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Foreign Sales Corporations--Subsidies, Sanctions, and Trade Wars

Candace Carmichael

NOTES

Foreign Sales Corporations—Subsidies, Sanctions, and Trade Wars

ABSTRACT

The largest sanctions in the history of the World Trade Organization, the need to stabilize an ailing economy, and the need to maintain strong alliances in the face of a new global war on terrorism are all issues the United States currently faces in deciding how to resolve its dispute with the European Union regarding U.S. tax policy. In 1997, the European Union filed a complaint with the WTO claiming that the then-current U.S. tax regime violated U.S. international trade agreements. The European Union contended that the U.S. tax system gave rise to export-contingent subsidies, in violation of U.S. trade obligations.

Ultimately, the WTO found that the U.S. tax regime provided export-contingent subsidies and thus violated U.S. trade agreements. Although the United States appealed the decision, the European Union prevailed on appeal. This Note examines these WTO opinions and the bases for their findings.

After the U.S. tax framework was found to be in violation of international trade obligations, the United States drafted the Extraterritorial Income Exclusion Act of 2000, which replaced the U.S. tax laws found to be in violation of U.S. trade obligations. This Note describes the replacement law and how it differs from the past tax system.

Although Congress hoped the replacement law would resolve the tax dispute, the European Union was not satisfied that the replacement law remedied the trade violations. The European Union filed a claim with the WTO alleging that the replacement law continued to violate U.S. trade obligations. The WTO ultimately decided that the replacement law violated U.S. trade obligations. This Note examines the latest decision.

The United States filed a notification of appeal in response to the latest WTO decision. This Note concludes by addressing

issues that the United States must consider in deciding how to resolve this dispute and possible solutions to the problem.

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I. INTRODUCTION

For the first time in its history, the United States has statutorily amended its domestic laws[1] in an attempt to comply with international trade obligations. In addition, the United States potentially faces sanctions for trade violations that would dwarf any sanctions previously imposed by the World Trade Organization.[2] Although the European Union[3] has complained about U.S.

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1. *Statement By the President: Signing of the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000,"* U.S. NEWSWIRE, Nov. 16, 2000.

2. Joann M. Weiner, *Stormy Year for EU Leaders, But Some Tax Progress Made*, WORLDWIDE TAX DAILY, Jan. 2, 2001.

3. The European Union is comprised of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal,

international tax laws for years, the European Union took official action in 1997 by filing a complaint against the United States with the WTO. The European Union claimed that the U.S. foreign sales corporation (FSC) tax structure was a breach of U.S. obligations under the Agreement on Subsidies and Countervailing Measures (SCM Agreement)[4] and the Agreement on Agriculture (AA).[5]

The European Union challenged the U.S. laws regarding FSC taxation, claiming that the laws were export-contingent subsidies that placed the United States in violation of its international trade obligations.[6] Barbados, Canada, and Japan joined the European Union in the dispute as third parties to the disagreement.[7] On October 8, 1999, the WTO dispute settlement panel (DSP) ruled that the FSC tax regime did not comply with WTO obligations.[8] Both the United States and the European Union challenged certain aspects of the DSP's findings in the WTO Appellate Body.[9] Canada and Japan joined the European Union as third parties on appeal.[10] On February 24, 2000, the WTO Appellate Body essentially affirmed the DSP ruling.[11] In an attempt to comply with the WTO rulings, President Bill Clinton signed into law the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (EIEA or replacement law) on November 15, 2000.[12]

After the enactment of the replacement law, the European Union continued to argue that the replacement law violated international trade obligations under the SCM Agreement and the AA, and

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Spain, Sweden, and the United Kingdom. H.R. REP. NO.106-845, n.1 (2000), *available at* 2000 WL 1337578.

4. World Trade Organization, Report of the Panel, United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/R (Oct. 8, 1999), at 62 [hereinafter Report of the Panel].

5. World Trade Organization, Agreement on Agriculture, *cited in* Report of the Panel, *supra* note 4, at 7.173. The long-term objective of the AA, as stated in its preamble, is "to establish a fair and market-oriented agricultural trading system . . . initiated through the negotiation of commitments on support and protection and through the establishment of strengthened and more operationally effective GATT rules and disciplines." *Id.*

6. *See generally* Report of the Panel, *supra* note 4.

7. *See generally id.* at 253-64.

8. *Id.* at 316.

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

10. *Id.* at 1.

11. *Id.* at 44.

12. *See generally* FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 [hereinafter Replacement Law].

challenged the replacement law.[13] The European Union again filed a petition with the WTO challenging the replacement law's compliance with U.S. trade obligations. On August 20, 2001, the DSP ruled that the replacement law failed to comply with WTO trade obligations.[14] Additionally, the DSP granted the European Union authorization to impose over four billion dollars in sanctions against the United States for past failures to comply with the DSP and Appellate Body recommendations and continuing violation of international trade obligations.[15] These potential WTO sanctions against the United States are the largest in the WTO's history.[16]

On October 15, 2001, the United States appealed the August 20 WTO decision. Clearly, the outcome of this dispute will have a significant impact on both the United States and the European Union because the industries that benefit most from the FSC tax regime are those in which U.S. and EU companies compete most fiercely.[17] Furthermore, the outcome will affect millions of U.S. jobs, in addition to revenues brought in through taxation and exportation.[18]

This Note will first explain the WTO's role in international trade disputes and the procedures that must be followed when filing a complaint with the WTO. A brief introduction to the WTO is provided in Part II. Part III depicts the long-standing dispute between the United States and the European Union regarding the U.S. tax structure. The different tax structures of the United States and European Union will also be introduced. Part IV sets forth the provisions of the original U.S. tax laws regarding FSCs that were found to be in violation of U.S. trade obligations. Part V presents the arguments made by the United States and the European Union regarding the validity of the FSC tax regime. The WTO's holdings are then discussed. The provisions of the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000," which Congress enacted in an attempt to comply with the WTO ruling, are set forth in Part VI. Part VII describes EU criticisms of the replacement law,

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13. World Trade Organization, Request for the Establishment of a Panel, United States—Treatment for "Foreign Sales Corporations," WT/DS108/16 (Dec. 8, 2000) [hereinafter Request for Panel].

14. World Trade Organization, Report of the Panel, United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/RW (Aug. 20, 2001) [hereinafter Second Report of the Panel].

15. Weiner, *supra* note 2.

16. Paul Meller, *EU Seeks Sanctions on United States of $4 Billion*, PITTSBURGH POST-GAZETTE, Nov. 18, 2000, at A4.

17. *Id.* Major industries benefiting from the FSC tax regime include, "chemicals, pharmaceuticals, machinery, electrical equipment, and transportation equipment." *Id.*

18. Gregory Lubkin, *FSC Replacement Update: Enacting Extraterritorial Exclusions*, TAX MGM'T INT'L J., Jan. 12, 2001, at 33.

which resulted in the most recent WTO finding that the replacement law continues to violate U.S. foreign trade obligations. Finally, Part VIII discusses the latest U.S. appeal and potential responses.

II. INTRODUCTION TO THE WORLD TRADE ORGANIZATION

The WTO was formed in 1995 to ensure that international trade flows as smoothly and freely as possible, to deal with the global rules of trade between nations, and to resolve international trade conflicts.[19] International trade disputes are resolved through the WTO's dispute resolution process, where the focus is on interpretation of agreements and commitments and determination of how to insure that each country's trade policies comply with the agreements it has signed.[20] For example, in the dispute between the United States and the European Union, the WTO will hear the arguments of both and suggest interpretations of the relevant international trade agreements. The WTO will then determine whether the U.S. tax regime is in compliance with the relevant agreements. Since the United States and European Union disagree about the validity of the U.S. FSC tax system, the WTO's role is to step in, at the request of the European Union, and interpret the related agreements to which the United States and European Union are parties.

The WTO's founding members created the organization's dispute settlement scheme to provide an established system and forum for the mutual resolution of disputes.[21] To achieve this goal, Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) dictates that an application to create a DSP may only be made after consultations between the complaining party and the party allegedly in violation of its WTO obligations have failed to produce a mutually acceptable resolution.[22]

If consultations or mediations do not produce a solution, the complaining party may request that a DSP be established to "rule" on the dispute.[23] Upon receipt of a request from the complaining party,

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19. *WTO In Brief, at* http://www.wto.org.

20. *Settling Disputes, The WTO's "most individual contribution," at* http://www.wto.org/english/thewto_e/whatis_e/tif_e/disp0_e.htm. Access to the dispute settlement system is currently limited to WTO Member Governments. Other organizations are not eligible to be WTO Members and therefore are denied formal participation in the dispute settlement process. Amy Ann Karpel & Terence P. Stewart, *Review of the Dispute Settlement Understanding: Operations of Panels*, 31 LAW & POL'Y INT'L BUS. 593, 625 (1999).

21. *Id.* at 597.

22. *Id.*

23. *Id.* at 598.

the Dispute Settlement Body (DSB) will determine the "terms of reference."[24] Three persons are then selected to serve on the DSP.[25] However, panelists cannot be from the nations acting as principal or third parties to the disagreement.[26] Interestingly, unlike the standing requirements found in U.S. courts, there is no prerequisite in the DSU requiring parties to have a legal or economic interest in the disagreement. The DSPs have also refused to read such a condition into the DSU.[27]

The DSU also permits third parties to participate in panel disputes.[28] Specifically, Article 10 of the DSU states that "any Member having a substantial interest in a matter before a panel and having notified its interest to the DSB . . . shall have an opportunity to be heard by the panel[,] . . . make written submissions to the panel," and receive submissions of the parties after their first meeting with the panel.[29] Additionally, Article 4 of the DSU provides that a Member with a substantial interest[30] in an ongoing disagreement

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24. *Id.* Terms of reference are formalistic statements of the complaint made by the party in its request for the establishment of a panel. The specificity required of a party's request for establishment of a panel and the need for identity between the request for the establishment of a panel and the request for consultations have been the subjects of much debate among WTO Members. *Id.* at 614. The DSU merely instructs Members to indicate in writing "the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly." *Id.*

25. *Id.* at 598. Given a "compelling reason," parties to the dispute may object to the selection of a particular panelist. *Id.* The DSU states, "panels shall be composed of well-qualified" individuals with a "sufficiently diverse background and a wide spectrum of experience." *Id.* at 609. Concerns regarding the selection of panelists and the ability of those selected to handle the increasingly complex WTO disputes have provoked some to ask whether it makes sense to move toward a more permanent system of panelists, similar to the Appellate Body. *Id.* at 611. Proponents argue that a more permanent system would bring greater consistency and experience to panel decisions. *Id.* Additionally, it would eliminate the disputes and time delays associated with objections to the panelists selected. *Id.*

26. *Id.* at 598.

27. *Id.* at 620. In EC—Bananas, the European Union contended that the United States lacked a legal or economic interest in the dispute because it was not an exporter of bananas and, therefore, lacked standing to bring its claim. The panel and the Appellate Body rejected this argument, finding that there was not, and should not be, a legal or economic interest test under the DSU. *Id.* at 630.

28. Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, arts. 4 & 10, *available at* http://wto.org/english/tratop_e/dispu_e/dsu_e.htm [hereinafter Understanding on Rules]. There are substantial differences between the rights of parties and third parties. A third party does not have the right to appeal panel decisions or to seek compensation and retaliation. Karpel & Stewart, *supra* note 20, at 623.

29. Understanding on Rules, *supra* note 28, art. 10.

30. Karpel & Stewart, *supra* note 20, at 623 (explaining that a Members' ability to participate in panel disputes as third parties turns on the interpretation of "substantial interest"). However, no dispute has arisen as to whether a Member has met the requirements to participate as a third party. *Id.*

between other Members may request to be joined in consultations.[31]

Once the DSP reviews the parties' arguments and third party submissions, it will issue an interim decision that sets forth each party's arguments and presents the panel's verdict.[32] Parties are allowed to make comments on the interim report, and the panel then considers the comments.[33] Final decisions are released first to the parties and third parties and then to all WTO Members and the public.[34]

Parties may appeal the panel's decision to the Appellate Body within sixty days of its circulation to the public.[35] However, the Appellate Body review is restricted to issues of law and legal interpretation of the panel.[36] If a party is found to be in violation of its international trade obligations, then the complaining party may impose sanctions.[37]

III. BACKGROUND

A. *History Behind the Foreign Sales Corporation Dispute Between the United States and the European Union*

Due to increased global trade and the need of basically every country to export, national governments feel obligated to maintain a tax structure that, at the very least, creates a level playing field for its domestic businesses in the international trading market.[38] For years the United States has felt pressure from U.S. businesses to create and maintain such laws. Domestic businesses pressure the U.S. government, claiming they are at a disadvantage in the global trading market.[39] They also claim that the differing tax philosophies of the United States and its European trading partners are the primary reason U.S. businesses are disadvantaged.[40] In response to

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31. Understanding on Rules, *supra* note 28, art. 4.

32. Karpel & Stewart, *supra* note 20, at 599. The interim decision is released in confidentiality to parties and third parties to a dispute. The process not only allows the parties a chance to make comments on the decision, but also gives parties a last chance to settle the dispute before an official decision is issued. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *See generally WTO In Brief*, *supra* note 19.

38. George G. Luscombe & Mark A. Luscombe, *The New Extraterritorial Income Exclusion*, ACCT. TODAY, Dec. 18, 2000, at 1011, *available at* 2000 WL 11748592.

39. *Id.*

40. *Id.*

these complaints, the United States has repeatedly attempted to create a tax structure that provides a level playing field in the international trading market for U.S. corporations.[41] However, the European Union has long challenged the United States tax structure, claiming that the U.S. system provides export-contingent subsidies, and thereby violates international trade agreements.[42]

The debate between the United States and the European Union over export-contingent subsidies began as early as 1971 when the Domestic International Sales Corporation (DISC)[43] tax regime was enacted.[44] The European Union condemned the law, claiming it violated Article XVI of the General Agreement of Tariffs and Trade (GATT),[45] which prohibits export-related subsidies.[46]

Members of the GATT agreed to prohibit export-contingent subsides because such subsidies can affect international trade in at least two ways.[47] First, if a manufacturer can sell subsidized goods abroad for a lower price than other producers selling similar, but non-subsidized goods, non-subsidized producers will be deterred from competing with the subsidized producers.[48] Second, if the subsidized export product sells in the foreign marketplace at below cost, its export sales will increase, often to the detriment of other exporters

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41. *Id.*
42. *Id.*
43. See Report of the Panel, *supra* note 4, at 60, for the following explanation of DISC:

> A DISC was a domestic subsidiary of a United States company engaged in exporting, and the DISC regime had very strict qualifying rules requiring that they participate almost exclusively in export transactions. The income of a DISC was not taxed directly by the United States, and DISCs were not required to file tax returns separate from their parent company's tax return. Instead, DISC income was taxed when it was paid as a dividend to the United States parent company. Each year, the DISC was deemed to have paid a portion of its income from export transactions as a dividend to the parent company, thereby subjecting the parent to taxation on the income. United States income tax on the remainder of the DISC's income could be deferred without an interest charge until the income was actually paid to the parent company (or until certain events occurred).

