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MOTIVES AND CONSEQUENCES OF THE FSC DISPUTE: RECENT SALVO IN A LONG STANDING TRADE WAR OR FASHIONING A BARGAINING CHIP?

“The money is the key to this thing.”¹

“Show me the money.”²

I. INTRODUCTION

On August 20, 2001 the World Trade Organization (“WTO”) formally ruled against the United States for its system of granting special tax breaks to U.S. exporters in violation of international law.³ The WTO decision stemmed from the European Union’s (“EU”) legal challenge of these tax breaks as export subsidies, which are prohibited under the General Agreement on Tariffs and Trade (“GATT”).⁴ Ironically, the U.S. fashioned the latest disputed tax provision, the Extraterritorial Income Exclusion Act (“ETIA”),⁵ in order to comply with a WTO decision from two years earlier that declared the Foreign Sales Corporation (“FSC”) provision of the tax code illegal under GATT as a prohibited export subsidy.⁶

Answering the call by both U.S. exporters and politicians, the United States Trade Representative (“USTR”) announced on

1. CARL BERNSTEIN & BOB WOODWARD, *ALL THE PRESIDENT’S MEN* 34 (1974).

2. JERRY MAGUIRE (TriStar Pictures 1996).

3. *EU May Hit U.S. with \$4 Billion in Penalties — Commission Calls Tax Credits Illegal*, WASH. POST, Aug. 21, 2001, at E1 [hereinafter WASH. POST].

4. See United States – Tax Treatment for “Foreign Sales Corporations,” Report of the Panel, WT/DS108/R (Oct. 8, 1999), at <http://www.wto.org> [hereinafter WTO Panel Report]; Text of the General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. 5, 55 U.N.T.S. 194 [hereinafter GATT].

5. Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000) (codified as amended in scattered sections of the I.R.C.).

6. See WTO Panel Report, *supra* note 4. For the Act creating the FSC, see Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 985-1103 (1984) (codified as I.R.C. §§ 921 – 927 (1994)).

October 10, 2001, that the U.S. would appeal this latest WTO ruling because it was clear, from the U.S. perspective, that “the decision was in error.”⁷ No doubt the decision to appeal was collaterally calculated to demonstrate a degree of normalcy in U.S. trade affairs in the wake of the September 11, 2001 terrorist attack in New York and Washington, D.C.⁸ Realistically, however, the decision by the Bush Administration to appeal was due in no small part to the immense political pressure mounted directly by a triumvirate of proxy actors — the export industrials acting severally, the export industrials acting collectively through their trade coalitions and the export industrials acting proximately through their members of Congress.⁹ As further evidence of the “seriousness” with which the Bush Administration took this case, the opening arguments for the U.S. appeal were made by Deputy Secretary of the Treasury Kenneth W. Dam.¹⁰

On January 14, 2002, the WTO Appellate Body issued its final ruling against the U.S., holding that the ETIA is an illegal subsidy, thus clearing the way for imposition of sanctions by the EU.¹¹ The import of the final WTO decision cuts across several fronts. First, if the U.S. does not comply with the WTO ruling and repeal the ETIA, the EU may be authorized to issue some \$4 billion in punitive trade sanctions on U.S. goods bound for Europe.¹² These potential sanctions are greater than all

7. Press Release, Office of the United States Trade Representative, U.S. to Appeal WTO Ruling on FSC/ETIA Tax Law (Oct. 10, 2001), available at <http://usinfo.state.gov/wto/01101001.htm> [hereinafter USTR Press Release].

8. See Robert B. Zoellick, Editorial, *Countering Terror with Trade*, WASH. POST, Sept. 20, 2001, at A35.

9. See *U.S. Appeals WTO Ruling on Export Tax Breaks*, AGENCE FRANCE-PRESSE, Oct. 10, 2001, 2001 WL 25034459 (USTR Robert Zoellick commented that many senators and business leaders had urged the government to appeal the latest WTO decision) [hereinafter AGENCE FRANCE-PRESSE].

10. Press Release, Department of the Treasury, Deputy Treasury Secretary to Argue FSC Appeal at WTO (Nov. 5, 2001), available at 2001 WL 1354269.

11. See United States — Tax Treatment for “Foreign Sales Corporations” — Recourse to Article 21.5 of the DSU by the European Communities, Report of the Appellate Body, WT/DS108/AB/RW (Jan. 29, 2002), at <http://www.wto.org> [hereinafter WTO ETIA Appeal Decision]; Edward Alden et al., *International Economy — Ruling Opens New Chapter in US-EU Trade Dispute*, FIN. TIMES (London), Jan. 15, 2002, at 10.

12. See WASH. POST, *supra* note 3.

previous WTO approved sanctions to date combined, and would no doubt prove devastating, not only to the U.S. export market but to the global trade system as well.¹³ Second, the WTO decision, by reaching into the political sanctity of the U.S. tax code, has stoked the fires of those politicians who decry the disingenuousness of the EU vis-à-vis the U.S. with regard to its restrictive trade practices.¹⁴ Finally, the decision is the most recent exchange in the protracted series of trade disputes between the U.S. and the EU.¹⁵ Indeed it could be argued that both European and American corporations are engaged in a proxy trade war through their respective governments — powerful multinationals that compete openly in the global marketplace, but also practice a kind of guerilla warfare in the WTO. Though both the EU and the U.S. have officially tried to downplay the disagreements, preferring to focus on the “common interests in working together to advance the trade agenda worldwide,” there are deep-seeded issues underlying these trade disputes that require comprehensive resolution.¹⁶

Historically, the U.S. government has been responsive to its corporate constituencies in order to furnish them with incentives to expand into new markets as well as ensure a stable, competitive environment in which to conduct commerce.¹⁷ This

13. *America's Taxing Trade Troubles*, J. OF COMM., Aug. 21, 2001, LEXIS, All Sources, News, Newspaper Stories, Combined Papers.

14. Senate Majority Leader Trent Lott promising to take legislative action against the EU and others for failure to adhere to WTO rules stated: “I’m getting really fed up with the way we’re being treated by our trading partners.” Gary Yerkey, *Dinner Plates and French Champagne*, EUROPE (Apr. 2001), at <http://www.eurunion.org/magazine/0104/dinner.htm>. See Robert Goulder & Warren Rojas, *U.S. Senate Finance Committee Approves FSC Repeal Bill*, 21 TAX NOTES INT’L 1384 (2000) (According to Senator Max Baucus, “It’s the EU bureaucrats in Brussels, who were upset about losing WTO disputes [the hormone-treated beef and banana import disputes with the United States], that caused us to be here [repealing the FSC law] today.”).

15. See Christine L. Agnew, *Overpriced Bananas, Bad Meat, or Foreign Sales Corporations: What Is the EU Really Complaining About?*, 21 TAX NOTES INT’L 139 (2000).

16. *Interview: EU Trade Commissioner Pascal Lamy*, EUROPE (Apr. 2001), at <http://www.eurunion.org/magazine/0104/interview.htm> [hereinafter *Interview - Lamy*].

17. See generally Paul Krugman, *Competitiveness: A Dangerous Obsession*, in *THE NEW SHAPE OF WORLD POLITICS* 161 (Council on Foreign Relations ed., 1997).

has translated into the U.S. government being a tireless advocate for and promoter of American goods and services in foreign markets.¹⁸ This also has meant providing appropriate and measured incentives in the tax code in the pursuit of the Holy Grail of tax policy — tax neutrality.¹⁹ While marshalling towards these achievements, the U.S., with the assistance of corporate beneficiaries, devised major tenants of both U.S. trade policy and U.S. international tax policy.²⁰ Notwithstanding this public-private partnership, these benefiting corporations are the likely stumbling blocks towards any progressive tax reform or conciliation with the EU over the ETIA/FSC dispute.²¹

The problem at the heart of the FSC dispute no doubt involves trade. The main domestic legal impediment to its resolution, however, is not to be found in trade policy, but in tax law.²² The U.S. tax code is structurally different than that of most other nations.²³ At issue is the fact that, generally, under the U.S. tax code, export income is taxed whereas under most EU member state's tax schemes, it is not.²⁴ Recognizing that U.S. exporters were at a distinct disadvantage to the Europeans tax-wise, the U.S. devised in law the Domestic International Sales Corporation ("DISC") in order to "equalize American exporters with foreign counterparts exporting from coun-

18. See, e.g., U.S. Department of Commerce, *Foreign Trade Service*, at <http://www.usatrade.gov> (last visited April 15, 2002); United States Trade Representative, at <http://www.ustr.gov> (last visited April 15, 2002).

19. See RICHARD L. DOERNBERG, *INTERNATIONAL TAXATION IN A NUTSHELL* 3 (4th ed. 1999).

20. See, e.g., Jacob Heilbrunn, *The Sanctions Sellout*, *NEW REPUBLIC*, May 25, 1998, at 26; Glenn Kessler & John Lancaster, *Lobbyists Shaping Stimulus Bill; Special Interests Scramble for Tax Breaks, Other Windfalls*, *WASH. POST*, Nov. 11, 2001, at A1, available at 2001 WL 29761716; Karen V. Kole, *The Status of United States International Taxation: Another Fine Mess We've Gotten Ourselves Into*, 9 *NW. J. INT'L L. & BUS.* 49, 51 (1988).

