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Avoiding a Nuclear Trade War: Strategies for Retaining Tax Incentives for U.S. Corporations in a Post-FSC World

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ABSTRACT

On January 14, 2002, the World Trade Organization (WTO) Appellate Body affirmed that the FSC Repeal and Extraterritorial Income (ETI) Exclusion Act, a replacement for the Foreign Sales Corporation (FSC) Act, was an unlawful export subsidy under WTO agreements. Though the European Union has indicated a willingness to wait before imposing the largest trade sanctions in the history of the WTO, it insists that the United States comply with the ruling. This Note explores the history of the conflict and consider possibilities for the future of international trade taxation.

This Note first examines the background to the conflict, beginning with the General Agreement on Tariffs and Trade conflict over domestic international sales corporations (DISCs). After years of haggling, the United States replaced DISCs with FSCs in 1986. Following many years without dispute over the issue of how the United States would tax its imports, the European Union challenged the FSC system in 1997 and prevailed before the WTO Panel.

This Note then examines the two most recent decisions regarding the FSC-ETI laws. The WTO Panel and Appellate Body have both concluded that the laws are impermissible because they constitute a foregoing of revenue otherwise due to the government that was based on export performance. Both bodies also rejected the defense that the laws are permissible because they help companies avoid double taxation.

The length of the dispute and the high financial stakes have made this battle particularly bitter. Further, the impact on trade and the U.S. economy would be enormous, which has furthered the tensions between the parties. The European Union has said it may forego the sanctions altogether if the United States complies with the WTO ruling. The United States should not test the European Union by refusing to comply. Still, the United States justifiably has serious concerns about bending to the will of the WTO and changing its preference on taxation *systems based on a Geneva edict. In light of these concerns, this Note concludes by exploring potential solutions for the problem and recommending one course for changing U.S. law. This option will maintain competitiveness and national sovereignty, and still meet international obligations. This Note advocates adopting an excise tax system on exported products to maintain the tax system that the United States has chosen while complying with the WTO mandate.*

TABLE OF CONTENTS

I. INTRODUCTION

On August 20, 2001, the World Trade Organization (WTO) decided a two-year battle between the European Union and the United States by declaring that the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (hereinafter EIEA or Replacement Law), a U.S. law allowing U.S. companies to receive a tax break through foreign sales corporations (FSCs), was an impermissible subsidy on exports.[1] Consequently, the WTO has authorized the European Union to impose four billion dollars in trade sanctions on the United States in response.[2] The United States claimed that the sanctions, if imposed, should be worth about $956 million[3] but no more than $1.1 billion. The United States contended that the figure endorsed by the European Union was "somewhat high."[4] The European Union countered that the amount it requested was "rather conservative."[5] On August 30, 2002, the WTO accepted the EU's proposed amount and authorized four billion dollars in sanctions.[6] These sanctions would not be exercised to force corporations that received the benefit to make payments to the European Union; rather, the sanctions would serve as reprisals against any U.S.

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1. World Trade Organization, Report of the Panel, United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/RW (Aug. 20, 2001), *available at* 2001 WL 967462 [hereinafter Tax Treatment I] (ruling on the permissibility of FSC Repeal and Extraterritorial Income Exclusion Law of 2000, Pub. L. No. 106-519, 114 Stat. 2423 [hereinafter Replacement Law]). As with most WTO decisions, finality was fleeting as the United States appealed the decision on October 10, 2001. *Washington Appeals Against WTO FSC Ruling*, EUR. REP., Oct. 13, 2001, *available at* 2001 WL 26061974. Although the Replacement Law refers to export subsidies as Extraterritorial Income (ETI), they are popularly known as Foreign Sales Corporations (FSCs). *Trade Scene: Trade Policy Alphabet Soup Stew*, J. OF COM.—JOC ONLINE, Apr. 5, 2002, LEXIS, News Library, Jcm File.

2. *America's Taxing Trade Troubles*, ECONOMIST GLOBAL AGENDA, Aug. 21, 2001, LEXIS, News Library, Econ File. *See also Washington Appeals Against WTO FSC Ruling*, *supra* note 1. The United States challenged the amount of the sanctions, claiming that the European Union calculated the figure based on domestic tax rates, whereas the WTO ruled that the figure should be calculated based on the rate of tax on foreign source income. *US Says 'No Real Significance' to EU Claim Tax Row Valued at 4 Bln USD*, AFX-ASIA, Feb. 11, 2002, LEXIS, News Library, Afxasi File. The WTO Ruling Panel consists of Crawford Falconer of the Organization for Economic Cooperation and Development (a former New Zealand trade diplomat); Didier Chambovey, a Swiss trade diplomat; and Seung Wha Chang of Seoul National University, South Korea. *See* Warren Giles, *Germany's Mueller Opposes EU Rush to Trade Sanctions on U.S.*, BLOOMBERG NEWS, Jan. 15, 2002, LEXIS, News Library, Allbbn File. There is no deadline for the European Union to request authority to impose sanctions, nor is there a deadline for the European Union to impose authorized sanctions. *WTO's Extraterritorial Income Decision: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 13-14 (2002) (statement of Peter Davidson, General Counsel, Office of the U.S. Trade Representative) [hereinafter *WTO's Extraterritorial Income Decision*].

3. Edward Alden, *U.S. Disputes EU Claim in Spat over Export Subsidies*, FIN. TIMES, Feb. 15, 2002, at 10.

4. *Trade*, NAT'L J.'S TECH. DAILY, Feb. 11, 2002, *at* http://nationaljournal.com/pubs/techdaily. The United States believes that the sanctions endorsed by the European Union are high, even assuming that the EU's methodology for calculation is correct. *Id.*

5. *Taxes*, NAT'L J.'S TECH. DAILY, Feb. 15, 2002.

6. Frances Williams, *WTO Arms Europeans with Weighty Weapon*, FIN. TIMES, Aug. 31, 2002, at 5.

industries that the European Union may choose.[7] The European Union plans to delay sanctions as of now but has reserved the right to impose them at a later date, choosing to exact the punishment on industries such as agriculture and machinery.[8] The United States decided to appeal the decision, hoping that the WTO Ruling Panel would reverse the Appellate Body's decision and save the tax scheme used by many U.S. corporations.[9] The Panel affirmed the decision that the tax plan was illegal on January 14, 2002, and compliance is now the key issue in the long battle.[10]

There is still hope for corporations to receive tax benefits for their export operations. While the United States may not wish to go through another round of revisions,[11] the elimination of the FSC Replacement Law provides an opportunity for the United States to undertake full-scale reform of portions of the tax code that affect trade.[12] The Replacement Law contained flaws that made it more objectionable to international trade organizations than the original law.[13] The key objective is to "prevent the development of an

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7. *Hearing on the President's Trade Agenda Before the House Comm. on Ways and Means*, 107th Cong. 30 (2002) (testimony of U.S. Trade Representative Robert Zoellick).

8. *America's Taxing Trade Troubles*, *supra* note 2. Germany's Economics Minister stated that "[s]peculating about sanctions isn't helpful. . . . An escalation of the row neither helps the European Union nor the U.S." Giles, *supra* note 2. Germany's economy is the largest in the European Union. *Id. See also Hearing Before the Senate Comm. on Finance*, 107th Cong. (2002) (Hearing On Trade Negotiations—Feb. 6, 2002), *available at* http://finance.senate.gov (statement of Robert Zoellick).

9. *Trade Representative to Appeal WTO Ruling against US Tax Policy*, WALL ST. J., Oct. 11, 2001, at B2. *See also Experts Advise What to Do Now that WTO Has Shot Down FSC Replacement Act*, MANAGING EXPORTS, Sept. 2001, at 5 (stating that there are 6000 U.S. corporations with FSCs that are worth four billion dollars in tax benefits to their parent corporations). The appeal was argued by Deputy Treasury Secretary Kenneth Dam and Kent Jones, assistant to the solicitor general. *Deputy Treasury Secretary to Argue FSC Case at WTO*, NAT'L J.'S CONGRESSDAILY, Nov. 6, 2001, *available at* http://nationaljournal.com/pubs/congressdaily.

10. *EU says U.S. Must Comply with WTO Ruling on Corporate Subsidies*, DEUTSCHE-PRESSE-AGENTUR, Jan. 14, 2002, LEXIS, News Library, DPA File; *see also U.S. to Cooperate with EU after WTO Tax Ruling*, AGENCE FRANCE PRESSE, Jan. 14, 2002, 2002 WL 2316578.

11. *Trade Representative to Appeal WTO Ruling Against US Tax Policy*, *supra* note 9; *see also* Curt Anderson, *Treasury: Trade Tax Breaks to Continue for U.S. Firms*, AUSTIN-AM. STATESMAN, Feb. 24, 2000, at D8 (stating that Congress was reluctant to go through the time-consuming process of changing the law).

12. *A Subsidy by Any Other Name*, WASH. TIMES, Aug. 31, 2001, at A20 (proposing that now is the time to reform the tax code).

13. Paul R. McDaniel, *Panel IV: The Pursuit of National Tax Policies in a Globalized Environment: Principal Paper: Trade and Taxation*, 26 BROOK. J. INT'L L. 1621, 1629 (2001) (outlining problems with the FSC provision of the U.S. tax code). Such provisions included a general deviation from the practice of taxing and then providing credit, and a clause that allowed FSCs to conduct all of their business within the United States. *Id.*

international double standard that will disadvantage the United States and, in the end, cripple the WTO."[14] With careful revisions, the U.S. Congress can retain the tax incentives for domestic corporations operating abroad while appeasing the European Union and the WTO.

The United States, in dealing with the FSC problem, cannot afford to suffer the potential consequences of non-compliance, nor can it depend on amicable negotiations. Rather, it is crucial that the United States devise a tax plan that will safeguard the interests of U.S. corporations while mollifying the European Union. These interests must be balanced with sovereignty concerns, requirements of the WTO agreements, and worries about future challenges to laws affecting international trade—both those to be brought by the United States and those to be brought against the United States. Given President Bush's decision this year to impose tariffs on steel,[15] causing a major stir in the European Union,[16] the United States must make every effort to allay the fears of EU leaders and come into compliance with the WTO decision. The implications of this conflict cannot be taken lightly, especially in a time of war and economic uncertainty. If mishandled or ignored, the squabble over FSCs could erupt into an entirely different kind of battle.[17]

This Note examines the background of the tax scheme, from the inception of the domestic international sales corporation (DISC) to the ultimate legislation embodied in the 2000 Replacement Law that allowed for the tax exemption on extraterritorial income. It then considers the impact of the WTO decision on foreign trade and on competition abroad. It also evaluates the implications of potential reprisal by the European Union. Finally, this Note analyzes several proposals for retaining the tax benefits in the post-FSC world to ensure competitiveness of U.S. exports, compliance with the WTO decision specifically and international obligations generally, and preservation of national sovereignty with respect to U.S. choices regarding taxation of its citizens.

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14. John Van Oudenaren, *E Pluribus Confusio: Living with the EU's Structural Incoherence*, NAT'L INT., at 34 (2001). *See also* Heather Stewart & Ian Black, *Dollars 4bn Sanctions Threat to US*, GUARDIAN, Jan. 15, 2002, at 21, 2002 WL 9513394 (quoting Confederation of British Industry spokesman Gary Campkin: "Unless calm heads prevail, there is a real danger of significant damage—not just to transatlantic relations but to the WTO itself.").

15. Tina-Marie O'Neill, *US Steel Tariff Exposes Tension with EU Alliance*, SUNDAY BUS. POST (IRELAND) ONLINE, Mar. 10, 2002, *at* http://thepost.ie.

