2001

The WTO Ruling on Foreign Sales Corporations: Costliest Battle Yet in an Escalating Trade War between the United States and the European Union

Hunter R. Clark
Amy Bogran
Hayley Hanson

Follow this and additional works at: https://scholarship.law.umn.edu/mjil

Part of the Law Commons

Recommended Citation
https://scholarship.law.umn.edu/mjil/3

This Article is brought to you for free and open access by the University of Minnesota Law School. It has been accepted for inclusion in Minnesota Journal of International Law collection by an authorized administrator of the Scholarship Repository. For more information, please contact lenz009@umn.edu.
The WTO Ruling on Foreign Sales Corporations: Costliest Battle Yet in an Escalating Trade War Between the United States and the European Union?

Hunter R. Clark, Amy Bogran & Hayley Hanson

I. THE COSTLIEST BATTLE YET IN AN ESCALATING TRADE WAR?

With exports worth roughly $960 billion during 1999, the United States finished the millennium as the world's largest exporter of goods and services. This may have been in part because of U.S. tax laws that encouraged export industries. Until recently, under the U.S. Internal Revenue Service Tax Code ("I.R.C."), Foreign Sales Corporations ("FSCs") could use special administrative pricing methods that exempted fifteen percent to thirty percent of their export profits from taxation by the United States. Approximately 7,000 American companies, and some twenty European firms, formed FSCs to take advantage of these and other tax incentives. These companies


2. For a discussion of how these administrative pricing methods operated, see William Lee Andrews, III, No Bull's Eye for "Targeted" International Tax Rules, 18 VA. TAX REV. 781, 817-22 (1999). An exhaustive examination of the complex and myriad tax rules that applied to FSCs is beyond the scope of this article.


included American corporate giants that are household names, such as Boeing, General Electric, Mars, Nike, and Proctor & Gamble. However, it appears that European opposition may finally bring an end to the FSC regime that has by the United States Treasury’s estimate saved U.S. corporations upwards of four billion dollars a year in taxes.

According to the European Union ("EU"), those tax savings came at the expense of European businesses. The EU claims that FSC rules put European businesses at a competitive disadvantage by allowing U.S. exporters to profit from "shell firms set up as off-shore paper subsidiaries" in tax havens such as Barbados, Guam, and the Virgin Islands. European dismay over the tax breaks dates back at least a quarter-century. In 1972, for example, the European Community ("EC") charged in a complaint under the General Agreement on Tariffs and Trade ("GATT") that U.S. tax laws permitting exporters to defer taxes on a portion of their export earnings violated GATT prohibitions on export subsidies. The legislation that created FSCs was "enacted as part of the bilateral settlement in 1981 of [the] GATT complaint filed by the EC against a predecessor U.S. tax provision."

More recently, the EU has sought redress through the World Trade Organization ("WTO"). The Europeans have followed procedures required by the WTO's Dispute Settlement Understanding ("DSU") to charge that the tax relief given to FSCs violates global trading rules. For example, the EU complained that I.R.C. provisions that allowed FSCs to use special formulas to calculate transfer pricing, or which permitted FSCs to choose among a group of advantageous

Hoechst, Elf-Aquitane and Rhone-Poulenc are some of the European corporations that had created FSCs to save on U.S. taxes. See Mid-air Collision, ECONOMIST, March 7, 1998, at 76.


6. See Winestock, supra note 5.


8. See Winestock, supra note 5; see also Glenn Hess, US Shrugs Off EU Threat to Start FSC Tax-Related Trade Sanctions, CHEMICAL MKT. REP., Nov. 20, 2000, 2000 WL 24156581; Meller, supra note 5.


10. Magnus, et al., supra note 1, at 507.

11. Time Extended for Filing FSC Grouping Redeterminations, supra note 3.
pricing formulas, constituted an illegal subsidy. On October 8, 1999, a WTO dispute panel handed the EU a victory, ruling that FSC tax breaks do indeed constitute illegal subsidies. The panel’s decision called for the United States to repeal or modify the I.R.C. provisions at issue by October 1, 2000. On February 24, 2000, the United States lost its appeal of that panel ruling.

Whether the United States will comply with the WTO decision, and how it will do so, remains to be seen. American negotiators and their counterparts from the EU met in September 2000 and agreed to extend for a month the October 1, 2000 deadline for U.S. compliance. The negotiated deadline lapsed, however, when American legislation aimed at remedying the dispute “became entangled in an election-year squabble in Congress between Republicans and Democrats . . .”

After the November 2000 presidential election, however, Congress passed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (“FSC Repeal Act”). When he signed the bill into law in November 2000, President Clinton explained, “[t]his legislation is necessary to address a World Trade Organization Appellate Body finding that the Foreign Sales Corporation (FSC) provisions of U.S. tax law violated the WTO Agreement on Subsidies and Countervailing Measures, and the Agreement on Agriculture.” He concluded, “We believe that this legislation specifically addresses the concerns raised by the WTO Appellate Body and will be found to be WTO-compliant.”

The Europeans disagreed with the President’s assessment.


13. See WTO Panel Report, supra note 12, para. 7.130


20. Id.
European Trade Commissioner Pascal Lamy went so far as to call the new law "even worse" than the old one.\textsuperscript{21} As its name suggests, the FSC Repeal Act repealed the I.R.C.'s FSC provisions in their entirety, and changed the way in which the United States taxes income generated outside the United States.\textsuperscript{22} Nonetheless, the bill's intended impact may be overstated. According to \textit{The Wall Street Journal}, the legislation "rewrites the legal basis for the [FSC] program and eliminates the need to set up an offshore company. But it maintains roughly the same level of benefits for the same companies, even increasing them for arms exporters that previously only qualified for a partial benefit."\textsuperscript{23}

At about the same time that Clinton signed the FSC Repeal Act, the EU asked the WTO to approve approximately four billion dollars in retaliatory trade sanctions against the United States.\textsuperscript{24} The Europeans subsequently published a list of the American goods against which the penalty tariffs would be targeted, including "46 general categories of products ranging from live animals to spacecraft."\textsuperscript{25} The four billion dollar claim is by far the largest in the WTO's brief history, although it is lower than the twenty-six billion dollar claim that some American officials expected.\textsuperscript{26} The four billion dollar figure is also in line with what the U.S. Treasury estimated to be the annual dollar value of the FSC tax benefit to American corporations.\textsuperscript{27}

Under an agreement with the EU, the WTO will not authorize the sanctions proposed by the EU until a WTO panel of experts has reviewed the new FSC legislation to determine whether it in fact conforms to WTO rules.\textsuperscript{28} Lamy has explained, "[a]lthough we believe the FSC replacement legislation does not solve the problem, the EU will leave it to the WTO to rule on this question. That's what the WTO is there for."\textsuperscript{29} The WTO's
decision in the matter is not expected until summer 2001.30

Until it is resolved, the FSC controversy threatens to turn into the costliest battle yet in the escalating trade war between the EU and the United States. The two sides already have been severely at odds over bananas31 and beef.32 In April 1999, the United States imposed $191 million in penalty duties on European goods in retaliation for EU banana import practices that are alleged to be discriminatory.33 In July of the same year, the United States imposed an additional $116 million in retaliatory tariffs in response to an EU ban on hormone-treated beef.34 But the total amount involved in those controversies pales by comparison with the $4 billion in sanctions looming in the FSC dispute.35

Before leaving office, former President Clinton expressed American intentions to "continue working with the EU to manage this difference of views responsibly and to avoid any harm to our strong bilateral relationship."36 A month later, however, he warned of an even bigger battle with the EU that the United States was prepared to take up over European support for Airbus Industrie's $12 billion super jumbo-jet project, the A3XX.37 Prodded by Boeing, the behemoth American aerodynamics firm, the United States has complained that EU

30. See id.
33. See Winestock, supra note 5.
34. See id.
36. See Statement on Signing the FSC Repeal Act, supra note 19.
support for Airbus violates global trade rules. Clinton administration officials said in December 2000 that the United States had not ruled out filing a WTO complaint against the EU over the A3XX.