21. See Alden, *supra* note 11.

22. Cf. Gary C. Hufbauer, *Income vs. Consumption Taxation: Domestic and International Reforms*, 26 *BROOK. J. INT'L L.* 1555, 1562 n.20 (2001) ("The origins of the FSC case had nothing to do with tax policy and everything to do with the European search for 'bargaining chips' to trade against EU losses in the *Bananas* and *Beef Hormone* cases, and the prospective expiration of the agricultural 'peace clause' in 2003.").

23. See DOERNBERG, *supra* note 19, at 6-11, 19.

24. See generally PAUL MCDANIEL & HUGH J. AULT, *INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION* 155 (4th ed. 1998).

tries providing indirect tax refunds and exemptions.²⁵ Unfortunately for the U.S., the DISC was challenged by the EU as illegal under international law, thus compelling its change.²⁶ The same result occurred with the tax program that succeeded the DISC, the FSC, and again with its successor, the ETIA.²⁷ These challenges raise the question of how to maintain the current tax code while providing tax incentives for exporters that are WTO compliant.

One option, but with serious revenue consequences for the federal government, is to simply forego all income tax derived from U.S. exports.²⁸ This solution, however, runs afoul of the basic principle of the U.S. tax code, which is the right to tax income wherever it is earned.²⁹ Another option is to simply abandon the FSC/ETIA regime altogether.³⁰ But this is unlikely since the formulation of tax policy and the drafting of tax law is too complicated to do in one session of Congress, let alone at the command of the WTO. Moreover, the government is under enormous pressure by lobbyists seeking to preserve this export benefit.³¹ The U.S. is thus constrained by the structure of its tax system, on the one hand, and by its obligations under international law to reform the tax code, on the other. Thus the question stands, what should the U.S. do?

25. Ronald D. Sernau, Note, *The Foreign Sales Corporation Legislation: A \$10 Billion Boondoggle*, 71 CORNELL L. REV. 1181, 1185, 1190 (1986).

26. See Tax Legislation, Dec. 7-8, 1981, GATT B.I.S.D. (28th Supp.) at 114 (1982).

27. See WTO Panel Report, *supra* note 4; United States — Tax Treatment for “Foreign Sales Corporations” — Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW20 (Aug. 20, 2001), at <http://www.wto.org> [hereinafter WTO Panel Report — ETIA].

28. See, e.g., Ernest R. Larkins, *WTO Appellate Body Rules Against FSCs: The Search for Alternatives Begins*, 11 J. INT’L TAX’N 14, 14-16 (2000) [hereinafter *Search for Alternatives*] (noting that such a plan, which is in effect a conversion of the U.S. tax code from a “worldwide” system to a “territorial” system [discussed at length, *infra* Part II.B.], would raise many serious issues for policy makers to contend with).

29. See U.S. CONST. amend. XVI; MCDANIEL & AULT, *supra* note 24.

30. See *Search for Alternatives*, *supra* note 28, at 14-16.

31. See, e.g., *U.S. Loses Dispute over Trade Taxes*, DESERET NEWS (Salt Lake City), Feb. 24, 2000, at E3 (“Business lobbyists said that if the corporations lost the tax breaks entirely, they would find themselves at a serious disadvantage against European competitors.”) [hereinafter DESERET NEWS]; AGENCE FRANCE-PRESSE, *supra* note 9.

As this Note will suggest, the answer lies in dissecting the underlying motivations of both the EU and the U.S. in their trade policies in general and in the FSC case specifically. Analysis will reveal that, to an extent, the FSC battle is being waged for the benefit of a few large multinational corporations³² in what may be characterized as an elaborate form of corporate welfare. In addition, the EU has recently been motivated to pursue the FSC case in order to counter-balance its own losses before the WTO for restrictive trade practices.³³ U.S. policy, on the other hand, has been arranged into a two-tiered strategy as influenced by its corporate citizenry. The first is to ensure tax relief for U.S. exporters in order to foster foreign trade.³⁴ The second is to pursue a strategy of delay, in order to stave off the inevitable loss of their tax benefit or until an alternate WTO-compliant regime can be devised.³⁵

Finally, since only a few U.S. multinationals directly benefit from the FSC program,³⁶ this Note will challenge the assertion that without FSCs, the U.S. export economy will wither. Moreover, criticism about loss of sovereignty, European disingenuity, and alarmist talk about trade wars are mere smokescreen attempts to pander to special interest groups and distract from dealing with the hard issues.³⁷ There are presently significant

32. Jose Oyola, *Foreign Sales Corporations Beneficiaries: A Profile*, 21 TAX NOTES INT'L 389, 389 (2000).

33. See Hufbauer, *supra* note 22, at 1562.

34. See DESERET NEWS, *supra* note 31.

35. Andrew Osborne, *WTO Backs Europe in Row over Tax Breaks: Brussels Tells US it Must Scrap Scheme or Face £2.7 bn. Sanctions*, GUARDIAN (London), Aug. 21, 2001, at 21.

36. Oyola, *supra* note 32, at 389.

37. For an academic perspective on these issues, see, e.g., Gregory Shaffer, *Symbolic Politics and Normative Spins: The Link Between U.S. Domestic Politics and Trade — Environment Protests, Negotiations, and Disputes*, 31 ENV'TL. L. REP. 11, 174 (2001) ("[Due to] the 2000 election of a Republican administration . . . the WTO will continue to be a target for attacks and a political symbol of the negative aspects of globalization . . . the consequences for the WTO could be stagnation, hesitancy, and calls for curtailing the scope of its authority, from conservative think tanks."); Clyde Summers, *The Battle in Seattle: Free Trade, Labor Rights, and Societal Values*, 22 U. PA. J. INT'L ECON. L. 61, 71 (2001) ("[T]o illustrate [the WTO's] reach into a country's sovereignty, the WTO, acting on a complaint by the European Union, ordered the United States to amend its tax code to close a loophole exploited by U.S. transnational enterprises."); John H. Jackson, *The Uruguay Round Results*

discounts and deferral programs in the tax code that exporters could employ to remain competitive in foreign trade.³⁸ It is the exacting reality of international economics, which keeps these companies engaged in foreign trade, not a tax credit. The proxy trade battles engaged by the U.S. and the EU seem to boil down to the classic struggle of free trade — protectionism vs. market access. The Bush Administration, Congress and the business community will need to consider these factors against the relative benefits of being a member of the WTO when crafting a policy and legal solution to the FSC dispute.

As background, Part II of this Note will discuss the major aspects of the U.S. and EU tax codes — how they contend with international taxation and their attendant structural frictions, which lay at the heart of the FSC dispute. Part II will also briefly focus on the procedural background of the FSC dispute³⁹ and trace the history of the tax credit from the DISC to the ETIA. Part III will analyze the suspected policy motivations of the EU's longtime attack on the FSC as well as U.S. resistance to effectuating fundamental change. Finally in Part IV, this Note will suggest that the time has come to bid the FSC farewell. It will be also be urged that diplomatic negotiations between the U.S. and EU begin in earnest to comprehensively address tax issues in a trade context in hopes of stemming future systemic frictions that yield no true positive benefits.

and National Sovereignty, in THE URUGUAY ROUND AND BEYOND 293 (Jagdish Bhagwati & Mathias Hirsch eds., 1998); Scott McBride, Note, *Dispute Settlement in the WTO: Backbone of the Global Trading System or Delegation of Awesome Power?*, 32 LAW & POL'Y INT'L BUS. 643 (2001); Paul B. Stephan, *American Hegemony and International Law: Sheriff or Prisoner? The United States and the World Trade Organization*, 1 U. CHI. J. INT'L L. 49, 74 (2000) (arguing that despite the fact that the U.S. dominates the post-Cold War international environment, it is nevertheless subject to the strong persuasion of the WTO in how it conducts its affairs in "at least one narrow but important area of international relations — commercial relations across borders").

38. See, e.g., *Search for Alternatives*, *supra* note 28 (suggesting that U.S. multinationals with excess foreign tax credits may be better off without a FSC and small and mid-sized exporters have available the DISC — which charges interest for tax deferrals, thus making them WTO compliant).

39. Technically, the DISC, the FSC, and the ETIA are different statutory tax relief programs with similar objectives, if not effects. For the sake of simplicity, this Note will refer to the EU challenge as the "FSC dispute" generally, unless a more specific reference is necessary.