16. *Id.*

17. EU Trade Commissioner Pascal Lamy has said he believes that the situation will be resolved without trade war. *EU's Lamy Expects Tax Dispute with US to Be Resolved without Trade War*, AFX-EUR. FOCUS, June 21, 2002, LEXIS, News Library, Afxef File. However, the United States should still be prepared for the possibility that negotiations will fail.

II. BACKGROUND OF CONFLICT—THE FSC-ETI CHALLENGES

While the U.S. government taxes the foreign income of its taxpayers, the European Union does not.[18] To offset this disadvantage and maintain the competitiveness of its products in the global market, the U.S. government developed the foreign sales corporation (FSC) to provide tax benefits for corporations operating abroad.[19] The stated purpose of the FSC was to "promote exports" of the goods of the parent company.[20] Small exporters and large corporations alike used FSCs for tax purposes.[21] Popular locations for these companies were Caribbean countries, such as Bermuda.[22] The parent corporation sold the product to be exported to the FSC, who sold the product to the purchaser.[23] The FSC, however, contracted the shipping of the product out to the parent corporation.[24] U.S. corporations benefited from the FSC scheme.[25] In 2000, for example, Boeing saved $291 million in taxes through its offshore company.[26] General Electric saved $746 million; Motorola saved $378 million from 1991 to 1998.[27] The rebates were also important to many chemical companies.[28]

The European Union challenged the legislation before the WTO in 1998.[29] It characterized the competitive disadvantage suffered by

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18. Raj Bhala & David Gantz, *WTO Case Review 2000*, 18 ARIZ. J. INT'L & COMP. L. 1, 53 (2000).

19. Anderson, *supra* note 11. Interestingly, some European corporations such as British Petroleum (England), BASF (Germany), and Rhone Poulenc (France) have also used the FSC benefit. Bhala & Gantz, *supra* note 18, at 55.

20. *EU/US: Officials Mull Options over WTO Tax Case*, EUR. REP., Jan. 12, 2002, *available at* 2002 WL 9467180.

21. Gordon Platt, *U.S. Tax Breaks are Still Available*, J. OF COM., Oct. 18, 1999, at 5. Large corporations that utilized FSCs include Boeing, Microsoft, General Motors, and Caterpillar. *Id.* Meat companies also used the FSC scheme. Sally Schuff, *FSC Ruling Sets Stage for EU to Flex Muscle at WTO Negotiating Table*, FEEDSTUFFS, Aug. 27, 2001, at 1.

22. Howard Gleckman, *Taxing Multinationals: The Donnybrook Ahead*, BUS. Week, Sept. 9, 2002, at 2002 WL 9362904. The Cayman Islands, where no income tax is paid, is also a popular location for FSCs. *Washington Appeals Against WTO FSC Ruling*, *supra* note 1. The most popular locales are the Virgin Islands, Guam, and Barbados. Bhala & Gantz, *supra* note 18, at 54.

23. Bhala & Gantz, *supra* note 18, at 54.

24. *Id.*

25. *Experts Advise What to Do Now that WTO Has Shot Down FSC Replacement*, *supra* note 9, at 5.

26. Paul Nyhan, *U.S. Braces for Jolt from WTO*, SEATTLE POST-INTELLIGENCER, Aug. 18, 2001, at F1.

27. *Id.*

28. *Soap Cosmetics Chemical Specialties: US-EU Trade Dispute Has Industry Concerned*, CHEM. BUS. NEWSBASE, Sept. 30, 2001; LEXIS, News Library, Chmbus File. Chemical manufacturers saved $250 million per year from FSCs. *Id.*

29. Nyhan, *supra* note 26.

the United States as "an internal problem."[30] There is much speculation, though, that the European Union was merely avenging its losses in other WTO rulings.[31] In March 2000, the WTO Ruling Panel ordered that the United States withdraw the FSC subsidies by October 1, 2000.[32] The deadline was extended to November 1, 2000.[33] On November 15, Congress passed the EIEA.[34] Lawmakers in the United States described it as "a ringing endorsement in favor of promoting free trade."[35]

The European Union, however, was not as pleased with the results. In early December 2000, the European Union requested review of the new legislation, citing a "disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings" of the WTO Ruling Panel.[36] The Panel found that the tax scheme was a financial contribution that conferred a benefit that is based on export performance as prohibited by Article 3.1(a) of the Agreement on Subsidies and Countervailing Measures (SCM).[37] Before the WTO decision on FSCs is analyzed, an overview of the origin and development of FSCs is necessary.

III. CHANGES IN TRADE TAX LAW—DISCS, FSCS, AND ETI

The taxation scheme on FSCs differs substantially from the normal U.S. tax system. Usually, U.S. taxpayers are taxed on all income, regardless of the source.[38] The United States gives taxing

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30. *EU Trade Chief Concedes US Faces "Complex Matter" in Changing Offending Law*, AGENCE FRANCE PRESSE, Jan. 16, 2002, 2002 WL 2317940. European Trade Commissioner Lamy has stated that "[t]here is no case for the U.S. to raise their external protection because they have a competitive problem." *Id.*

31. *Serious End*, GUARDIAN, Jan. 17, 2002, at 26. European officials vigorously deny such implications. Leon Brittan of Spennithorne, Letter to the Editor, *EU Bound to Protect Business Interests*, FIN. TIMES, Jan. 16, 2002, at 16. Still, the relationship between Lord Brittan and Charlene Barshefsky, the former U.S. trade representative, was far from cordial (in contrast to the relationship between the current combatants, Zoellick and Pascal Lamy). Some claim this is one of the reasons the dispute has been so contentious. Larry Elliott & Charlotte Denny, *Strangelove Tendency Revived*, GUARDIAN, Jan. 17, 2002, at 26.

32. Tax Treatment I, *supra* note 1, ¶ 1.1.

33. *Id.* ¶ 1.3.

34. *Id.* ¶ 1.5.

35. Richard A. Barsky & Christopher C. Adler, *Changes in Tax Law Affect Global Trade*, N.Y. L.J., Nov. 19, 2001, at S14.

36. Tax Treatment I, *supra* note 1, ¶ 1.8.

37. *Id.* ¶ 9.1.

38. Brenda O'Leary, *Comment: The Continued Viability of Foreign Sales Corporations (FSCs): An Analysis of the WTO Decision Declaring FSCs Incompatible with GATT Trading Rules*, 2 SAN DIEGO INT'L L.J. 149, 151-52 (2001).

rights to foreign countries from which foreign income is obtained.[39] From this, a double taxation potentially arises because of different tax laws in different countries.[40] The FSC provision was designed to alleviate this problem.[41] The FSCs were designed to "promote the export of their parent U.S. company's products and services," but are actually more like paper companies that "book profits from overseas sales."[42]

The original law at issue set forth a taxation scheme for domestic international sales corporations (DISCs) and former DISCs.[43] This law was meant to encourage U.S. corporations to export their goods.[44] Essentially, as long as a corporation declared its intent to be a DISC, it could defer taxes on qualified export income.[45] Half of the profits of a DISC were taxed as regular income, but no tax was assessed on the other half.[46]

When DISCs became FSCs in 1984,[47] the goal was to offset benefits that European companies received from a similar scheme within the European Union.[48] Corporations set up the FSCs to reduce taxes when exporting their goods.[49] Some European nations do not tax export income, and the United States considers the FSC law a "remedy for the comparative disadvantage" that U.S. companies face in the global market.[50] The European Union claims that the Replacement Law has provided benefits beyond those that were intended to flow from the legislation, particularly considering that

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39. *Id.*

40. *Id.* The two grounds for taxing income are jurisdiction over the person (residence principle) or jurisdiction over the activity (territorial system). *Id.*

41. *Id.* (outlining strategies for dealing with double taxation).

42. *EU/US: WTO Confirms Ruling Against US Tax Havens*, EUR. REP., Sept. 1, 2001, *available at* 2001 WL 26061313.

43. I.R.C. § 991 (1986).

44. Anderson, *supra* note 11 (stating that the scheme was originally intended to encourage exports).

45. O'Leary, *supra* note 38, at 152.

46. *Id.*

47. This action was taken pursuant to the GATT Council Understanding, adopted in 1981 in response to the GATT stalemate in 1976. The GATT ruled that DISCs and several European tax regimes challenged by the United States were invalid. *WTO's Extraterritorial Income Decision*, *supra* note 2, at 15-16 (statement of Barbara Angus, International Tax Counsel, U.S. Department of the Treasury). *See also WTO's Extraterritorial Income Decision*, *supra* note 2, at 15 (statement of Peter Davidson) (providing a history of the DISC-FSC controversy).

48. Anderson, *supra* note 11. "We stand to lose tax parity with our trading partners," said Steve Elkins of the Chemical Manufacturers Association. *Id.* Indeed, "most major trading nations have features in their income tax laws that favor exports." O'Leary, *supra* note 38, at 149-50.

49. *US Formally Announces WTO Appeal on Export Tax Breaks Ruling*, AGENCE FRANCE PRESSE, Oct. 15, 2001, 2001 WL 25038169.

50. *WTO Ruling on Export Sales Complicates Trade, Tax Issues*, BULLETIN'S FRONTRUNNER, Feb. 25, 2000, LEXIS, News Library, Frntrn File.

Microsoft and other software makers were permitted to use the scheme in 1997.[51]

The new legislation was suspect because it deviated from the usual U.S. system of worldwide taxation with a foreign tax credit.[52] The FSC could perform all of its activities within the United States, and no more than fifty percent of the fair market value of the export "could be attributable to articles imported into the [United States]."[53] In striking down the FSC legislation, the WTO panel noted,

> The United States is free to maintain a world wide system, a territorial tax system or any other system it sees fit. . . . What it is not free to do is to establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim 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.[54]

The new legislation, governing taxation of extraterritorial income (ETI), created new tax breaks that "appl[ied] equally to U.S. exports and to products the companies manufacture in their overseas plants."[55] The provisions create a system in which there is "a specific exclusion from gross income for extraterritorial income," and companies did not have to actually establish a foreign subsidiary to partake of the benefit.[56] This legislation, the FSC Replacement Law, repealed provisions in the Internal Revenue Code that related to FSCs.[57] No new FSCs could be formed, and all inactive FSCs (i.e., those that had no foreign trade income for any period of five years) would cease to be treated as FSCs for tax purposes.[58] Additionally, existing FSCs were given a transitional period to come into compliance with the new laws.[59]

The WTO found that Section 114 of the EIEA allows certain taxpayers to be excluded from taxation on certain income, including extraterritorial income.[60] This includes foreign corporations that choose to be treated as U.S. corporations for tax purposes.[61] Extraterritorial income is the gross income of a company that is derived from foreign trading receipts involving the sale or lease of

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51. Anderson, *supra* note 11.

52. McDaniel, *supra* note 13, at 1629.

53. *Id.*

54. *Id.* at 1632 (quoting World Trade Organization, Report of the Panel, United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/R, ¶ 7.122, (Oct. 8, 1999)).

55. *Deal with EU Gives U.S. Time to Rewrite Law on Tax Breaks; Americans' Offshore Investments at Issue*, CHI. TRIB., Oct. 1, 2000, at C20.

56. Barsky & Adler, *supra* note 35.

57. Tax Treatment I, *supra* note 1, ¶ 2.1.

58. FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2433(b)(1)-(2) (2000).

59. 114 Stat. 2433(c) (2000).

60. Tax Treatment I, *supra* note 1, ¶ 2.3.

61. *Id.* ¶ 2.3 n.22.