In the meantime, the EU's agreement to await WTO review of the FSC Repeal Act before imposing retaliatory sanctions has bought time for the United States to reconsider the FSC Repeal Act. As a practical matter, however, it may be hard for the United States to change a tax policy that powerful corporate interests favor for obvious reasons. Yet, there are sound bases for abandoning that policy which, as will be discussed, may do more harm than good to American companies by in effect offering them tax breaks that tend to undermine their overall competitiveness.

Part II of this Article examines the factors that led to the EU's claim that the FSC provisions violate WTO rules, and explores the history of FSCs, which were a replacement for the Domestic International Sales Corporations ("DISCs") legislation enacted during the 1970s to promote American exports. Part III explains the WTO dispute settlement process. Contrary to what some Americans think, the WTO has no authority to force the U.S. to change its tax code. In fact, the purpose of the WTO dispute settlement process is to encourage communication between aggrieved parties. The system is set up to foster an adjudicative, or rule-based approach, that encourages the parties involved in a dispute to reach a settlement while advancing the overall goal of freer trade.

Part IV of the article discusses the October 8, 1999 panel ruling of the WTO. The goal is to simplify an 800-page ruling made by a panel of international trade experts by identifying exactly what it was about FSCs that the WTO found to violate global trade agreements. Furthermore, the analysis will explain the WTO panel's interpretation of a "subsidy," and how the U.S. tax code enabled FSCs to avoid paying taxes on

38. See id.
39. See id.
41. One of the arguments against the WTO is that membership results in the loss of sovereignty. This is simply not true because disputes are only between the parties. So, in the end, it is up to the European Union to either negotiate a settlement with the United States or retaliate in some way.
42. See WTO Panel Report, supra note 12.
FOREIGN SALES CORPORATIONS

portions of exported goods.

Part V describes the U.S. position regarding the tax treatment of FSCs. The United States contends that the EU is allowing its members to give the same tax treatment to its companies that the United States gave to FSCs.43

Finally, Parts VI and VII discuss the U.S. appeal and the viable options for resolving the dispute. There are several alternatives that the United States will have to weigh and consider. If the United States does not change its tax code in a way that comports with the WTO's ruling, despite sound reasons for doing so, the United States could face some four billion dollars in retaliatory trade sanctions by the EU. Moreover, for reasons that will be discussed, the unresolved dispute threatens the viability, and perhaps even the continued existence, of the WTO.

II. THE BACKGROUND AND HISTORY OF FOREIGN SALES CORPORATIONS

A. DOMESTIC INTERNATIONAL SALES CORPORATIONS ("DISCs")

Tax code incentives to promote export trade have existed for nearly three decades. In 1971, Congress created the Domestic International Sales Corporation (DISC) to increase exports and reduce an increasing trade deficit.44 DISCs were used to defer taxes, at the corporate level, on income generated from export sales. The income was not taxed until it was distributed to the shareholders of the DISC as dividends, at which time it was taxed at the shareholder level. As long as the DISC did not pay dividends, reinvested the income in qualified export assets, and did not run afoul of any of the other income rules; it could indefinitely defer payment of its corporate taxes.45 In effect, DISCs were allowed a tax exemption from federal corporate taxes for one-half of the profits accumulated from exports.46 The tax exemptions allowed DISCs to achieve the two main goals of the DISC legislation: (1) enabling exporters to lower their prices

44. Corona, supra note 40, at 363.
45. S. REP. NO. 437 (1971); see also Corona, supra note 40, at 364.
due to tax reduction; and (2) increasing profitability of exporting with the intention of drawing a greater number of American firms into the exportation field.\footnote{47} To qualify as a DISC under the tax code, an American corporation had to comply with the following criteria:

(1) ninety-five percent or more of its gross receipts must be “qualified export receipts.” These are specifically detailed in the Code and Regulations but, generally, are sales or income from sales by a DISC to a purchaser “for direct use, consumption or disposition outside the United States;” (2) ninety-five percent of the assets must be “qualified export assets;” (3) the firm has only one class of stock and at least $2,500 in capital; (4) the corporation has elected to be a DISC.\footnote{48}

DISCs were very popular in the 1970s and 1980s. In fact, in 1972 there were approximately 1,100 DISCs in the United States. By 1981, that number soared to an estimated 13,800.\footnote{49} Experts estimate that in 1979 alone the DISC legislation increased exports by $2.5 billion.\footnote{50}

Shortly after the enactment of the DISC legislation, European GATT members challenged it as creating an illegal deferral of direct taxes.\footnote{51} They argued that the DISC system resulted in an unlimited deferral of direct taxes, with no rule preventing the deferral being maintained indefinitely.\footnote{52} In 1976, a GATT panel concluded the DISC scheme was not a tax deferral scheme, but instead constituted an illegal subsidy.\footnote{53} To avoid retaliation, the U.S. Congress in 1982 announced its commitment to formulate legislation addressing the concerns of other GATT countries.\footnote{54}

\section*{B. HOW FSCS WORKED}

The Congressional solution to the DISC dispute was the Foreign Sales Act of 1983, which established FSCs.\footnote{55} Similar to the DISC regime, the FSC scheme provided for tax incentives to promote export sales. However, unlike DISCs, an FSC had to be

\begin{footnotes}
\item[48] Corona, supra note 40, at 365-66.
\item[49] Id. at 366.
\item[50] Id.
\item[51] Id. at 367.
\item[52] Id.
\item[53] Id. at 368.
\item[54] Id.
\end{footnotes}
a foreign corporation. To qualify as a foreign corporation, the FSC had to meet complex foreign management and economic process tests, unless it qualified as a small FSC, one with export sales of less than five million dollars.\textsuperscript{56} Under the applicable tax rules, the FSC could meet the foreign management requirement by satisfying three elements:

(1) it holds all board of directors meetings outside the United States; (2) it maintains its principal bank account outside the United States at all times during the taxable year; and (3) it disburses all dividends, legal and accounting fees, and salaries of officers and directors from a bank account outside the United States.\textsuperscript{57}

In most cases, an FSC was owned by a corporation and achieved at least a fifteen percent exemption of its export income on its American taxes.\textsuperscript{58} The FSC's income could be repatriated to the corporate parent in the United States tax-free by issuing a dividend to the parent. The FSC did not pay U.S. taxes on the amount of the dividend, but did have to pay taxes in the foreign jurisdiction where it was established. The parent corporation did not have to pay taxes on the dividend received.\textsuperscript{59} The parent corporation could either retain the dividends or issue dividends to its shareholders. If the shareholders of the parent were another corporation, the income could be distributed tax-free indefinitely or, until it was either distributed to an individual or a corporation, the recipients had to pay taxes on the amount received due to other sections of the I.R.C. After a careful examination of the history of DISCs and FSCs, it appeared history was repeating itself.