44. Phillip L. Jelsma, *The Making of a Subsidy, 1984: The Tax and International Trade Implications of the Foreign Sales Corporation Legislation*, 38 STAN. L. REV. 1327, 1327 (1986).
45. General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194 [hereinafter GATT]. In 1947, the United States along with many other countries signed the GATT, which attempted to promote free trade and has became one of the central regulatory institutions for the majority of world trade issues. *The Multilateral Trading System—past, present and future, at* http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr01_e.htm.
46. Jelsma, *supra* note 44, at 1329.
47. *Id.*
48. *Id.*

and domestic manufacturers.[49] The general rule is that any direct or indirect subsidy that results in the sale of an exported product at a price lower than that charged for a similar product in the domestic market violates GATT.

To relieve tension over the legality of DISC, the Reagan Administration enacted the Deficit Reduction Act of 1984, Title VIII, that effectively replaced the DISC with the FSC.[50] In crafting the FSC, Congress sought to devise a system where it could exempt a portion of the income from foreign economic processes occurring outside the United States in order to afford U.S. exporters treatment comparable to that of Members of the European Union.[51] Contrary to underlying intentions, the 1984 legislation only intensified the debate surrounding U.S. export subsidies.[52]

When the WTO was formed in 1995, the SCM Agreement was created[53] and Article XVI of GATT was adopted by the WTO.[54] Therefore, the disagreement between the United States and European Union persisted within the newly formed framework of the WTO. Only two years after the establishment of the WTO, the European Union took advantage of the WTO dispute resolution system by initiating an official statement against the FSC tax regime, claiming that it violated the SCM Agreement and the AA.[55]

B. *What is a Foreign Sales Corporation?*[56]

An FSC is a foreign corporation organized outside of the fifty United States and the District of Columbia[57] that is responsible for certain sales-related activities in connection with the sale or lease of goods produced in the United States for export outside the United

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49. *Id.*

50. Report of the Panel, *supra* note 4, at 62.

51. *Id.*

52. *See generally id.* Although Congress intended for FSC legislation to be GATT-consistent and to relieve the conflict between the United States and the European Union regarding U.S. compliance with international obligations, the new legislation did not accomplish this goal, as evidenced by the current debate discussed in this Note. *Id.*

53. *See generally id.*

54. *See generally id.*

55. *Id.*

56. There is a distinction between FSCs generally and "small FSCs." Generally, a small FSC is like an FSC, "except that the tax exemption for a small FSC is limited to the income generated by $5 million or less in gross export revenues it does not have to meet foreign management or foreign economic process requirements." Report of the Panel, *supra* note 4, at 41. This Note deals with the typical FSC and does not discuss "small FSCs."

57. *Id.* at 40.

States.[58] An FSC must be created in an eligible U.S. possession,[59] or "under the laws of a country that either has a bilateral or multilateral exchange of information agreement with the United States or has entered into an income tax treaty with the United States that permits the exchange of information."[60] The eligible corporation must file a timely election to be taxed as an FSC during the ninety-day period immediately before the beginning of its taxable year.[61]

A corporation must fulfill several requirements to qualify as an FSC. An FSC may not have more than twenty-five shareholders at any time during the taxable year and may not issue preferred stock.[62] The FSC must also keep a set of permanent records at an office outside the United States and a duplicate set within the United States.[63]

An FSC must have a board of directors that includes at least one person who is not a resident of the United States.[64] FSC meetings between the board of directors and shareholders must take place outside the United States.[65] However, this requirement is usually not difficult to meet, as holding meetings over the telephone can easily satisfy foreign management requirements. Additionally, the corporation can use service companies in its country of incorporation to deal with paperwork.[66] That is, activities may be subcontracted, and the subcontractor is not necessarily required to have a direct contract with the FSC. Moreover, an FSC's primary bank account must be in a qualifying foreign country, and all dividends, legal and accounting fees, salaries of officers, and director's fees are required to be distributed from the foreign bank account.[67]

The FSC, or its agent, must take part in the sales process outside of the United States, including soliciting, negotiating, and

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58. *Id.*

59. There are four eligible United States possessions—American Samoa, the Commonwealth of Northern Mariana Islands, Guam, and the Virgin Islands of the United States. Charles Bruce et al., Portfolio 934-1st: *Foreign Sales Corporations*, TAX MGMT. PORTFOLIOS (BNA), II.B.2 (2001) [hereinafter Portfolio 934-1st].

60. Jelsma, *supra* note 44, at 1338; *see* I.R.C. § 274 (h)(6)(C) (Supp. 1985). A list of twenty-four qualifying foreign jurisdictions has been published. The countries listed are: Australia, Austria, Barbados, Belgium, Bermuda, Cyprus, Denmark, Egypt, Finland, France, Germany, Iceland, Ireland, Jamaica, Korea, Malta, Morocco, the Netherlands, New Zealand, Norway, Pakistan, the Philippines, Sweden, and the Republic of Trinidad and Tobago. Portfolio-934-1st, *supra* note 59, at II.B.2.

61. Jelsma, *supra* note 44, at 1340.

62. *Id.* at 1339.

63. *Id.* at 1339-40.

64. *Id.* at 1340.

65. Portfolio 934-1st, *supra* note 59, at IV.B.

66. Report of the Panel, *supra* note 4, at 41.

67. Portfolio 934-1st, *supra* note 59, at IV.B.2.

contracting.[68] Also, the FSC must have a minimum percentage of direct foreign costs,[69] which include "advertising and sales promotion, processing customer orders, arranging for delivery of the export property, transportation, assembling and transmission of a final invoice or statement of accounting the receipt of payment, and assumption of credit risk."[70]

Most often, a U.S. corporation that produces goods in the United States owns an FSC.[71] The U.S. corporation may provide goods to the FSC for resale abroad or pay the FSC a commission in connection with such sales.[72] There is no statutory obligation that an FSC be associated with or controlled by a U.S. corporation;[73] however, the FSC tax regime is set up such that the benefit to both FSCs and the U.S. corporations will usually be greater if the supplier is associated with the FSC.[74] Consequently, many FSCs are controlled foreign subsidiaries of the U.S. corporations.[75] Over seventy major U.S. corporations benefit from the FSC tax system,[76] including: 3M, Cargill, Boeing, Microsoft, Duke Energy Corporation, Eli Lilly, Eastman Kodak, Exxon Mobil, Lockheed Martin, General Motors, General Electric,[77] Motorola,[78] and the Walt Disney Company.[79]

Although oversimplified, the benefit for the FSC itself amounts to an exemption of a portion of its export profits.[80] In other words, the income of an eligible FSC is partially subject to U.S. tax and partially exempt from U.S. tax.[81] For the related supplier—the exporter—generally the FSC's corporate shareholder, "a full dividends-received deduction for earnings and profits distributed out

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68. Report of the Panel, *supra* note 4, at 40.

69. *Id.* at 41.

70. *Id.*

71. *Id.* at 40.

72. Report of the Appellate Body, *supra* note 9, at 3.

73. *Id.*

74. *Id.*

75. *Id.*

76. Les Blumenthal, *WTO Ruling Targets U.S. Tax Breaks for Exporters Trade: Boeing, Microsoft Among Companies that WTO Saw Are Receiving Billions in Illegal Subsidies*, NEWS TRIB., Aug. 26, 2001, at D1.

77. *U.S. Trade Policy Suffers a Blow As WTO Rules Against Tax Break*, SEATTLE POST INTELLIGENCER, Aug. 21, 2001, at A1 [hereinafter U.S. Trade Policy Suffers]. According to the European Union website, from 1991 to 1998, General Electric saved $746 million under the FSC tax scheme. *Id.*

78. *Id.* According to the European Union's website, from 1991 to 1998, Motorola saved $378 million under the FSC tax scheme. *Id.*

79. Blumenthal, *supra* note 76, at D1.

80. Portfolio 943-1st, *supra* note 59, at III.A.

81. H.R. REP. NO. 106-1004, at 170 (2000), *available at* 2000 WL 1623047; *see infra* notes 120-30 and accompanying text (discussing what part of an FSC's income qualifies for an exemption from U.S. taxation).

of foreign trade income[82] is available, so that the exempt portion of the FSC's foreign trade income is not taxed to the exporter and the taxable portion is not double-taxed in the hands of the exporter."[83] Thus, a U.S. corporation benefits from setting up an FSC to which it can allocate certain income and thereby reduce its overall taxation.

C. *Tax Systems*

The United States and countries within the European Union have fundamentally different tax frameworks.[84] These different systems help fuel the long-standing debate over subsidies and the taxation of exports. Both the United States and the European Union argue that the other side misunderstands the other's tax structure, which gives rise to many issues within the tax dispute.[85]

Essentially, there are two basic types of income tax systems: (1) a residence-based—or worldwide—system, which has been adopted by the United States, and (2) a territorial system, which has been implemented by countries in the European Union.[86] In practice, however, neither the United States nor the Member States of the European Union employ a "pure" system;[87] most countries employ

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82. *See infra* note 121 and accompanying text.

83. Portfolio 934-1st, *supra* note 59, at III.A.

84. Michael Graetz, The David R. Tillinghast Lecture, *Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 54 TAX L. REV. 261, 271-75 (2001). There has been a long-standing debate regarding which tax structure/philosophies are most beneficial. Underlying the debate are three main competing tax theories. "Capital export neutrality" ("CEN") supports the idea that the exporting company should be subject to the same level of worldwide tax as its domestic U.S. rivals. *Id.* at 271. CEN "is neutral about a resident's choice between domestic and foreign investments providing the same pretax rates of return." *Id.* at 270. CEN is the philosophy adopted by those countries implementing the worldwide tax system. *Id.* at 271. A second theory, "capital import neutrality" ("CIN"), supports export companies paying the same level of worldwide tax as foreign rivals. *Id.* CIN requires all investments "in a given country pay the same marginal rate of income taxation regardless of the residence of the investor." *Id.* at 270. CIN "subjects all business activity within a specified country to the same overall level of taxation," whether a resident or a foreigner conducts the activity. *Id.* at 271. The CIN theory is the philosophy that has been adopted by those countries implementing the territorial tax system. The third tax theory is "national neutrality" ("NN"). *Id.* at 274. This theory "seeks neutrality between the pretax return on domestic investments and the return on foreign investments after the payment of foreign taxes." *Id.* NN "regards domestic investments as preferable to foreign investment." *Id.* Under this theory, foreign taxes are treated "the same as domestic costs of doing business and [are allowed] only a deduction for foreign income taxes." *Id.* Although NN is a recognized theory, it has been "routinely dismissed as unwise and unrealistic." *Id.* at 275.

85. Report of the Appellate Body, *supra* note 9, at 6.

86. H.R. REP. NO. 106-845, at 15.

87. *Id.*

some combination of the two concepts.[88] Both systems are intended to avoid double taxation of income.[89]

Each country is permitted to develop its own unique tax structure because there are no rules of international law requiring nations to conform to a single tax system.[90] Each country is encouraged to implement the tax system of its choice, so long as the provisions of the tax regime do not breach any international trade agreements.[91] WTO Members agree that it has never been the WTO's intent to establish international tax "norms."[92] The freedom each country has to establish a distinctive tax structure is beneficial because it allows each country to create tax laws that promote that country's objectives. It complicates the drafting of tax laws, however, because each country wants its corporations to be on a "level playing field" in the international market, while simultaneously maximizing its own tax revenue.

1. World-Wide System Currently in Place in the United States

The U.S. tax regime, although not a pure system, is regarded as a worldwide system of taxation.[93] Under a worldwide system, all of the income earned by a resident[94] is subject to tax, regardless of where that income is earned.[95] Thus, U.S. residents begin with the premise that all their worldwide income is subject to tax. U.S. residents must then look for specific provisions within the Internal Revenue Code (I.R.C.) for exceptions to this general rule.[96]

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88. *Id.*

89. "Double taxation arises when the same income of the same taxpayer is subjected to comparable taxes both in the source country and in the country of residence for identical periods." Report of the Panel, *supra* note 4, at 37. If a United States corporation has an entity abroad and that entity's income was taxed both in the country in which it was earned, under the territorial system, and by the United States, because the corporation is a resident and therefore taxable under the worldwide system, that corporation would have been subject to double taxation. *Id.*

90. *Id.* at 59.

91. *Id.*

92. *Id.* at 60.

93. The United States employs an aggressive, hybrid system. H.R. REP. NO. 106-845, at 15.

94. A corporation formed under the laws of one of the fifty Unites States or the District of Columbia is a "domestic" corporation and is "resident" in the United States for purposes of the worldwide taxation system. Report of the Panel, *supra* note 4, at 36.

95. *Id.* at 58.

96. Generally, in order not to be taxed on worldwide income, U.S. residents must look for one of the many ways in which the I.R.C. provides for relief from taxation. A discussion of the specific ways to avoid taxation on worldwide income is beyond the scope of this Note. *See generally* I.R.C.

A worldwide system generally avoids double taxation by granting foreign tax credits.[97] When income is earned abroad and taxed by a foreign government, a tax credit is provided to U.S. corporations to avoid double taxation.[98]

In addition to residents, the United States also taxes any income earned by foreign corporations within the United States.[99] Under U.S. tax law, all corporations that are not incorporated in one of the fifty states or the District of Columbia are considered foreign corporations.[100] The United States generally does not tax income that is earned by foreign corporations outside the United States. However, foreign-source[101] income of a foreign corporation generally will be subject to U.S. taxation when such income is "effectively connected with the conduct of a trade or business within the United States."[102] U.S. tax laws and regulations provide for the tax authorities to conduct a factual inquiry to determine whether a foreign corporation's income is "effectively connected income."[103]

Alone among the large economies, the United States relies largely on the income tax for its national revenue base.[104] Arguably, the U.S. tax system collects more money than any other tax system in the world and at the lowest cost of any system.[105] The United States favors the worldwide system because it is perceived to be fairer for income taxes to be based on the taxpayer's ability to pay rather than on the source of income.[106]

2. Territorial System Currently in Place Within the European Union

Most countries within the European Union operate under a hybrid tax system; however, the tax system in those countries is closer to a territorial system than a worldwide system.[107] Under a territorial system, only income earned within the borders of the taxing jurisdiction is subject to tax.[108] Thus, a resident of a country within the European Union can earn income from sources outside his

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97. H.R. REP. NO. 106-845, at 15.

98. *Id.*

99. Report of the Appellate Body, *supra* note 9, at 3-4. This element of the U.S. tax system looks more like that of a territorial system.

100. *Id.* at 4.

101. Foreign source income is income earned outside the United States. *Id.*

102. *Id.*

103. *Id.*

104. Paul Stephan, *Sheriff or Prisoner? The United States and the World Trade Organization*, 1 CHI. J. INT'L L. 49, 61 (2000).

105. Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the United States International Income Tax Rules*, 51 U. MIAMI L. REV. 975 (1997).

106. *Id.* at 980.