II. BACKGROUND

A. Structural Differences Between U.S. and EU Tax Schemes

1. National Systems of Taxing Income

There are basically two forms of income tax systems employed by nations: (1) a "worldwide" system; and (2) a territorial system.⁴⁰ The U.S. utilizes a worldwide system — i.e., all income of U.S. residents (including a corporation organized in the U.S.) is taxable regardless of the source of that income, whether earned through domestic or foreign endeavors.⁴¹ By contrast, the Member States of the EU employ a territorial system — i.e., only income earned within the borders of the nation's taxing jurisdiction is subject to tax.⁴² Foreign income, under the territorial system, is either not taxed or is taxed at a significantly lower rate than domestic earnings.⁴³ The choice to adopt either tax system is entirely a national political decision and neither system is advocated nor preferred under international law. Indeed, the WTO Report of the Appellate Body called attention to this premise when it declared that its decision against the U.S. FSC was:

[N]ot a ruling that a Member must choose one kind of tax system over another so as to be consistent with that Member's WTO obligations. In particular this is not a ruling on the relative merits of "worldwide" and "territorial" systems of taxation. A Member of the WTO may choose any kind of tax system it wishes — so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations.⁴⁴

The relative merits of each system are the subject of tax policy, government revenue necessities and other legal and political

40. See JACOB A. FRENKEL ET AL., INTERNATIONAL TAXATION IN AN INTEGRATED WORLD 22-24 (1991); MCDANIEL & AULT, *supra* note 24, at 33.

41. See H.R. REP. NO. 106-845, at 13 (2000), *reprinted in* 2000 U.S.C.C.A.N. 2206, 2210-11; U.S. CONST. amend. XVI.

42. H.R. REP. NO. 106-845, *supra* note 41.

43. *Id.*

44. See Report of the Appellate Body on United States: Tax Treatment for Foreign Sales Corporations, WT/DS108/AB/R (Feb. 24, 2000), at 60, at http://www.wto.org/english/tratop_e/dispu_e.htm [hereinafter WTO Report of the Appellate Body].

considerations that each nation must uniquely address for itself.⁴⁵

2. Principles of International Taxation and the Problem of Double Taxation

Foreign trade gives rise to opportunities to engage in commercial activities that exploit comparative advantages in capital and labor, thus earning its owners vast profits. The governments of those trading partners reserve the right to tax any of this foreign income based on, for example, the nationality of the trading entity (as under the worldwide system) or based on the location of the transaction (as under the territory principle).⁴⁶ In practice, nations typically adopt features of both tax systems (e.g., employing one system for personal income and another system for corporate income).⁴⁷

When there are overlapping claims of taxing authority, coordination difficulties between countries may exist.⁴⁸ Known as “juridical double taxation,” most nations attempt to alleviate it through domestic legislation as well as through bilateral tax treaties.⁴⁹ The issue of tax overlap is acute when dealing with exports since, by their nature, they involve cross-border transactions in at least two separate taxing jurisdictions.⁵⁰ This typical problem is especially complicated where both nations exercising tax jurisdiction employ regimes based on the different income tax theories described above.⁵¹ Comparatively, each system has fundamentally different methods for avoiding the double taxation problem.⁵²

Any instance of double taxation, resulting from a domestic combination of the different tax systems or due to juridical

45. See generally Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOK. J. INT’L L. 1335, 1336-42 (2001).

46. DOERNBERG, *supra* note 19, at 2.

47. FRENKEL, *supra* note 40, at 22.

48. See DOERNBERG, *supra* note 19, at 2.

49. *Id.*

50. See United States — Tax Treatment for “Foreign Sales Corporations” — Recourse to Article 21.05 of the DSU by the European Communities, WT/DS108/RW, at 10, (Nov. 1, 2001), at http://www.ustr.gov/enforcement/2001-11-01_appellantsub.pdf [hereinafter U.S. Appellant Brief — ETIA].

51. See DOERNBERG, *supra* note 19, at 2.

52. See H.R. REP. NO. 106-845, *supra* note 41.

double taxation, is commonly ameliorated through either a *tax credit* or a *tax exemption*.⁵³ These approaches are utilized either unilaterally, by a nation through its domestic laws, or bilaterally, among nations through tax treaties.⁵⁴ Oversimplified for illustrative purposes, in a country that utilizes a worldwide system, a *tax credit* is granted to corporations or individuals that have paid taxes to a foreign government on income earned overseas.⁵⁵ Generally this tax credit is deducted from what is owed domestically by the taxpayer.⁵⁶ In a territorial system country, a *tax exemption* is the preferred method of avoiding double taxation.⁵⁷ That is, income earned overseas under this system is usually not subject to taxation at all.⁵⁸ The EU has observed that “countries that apply a territorial system, of course, do not need special provisions for the avoidance of double taxation, since in the exercise of their residence jurisdiction, they do not tax foreign source income.”⁵⁹ Intuitively, if all countries adhered to the same tax system, there would be no double taxation problem.⁶⁰

3. International Taxation — The Worldwide System in the U.S.

Adopting the worldwide tax theory, the U.S. reserves the right to tax all residents on income wherever it is earned.⁶¹ Since most exporters are corporations, for simplicity, this Note will analyze the varying tax theories as they relate to business enterprises. Thus, when an American firm with a wholly-owned foreign subsidiary (known generically in the tax world as a controlled foreign corporation or “CFC”) repatriates its profits back to the U.S. parent corporation, after paying tax to the foreign nation also exercising jurisdiction over the subsidiary, under U.S. tax law, these profits will be taxed again.⁶² The income earned overseas is commonly repatriated when it is dis-

53. *See id.*

54. *See* U.S. Appellant Brief – ETIA, *supra* note 50, at 10.

55. *See* H.R. REP. NO. 106-845, *supra* note 41.

56. *Id.*, at 14.

57. *Id.*

58. *Id.*

59. U.S. Appellant Brief – ETIA, *supra* note 50, at 13.

60. *See* FRENKEL, *supra* note 40.

61. *Id.*

62. *See* MCDANIEL & AULT, *supra* note 24, at 109.

tributed as a dividend to the U.S. shareholders.⁶³ To minimize deferral of corporate income taxes by operating through offshore tax havens that impose little or no income tax, the U.S. Congress enacted "Subpart F" of the Internal Revenue Code ("I.R.C.").⁶⁴ At the same time, however, in order not to stifle U.S. firms with an overbearing tax burden, the U.S. foregoes the foreign tax paid and credits that amount, against the domestic tax due to the treasury.⁶⁵ This way, double taxation is mitigated. This basic outline of the U.S. rebate system is beset with complex rules and procedures that determine the source (domestic or foreign) of income as well as other specific exemptions and procedures.⁶⁶ These rules are, however, beyond the scope of this Note.

4. Direct Taxation v. Indirect Taxation — Income Tax v. VAT

A *direct tax system* is one that imposes a duty specifically on earnings or profits.⁶⁷ The U.S. federal income tax regime is model of a direct tax.⁶⁸ An *indirect tax system* is one that imposes a duty on consumption of a good or service.⁶⁹ Most EU nations employ some form of an indirect tax, usually a value added tax ("VAT").⁷⁰ An example of an indirect tax in the U.S. is the sales tax imposed by the several states on goods sold

63. *Id.*

64. See MCDANIEL & AULT, *supra* note 24, at 109-110; I.R.C. §§ 951-954 (2000).

65. See FRENKEL, *supra* note 40, at 23.

66. WTO Report of the Appellate Body, *supra* note 44. For example, under these rules is the "foreign tax credit." I.R.C. § 901(a) (2000).

67. See Hunter R. Clark et al., *The WTO Ruling on Foreign Sales Corporations: Costliest Battle Yet in an Escalating Trade War Between the United States and the European Union?*, 10 MIN. J. GLOBAL TRADE 291, 306 (2001).

68. *Id.*

69. See Christopher Deal, Note, *The GATT and VAT: Whether VAT Exporters Enjoy a Tax Advantage Under the GATT*, 17 LOY. L.A. INT'L & COMP. L. REV. 649, 650-51 (1995).

70. *Id.* at 650. VAT:

[I]s a "consumption tax" levied on sales of goods and services. VAT is computed by assessing a rate percentage of the value added to a good at each stage of production, normally at a flat rate. In contrast, a corporate income tax is levied only on a corporation's net profits.

Id. at 651.

there.⁷¹ The distinction between direct and indirect taxation is important because, it helps to explain the underlying conflict between the U.S. and EU in the FSC dispute as well as the structural legal impediment to resolution.

American corporations are subject to both federal and state income taxes as well as state sales tax, which is a product of the division of powers between the federal government and the state governments as provided by the U.S. Constitution.⁷² Central governments generally create incentives to encourage a particular activity that it deems important to the welfare of the nation. A subsidy is a prime example of such an incentive. One method of subsidizing an activity is for the government to provide tax relief. Striking a balance between the incentive, here tax relief, and government revenue requirements is, to be sure, complicated. The U.S. federal government is particularly sensitive to these concerns since, if it did not provide some tax relief, U.S. exporters would be subject to a significant total tax burden, possibly eroding competitiveness.⁷³ However, due to constitutional separation of powers reasons, the U.S. can only provide relief of some of the direct tax burden imposed on its taxpayers.⁷⁴

The U.S. direct tax, coupled with the state tax burdens (both direct and indirect), functionally penalize exports since income arising from this activity is subject to tax without relief.⁷⁵ Most governments of the EU by comparison raise revenue by indirect taxation, the most popular form of which is the VAT.⁷⁶ EU exporters do not pay tax on their foreign sales, which is a function of the their territorial principle of taxation. This is accomplished under a VAT system by way of a tax credit, which is refunded to the exporter.⁷⁷ The significance of this cannot be understated. Under GATT rules, indirect taxes on exports may be refunded, *but* direct taxes may not.⁷⁸ Thus, this recognized distinction under international law between indirect and direct

71. See Clark, *supra* note 67, at 310-11.

72. U.S. CONST. amends. X, XVI.

73. *Id.*

74. *Id.*

75. See MCDANIEL & AULT, *supra* note 24, at 155.

76. Deal, *supra* note 69, at 650-51.

77. *Id.* at 664-65.