III. WTO DISPUTE RESOLUTION

A. PROMOTING CONSULTATION, ENCOURAGING DIALOGUE, AND FACILITATING RESOLUTION

The WTO dispute resolution process was designed as a simple way for countries to resolve problems in a manner beneficial to all parties involved in the dispute. It is important to have a basic understanding of the dispute resolution process

\textsuperscript{56} Export Clip & Sace Service Tax Relief for Exporters: DISC vs. FSC, J. Com., June 9, 1989, at 1A.
\textsuperscript{57} Corona, supra note 40, at 369.
\textsuperscript{58} Id. at 370.
to fully comprehend the events taking place in the dispute between the EU and the United States over FSCs. The bases of the WTO system are to promote consultation, encourage dialogue, and facilitate resolution. It is imperative to recognize that the WTO dispute resolution process is not primarily concerned with compensating the victim, but rather with stopping the violation before the liberalized trade regime is undermined or comes unraveled.

One of the best functions of the WTO dispute resolution process is that it prescribes specific steps, each with its own time limit, that a country must follow to initiate the process.\textsuperscript{60} First, a complaining country states the complaint and requests consultations.\textsuperscript{61} The purpose of this step is to get the parties together to begin discussing the actual problem. The consultation proceedings are limited to sixty days.\textsuperscript{62}

Second, if the parties do not reach a resolution, they may either request a panel of experts in the field to hear the arguments and decide the issues,\textsuperscript{63} or they can try mediation to settle the disagreement.\textsuperscript{64} Once the panel has made a determination about the case, its decision is automatically adopted unless the losing party files notice of its intent to appeal the decision or the WTO membership by consensus decides not to adopt it.\textsuperscript{65} This means that the decision is, in effect, binding automatically because the winning party has the ability to block a decision by the WTO membership rejecting the panel's ruling.\textsuperscript{66}

If the losing party decides to appeal the decision, it presents its case to the Appellate Body.\textsuperscript{67} If the Appellate Body rules against the losing party, that party has three options: 1) subject itself to immediate retaliation; 2) choose to negotiate compensation owed to the winning party;\textsuperscript{68} or 3) change the regulations or laws that caused the dispute in the first place. The parties are at all times free to work out a mutually

\textsuperscript{60} See BARRY E. CARTER & PHILLIP R. TRIMBLE, INTERNATIONAL LAW 435-36 (3d ed. 1999).
\textsuperscript{61} Id. at 435.
\textsuperscript{63} Id.
\textsuperscript{64} Id. at 340.
\textsuperscript{65} CARTER & TRIMBLE, supra note 60, at 436.
\textsuperscript{66} See Id.
\textsuperscript{67} See JACKSON ET AL., supra note 62, at 340-42. For a more detailed description of the Appellate Body, see CARTER & TRIMBLE, supra note 60, at 436-37
\textsuperscript{68} CARTER & TRIMBLE, supra note 60, at 435.
acceptable plan. As stated earlier, punishment is not the goal of the WTO dispute resolution process. Its focus is the continued promotion of freer trade. Allowing parties to craft their own solution promotes voluntary compliance with the solution and the system. This in turn strengthens and legitimizes the WTO.

In fact, studies show that nations have come to rely on the WTO dispute resolution process more in recent years, which can be taken as a testament to the efficacy and credibility of that process. As one commentator has observed,

The proliferation of substantive WTO rules, coupled with a quasi-automatic, rule-based dispute settlement system, [has] led to an exponentially growing number of disputes being brought to the WTO, including the politically sensitive ones. This obvious success of the DSU is testimony to the high expectations that were raised by the new system.

B. "ANTILEGALISTIC" VERSUS "LEGALISTIC" DISPUTE SETTLEMENT

Nevertheless, at least one scholar has questioned whether the DSU provides the appropriate forum for the resolution of tax disputes. The problem, according to Cornell University law professor Robert A. Green, is that "legalistic dispute settlement systems," such as the DSU, "impose costs on cooperative international regimes" like the WTO. These costs include the possibility that the use of confrontational and adversarial processes will undermine ongoing relationships; that political forces will lead to conspicuous cases of noncompliance that will threaten the

69. According to one leading publicist, the WTO dispute settlement process over its first several years was "enormously successful" and had "a more successful launch than many people anticipated." John H. Jackson, Symposium on the First Three Years of the WTO Dispute Settlement System: Introduction and Overview, 32 INT'L LAW. 613, 613 (1998). Moreover, as the last millennium drew to a close, "[u]se of the WTO dispute settlement system remained at a high level...." John R. Magnus, C. Christopher Parlin & Navin Joneja, International Legal Developments in Review: 1999 Business Regulation, 34 Int'l Law. 501, 505 (2000). During 1999, for example, "[t]wenty-eight new requests for consultations were filed, along with twenty-one requests for the establishment of panels." Id. In addition, the "WTO Dispute Settlement Body (DSB) was very active both in adopting panel and Appellate reports and in reviewing members' implementation of WTO decisions." Id. See also Joost Pauwelyn, Enforcement and Countermeasures in the WTO: Rules Are Rules—Toward a More Collective Approach, 94 AM. J. INT'L. L. 335, 338, 338 n.24 (2000) (estimating that "almost 150 distinct matters have been brought under the DSU in the WTO's five-year history.").

70. Pauwelyn, supra note 69, at 338.

71. Green, supra note 9, at 139.
prestige of the regime; that the decisions of politically unaccountable
dispute settlement bodies will be perceived as lacking in legitimacy;
and that legalistic systems will fail to be sufficiently flexible to
accommodate treaty rules to changing circumstances and issues.\textsuperscript{72}

The United States evidently subscribed to this view at one
point in time. During the Uruguay Round of GATT negotiations,
the United States opposed the “inclusion of income tax measures
under the GATT.”\textsuperscript{73} These measures “would have made a wide
range of ‘tax policies’ and ‘domestic tax laws’ subject to
mandatory legalistic GATT dispute settlement procedures.”\textsuperscript{74}
Presumably, U.S. opposition was based on unwillingness to have
American tax laws and policies subjected to what Green calls
“quasi-judicial international review.”\textsuperscript{75} Other countries
suspected that the United States “wanted to carve income tax
measures out of the national treatment obligation because it
intended to pursue discriminatory tax policies, particularly in
the area of transfer pricing regulation.”\textsuperscript{76} In the end, the United
States relented, and the national treatment obligation was
applied to income taxes, albeit in a very limited way, by
language included not in GATT, but in the General Agreement
on Trade in Services (“GATS”).\textsuperscript{77}

Green’s article suggests that international tax disputes are
best resolved using “antilegalistic” methodology, as provided in
most tax treaties, despite that methodology’s limitations. He
explains:

\begin{quote}
[T]he dispute settlement procedures in tax treaties are antilegalistic.
Under most tax treaties, consultations and negotiations between
designated tax officials of the two treaty countries are the exclusive
means for resolving disputes. There is no assurance that this process
actually will produce a resolution. Even if it does, the resolution is
likely to represent a political compromise rather than a reasoned
decision based on the application of legal rules. Moreover, the
mechanism is intended to deal with relatively fact-specific disputes. It
is highly improbable that it will succeed in resolving a dispute
involving a policy-level conflict between a domestic tax law and a
treaty obligation. The resolution of such disputes likely will require
resort to diplomatic channels.\textsuperscript{78}
\end{quote}

In other words, a tax dispute like the one between the EU and
the United States over FSCs might better lend itself to a settlement negotiated by tax experts or, in the alternative, to a diplomatic solution, rather than to a legalistic resolution under the rubric of the WTO.