"qualifying foreign trade property" not for use in the United States.[62] Qualifying income is, within a given transaction, the greater of 30% of foreign sale and leasing income,[63] 1.2% of the foreign trading gross receipts,[64] or 15% of the foreign trade income of the taxpayer from the transaction.[65] Foreign trade income is income that is attributable to foreign trading receipts of the taxpayer.[66]

For the Replacement Law to apply to a corporation, at least half of its foreign trading gross receipts had to come from the sale or exchange of qualified foreign trade property.[67] Property that is in "short supply" is not excluded;[68] nor is property leased to a relative or a patent or invention.[69] Qualifying property, to be eligible for the taxing system, had to be produced by a domestic corporation, an individual citizen of the United States, a foreign corporation that has elected to be subject to U.S. tax laws, or a partnership composed of those described in the other three groups.[70] Businesses that chose to create FSCs received a thirty percent tax rebate on their export income.[71]

The European Union, in challenging the law, claimed that the exclusion of extraterritorial income from taxation resulted in a "financial contribution" in the form of "government revenue that was otherwise due."[72] Given that there was no general provision in the tax code excluding such income, other income that could be characterized as extraterritorial was subject to normal taxation.[73] The United States urged that the new law did not provide a financial

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62. *Id.* ¶ 2.4. "Qualifying foreign trade property" includes property that is manufactured in the United States, but held for sale outside of the United States. The property must not have more than 50% of its value attributable to articles manufactured outside the United States or direct cost for labor performed outside of the United States. I.R.C. § 943(a)(1) (2000).

63. I.R.C. § 941(a)(1)(A). Foreign sale and leasing income includes income allocable to foreign economic processes performed outside the United States that are procured from the lease of property outside the United States. I.R.C. § 941(c)(1); *see also* Tax Treatment I, *supra* note 1, ¶ 2.5.

64. I.R.C. § 941(a)(1)(B). Foreign trading gross receipts are generated by sale or lease of property not for use domestically. Tax Treatment I, *supra* note 1, ¶ 2.6(B).

65. I.R.C. § 941(a)(1)(C). Companies could choose which benefit they wanted, but ascertaining which provision would maximize the benefit required "extensive calculations." Barsky & Adler, *supra* note 35.

66. I.R.C. § 941(b)(1).

67. I.R.C. § 942(a)(1)(E); *see also* I.R.C. § 942(a)(1)(A) (clarifying the requirements of the Replacement Law).

68. Tax Treatment I, *supra* note 1, ¶ 2.6. Property in "short supply" includes items such as oil and unprocessed timber. *Id.*; *see also* I.R.C. § 943(a)(4).

69. I.R.C. § 943(a)(3).

70. I.R.C. § 943(a)(2).

71. Faisal Islam, *EU Told Trade War Would Sink Global Recovery*, OBSERVER, Aug. 26, 2001, at 2.

72. Tax Treatment I, *supra* note 1, ¶ 8.4.

73. *Id.*

contribution, but that extraterritorial income simply was not taxable at all without the EIEA.[74] The WTO reported its findings on the FSC-ETI laws on August 20, 2001.[75]

IV. THE WTO DECISIONS

A. *Tax Treatment I (August 2001)*

The European Union claimed that the FSC Replacement Law was flawed because it granted export subsidies within the Agreement on Subsidies and Countervailing Measures (SCM Agreement) and the Agreement of Agriculture (AA)—subsidies that were contingent upon export performance.[76] The European Union also said that the United States failed to remove the subsidy after the deadline and had not complied with its obligations to the WTO.[77] The United States countered that the exclusion of extraterritorial income did not give less favorable treatment to imports as compared to domestic goods.[78]

The WTO, in analyzing whether a subsidy existed, looked to whether there was a financial contribution by the government that constituted uncollected government revenue.[79] The threshold question was whether the Replacement Law itself foregoes collecting the revenue to which the government has given up its entitlement.[80] In this analysis, the WTO Ruling Panel used a "but for" test to answer the question.[81] In doing so, it noted that certain income is excluded from taxation, and that income must "satisfy stringently selective qualitative conditions and quantitative requirements."[82] The Panel found that this was an "effective departure" from the general principles of the tax regime.[83] The income would normally be taxed, but, because of the FSC Replacement Law, it was not being taxed.[84] From this exclusion of portions of gross income, the Panel decided that the initial question of whether the Replacement Law foregoes collecting the revenue should be answered affirmatively.[85] The Panel characterized the "qualifying foreign trade" and similar

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74. *Id.* ¶ 8.6.
75. *Id.*
76. *Id.* ¶ 3.1.
77. *Id.*
78. *Id.* ¶ 3.3.
79. *Id.* ¶ 8.8.
80. *Id.* ¶¶ 8.13, 8.16.
81. *Id.* ¶ 8.11.
82. *Id.* ¶ 8.21.
83. *Id.* ¶ 8.25.
84. *Id.*
85. *Id.* ¶ 8.26.

exceptions as "carve-outs" of the prevailing tax system, noting that these characteristics made the Replacement Law suspect.[86] The Panel ultimately determined that the FSC Replacement Law did provide a financial contribution within the meaning of the SCM Agreement.[87]

The United States maintained that the purpose of the exclusion clause of the legislation was "to treat all foreign transactions alike regardless of where goods are manufactured."[88] The European Union countered that, while foreign income could be excluded from taxation within the dictates of WTO agreements, extraterritorial income was not foreign income.[89] The WTO ultimately rejected the U.S. argument, stating that just because the United States included language indicating that extraterritorial income was a category that *could be* excluded from taxation did not mean that ETI was such an excludable category.[90]

In analyzing the FSC Replacement Law through this lens, the Panel first noted that the provision was "inconclusive on its face" as to the question of whether revenue existed that was "otherwise due."[91] Functionally, however, the Panel found the legislation much less benign.

> Taken to its logical extreme, this 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" . . . it desired, so that there could *never* be a foregoing of revenue "otherwise due." This would have the effect of reducing [the subsidy clause] of the SCM Agreement to "redundancy and inutility and cannot be the appropriate implication to draw from the stipulation as to what constitutes one of the enumerated forms of 'financial contribution.'"[92]

There was much discussion of footnote 59 of the SCM Agreement, which stated that the Agreement 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."[93] The United States urged that this sentence meant there was no limit on how members provided relief from double taxation.[94] The European Union questioned whether the intent was truly to

86. *Id.* ¶ 8.28.
87. *Id.* ¶ 8.30.
88. *Id.* ¶ 8.33.
89. *Id.* ¶ 8.33.
90. *Id.* ¶ 8.36 (emphasis added).
91. *Id.* ¶¶ 8.37, 8.38.
92. *Id.* ¶ 8.39 (emphasis in original).
93. *Id.* ¶ 8.72 (quoting the SCM Agreement).
94. *Id.* ¶ 8.82.

allow members to avoid double taxation completely.[95] Further, the European Union claimed the U.S. system did not achieve the goal of avoiding double taxation, since some businesses still needed foreign tax credits to avoid the problem.[96] The Panel concluded that the Replacement Law was not designed to avoid double taxation and therefore was not defensible under footnote 59 of the SCM Agreement.[97]

The FSC Replacement Law was classified as "even worse" than the original law.[98] The European Union called upon the United States to make "wholesale changes" to the legislation in order to comply with the WTO's standards.[99] In October 2001, U.S. Trade Representative Robert Zoellick announced that the United States would seek an appeal of the decision.[100] However, from the outset it was clear that the prospects that the WTO would reverse the decision were slim.[101] The United States urged that the ruling violated the WTO principle that members should not be forced into choosing "a particular kind of tax system."[102] However, as expected, the WTO Panel affirmed the initial decision on January 14, 2002.[103]

B. *Tax Treatment II (January 2002)*

The WTO's decision on appeal was more narrow than its original decision.[104] The Appellate Body re-examined the issues of (1)

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95. *Id.* ¶ 8.86.
96. *Id.* ¶ 8.89.
97. *Id.* ¶ 8.97.
98. *US Tax Break is Illegal*, ACCOUNTANCY, Sept. 30, 2001, at 17.
99. *Id.*
100. *Trade Representative to Appeal WTO Ruling against US Tax Policy*, *supra* note 9.
101. *See Experts Advise What to Do Now that WTO Has Shot Down FSC Replacement Act*, *supra* note 9. *See also* Ian Elliott, *U.N. to Pump $200 Million into Afghanistan for Agricultural Aid*, FEEDSTUFFS, Nov. 19, 2001, at 2 (citing recent studies indicating that "in almost 75% of the cases brought under WTO's dispute settlement process, the complaining country...subsequently wins"); Michael Mann, *US Call for Clear Rules on Taxation*, FIN. TIMES, Nov. 20, 2001, at 14 (stating that the decision ruling was "so overwhelming that few expect" it to be overturned on appeal).
102. William New, *Taxes: U.S. Presents Appeal on WTO Tax Case*, NAT'L J.'S TECH. DAILY, Nov. 27, 2001 *available at* www.nationaljournal.com/pubs/ techdaily (quoting Assistant Treasury Secretary Kenneth Dam). "Few things are as central to a country's sovereignty as how it raises revenue. . . . It is not the role of the WTO to substitute its judgment for the judgment of a member's own lawmakers in this regard." *Id.*
103. *WTO Rules Against US in Tax Break Dispute with EU*, AGENCE FRANCE PRESSE, Jan. 14, 2002, 2002 WL 2316480. The decision authorized an offset of the subsidy, gained by increasing tariffs on U.S. goods. Robert Branand, *Three Trade Issues Mean 'Boom or Bust,'* MODERN PLASTICS, Mar. 1, 2002, at 52.
104. William New, *Taxes: WTO Panel Delivers Final Blow to U.S. Tax Break*, NAT'L J.'S TECH. DAILY, Jan. 14, 2002, *available at* www.nationaljournal.com/ pubs/techdaily.

whether the FSC-ETI statutes involved "a "foregoing of revenue . . . 'otherwise due'" that provided a "financial contribution,"[105] (2) whether the alleged subsidy was "contingent . . . upon export performance,"[106] and (3) SCM Agreement footnote 59 double tax avoidance.[107]

While upholding the bulk of the Panel's decision, the Appellate Body found some error in the original analysis. First, the appellate decision noted that the Panel erred in characterizing the prevailing U.S. tax system as one in which gross income is taxed, noting that taxpayers can make deductions when calculating income tax.[108] The Appellate Body compared how the United States taxes income covered by the FSC Replacement Law with the way it taxes other foreign source income.[109] The Appellate Body found that most foreign source income is taxable subject to deductions[110] and a tax credit for "taxes deemed to have been paid by that taxpayer" to another jurisdiction.[111] The Appellate Body found that, based on the fact that a business chooses to be treated under the FSC statute, the Replacement Law was a departure from the general taxation scheme and deemed the Law impermissible despite the Panel's procedural error.[112]

The Appellate Body's decision regarding footnote 59 of the SCM Agreement was a major blow, finding that the footnote was not an "exception to the general definition of subsidy."[113] Further, the Appellate Body stated that the U.S. statute did not fall within the meaning of footnote 59 and could not be salvaged in that respect.[114] The minor narrowing of the decision was cold comfort for those hoping the U.S. arguments regarding the FSC legislation would be vindicated on appeal. Therefore, change and compliance are now the key issues in the FSC saga. President Bush has pledged to comply with the WTO ruling and has promised an overhaul of the tax laws to

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105. World Trade Organization, Report of the Appellate Body, United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/AB/RW (Jan. 14, 2002), ¶ 80, *available at* http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm [hereinafter Tax Treatment II].

106. *Id.* (ellipses in original).

107. *Id.*

108. *See id.* ¶ 84. The Appellate Body instead characterized the U.S. system as one that "seeks to allocate income between domestic- and foreign-source income." *Id.* ¶ 97.

109. *Id.* ¶ 98.

110. *Id.* ¶ 99.