78. See *id.*; GATT, *supra* note 4, art. XVI:4.

taxes furnishes a comparative advantage on EU exporters over their U.S. counter-parts. Succinctly put by Professor Hunter R. Clark, "[s]ince the EU does not tax foreign income of its corporations, many of which have established subsidiaries in tax haven, and the European corporations are allowed a VAT credit, EU exports are relieved from virtually all tax burdens, whereas American firms are not."⁷⁹ As a result, the European exporter can sell its goods overseas at a reduced price. Exports are thus encouraged (or arguably subsidized) because of the structure of the EU tax system.

This comparative tax advantage does not present the entire picture, however. Firms by and large do not decide whether to engage in foreign trade solely based on tax liability. When a corporation seeks to expand its reach into a foreign market there are many avenues of approach. For purposes of this Note, the most significant are: (1) foreign direct investment; and (2) export and import of goods or services.⁸⁰

As briefly demonstrated above, the tax treatment of an American CFC (an example of a foreign direct investment)⁸¹ is exceedingly complicated. Equally complicated, and underlying the FSC issue, is the tax treatment of income derived from export operations. Generally, under U.S. tax rules there is no special treatment for the income of U.S. citizens derived from foreign sources.⁸² If a foreign government taxes that income, the domestic taxpayer has available to it, *inter alia*, a foreign tax credit, otherwise it is subject to U.S. tax.⁸³ The U.S. has, however, from time to time, adopted preferential tax treatment in several instances to advance some vital policy goal.⁸⁴ One such goal was to stimulate U.S. foreign trade. From this concern developed the line of tax programs that became known collectively as the FSC.⁸⁵

79. See Clark, *supra* note 67, at 312.

80. See generally RALPH H. FOLSOM ET AL., INTERNATIONAL BUSINESS TRANSACTIONS 41-46 (4th ed. 1999).

81. *Id.* at 45.

82. See MCDANIEL & AULT, *supra* note 24, at 155.

83. *Id.*

84. *Id.*

85. *Id.*

*B. A Brief History of FSCs and the Nature of the Dispute*⁸⁶

1. Closing the Trade Deficit — The DISC

At the close of the 1960's, America's trade balance and position on debt servicing was dismal.⁸⁷ Consequently, to remedy the problem, in 1971 the Nixon Administration removed the U.S. from the gold standard and simultaneously urged Congress to enact a package of trade measures designed to improve the balance-of-payments position.⁸⁸

The Domestic International Sales Corporation ("DISC") program was part of the legislative package.⁸⁹ The DISCs encouraged American firms to export their products by means of a tax deferral on goods bound for foreign markets.⁹⁰ Under provisions of the DISC Act, an American firm would establish a shell subsidiary corporation — one that had no assets and no employees — for the sole purpose of running foreign bound goods through it in order to obtain lower taxes on eventual export profits.⁹¹ In effect, the DISC would "buy" the goods from the manufacturer and "sell" them to the foreign clients overseas.⁹² Of the profits made, one-half would remit back to the corporate parent (as fully taxable), but the other half was tax deferred.⁹³ According to Paul McDaniel and Hugh J. Ault, the "subsidy took the form of a deferral of U.S. tax on a portion of export income channeled through a DISC, [rendering it] in effect an interest-free loan from the Treasury to U.S. exporters."⁹⁴ This tax deferral was the method by which Congress encouraged

86. This section is intended only to be a cursory review of the FSC dispute, including its procedural history before the WTO and how FSCs operate. A more in-depth explanation of these technical aspects is beyond the scope of this Note.

87. See Robert E. Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN. L. REV. 1443, 1445 (1988).

88. *Id.* at 1445-46.

89. *Id.*

90. See Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497, 535 (1971) (codified as amended at I.R.C. §§ 991-997 (1994)); H.R. REP. NO. 106-845, *supra* note 41, at 13.

91. See sources cited *supra* note 90.

92. *Id.*

93. *Id.*

94. MCDANIEL & AULT, *supra* note 24, at 155.

exports. Though merely a deferral, exporting firms eventually relied on the mechanism as a full tax exemption.⁹⁵

Practically from its inception, DISCs were the subject of complaints from the EU and other nations.⁹⁶ They objected that DISCs violated the GATT, specifically Article XVI: 4, claiming it was an "illegal export subsidy."⁹⁷ In an attempt to cease their use, the EU commenced a lawsuit in 1972, which for all parties ended, by all accounts, unsatisfactorily several years later.⁹⁸ Taking the offensive, the U.S. counter-sued the Netherlands, Belgium and France alleging that the DISC legislation merely mirrored their tax structures.⁹⁹ In 1976, a GATT dispute panel ruled against the DISC program but also ruled against the European governments that taxed their exports more favorably than similar domestic transactions.¹⁰⁰ Under GATT rules, in order for a dispute panel's findings to have the force of law, it must be adopted unanimously by the litigating parties.¹⁰¹ The U.S. was willing to accept the panel's ruling on the DISC, provided that the Dutch, Belgians and French also accepted the panel's adverse findings over their own tax systems.¹⁰² The EU refused to accept, however, that their tax regimes allowed for export subsidies.¹⁰³ As a result of this impasse, these GATT tax reports were not adopted for several years by its litigants.

95. See Hudec, *supra* note 87, at 1446.

96. *Id.*

97. *Id.*

98. See *id.* at 1443; see *infra*, note 100.

99. See Hudec, *supra* note 87, at 1445.

100. See Tax Legislation – United States Tax Legislation (DISC), Nov. 12, 1976, GATT B.I.S.D. (23rd Supp.) at 98 (1977); Income Tax Practices Maintained by France, Nov. 12, 1976, GATT B.I.S.D. (23rd Supp.) at 114, para. 47 (1977); Income Tax Practices Maintained by Belgium, Nov. 12, 1976, GATT B.I.S.D. (23rd Supp.) at 127 (1977); Income Tax Practices Maintained by The Netherlands, Nov. 12, 1976, GATT B.I.S.D. (23rd Supp.) at 136 (1977); see generally Hudec, *supra* note 87, at 1482-85. For a more in-depth discussion on the DISC dispute specifically, see also John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. 747 (1978).

101. See GATT, *supra* note 4.

102. See Hudec, *supra* note 87, at 1481.

103. H.R. REP. NO. 106-845, *supra* note 41, at 14.

2. The Foreign Sales Corporation

In 1981, the U.S. and the EU agreed to adopt the GATT tax reports under a mechanism whereby the GATT Council adopted the factual findings subject to an "understanding."¹⁰⁴ The 1981 understanding, arguably incorporated the principles established in a footnote of the Tokyo Round Subsidies Code accepting that it was not an export subsidy when a country refrained from taxing foreign-source income (derived from foreign economic processes), even if this resulted in exports being taxed more favorably than domestic transactions.¹⁰⁵ Based on this principle, the Congress created the FSC program as part of the Deficit Reduction Act of 1984.¹⁰⁶ The purpose of the law was, *inter alia*, to bring the U.S. into conformity with GATT's legal obligations as well as "to reap the export-enhancing benefits of the [approved] exemption method."¹⁰⁷ Thus, as the U.S. understood the GATT rules, an exemption from tax on export income was permissible only if the economic processes that gave rise to the income took place outside the U.S.¹⁰⁸ Though mirroring aspects of the territorial tax system, in that export transactions are completely separated from domestic sales and are tax exempt, the major difference was that the FSCs tax exemption applied *only* to exports, while a territorial tax system exempts from taxation, both exports and other foreign earned income.¹⁰⁹

Typically, FSCs were established by corporations as wholly owned subsidiaries.¹¹⁰ The parent corporation then supplied those goods, using arm's length or special administrative pric-

104. See Tax Legislation, *supra* note 26 (the U.S. agreed to the Panel's adoption of the DISC Report decision without conceding that the DISC violated the GATT); WTO Report of the Appellate Body, *supra* note 44.

105. See Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trades, Apr. 12, 1979, 1186 U.N.T.S. 204.

106. I.R.C. §§ 921 - 927 (1994).

107. H.R. REP. No. 106-845, *supra* note 41, at 14. See also Sernau, *supra* note 25, at 1190; WTO FSC/ETIA DISPUTE, *infra* note 132.

108. STAFF OF THE JOINT COMM. ON TAX'N, 98TH CONGRESS, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 1041-42 (Committee Print 1985) [hereinafter Joint Committee Report].