107. H.R. REP. NO. 106-845, at 15.

108. Report of the Panel, *supra* note 4, at 59.

home country and will not be taxed on that income, regardless of whether the entity earning the income is a resident of the country or not. To avoid double taxation, the territorial system grants a general exemption—income earned abroad is simply not subject to tax.[109] This leads to problems for U.S. businesses because a European business could set up an operation in a low tax jurisdiction and reduce its overall taxes, while a U.S. business doing the same could not reduce its overall taxes.[110]

IV. THE FORMER U.S. FOREIGN SALES CORPORATION TAX REGIME

A. *Overview*

To understand where the tax dispute currently stands and the options the United States faces, it is first necessary to understand the FSC tax regime that the European Union challenged in 1997. The general assumption under the U.S. worldwide tax system is that the United States has the right to tax all income earned worldwide by its citizens and residents, including all foreign source income.[111] Thus, a U.S. corporation benefits from setting up an FSC to which it can allocate certain income and thereby reduce its overall tax burden.

Under the former FSC tax regime, although an FSC is a foreign corporation,[112] and therefore not a U.S. resident, the United States asserted its taxing jurisdiction over the foreign corporation through the corporation's election to become an FSC.[113] Therefore, the FSC was treated as if it engaged in a U.S. trade or business and its income was effectively connected thereto.[114] The FSC tax regime functioned, however, as an exception to the general rule that worldwide income of United States citizens, residents, and corporations would be taxed by the United States.[115]

In essence, U.S. taxpayers using an FSC received a partial exemption from U.S. taxes for export profits.[116] A portion of an FSC's export profits was allocated to the FSC. A percentage of that amount

109. *Id.*

110. Luscombe & Luscombe, *supra* note 38, at 2.

111. *See supra* note 3 and accompanying text.

112. *See supra* note 94 and accompanying text (explaining that a corporation is domestic if it is created under the laws of the fifty United States or the District of Columbia).

113. Jelsma, *supra* note 44, at 1340.

114. Portfolio 934-1st, *supra* note 59, at 41.

115. *Id.*

116. Report of the Panel, *supra* note 4, at 45.

was then treated as tax exempt in the hands of the FSC.[117] The other portion was taxable to the FSC.[118] However, dividends paid by the FSC out of exempt or nonexempt income to the shareholder—usually the related supplier/exporter—normally were eligible for a full dividends-received deduction, on the condition that the recipient was a corporation.[119]

The foreign-source income of an FSC was divided into foreign trade income and all other foreign-source income.[120] An FSC's foreign trade income was defined as its foreign trading gross receipts generated in qualifying transactions.[121] In the context of the FSC tax regime, foreign trading gross receipts were generally gross receipts of the FSC from the "sale, exchange, or other disposition of export property."[122]

Only certain transactions qualified for such treatment. Qualifying transactions involved the sale or lease of export property or the performance of services "related and subsidiary" to such sale or lease.[123] Therefore, to qualify as having tax-exempt income, export property must have been involved in the transaction.[124] Export property was defined as property manufactured or produced[125] in the United States[126] by a person other than an FSC, sold or leased by or to an FSC for use, consumption, or disposition outside the United States,[127] and of which no more than fifty percent of its fair market

117. *Id.* at 43.
118. *Id.*
119. *Id.*
120. Portfolio 934-1st, *supra* note 59, at 41.
121. Report of Appellate Body, *supra* note 9, at 4.
122. Portfolio 934-1st, *supra* note 59, at 41.
123. Report of Appellate Body, *supra* note 9, at 4.
124. *Id.*
125. Portfolio 934-1st, *supra* note 59, at 45. Purchased property is considered manufactured or produced only if it is substantially transformed prior to sale. For example, in Revised Rule 73-279, 1973-1 C.B. 363, the IRS ruled that the dismantling of old railroad cars, the shearing and baling of scrap metal, and the cutting of old railroad rail constituted substantial transformation. *Id.*
126. The definition includes the fifty states, the District of Columbia, and Puerto Rico, all within United Stated customs territory. Portfolio 934-1st, *supra* note 59, at 45.
127. *Id.* at 46-47.

> [T]he destination test will be considered satisfied if the seller or lessor delivers the property: (i) Within the United States to a carrier or freight forwarder for ultimate delivery outside the United States to a purchaser or lessee; (ii) Within the United States to a purchaser or lessee, if the property is ultimately delivered outside the United States by the purchaser or lessee within one year after the sale or lease; (iii) Within or outside the United States to a purchaser or lessee which, at the time of the sale or lease, is an FSC or an interest charge DISC and is not a member of the same controlled group as the seller or lessor; (iv) From the United States to the purchaser or lessee at a point outside the

value is attributable to imports.[128] Export property was also property designated by the President to be in short supply.[129] In other words, to have potentially tax-exempt income, an FSC must have been involved in the sale, lease, or exchange of products at least partially produced in the United States and which were being sold for final use outside the United States.[130]

B. *Alternatives and Exemptions Provided to Foreign Sales Corporations From Generally Applicable United States Tax Rules*

An FSC benefited from this tax structure because the system established either alternatives or exemptions from generally applicable U.S. tax laws that affected the U.S. tax liability of the FSC and its U.S. supplier/exporter.[131] First, the FSC tax regime created alternative transfer-pricing rules for FSCs.[132] The transfer pricing rules were used to allocate the income from transactions involving U.S. export property between the FSC and its U.S. exporter.[133] Also, the transfer pricing rules were used to determine how much of the income—from transactions involving U.S. export property that is allocated to the FSC as foreign trade income—was exempt foreign trade income.[134]

The generally applicable rule the United States developed for dealing with transfer pricing between associated enterprises was set out in Section 482 of the I.R.C.[135] The rule required arm's-length pricing[136]

> United States by means of the seller's or lessor's own ship, aircraft, or other delivery vehicle, owned, leased, or chartered by the seller or lessor; (v) Outside the United States to a purchaser or lessee from a warehouse, storage, facility, or assembly site located outside the United States, if the property was previously shipped by the seller or lessor from the United States; or (vi) Outside the United States to a purchaser or lessee if the property was previously shipped by the seller or lessor from the United States and if the property is located outside the United States pursuant to a prior lease [that was terminated at the conclusion of its term].

Id.

128. Report of Appellate Body, *supra* note 9, at 4.
129. S. REP. NO. 106-416, at 4 (2000).
130. *See supra* notes 120-22 and accompanying text.
131. Report of the Appellate Body, *supra* note 9, at 4.
132. *Id.*
133. *Id.*
134. *Id.*
135. *See generally* I.R.C. § 482 (1986).
136. The definition is flexible and is typically based on the latest interpretation of arm's-length principle as out by the OECD's "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" ("the Guidelines"). The Guidelines are a result of an internal consensus that rules must be established to deal with transfer pricing occurring from one jurisdiction to another. Report of the Panel, *supra* note 4, at 45.

between the relevant enterprises.[137] Any alternative transfer pricing methods used were subject to Internal Revenue Service (IRS) inquiries to ensure the arm's-length pricing requirement was upheld.[138]

Contrary to the general transfer-pricing rule set forth for non-FSCs, under the FSC scheme an FSC could choose to apply one of three transfer-pricing rules to calculate its foreign trade income from qualifying transactions.[139] Therefore, an FSC's taxable income from an export transaction may have been determined on the basis of one of two administrative pricing rules[140] or the generally applicable rule.[141]

One alternative transfer-pricing rule an FSC could choose to apply apportioned twenty-three percent of the total combined taxable income—net income earned by the related supplier and the FSC together—derived from the sale of export property to the FSC and the remaining seventy-seven percent to its related supplier.[142] This rule further provided that approximately sixty-five percent of the FSC's foreign trade income was exempt from U.S. tax.[143] Thus, this rule provided an exemption for fifteen percent (23% x 15/23) of the total combined taxable income earned in the transaction.[144] This exemption unmistakably conferred a benefit to FSCs by significantly reducing the amount of taxes owed to the U.S. government.

The second administrative pricing rule an FSC could choose to implement allowed the FSC to take 1.83% of its total foreign trading gross receipts from the sale of export property as foreign trade income, not to exceed twice the amount allocable to the FSC under the combined taxable income method, that is forty-six percent of the total combined net income earned in FSC transactions.[145] This rule further provided that approximately sixty-five percent (15/23) of the FSC's foreign trade income was exempt from U.S. tax.[146] Thus, this rule provided an exemption for up to thirty percent (46% x 15/23) of the total combined taxable income earned in the transaction.[147] However, the thirty percent exemption was only available in limited circumstances.[148] If applicable, the reduction in taxes owed under

137. *Id.*
138. *Id.* at 46.
139. *Id.*
140. I.R.C. § 925 (1986).
141. *Id.*
142. Report of the Panel, *supra* note 4, at 3.
143. *Id.*
144. *Id.*
145. *Id.* at 4.
146. *Id.*
147. *Id.*
148. *Id.*

this second alternative pricing rule created a considerable advantage to an FSC by decreasing the taxes it owed the U.S. government.

The significance of allowing an FSC to use the alternative administrative pricing rules was that the alternative rules allowed FSCs to choose which transfer pricing rule to implement in a particular transaction.[149] Moreover, these alternative transfer pricing rules could be implemented without requiring government inquiry as to whether the FSC was conducting itself in an arm's-length fashion.[150]

In addition to alternative transfer-pricing rules, an FSC benefited from the FSC tax structure because the system established three main exemptions from generally applicable U.S. tax laws.[151] First, under U.S. law generally, the foreign-source income of a foreign corporation engaged in a trade or business in the United States is only taxable to the extent that it is "effectively connected with the conduct of a trade or business within the United States."[152] Normally, to determine whether the foreign-source income of a foreign corporation is effectively connected, a factual inquiry would be undertaken by tax authorities.[153] However, under the FSC tax structure, the exempt portion of an FSC's foreign trade income was "treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States."[154] In other words, the exempt portion of the FSC's foreign trade income was not subject to a factual inquiry to determine if it was effectively connected.[155] Therefore, income that met the established

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> Because the ceiling for the gross receipts method is linked to the combined taxable [net] income method, it is not mathematically possible to receive the full 30 percent exemption unless the profit margin on a transaction is 4 percent or less. At a profit margin of 8 percent or more, the exemption amount under the gross receipts method will be no more than 15 percent under any circumstances.

Id.

149. Actually, there is even a redetermination rule in which an FSC and its related supplier may make a redetermination of the transfer price to the FSC on a transaction if they determine that a different transfer pricing method is more advantageous. This redetermination may be made up to the time of an audit. Portfolio 934-1st, *supra* note 59, at V.A.2.c.

150. It should be noted that § 482 allows for alternative methods to be employed, but the alternatives are subject to approval by United States tax authorities (the IRS), conditioned on arm's length dealing, and is not at the taxpayer's free choice. Report of the Panel, *supra* note 4, at 46.

151. *Id.* at 45.

152. Report of Appellate Body, *supra* note 9, at 4.

153. *Id.*

154. *Id.*

155. *Id.*

requirements set out for FSCs was automatically deemed not to be effectively connected.[156]

Second, under U.S. law generally, a shareholder in a controlled foreign corporation[157] must include in his gross income each year a pro rata share of certain types of income[158] of the foreign controlled corporation even though such income has not yet been distributed to the U.S. parent.[159] This income is known as Subpart F income.[160] The effect of Subpart F is that U.S. parent corporations are immediately subject to U.S. taxation on such imputed income even though the income remains in the foreign subsidiary's control.[161] However, under the FSC tax regime, an FSC was generally exempt from Subpart F income.[162] The parent of an FSC was not required to declare its pro rata share of the undistributed income of an FSC that was derived from the FSC's foreign trade income.

Third, under U.S. law generally, dividends received by a U.S. corporation that were derived from the foreign-source income of a foreign corporation, were taxable, unless such income has already been taxed under the Subpart F rules.[163] U.S. corporate shareholders of an FSC, however, generally could have deducted one hundred percent of dividends received from distributions made out of the foreign trade income of an FSC.[164] Therefore, the U.S. corporate shareholder benefited by setting up an FSC because it could avoid U.S. taxation on dividends received from the FSC.

According to the European Union, the underlying problem was that in order to qualify for these alternatives and exemptions, a business had to be an FSC, and in order for an FSC's income to qualify for the exemptions, it had to be involved in transactions dealing with U.S. exports.[165]

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156. *Id.*

157. I.R.C. § 957 (1986). A "controlled foreign corporation" is any corporation where more then 50% of the total combined voting power of all classes of stock of such corporation entitled to vote, or the total value of the stock of such corporation is owned or considered owned by U.S. shareholders on any day during the taxable year of such foreign corporation. *Id.*

158. I.R.C. §§ 952, 954 (1986). Subpart F income rules are only applicable when dealing with certain types of income. For example, a CFC engaged in manufacturing would not be subject to the deemed divided rules. *Id.*

159. Report of Appellate Body, *supra* note 9, at 5.

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

165. *See generally* Report of the Panel, *supra* note 4; Report of the Appellate Body, *supra* note 9.

V. THE FINDINGS OF THE WORLD TRADE ORGANIZATION[166]

A. *The Decision of the Dispute Settlement Panel*

The European Union alleged that the U.S. FSC tax regime conferred subsidies that were export-contingent in violation of international trade obligations under the SCM Agreement and the AA.[167] The European Union set forth several issues in its complaint.[168] First, the DSP had to determine whether FSC measures were subsidies contingent upon export performance within the meaning of Articles 1 and 3.1(a) of the SCM Agreement.[169] Next, the DSP was asked to decide whether the FSC tax regime created subsidies that were contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the SCM Agreement.[170] The DSP, however, declined to consider this issue.[171] Finally, the DSP had to determine whether FSC measures violated Articles 3.3 and 8 of the AA.[172]

1. Is the Foreign Sales Corporation Tax Regime an Export-Contingent Subsidy?

a. Establishment of the "But For" Test

The panel's first goal was to determine whether the FSC system created subsidies.[173] The panel looked to the SCM Agreement for the definition of a subsidy.[174] According to Article 1.1(a)(1)(ii) of the SCM Agreement:

> 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

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166. *See generally* Report of the Panel, *supra* note 4.
167. Both the European Union and the United States argued that the other had not complied with procedural requirement under the SCM Agreement and the AA. However, since these arguments do not go to the substantive problem of the FSC tax regime and were not considered in drafting the replacement law, they are not discussed in this Note. *Id.*
168. *See generally id.*
169. *Id.*
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.* at 36.
174. *Id.* at 278-79.

> body within the territory of a Member (referred to in this Agreement as "government") where: . . . (ii) government revenue that is otherwise due is foregone or not collected and . . . (b) a benefit is thereby conferred.[175]

However, this definition did not clarify the debate as to whether the FSC tax regime was a subsidy offered by the United States. The European Union averred that the exemptions and alternatives offered to FSCs from the generally applicable laws through the FSC tax regime constituted subsidies within the meaning of Article 1 of the SCM Agreement.[176] The parties disagreed about what benchmark should be used to determine what was "otherwise due."[177]

The European Union claimed that the FSC scheme involved two subsidies.[178] First, the European Union asserted that the three exemptions[179] from income taxes for FSCs and their parent companies created subsidies.[180] The European Union also claimed that the FSC transfer-pricing rules,[181] which were distinguishable from normal U.S. transfer-pricing rules,[182] created subsidies. Arguing that these were subsidies because FSCs were exempt from generally applicable laws, the European Union reasoned that if the FSCs had not been exempt from the generally applicable laws through the FSC tax regime, the United States would have collected from at least some of these foreign corporations.[183] Therefore, the United States was foregoing revenue that was "otherwise due."

