, that although the Panel's 'but for' test works in this case, it may not work in other cases.")

[82] Pub. L. 106-519, 114 Stat. 2423, at 2426.

[83] *Id.*, at 2426-27.

[84] *Id.*, at 2427.

[85] *Id.*

[86] *Id.*

trade property (QFTP), is substantially similar to the definition under the prior regime, but with two notable differences tied in to the new simplicity. The first is tied to the technical simplification: the entity utilizing the FSC Repeal Act may be the same entity that manufactured, grew, or extracted the QFTP. The other change is that the QFTP need not have been manufactured in the United States. Otherwise, QFTP shares the same definition as export property under FSC law: no more than 50 percent of the fair market value of the QFTP may be attributable to foreign content.[87] In a report of the House Ways and Means Committee accompanying the proposed legislation, the Committee declared that "the new regime [does] not confer export-contingent benefits" because it applies to all foreign sales "whether the goods were manufactured in the United States or abroad."[88]

Without the requirement of a foreign subsidiary to perform foreign sales, gone are the transfer pricing rules. However, the calculations for determining exempt income have been adjusted in such a way that ensures that substantially the same benefits are provided to exporters. The exempt income from foreign trade under FSC Repeal Act is "qualifying foreign trade income" (QFTI). QFTI is calculated as the greater of (1) 1.2 percent of FTGR,[*] (2) 15 percent of FTI (defined as taxable income attributable to FTGR, as previously defined under FSC law),[**] or (3) 30 percent of "foreign sale and leasing income" (FSLI), a new term.[89] FSLI is FTI that is allocable to foreign economic processes or which is derived from lease or rental of QFTP outside the United States.[90]

Even the new FSLI replicates the old regime. FSLI is limited to property manufactured, produced, grown, or extracted by the taxpayer, or acquired by the taxpayer for arm's-length prices as determined according to section 482 transfer pricing rules.[91] Just as it was under the old regime, 30 percent of profits from transactions in export property are exempt where pricing is determined by reference to section 482 rules.[92]

One interesting wrinkle in the new regime is coordination with the foreign sourcing rules of section 863(b). Section 863(b) provides that if a U.S. person manufactures goods in the United States and completes the sale overseas (with title passing overseas), the default rule is 50 percent of the income on such income is treated as foreign source and exempt from U.S. taxation. The European Communities have not yet attempted to challenge this rule.[93] That provision, combined with the FSC regime, created the potential that in the absence of special rules all such income could be foreign sourced.

> The FSC Repeal Act provides that 'extraterritorial income' is exempt from U.S. taxation, ostensibly converting the U.S. tax regime from a worldwide regime to a territorial regime.

This potential abuse of foreign sourcing was limited by Treas. Reg. section 1.927(e)-1, which limited foreign sourcing by the FSC entity by reference to special DISC sourcing rules. Those DISC sourcing rules, based on DISC inter-company pricing rules, limited application of section 863(b) foreign sourcing of income to 4 percent of qualified export receipts (or FTGR under language of the FSC regime), 50 percent of the DISC combined taxable income (or combined taxable income on sales of export property), or income based on the price actually charged, subject to section 482 rules.[94]

However, in eliminating the FSC entity and collapsing the foreign export function into the domestic manufacturer, Congress created the potential for combining two sets of export subsidies: the FSC Repeal Act regime and the section 863(b) provision. Congress then sought to limit the foreign sourcing exemption for transactions using the new extraterrito-

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[87]*Id.* at 2428 ("Sec. 943(a). The term 'qualifying foreign trade property' means property manufactured, produced, grown, or extracted within or outside the United States held primarily for sale, lease, or rental, in the ordinary course of business for direct use, consumption, or disposition outside the United States, and not more than 50 percent of the fair market value of which is attributable to articles manufactured, produced, grown, or extracted outside the United States and direct costs for labor . . . performed outside the United States.").

[88]H.R. Rep. No. 106-519 at 10-11 (2000), *reprinted in* 179 *Daily Tax Rep.* at L-1 (14 Sept. 2000).

[*]If the FTGR method is utilized with respect to a transaction or group of transactions, the FTI method then may not be used by that taxpayer or any other taxpayer with respect to the same export property. This avoids double counting of exclusions.