111. *Id.* ¶ 100.

112. *Id.* ¶ 103. This was also seen as a confirmation of the finding that revenue "otherwise due" was foregone by the government. *Id.* ¶ 104.

113. *Id.* ¶ 129.

114. *Id.* ¶ 186.

do so.[115] Still, the battle over the specific implications of the decision is far from over, as the United States and European Union are still squabbling over various aspects of what the WTO's decision will require of the United States.

C. *Aftermath of the Decisions*

Since the WTO's decision, most of the discussion on FSCs has focused on how much will be paid and what will be done to cure the problem with the law.[116] While strategies for change are discussed more fully later in this Note, the argument over the amount of sanctions merits mention. The WTO originally claimed that the tax subsidy was worth four billion dollars in sanctions and authorized the imposition of this penalty against various U.S. industries.[117]

The United States suggested the sanctions should be less than one-fourth of what the European Union requested.[118] The United States based its number on the theory that the European Union is entitled to impose sanctions only in the amount of "actual trade losses suffered due to the U.S. subsidy."[119] Put another way, the United States argued that the European Union can only impose sanctions for sales lost as a "direct result" of the FSC break.[120] The U.S. model for sanctions was more in keeping with the WTO's "traditional methodology" in calculating sanctions.[121] However, the WTO ultimately accepted the EU's four-billion-dollar proposal.[122] The sanctions imposed will be the largest retaliation ever authorized by the WTO.[123]

115. Edward Alden, *Brussels Hails Bush Tax Reform Pledge*, FIN. TIMES, May 3, 2002, at 2. President Bush acknowledges, however, that he will need the help of the legislature to meet the demands of the European Union. *See* Keith Koffler, *Europeans Not Dropping Retaliatory Threats over Steel Tariffs*, NAT'L J.'S CONGRESSDAILY, May 3, 2002, *available at* www.nationaljournal.com/pubs/congressdaily.

116. *See infra* Part VI; *see e.g.*, Alden, *supra* note 3.

117. *See, e.g.*, *America's Taxing Trade Troubles*, *supra* note 2.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *See* Williams, *supra* note 6.

123. *Id.*

V. "A NUCLEAR BOMB"[124]—IMPACT ON TRADE

The WTO's decision has the potential for spurring a trans-Atlantic trade war between the United States and Europe.[125] In fact, former U.S. Deputy Treasury Secretary Stuart Eizenstadt, one of the drafters of the FSC Replacement Law, says that the sanctions "could bring the [European Union] and the [United States] to their biggest ever trade war" that could destroy a global economic recovery.[126]

The United States maintains that the challenge was merely a ploy by the European Union to "gain clout" in WTO agricultural negotiations.[127] At the time of the decision, about half of all U.S. exports were made through FSCs.[128] The United States has characterized the imposition of sanctions as a "nuclear option"; that is, one that will completely obliterate the trade relationship between the two entities.[129]

The European Union has said that if sanctions are imposed, it may not choose to seek the full entitlement of four billion dollars.[130] The European Union has also indicated that it would prefer not to exercise the sanctions option but would prefer that the United States

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124. Warren Giles and Blair Pethel, *EU Says WTO Rejects U.S. Tax Law, Permitting Sanctions Claim*, BLOOMBERG NEWS, Jan. 14, 2002, LEXIS, News Library Allbbn File (reporting Trade Representative Robert Zoellick's comment on the effects of sanctions on foreign trade). *But see* Carter Dougherty, *WTO Nullifies U.S. Tax Break in Trade Dispute with EU*, WASH. TIMES, Jan. 15, 2002, at A3 (quoting Robert Litan, a trade scholar at the Brookings Institute, who dismissed this notion: "It's not the start of a nuclear war....It is one of a zillion problems that make life difficult."). The vast consensus, however, is that the results of retaliation could be quite dire. *See* Edward Alden et al., *Ruling Opens New Chapter in US-EU Trade Dispute*, FIN. TIMES, Jan. 15, 2002, at 10.

125. *See America's Taxing Trade Troubles*, *supra* note 2.

126. *EU/US: WTO Confirms Ruling Against US Tax Havens*, *supra* note 42.

127. Schuff, *supra* note 22. "The EU has alleged little actual harm to European producers" in its complaint to the WTO. Van Oudenaren, *supra* note 14.

128. *Exporters' Tax Break Ruled Illegal; The World Trade Organization Upheld its Ruling that U.S. Business Gets an Unfair Advantage*, ORLANDO SENTINEL, Feb. 24, 2000, at B5. Affected industries include machinery, chemicals, transportation, and agriculture. *Id.*

129. *See America's Taxing Trade Troubles*, *supra* note 2. The European Union has made a preliminary list of industries it will target—industries where the European Union has found that the products could be subject to sanctions without detrimental effects on EU consumers and industry. *EU/US: WTO Confirms Ruling Against US Tax Havens*, *supra* note 42. Targeted goods include live animals, books, iron and steel machinery, cereals, aircraft, and toiletries and cosmetics. *See America's Taxing Trade Troubles*, *supra* note 2; *see also Soap Cosmetics Chemical Specialties: US-EU Trade Dispute Has Industry Concerned*, *supra* note 28 (both listing products on which the European Union plans to increase tariffs).

130. *America's Taxing Trade Troubles*, *supra* note 2.

simply end the FSC scheme altogether.[131] Some suggest, however, that the European Union would be unwise to force the issue, given its "large trade surpluses with the United States, its own failure to comply with WTO rulings, and the spotty record it brings to market enforcement within the Union."[132] Despite this, the European Union will turn to "more formal dispute settlement procedures" if "insufficient flexibility is shown" on the FSC issue.[133] At this stage, the United States must begin to consider ways to change the current trade tax system to avoid the catastrophic impact that EU retaliation would have on its trading regime.

VI. AVOIDING SANCTIONS—STRATEGIES FOR CHANGE

Corporate taxation of export income "is an area that is really ripe for reform."[134] Unfortunately, the FSC decision comes at a particularly difficult time, when the economic downturn has reached global proportions,[135] the United States is at war, and major companies are suffering serious financial problems. It is true that the United States is not required by international pacts to change its tax laws in response to the WTO decision.[136] Some groups have advocated non-compliance with the WTO decisions regarding FSCs.[137] Indeed, corporate tax consultants say that until there is a new statute in force, corporations have "no choice but to go on accepting the FSC Replacement Act . . . until and unless it is replaced."[138]

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131. *Id. See also Managing Exports Miscellany*, MANAGING EXPORTS, Dec. 2001, at 8 (reporting that the European Union would rather negotiate a settlement than impose sanctions on the United States).

132. Van Oudenaren, *supra* note 14. *See also* Blair Pethel, *Senate Fast-Track Bill Puts U.S.-EU Tax Row into New WTO Round*, BLOOMBERG NEWS, Dec. 12, 2001, LEXIS, News Library, Allbbn File (quoting Deputy Treasury Secretary Kenneth Dam as stating that the affirmance of the WTO decision "would place the tax provisions...of many other countries at risk").

133. Press Release, European Union, *EU Issues Annual Report on US Trade Barriers* (Oct. 8, 2001), 2001 WL 28792126.

134. Edward Alden, *White House Backs Repeal of Exporters' Tax Break*, FIN. TIMES, June 14, 2002, at 9 (quoting Glenn Hubbard, Chair of the White House Council of Economic Advisers).

135. *America's Taxing Trade Troubles*, *supra* note 2.

136. Ben Stone, *WTO Rules Against U.S. Export Tax Law*, NAT'L DEFENSE, Oct. 2001, at 43.

137. *See* Platt, *supra* note 21. Robert Thornton characterized shutting down FSCs as a mistake, and noted that corporations should "go ahead and get [their] tax benefit." *Id.* This was, however, written before the repeal of the Replacement Law. *See id.*

138. *Experts Advise What to Do Now that WTO Has Shot Down FSC Replacement Act*, *supra* note 9.

However, by refusing to comply with the decision, selected industries will be subject to massive trade sanctions that they will be loath to accept.[139] Even so, the benefit cannot be completely abandoned by merely repealing the EIEA. Doing so will significantly disadvantage U.S. businesses vis-à-vis their foreign counterparts because of their taxation systems.[140] For example, the French value-added-tax (VAT) is twenty-five percent of the retail price of a good, but it is waived on goods that leave the country.[141] However, similar taxes imposed by the U.S. government are not refunded upon the export of those goods.[142] The United States accepted this system when Europe was rebuilding following World War II, but it can no longer afford to do so in the current economy without taking some measures to ensure its own economic stability and trading competitiveness.[143]

Some suggest that if the United States does not comply with the WTO decision, the European Union will impose tariffs unilaterally as a retaliatory measure.[144] The United States also risks "rack[ing] up WTO-sanctioned duties on U.S. exports" should it choose to ignore the WTO ruling.[145] It would be very difficult for the European Union to find four billion dollars worth of goods to block "without doing serious damage" to itself.[146] Still, the United States uses the export subsidy "stick" against other countries more than any other nation.[147] It is imperative that the United States avoid setting a bad example and encouraging other nations to use similar tactics of non-compliance

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139. Stone, *supra* note 136.

140. *Impact of Financial and Professional Service Exports on Small Business: Hearing Before the Comm. on Small Business*, 107th Cong. 116 (2001) (statement of David L. Aaron, Senior International Adviser, Dorsey & Whitney). International trade rules "bar the refund of income taxes but encourage the refund of excise taxes." *Id.* This is particularly disadvantageous to U.S. businesses as compared to European competitors because the United States derives its revenue from income tax, whereas European nations acquire their revenue from excise taxes (specifically, the value added tax, or VAT). *Id.*

141. *Id.*

142. *Id.*

143. *See id.*

144. Anderson, *supra* note 11.

145. *A Subsidy by Any Other Name*, *supra* note 12.

146. *Impact of Financial and Professional Service Exports on Small Business: Hearing Before the Comm. on Small Business*, *supra* note 140. The trade relationship between the United States and the European Union is worth about $1.9 trillion per year. Brian Knowlton, *U.S. and EU in Accord on Future of Mideast; Trade Disputes Remain at Summit Talks*, INT'L HERALD TRIB., May 3, 2002, at 1. "'Pascal Lamy...is like the dog who caught the bus' . . . the EU might end up worse off as a result of a WTO ruling [on the FSC issue] it so badly sought." Edward Alden, *Congress Looks at Tax Advantages of Foreign Companies*, FIN. TIMES, June 7, 2002, at 3 (quoting Rep. Sander Levin).

147. *Impact of Financial and Professional Service Exports on Small Business: Hearing Before the Comm. on Small Business*, *supra* note 140.

against the United States.[148] Such a situation could have a severe economic and non-economic impact on U.S. businesses, both on their international reputations and on lost revenues from foreign subsidization of other nations' industries.[149]

The WTO suggests "reforming the very basis of the U.S. tax system."[150] Despite this call to action, some in the United States still suggest that the tax code be revamped again, not in the vision of the WTO, but to retain the tax benefit granted by the FSC laws.[151] Another option that has been suggested is a territorial tax system that would not tax companies' foreign business operations and would be even more beneficial to exports.[152] Still others urge a negotiated settlement.[153]

Some action must be taken to ensure competitiveness.[154] However, U.S. officials believe that the WTO's instructions are unclear and riddled with new and vague rules.[155] Deputy Treasury Secretary Kenneth Dam opines, "the only way to maintain parity with the tax systems of other countries could be through comprehensive reform by scrapping our entire tax system and starting over."[156] Hopefully, the solution will not have to be so rash. Senate Finance Chairman Max Baucus believes that "legislative action might not even be possible,"[157] and that solving the tax spat

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148. *See id.*

149. *See id.*

150. Islam, *supra* note 71.

151. Schuff, *supra* note 21. Chuck Grassley (R-IA), the ranking Republican on the Senate Finance Committee, suggested that the appeal would buy time that Congress needed to accomplish this task. *Id.* He says the United States should "play the same game the EU plays...using every stall available." *Id.* *See also A Subsidy by Any Other Name*, *supra* note 12 ("Rather than complain, the U.S. government could use the ruling to its own advantage to improve its tax code and to battle against widespread European subsidies.").