109. *Id.*

110. BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION 68-11, 68-11 (2d ed. 1997).

ing rules, to the FSC for resale abroad.¹¹¹ There are more than 6,000 companies that depend on the FSC tax regime.¹¹² Most of the FSCs were set up in U.S. territories (the U.S. Virgin Islands and Guam) or in Barbados, where registration fees and local taxes are very low.¹¹³

Unlike DISCs, FSCs are separately incorporated companies located outside the U.S. for the purpose of conducting export transactions (sales and distribution) of goods outside the U.S.¹¹⁴ In making these shell corporations GATT-compliant, Congress split the foreign aspect of relevant export transactions — sales and distribution — from the domestic aspect — manufacture.¹¹⁵ The result was that U.S. manufacturers ran all their export sales through the FSC and received a generous tax benefit, while their domestic sales would be handled locally and taxed at their normal corporate rate.¹¹⁶ In addition, any domestic income earned by the FSC was taxed fully but income from foreign sales was exempted and segregated.¹¹⁷

The essence of the FSC dispute is similar to the DISC case. Recall that the FSCs were devised to employ facets of the territorial tax system — the exemption method — in conformance with the 1981 GATT understanding.¹¹⁸ Notwithstanding this accord, the EU argued that the FSCs violated the WTO Agreement on Subsidies and Countervailing Measures (“SCM”) and the Agreement on Agriculture as an illegal export subsidy.¹¹⁹ Distinguishing the DISC case of the 1970’s from the FSC case of the 1990’s is the presence of the WTO. As the successor to

111. *Id.* at 68-12. Arm’s length pricing is governed by I.R.C. § 482 (2000). It is a method of allocating income between different branches of the same firm that is based on the prices that the separate branches would charge each other if they were unrelated. It is meant to prevent the evasion of taxes and reflect each branch’s true tax liability. FSCs also employ special administrative pricing which was meant to further enhance export trade. For a more thorough analysis, see *id.* at 79-2.

112. See Agnew, *supra* note 15, at 140.

113. See BITTKER & LOKKEN, *supra* note 110, at 68-12.

114. *Id.* at 68-17.

115. See WTO FSC/ETIA DISPUTE, *infra* note 132.

116. *Id.*

117. *Id.*

118. See H.R. REP. NO. 106-845, *supra* note 41.

119. See WTO Panel Report, *supra* note 4.

the GATT dispute settlement process, the WTO was empowered with greater authority as well as enforcement protocols.¹²⁰

The EU contended that the U.S. tax code provided improper export subsidies by permitting special tax treatments for income earned by FSCs.¹²¹ These tax treatments were illegal because the U.S. was waiving tax receipts otherwise due for the benefit of encouraging exports.¹²² This forbearance of taxes violated Articles 3.1(a) and 3.1(b) of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement").¹²³ Under the SCM Agreement, a subsidy is deemed to exist, *inter alia*, when "there is a financial contribution by a government or any public body within the territory of a Member . . . where: government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits); and a benefit is thereby conferred."¹²⁴

The WTO ruled against the U.S. when its dispute panel issued its report in October 1999.¹²⁵ The U.S. subsequently lost on appeal in February 2000.¹²⁶ Essentially, the WTO agreed with the EU that the tax benefit conferred upon FSCs constituted foregone revenue otherwise due and therefore was a subsidy.¹²⁷ Furthermore, because the subsidy was contingent upon "export performance," it was prohibited under the SCM Agreement and thus illegal.¹²⁸ Accordingly, the WTO requested that the U.S. bring the FSC program into compliance with the SCM

120. See Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, art. 22, Marrakesh Agreement Establishing the World Trade Organization [hereinafter WTO Agreement], Annex 2, LEGAL INSTRUMENTS – RESULTS OF THE URUGUAY ROUND vol. 31, 33 I.L.M. 1226 (1994) [hereinafter DSU].

121. See WTO Panel Report, *supra* note 4.

122. *Id.*

123. Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Annex 1A, at 229, WTO Agreement, Annex 2, LEGAL INSTRUMENTS – RESULTS OF THE URUGUAY ROUND vol. 31, 33 I.L.M. 1226 (1994) [hereinafter SCM Agreement].

124. SCM Agreement, *supra* note 123, arts. 1, 1.1(a)(1)(ii) & (b).

125. See WTO Panel Report, *supra* note 4.

126. See WTO Report of the Appellate Body, *supra* note 44.

127. *Id.*

128. *Id.* The WTO Dispute Panel also found (and was subsequently upheld by the Appellate Body) that the FSC program violated Articles 3.3, 8 and 10.1 of the WTO Agreement on Agriculture. *Id.* For simplicity, this Note concentrates only on the SCM Agreement violations.

Agreement and the Agreement on Agriculture.¹²⁹ Responding to the WTO Appellate Panel's decision, then USTR Charlene Barshefsky noted that although the U.S. will respect its WTO obligations, it will ensure that "U.S. firms and workers are not at a competitive disadvantage with their European counterparts."¹³⁰

3. The Extraterritorial Income Act and the Next Move

In the late summer of 2000, in order to bring the U.S. tax code into WTO conformity, Congress began work on H.R. 4986 — the Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act of 2000, which was intended to be a simultaneous repeal and replacement of the FSC.¹³¹

At the same time the EU and the U.S. had agreed on a framework that governed any further challenges that the EU may have with corrective measures taken by the U.S. in wake of the WTO findings.¹³² The U.S. enacted the ETIA in November 2000, making it the first U.S. law ever changed in response to an international trade ruling.¹³³ Senator William Roth, Jr., Chairman of the Senate Finance Committee remarked that the ETIA "satisfies the United States' obligations with the [WTO] and ensures that U.S. businesses will be able to compete on a level playing field against foreign competitors in the global marketplace."¹³⁴

Contrary to the rhetoric of both the Clinton Administration and the Congress, the ETIA did not bring the U.S. corporate tax code into WTO compliance, but instead *broadened* both the benefits and beneficiaries of the tax abatement.¹³⁵ Indeed, the

129. *Id.* ¶ 178.

130. Press Release, Office of the United States Trade Representative, US Disappointed with WTO FSC Ruling, Vows to Work With EU to Reach Solution (Feb. 24, 2000), available at <http://www.ustr.gov/press>.

131. Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000) (codified in scattered sections of the I.R.C.).

132. See NAT'L FOREIGN TRADE COUNCIL, WTO FSC/ETIA DISPUTE, available at <http://www.nftctax.org/FSC/> (last visited May 31, 2002).

133. *Id.*

134. Robert Goulder & Warren Rojas, *U.S. Senate Finance Committee Approves FSC Repeal Bill*, 21 TAX NOTES INT'L 1384, 1384 (2000).

135. See, e.g., 146 CONG. REC. H11,885 (daily ed. Nov. 14, 2000) (statement of Rep. Archer) [hereinafter Statement of Rep. Archer]; 146 CONG. REC.

EU's Trade Minister, Pascal Lamy, went so far as to call the new ETIA law "even worse" than the original FSC program.¹³⁶

To co-opt a phrase, congressional tax experts and their corporate suitors assisting through trade coalitions, in a fit of "irrational exuberance," clearly deluded themselves into believing that the ETIA would be the panacea to their WTO troubles.¹³⁷ Though trumpeted as bringing the U.S. under WTO compliance by dismantling the FSC program, the ETIA's "language and concepts are largely borrowed" from the repealed FSC program.¹³⁸ An analysis of the ETIA and its legislative history reveals that Congress intended to provide export incentives to a broader constituency.¹³⁹ In short, the ETIA creates a package of tax benefits that are comparable to the FSC program, but allows a "broader spectrum of taxpayers" to be eligible.¹⁴⁰ To incorporate the benefits of a territorial tax regime within the U.S. worldwide system was the legislative slight-of-hand that the Congress hoped to achieve.¹⁴¹ Indeed, a press release by the National Foreign Trade Council ("NFTC") noted that the ETIA's scheme "would impose broader territorial limits on U.S. tax authority so that extraterritorial income, or income earned outside the United States would not be taxed."¹⁴² However,

S11,455 (daily ed. Nov. 1, 2000) (statement of Sen. Roth) [hereinafter Statement of Sen. Roth]. See also President's Statement on Signing the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, 36 WEEKLY COMP. PRES. DOC. 2885 (Nov. 20, 2000), reprinted in 2000 U.S.C.A.N. at 2234; but see, e.g., Dissenting and Additional Views, H.R. REP. NO. 106-845, *supra* note 41, at 63 (criticizing the preservation and expansion of export tax benefits to both the software, tobacco, pharmaceutical and military technology industries).

136. *EU/US: Americans Contest EU Demand for USD4 Billion Sanctions*, EUR. REP., Dec. 2, 2000, 2000 WL 24320190.

137. The phrase "irrational exuberance" is attributed to the current U.S. Federal Reserve Chairman Alan Greenspan.

138. Ernest R. Larkins, *Extraterritorial Exclusion Replaces FSC Regime: Mirror Rules, Broader Spectrum*, 12 J. INT'L TAX'N 22, 22 (2001).

139. *Id.* at 22-23 (Unlike the FSC program, the ETIA permits foreign distributors and manufacturers to also share in the tax benefits, imposes no geographical restriction on where eligible subsidiaries may be organized (though it is expected that they will incorporate in tax havens imposing little or no foreign tax, e.g., Guam), and allows aggressive pricing procedures between the parent corporation and the tax reducing subsidiary).