The United States responded that the FSC transfer pricing rules and the FSC tax exemptions did not amount to a subsidy under Article 1 of the SCM agreement.[184] A crucial part of the U.S. defense was footnote 59 of the Illustrative List.[185] Although the Illustrative List, Item (e), identifies as an export subsidy "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes," the United States pointed to footnote 59 which states:

> The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices

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175. *Id.*
176. *Id.* at 277.
177. *Id.* at 269-84.
178. *Id.* at 277.
179. *Id.*
180. *Id.*
181. *Id.*; I.R.C. § 925 (1986).
182. Report of the Panel, *supra* note 4, at 277; I.R.C. § 482 (1986).
183. The United States would have collected taxes from at least some of the foreign businesses that elected to become FSCs based on the "effectively connected" analysis. Report of Appellate Body, *supra* note 9, at 4.
184. Report of the Panel, *supra* note 4, at 277.
185. *Id.*

which would be charged between independent enterprises acting at arm's-length. . . .[186]

The United States interpreted footnote 59 to mean that income generated from foreign economic processes need not be taxed, and that the exemptions of some or all of such income, by whatever means, is not a prohibited export subsidy.[187] The United States argued that the arm's-length principle in footnote 59 would be irrelevant if income from foreign economic processes was not allowed to be exempt from direct taxes.[188] The main thrust of the U.S. defense rested on the 1981 interpretation of tax rules as subsidies, which the United States maintained found its way into the SCM through footnote 59.[189]

The basic difference in arguments between the United States and European Union, which led to the conflicting results, is the order in which provision are to be considered.[190] The European Union began it analysis with Articles 1 and 3 of the SCM Agreement, and then proceeded to the Illustrative List as confirmation for its conclusions.[191] On the other hand, the United States began its analysis with footnote 59 of Item (e) of the Illustrative List.[192]

The panel interpreted the foregoing of revenue otherwise due to mean that less revenue had been raised by the government than would have been raised in a different situation.[193] According to the panel the word "foregone" suggested, "The government has given up an entitlement to raise revenue that it could 'otherwise' have raised."[194]

The panel clarified that this is not entitlement in the abstract, because in theory, governments could tax all revenues.[195] Therefore, the term "otherwise due" implies a comparison between the revenues due under the contested measure and revenues that would be due in another situation.[196] In other words, the panel looked at what revenues the United States was entitled to collect under its current tax system "but for" the FSC tax regime.[197] When analyzed in this manner, the U.S. tax structure was used as the benchmark for

186. *Id.* at 293.
187. *Id.* at 277.
188. *Id.* at 293.
189. *Id.* at 281-85.
190. *Id.* at 291-94.
191. *Id.*
192. *Id.*
193. *Id.* at 279.
194. *Id.* at 280.
195. *Id.*
196. *Id.*
197. *Id.*

determining what was otherwise due.[198] The panel stated that a Member that decides that it will tax income arising from foreign economic activities foregoes revenue otherwise due if it decides in a selective manner to exclude certain limited categories of such income from taxation.[199]

b. Does the Foreign Sales Corporation Tax Regime Pass the "But For" Test?

Using the "but for" test, the panel considered whether the tax exemptions provided to FSCs under the FSC tax system amounted to the "foregoing of revenue that was otherwise due."[200] The European Union first argued that the rules provided to determine whether the income of an FSC was "effectively connected with the conduct of a trade or business within the United States" exempts from taxation certain income of an FSC which, in the case of a non-FSC, the United States would treat as taxable.[201] Under the generally applicable rules, an evaluation is to be conducted to determine whether foreign income is "effectively connected with the conduct of a trade or business in the United States."[202] However, the FSC tax regime automatically treated an FSC's foreign trade income as not effectively connected to a U.S. business and therefore not taxable.[203] Thus, "but for" the FSC tax scheme, the United States might have collected revenue from these foreign corporations upon determining that the business was effectively connected to a U.S. business.

The European Union next pointed out that foreign trade income of an FSC was exempt from the requirements of Subpart F.[204] Therefore, the parent of an FSC did not need to report as income undistributed income from the FSC that would otherwise have been subject to immediate taxation under Subpart F, "but for" the FSC tax regime.[205] Therefore, the United States was not collecting revenue

198. *Id.*

199. *Id.* at 294. Additionally, the panel stated:

> [A]ssuming for the sake of argument that footnote 59 is predicated on the assumption that income arising from foreign economic processes is not as a general matter "otherwise due" within the meaning of Article 1.1(a)(1)(ii), we could at most conclude that a decision by a Member not to tax any income arising from foreign economic processes would not represent the foregoing of revenue "otherwise due."

Id.

200. *Id.* at 295.

201. *Id.*

202. Report of the Appellate Body, *supra* note 9, at 4.

203. I.R.C. § 921(a) (1986).

204. Report of the Panel, *supra* note 4, at 296.

205. *Id.*

that was otherwise due because certain FSC income was exempt from Subpart F requirements.

Finally, the European Union claimed that the parent of an FSC need not pay income taxes on income distributed to it and attributable to the foreign trade income of an FSC that would otherwise be fully taxable at the time the income was distributed "but for" the FSC tax system.[206] Therefore, the United States was not collecting revenue it would collect if the FSC tax regime were not in place.

The panel found all three exemptions to be foregone revenue otherwise due; therefore, each exemption constituted a subsidy.[207] The panel stated, "Applying the 'but for' test to the FSC scheme, there can be no doubt that, in the absence of the FSC scheme, income which is shielded from taxation by that scheme would be subject to taxation."[208] Once the panel established the "but for" test to apply to the exemptions, the United States did not dispute the conclusion.[209]

Additionally, the panel found that the financial contributions clearly conferred a benefit, which is a requirement under Article 1 of the SCM Agreement, because it relieved both the FSC and its parent from having to pay taxes that were otherwise due.[210] Moreover, that benefit was found to be substantial because the tax exemption could be as much as fifteen to thirty percent of gross income from exporting.[211]

c. Are the Foreign Sales Corporation Exemptions Export-Contingent?

Determining whether the FSC tax regime enabled the United States to create a subsidy was only the first step in the panel's analysis, because subsidies alone are not a violation of the SCM Agreement.[212] Although the panel found the FSC exemptions to be subsidies within the meaning of Article 1.1(a)(ii), in order to be a violation of the SCM Agreement the subsidies must also be export-contingent within the meaning of Article 3.1(a) of the SCM Agreement.[213] Article 3.1(a) of the SCM Agreement, entitled "Prohibitions," states in pertinent part: "[E]xcept as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited: (a) subsidies contingent, in

206. *Id.*
207. *Id.* at 298.
208. *Id.* at 196.
209. *Id.*
210. *Id.* at 298.
211. *Id.*
212. *Id.*
213. *Id.*

law or in fact, whether solely or as one of several other conditions, upon export performance. . ."[214]

The panel found that the FSC exemptions were in fact export-contingent, and therefore, a breach of U.S. obligations under the SCM Agreement.[215] A subsidy, the panel reasoned, was only available with respect to foreign trading income.[216] "Foreign trading income" is that income which arose from the sale or lease of export property.[217] "Export property" was limited in effect to goods manufactured, produced, grown, or extracted in the United States that were held for direct use, consumption, or disposition outside the United States.[218] Therefore, the subsidy could only be granted to income involved in transactions dealing with U.S. export property.[219] The panel easily found that such a subsidy was export-contingent.[220]

The United States argued that the WTO was penalizing a country using a worldwide system for incorporating elements of a territorial system in order to obtain comparable tax treatment for its exporters.[221] The WTO responded that the United States was free to maintain a worldwide system, a territorial tax system, or any other type of system it saw fit.[222] However, the panel stated that that did not mean that,

> The United States is free to establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim that it is entitled to provide such an export subsidy because it is necessary to eliminate a disadvantage to exporters created by the U.S. tax system itself.[223]

The panel declined to rule on the validity of the FSC transfer-pricing rules.[224]

2. Does the Foreign Sales Corporation Scheme Violate Article 3.3 of the Agreement on Agriculture?

The European Union asserted that the FSC tax system violated Article 3.3 of the AA.[225] A violation of Article 3.3 of the AA may be found to exist upon the determination that (a) a Member is providing

214. *Id.*
215. *Id.* at 299-300.
216. *Id.* at 299.
217. *Id.*
218. *Id.*
219. *Id.*
220. *Id.*
221. *Id.* at 304.
222. *Id.*
223. *Id.*
224. *Id.* at 305.
225. *Id.* at 228-32.

"export subsidies listed in paragraph 1 of Article 9 of that Agreement;" and (b) in respect of a scheduled product, that those export subsidies are being provided in excess of the budgetary outlay and/or quantity commitment levels specified in its Schedule, or in respect of an unscheduled product,[226] that it is providing any such subsidies.[227] Therefore, with respect to agricultural products in which a Member has specific export subsidy commitments, "scheduled agricultural products,"[228] a violation of Article 3.3 can only arise if the Member provided subsidies in excess of the commitment level.[229] However, regarding unscheduled agricultural products, an inconsistency under Article 3.3 would arise if a Member provided any subsidy.[230]

For Article 3.3 of the AA to be violated, section 9.1(d) had to be satisfied.[231] Thus, to determine whether there was a violation of Article 3.3 of the AA, the panel first had to decide whether the subsidy was listed in paragraph 1 of Article 9.[232] For the FSC scheme to fall within the scope of Article 9.1(d), two criteria had to be satisfied. First, there must have been a subsidy.[233] Second, the subsidy must have been given to reduce the costs of marketing exports of agricultural products.[234]

The panel had already determined that a subsidy existed.[235] Thus, the panel only had to determine whether the subsidy provided by the FSC tax scheme was provided to "reduce the costs of marketing agricultural exports."[236] The European Union argued that by reducing the tax liability arising out of foreign sales, the FSC scheme reduced the costs of marketing exports.[237] The European Union reasoned that the FSC scheme reduced the costs of marketing exports, since marketing means advertising, sales promotion, and solicitation, and these are all activities for which the FSC is

226. *Id.* at 307.
227. *Id.* at 310.
228. Generally, scheduled agricultural products are those to which the Member (in this case the United States) provides subsidies but has committed to reduce the level of subsidies offered for the particular product. Under the Uruguay Round, Members of the WTO committed to reduce subsidies on scheduled products. Wheat is a scheduled product, meaning that it has received export subsidies in the past. *Id.* at 307.
229. *Id.* at 308.
230. *Id.*
231. *Id.* at 310.
232. *Id.*
233. *Id.*
234. *Id.*
235. *Id.*; *see also supra* note 207 and accompanying text.
236. Report of the Panel, *supra* note 4, at 311-12.
237. *Id.* at 311.

responsible.[238] Conversely, the United States asserted that the FSC scheme did not reduce marketing expenses but merely reduced an FSC's tax liability.[239]

Although the word "subsidy" is not defined within the AA, the panel found the meaning of subsidy under the AA to be the same as the meaning of subsidy under the SCM Agreement.[240] Therefore, the "but for" test used to determine whether a subsidy existed within the SCM agreement was also used to determine whether a subsidy existed under the AA.[241] As discussed in Part V.A.1.a, the FSC did constitute a subsidy under the "but for" test and therefore also constituted a subsidy under the AA.

The panel held that income taxes are a cost of doing business, and because FSC subsidies reduced an exporter's income tax liability with respect to marketing activities, they effectively reduced the cost of marketing agricultural products.[242] Therefore, Article 9.1(d) of the AA requirements had been met.[243]

The panel next turned to Article 3.3 of the AA.[244] The first part of Article 3.3 of the AA deals with subsidies provided for scheduled products.[245] The European Union contended that the United States provided subsidies in excess of quantity commitment levels with respect to wheat from 1995 to 1997.[246] The United States did not contest the accuracy of the evidence presented by the European Union to establish this violation.[247] Thus, the panel ruled in favor of the European Union, holding that the United States violated the first part of Article 3.3 of the AA.[248]

The second part of Article 3.3 of the AA provides that no Member may provide subsidies to unscheduled agricultural products.[249] The panel interpreted the phrase "provide subsidies" to mean making the subsidy available, as well as actually granting or paying the subsidy.[250] The United States did not contest that FSC subsidies were available to FSCs, which were engaged in the marketing of any agricultural product; nor did the United States contest that an FSC

238. *Id.*
239. *Id.*
240. *Id.* at 310.
241. *Id.*
242. *Id.* at 312.
243. *Cf. id.* at 313. In other words, there was a subsidy created by the FSC tax regime and the subsidy was given to reduce the costs of marketing exports of agricultural products. *See supra* notes 233-34 and accompanying text.
244. *Id.* at 313-16.
245. *Id.* at 313.
246. *Id.*
247. *Id.*
248. *Id.*
249. *Id.* at 314.
250. *Id.* at 315.

which satisfied the relevant requirements was thereby entitled to FSC subsidies under the relevant provisions of the I.R.C.[251] Therefore, the panel found a violation of the second part of Article 3.3 of the AA.[252]

3. Does the Foreign Sales Corporation Tax Regime Violate Article 8 of the Agreement on Agriculture?

The European Union also asserted that the FSC regime violated Article 8 of the AA.[253] Article 8 of the AA stipulates that "[e]ach member undertakes not to provide export subsidies otherwise than in conformity with this Agreement."[254] Because the United States violated obligations under Article 3.3 of the AA with respect to wheat and with respect to all unscheduled products, the panel consequently found a violation of Article 8.[255]

4. Summary of the Decision of the Dispute Settlement Panel

The panel held that the FSC tax regime violated Article 3.1(a) of the SCM Agreement and Articles 3.3, 9.1(d), and 8 of the AA. When the SCM Agreement or AA is violated, Article 3.8 of the DSU provides that "in cases where there is an infringement of the obligations assumed under a covered agreement [including the SCM Agreement and the Agreement on Agriculture], the action is considered prima facie to constitute a case of nullification or impairment."[256] Therefore, the panel recommended that the United States bring the FSC tax provisions into compliance with the SCM Agreement and AA by October 1, 2000.[257]

B. *The Appellate Body Decision*

The United States appealed the decision, requesting that the WTO Appellate Body reverse the panel's finding that the United States violated its obligations under Articles 3.3, 8, and 9.1(d) of the AA.[258] Additionally, the United States requested that the Appellate Body review the meaning of "subsidy" under Article 1.1(a)(1)(ii) of the

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251. *Id.* at 316.
252. *Id.*
253. *Id.*
254. *Id.*
255. *Id.*
256. *Id.*
257. *Id.* at 317.
258. Report of the Appellate Body, *supra* note 9, at 8.