152. Platt, *supra* note 21.

153. Anderson, *supra* note 11. Senator William Roth (R-DE) and Congressman Bill Archer (R-TX) said that if the conflict were not solved bilaterally, it would be "likely to lead to a highly charged tax and trade environment that we are sure all parties would like to avoid." *Id.*

154. *See Impact of Financial and Professional Service Exports on Small Business: Hearing Before the Comm. on Small Business*, *supra* note 140 (commenting that U.S. exports will be "sorely disadvantaged" if the law is simply repealed).

155. New, *supra* note 102 (quoting Assistant Treasury Secretary Kenneth Dam).

156. *Deputy Treasury Secretary Argues WTO Case on FSCs*, NAT'L J.'S CONGRESSDAILY, Nov. 28, 2001, *available at* www.nationaljournal.com/pubs/congressdaily.

157. *Thomas Says Remedy For Foreign Sales Corporations Could Take* Over, NAT'L J.'S CONGRESS Daily, Feb. 7, 2002, *available at* http://www.nationaljournal.com/pubs/congressdaily. However, Baucus has promised to hold hearings this year on international taxation in the Senate Finance Committee. Alden, *supra* note 134.

could take years.[158] Whatever the outcome, "no solution will be ideal for the United States."[159]

If a new tax is the answer, however, the new scheme should give answers to the following six questions: what is the tax base, what are the rates,[160] who will pay the tax,[161] when will the tax be paid, how should the tax be applied to cross-border transactions,[162] and how should the tax be administered.[163] Professor Paul R. McDaniel suggests that the tax scheme should be generally applicable and must not deviate for "specified classes of taxpayers or activity."[164] For Professor McDaniel, the key inquiry at this juncture is "who will pay the tax."[165] The WTO has answered that all corporations, regardless of where they operate or what percentage of their goods are exported, must pay the same tax rate.[166]

The WTO arbitration procedure will be reactivated now that the appeal has been decided,[167] but the United States needs a back-up plan in the event that negotiations fail. While Trade Representative Zoellick is hopeful about the prospects of negotiation,[168] given the nature of the problem there must be another solution that the United

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158. *EU/US: Key US Senator Warns over Tax Deal for FSC Dispute*, EUR. REP., Feb. 9, 2002, *available at* 2002 WL 13764231. Indeed, Senator Baucus believes that Congress will not pass a new tax this year. *U.S. Says Correct FSC Trade Sanctions Less than $1 Billion*, NAT'L J.'S CONGRESSDAILY, Feb. 15, 2002, *available at* www.nationaljournal.com/pubs/congressdaily.

159. Candace Carmichael, Note, *Foreign Sales Corporations—Subsidies, Sanctions, and Trade Wars*, 35 VAND. J. TRANSNAT'L L. 151, 209 (2002). This is true both in terms of effect on export commerce and in terms of preservation of national sovereignty. *See id.*; *see also* Evelyn Iritani, *WTO Disallows U.S. Tax Breaks*, L.A. TIMES, Jan. 15, 2002, at C1.

160. Some examples of tax rates are progressive, proportional, and regressive. McDaniel, *supra* note 13, at 1623.

161. For example, the government must decide whether to treat shareholders and corporations as separate taxpayers or to integrate their taxes. *Id.* This is difficult because the corporations that have previously benefited from the FSC provisions are eager to preserve their benefits, but their only common characteristic is that they all export. Carter Dougherty, *Export Subsidy Eyed; Congress to Tackle WTO Tax Irritant*, WASH. TIMES, May 9, 2002, at C9. A tax based solely on whether the company exports goods will not comply with the WTO ruling. *See id.*; *see also infra* Part IV.A.

162. McDaniel, *supra* note 13, at 1624. Three possibilities for dealing with export are worldwide taxation of income with a credit for foreign tax paid, exemption of foreign income, or worldwide taxation with a deduction for foreign tax paid. *Id.*

163. *Id.* at 1622 (listing the questions to be answered). The rules should be uniform for all taxpayers. *Id.* at 1624.

164. *Id.* at 1623.

165. *See id.*

166. *See* Tax Treatment I, *supra* note 1, ¶ 8.33.

167. *WTO Rules in Favor of EU in US Export Subsidy Case*, AGENCE FRANCE PRESSE, Jan. 14, 2002, LEXIS, News Library, AFP File.

168. *See Zoellick, Rockefeller Butt Heads over Trade Negotiations*, NAT'L J.'S CONGRESSDAILY, Feb. 6, 2002, *available at* www.nationaljournal.com/pubs/congressdaily.

States can use if the two parties fail to reach a mutually agreeable solution. The alternatives to writing a new tax code involve tinkering with the current tax system. The remainder of this discussion will explore such propositions centered on changes to the current tax system.

A. *A Change in Direction—The Territorial Tax Plan and Value-Added Tax (VAT)*

The most-frequently mentioned option is to create a territorial system of taxation, akin to that used in Europe.[169] Under a territorial plan, only income earned inside the United States would be taxed, though some selected foreign income could also be taxed.[170] Supporters of such a plan cite many benefits. First and foremost, it would comply with the WTO ruling.[171] Indeed, Daniel Mitchell advocates "'junk[ing] our worldwide corporate tax system and switch[ing] to a territorial tax system. If [the United States] goes to a territorial system', it will be 'completely WTO compliant.'"[172] Under the SCM Agreement, VAT and similar sales taxes were not considered to be subsidies within the meaning of the Agreement.[173] This is because VAT is an indirect tax that is placed on a good rather than directed at a person.[174] Such an endorsement by the SCM Agreement ensures that if this line of action were pursued, the United States would be in compliance with WTO requirements.

Additionally, proponents argue that a territorial tax will make U.S. companies more competitive by eliminating taxation by the U.S. government when the company is in a jurisdiction with a low tax

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169. *Experts Advise What to Do Now that WTO Has Shot Down FSC Replacement Act*, *supra* note 9.

170. Warren Giles and Blair Pethel, *WTO Rejects U.S. Tax Law, Setting Stage for EU Punitive Tariffs*, BLOOMBERG NEWS, Jan. 14, 2002, LEXIS, News Library, Allbbn File.

171. *See* Daniel Mitchell, *Europe's Tax Hit on America*, WASH. TIMES, Jan. 24, 2002, at A16 (noting that most U.S. trading partners have a territorial taxation system).

172. *Trade Analyst Warns Administration is on Wrong Track with FSC Negotiations*, WHITE HOUSE BULLETIN, Mar. 11, 2002, *available at* http://www.pff.org/press/ecommerce/WHB032702_files/WH020327.htm (last visited Oct. 1, 2002).

173. Bhala & Gantz, *supra* note 18, at 54. This decision is seen as a "disparity in treatment" by some commentators, who claim that there is no difference in economic effect between the VAT and the FSC. *Ongoing Trade Negotiation: Hearing Before the Senate Comm. on Finance*, 107th Cong. (2002), *available at* http://finance.senate.gov (statement of George Scalise, President, Semiconductor Industry Association).

174. Sarah Ostergaard, Note, *The Third Strike: United States' Attempts at Achieving Tax Parity Between Its Income Tax and the European Value-Added Tax*, 27 J. LEGIS. 421, 424 (2001).

rate.[175] Reduced compliance costs are also another benefit—simpler rules (i.e., rules that do not have a complicated tax credit system) would reduce paperwork and the chance of error in attempting to apply the "myriad rules and restrictions."[176] Finally, by eliminating the current system, supporters of the territorial system urge that companies will stop fleeing to lower tax jurisdictions.[177]

In an exemption system, an exemption would apply to the "branch profits of any U.S. corporation and to dividends received by U.S. corporate taxpayers from foreign corporations."[178] For example, income from royalties and interest are not taxable in foreign jurisdictions and would not be exempt under the new U.S. law.[179] Passive income—income that has no "nexus to business activity"—would not be eligible for exemption.[180] Proponents of this plan argue that there should still be foreign tax credits to avoid double taxation.[181] Generally, income would be divided into two categories—income that is already taxed, and income that is exempt.[182] Eliminating the deferral system under the DISC law and its progeny would simplify and streamline the compliance process for corporations, reducing costs for those corporations.[183]

To ease transition, the U.S. government could forgive tax on income that would be exempt under the new law earned in the time

175. Mitchell, *supra* note 171. Mitchell suggests that the framers of the FSC legislation understood that "worldwide taxation harms America's export-oriented companies." *Id.*

176. *See id.* One study suggests that about 40% of "tax compliance costs is attributable to the taxation of foreign source income, even though foreign operations account for only about 20% of these companies' economic activity." Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771, 772 (Dec. 1, 2001).

177. Mitchell, *supra* note 171. Mitchell claims that the worldwide tax system caused Accenture, Ingersoll-Rand, Tyco and Fruit of the Loom to move their headquarters to foreign countries. *Id.* Mitchell claims "the only reason" the firms go to lower tax jurisdictions is "to get out from our worldwide corporate tax system" and preserve their offshore revenues. *Trade Analyst Warns Administration is on Wrong Track with FSC Negotiations*, *supra* note 172. *See also WTO Export Subsidy Decision: Hearing Before the House Comm. on Ways and Means*, 107th Cong. (2002), *at* http://waysandmeans.house.gov/fullcomm/107cong/2-27-02/2-27rams.htm (statement of Congressman Jim Ramstad).

178. Graetz and Oosterhuis, *supra* note 176, at 774.

179. *Id.*

180. *Id.* at 775. This policy, it is argued, would reduce the incentive for companies to move such assets offshore. *Id.*

181. *Id.* To come within SCM Agreement footnote 59, the United States must be able to show that the scheme was implemented to avoid double taxation. *See* Tax Treatment II, *supra* note 105, ¶ 186.

182. Graetz and Oosterhuis, *supra* note 176, at 777-82.

183. *Id.* at 777; *see also* Mitchell, *supra* note 171.

before the new law went into effect.[184] Alternatively, the government could levy a toll on investments in foreign corporations as a condition for exemptions.[185] Finally, Congress could provide for a transition system that would make dividends from pre-exemption earnings eligible for tax credit.[186]

One permutation of the tax code modification plan is to create a VAT in the United States.[187] A U.S. VAT would require a massive rewrite of the tax code, something Congress would likely be unwilling to undertake.[188] The VAT is a tax on the consumption of goods.[189] This tax does not apply to income earned on exports.[190] To implement a VAT, the U.S. tax system would have to change substantially.[191] The FSC Replacement Law is seen as a mimicking of a VAT.[192] The problem is that while the European version is an indirect tax from which a government may exclude a portion from liability, the U.S. income tax is a direct tax from which the government cannot exclude a portion from liability.[193] Therefore, the United States would have to change its corporate tax structure to an indirect system to fully comply.[194] Such an overhaul is not a task that Congress would want to take up at this juncture, particularly with other pressing issues, such as the war against terrorism and a midterm election, on the minds of its members.

Critics of the exemption system, who advocate adhering to the worldwide taxation system, cite the uncertainty of benefits of simplification in an exemption system and the reduced competitiveness of U.S. businesses abroad if the United States forsakes its current system.[195] Further, "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

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184. Graetz and Oosterhuis, *supra* note 176, at 783-84. This option is unlikely to be adopted. *Id.* at 784.