IV. THE WTO PANEL RULING ON FOREIGN SALES CORPORATIONS

On November 18, 1997, the EU requested consultations with the United States to discuss why the FSC regime allegedly violated the Agreement on Subsidies and Countervailing Measures ("SCM"). On March 4, 1998, the Europeans requested that the consultations be extended, and included in its argument that FSCs also violated the GATT Agreement on Agriculture, specifically Article 19. On three occasions, the representatives of the two sides consulted, but no settlement or resolution was achieved, On July 1, 1998, a WTO panel convened to hear and decide the EU dispute with the United States.

The WTO Dispute Settlement Body assembled a panel of three experts to hear the case. Meetings were held in February and March of 1999 to hear the EU's complaint and the American response. The crux of the complaint was the EU's contention that the U.S. tax code provided tax treatments for FSCs that are in effect impermissible export subsidies. The EU alleged that the tax incentives were illegal because the United States was forgoing the tax normally due for the benefit of FSCs. This allegedly violated Articles 3.1(a) and 3.1(b) of the SCM Agreement. Article 1.1 of the SCM defines the term "subsidy" and reads as follows:

For the purpose of this Agreement, a subsidy shall be deemed to exist if: (a)(i) there is a financial contribution by a government or any other public body within the territory of a member, i.e. where: (ii)

---

79. WTO Panel Report, supra note 12, para. 1.1. The complaint alleged that the United States violated Articles 3, 3.1(a), 3.1(b), and 8. See id. para. 3.2.
80. See id. para. 1.2.
81. See id. para. 1.3
82. See id.
83. See id. para. 1.6. Barbados, Canada, and Japan all reserved the right to participate in the proceeding as third parties. Id. para. 1.5. The panel heard their complaints at the February 10, 1999 meeting. See id. para. 1.7.
84. See id. para. 1.7
85. See id. para. 4.106.
86. See id.
government revenue that is otherwise due is foregone or not collected and (b) a benefit is thereby conferred.\textsuperscript{87}

The WTO panel agreed with the EU's assessment.\textsuperscript{88} The panel concluded the United States was forgoing revenue and thereby conferring a benefit on FSCs.\textsuperscript{89}

FSCs achieved tax benefits in a complicated way. The FSC received a commission payment from the parent corporation for work done on the parent's behalf.\textsuperscript{90} The paid commission was tax deductible to the parent, and was received by the FSC as its profit or income.\textsuperscript{91} At the FSC level, a portion of the profit received would then be exempt from U.S. tax as foreign source income.\textsuperscript{92} The commission was then calculated using the special FSC administrative pricing rules, or the traditional arm's length pricing rules.\textsuperscript{93}

Administrative pricing rules were used to determine the portion of profit or income allocable to a subsidiary after the total profit or income had been determined at the parent level. The rules approximated the payment received by the subsidiary to what the product or service performed by the subsidiary would have cost the parent on the open market. The United States had adopted the arm's length pricing principle in I.R.C. § 482.\textsuperscript{94} However, I.R.C. § 925 allowed an FSC to choose between two fixed formula methods of taxation, instead of applying § 482, which would have taxed the FSC as the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("Guidelines") advocated.\textsuperscript{95} I.R.C. § 925 stated that the transfer price "shall be in the amount which allows the FSC to derive taxable income 'which does not exceed the greatest of the amount resulting from each of the administrative pricing rules in section 482'"\textsuperscript{96}

The EU asked the panel to determine whether the U.S. administrative pricing rules complied with WTO standards.\textsuperscript{97}

\textsuperscript{87} Id. para. 4.268
\textsuperscript{88} See id. para. 7.102.
\textsuperscript{89} See id. para. 7.103.
\textsuperscript{90} See David H. Culpepper & Steven C. Wells, Tax Incentives for Small Exporters, 176 J. ACCOUNTANCY 39, 42 (October 1993).
\textsuperscript{91} See id.
\textsuperscript{92} See id.
\textsuperscript{93} See id.; I.R.C. § 925 (2000).
\textsuperscript{94} See WTO Panel Report, supra note 12, para. 4.229
\textsuperscript{95} See id. para. 4.231.
\textsuperscript{96} See id. para. 4.232.
\textsuperscript{97} See id. para. 4.234.
Administrative pricing rules were originally part of the DISC legislation of the 1970s, and the panel viewed these rules as a major departure from the basic principles used by other developed countries to deal with the problem of transfer pricing between related companies. The Guidelines were the result of an international consensus concerning how to deal with these issues. The EU claimed that I.R.C. § 935 violated the Guidelines. The Guidelines stated "the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in the transactions between independent enterprises." They also provided, "In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable." The Guidelines did state, however, that alternative methods of arriving at arm's length pricing may be used.

Taxpayers achieved the greatest tax advantage by using I.R.C. § 482 as a cap instead of a floor as the Guidelines intended. FSCs could even make the choice after the exact amount of the commission was determined and before the FSC had filed its taxes. FSCs could also choose to apply one pricing method to all of the transactions for the year, or apply a different one to each transaction.

The transfer pricing rules were important because immediately upon receipt of the commission, the FSC distributed the same amount back to the parent as a dividend. Thus the parent received the dividend tax-free. The panel concluded, however, that the administrative pricing rules did not have to be ruled upon since the panel had previously determined that the United States violated the SCM Agreement.

Another factor influencing the panel's determination was the geographic location of the majority of FSCs. The panel found that 74 percent of all FSCs were located in U.S. possessions. The U.S. Virgin Islands alone was home to sixty-six percent of

\[98. \text{See id. para. 4.224}\]
\[99. \text{See id. para. 4.223}\]
\[100. \text{Id. para. 4.226 (citing OECD Guidelines § 1.6 (1994)).}\]
\[101. \text{Id. (citing OECD Guidelines § 1.15 (1994)).}\]
\[102. \text{See WTO Panel Report, supra note 12, para. 4.227.}\]
\[103. \text{See Culpepper & Wells, supra note 90, at 43.}\]
\[104. \text{See WTO Panel Report, supra note 12, para. 7.127.}\]
\[105. \text{See id. para. 4.199.}\]
all FSCs. The panel found that these percentages illustrated that FSCs lacked truly "foreign" character. For example, I.R.C. § 932 stated that the Virgin Islands would be treated as part of the United States for "purposes of determining U.S. tax liability of U.S. citizens or residents with Virgin Islands income." Yet FSCs residing in the Virgin Islands were treated as foreign corporations, a factor which the panel took into consideration in determining whether the tax exemptions were, in effect, subsidies provided by the United States.