SCM Agreement and use footnote 59 as the controlling legal provision in the case.[259]

The Appellate Body first affirmed the panel's ruling that the U.S. FSC tax regime fit within the meaning of "subsidy" under Article 1.1(a)(1)(ii).[260] However, the Appellate Body hesitated to use the "but for" test established by the panel and preferred to look directly at the treaty language.[261] The Appellate Body specifically stated,

> We would have particular misgivings about using a "but for" test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contest measure. 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 contest measures.[262]

The panel conceded that the "but for" test works in this particular case, but might not always be the appropriate test to impose.[263] Regardless of the test used, the Appellate Body found that the FSC tax regime constituted an export-contingent subsidy.[264] Therefore, the Appellate Body affirmed the panel's decision that the FSC measure constituted a prohibited subsidy under Article 3.1(a) of the SCM Agreement.[265]

The United States further argued that the panel erred in its interpretation of Article 9.1(d) by focusing on the nature of the activities carried out by the recipient of the subsidy, rather than on the nature of the subsidy itself.[266] The United States maintained that although income taxes may be a cost of doing business, they are not part of the "costs of marketing exports" under Article 9.1(d).[267] The Appellate Body agreed with the United States that the panel had interpreted Article 9.1(d) too broadly.[268]

The Appellate Body held that marketing costs are specific types of costs that differ from general business costs and therefore relate to the marketing of exports only in the broadest sense.[269] For the FSC scheme to be inconsistent with Article 3.3 of the AA, the FSC measure must include an export subsidy within the meaning of

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259. *Id.* at 6.
260. *Id.*
261. *Id.* at 24.
262. *Id.*
263. *Id.*
264. *Id.*
265. *Id.* at 45.
266. *Id.* at 33.
267. *Id.*
268. *Id.* at 34.
269. *Id.*

Article 9.1(d).[270] Because the Appellate Body decided that the export subsidy did not fit within the meaning of Article 9.1(d), the panel therefore held that there was no violation of Article 3.3 of the AA.[271]

The Appellate Body reversed the panel's decision that FSC tax breaks were given to reduce the costs of marketing exports of agricultural products under Article 9.1(d) of the AA and, as a result, reversed the panel's finding that the United States acted in breach of its obligation under Article 3.3 of the AA.[272]

The Appellate Body also found that the United States breached its obligations under Articles 10.1 and 8 of the AA.[273] The FSC violated Article 10.1 because it was applied in a manner which resulted in, or threatened to lead to, circumvention of its export subsidy commitments for both scheduled and unscheduled agricultural products.[274] The FSC tax system violated Article 8 because it provided "export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in the [U.S.] Schedule."[275]

The Appellate Body recommended that the United States bring the FSC tax system into conformity with its obligations under the Agreements by October 1, 2000.[276]

C. *The Subsequent Agreement Between the United States and the European Union*

With EU consent, the October 1, 2000 deadline for compliance was extended to November 1, 2000.[277] The deadline extension was partially due to the chaos in the 2000 Presidential election.[278] The European Union realized that Congress could not realistically meet the deadline in light of the election events.[279] The European Union did not want to impose sanctions on the United States without giving the United States a fair chance to comply with the WTO conclusion

270. *Id.* at 35.
271. *Id.*
272. *Id.*
273. *Id.*
274. *Id.*
275. *See id.*
276. *Id.* at 45.
277. David Benson et al., News Analysis, *New Law Repeals FSC, Implements New US Tax Scheme for Extraterritorial Income*, TAX NOTES INT'L, Nov. 27, 2000, at 2454.
278. *Id.*
279. *Id.*

and recommendations because the European Union did not want to elevate the potential for a trans-Atlantic trade war.[280]

VI. THE FSC REPEAL AND EXTRATERRITORIAL INCOME EXCLUSION ACT OF 2000

On May 2, 2000, the U.S. government made a proposal to the European Union to replace the FSC regime with an elective regime for foreign sales.[281] Unlike the then-current FSC tax system, the replacement law would not require that eligible goods be manufactured in the United States.[282] Moreover, there would be a number of corporations with foreign sales of goods manufactured outside the United States that would benefit from the new regime.[283] The European Union did not respond encouragingly to the proposed law.[284]

In an attempt to comply with the WTO ruling, the United States enacted the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.[285] The replacement law represents the third attempt[286] in an ongoing effort by the United States to implement a tax law that aids U.S. companies by leveling the playing field of international trade without violating the rules that govern international trade.[287] The passage of the replacement law by the lame-duck 106th Congress, even before the enactment of some critical budget legislation, reflects its importance to the U.S. economy.[288]

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280. "American officials have warned that if the EU goes ahead with sanctions, it could unleash a full-scale trade war across the Atlantic. The United States already has imposed 308 million dollars in sanctions against the EU in trade disputes over bananas and hormone-treated beef . . ."–a "case" also heard by the WTO. *EU will Request WTO Sanction Authorization: Official*, XINHUA COMTEX, Nov. 16, 2000, *available at* 2000 WL 29754236.

281. Portfolio 934-1st, *supra* note 59, at 9.

282. S. REP. NO. 106-416, at 5.

283. *Id.*

284. *WTO Countries Advance on Trade Round, but Will is Weak: EU*, AGENCE FRANCE-PRESSE, Nov. 21, 2000, *available at* 2000 WL 24764352 [hereinafter WTO Countries Advance].

285. S. REP. NO. 106-416, at 2.

286. First, DISC was enacted in an attempt to level the playing field of international trade and also to comply with U.S. international obligations. *See supra* note 43. Next, the FSC tax scheme was implemented in an attempt to accomplish the same goals that the DISC had failed to achieve. *See supra* note 50. This led to the third and most recent attempt to fulfill these goals, the enactment of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. *See supra* note 12.

287. Lubkin, *supra* note 18, at 32.

288. *Id.*

Most significantly, the replacement law repeals FSC tax laws in sections 921 through 927 of the I.R.C.[289] Consequently, a corporation cannot elect to be an FSC after September 30, 2000.[290]

The legislation also modifies the general rules of U.S. taxation by fundamentally amending the definition of gross income.[291] The replacement law starts with the proposition that, for U.S. tax purposes, gross income does not include extraterritorial income.[292] In other words, the replacement law eliminates the presumption that worldwide income is taxable if it does not fall within a specific exclusion. Congress contends that the extraterritorial income excluded by the replacement legislation from the scope of U.S. income taxation parallels the foreign-source income excluded under most territorial tax systems, particularly those employed by EU countries.[293]

Congress claims that the replacement law treats all foreign sales alike, whether manufactured in the United States or abroad.[294] This is a substantially broader category of income than that which was exempt from taxation under the former FSC provisions.[295] While many of the former FSC concepts are incorporated into the replacement law, the basic exclusion rules function quite differently from the FSC rules.[296]

The basic logic behind the replacement law is that the structure avoids the creation of a new subsidy because the government does not have the right to tax extraterritorial income in the first place.[297] Also, by allowing a general exemption for extraterritorial income, the replacement law avoids double taxation on income in much the same manner as many European and other territorial-type systems.[298]

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289. S. REP. NO. 106-416, at 5.

290. *See generally* Replacement Law, *supra* note 12.

291. S. REP. NO. 106-416, at 5.

292. *See generally* Replacement Law, *supra* note 12. This initial assumption is contrary to the general rule under the prior FSC tax regime, which began with the assumption that all extraterritorial income was included in gross income unless an exception applied. *Id.*

293. S. REP. NO. 106-416, at 5. Many scholars believe that the replacement law suggests that the United States will abandon its global tax structure and move to a purely territorial system. This argument is based primarily on the fact that extraterritorial income is no longer included in the definition of gross income. However, Manal Corwin from the U.S. Treasury Department made clear that the United States remains a jurisdiction with a worldwide approach to taxation and that the replacement law is a narrow exception to the traditional U.S. tax system. Robert Goulder, *U.S. Treasury Official Denies FSC Repeal Signals Move to Territoriality*, TAX NOTES INT'L, Dec. 18, 2000, at 2749.

294. S. REP. NO. 106-416, at 5.

295. *Id.*

296. *Id.*

297. Goulder, *supra* note 293, at 2749.

298. *Id.* at 2454.

Therefore, no foreign tax credit is allowed for income taxes paid with respect to such excluded income.[299]

Another distinction from the old law is that individuals may benefit from the income exclusion provisions.[300] Any U.S. person or foreign corporation that elects to be taxed as a U.S. corporation and meets certain requirements can claim the replacement law's benefits.[301]

A foreign corporation, whether U.S. or foreign-owned, may elect to claim the extraterritorial income exclusion if: (i) it manufactures property in its ordinary course of business and (ii) substantially all of its gross receipts are reasonably expected to be foreign trading gross receipts.[302] "Foreign trading gross receipts" are gross receipts from the sale, exchange, or other disposition of qualifying foreign trade property, from the lease or rental of qualifying foreign trade property for use outside the United States, and for services that are related and subsidiary to the above activities, if at least fifty percent of the taxpayer's other foreign trading gross receipts for the year are derived from those above three activities.[303] Generally, "qualifying foreign trade income" is gross income from transactions that, if excluded, results in a reduction of the taxpayer's taxable income, not to exceed the greater of thirty percent of the taxpayer's foreign sale and leasing income, one and two-tenths percent of the taxpayer's income that is from foreign trading gross receipts, or fifteen percent of the taxpayer's foreign trade income.[304] "Foreign trade income" is a taxpayer's income that is attributable to foreign trading gross receipts.[305]

The threshold for determining if gross receipts will be treated as foreign trading gross receipts is whether the gross receipts are derived from a transaction involving qualifying foreign trade property.[306] "Qualifying foreign trade property" is property manufactured, produced, grown, or extracted in or outside the United States that is held for sale, lease, or rental in the ordinary course of business for direct use, consumption, or disposition outside the United States.[307] Additionally, to be considered qualifying foreign trade property, not more than fifty percent of the fair market value of the property can be attributable to articles manufactured, produced,

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299. S. REP. NO. 106-416, at 6.
300. Portfolio 934-1st, *supra* note 59, at 20.
301. *Id.*
302. I.R.C. § 943(e).
303. S. REP. NO. 106-416, at 7.
304. I.R.C. § 941(a)(1).
305. I.R.C. § 941(b).
306. S. REP. NO. 106-416, at 8.
307. I.R.C. § 943(a).

grown, or extracted or having other value added outside the United States and direct costs for labor performed outside the United States.[308] "Foreign trading gross receipts" do not include gross receipts from a transaction if the qualifying foreign trade property or services are for ultimate use in the United States, or for use by the United States and such use is required by law or regulation.[309] Gross receipts from a transaction are foreign trading gross receipts only if certain economic processes take place outside of the United States.[310]

The replacement law also sets forth a foreign economic processes requirement.[311] The foreign economic processes requirement is satisfied if the taxpayer participates, outside of the United States, in the solicitation, negotiation, or making of the contract relating to such transaction and incurs a specified amount of foreign direct costs attributable to the transaction.[312]

The replacement law requires that property manufactured outside of the United States be manufactured by (1) a domestic corporation, (2) an individual who is a citizen or resident of the United States, (3) a foreign corporation that elects to be subject to U.S. taxation in the same manner as a United States corporation, or (4) a partnership or other pass-through entity, all of the partners or owners of which are described in (1), (2), or (3) above.[313]

The replacement law is effective for transactions entered into after September 30, 2000.[314] In addition, no corporation may elect to be an FSC after September 30, 2000.[315] The replacement law provides a transition period for existing FSCs and for binding contractual agreements.[316] The new rules do not apply to transactions in the ordinary course of business involving an FSC before January 1, 2002.[317]

In comparing the replacement law to the FSC tax regime, it initially looks as if U.S. tax policy has changed significantly.[318] Some critics believe that the replacement law was enacted at least in part to appear responsive to the WTO ruling.[319] In reality, however, the same net reduction in U.S. tax law will be available to U.S. exporters

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308. *Id.*
309. S. REP. NO. 106-416, at 7.
310. *Id.* at 8.
311. *Id.*
312. *Id.*
313. *Id.* at 9.
314. Replacement Law, *supra* note 12, § 5.
315. *Id.*
316. *Id.*
317. *Id.*
318. Mark A. Luscombe, *The Future of Foreign Sales Corporations*, TAXES, Oct. 1, 2000, at 32, *available at* 2000 WL 12855720.
319. *Id.*

under the replacement law as under the FSC tax regime.[320] Conceivably, "the greatest difference between the old FSC regime . . . and the [replacement law] is that foreign manufacturing operations, including foreign manufacturing done by foreign corporations, can take advantage of the new rules."[321]

VII. REACTIONS TO THE REPLACEMENT LAW

A. *The Response of the European Union to the Replacement Law*

Although "the European Union has acknowledged that the exclusion of foreign income provided for by the FSC replacement [law] is not limited to U.S. exporters but benefits also companies that sell and manufacture abroad," the European Union is still not satisfied that the replacement law fulfills U.S. trade obligations.[322] The European Union Trade Commissioner, Pascal Lamy, stated that the new law is "even worse" than the previous one regarding export subsidies.[323]

The European Union contends that, like the FSC scheme, the replacement law results in the foregoing of tax revenue that is otherwise due, thereby conferring a benefit to recipients.[324] Therefore, the replacement law provides subsidies within the meaning of Article 1 of the SCM Agreement and under the AA.[325]

The European Union further claims that the subsidies provided by the replacement law are export-contingent, contrary to Article 3.1(a) of the SCM and Articles 3.3, 8, and 10.1 of the AA.[326] The replacement law also provides treatment less favorable to imported products than is accorded to similar U.S. products, contrary to Article III:4 of GATT 1994.[327]

Lastly, the European Union maintains that the FSC replacement law contains transitional provisions, which allow companies to continue to benefit from the WTO-incompatible FSC scheme beyond the deadline, thus failing to withdraw the subsidy and implement the panel decision.[328]

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320. David Benson et al., *supra* note 277, at 2454, 2457.

321. *Id.*

322. Daniel Pruzin, *FSCs: U.S. Defends FSC Replacement at WTO, Advances "Points of Agreement" with EU*, DAILY TAX REP., Dec. 21, 2000, at G-4.

323. WTO Countries Advance, *supra* note 284.

324. Pruzin, *supra* note 322.

325. Report of the Panel, *supra* note 4, at 4.

326. *Id.*

327. *Id.* at 2.

328. *Id.* at 5.

The European Union estimated and requested damages of over four billion dollars[329] in annual sanctions against the United States—the largest sanctions demanded in WTO history.[330] The European Union said its figure for damages was based on the value of the subsidies granted by the United States under the FSC tax regime.[331] Under WTO rules, the European Union had to submit an indicative list of products eligible for sanctions.[332] "The DSB will appoint an

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329. The estimate is based on the value of the subsidy provided by the United States to exporters through the FSC regime as of February 2000.

330. Weiner, *supra* note 2.

331. *EU/United States: EU asks for USD4 Billion in Export Subsidy Sanctions*, EUR. REP., Nov. 18, 2000, at 508, *available at* 2000 WL 24319928.