185. *Id.* at 784.

186. *Id.*

187. *Impact of Financial and Professional Service Exports on Small Business: Hearing Before the Comm. on Small Business*, *supra* note 140.

188. *Id.*

189. Ostergaard, *supra* note 174, at 421. Europe's VAT is set at 20%. Bhala & Gantz, *supra* note 18, at 53.

190. Ostergaard, *supra* note 174, at 421. U.S. exports, similarly, are not subject to state sales taxes, but state sales taxes are much lower than the VAT. Bhala & Gantz, *supra* note 18, at 54.

191. *See* Ostergaard, *supra* note 174, at 438.

192. *Id.*

193. *See id.*

194. *Id.* at 439.

195. *See* J. Clifton Fleming et al., *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 352 (2001) (citing fairness as a standard for taxation of income, and arguing that the current U.S. taxation system best fits that model).

environment."[196] At a time when the United States must show all the strength it can muster, it cannot afford to give the impression that it will bend to the will of other entities and allow its taxation scheme to be dictated by the WTO.[197] The United States risks such a perception in adopting a tax plan more like that of the European Union.

In terms of Professor McDaniel's model and the WTO mandate, the VAT would have to apply to all industries, not only those industries with large export divisions.[198] This could cause problems for goods sold domestically since the VAT would have to be paid on goods that are sold in the United States, raising prices on domestic goods and making them less competitive in this country.[199] In this way, a VAT in the United States could create a unique competitive disadvantage for U.S. goods sold domestically, giving foreign businesses a new advantage in the U.S. market. For this reason, the VAT seems particularly unattractive as a solution to the current tax problem.

While some lawmakers favor a broad program of fiscal reform,[200] such a drastic change is unlikely to capture majority support in the legislature, especially because the United States justifiably views this attack on the tax system as an attack on national sovereignty.[201]

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196. Carmichael, *supra* note 159, at 207.

197. *See WTO's Extraterritorial Income Decision: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 46 (2002) (testimony of Gary Hufbauer, Senior Fellow, Institute for International Economics). "I believe in the virtues of uniform taxation. But I don't believe these virtues should be imposed from Geneva." *Id.* (quoting Hufbauer).

198. *See supra* notes 160-64 and accompanying text.

199. *See supra* notes 190-91 and accompanying text.

200. The Treasury Department is eager to undergo full-scale tax reform, stating that the current U.S. international corporate taxation system is "at least 30 years outdated." Edward Alden, *WTO Ruling 'Will Require US Corporate Tax Reform,'* FIN. TIMES, Feb. 28, 2002, at 7. Congressman Bill Thomas, Chairman of the House Ways and Means Committee, also sees an opportunity to reform the tax structure while meeting international obligations. *WTO's Extraterritorial Income Decision: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 4 (2002) (statement of Congressman Thomas).

> It is in our interest that others follow the rules and therefore it is imperative that we follow the rules as well. To that end, we must carefully and thoroughly address the problems created at the intersection of our tax code and our international trade obligations. . . . This decision marks the fourth time that the WTO has ruled this way, twice in the [FSC] case and now twice in the [ETI] case.

Id. (quoting Congressman Thomas).

201. *See* Guy de Jonquieres, *Raising the Transatlantic Trade Stakes*, FIN. TIMES, Jan. 14, 2002, at 17. *See also* Iritani, *supra* note 159 (quoting Max Baucus, Chair of the Senate Finance Committee). The United States should not give in to European pressure to change the tax system and should see that the WTO "preserve the sovereign right of each country to set its own tax policy." *Id.* *See also Dangerous*

These arguments, however, will not release the United States from its obligations. Though a plan must be formulated, full-scale tax reform probably will not come quickly enough to satisfy EU complaintants, even given its purported desire to avoid retaliation, because of the complicated nature of such a fundamental change in tax law.[202] Indeed, even proponents of the plan acknowledge that such change could take "at least another year."[203] Currently, no branch of government seems particularly willing to come up with any legislative solution;[204] therefore, passing one of this magnitude would be quite remarkable.[205] Though the territorial tax plan would unquestionably comply with the WTO decisions, the answer to the U.S. tax woes appears to lie elsewhere.

B. *A Variation of the European Model—Rebate of Excise Taxes*

Another option rebates existing excise taxes in a manner similar to the way European nations rebate the VATs.[206] U.S. Representative

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Activities-Trade Disputes, ECONOMIST, May 5, 2002, at 92 ("Many lawmakers are already furious at the notion that the WTO has any role in domestic tax changes. Their willingness to comply in an atmosphere of transatlantic trade fights is likely to be minimal.").

202. *See The Role of the Extraterritorial Income Exclusion Act in the International Competitiveness of the U.S. Companies: Hearing by the Senate Finance Committee*, 107th Cong. (2002), *available at* http://finance.senate.gov (statement of Robert Zoellick) (noting that the process of legislative response of EU requests is lengthy, and noting the critical need to expedite the process). *See also Thomas Says Remedy for Foreign Sales Corporations Could Take over Six Months*, *supra* note 157.

203. *Trade Analyst Warns Administration is on Wrong Track with FSC Negotiations*, *supra* note 172. Mitchell thinks that the European Union will eventually go forward with imposing sanctions. *Id.*

204. *See Trade Scene: Trade Policy Alphabet Soup Stew*, *supra* note 1. The House Ways and Means Committee is evaluating the proposed American Competitiveness Act of 2002, that repeals the Replacement Law. Robert Branand, *New U.S. Tax Legislation Cracks Down on Loopholes*, MODERN PLASTICS, Aug. 1, 2002, at 55. The bill strives to "offset the repeal with other tax breaks." *Software Firms Lobby for an Overseas Tax Break*, NAT'L J.'S CONGRESSDAILY, Aug. 6, 2002, *available at* http://www.nationaljournal.com/pubs/congressdaily.

205. The House of Representatives began hearings on the issue on April 10, 2002, but thus far legislators have made little or no progress toward an actual solution. *See Exclusion of Foreign Income from U.S. Taxes: Hearing Before the House Comm. on Ways and Means*, 107th Cong. (2002). Chairman Thomas said he hopes to have legislation through the House by October 4, 2002 after legislators return to their districts from their campaign trips. *U.S. House Tax Panel Head Says U.S. Committed to Changing Tax Law to Meet WTO Rule*, AFX NEWS, Apr. 15, 2002. House Speaker Dennis Hastert, however, seems committed to a continued fight against the WTO decision. *See id.* In response, President Bush's chief economic adviser, Lawrence Lindsey, said that the matter was one best solved by a change in the law. *Pro-Trade Dems Prod Bush on TAA*, NAT'L J.'S CONGRESSDAILY, Apr. 16, 2002, *available at* http://www.nationaljournal.com/pubs/congressdaily.

206. *Impact of Financial and Professional Service Exports on Small Business: Hearing Before the Comm. on Small Business*, *supra* note 140. This practice is already exercised at the federal level for whiskey manufacturers who export their goods. *Id.*

Wilbur Mills suggested this plan in 1969, but it was rejected because of the high cost of implementation.[207] Today, however, compliance costs are less of a concern, now that the "benefit on the books already costs the Treasury [Department] $4 billion."[208] Now is the time to give the excise tax rebate plan full consideration as an option to avoid sanctions and competitive disadvantage to U.S. goods in the export market.

For example, manufacturers of distilled spirits are currently exempt from tax on spirits manufactured for export.[209] Further, after applications are filed and bonds are secured, such spirits are free from export taxes as well.[210] Manufacturers are also exempt from tax when transferring their goods to foreign trade zones.[211] In general, there is a tax of $13.50 per proof gallon of distilled spirits produced in the United States.[212] However, when exported, the goods are free of tax, making the product less expensive and more competitive in the global market.[213] Similarly, the European statutes allow for the repayment of the tax for "those in business overseas."[214]

Congress could write a similar law for other export industries that would allow those industries to exempt certain taxes on exporting their goods. For example, automobiles are subject to a ten percent excise tax on the first retail sale.[215] Congress could waive this tax for manufacturers who export their vehicles. Such a system would be in line with current U.S. policy to waive excise taxes for exports.[216]

To fit into Professor McDaniel's model, it is important that the tax be generally applicable with respect to corporations.[217] Put another way, the excise tax exemption system cannot be applied only to industries that the European Union might target for sanctions, nor can it be applied only to those corporations with the most export revenue. Rather, it must be implemented across the board, regardless of the exporting status or power of the industry. Further, if excise taxes were generally exempted for all exports for all industries, the U.S. government would not have the perception problem that it is foregoing revenue to which it is otherwise

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207. *Id.*
208. *Id.*
209. I.R.C. § 5214(a)(1)(A).
210. I.R.C. § 5214(a)(4). These products are also eligible for other exemptions for other reasons, such as use by a governmental agency for testing. I.R.C. § 5214(a)(2).
211. I.R.C. § 5214(a)(8).
212. I.R.C. § 5001(a)(1).
213. *See* I.R.C. § 5001(a)(4); *see also* I.R.C. § 5214.
214. *See, e.g.*, Value Added Tax Act, 1994, c. 23, § 39 (Eng.).
215. I.R.C. § 4001.
216. *See supra* notes 209-213 and accompanying text.
217. *See supra* note 164 and accompanying text.

entitled.[218] This plan should be acceptable because it is functionally the same as a VAT because the tax is generally applied, but it is deducted when the goods are exported.[219]

The European Union might challenge this tax plan as one that only applies to certain activities (exports), arguing that this plan violates other WTO agreements.[220] However, making such an argument would place the tax systems of EU nations in serious peril. The United States could argue that this indirect tax plan is indistinguishable from VAT plans used widely in the European Union. A tax is levied against a good but is then forgiven when the good leaves the country.[221] If a VAT is in compliance with the SCM Agreement, which it is,[222] the proposed indirect taxation plan must also be in compliance, making the indirect taxation plan and the VAT functionally the same.[223]

Further, it could be argued that the excise tax plan is just another way that the United States would solve the tax problem at the expense of its sovereignty because it is a functional equivalent to the EU tax plan. However, for this plan to be implemented, the United States would not be forced to give up its current worldwide taxation plan. Rather, this plan fully comports with U.S. taxation policy and would preserve the system that the United States has chosen with respect to taxing its citizens and its corporations without requiring the government to give up revenue otherwise due to it.

The excise tax exemption plan is a viable alternative to the current system because it does not require overhaul of the tax system, but it has the same compliance benefits as a VAT system.[224] It would satisfy both the competitive needs of U.S. businesses operating abroad and the desire of tax reform proponents for a new system. Though Congress may not relish the thought of rewriting tax law,[225] it needs to take action to avoid the dire consequences of non-compliance. The excise tax plan is one such action that can allay most fears regarding national sovereignty and complications in the WTO.

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218. *See* Tax Treatment I, *supra* note 1, ¶ 8.4.

219. *See supra* notes 209-13 and accompanying text; *see also supra* notes 189-90.

220. *See id. See also* McDaniel, *supra* note 13, at 1623 (for Prof. McDaniel's proposition that the tax must not deviate based on activity regulated).

221. *See supra* note 141 and accompanying text.

222. *See* Bhala & Gantz, *supra* note 18, at 54.

223. It is important to note that the FSC is economically indistinguishable from the VAT. However, the excise tax plan looks more similar to the VAT, and would likely be less subject to challenge than the FSC.

224. *See* Bhala & Gantz, *supra* note 18 (for the proposition that VATs do comply with WTO standards).

225. *See Zoellick, Rockefeller Butt Heads over Trade Negotiations*, *supra* note 168.