[**]For the FTI method, however, each party to the transaction[s] may exclude 15 percent of the profits on the transaction. As FTI is taken as taxable income from a portion of the ultimate sale, multiple use of the FTI method cannot add up to more than 100 percent of the taxable income on the ultimate sale of the QFTP.

[89]114 Stat. 2423, at 2424.

[90]*Id.*

[91]*Id.*, at 2425.

[92]*Id.*, at 2424.

[93]Treas. Reg. section 1.863-3(b).

[94]I.R.C. section 994(a).

rial income regime in the same manner as was used under the FSC regime. If QFTP is subject to the FTGR method (1.2 percent) of calculating the exemption, then foreign-source income may not exceed the half of the excess of FTI over 4 percent of FTGR (50 percent x [FTI - (4 percent x FTGR)]).[95] If QFTP is subject to the FTI method (15 percent), then foreign-source income may not exceed 25 percent of FTI.[96]

Under the new rules, no corporation may elect FSC status after 30 September 2000.[97] Inactive FSCs that do not have FTI for five consecutive taxable years after 31 December 2001 will no longer be treated as FSCs.[98] For FSCs still in existence as of September 2000, the old FSC regime will still apply to transactions occurring "before 1 January 2002 or after 31 December 2001 pursuant to a binding contract" which was in effect on 30 September 2000.[99] FSCs may elect to operate under the new regime at an earlier date.[100] An FSC with exempt FTI derived from the lease or rental of export property as defined under the FSC rules must treat such property as QFTP under the new regime.[101] An FSC which computed FTI with respect to export property based on the administrative pricing methods provided under the FSC regime is not permitted to classify any additional income as QFTI under the new regime with respect to the same property, thus avoiding a double exemption of income derived from the same property.[102]

EC officials quickly saw the FSC Repeal Act as a violation of the United States' WTO obligations and requested WTO proceedings to authorize trade sanctions against U.S. goods. As previewed by Lee Sheppard in *Tax Notes International*, the proceedings regarding the FSC Repeal Act focused on three questions.[103] Is it a subsidy? Is it export contingent? Is it a permissible means to avoid double taxation?

The question of whether the new tax regime is a subsidy focused on article 1.1(c)(2)(ii) of the SCM Agreement, which defined a subsidy as a "financial contribution" by a government including a decision to forego taxes that are otherwise due. The United States argued that the FSC Repeal Act is not a subsidy. In its brief, U.S. officials stated that the act's taxing jurisdiction is defined by "gross income."[104] Under section 114, the gross income now excludes extraterritorial income. The United States, accepting the "otherwise due" test, argued that the otherwise due test requires

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comparing the disputed provisions to a domestic standard.[105] Because either the domestic standard is that extraterritorial income is not taxed or alternatively, there is no general rule, the exclusions provided by the FSC Repeal Act could not be an exception foregoing taxes otherwise due.

The European Communities argued in its WTO brief that the extraterritorial income exclusion was not a true exclusion, but an exemption from taxes that would be otherwise due. The basis of the argument is that the purported exclusion was defined in terms of the tax base, that is, the excluded income is a stated percentage of taxed income.[106] Because of this definition, they argued, extraterritorial income does not constitute a genuine class of income that can be excluded from taxation. Rather, a true exclusion must qualitatively define a class or category of income that is excluded from the tax base.[107]

The European Communities agreed that the crucial inquiry is the "otherwise due" inquiry. To determine whether tax is otherwise due requires reference to a benchmark. EC officials were prepared to concede that the United States may have created a tax law with no general rule, but that did not render the "otherwise due" test moot.[108] Instead, the normative benchmark is the tax

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[95] *Id.*, at 2430.

[96] *Id.*

[97] 114 Stat 2423, at 2433.

[98] *Id.*

[99] *Id.*

[100] *Id.*, at 2433-34.

[101] *Id.*, at 2435.

[102] *Id.*

[103] Lee A. Sheppard, "News Analysis: Eye-Poking Over the FSC Replacement," *Tax Notes Int'l,* 12 Mar. 2001, p. 1216, or *2001 WTD 44-18*, or *Doc 2001-6392 (9 original pages).*

[104] United States – Tax Treatment for "Foreign Sales Corporations" – Recourse by the European Communities to Article 21.5 of the DSU, *First Written Submission of the United States of America*, (7 Feb. 2001), at paragraph 70.