Some background in the U.S. corporate tax system is beneficial to understand the EU's complaint and the panel's ruling. The U.S. tax system is a direct tax system. It taxes all American citizens and entities, regardless of their location, on the basis of worldwide income. As corporate shareholders owned most FSCs, this review will focus on the tax affects for corporations.

Normally, an American corporation must pay taxes to the United States on all income, unless it can find a provision in the tax code that provides some relief from taxation. To alleviate the potential double taxation faced by American corporations with foreign operations, the I.R.C. contains provisions to ameliorate double taxation, as do the tax codes of most countries. The I.R.C. allows corporations a credit, in the amount of the foreign taxes paid or accrued on foreign source income, to the extent the foreign source income is taxable in the United States. This

106. Id.
108. Another very important location for FSCs is Barbados. See id. para. 4.205. In 1984, when Congress passed the FSC legislation, the Barbados Parliament enacted the Foreign Sales Act of 1984, which basically exempted FSCs from paying taxes on income arising from their operations, except for income on investments made in Barbados. Id. To be a valid FSC in Barbados, a company must engage in foreign trade transactions and be licensed as an FSC in Barbados. Id. The fee to obtain a license is $1,000, and for a small FSC it is $500. Id.

It is interesting to note that Barbados was one of three countries that reserved the right to be a third party in the dispute. It is ironic that a country clearly benefiting from the existence of FSCs may also be involved in the demise of U.S. FSC legislation. Barbados's reasons for being part of the dispute are difficult to understand.

110. A credit is more valuable than a deduction because a credit is a dollar for dollar reduction in the amount of taxable income whereas a deduction is merely a reduction in the amount of tax owed.

111. The term foreign source income is a term of art referring to income not effectively connected to a trade or business in the United States, and so it is not taxable in the U.S. In essence, it is income that is exempt from U.S. taxes because a
FOREIGN SALES CORPORATIONS

income is classed as exempt foreign source income.

Achieving the classification of exempt foreign source income is difficult and complex because U.S. taxpayers have an incentive to classify as much of their income as possible as foreign source if the foreign location has a lower tax rate than the United States.\textsuperscript{112} To encourage exports, Congress classified income earned by FSCs as exempt foreign source income, creating the fiction that it was not effectively connected to a U.S. trade or business. FSC income received this classification even though one of the requirements to be an FSC was that it be established in a U.S. possession, or a foreign country that had an exchange-of-information treaty with the United States. The panel found that the American parent companies were using FSCs to avoid paying taxes on approximately thirty percent of their foreign trade income.\textsuperscript{113}

An American corporation operating in a foreign country through an entity established in that country could defer payment of U.S. tax on the foreign source income, until the income was repatriated to the United States. Repatriation normally occurred through dividends paid by the foreign corporation to the American shareholders. The corporate shareholders received a deduction for the entire amount of dividend received as long as the funds remained in the corporate solution.\textsuperscript{114}

To avoid potential abuse by moving to tax havens or permanently deferring repatriation, the I.R.C. contains anti-abuse sections. The main anti-abuse section in the I.R.C. classifies certain foreign corporations as controlled foreign corporations ("CFCs").\textsuperscript{115} Shareholders of CFCs are required to include in their gross income their pro rata portion of the CFC's undistributed income, thus removing any benefit from deferring distributions perpetually. To encourage exports, in I.R.C §§ 951(e) and 954(d) and (e), Congress specifically exempted FSCs from the anti-abuse provisions.\textsuperscript{116} If these exclusions had not have existed, FSCs would have been required to pay taxes on all their income.\textsuperscript{117}

\begin{thebibliography}{9}
\bibitem{112} Treas. Reg. § 1.921-3T (2000).
\bibitem{113} See WTO Panel Report, \textit{supra} note 12, para 4.212.
\bibitem{114} I.R.C. § 243 (2000).
\bibitem{115} I.R.C. §§ 951-962 (2000).
\bibitem{116} See I.R.C. §§ 951(e), 954(d), (e) (2000).
\bibitem{117} See WTO Panel Report, \textit{supra} note 12, para. 4.221.
\end{thebibliography}
When the aforementioned tax features of the American system were combined with the FSC rules, the effect was substantial. The FSC received income from the parent tax-free. The parent deducted the payment made to the FSC. The income of the FSC was not taxable to the parent as a CFC. The parent immediately received back the entire amount paid to the FSC tax free in the form of a dividend from the subsidiary. The most favorable pricing rules could be used to calculate the amount of the payment to the subsidiary.

This combination of the preferential treatment regarding foreign source income, the ability to choose among preferential administrative pricing rules only available to FSCs, and other favorable I.R.C. provisions, was ruled to be an impermissible export subsidy. The combination resulted in the deferral of billions of dollars in taxes that FSCs did not have to pay. Thus, the EU argued, FSCs could offer lower prices on goods because of the lack of taxation by the United States.

The WTO panel decision embraced the EU's assessment of what a subsidy is under the SCM Agreement. Enormous tax incentives for some 6,000 companies were the result of the combination of the above-referenced sections of the I.R.C. and the FSC administrative pricing rules. The panel found the specific sections of the I.R.C. it reviewed to provide an impermissible tax subsidy to FSCs, in violation of the SCM Agreement. The panel noted that the number of FSCs had dramatically increased and the amount of foreign trade income had doubled in the last decade.

V. HOW THE UNITED STATES AND THE EUROPEAN UNION TAX EXPORT INDUSTRIES: A DISTINCTION WITHOUT A DIFFERENCE?

The United States and the EU have completely different perspectives regarding the FSC dispute. Initially, the United States argued that there were a number of procedural defects in the way the dispute came before the WTO panel. On appeal,
the United States dropped the procedural issues and focused on a few specific arguments which best defined its position and rationale.

First, the United States argued that a 1981 decision by the GATT General Council should be relevant to the case at hand. In that 1981 decision, the General Council set forth three general rules that were to be followed to support tax exemptions for export-related income. The rules were that: (1) the foreign economic process did not have to be taxed by the exporting country; (2) arm's length pricing should be observed; and (3) measures could be adopted to avoid double taxation of foreign income. The United States claimed it complied with these rules, asserting that a footnote added to the SCM Agreement stated that full or partial exemption of direct taxes specifically related to exports constitutes a legal tax exemption.

More specifically, footnote fifty-nine of the SCM Agreement set forth the rules for allocating income to economic activities outside the territory of the taxing authority. Footnote fifty-nine states that "income from foreign economic processes may be exempted from direct taxes." The United States argued for an interpretation consistent with footnote fifty-nine since arm's length pricing would be irrelevant if footnote fifty-nine was not applicable. In other words, the United States reasoned that unless the full meaning of footnote fifty-nine was considered, the entire concept of administrative pricing would be superfluous and have no meaning.

The panel rejected the U.S. interpretation, stating that the 1981 decision no longer applied because of the 1994 amendments to the GATT. The panel agreed, however, to review the decision for its historical definition of a subsidy.