C. *Fourth Time's a Charm—Rewriting the FSC Legislation*

Congress could also go back to the drawing board and rewrite the FSC legislation once again.[226] Two key aspects of the law must change in order to bring the United States into compliance. First, the new tax scheme must not provide for a benefit based on export performance in violation of Article 3.1(a) of the SCM Agreement.[227] Second, the FSC Replacement Law does not apply to goods produced in the United States for use in the United States.[228] Exporting must not be "a necessary precondition to qualify for the subsidy."[229]

First, a possible solution is to remove the fifty percent "foreign content limitation" and requirement that the property be held for use outside the United States.[230] The European Union agreed that the law would no longer be a prohibited subsidy if those two clauses were removed.[231] However, removing such language would defeat the purpose of the Replacement Law, which was to encourage exports.[232] The subsidy could be given to products sold within the United States as well as products for export,[233] but the U.S. government could ill afford to forfeit that much tax revenue.

Second, the new tax plan must not violate Article 1.1(a)(1)(ii) of the SCM Agreement that prohibits the foregoing of "a government revenue otherwise due" to the government from the corporation.[234] Therefore, if money is owed to the government, it must collect that money.[235] Put another way, Congress cannot carve out a portion of income and shield it from taxation.[236] The key in this regard is to avoid a double taxation problem for U.S. businesses operating abroad. Congress could pass a resolution providing for taxation of export income by the country where the corporation is a resident. However, such a resolution would create a situation where every U.S. export company would set up shop in a tax haven where it would pay zero tax, depriving the U.S. government of any benefit of the companies' exports.[237]

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226. *Experts Advise What to Do Now that WTO Has Shot Down FSC Replacement Act*, *supra* note 9.

227. *See* Tax Treatment I, *supra* note 1, ¶ 8.53.

228. *Id.* ¶ 8.60.

229. *See id.* ¶ 8.60.

230. *See id.* ¶ 8.1.

231. *Id.*

232. *See* Anderson, *supra* note 11.

233. Tax Treatment I, *supra* note 1, ¶ 8.72.

234. *See id.* ¶ 8.4.

235. *See id.* ¶ 8.9; *see also id.* ¶ 8.17.

236. *Id.* ¶¶ 8.25-8.26.

237. *See Washington Appeals Against WTO FSC Ruling*, *supra* note 1; *see also* Bhala & Gantz, *supra* note 18, at 54.

Within Professor McDaniel's construct, any rewrite of the FSC Replacement Law that retains the original purpose of the laws will be subject to further challenge. The most significant problem is the lack of general applicability of the tax. Indeed, the FSC Replacement Law applied only to exporting corporations. Therefore, the Replacement Law is in opposition with the McDaniel construct and the WTO decision. Indeed, through this lens, a mere rewrite of the law on the books is futile at best and foolish at worst.

The danger in this strategy, amply illustrated above, is that the attempt to rewrite the legislation to bring it into compliance may devolve into a "charade" that merely "adopt[s] another version of the same old tax break."[238] The key to rewriting the statute is to avoid differential treatment between exports and goods for sale within the United States.[239] Rewriting the statute in that manner is a heady task that will likely come at great cost of time and money.[240] Additionally, Congress will not likely wish to undertake such a task.[241] As House Ways and Means Committee Chairman Bill Thomas noted, the United States must do more than "put a patch" on the FSC legislation.[242] At this stage, rewriting the laws to retain FSCs does not seem viable or worthwhile.

D. *Other Options*

Several other options for change, while less attractive than the aforementioned plans, do bear mention.

1. Leaving the WTO

Some commentators have suggested that the United States could choose to leave the WTO.[243] Senate leaders have cautioned against this and have said that "we can't take all of our marbles and go home just because we disagree with one decision out of the WTO."[244] Indeed, pulling out of the WTO would appear highly hypocritical given that the United States has "vigorously supported" the mandate of the WTO when the panel decided disputes in its favor.[245] Further,

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238. *Impact of Financial and Professional Service Exports on Small Business: Hearing Before the Comm. on Small Business*, *supra* note 140.

239. Tax Treatment I, *supra* note 1, ¶ 8.72.

240. O'Leary, *supra* note 38, at 164.

241. *See EU/US: Officials Mull Options over WTO Tax Case*, *supra* note 21.

242. *Thomas Says Remedy for Foreign Sales Corporations Could Take over Six Months*, *supra* note 157.

243. *See WTO Ruling on Export Sales Complicates Trade, Tax Issues*, *supra* note 50.

244. *Id.* (quoting Senate Democratic Leader Tom Daschle).

245. O'Leary, *supra* note 38, at 171.

with the need to work closely with allies against terrorism,[246] the United States can ill afford to alienate European allies by ending the U.S. relationship with the WTO. This is true both in terms of retaining good relationships with allies, and in presenting a united front in the battle against international terrorism.[247] While, in theory, leaving the WTO would alleviate a drawn-out battle, it is not a viable solution in practice.

2. Paying the Sanctions

The United States could choose to pay the sanctions authorized by the WTO.[248] However, given the huge impact that the sanctions would have on trade,[249] the United States should not seriously consider this option. In addition to the economic consequences, such a course also raises concerns with enforcing future decisions in the WTO against other nations.[250] Fortunately, given the concerns for both sides in terms of potential negotiations on the issue, it is unlikely that this option will be considered or that the situation will "escalate to this level."[251] Indeed, this is one of the most unwise courses that the United States could take in response to the WTO decision.

3. Relinquishing Tax Breaks

Removing all tax breaks from the corporate taxation laws would also be an ill-advised solution.[252] While removing all tax breaks would certainly comply with the WTO ruling, such compliance would come at too great of a cost. Given the competitive disadvantages that would accrue, such a course would be devastating to U.S. export performance.[253] It is certain that this option does not present the solution to the issue.

A spin on this solution is to offer compensation to the European Union by lowering U.S. tariffs.[254] Decreasing tariffs might appease the European Union for a time, and it might also benefit U.S.

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246. *WTO Ruling on Export Sales Complicates Trade, Tax Issues*, *supra* note 50.
247. *See id.*
248. Carmichael, *supra* note 159, at 205.
249. *See infra* Part V.
250. *See supra* note 149 and accompanying text.
251. Carmichael, *supra* note 159, at 206.
252. *Accord* Carmichael, *supra* note 159, at 206.
253. *See, e.g.*, *Extraterritorial Income Regieme, Exclusion of Foreign Income: Hearing Before the House Subcomm. on Select Revenue Measures*, 107th Cong. (2002), *available at* http://waysandmeans.house.gov/srm/107cong/5-9-02/107-77final.htm (testimony of Eric M. Engen, Resident Scholar, American Enterprise Institute).
254. Branand, *supra* note 103.

importers.[255] However, the lowered tariffs would harm U.S. producers by forcing them to take a smaller return on their goods.[256] In short, neither version of a tax break relinquishment will solve the problem in a satisfactory way.

4. Challenging EU Tax Systems

Governmental officials have suggested the United States might challenge the European tax systems with which the FSCs were created to compete.[257] By doing this, foreign laws may also be struck down, reducing the competitive disadvantage caused by the loss of the benefit and the potential sanctions authorized by the WTO.[258] The United States has already identified a Belgian tax scheme similar to the FSC Replacement Law that was designed to attract U.S. operations, and such a scheme would be a likely target for challenge.[259]

However, history cautions against such a tit-for-tat battle. In 1976, nations argued bitterly over differing tax schemes in the General Agreement on Tariffs and Trade (GATT), resulting in a stalemate on tax regulation.[260] The United States should not expose itself to a situation in which it must depend on other nations to refrain from challenging its laws.[261] Reactionary challenges would merely waste time in another bitter dispute that will not accrue any benefit or provide any clarity as to what is acceptable internationally with respect to tax codes, and then would merely put the tax code in an even worse state of flux.[262]

Further, the WTO has already held that the European VAT system does meet WTO compliance standards, adding force to the argument that the United States should not waste time challenging European VAT systems.[263] Indeed, while such action may "encourag[e] the sides to reach a compromise solution," it may also

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255. *Id.*

256. *See id.*

257. *America's Taxing Trade Troubles*, *supra* note 2. *See also Bush Administration May Challenge Tax Codes of Other Countries*, BULLETIN'S FRONTRUNNER, Nov. 28, 2001, LEXIS, News Library, Frntrn File.

258. *See* Mann, *supra* note 101.

259. *See* Michael Mann, *Belgian Tax Break Probed*, FIN. TIMES, Apr. 10, 2002, at 8.

260. New, *supra* note 102.

261. *See Impact of Financial and Professional Service Exports on Small Business: Hearing Before the Comm. on Small Business*, *supra* note 140 (discussing the "gentleman's agreement" between the United States and European Union not to challenge each other's tax laws).

262. *See* New, *supra* note 102; *see also* Dan Sabbagh, *US Loses WTO Tax Dispute*, DAILY TELEGRAPH, Jan. 15, 2002, at 32 (quoting Gary Campkin: "There is now real potential for a damaging spiral of claim and counter-claim.").

263. Bhala & Gantz, *supra* note 18, at 54.

"increase tensions between the two sides and weaken the relationship" between the two parties.[264] Given the long history of the battle over taxation systems, the latter outcome appears more likely.[265]

5. Negotiated Settlement

Finally, the United States and the European Union could attempt to reach a mutually beneficial settlement.[266] It is important, however, that such a settlement be more than a mere "gentleman's agreement," similar to the settlement that existed on the issue of FSCs until the European Union challenged the Replacement Law in 1999.[267] If another trade dispute like the dispute over banana and beef import regulations occurred, a gentleman's agreement would potentially deter the U.S. trade representative from bringing legitimate challenges against foreign laws to the WTO.[268] If another EU trade policy warranted challenge, the United States could once again incur the wrath of the European Union and risk challenge of another U.S. policy.[269]

The current state of the negotiations evinces the problems with this option. EU officials wish to use the FSC ruling to gain concessions from the United States on other trade issues.[270] In return for concessions on import regulations on bananas and beef, the European Union would "reduce, delay, or even waive the sanctions . . . and possibly soften its demands for export-tax reform."[271] Trade Representative Zoellick has made veiled threats of his own, hinting that if the European Union proceeds with sanctions against U.S. goods, he will challenge "alleged illegal tax breaks" for European

264. Carmichael, *supra* note 159, at 208.

265. *See* New, *supra* note 102. *See also* Stephen Castle, *Europe Warns of Worldwide Trade War over Steel; Commissioner Accuses America of 'Wild West' Tactics as Leaders Prepare for a Damaging Round of Tit-for-Tat Sanctions*, INDEPENDENT (LONDON), Mar. 7, 2002, at 15 ("Asked whether such a reaction [to the steel tariff decision] from Brussels might spark a damaging round of tit-for-tat trade sanctions, Lamy replied, 'That danger exists.'").

266. Anderson, *supra* note 11.

267. *Impact of Financial and Professional Service Exports on Small Business: Hearing Before the Comm. on Small Business*, *supra* note 140.

268. *Id.*

269. *Id.* To put it slightly differently, the proposition that "we won't challenge you if you don't challenge us" will not merely apply to the subsidy issue at hand. Instead, it will extend further to prevent U.S. challenges on issues that may be of the utmost importance, such as health standards. *See id.*

270. Richard Tomlinson, *With Friends Like These. . .*, FORTUNE INT'L, Feb. 4, 2002, at 20.

271. *Id.*

corporations.[272] These statements amply illustrate the fundamental problem with attempting negotiations on the FSC issue. Such an arrangement invites another stalemate on trade taxes or other issues until one party brings another legitimate claim, at which point the challenged party will bring a claim on this issue to punish the other party.