[105] *Id.* at paragraphs 64-65.

[106] United States – Tax Treatment for "Foreign Sales Corporations" – Recourse by the European Communities to Article 21.5 of the DSU, *First Written Submission of the European Communities*, (17 Jan. 2001), at paragraphs 46-47.

[107] *Id.*at paragraphs 57.

[108] United States – Tax Treatment for "Foreign Sales Corporations" – Recourse by the European Communities to Article 21.5 of the DSU, *Second Written Submission of the European Communities*, (27 Feb. 2001), at paragraphs 63-64.

due in "some other situation."[109] They argued that the "other situation" is domestic sales of goods.[110] It based its argument on the SCM Agreement, which tests export subsidies by comparing treatment of exports to "the like product when destined for domestic consumption."[111]

As Sheppard noted, the United States argued there is no textual support for the proposition that a category of income, to be valid, must be either fully taxed or fully excluded and, thus, it may establish partial exclusions as a benchmark rule.[112] U.S. officials thus dismissed European criticism that extraterritorial income does not constitute a true category as conclusory.[113]

The European Communities, having first argued that the FSC Repeal Act is a subsidy, then argued that the subsidy is export-contingent and, therefore, illegal. EC officials noted that under the FSC Repeal Act, where a U.S. person sells goods, to receive the benefits of the new legislation those goods must not be destined for ultimate use within the United States. Merely because products may qualify by being manufactured abroad and sold abroad does not diminish the argument for the European Communities. EC officials, citing the definition of exports as products destined for foreign markets, argued that an export subsidy need not be available for only export transactions or even for all export transactions, just for exports in general.

The European Communities conceded there were ways of receiving the subsidy without export, such as the foreign leasing, foreign construction, and foreign management projects, but where sales of exports were involved, exports were required. The inclusion of other methods of obtaining the income exclusion should not vitiate the EC argument. To use a metaphor that has become common in this debate: "if it is illegal to hunt ducks, then hunting ducks and elephants should also be impermissible."

The United States maintained that export was not required to receive the benefit of the FSC Repeal Act. For instance, a taxpayer could qualify for the exclusion by manufacturing abroad and selling abroad or by manufacturing in the United States and selling to another U.S. person who leases the property abroad. Therefore, even if the FSC Repeal Act is a subsidy, it is not export contingent.

The United States has been one of the most important advocates of open international trade and the WTO system. However, the U.S. government has been on the losing side of this export subsidy dispute for 30 years.

For the European Communities, the U.S. 50 percent foreign content limitation contained in the FSC Repeal Act is further evidence of the export-contingent nature of the subsidy, and an independent violation of the SCM Agreement. The 50 percent limitation has the effect of requiring that U.S. articles be used. Even though the legislation does not affirmatively state a U.S. content requirement, it is a de facto requirement; only use of U.S. articles can guarantee compliance with the statute.

The United States responded that the foreign content limitation is not identical to a domestic content requirement, and therefore does not violate U.S. obligations under the SCM Agreement. U.S. officials also argued that the limitation does not translate into an affirmative domestic content requirement that U.S. articles be used. For example, if U.S. intellectual property constitutes more than 50 percent of the fair market value of the goods, then the foreign inputs will not run afoul of the FSC Repeal Act.

The final U.S. argument was that the FSC Repeal Act was a permissible measure to avoid double taxation of foreign-source income. Citing footnote 59 of Annex I, paragraph (e) of the SCM Agreement, the United States noted that exclusion of foreign-source income is a permissible method of avoiding double taxation, even if such exemption is only partial.* The European Communities replied that to be eligible for such exclusion a non-U.S. taxpayer must elect to be treated as a U.S. taxpayer, thereby subjecting such taxpayer to two taxation regimes.

The WTO dispute panel made short work of this most recent U.S. attempt at compliance, requiring only 61 pages to dispose of the FSC Repeal Act (as opposed to 294 pages for the original FSC decision). In its report, the WTO panel took the main issues in turn: is it a subsidy; is it export contingent; and is it a permissible means of avoiding double taxation?

The WTO agreed with the European Communities regarding

[109] *Id.* at paragraph 64.

[110] *First Written Submission of the European Communities*, at paragraph 81.

[111] *Id.* at paragraph 89.

[112] *First Written Submission of the United States of America*, at paragraphs 93-96.