140. *Id.*

141. See H.R. REP. NO. 106-845, *supra* note 41, at 14.

142. Press Release, National Foreign Trade Council, House Approves H.R.

U.S. Treasury Department officials were careful to note that the new law did not abandon the U.S. worldwide tax system in favor of a territorial system.¹⁴³ The drafters of the ETIA sought to use the WTO FSC findings as a template from which to carefully craft a compliant law while maximizing benefits for exporters.¹⁴⁴

The EU was unhappy with the ETIA. Almost immediately after its passage, the EU requested that the WTO constitute a panel to review the legislation.¹⁴⁵ The EU declared that the "new law not only maintains the violations found by the WTO in the FSC case but may even aggravate them."¹⁴⁶ Simultaneously, the EU filed a procedural request with the WTO for authorization to impose some \$4 billion in sanctions against the U.S. to retaliate for harm done to European companies by the U.S. tax breaks.¹⁴⁷ The effect of these procedural movements by the EU merely extended the timeline for a final WTO determination, in essence a stay of execution, until the summer of 2001.¹⁴⁸ Though the U.S. remained confident that the ETIA would withstand WTO scrutiny, the WTO dispute panel announced its findings in June 2001 confirming suspicions that the enactment of the ETIA did not bring the U.S. into WTO compliance and that the law constituted a prohibited export

4986 (Nov. 14, 2000), available at <http://www.nftctax.org/FSCBillPassesCongress.html>.

143. See Robert Goulder, *U.S. Treasury Official Denies FSC Repeal Signals Move to Territoriality*, 21 TAX NOTES INT'L 2749, 2749 (2000).

144. Press Release, U.S. Department of the Treasury, Deputy Secretary of Treasury Stuart E. Eizenstat, Remarks at House Ways and Means Committee FSC Mark Up (July 27, 2000), available at <http://www.ustreas.gov/press/releases/ps812.htm>.

145. UNITED STATES TRADE REPRESENTATIVE, DISPUTE SETTLEMENT UPDATE (2001), at <http://www.ustr.gov/dsu/>.

146. *Officials – EU-U.S. May Have Time to Work Out More Than FSC Flap*, MARKET NEWS INT'L, Nov. 20, 2000, 2000 WL 33291047.

147. See Elizabeth Olson, *EU Says No Deal in U.S. Tax Spat Dispute, Will Rest with WTO*, INT'L HERALD TRIB., Nov. 22, 2000, at 14; Geoff Winestock, *Europe Could Impose Sanctions After WTO Report Condemns Subsidies*, WALL ST. J. EUR., Aug. 21, 2001, 2001 WL-WSJE 21835711; WASH. POST, *supra* note 3.

148. See Olson, *supra* note 147.

subsidy.¹⁴⁹ The WTO dispute panel formally adopted these findings on August 21, 2001.¹⁵⁰

Ending weeks of speculation over the possibility of a negotiated settlement, on October 10, 2001, the U.S. announced, to a disappointed EU, its intention to appeal the WTO dispute panel decision on the ETIA.¹⁵¹ Arguably, the appeal was less on substance and more on form — many trade experts believe that an appeal by the U.S. is a tactic to buy more time in which to resolve this dispute “peacefully,” i.e., without resorting to sanctions.¹⁵² The concern over sanctions is very real. Earlier this year USTR Robert Zoellick declared that looming European trade sanctions this large would be equivalent to “using a nuclear weapon on the trading system.”¹⁵³ Ideally, the EU would prefer that the U.S. dismantle the ETIA.¹⁵⁴ However, seeing the U.S. tax provision dismantled will be no easy task for several reasons. First, Congress hesitatingly replaced the FSC with the ETIA only two years ago in response to the WTO decisions and any attempt to fix this provision legislatively will take many months, if at all.¹⁵⁵ Second, the Bush Administration and the Republican-controlled Congress are not readily amenable to “multilateral constraints on American freedom of action.”¹⁵⁶ Moreover, this dispute has developed a systemic inertia all its own that may be difficult to stop.¹⁵⁷ Tellingly, al-

149. See, e.g., H.R. REP. NO. 106-845, *supra* note 41, at 14.

150. WTO Panel Report — ETIA, *supra* note 27.

151. See Joseph Kahn, *U.S. Will Appeal Tax Ruling After Talks with Europe Fail*, N.Y. TIMES, Oct. 11, 2001, at A15; USTR Press Release, *supra* note 7.

152. See Osborne, *supra* note 35.

153. See *America's Taxing Trade Troubles*, *supra* note 13.

154. See Osborne, *supra* note 35.

155. See *Thomas Says Remedy for Foreign Sales Corporations Could Take over Six Months*, CONGRESS DAILY, Feb. 7, 2002, 2002 WL 8307321 [hereinafter CONGRESS DAILY].

156. *Pascal Lamy*, ECONOMIST, July 7, 2001, at 52, 52 [hereinafter ECONOMIST].

157. See Larry Elliot & Charlotte Denny, *Strangelove Tendency Revived*, GUARDIAN (London), Jan. 17, 2002, at P26, available at 2002 WL 9514836 (The FSC dispute “is a hangover from the different relationship between Sir Leon Brittan, the former EU trade commissioner, and . . . the pedantic lawyer Charlene Barshefsky [the former USTR] . . . People haven't been able to stop it in the past, and it is worrying that it might go to another stage without people being able to stop it now.”).

though the EU spoke of its desire to avoid a confrontation, on the very day that the WTO announced its formal findings in the FSC case, the EU threatened to push the trade sanctions' "nuclear button" anyway.¹⁵⁸

While U.S. resolve has been demonstrated by the symbolic assignment of senior Treasury and Commerce Department officials to present the opening remarks of this latest appeal, it does appear, according to recent press releases, that the U.S. anticipated defeat.¹⁵⁹ Indicating that the "U.S. was ready to abide by whatever decision the appeals body reached," Under-Secretary of Commerce Grant Aldonas criticized previous WTO decisions as providing little guidance on what the U.S. needs to do to bring its tax code into WTO compliance.¹⁶⁰ Despite foreshadowing a loss by the U.S., it interestingly signaled a willingness by the U.S. to remedy the problem given clear guidance from the WTO.

On January 14, 2002, the WTO appellate body rejected the U.S. appeal on the merits.¹⁶¹ After an almost six-year odyssey the EU's quest to attack the FSC has almost come to an end, at least legally. While certainly a *win* for the EU as a legal matter, because of the size of the penalty, this victory as a *trade* matter may be Pyrrhic. What makes this trade dispute anything but ordinary is the sheer size of the penalty — \$4 billion in economic sanctions. Sanctions of this size, if imposed, will hurt the EU as well as the U.S. Perhaps buying time, the U.S. immediately petitioned the WTO over the inaccurate size of the EU sanctions award, petitioning for a lower, albeit still devastating penalty of almost \$1 billion dollars.¹⁶² Surrender or negotiation are all that remain for the U.S.

It is curious that in the midst of an economic slowdown and recovery, the world's two largest trade blocs are edging towards

158. *ECONOMIST*, *supra* note 156.

159. See Michael Mann, *International Economy — U.S. Calls for Clear Rules on Taxation*, *FIN. TIMES* (London), Nov. 20, 2001, at 14.

160. *Id.*

161. See WTO ETIA Appeal Decision, *supra* note 11; Elliot & Denny, *supra* note 157; Paul Blustein, *U.S. Loses Ruling in Trade Fight with Europe; WTO Decision Allows EU to Seek Penalties*, *WASH. POST*, Jan. 15, 2002, at E1; *CONGRESS DAILY*, *supra* note 155.

162. See Heather Scott, *USTR Appeals to WTO to Cut EU FSC Sanctions to \$956M from \$4B*, *MARKET NEWS INT'L*, Feb. 14, 2002, 2002 WL 14350950.

multi-billion dollar trade sanctions.¹⁶³ How is it that the U.S. and the EU, which represent the world's most wealthy and democratic-liberal regimes, could not, up to this point, settle this dispute through diplomacy and compromise?¹⁶⁴ In the immediate aftermath of the terrorist attack against the U.S. on September 11, 2001, an embroiled trade war with Europe seemed to be remote.¹⁶⁵ Indeed in a time of international charity, as the U.S. and its allies were engaged in the war on terrorism, a negotiated settlement appeared all the more likely. However, the EU's charity is sorely being tested with the announced decision by the Bush Administration to impose tariffs on steel imports from the EU and elsewhere.¹⁶⁶

That both the U.S. and the EU find themselves on the brink of, what some commentators have called, a trade war, demonstrates that there is something more fundamentally at stake here than quibbling over the definition of what is an export subsidy.¹⁶⁷ It might be useful to unveil the motivations behind these tax and trade policies in order to distill the politics from both trade and tax policy and the legal impediments toward a workable compromise.

III. POLICY MOTIVATIONS OF THE EU AND THE U.S.

In analyzing any international conflict, an exploration of the aggrieved party's motives may be revealing. However, it is wise to caution that inevitably there is not one overriding motive that compels states to act but, rather, several strands of intertwined policy considerations derived from both domestic and international, political and economic forces.¹⁶⁸ Making mo-

163. WASH. POST, *supra* note 3.

164. See Kahn, *supra* note 151.

165. See Vago Muradian, *Export Control, Trade Issues Slide to Back Burner in Wake of Attacks*, DEFENSE DAILY INT'L, Sept. 21, 2001, 2001 WL 7476068.