The possibility of further aggression is highlighted by the dispute over the recent U.S. decision to impose tariffs on European steel.[273] Europe and Asia have already filed complaints with the WTO asking for lower tariffs to compensate for losses of revenue.[274] Further, the European Union hinted that while it had previously agreed to give the United States time to change the FSC Replacement Law, with the steel decision "that position may no longer be sustainable."[275] Put another way, the European Union may decide to impose sanctions, despite its previous pledge to delay in doing so, in retaliation for the tariffs on steel, that the European Union feels are blatantly protectionist.[276] Though European Trade Commissioner Pascal Lamy later stated that the European Union will not link the steel dispute to the FSC dispute,[277] the United States should not take a chance that it will become involved in another decades-long war whereby it reaches another gentleman's agreement and then finds itself in the same position in another twenty years. This new twist further demonstrates the need for a stand-alone solution—one that does not depend on the good faith of the European Union.

Further, because there is no deadline for imposing the sanctions,[278] the European Union can back out of the deal and decide to impose the authorized sanctions against the United States if it grows weary of the arrangement that was secured in negotiation. While it may be in the interests of the United States and Europe to settle the dispute at the bargaining table,[279] it is unlikely that either trade representative would be willing to make substantial concessions

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272. *Id.*

273. *See, e.g.*, Castle, *supra* note 265.

274. Dan Shope, *Opposition to Steel Tariffs Rises from International Trade Partners; The European Union, China and Japan Strike Back against President Bush's Levies*, MORNING CALL (Allentown, Pa.), Mar. 16, 2002, at A36. All told, the two disputes could be worth about $6 billion combined. Robert McLeod and Blair Pethel, *EU Readies $6 Bln in U.S. Tariffs in Steel, Tax Feuds*, BLOOMBERG NEWS, Mar. 15, 2002, LEXIS, News Library, Allbbn File.

275. Castle, *supra* note 265.

276. *Id.* (statement of Nick Clegg, trade spokesman for the Liberal group in the European Parliament).

277. *EU to Ask US for Trade Compensation of Same Value as EU Steel Exports*, AFX NEWS, Mar. 6, 2002, LEXIS, News Library, Afxnl File. "If I made a link, that would be escalation." *EU/U.S.: Lamy and Bush Play Down Trade Spats*, EUR. REP., May 25, 2002, 2002 WL 13766061 (quoting Lamy).

278. *See supra* note 2 and accompanying text.

279. *See* O'Leary, *supra* note 38, at 169.

regarding taxation and sacrifice sovereignty for settlement.[280] Given these considerations, "negotiations in the Doha Round should be a supplement, not a substitute, for Congressional action."[281]

Further, the European Union has plainly indicated that it does not want to negotiate the FSC Replacement Law issue with the full membership of the WTO at the next set of trade talks.[282] Additionally, the incoming director-general of the WTO, Supachai Panitchpakdi of Thailand, also believes that the dispute should not be involved in the new round of talks launched in Doha.[283] Settlement is a desirable solution, but not one that is truly viable given what is at stake for both the United States and the European Union—especially since "there is little appetite in Washington for further compromise" or negotiation.[284]

VII. CONCLUSION

Given all the aforementioned considerations, it is imperative that the solution to the FSC issue be one that can stand alone, with or without cooperation from the European Union.[285] With this in mind, negotiation—suggested by some to be the best solution[286]—should not be seen as, and is not, a panacea. After the long, drawn-out battle with the European Union, the United States cannot afford to depend on the generosity or mercy of its economic adversary. Rather, it must formulate a solution that first and foremost meets the needs of its corporations, and that secondly makes a good faith effort to meet its obligations to the WTO.

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280. *See* New, *supra* note 102 (stating the proposition that sovereignty over taxation systems is a key issue in the WTO appeal).

281. *WTO's Extraterritorial Income Decision*, *supra* note 197 (testimony of Gary Hufbauer).

282. *Lamy Says EU Will Use All Tools to 'Leverage' US Compliance in WTO Tax Dispute*, AFX NEWS, Jan. 25, 2002, LEXIS, News Library, Afxnl File.

283. *WTO's Supachai Says US, EU Should Resolve Tax Row Outside of New Round*, AFX NEWS, Feb. 5, 2002, LEXIS, News Library, Afxnl File.

284. Charlotte Denny, *Dollars 4bn US Subsidies Incur WTO's Wrath*, GUARDIAN, Jan. 14, 2002, at 22. *See also* Barry James, *U.S. and EU Seek to Cool Trade Fires After Ruling*, INT'L HERALD TRIB., Jan. 16. 2002, at 1; *but see US to Cooperate with EU after WTO Tax Ruling*, AGENCE FRANCE PRESSE, Jan. 14, 2002, 2002 WL 2316578 (stating that the United States is willing to cooperate with the European Union). Despite this willingness, too much is at stake for the United States to risk excessively giving up ground in the spirit of international cooperation. *See, e.g.*, *America's Taxing Trade Troubles*, *supra* note 2 (reporting that the European Union could impose sanctions of up to $4 billion).

285. *See* New, *supra* note 102.

286. *See* O'Leary, *supra* note 38, at 169.

While an overhaul of the tax code may be appealing to some,[287] the European Union will not wait forever for compliance. Given the large agenda that Congress takes on each year, tax reform may fall by the wayside, provoking the European Union to follow through on its threat to impose sanctions on the United States. Further, it would be wise to move on to other issues of concern to the trade community, rather than challenging other tax regimes in what could lead to an even longer, more bitter battle that will benefit no one. Given the two failed attempts to save the FSC Replacement Law,[288] rewriting the legislation is a futile endeavor that could very likely lead to the U.S. Trade Representative being forced to re-defend the system before the WTO Panel.

Given these concerns, the best option for the United States is to attempt to implement an excise tax rebate, similar to the current model, for foreign income. First, because of its similarity to the VAT system used in EU countries, an excise tax rebate would be compliant with WTO standards. Further, although such a plan would be an intrusion on the sovereignty of the United States, it would not be so egregious as the violation of sovereignty that would occur if the United States adopted an entirely different taxation plan—that is, exchanging its worldwide system for a territorial system.[289] Finally, the excise tax exemption is a current feature of the U.S. taxation system.[290] Unlike the FSC plan, this option would not be seen as a departure from the current taxation scheme[291]

A key problem with any legislative package is time lag. Some lawmakers believe that passing a new Replacement Law could take more than six months.[292] The European Union wants to be assured that the United States is taking its obligation to cure the problem seriously.[293] Despite the inevitably long length of time it will take to push a bill through Congress, the European Union will likely grant the United States the benefit of the doubt if Congress appears to be making a serious attempt to comply with the WTO ruling, and would therefore wait before retaliating.[294]

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287. *See A Subsidy by Any Other Name*, *supra* note 12.

288. *See generally infra* Part III.

289. *See supra* note 294 and accompanying text.

290. *See supra* note 209 and accompanying text.

291. *See supra* notes 38-42 and accompanying text.

292. *Thomas Says Remedy for Foreign Sales Corporations Could Take over Six Months*, *supra* note 157.

293. *Id. See also Zoellick, Rockefeller Butt Heads over Trade Negotiations*, *supra* note 168 (reporting Zoellick's assertion that he would have more bargaining power with the European Union if it "appeared Congress was willing to at least consider [tax] reform").

294. *See Role of the Extraterritorial Income Exclusion Act in the International Competitiveness of U.S. Companies: Hearing Before the Senate Comm. on Finance*, *supra* note 203 (indicating that the European Union is not eager to retaliate against the United States on the FSC issue). *See also* Carter Dougherty, *Lawmakers Struggle*

Another problem specific to the excise tax exemption plan is that it is a sacrifice of U.S. sovereign power to choose its own taxation system. Indeed, since there is no functional economic difference between the U.S. Replacement Law and the European plan, it seems that the WTO decision creates a double standard by which the WTO inexplicably shows preference for one of two economically indistinguishable tax plans.[295] The battle over such a plan will very obviously depend on the vote in the U.S. Senate, which appears much less likely than the House of Representatives to accept such an intrusion on sovereignty.[296]

In the final analysis, however, it would be much better to have a legislative solution created by the United States, as opposed to a solution essentially crafted by the WTO or, worse yet, by the European Union. Indeed, negotiation could further intrude on U.S. sovereignty by forcing the U.S. trade representative to accept a tax system that fundamentally alters the current tax plan in the United States. Further, the United States must feel free to bring its own claims before the WTO, making negotiation less attractive at this time. With an excise tax exemption similar to the one proposed in this Note, the United States will maintain its sovereignty by retaining its worldwide taxation system while adopting an export tax plan that both complies with the WTO standards and conforms with its basic taxation model.

As Trade Representative Zoellick noted, "we're now in a world where they retaliate, we compensate . . . or we change the law."[297] The European Union recognizes that such a process will take time, but it will not wait forever.[298] While none of the proposed plans are ideal for the United States,[299] the excise tax plan has the most trade benefits with the fewest procedural and substantive problems.

An EU trade official has said that with the WTO ruling, the European Union has been "given a gun . . . then they [the WTO] decide how many bullets [we] have. Then, it's up to [the European

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to Fix Export-Tax Flaw, WASH. TIMES, Feb. 7, 2002, at C9 (paraphrasing Zoellick's call to Congress to "demonstrate progress in changing the law" to avoid retaliation by the European Union).

295. *See Ongoing Trade Negotiation: Hearing Before the Senate Comm. on Finance*, *supra* note 173.

296. *Thomas Says Remedy For Foreign Sales Corporations Could Take Over*, *supra* note 157. House Ways and Means Chairman Bill Thomas speaks in terms of how long the legislation might take. *Id.* Indeed, Chairman Thomas is a proponent of "major changes in the U.S. tax laws." Dougherty, *supra* note 294. Senate Finance Chairman Max Baucus, however, opines, "I don't think [a legislative solution is] going to happen." *Id.*

297. Dougherty, *supra* note 294 (ellipses in original).

298. Hess Hess, *Bush Developing New Bill to Resolve EU, ETO Tax Dispute*, CHEM. NEWS & INTELLIGENCE, Jan. 29, 2002, LEXIS, News Library, CNI File.

299. *See* Carmichael, *supra* note 159, at 209.

Union] to decide whether to pull the trigger, and what size bullets [to] use. But [we are] completely free as to whether to use the gun or not."[300] In plotting a future course of action, the United States must be prepared for the European Union to use that gun against the United States and U.S. corporations. If sanctions are imposed, the effect on the U.S. economy will be catastrophic. Indeed, it could have nuclear proportions that cannot fully be comprehended at this stage. The United States must be prepared to defend against this most dire consequence. Now, trade officials and lawmakers must ensure that U.S. interests are well-defended against any weapon that the European Union chooses to use. Changing the way that corporations are taxed on their exports is an important preparatory step.

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300. Allen Nacheman, *EU Awaits WTO Word on "Bullets" for Trade Sanctions Against U.S.*, AGENCE FRANCE PRESSE, Jan. 15, 2002, 2002 WL 2317372. Another official preferred to talk in terms of "flowers, not bullets." *Id.* Most, however, see the EU threat of sanctions as a weapon. *See* James, *supra* note 284, (characterizing the victory as giving the European Union "a big stick to beat the United States with"). Indeed, Commissioner Lamy himself stated, "[I]f anyone out there wants to gamble on compliance on the basis that they don't think retaliation is a likely outcome, all I can say is that that would be very dangerous indeed. I don't think I need say any more than that, at this stage." Pascal Lamy, Remarks by European Commissioner for Trade Pascal Lamy at the Woodrow Wilson International Center for Scholars (Jan. 25, 2002), *available at* http://wwics.si.edu/NEWS/speeches/lamy.htm.

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