332. On November 17, 2000, the European Communities filed a statement with the WTO stating:

> As the United States has failed to implement the DSB recommendations and rulings by 1 November 2000, and as envisaged in the agreed procedure . . . , the European Communities hereby requests authorization from the DSB to take appropriate countermeasures and to suspend concessions pursuant to Article 4.10 of the SCM agreement and Article 22.2 of the DSU in the amount of US $4043 million per year. The European Communities intends to take countermeasures and suspension of concessions in the form of the suspension of tariff concessions and related obligations under the GATT 1994 by imposing an additional duty of 100 percent ad valorem above bound custom duties on a final list of United States . . . : Live animals; meat and edible meat offal; dairy produce, birds' eggs, natural honey, edible products of animal origin, not elsewhere specified or included; products of animal origin not elsewhere specified or included; edible vegetables and certain roots and tubers; edible fruit and nuts; peel of citrus fruits or melons; cereals; products of the milling industry; malt; starches; inulin; wheat gluten; oil seeds and oleaginous fruits; miscellaneous grains, seeds and fruit; industrial or medical plants; straw and fodder; animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes; preparations of meat, fish or crustaceans, molluscs or other aquatic invertebrates; sugars and sugar confectionery; preparations of cereals, flour, starch or milk; pastrycooks' products, preparations of vegetables, fruits, nuts or other parts of plants; miscellaneous edible preparations; residues and waste from the food industries; prepared animal fodder; essential oils and resinoids; perfumery, cosmetic or toilet preparations; soaps, organic surface-active agents, washing preparations, lubricating preparations, artificial waxes, prepared waxes, polishing or souring preparations, candles and similar articles, modeling pastes, "dental waxes" and dental preparations with a basis of plaster; albuminous substances; modified starches; glues; enzymes; hides and skins (other than furskins) and leather; articles of leather; saddlery and harness; travel goods, handbags and similar containers; articles of animal gut (other than silkworm gut); furskins and artificial fur; articles thereof wood and articles of wood; wood charcoal; paper and paperboard; articles of paper pulp, paper or paperboard; books, newspapers, pictures and other products of the printing industry; manuscripts, typescripts and plans; wool, fine and coarse animal hair; yarn and fabrics of horsehair; cotton; man-made filaments; carpets and other textile floor coverings; articles of apparel and clothing accessories, knitted or crocheted; articles of apparel and clothing accessories, not knitted or crocheted; other made up textile articles; sets; worn clothing and worn textile articles; rags;

arbitrator before the final level of sanctions are set, however, and the European Union has agreed to abide by the level of sanctions that the arbitrator approves."[333]

On November 17, 2000, the European Union requested that the United States enter into consultations under Articles 4 and 21.5 of the Understanding on Rules and Procedures Governing the Settlement of Disputes, Article 4 of the SCM Agreement, Article 19 of the Agreement on Agriculture, and Article XXIII:1 of the GATT 1994 with respect to the replacement law.[334] Consultations were held between the parties on December 4, 2000 in Geneva, but the consultations failed to settle the dispute.[335] On December 7, 2000, the European Union requested that a panel be established, as "there is a disagreement to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings" of the DSB.[336] Australia, Canada, India, Jamaica, and Japan joined the European Union as third parties to the dispute.[337]

B. *The Findings of the World Trade Organization Regarding the Replacement Law*

The DSP established to consider the U.S. replacement law consisted of the same panelists as in the original FSC dispute in 2000.[338] Before addressing the issues at hand, the DSP first noted that the European Union agreed that "there would no longer be a

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footwear, gaiters and the like; parts of such articles; ceramic products; glass and glassware; natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal, and articles thereof; imitation jewelry; coins; iron or steel; articles of iron or steel; copper and articles thereof; aluminium and articles thereof; tools, implements, cutlery, spoons and forks, of base metal; parts thereof of base metal; miscellaneous articles of base metal; nuclear reactors, boilers, machinery and mechanical applicances; parts thereof; electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers; and parts and accessories of such articles; aircraft, spacecraft, and parts thereof; toys, games and sports requisites; parts and accessories thereof.

Recourse by the European Communities to Article 4.10 of the SCM Agreement and Article 22.2 of the DSU, United States-Tax Treatment for "Foreign Sales Corporations", WT/DS108/13 (Nov. 17, 2000), *available at* 2000 WL 1726528.

333. Trevor Drury & Chuck Gnaedinger, *European Union Asks for Sanctions Against the United States in FSC Dispute*, WORLDWIDE TAX DAILY, Nov. 20, 2000, at 224-1.

334. Second Report of the Panel, *supra* note 14, at 3.

335. *Id.* at 4.

336. *Id.*

337. *Id.*

338. *Id.* The Panel was composed of Mr. Crawford Falconer as Chairman, and Mr. Didier Chambovey and Professor Seung Wha Chang as Members. *Id.*

prohibited subsidy within the meaning of Article 3 of the SCM Agreement" if the United States eliminated the requirements that the property be held for use outside the United States and the fifty percent "foreign content limitation."[339] Based on this concession, the DSP concluded that it would focus its examination on those two aspects of the replacement law.[340] The European Union set forth several arguments in which it asserted that the replacement law continued to violate international agreements.

1. The Agreement on Subsidies and Countervailing Measures

a. Does the Replacement Law Create a Subsidy/Financial Contribution?

The first issue addressed by the DSP was whether the "exclusion" from gross income of certain extraterritorial income in the replacement law gives rise to a financial contribution in the form of a foregoing of government revenue that is otherwise due within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.[341] Ultimately, the panel sought to determine whether or not the replacement law created a subsidy. As noted, Article 1.1(a)(1)(ii) of the SCM Agreement states:

> For the purposes 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 where: . . . (ii) government revenue that is otherwise due or not collected and . . . (b) a benefit is thereby conferred.[342]

As in the original FSC dispute, the panel held that a defined normative benchmark had to be established from which a comparison could be made between the revenue actually raised and the revenue that would have otherwise been raised.[343] The panel pointed to its original decision in the FSC dispute in holding that, when determining whether the government has given up an entitlement to raise revenue that it could otherwise have raised, it cannot be an entitlement in the abstract, because governments, in theory, could tax all revenues.[344] Thus, the panel held that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and the revenues that would be due in

339. *Id.* at 18.
340. *Id.*
341. *Id.*
342. *Id.*
343. *Id.* at 18.
344. *Id.*

some other situation.[345] The panel further stated that the basis of the comparison must be the tax rules applied by the Member State in question.[346]

In the view of the European Union, there is no general U.S. taxation rule excluding extraterritorial income from taxation since the majority of extraterritorial income is subject to the normal rate of taxation.[347] The European Union argued that the replacement law does not qualitatively define a class or category of income that is excluded from the tax base, but rather lays down conditions for the non-taxation of a part of extraterritorial income—qualifying foreign trade income—that would otherwise be taxed.[348] The European Union argued, therefore, that the replacement law gives rise to a foregoing of revenue that is otherwise due and thus to a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.[349] The European Union asserted that the "prevailing domestic standard" in the United States is that "corporate income from a commercial activity" may be taxed, if it is earned by a U.S. corporation.[350] Thus, the European Union also argued that the benchmark for assessing the replacement law under Article 1.1(a)(1)(ii) should be the situation prevailing if the conditions[351] are not fulfilled.[352]

The United States responded that the replacement law is not a "financial contribution" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.[353] The United States argued that "the foregoing of revenue otherwise due means that a government has refrained from collecting income that in another circumstance would be legally owed to the government."[354] The United States asserted that the replacement law redefines the concept of gross income and that the revised definition of gross income is the "prevailing domestic standard" for U.S. taxation.[355] The United States contended that it lacked statutory authority to tax outside the definition of gross income.[356] In other words, there is no general rule of taxation that would apply "but for" the definition of gross income. The United

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345. *Id.* at 20.
346. *Id.*
347. *Id.*
348. *Id.*
349. *Id.*
350. *Id.*
351. The conditions referenced are notably the sale "not for use within the United States" and the "foreign content limitation." *Id.*
352. *Id.*
353. *Id.* at 19.
354. *Id.*
355. *Id.*
356. *Id.*

States further asserted the "exception" concerning extraterritorial income that is not qualifying foreign trade income is a revenue-raising exception; without it, all extraterritorial income would be excluded from gross income and revenues would be lower.[357] The United States argued that the exclusion of extraterritorial income from U.S. taxation represents a shift in U.S. taxing jurisdiction.[358] Thus, the normative benchmark for U.S. taxation of foreign income has shifted and the prevailing domestic standard is that extraterritorial income is not taxable because it is not included within the definition of gross income.[359]

The panel narrowed the main issue to whether the "exclusion" of extraterritorial income can properly be characterized as a situation in which no revenue is inherently due, or whether it is a situation in which revenue otherwise due is foregone.[360] The panel then turned to the U.S. replacement law.[361] The panel pointed out that certain income is "excluded" from taxation.[362] To qualify as "excluded" extraterritorial income, several stringently selective qualitative conditions and quantitative requirements must be satisfied.[363] The panel pointed out that where income does not qualify for the "exclusion" from gross income upon the fulfillment of the replacement law's stringently selective conditions, it is not shielded from taxation.[364] Income that does not meet the selective conditions is part of gross income and is subject to taxation under otherwise applicable U.S. taxation laws.[365]

As analyzed, the panel found it "clear to us that there is a 'prevailing' domestic standard and that the measure at issue functions, indeed, as an effective departure from it."[366] The panel illustrated its point with the following example: income earned by a U.S. corporate taxpayer in transactions not involving foreign trading gross receipts or qualifying foreign trade property would ordinarily be subject to taxation.[367] Thus, the panel held that the normative U.S. benchmark for taxation is that extraterritorial income is taxable despite the definition of gross income.[368]

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357. *Id.*
358. *Id.*
359. *Id.*
360. *Id.* at 23.
361. *Id.*
362. *Id.*
363. *Id.* at 22.
364. *Id.* at 23.
365. *Id.*
366. *Id.*
367. *Id.*
368. *Id.*

The panel stated that by treating as non-taxable certain income on the basis of highly selective qualitative conditions and quantitative requirements, the replacement law effectively carves income out from "another situation."[369] The "other situation" is the one that prevails where the replacement law's conditions for obtaining an "exclusion" are not fulfilled.[370] For example, where goods are for use within the United States or where they do not satisfy the foreign articles/labor limitation, the conditions are not fulfilled. These analyses led the panel to conclude that this constitutes foregoing of revenue otherwise due.[371]

The panel explicitly rejected the U.S. argument that it can exclude certain income from the definition of gross income and that, when it does so, the "excluded" income is, by definition, not otherwise due within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.[372] The panel responded to the U.S. argument by stating that the examination as to whether there is revenue foregone that is otherwise due must be based on actual substantive realities and not restricted to the pure formalistic arguments the United States asserted.[373] Looking to section 114(a) of the replacement law, the panel read that "gross income does not include extraterritorial income."[374] In section 114(b), the panel read that this "exclusion" does not apply to certain extraterritorial income.[375]

Looking to section 114(e), the panel saw that "extraterritorial income" is defined as ". . . the gross income of the taxpayer attributable to foreign trading gross receipts."[376] In addition, the replacement law defines "qualifying foreign trade income" as "the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer. . . ."[377] The panel found that it is not discernable from the replacement law's wording whether extraterritorial income is actually "excluded" from gross income or is rather gross income that may become "excluded" upon fulfillment of certain conditions.[378]

Furthermore, the panel pointed out the risky systemic implications inherent in the approach the United States advocated.[379] Particularly revealing in this regard was the U.S. response to the

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369. *Id.*
370. *Id.*
371. *Id.*
372. *Id.* at 25-26.
373. *Id.* at 26.
374. *Id.*
375. *Id.*
376. *Id.*
377. *Id.*
378. *Id.*
379. *Id.*

panel when asked whether the United States believed that there would be revenue foregone that was otherwise due within the meaning of Article 1.1 of the SCM Agreement if the U.S. legislation provided that "gross income does not include income generated from export activities."[380] The United States was of the view that ". . . the ordinary meaning of the terms of Article 1.1(a)(1)(ii) suggests that in such a situation there would not be a financial contribution . . . , as the tax revenue on export activities would not be otherwise due under the law of the Member, which is the normative benchmark for Article 1 analysis."[381]

The panel reasoned that, taken to its logical extreme, the U.S. argument would be that a government could opt to bestow financial contributions in the form of fiscal incentives simply by modulating the "outer boundary" of its "tax jurisdiction" or by manipulating the definition of the tax base to accommodate any "exclusion" or "exemption" or "exception" it desired; there could never be a foregoing of revenue otherwise due.[382] In short, such an approach would eviscerate the subsidy provisions in the SCM Agreement.[383] The panel concluded that the "exclusion" from U.S. taxation of certain income on the basis of the replacement law's highly selective qualitative conditions and quantitative requirements results in the foregoing of revenue which is otherwise due.[384] Therefore, the replacement law gives rise to a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.[385]

b. Is a Benefit Conferred by the Subsidy?

Having found that the tax "exclusion" under the replacement law gives rise to a financial contribution, the panel next examined whether a benefit is thereby conferred within the meaning of Article 1.1(b).[386] Under the replacement law, a taxpayer involved in a qualifying transaction may exclude qualifying foreign trade income from its gross income and thereby reduce its U.S. tax liability;[387] it is therefore "better off" than it would have been absent the contribution, and a benefit has been conferred.[388] In sum, there exists a financial

380. *Id.*
381. *Id.*
382. *Id.*
383. *Id.*
384. *Id.*
385. *Id.* at 27.
386. *Id.* at 28.
387. *Id.*
388. *Id.*

contribution conferring a benefit, thus a subsidy exists within the meaning of Article 1.1 of the SCM Agreement.[389]

c. Is the Subsidy Export-Contingent?

The panel considered whether the subsidy is contingent upon exporting within the meaning of Article 3.1(a) of the SCM Agreement.[390] The heart of the disagreement between the parties was the U.S. contention that the exclusion of extraterritorial income is not export-contingent, because such income could be earned in many ways besides exporting U.S. goods.[391] The European Union asserted instead that the subsidy is export-contingent with respect to U.S.-produced goods because it is conditioned upon exportation.[392] The panel stated the issue as "whether the export of U.S. goods is a 'condition' for satisfying the requirement of 'use outside the United States' and therefore, for receiving a subsidy."[393]

For a subsidy to be de jure[394] export-contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfillment of the condition of export performance.[395] Such conditionality can also be derived by necessary implication.[396] The phrase "foreign trading gross receipts" does not include receipts of the taxpayer from a transaction if the qualifying foreign trade property is for ultimate use in the United States.[397] Instead, the replacement law limits situations of non-taxation to property that is for ultimate use outside the United States.[398] The panel decided that, based on this fact, the subsidy is only available to transactions relating to export property.[399] The panel held that the words of the replacement law make "clear that the subsidy is not available in relation to goods produced within the United States and sold for use within the United States."[400]

The fact that the definition of the term "qualifying foreign trade property" refers to property manufactured, produced, grown, or extracted within or outside the United States was, according to the

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389. *Id.*
390. *Id.*
391. *Id.* at 29.
392. *Id.*
393. *Id.*
394. *Id.* at 30.
395. *Id.*
396. *Id.*
397. *Id.*
398. *Id.*
399. *Id.*
400. *Id.* at 31.