126. Id. at 1658
127. Id.
128. Id.
129. Id.
130. Id.
131. Id.
132. See WTO Panel Report, supra note 12, paras. 7.52-7.85. The 1994 amendments to the GATT included the SCM and Agricultural Agreement. See Pruzin, supra note 125. The 1994 amendments led to the European Union's initiation of the WTO dispute proceeding. See id. The impact of the 1994 amendments continues to be felt. The 1994 amendments reopened the subsidy issue for the European Union. The European Union thought of bringing the case after the amendments were passed, and the Clinton administration made an intense effort to
Ultimately, the panel decided against the U.S. interpretation of footnote fifty-nine, but it also refused to rule on the administrative pricing complaints asserted by the EU.\(^\text{133}\)

The second argument advanced by the United States concerned the differences in tax systems. The United States argued that the EU offers tax exemptions or incentives for exports and foreign corporations that have an effect that is similar to that achieved by the FSC regime.\(^\text{134}\) The panel refused, however, to comment on whether the EU was offering the same tax exemptions that the panel determined were in fact subsidies.\(^\text{135}\) Nevertheless, it is worth comparing the FSC provisions of the I.R.C. with the effect of the EU's value added tax ("VAT").

The United States has a system of direct taxation of income earned during a twelve month period.\(^\text{136}\) As discussed, both individuals and corporations, subject to U.S. taxation, must pay based on their worldwide income. However, foreign corporations are exempt from direct taxation on income earned outside the United States.\(^\text{137}\) This means that normally, an American corporation must pay taxes to the United States on all income, unless it can find an I.R.C. provision that provides some relief from taxation.

The FSC legislation was created to encourage exports by relieving some of the income tax paid by exporting corporations. It should be noted that due to the particulars of the division of powers between the state and federal governments in the United States, the federal government could only relieve some of the direct tax burden that it places on income tax. For example, the federal government cannot relieve any of the indirect tax burden created by sales taxes levied by the individual states. This is important because international tax conventions allow the forgiveness of indirect taxes without considering such behavior an impermissible tax subsidy.\(^\text{138}\) If the federal government did not relieve some of the total tax burden, American exporters would be burdened by both federal and state income taxes, as well as state sales taxes. Unlike the VAT

\(^\text{133}\) See WTO Panel Report, supra note 12 paras. 7.92, 7.127.
\(^\text{134}\) See generally Pruzin, supra note 125.
\(^\text{135}\) See WTO Panel Report, supra note 12, para. 7.127.
\(^\text{136}\) See Knight & Knight, supra note 109, at 257-58.
\(^\text{137}\) See WTO Panel Report, supra note 12, para. 4.315.
in the EU, these sales taxes are not refundable.

Unlike the United States, most other countries, including the European states, use systems of indirect taxation based on taxing consumption, instead of income, when consumption occurs and in the country where the final transaction takes place. An example of this form of taxation is the VAT. The VAT is usually applied to all goods and services, with exceptions normally made for items considered basic or essential, such as food, children's clothes, and rent. The most prominent form of VAT is the credit-method VAT. Under this type of VAT, the tax is imposed on the sale price of each item from the production process through the last sale to the ultimate consumer. Double taxation of the same value added is avoided by allowing each subsequent seller a credit in the amount of the previously paid VAT.

The EU applies VAT on a destination principle. This means that the applicable VAT rate is that of the country where the good is sold. There have been attempts aimed at making the VAT amount more uniform throughout the EU, but each country retains the right to set the VAT amount and its own exemptions. The result of the destination principle is that imports, but not exports, are subject to VAT.

There are two types of VAT exemptions: true exemptions and zero-rate exemptions. True exemptions apply to articles on which VAT is not charged. Sellers of items that are true exemptions do not receive a credit for the previously paid VAT. Zero-rate exemptions apply to articles on which VAT is collected and allows the seller a credit for the VAT the seller previously paid. Exports are zero-rate products, which means that EU exporters receive a credit for the VAT previously paid.

Exports are justified as zero rate products based on the destination principle that goods should be taxed where they are

---

139. See Knight & Knight, supra note 109, 257-58.
141. See id.
142. See id. at 30.
143. See id.
144. See id.
145. See id. at 27.
146. See id.
147. See id.
148. See id.
149. See id.
This makes exports from the EU potentially cheaper because the exporter receives back the VAT the exporter paid. Consequently, the exporter can reduce his sale price. Since the EU does not tax foreign income of its corporations, many of which have established subsidiaries in tax havens, and the European corporations are allowed a VAT credit, EU exports are relieved from virtually all tax burdens, whereas American exports are not.

Finally, international treaties specifically allow countries to forego the collection of indirect taxes and do not consider such behavior to be an impermissible subsidy. Nevertheless, subsidization is exactly what is occurring. On average, the VAT rate in the EU is approximately twenty percent. EU exports total approximately $800 billion dollars per year, making the zero-rating of exports worth approximately $160 billion dollars annually. The United States has argued that its FSC legislation was enacted to counter the zero rate VAT on EU exports, and to counter the effect of U.S. taxation. The United States could attempt to make a case at the WTO, but it is not likely to go far given the specific exemption in various applicable conventions.

VI. THE U.S. APPEAL TO THE WTO DISPUTE SETTLEMENT BODY

Obviously, the WTO panel ruling disappointed the United States. But some American tax specialists believe the decision could be a blessing in disguise if it now enables the United States to follow its own taxation policies instead of trying to cater to demands imposed by agreements like the SCM and Agricultural Agreements. The decision also raises questions as to whether the United States will continue to be part of the WTO. As Senator Philip M. Crane (R-Illinois) has observed, "There is going to be a lot of critical examination [of the WTO in

151. See Trade – A Tussle Over Tax, ECONOMIST, Mar. 4, 2000, at 75.
152. See id. at 76.
153. See id.
156. Id.
He asked rhetorically, "Is it worth it to be a member of the WTO? What is in it for us?"

On October 28, 1999, the United States notified the WTO's Dispute Settlement Body ("DSB") of its intention to appeal the panel ruling. Then, on November 2, 1999, the United States appeared to do an about face, informing the Chairman of the Appellate Body and the Chairman of the DSB of its decision to withdraw its appeal. Meanwhile, the United States and the EU tried to negotiate a settlement. The settlement talks did not last long, however. On November 26, 1999, the United States once again notified the DSB of its intention to appeal the panel ruling.

It is interesting to note that both the United States and the EU submitted appellant and appellee briefs on certain issues raised in the panel decision. Also, Canada and Japan each filed third party participant submissions.