[113] *Id.*

*The Foreign Tax Credit provisions are already largely designed to, and successfully, avoid double taxation.

the subsidy question. This analysis again hinged on whether the U.S. government had foregone revenue otherwise due.[114] The panel rejected the U.S. mechanical formulation of the but for rule, stating "the key is to apply critical judgments to the facts of this matter."[115] It used the rules and definitions within the U.S. tax code as the basis for its decision.[116] Looking at the tax system as a whole, the panel found that it was an easy decision: the FSC Repeal Act excepted revenue otherwise due.[117] Particularly damning in the view of the WTO was that the exception for extraterritorial income was defined in terms of "gross income attributable" to specified activities.[118]

Having determined that the FSC Repeal Act was a subsidy, the WTO panel then concluded it was export contingent. To find a subsidy contingent on export performance, it need only be so contingent "in law or in fact."[119] Even where the words of the statute did not explicitly provide for contingency, the panel found that it may be derived by "necessary implication from the words actually used."[120] Here, it was clear that for goods to qualify for the subsidy, they had to cross over the U.S. border at some time.[121] The subsidy was not available for goods manufactured in the United States and then sold domestically.[122] The fact that other ways of obtaining the subsidy existed did not vitiate the essential nature of the subsidy.[123] Thus, the FSC Repeal Act subsidy was held contingent on exports.

The WTO then turned to the U.S. argument that the FSC Repeal Act was necessary to avoid double taxation, an argument the WTO did not seem to take seriously. The WTO stated that the argument was in the nature of an affirmative defense; therefore the persuasive burden fell on the United States.[124] The panel expressed sympathy for the goal of avoiding double taxation, but then stated that the relationship between the measure and the goal of avoiding double taxation "must be reasonably discernible."[125] It then declared that the FSC Repeal Act clearly failed that test. Having held that the legislation was an export subsidy not subject to an affirmative defense, the panel held that the legislation violated U.S. trade obligations.

Trade and Consequences

The WTO ruling should have come as a surprise to no one who has followed this issue. The FSC Repeal Act provides a partial exclusion from tax for the sale of products that receive substantial U.S. inputs and are destined for use outside the United States. Given the WTO rules, this should clearly be vocative of U.S. trade obligations.

As U.S. officials have repeatedly pointed out during this row, the WTO's 'but for' test as currently construed favors more territorial systems over more worldwide taxation regimes.

Many of the individual components of the FSC Repeal Act pass muster under WTO rules. Depending on one's interpretation, the United States now has a general rule that extraterritorial income is excluded or it has no general rule at all. Either way, the exclusion is not technically an exception to a general rule. And it is also true that there are no uniform standards regarding what constitutes a true general rule, a true exception, or even a true category of income. Therefore, the text of the WTO rules may not have been violated.

Instead, the violations go to the intent of WTO rules. In reading the relevant provisions as a whole, there is arguably an intent to prohibit all practices that result in subsidizing exports. The WTO is merely executing its mandate in prohibiting attempts to circumvent the proscription of export subsidies.

Had the WTO not done so, it would have rendered rules that were essentially elective provisions — a member state could choose to comply with the intent of WTO obligations, or evade them through technical compliance while flouting the substance. That would violate the most fundamental rule of treaty law: *pacta sunt servanda* — treaties must be obeyed. If international trade obligations are to have meaning, then the WTO must have robust authority to outlaw attempts to circumvent its rules.*

But in enforcing its intent, the WTO may now find that it bumps up against political realities. The United States has been one of the most important advocates of open

[114] WTO Report of the Panel, at paragraph 8.9.

[115] *Id.* at paragraph 8.17.

[116] *Id.* at paragraph 8.18.

[117] *Id.* at paragraph 8.29.

[118] *Id.* at paragraph 8.38.

[119] *Id.* at paragraph 8.53.

[120] *Id.* at paragraph 8.56.

[121] *Id.* at paragraph 8.74.

[122] *Id.* at paragraph 8.68.

[123] *Id.* at paragraph 8.69.

[124] *Id.* at paragraph 8.90.

[125] *Id.* at paragraph 8.95.