166. See Geoff Winestock, *How One Trade Dispute Fuels Another — U.S. Steel Tariffs May Stiffen EU Opposition to Tax Breaks*, WALL ST. J., Mar. 12, 2002, at A18 ("Both EU and U.S. officials say that the steel dispute has worsened the atmosphere" in the weeks leading up to the WTO decision of a final sanctions award on April 29, 2002.).

167. See Daniel T. Griswold, *Trade Feuding: The Coming Trans-Atlantic Trade Tussle*, ASIAN WALL ST. J., Dec. 20, 2000, 2000 WL-WSJA 23754032; William M. Funk, *The Thirty-Years Tax War*, 22 TAX NOTES INT'L 65 (2001) (describing the entire three decades FSC dispute as a tax war).

168. Though beyond the scope of this Note, for background on general international relations theory, see INTERNATIONAL RELATIONS THEORY (P.

tive analysis even more complicated, the FSC dispute is a friction between an independent state actor (the U.S.) and an international regional confederation (the EU). Though it may be more readily apparent to discover a single state actor's policy motives, it will surely be difficult to derive, with the same degree of confidence, policy motives of a confederacy, as it is the product of several complicated parts. That said, trade disputes are nominally about each state actor (or trade union's) attempts at domestic industrial and agricultural hegemony, while simultaneously striving to break through and access the markets of one's foreign competitor, who in turn is seeking its own form of hegemony. The pursuit for greater market access through the tearing down of protectionist tariffs and non-tariff barriers has long marked the trade struggle between the U.S. and EU.¹⁶⁹ This idea has provided powerful rhetoric for each side in its quest. It oversimplifies and ignores the driving influences, however, faced by both Brussels and Washington — their respective constituencies.¹⁷⁰ For the U.S., its corporate citizenry wields tremendous influence with regard to both tax and trade policy and thus colors how its government will approach the EU over the FSC dispute. Likewise, the EU is also influenced by its citizen corporations but is also swayed by the participation of its governmental bureaucracy at the nation-state level and within the EU organization itself.¹⁷¹ Comparatively, government participation in European business affairs is more closely aligned than one finds in the U.S. where *laissez-faire* still predominates.

ternational relations theory, see INTERNATIONAL RELATIONS THEORY (P. Viotti & M. Kauppi eds., 1987); ROBERT KEOHANE & JOSEPH NYE, POWER AND INTERDEPENDENCE: WORLD POLITICS IN TRANSITION (2d ed. 1989); A. Slaughter et al., *International Law and International Relations Theory: A New Generation of Interdisciplinary Scholarship*, 92 AM. J. INT'L L. 367 (1998).

169. See generally KENNETH W. DAM, THE RULES OF THE GLOBAL GAME — A NEW LOOK AT U.S. INTERNATIONAL ECONOMIC POLICYMAKING 95 (2001); Christopher Stevens, *EU Policy for the Banana Market: The External Impact of Internal Policies*, in POLICY-MAKING IN THE EU 326 (Helen Wallace & William Wallace eds., 1996).

170. See J.D. Greenwald, *U.S. Law and Practice*, in SUBSIDIES AND INTERNATIONAL TRADE — A EUROPEAN LAWYERS' PERSPECTIVE 33 (Jacques H. J. Bourgeois ed., 1991).

171. See generally STEPHEN GEORGE, POLITICS AND POLICY IN THE EUROPEAN UNION 88-91 (3d ed. 1996).

A. Corporate Influence in U.S. Tax & Trade Policy

One facet that is generally overlooked in an international trade dispute is the extent to which corporate interests drive (perhaps manipulate) a trade grievance under the WTO dispute settlement understanding ("DSU"). Ultimately, the WTO complaint that starts out as a grievance by a company, soon emerges as the *cause célèbre* of an industry and then takes on a life of its own through the WTO as the USTR gets attached to and nurtures the case, much like an attorney, seeking the best deal for its "corporate client." Under this type of arrangement the system is bound to become strained. This pattern is also played out within the EU. Its net result is the exposure of the flaw with the DSU. Not inherently, but in the way it is being used — there is increasingly less incentive to negotiate and more incentive to litigate.¹⁷²

WTO trade disputes may be brought only by its members (i.e., nation-states) and not the aggrieved multinational corporation or any other entity.¹⁷³ In effect, the national governments of WTO members can be characterized as agents of their respective corporate body politic at WTO tribunals. No doubt, national governments are significantly influenced by the parochial agenda of its corporate citizenry no less than by the desires of its people.¹⁷⁴ This helps to explain why both the U.S. and the EU have been reactive in their position strategies in trade disputes, generally, and in the FSC dispute, particularly.¹⁷⁵

To briefly address what is at stake, it is helpful to review a few pertinent statistics. For the calendar year 1999, the U.S.

172. See generally Robert A. Green, *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 YALE J. INT'L LAW 79 (1998); Pascal Lamy, Address to the Economic Strategy Institute, Washington, D.C. (June 7, 2001), available at http://europa.eu.int/comm/trade/speeches_articles/spla59_en.htm [hereinafter Lamy - Address].

173. See generally WTO Agreement, *supra* note 120; DSU, *supra* note 120.

174. For a cynical, if not truthful view of corporate influence in the legislative process in the U.S., see DAN CLAWSON ET AL., *DOLLARS AND VOTES: HOW BUSINESS CAMPAIGN CONTRIBUTIONS SUBVERT DEMOCRACY* (1998); NORMAN J. ORNSTEIN & SHIRLEY ELDER, *INTEREST GROUPS, LOBBYING AND POLICYMAKING* (1978); DAM, *supra* note 169, at 11.

175. See Griswold, *supra* note 167.

exported \$696 billion worth of goods and services.¹⁷⁶ Of this, companies accounted for \$585 billion or 84% of the total export value.¹⁷⁷ Large companies, defined as having more than 500 employees, account for only 4% of all exporters but export 71% of the total export value.¹⁷⁸ These figures are significant in demonstrating the enormous economic power that large companies wield. One demonstration of this power is the ability and willingness of companies, at least in the U.S., to influence government policymakers through their governmental lobbying efforts and campaign donations.¹⁷⁹ For example, in the 2000 election year cycle, the computer software industry made over \$12 million in campaign contributions to those running for a federal office.¹⁸⁰ The defense industries contributed almost \$13.6 million¹⁸¹ and the communications industry contributed some \$131 million.¹⁸² Assuming that dollars correlate with influence in the political process, these facts are illustrative of the tremendous influence that corporations can levy through campaign donations.¹⁸³ For their contributions, the corporate actors are granted “access” to officials that provides them with “a chance to shape the details of legislation, crafting loopholes that undercut the stated purpose of the law.”¹⁸⁴ The classic

176. See U.S. CENSUS BUREAU, ECONOMICS AND STATISTICS ADMINISTRATION: A PROFILE OF U.S. EXPORTING COMPANIES, 1998–1999 (2001), available at <http://www.census.gov/foreigntrade/aip/h-edbrel-9899.pdf> (Aug. 21, 2001).

177. *Id.* The remaining portion of the total export value was accounted for by individuals, governments, low-value estimates, and documentation filed with missing or incomplete company identifiers. Because not all export shipments can be linked to specific companies, the number of exporters may be understated. *Id.*

178. *Id.*

179. See CLAWSON, *supra* note 174, at 13.

180. See The Center for Responsive Politics, *Long Term Contribution Trends — Computer/Software Industry*, at <http://www.opensecrets.org/industries/indus.asp?Ind=C5120> (last visited May 31, 2002).

181. The Center for Responsive Politics, *Long Term Contribution Trends — Defense Industry*, at <http://www.opensecrets.org/industries/indus.asp?Ind=D> (last visited May 31, 2002).

182. The Center for Responsive Politics, *Long Term Contribution Trends — Communications/Electronics Industry*, at <http://www.opensecrets.org/industries/Indus.asp?Ind=B> (last visited May 31, 2002).

183. See CLAWSON, *supra* note 174, at 13.

184. *Id.*

loophole that is sought is the coveted corporate tax break.¹⁸⁵ So many tax breaks are lobbied for each year that according to one commentator, “[t]he Tax Code has become the de facto U.S. industrial policy.”¹⁸⁶ For example, “In 1955, corporations paid 27.5% of all federal taxes, but in 1995 they paid only 11.6%.”¹⁸⁷ For purposes of this Note, these facts demonstrate that: (1) elected officials are influenced by corporations because they contribute heavily to their campaigns; and (2) because corporations are a powerful force within the economy. Thus when companies that are heavily dependent on foreign trade, such as those in communications, defense and software industries, require government assistance, they generally receive it — when the FSC was threatened, the government responded.

According to a recent study of corporate financial statements, 250 companies utilizing the FSC have reported approximately \$1.2 billion in FSC tax benefits received.¹⁸⁸ Eighty-seven percent of these benefits are received by the fifty largest companies (over 500 employees) that are heavily engaged in export trade.¹⁸⁹ The WTO has found that the FSC benefits amount to \$2.5 billion per year.¹⁹⁰ Perhaps not coincidentally, a large share of these firms are in the defense, communications and software industries.¹⁹¹

Corporations are certainly not shy when it comes to asking the U.S. government for help. The nature of that help, of course, comes in different forms depending upon the immediacy of the circumstances.¹⁹² Generally, the level of vigor with which

185. See Glenn Kessler & John Lancaster, *Lobbyists Shaping Stimulus Bill; Special Interests Scramble for Tax Breaks, Other Windfalls*, WASH. POST, Nov. 11, 2001, at A1.