The arguments made to the Appellate Body by both sides were essentially the same as those made by each party since the beginning of the dispute. First, the United States argued that the panel decision should be reversed because the panel had not read footnote fifty-nine of the SCM Agreement in conjunction with other provisions of the Agreement dealing with subsidies. The Appellate Body concluded, though with some reservation, that the panel ruled correctly that Section 3.1 of the SCM Agreement established a "but for" test to determine if a tax exemption was a subsidy. The Appellate Body found that this test does not require that footnote fifty-nine be read in conjunction with other parts of the SCM Agreement in order to

158. Id. For a discussion of the relative benefits and disadvantages of WTO membership from the American perspective, see Stephan, supra note 12.
160. See id.
161. See id. The dispute settlement process is analogous to the U.S. court's amicus system. See CARTER & TRIMBLE, supra note 60, at 435. Therefore, another country that wants to have some say in the outcome of the decision is able to file briefs in support of that country's position on the issue. See id. It is important to remember that the WTO dispute settlement process is designed to settle only the dispute between the primary parties. Thus, if a third party wanted to bring a claim at a later time, that country would be able to do so. See id. at 434.
163. See id. Notably Barbados did not file a submission with the Appellate Review Body. See id.
164. See id. para. 42.
165. See id. para. 91.
determine whether a tax exemption is in effect a subsidy.\textsuperscript{166} Therefore, the Appellate Body upheld the panel's finding that the United States was providing FSCs with illegal subsidies in violation of sections 3.1 of the SCM Agreement.\textsuperscript{167}

Second, the Appellate Body addressed the American assertion that the 1981 GATT decision had relevance to the present dispute. Again, the United States contended that the 1981 decision by the GATT panel confirmed that the definition of subsidy must be read in conjunction with footnote fifty-nine.\textsuperscript{168} The Appellate Body concluded that this was the same argument the United States used to claim that it did not violate specific sections of the SCM Agreement.\textsuperscript{169} The Appellate Body reaffirmed that footnote fifty-nine did not have to be followed in order to determine the definition of subsidy. It went on to declare that the 1981 GATT ruling was relevant to the FSC dispute only to the extent that it provided background information in regard to the history of the dispute.\textsuperscript{170}

Next, the Appellate Body considered American arguments concerning the Agricultural Agreement, and concluded that the United States was in violation of the Agricultural Agreement in regard to subsidies.\textsuperscript{171} The panel ruled that the American tax exemptions given to FSCs violated Articles 3.3 and 9.1(d) of the Agricultural Agreement, stating, "Because FSC subsidies reduce an exporter's income tax liability with respect to marketing activities, they effectively reduce the cost of marketing agricultural products."\textsuperscript{172} The panel added, "In any event, a subsidy such as the FSC, which is provided to offset costs of marketing agricultural products, should be considered to reduce the costs of marketing agricultural products."\textsuperscript{173}

Nevertheless, the Appellate Body disagreed with the earlier panel's finding that the United States had violated the Agricultural Agreement. The subsidies that are permissible under the Agricultural Agreement are listed in Article 9.1.\textsuperscript{174} The Appellate Body ruled, however, that Article 9.1 could be

\textsuperscript{166. See id. paras. 93-94.}
\textsuperscript{167. See id. para. 121.}
\textsuperscript{168. See id. para. 104.}
\textsuperscript{169. See id. para. 103.}
\textsuperscript{170. See id. para. 120.}
\textsuperscript{171. See id. paras. 122-54.}
\textsuperscript{172. WTO Panel Report, supra note 12, para. 7.155.}
\textsuperscript{173. WTO Panel Report, supra note 12, para. 7.156.}
\textsuperscript{174. See Report of the Appellate Body, supra note 15 para. 130.
read together with Article 3.3 of the agreement. Doing so, the Appellate Body concluded that the United States was in compliance with both articles of the Agreement. Thus the Appellate Body ruled that the panel was not correct in its interpretation that the United States was providing subsidies to its agricultural industries through FSCs. This was, however, the only section of the panel’s decision that was reversed by the Appellate Body.

Lastly, the Appellate Body considered the panel’s decision not to rule on the EU’s claim that the United States had violated administrative pricing procedures. It refrained, however, from ruling on the matter, explaining instead that “having found that the exemptions provided by the FSC scheme are an export subsidy inconsistent with the SCM Agreement, it would be neither necessary nor appropriate for us to make a further and independent ruling on the consistency of that scheme’s administrative pricing rules.” In other words, because the ruling of the panel regarding the SCM Agreement had been upheld, the Appellate Body found no reason to examine the administrative pricing issue.

In conclusion, the Appellate Body recommended that the DSB ask the United States to bring its FSC regime into compliance with its ruling. The Appellate Body emphasized in its concluding paragraphs that its decision applies only to the parties in the case, and that by making its decision the WTO was not advocating one tax system over another. Finally, the Appellate Body reminded each member of the WTO that by becoming a WTO member each had imposed on itself an obligation to comply with all the terms of the agreements into which each might enter.

VII. OPTIONS FOR THE UNITED STATES

As discussed, the EU has asked the WTO to approve some four billion dollars in trade sanctions against a wide range of

175. See id. para. 132.
176. See id.
177. See id.
178. See id. paras. 172-73.
179. WTO Panel Report, supra note 12, para. 7.127.
181. See id. para. 178.
182. See id. para. 179.
183. See id. para. 180.
American goods as compensation for tax breaks granted to FSCs. The Europeans have agreed to postpone implementation of the penalty tariffs until a WTO panel rules on the legality of the FSC Repeal Act that went into effect in November 2000. That panel decision is expected sometime during the summer of 2001. In the meantime, American policymakers have time to ponder a number of options.

One option simply is to let the proposed sanctions take effect if the WTO panel finds the FSC Repeal Act unacceptable. The sanctions imposed by the Europeans would then in effect become the price that the United States is willing to pay to maintain an FSC regime that the WTO considers illegal under global trading rules. The message sent by the United States would be that it is prepared for, or even welcomes, a tit-for-tat escalation of what appears to be a widening trade war. The United States could, as discussed, respond to European sanctions in the FSC matter by pursuing its own array of claims against the EU at the WTO. For example, as the former Clinton administration threatened, this could include challenging the subsidies that European governments have provided Airbus to facilitate development of the A3XX super jumbo jet.

Another option for the United States would be to try to achieve a negotiated settlement with the EU. Such an agreement could take the form of a narrow accord, limited in its scope to the taxation of American exports, or it could come as a comprehensive settlement across the entire spectrum of trade disagreements that divide the EU and the United States. Among other things, the two sides are currently at odds over banana imports, hormone treated beef restrictions, subsidies to Airbus, farm subsidies, and data processing. A negotiated settlement might possibly approximate the damages owed to each party and contain broad legislative aims that each side should implement regarding future behavior.

Such a settlement would not be easy to achieve. Some commentators say that the EU is still bitter about American attempts to pry open certain of its markets—hence the discord

184. See supra notes 24-27 and accompanying text.
185. See supra notes 28-29 and accompanying text.
186. See supra note 30 and accompanying text.
187. See supra notes 36-39 and accompanying text.
188. See Archer Urges Cautious Approach on Foreign Sales Corps., CONGRESS DAILY/AM, Mar. 9, 2000.
over bananas, beef, aerodynamics, agricultural subsidies, and data processing. Some think the EU wants to savor its victory in the FSC matter, and regard the Europeans as generally unwilling to admit defeat in the panel decisions they have lost. As Gerry O'Driscoll, an economist who is reportedly close to President George W. Bush, has put it, "The Europeans keep tweaking America's nose on trade and, in the end, they're going to get a reaction."

The truth is that uncooperative attitudes on both sides raise the specter of the fundamental obstacle to achieving a negotiated settlement—namely, traditional notions of sovereignty. Each side wants to keep its sovereign prerogatives intact; each guards its sovereignty jealously. Viewed from this perspective, many of the current disputes between the United States and the EU can be traced to domestic issues even though they reverberate in the foreign trade arena. For example, the European ban on hormone treated beef is justified as a domestic health issue. In much the same way, FSC tax regulations are justified as domestic tax policy aimed merely at avoiding double taxation. For a settlement to succeed, each party will have to accept some degree of outside "interference" in even its most sensitive "internal" affairs and domestic policy-making. Furthermore, for a negotiated settlement to work, both Europeans and Americans will have to be content in the long run with all that this implies because, no matter what settlement is achieved, compliance with it will still be voluntary.