*The Agreement on Agriculture provides explicit authority for a robust reading, prohibiting subsidies which may lead to circumvention of export subsidy rules.

international trade and the WTO system. However, the U.S. government has been on the losing side of this export subsidy dispute for 30 years. More recently, the United States has been on the losing side of some international diplomatic disputes, most notably the vote over membership in the United Nations' human rights body. Given the current administration's apparent lack of enthusiasm for treaties and international bodies, the European Communities may wish to be cautious about how they press their momentary advantage.*

Despite the compliance problems, the United States will not easily be dissuaded from enacting export subsidies. There have always been questions about the international legitimacy of these subsidy regimes: first the DISC, then the FSC, and now the FSC Repeal Act. Yet, it appears that major U.S. multinationals and labor unions are hooked on subsidies. The estimated tax benefits run nearly US $4 billion per year and are increasing.

One recent study found that exchange rates of the U.S. dollar against European currencies fluctuated according to the twists and turns of the international FSC litigation.[126] When the FSC regime encountered international challenges or adverse WTO rulings, the dollar declined against European currencies.[127] Even the transition from the DISC scheme to the more administratively burdensome FSC regime caused growth of export income to slow significantly during the transition period.[128] This interruption in the growth of export revenues has now been overcome with FSC-related income and export subsidies rising to unprecedented levels, something which no doubt helped spur the European Communities into action. Congress now projects that the export subsidies of the FSC Repeal Act will cost the U.S. Treasury an additional US $153 million in lost revenue in 2001, increasing to US $687 million by 2010 (over and above earlier projections for revenue lost to the now-defunct FSC regime).[129]

One of the few areas where business and labor interests can agree — and declare cease-fire from their disputes over healthcare and other programs — is export subsidies. (And those measures annoy only Europeans, who do not vote in our elections.) That leaves U.S. compliance with WTO obligations lacking a constituency outside *The Wall Street Journal,* and very much in controversy.

Just as only Nixon could go to China, perhaps only U.S. President George W. Bush could in one fell swoop satisfy our treaty obligations, mollify our European trading partners, and oppose corporate and labor backers of export subsidies, including those same corporate interests that supported his campaign effort. Or perhaps not.

Despite the self-interested nature of the support for export subsidies, that position is not totally unprincipled. As U.S. officials have repeatedly pointed out during this row, the WTO's "but for" test as currently construed favors more territorial systems (which exclude extraterritorial income) over more worldwide taxation regimes. That leads the proponents of U.S. export subsidies to argue that they seek only "a level playing field" among nations with regard to the rules of international trade.

So where does this leave the current dispute? In the short run, the FSC Repeal Act has time to run in the WTO adjudicative processes. The United States may appeal the decision to the WTO Appellate Body, buying time, but then what? Absent U.S. capitulation on this issue, we could be headed for a fourth round — and a fourth decade — of this dispute.

As with any dispute, there are a limited number of outcomes. The parties could continue their dispute indefinitely, all the while paying lip service to the concept that the WTO is actually adjudicating a dispute. Alternately, one side could capitulate and declare that the other side is correct. Lastly, the parties could compromise.

For the outlines of a possible compromise, it can be helpful to recall how other long-running stalemates have been solved in the past. Such disputes are often resolved by agreeing to recognize the reality on the ground. For instance, the Thirty-Years War in Central Europe ended with the Peace of Westphalia in 1648 that recognized the realities of new states and new religions. The equivalent solution in this 30-year tax war would be to recognize the reality of territorial and worldwide systems of taxation, and then set forth rules, such as a safe harbor for excluding extraterritorial income. That was the basis for the compromise announced by the 1981 Council Decision. Ultimately, the strength of such a compromise is not that it represents the high ideals of the international trading community or that it embodies some intrinsic fairness, but rather that it accurately reflects the international economic balance of power. ✦

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*However, the ghastly events of 11 September 2001 may also have unforeseeable domestic and international political consequences for this issue.

[126]Mihir A. Desai and James R. Hines Jr., Nat'l Bureau of Econ. Res., Pub. No. 8009, "The Uneasy Marriage of Export Incentives and the Income Tax" 18 (2000), at 40-43.

[127]*Id.*

[128]*Id.* at 38.

[129]Staff of the Joint Comm. on Taxation, 106th Cong., Estimated Revenue Effects of H.R. 4986, the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000," as Passed by the House of Representatives and Scheduled for Markup by the Committee on Finance on 19 September 2000 *reprinted in Daily Tax Rep.*, 18 Sept. 2000, at L-49.