United States;" the most significant aspect of the definition.[401] According to the United States, this reference shows that the replacement law applies equally to all foreign transactions irrespective of whether goods are produced in the United States or abroad and thus non-taxation is not export-contingent.[402] The European Union argued that it is not necessary to show that all subsidies under the replacement law were export-contingent.[403]

The panel did not agree with the U.S. argument.[404] The panel held that the statute's words themselves make it clear that exporting is a necessary precondition to qualify for the subsidy.[405] With respect to U.S.-produced goods, the existence and amount of the subsidy depends upon of the amount of income arising from the exportation of such goods.[406] In relation to U.S.-produced goods, the existence of such income is clearly conditioned upon the exportation of such goods from the United States.[407] Additionally, the panel addressed the argument of the United States that U.S. manufacturers may earn extraterritorial income without exporting, as they have the option to produce and sell outside the United States in a wholly non-U.S. transaction.[408] The panel held that the opportunity to engage in wholly non-U.S. transactions does not alter the fundamental reality that, for U.S.-produced goods, export is a necessary precondition for benefiting from the subsidy under the replacement law due to the requirement of "use outside the United States."[409] The panel agreed with the EU argument that it is not necessary that the replacement law involve exclusively subsidies that are export-contingent in order to make a finding that the replacement law provides prohibited export subsidies.[410] In reaching this conclusion, the panel found support for its view that export-contingent subsidies may exist in the context of a broader subsidy scheme in the reasoning of the Appellate Body in *Canada-Aircraft*, where the Appellate Body stated:

> The fact that some of TPC's contributions, in some industry sectors, are not contingent upon export performance does not necessarily mean that the same is true of all of TPC's contributions. It is enough to show that one or some of TPC's contributions do constitute subsidies contingent upon export performance.[411]

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401. *Id.* at 30.
402. *Id.*
403. *Id.* at 31.
404. *Id.*
405. *Id.*
406. *Id.*
407. *Id.*
408. *Id.*
409. *Id.*
410. *Id.* at 32.
411. *Id.*

As long as there is a differentiation between the treatment of those domestically-produced goods depending on whether they are exported or sold domestically, there exists a subsidy that is contingent on export.[412]

d. Does the Export-Contingent Subsidy Fall Within the Exception of Footnote 59?

The United States argued that even if the replacement law's exclusions are an export-contingent subsidy, it is not prohibited because the fifth sentence of footnote 59, when read in conjunction with footnote 5, provides that measures to avoid double-taxation of foreign-source income are not prohibited by the SCM Agreement.[413] The fifth sentence of footnote 59 provides that "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."[414] Footnote 5 provides that, "measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement."[415]

In order for the United States to have prevailed on the basis of footnotes 59 and 5 of the SCM Agreement, the panel had to find that the replacement law was a measure to avoid the double taxation of foreign-source income and that the fifth sentence of footnote 59 falls within the scope of footnote 5 of the SCM Agreement.[416] For a measure to fall within the scope of the fifth sentence of footnote 59, it must satisfy each of three elements: (i) to avoid, (ii) the double taxation, (iii) of foreign-source income earned by the enterprises of the Member concerned.[417]

First, the panel turned to the term "to avoid" in footnote 59,[418] and held incidental prevention of double taxation would not, in and of itself, be sufficient to bring the measure within the scope of footnote 59.[419] In examining the overall structure, design, and operation of the replacement law, the panel felt that the parameters of the law do not roughly approximate the parameters of a measure to avoid the double taxation of income.[420]

412. *Id.* at 34.
413. *Id.* at 35.
414. *Id.*
415. *Id.*
416. *Id.* at 35-36.
417. *Id.* at 38.
418. *Id.* at 39.
419. *Id.*
420. *Id.*

The panel noted that the replacement law is unusually broad for a measure whose purpose is to avoid double taxation.[421] At the same time, the extraterritorial income excluded from taxation does not include a range of income that is potentially subject to taxation in other jurisdictions.[422] Thus, the replacement law is unusually narrow for a measure whose asserted purpose is to avoid double taxation.[423] Additionally, the panel noted that the replacement law overlaps with an extensive system of bilateral agreements to avoid double taxation through foreign tax credits, and its application is not designed to cover gaps in these agreements.[424] Taken together, these facts led the panel to conclude that the replacement law is not a measure taken to avoid the double taxation of foreign-source income within the meaning of footnote 59's exception.[425]

2. The Agreement on Agriculture

The European Union contended that the replacement law gives rise to export subsidies within the meaning of the AA, and that the subsidies it provides are contrary to Articles 10.1 and 8 of the Agreement.[426] The panel defined the issue as whether, for purposes of the anti-circumvention provisions of Article 10.1 of the AA, the subsidies to which the replacement law gives rise constitute subsidies contingent on export performance, other than those listed in Article 9.1 of the Agreement, as defined in Article 1(e) of the AA.[427] The panel stated that its reasoning and conclusions with respect to Article 1.1 and 3.1 of the SCM Agreement were also applicable as regarding whether the replacement law gives rise to subsidies contingent on export performance within the meaning of Article 1(e) of the AA for the purposes of Article 10.1 of the AA.[428] Thus, the replacement law does give rise to export-contingent subsidies under the AA.

The next issue the panel addressed was whether the export subsidies are "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments" within the meaning of Article 10.1 of the AA.[429] The panel pointed out that the replacement law creates a legal entitlement for recipients to receive export subsidies not listed in Article 9.1, with

421. *Id.* at 40.
422. *Id.*
423. *Id.*
424. *Id.*
425. *Id.*
426. *Id.* at 43.
427. *Id.* at 44.
428. *Id.*
429. *Id.*

respect to both scheduled[430] and unscheduled agricultural products.[431] Moreover, it was noted that the replacement law does not set forth any limitation on the amount of extraterritorial income, and thus on the amount of qualifying foreign trade income, that may be claimed with respect to eligible transactions, or the amount of export subsidies unqualified.[432] Thus, with respect to unscheduled agricultural products, the panel held that the replacement law involves the application of export subsidies not listed in Article 9.1, in a manner that, at the very least, "threatens to lead to circumventions [of the] export subsidy commitment" in Article 3.3.[433]

As for scheduled agricultural products, the replacement law allows for the provision of an unlimited amount of subsidies and, therefore, scheduled agricultural products benefit from those subsidies even after the reduction in commitment levels specified by the U.S. schedule for those products are reached.[434] Therefore, the panel concluded that the United States acted inconsistently with its obligations under Article 10.1 of the AA by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its export subsidy commitments under Article 3.3 of the AA.[435] Furthermore, the panel held that by acting inconsistently with Article 10.1 of the AA, the United States necessarily acted in a manner inconsistent with its obligation under Article 8 of the AA "not to provide export subsidies otherwise than in conformity with this Agreement . . . ."[436]

3. Article III:4 of the GATT 1994

The European Union contended that the foreign articles/labor limitations[437] are inconsistent with Article III:4 of the GATT 1994.[438]

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430. *Id.*; *see also supra* note 228 and accompanying text.

431. Second Report of the Panel, *supra* note 14, at 44; *see also supra* note 226 and accompanying text.

432. Second Report of the Panel, *supra* note 14, at 44.

433. *Id.* at 45.

434. *Id.*

435. *Id.*

436. *Id.*

437. *Id.* Under the replacement law, "qualifying foreign trade property" is property made within or outside the United States, and sold for ultimate use outside the United States, no more than fifty 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 labour . . . performed outside the United States." *Id.*

438. *Id.* Article III:4 of the GATT 1994 proves in relevant part:

The European Union argued that such limitations are a requirement contained in the law that provides less favorable treatment to imported parts and materials than to similar domestic goods with respect to their internal use in the production of goods within the United States.[439] Conversely, the United States argued that the replacement law does not require the use of domestic rather than imported goods.[440] The United States argued that goods could meet the foreign articles/labor limitation even if one hundred percent of the fair market value of their input is foreign.[441]

The issues the panel addressed were: (a) whether the imported and domestic products at issue are "like products," (b) whether the measure at issue is a "law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution, or use," and (c) whether the imported products are accorded less favorable treatment than that accorded to like domestic products."[442]

The panel stated that the mere fact that a good had an origin in the United States does not render it "unlike" an imported good.[443] Thus, the panel held the "like product" element of Article III:4 was satisfied. The panel held that the foreign articles/labor limitation is a "law or requirement," as it is a U.S. statute.[444] On the basis of the text and context of Article III:4 and in light of the object and purpose of the GATT and the WTO Agreement, the panel held that Article III:4 of the GATT 1994 applies to measures conditioning access to income tax advantages with respect to certain products.[445]

Next, the European Union argued that it is sufficient that the limitation "affects" the competitive position of the imported product on the market.[446] The European Union stated that the replacement law provides an incentive to source inputs domestically because this enhances the chances that a U.S. producer would qualify for the tax benefit. This is sufficient to violate Article III:4, which guarantees equality of competitive opportunities.[447] On the contrary, the United

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> The products of the territory of any Member imported into the territory of any other Member shall be accorded treatment no less favorourable than that accorded to like products of national origin in respect of all laws, regulations, and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

Id. at 46.

439. *Id.*
440. *Id.*
441. *Id.*
442. *Id.*
443. *Id.* at 47.
444. *Id.*
445. *Id.* at 49.
446. *Id.* at 48.
447. *Id.*

States argued that the replacement law does not affect competitive conditions between imported and like domestic products as it does not require the use of any U.S.-origin goods for a transaction to earn excluded extraterritorial income.[448] Goods can meet this requirement even if one hundred percent of the fair market value of their inputs is foreign.[449]

The panel pointed out that by reason of the foreign articles/labor limitation of the replacement law, the use of U.S.-origin products contributes to obtaining the exclusion while the use of imported products does not.[450] Thus, the panel considered that the foreign articles/labor limitation is a measure that affects the internal use of imported products, even if ways other than the use of goods exist to impute permissible fair market value.[451]

Lastly, the panel addressed whether the replacement law accords imported products less favorable treatment than that accorded to like domestic products by reason of the foreign articles/labor limitation.[452] The panel again pointed to the fact that the foreign articles/labor limitation acts as an incentive to source inputs domestically because this enhances the chances of qualifying for the tax benefit.[453] The panel pointed out that the replacement law contains a statutory requirement that is expressly and explicitly origin-based.[454]

Furthermore, the panel pointed out that the foreign articles/labor limitation explicitly places a limit on the proportion of the fair market value of a product that can be derived from imported products and foreign labor only; it places no similar constraint on the proportion of the fair market value of a product that can be derived from domestic products and labor.[455] In other words, use of imported products by a manufacturer in the United States cannot contribute to the fulfillment of the foreign articles/labor limitation, whereas, the use of a domestic product can.[456] Thus, the panel found an advantage conferred upon the use of domestic products that is not conferred upon the use of imported products.[457] As far as goods are concerned, the foreign articles/labor limitation creates an incentive to use

448. *Id.*
449. *Id.*
450. *Id.* at 51.
451. *Id.*
452. *Id.* at 52.
453. *Id.* at 51.
454. *Id.* at 52.
455. *Id.*
456. *Id.*
457. *Id.*

domestic rather than imported goods; therefore, domestic products are treated more favorably than other products.[458]

4. Transitional Issues

The European Union argued that by maintaining the availability of FSC subsidies for transactions affected by existing FSCs between September 30, 2000 and December 31, 2001, the United States failed to withdraw the FSC subsidies as required by Article 4.7 of the SCM Agreement and the recommendations and rulings of the DSB, and failed to comply with its obligations under Article 21 DSU.[459] The United States did not dispute that prohibited FSC subsidies continued to be available after the time-period set for compliance in this dispute.[460] However, the United States pointed out that the WTO panels have, in the past, excused procedural violations in the absence of prejudice to the complaining party, essentially taking into account equitable considerations.[461]

The panel noted that according to the U.S. transition plan, the FSC subsidies continue in operation for one year if an FSC in existence before September 30, 2000 has not entered into any long-term, binding contracts with unrelated third parties before September 30, 2000. Additionally, with respect to FSCs that have entered into long-term, binding contracts with unrelated parties before September 30, 2000, the replacement law does not alter the tax treatment for an indefinite period of time.[462] Based on the above transition provisions, the panel sided with the European Union. The panel held that the United States had not fully withdrawn the prohibited FSC subsidies and therefore failed to implement the recommendations and rulings of the DSB and Appellate Body.[463] Furthermore, the panel chose not to excuse the procedural violations.[464]

5. Summary of the Decision of the Dispute Settlement Panel

The panel held that the replacement law violates Article 3.1(a) and 3.2 of the SCM Agreement, Article 10.1 and Article 8 of the AA, and Article III:4 of the GATT 1994.[465] Additionally, the United

458. *Id.*
459. *Id.* at 55.
460. *Id.*
461. *Id.*
462. *Id.*
463. *Id.*
464. *Id.*
465. *Id.* at 56.

States failed to implement the recommendations and rulings of original FSC dispute. Thus, the panel recommended that the replacement law be nullified according to Article 3.8 of the DSU.[466]

VIII. THE RESPONSE OF THE UNITED STATES TO THE FINDINGS OF THE WORLD TRADE ORGANIZATION

On October 15, 2001, the United States reacted to the WTO holding by filing an official notice of appeal.[467] In the notice, the United States seeks review of the panel's findings that the replacement law involves export subsidies prohibited by Article 3.1(a)[468] of the SCM Agreement, and the corollary finding that the United States has acted inconsistently with its obligation under Article 3.2[469] of the SCM Agreement.[470] The United States also seeks review by the Appellate Body of the panel's findings and related legal interpretations that the replacement law is inconsistent with obligations under Article 8[471] and 10.1[472] of the AA and Article III:4[473] of the GATT 1994.[474] Lastly, the United States seeks review by the Appellate Body of the finding that the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a)[475] of the SCM Agreement and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7[476] of the SCM Agreement.[477] The Appellate Body is expected to make a decision in mid-January of 2002.[478]

Many U.S. officials support the appeal; however, motives vary.[479] Some believe that the WTO's opinion was "in error" and that the

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466. *Id.*

467. Notification of an Appeal, United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/21 (Oct. 15, 2001), *available at* 2001 WL 1244494 [hereinafter Notification of an Appeal]. The notice of the decision to appeal was filed pursuant to Article 16 of the DSU and Rule 20 of the Working Procedures for Appellate Review. *Id.*

468. *Id.*; *see supra* note 465 and accompanying text.

469. Notification of an Appeal, *supra* note 467; *see supra* note 465 and accompanying text.

470. Notification of an Appeal, *supra* note 467.

471. *Id.*; *see supra* note 465 and accompanying text.

472. *See supra* note 465 and accompanying text.

473. *Id.*

474. *Id.*

475. *Id.*

476. *Id. See generally* Second Report of the Panel, *supra* note 14.