Another thorny issue that would have to be negotiated is how to address the problems that stem from the different tax systems in the EU and the United States. The two sides would probably have to come to some accord that would allow the American federal government a means of providing a benefit similar to that provided under the credit method VAT in the EU. One solution might be a system whereby some of the state

190. See Kahn, supra note 189.
193. See, e.g., Statement on Signing the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, supra note 19, wherein former President Clinton alluded to a certain measure of sovereign affront when he emphasized, "Never before has the United States had to enact legislation—and particularly legislation in the sensitive field of taxation policy—in order to implement the findings of a dispute settlement panel of the World Trade Organization (WTO)."
sales taxes paid by American exporters during the production process be credited against foreign source income taxed by the United States. Another might be to use currently existing I.R.C. sections that apply to all corporations, not only to FSCs, to achieve the same or similar results as those achieved under the old FSC provisions. 194

Given all that is at stake, a serious effort that overcomes these and other obstacles to a negotiated agreement seems to be the most desirable result. The current controversy over FSCs threatens much more than to become the costliest battle yet in the European-American trade war—it threatens the continued existence of the WTO. 195 As discussed, legalistic systems of dispute resolution can lack the flexibility required to address changing circumstances or, by extension of the same logic, political imperatives. 196 When this happens, conspicuous cases of noncompliance can result. These conspicuous cases of noncompliance can undermine ongoing relationships, such as the one between the EU and the United States, as well as the efficacy of the WTO system itself. Such a result as an outgrowth of the FSC matter looms all the more ominously, coming as it does at a time when some American scholars and policy-makers are questioning the value and even the legality of continued membership in the WTO. 197

It would be both undesirable and ironic if the current controversy over FSCs were to in fact damage permanently in some way the relationship between the EU and the United States, or the viability of the WTO as an institution. It would be undesirable because the dispute has escalated at a time when the WTO otherwise appears to be gaining acceptance worldwide

---

194. See Bruce, supra note 191.
195. See, e.g., O'Clery, supra note 192:

Trade is the main issue of contention between the US and the EU. The old "beef and bananas" rows inherited by the Bush team, and some more recent ones over US protectionist measures, are so serious that if mishandled, economists say they could precipitate a breakdown in global trade diplomacy.

See id.
196. See supra notes 71-72 and accompanying text.
197. See, e.g., Stephan, supra note 12; Julian G. Ku, The Delegation of Federal Power to International Organizations: New Problems With Old Solutions, 85 MINN. L. REV. 71 (2000) (questioning whether power and authority held by the United States government has been impermissibly transferred to international organizations like the WTO in violation of the Constitution or American sovereignty.).
as a reliable and efficacious arbiter of trade disputes.\textsuperscript{198} It would be ironic because scrapping, or at least modifying, the FSC scheme in a way that might address WTO concerns as to its legality could well be in the best long-term interest of the United States anyway.

Consider, for example, the view that tax breaks for domestic export industries—in effect, export subsidies—tend to do more harm than good by reducing those industries' global competitiveness. Their overall impact on domestic and foreign economies is detrimental, as well. \textit{The Economist} has observed:

Several justifications are offered for the existence of export subsidies. They include the need to nurse infant industries; to compensate for protectionism abroad; to overcome capital market problems faced by firms in small countries; to promote employment; and to keep trade balances positive. The subsidies can range from simple ad valorem payments to companies based on the size of their export sales, to complex systems of tax credits, loans, insurance policies and price supports.

These policies, however, bring with them some huge problems. Any company coddled by a subsidy has less incentive to improve its bottom line (and hence make the subsidy unnecessary). Tax revenues used for subsidies are distributed in a way that makes them regressive. And artificially low prices supported by subsidies may force more efficient producers in importing countries out of business. Besides harming domestic producers in poor importing countries, export subsidies may crowd out competing trade from other countries whose governments are too poor to retaliate.\textsuperscript{199}

Be that as it may, American lawmakers are unlikely to eliminate or significantly reduce the offending FSC tax breaks any time soon—not if recent history is any indication. As discussed, the EU regards the most recent United States attempt to address the issue legislatively, as embodied in the FSC Repeal Act, as more offensive than the law that came before.\textsuperscript{200}

There are, however, hopeful signs that reconciliation remains possible. Some European policymakers see the coming to power of a new presidential administration in Washington as an opportunity for the United States and the EU to make a fresh start.\textsuperscript{201} For example, Stephen Byers, the United

\textsuperscript{198} See supra notes 69-70 and accompanying text.
\textsuperscript{200} See supra notes 21-23 and accompanying text.
\textsuperscript{201} See, e.g., \textit{EU, U.S. Should Work Towards Ending Trade Disputes—UK's Byers}, \textit{AFX NEWS}, Feb. 6, 2001, available at Westlaw ALLNEWSPLUS Database,
Kingdom’s Trade and Industry Secretary, declared in a February 2001 address that the “time is right” for the two sides to “put the disputes of the past behind them.” Byers went on to state, “Over recent years, there have been too many trade disputes between Europe and the United States. Whether over bananas, foreign sales corporations, hushkits in aeroplanes or hormone treated beef, we cannot allow the benefits of trade to be lost.” Byers called for steps to be taken to resolve trade disputes “soon after they arise, and not just send every issue away to be dealt with [by] the WTO’s dispute settlement mechanisms.” Whether the voices of reconciliation can prevail remains to be seen.

VIII. CONCLUSION

As this article has shown, the current dispute between the United States and the EU over American tax breaks for FSCs threatens to become the costliest battle yet in an escalating trade war between the United States and Europe. Moreover, the ongoing controversy poses a threat to the viability of the WTO dispute settlement process, and perhaps even to the continued existence of the WTO. This possibility is all the more unfortunate, coming as it does at a time when the WTO dispute settlement process otherwise seems to be acquiring broader acceptance worldwide.

On October 8, 1999, a WTO panel found that the FSC regime, from which thousands of American corporations have benefited, violates global trading rules by extending illegal subsidies to American export industries. The WTO Appellate Body subsequently upheld that ruling. In response, Congress passed, and former President Clinton in November 2000 signed into law, the FSC Repeal Act, which purported to make the American FSC regime WTO-compliant.

Representatives of the EU complained, however, that the new law was even more offensive than its predecessor, and asked the WTO to approve four billion dollars in penalty tariffs against an array of American goods ranging from live animals to space craft. The WTO will not authorize the sanctions proposed by the Europeans until a WTO panel of experts has reviewed

2/06/01 AFX 13:10:00.
202. Id.
203. Id.
204. Id.
the new FSC legislation to determine whether it in fact conforms to WTO rules. In the meantime, American policy makers have time to consider a number of options before the proposed sanctions take effect.

Among these options would be for the United States to negotiate a settlement with the EU across the broad spectrum of American-European trade disagreements, or at least one that is specific to FSCs and the taxation of domestic export industries. For the reasons discussed, such an agreement might prove difficult to achieve. Given all that is at stake, however, a negotiated settlement would appear to be the most desirable result.