477. Notification of an Appeal, *supra* note 467.

478. *Trade Representative to Appeal WTO Ruling Against U.S. Tax Policy*, WALL ST. J., Oct. 11, 2001, at B2.

479. *See infra* notes 480-81 and accompanying text.

United States will prevail on appeal.[480] Others do not necessarily believe the United States has a chance of winning the appeal, but support the appeal in order to allow the United States more time to determine the most appropriate resolution.[481]

Regardless of the reasoning behind the appeal, it seems unlikely that the United States will prevail. Thus far the United States has made very formalistic arguments in defending its tax regime.[482] Based on the three decisions issued by the WTO panels, it seems that the WTO is interested in substance rather than form.[483]

Under a substance analysis, it will be difficult for the United States to prevail because the replacement law functions almost exactly like the FSC tax regime. The only significant difference is in form, not in effect. The FSC tax regime started with the premise that extraterritorial income was generally taxable unless it fell under the FSC exclusion, in which case the income was not subject to U.S. taxation.[484] By contrast, the replacement law starts with the premise that extraterritorial income is not taxable unless it falls within an exception in which case it is subject to U.S. taxation.[485] Therefore, in both situations, the U.S. government is excluding income from taxation only if it meets certain requirements, which are almost identical under both the FSC and replacement tax systems. Based on the lack of actual substantive changes in the U.S. FSC tax structure, it seems unlikely that the United States would prevail on appeal.

Despite the European Union's failure to eliminate sanctions as an option if the United States loses on appeal, U.S. and EU officials have repeatedly stated that they are looking at other options for

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480. *Extraterritorial Income: U.S. To Appeal WTO Ruling Against Extraterritorial Income Exclusion Act*, DAILY TAX REP., Oct. 11, 2001, at G-7. U.S. Trade Representative Robert Zoellick said, "[w]e have decided to appeal because we believe the decision was in error." *Id.* Letters written by eleven House Democrats, led by Representatives Charles Rangel (NY) and Sander M. Levin (MI), said that the WTO decision was "deeply flawed." *See infra* note 481 and accompanying text.

481. *Extraterritorial Income: House Democrats Call on Administration to Appeal WTO Ruling on FSC Replacement*, DAILY TAX REP., Sept. 14, 2001, at G-5. Some Members of the House of Representatives sent U.S. Trade Representative Robert Zoellick a letter stating that a decision not to appeal the WTO's "errors" would also sacrifice negotiating leverage with the European Union to secure the "key objective" of ensuring that differences in U.S. and foreign tax regimes do not disadvantage U.S. workers, farmers, and businesses in international competition. *Id.* The letter stated, "If the United States were to permit the panel report, with none of its errors corrected, to be adopted, we would be negotiating from a position of weakness." *Id.*

482. *See generally* Report of the Panel, *supra* note 4; Report of the Appellate Body, *supra* note 9; Second Report of the Panel, *supra* note 14.

483. *Id.*

484. *See supra* notes 111-15 and accompanying text.

485. *See supra* note 292 and accompanying text.

resolving the dispute.[486] The Bush administration stated, "We need to manage this dispute so it doesn't spill over into other issues. The worst thing that could happen would be to have some kind of confrontation over this. Neither side wants this to happen."[487] The feeling that the tax dispute must be solved by compromise has intensified since the September 11, 2001 terrorist attacks. Even industries that would be affected by a change in the U.S. tax structure agree that the United States and European Union should cooperate with each other to reach a solution to the dispute.[488] As Joel Johnson, vice president international at the Aerospace Industries Association, said, "It is difficult to threaten a trade war with each other when it looks like you are going to be fighting a real war together."[489]

However, if no agreement can be reached, the United States loses on appeal, and the European Union decides to impose sanctions, it is unclear exactly which products might be affected by those sanctions.[490] Considering the United States placed one hundred percent duties on a number of EU products during the banana dispute,[491] anything is fair game.[492]

Assuming the United States loses on appeal, the United States could respond in several different ways. One option is for the United States to ignore the WTO ruling and risk retaliation. It does not seem that this would be the best strategic decision for the United States, however, because of its current political need to maintain strong international relationships. It is also very likely that the European Union would respond by initiating a trade war. The United States has made clear it does not want to risk retaliation in the form of a major trade war with the European Union because that would have significant harmful effects on the world economy.[493]

A second alternative is for the United States to pay the sanctions, if imposed by the European Union. However, it is unlikely

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486. *ETI: US, EU will Need to 'Manage' Tax Dispute or Risk Harm to Overall Ties*, DAILY TAX REP., Oct. 12, 2001, at G-3 [hereinafter ETI: US, EU].

487. *Id.*

488. Vago Muradian, *Export Control, Trade Issues Slide to Back Burner In Wake of Attacks*, DEFENSE DAILY INT'L, Sept. 21, 2001, *available at* 2001 WL 7476068.

489. *Id.*

490. In late 2000, the European Union unveiled a general list of U.S. imports into Europe that could be targeted for sanctions. *Experts Advise What to Do Now That WTO Has Shot Down FSC Replacement Law*, MANAGING EXPORTS, Sept. 1, 2001, *available at* 2001 WL 17700319. The list includes items such as steel, meat products, cereals, textiles, and aircraft. *Id.* The list excludes some items such as chemicals, pharmaceuticals, fertilizers, plastics, rubber articles, and beverages. *Id.*

491. *European Union Mulls Trade Sanctions vs. US*, WORLD TRADE, Sept. 1, 2001, *available at* 2001 WL 6716735.

492. *Id.*

493. ETI: US, EU, *supra* note 486.

the United States would make this choice. U.S. Special Trade Representative Robert Zoellick has compared EU sanctions of the magnitude proposed to "dropping a nuclear bomb" on the global trading system.[494] The effects of paying the sanctions would require the United States to overhaul its current tax system. Although a major overhaul in the tax system is a possible, it is unlikely that the United States would put itself in a position where it had such limited choices. Moreover, in light of the fact that both sides hope to reach a compromise solution, it is improbable that the dispute will escalate to this level.

A third option is to remove the tax breaks, effectively increasing taxes on American companies.[495] Although many U.S. companies would be hit hard[496] if such a tax scheme were adopted, this idea has gained some supporters who claim the FSC tax scheme is "a pure gift for corporations that would be exporting anyway."[497] Despite limited support for imposing generally applicable tax laws on exporters and non-exporters, it would be surprising if this option were adopted since U.S. exporters include large corporations[498] with extremely powerful lobbying groups. Clearly, the main concern that arises when considering generally applicable tax laws is how such laws would affect U.S. exporting and thus the U.S. economy. Between 1992 and 1997, export activity led to one-third of the economic growth in the United States.[499] If the tax reductions offered to U.S. exporters are significantly reduced, this could lead to a significant economic contraction.[500] With the U.S. economy already ailing, an economic contraction of this proportion could cause considerable damage.

A fourth option is for the United States to adopt a territorial tax structure similar to the tax structure in EU countries. Representative Bill Thomas (R-Cal.), chairman of the House Ways and Means Committee, favors a territorial system under which only domestic earnings would be subject to U.S. tax.[501] Thomas and other

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494. William Drozdiak, *EU May Hit U.S. with $4 Billion In Penalties; Commission Calls Tax Credits Illegal*, WASH. POST, Aug. 21, 2001, at E1.

495. *A Gas tax hike?/With notions like Matsunaka's, Democrats could use a new playbook*, GAZETTE, (Metro), at 6, Aug. 29, 2001, *available at* 2001 WL 27136664 [hereinafter A Gas tax hike].

496. For example, Boeing, which sells roughly seventy percent of the commercial jets it produced overseas and is the nation's leading exporter, saved $291 million in 2000 and more than $730 million over the past four years as a result of the tax breaks. Blumenthal, *supra* note 76, at D1.

497. *Id.* (quoting Representative Pete Stark (D-CA), a Member of the Ways and Means Committee).

498. *See supra* notes 76-79 and accompanying text.

499. Ernest R. Larkins, *WTO Appellate Body Rules Against FSCs: The Search for Alternatives Begins*, 11 J. INT'L TAX'N 14, 18 (2000).

500. *Id.*

501. Drozdiak, *supra* note 494, at E1.

advocates contend that adopting a territorial system would benefit American companies while bringing the United States into compliance with WTO rules.[502]

At first glance, adopting a territorial system may seem like the ideal solution to U.S. problems, since it would necessarily end EU complaints regarding U.S. tax laws. However, several issues arise when considering whether the United States should adopt a territorial tax structure. First, adopting such a system would discourage U.S. exporting because, if products were produced in the United States, they would be subject to U.S. taxation. On the other hand, if products were produced outside the United States, in a low tax jurisdiction, through international subsidiaries, the producer could avoid paying U.S. taxes. Under these circumstances, a producer would most likely choose to produce outside the United States, decreasing the level of U.S. exports. Furthermore, once international subsidiaries are established as an alternative to producing products in the United States, employment in the United States will be significantly affected.

The second issue that arises in considering a conversion to a territorial tax system is the amount of revenues that the U.S. government would lose. Converting to a territorial tax structure would reduce the number of taxable entities, thereby reducing U.S. tax revenue collections. Considering the U.S. government relies heavily on federal taxes to operate,[503] converting to a territorial tax system does not seem consistent with the goal of the United States of maximizing its possible tax revenue collection.[504]

A third problem arises when the United States considers converting to a territorial tax structure. The WTO purports not to endorse any particular tax structure. Abandoning the worldwide tax scheme in favor of a territorial scheme would give the appearance of the WTO favoring one system over the other.[505] Moreover, if the WTO is able to place such pressure on the United States, it suggests serious limitations on the ability of the United States to shape the international environment.[506] Thus, adoption of a tax structure that in essence duplicates those in EU countries not only thwarts the U.S. goal of being a world leader and trendsetter, but also frustrates the WTO's goal of not endorsing any particular tax structure.

A fifth alternative is for the United States to maintain the worldwide tax system as the basis for its tax structure and provide subsidies to U.S. manufacturers, including exporters, that are not

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502. *Id.*
503. *See supra* note 104 and accompanying text.
504. *Id.*
505. *See supra* note 222 and accompanying text.
506. Stephan, *supra* note 104, at 65.

export-contingent. The idea would be to reform the tax code to reduce taxes on earnings from all exports.[507] The panel, in its August 20, 2001 decision held that one way to cure the export-contingency would be to eliminate the conditionality on exporting by making the subsidy available irrespective of whether a product of national origin is sold in the domestic market or abroad.[508] The panel stated that it was the differential treatment provided for in the replacement law that renders the replacement law contingent upon exporting. If the contingency were eliminated, the subsidy alone would not violate U.S. trade obligations. However, this alternative is not without problems. It would reduce U.S. tax revenue. Such an outcome does not comport with the U.S. goal of maximizing its possible tax revenue collection.[509]

A sixth choice would be for the United States to challenge the EU tax scheme.[510] For example, it has long been asserted that Airbus receives illegal subsidies from European governments.[511] The proposal of a U.S. WTO suit against Europe over Airbus resurfaced last summer after the European airplane producer said it would launch a program that would be funded in part by government loans.[512] Although, it is impossible to predict whether a claim challenging the European tax code would be successful, bringing such a claim against the European Union may prove beneficial by encouraging the sides to reach a compromise solution. On the other hand, filing a counter-claim may increase tensions between the two sides and weaken the relationship between the United States and European Union.

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507. A Gas tax hike, *supra* note 495.

508. Second Report of the Panel, *supra* note 14.

509. *See generally supra* notes 503-04 and accompanying text.

510. Vago Muradian, *Boeing Plans Key Air Transport Meeting, Step to U.S. WTO Suit Against Airbus*, DEFENSE DAILY INT'L, Sept. 28, 2001, *available at* 2001 WL 7476122.

511. *Id.* For decades, Boeing has considered asking the U.S. government to file suit against Airbus, claiming the European company enjoys what amount to governmental subsidies to steadily grow its business. *Id.* U.S. officials have never filed a suit against Airbus because senior Boeing executives have consistently balked at the last minute under pressure from European air carriers that have asked the U.S. giant to reconsider launching a messy trade dispute. *Id.*

512. *Id.* Airbus accepted four billion dollars in loans below market rates from Britain, France, Germany, and Spain to develop the A380 super jumbo jet under a twelve billion dollar program. *Id.*

IX. CONCLUSION

The outcome of the U.S.-EU tax dispute will have a significant impact on transatlantic trade and particularly on the productivity of U.S. exporters. Clearly, there is no simple solution to the dispute and no solution will be ideal for the United States.

The ultimate U.S. goal is to promote its own economic interests while at the same time fulfilling its WTO obligations.[513] As an effort to fulfill this crucial goal, the Bush administration has been urged to settle with the European Union in order to dilute the potential for a trade war and void enormous pending sanctions.[514] Because the United States seems to be in the weaker position under relevant international treaties regarding the validity of the replacement law, it would be wise for the United States to work diligently to reach a compromise. Likewise, the European Union has incentives to compromise because imposing sanctions would not only harm the U.S. economy but also the global economy, including that of the European Union. Given that forty-five percent of world trade is between Europe and the United States,[515] the stakes are too high for the sides not to find a compromise solution.

Beyond the need to protect the global economy, the September 11, 2001 terrorist attacks have given the United States and the European Union additional incentives to reach a compromise solution to the current tax dispute. Fighting trade war disputes may prove more difficult in the wake of a decision by NATO that the terror attacks against the United States constitute an assault on the entire nineteen-member alliance.[516] This unprecedented NATO decision will likely require dramatic increases in military and intelligence cooperation among NATO allies.[517] It is crucial that NATO countries not enter hostile relations with one another in light of this new war.

Considering the need to protect a fragile global economy and to maintain strong international relationships, it seems appropriate for the United States to modify the replacement law and for the European Union to be flexible. In making revisions to the replacement law, it is also important that the United States not

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513. Farran Nehme, *EU Eases Stance On Trade Sanctions After WTO Victory*, WALL ST. J., Aug. 12, 2001, at A12 (statement by U.S. Trade Representative Robert Zoellick).

514. Edward Lotterman, *Foreign Sales Break Isn't Worth a Fight*, KNIGHT-RIDDER TRIB. BUS. NEWS, Aug. 23, 2001, *available at* 2001 WL 26627346.

515. U.S. Trade Policy Suffers, *supra* note 77, at A1.

516. Muradian, *supra* note 510.

517. *See id.*

completely eradicate the level playing field U.S. businesses currently enjoy in the international market. Thus, it seems that the United States and European Union should continue their efforts to reach a compromise solution. If it looks unlikely that a compromise will be reached, it seems the United States should at least threaten, if not actually file, a counter-complaint challenging the EU tax structure. The primary purpose would be to put greater pressure on the European Union to reach a compromise and to give the United States the greater negotiating power needed to achieve a solution that meets its objectives. Additionally, it seems revisions resembling those suggested by the WTO—eliminating the conditionality on exporting by making the subsidy available irrespective of whether a product of national origin is sold in the domestic market or abroad—should be the basis of the compromise.

*Candace Carmichael**

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