186. See CLAWSON, *supra* note 174, at 71.

187. *Id.* at 223.

188. See Oyola, *supra* note 32, at 389.

189. *Id.*

190. Press Release, European Union, WTO Panel Condemns U.S. Export Subsidies (Sept. 20, 1999), available at <http://www.eurunion.org/news/press/1999/1999058.htm>.

191. See Oyola, *supra* note 32, 389-91.

192. One needs only to look at the recent aftermath of the September 11, 2001 terrorist attacks for an example, where the U.S. airline industry asked for and received a multi-million dollar bailout. Other more mundane instances occur through routine lobbying efforts. See, e.g., Airline Industry Financial Assistance Act, Pub. L. No. 107-42, 115 Stat. 230 (2001).

corporations employ when engaged in petitioning their government varies with both the legislative cycle and the company's business goals.¹⁹³ The corporate pressure on both the administration and Congress with regard to the FSC issue has been targeted and effective. Domestic business and trade organizations such as the Business Roundtable, the European American Business Council, and National Foreign Trade Council as well as policy think tanks, such as the CATO Institute and the American Enterprise Institute, have organized discussion fora and Internet sites that are focused on the FSC dispute in order to focus concern over the issue in a measured way that benefits the firms.¹⁹⁴ The NFTC for example, organized a joint letter to President George W. Bush, signed by sixty-eight chief executive officers of the largest U.S. corporations, urging the administration to make the FSC dispute a trade priority and encourage a negotiated settlement, presumably to avoid losing their tax break.¹⁹⁵

An important rift in the political support for the FSC comes from those members of Congress and public policy groups opposed to the tremendous returns that the exporters receive in tax breaks as an example of corporate welfare. Senator John McCain denounced the ETIA as an expansion of an "unnecessary subsidy" that includes "full benefits to defense contractors . . . and agricultural cooperatives" where "few of these benefits . . . trickle down to the American worker."¹⁹⁶ There were several speeches made on the floor of the House of Representatives, as well as dissenting views included in the congressional committee report on the ETIA, which railed against the legislation for the enormous subsidy benefits it provided as corporate welfare to weapons exporters, the pharmaceutical industry and the to-

193. See, e.g., Stephen Labaton, *Congressional Broadband Fight Intensifies*, N.Y. TIMES, Feb. 27, 2002, at C4; CLAWSON, *supra* note 174.

194. See, e.g., NFTC, at <http://www.nftc.org> (homepage discussing the FSC Dispute and its efforts to assist in legislative solutions); Symposium, *Will the FSC Dispute Ignite a Transatlantic Trade War?* (Oct. 4, 2000) (forum transcript and audio/visual recording), at <http://www.freetrade.org/pubs/speeches/cf-100400.html> (last visited April 15, 2002).

195. See NFTC, *supra* note 194; Paul Magnusson, *This Tax Break Could Trigger a Trade War*, BUSINESS WEEK, Sept. 4, 2000, at 103.

196. 146 CONG. REC. S11,454 (daily ed. Nov. 4, 2000) (statement of Sen. McCain).

bacco industry.¹⁹⁷ Despite these modest attempts to defeat the bill and as testament to the power of industry lobbying, the ETIA did of course pass both chambers of Congress and become law.

American industry has had some form of export subsidy for over thirty years. Firms first received the DISC to encourage exports.¹⁹⁸ Once utilized and relied on, it became a necessity of exporting, and companies were loath to surrender the subsidy in spite of the GATT decision against it.¹⁹⁹ According to one commentator, "the business lobby's challenge [was to] . . . preserve the lucrative tax break while at least appearing to address the substance of Europe's complaint."²⁰⁰ As part of the 1984 tax relief legislation, exporters demanded and received the GATT compliant FSC.²⁰¹ Corporate exporting interests, again, lobbied to preserve the subsidy and assisted in the passage of the ETIA, only this time with greater benefits.²⁰² Perhaps recognizing that these export benefits will have a brief shelf-life under the WTO, a degree of over-compensation was built into the law.²⁰³ In the final analysis, now that the U.S. has lost the ETIA appeal — and with it, all legal recourse — serious political decisions (as well as corporate resistance) over both tax and trade policy will have to be confronted and overcome.²⁰⁴ Whenever these discussions do commence, industry will undoubtedly be a party to them.²⁰⁵

197. See 146 CONG. REC. H11,891 (daily ed. Nov. 14, 2000) (statement of Rep. Stark); 146 CONG. REC. H11,893 (daily ed. Nov. 14, 2000) (statement of Rep. Doggett); H.R. REP. NO. 106-845, *supra* note 41, at 63-70 (Dissenting and Additional Views of Reps. Stark, Doggett and Lewis).

198. See *supra* Part II.B.1. discussion on the DISC; see also Hudec, *supra* note 87.

199. See *supra* Part II.B.2. discussion on the FSC; see also Sernau, *supra* note 25.

200. Magnusson, *supra* note 195, at 103.

201. See *supra* Part II.B.2. discussion on the FSC; Sernau, *supra* note 25.

202. See Magnusson, *supra* note 195, at 103; *supra* Part II.B.3. discussion on the ETIA; Clark, *supra* note 67.

203. See Magnusson, *supra* note 195, at 103.

204. See Stephen Norton, *TAXES: Thomas, Rangel Urge Administration to Lead on FSC*, CONGRESS DAILY, Feb. 27, 2002, at 17; Guy de Jonquieres, *Raising the Transatlantic Trade Stakes*, FIN. TIMES (London), Jan. 14, 2002, 2002 WL 3313225; Funk, *supra* note 165.

205. See, e.g., Stephen Clapp, *Food Industry Fears Impact of WTO Tax Decision*, FOOD CHEMICAL NEWS, Jan. 21, 2002, at 13, available at 2002 WL

B. Fashioning a Bargaining Chip — Motivations of the EU

After the initial creation of the FSC in 1984, the EU did not challenge the U.S. for some fourteen years.²⁰⁶ Why? The most palpable theory is that the EU attacked the FSC because it was tactically looking for a quid pro quo exchange of sanctions penalties.²⁰⁷ Earlier the EU was badly bruised by two major trade defeats before the WTO, over its discriminatory banana importing practices (“Banana’s case”)²⁰⁸ and for its ban on hormone treated beef (“Beef-hormone”).²⁰⁹ As was permitted by the WTO, the U.S. imposed respectively \$191 million and \$116 million in punitive duties on European products imported into the states.²¹⁰ However, this has been somewhat muted in the Banana’s case as the EU and the U.S. eventually brokered a deal and avoided the punitive sanctions under the so-called “carousel” retaliation plan.²¹¹

Comparatively, the penalties faced by the EU in the Bananas and Beef-hormone cases are miniscule to that faced by the U.S. in the FSC case. At least one commentator has described the FSC matter as the “costliest battle yet in an escalating trade

11878560. The industries that have been targeted for EU sanctions seem to be more concerned over the prospects of being hit by \$4 billion in punitive sanctions than they are at losing their ETIA tax benefit. Proof of this is in the recent U.S. appeal to the WTO to cut the sanctions figure to a level that is “linked to the purported impact of the FSC on the EU’s actual trade interests.” Scott, *supra* note 162.

206. See Magnusson, *supra* note 195, at 103.

207. See Agnew, *supra* note 15; Hufbauer, *supra* note 22.

208. WTO Panel Report on European Communities: Regime for Importation, Sale and Distribution of Bananas, *adopted* Sept. 25, 1997 (WT/DS27/R/USA), at http://www.wto.org/english/tratop_e/dispu_e.htm.

209. WTO Panel Report on European Communities: Measures Affecting Meat and Meat Products (Hormones), *adopted* May 20, 1996 (WT/DS27/R/USA), at http://www.wto.org/english/tratop_e/dispu_e.htm.

210. *EU Aims for Huge Sanctions on the U.S.*, WALL ST. J., Nov. 20, 2000, at A2.

211. See Press Release, Office of the United States Trade Representative, U.S. Trade Representative Announces the Lifting of Sanctions on European Products as EU Opens Market to U.S. Banana Distributors (July 1, 2001), available at <http://usinfo.state.gov/topical/econ/wto/pp0701.htm> (The “carousel” sanctions plan, as part of the African and Caribbean Trade Act of 2000, Pub. L. No. 106-200, 114 Stat. 251 (2000) (codified in scattered sections of 19 U.S.C. (2000)) provided for a rotating list of punitive sanctions on European goods, worth collectively \$300 million, in order to make the retaliation more painful).

war between the United States and the European Union."²¹² With so much at stake, it would seem reasonable to believe that good faith negotiations between the U.S. and the EU are underway. The Fourth WTO Ministerial Meeting in Doha, Qatar in November 2001, seemed to present an opportunity to jump-start such talks, but with the U.S. appeal already in play at the time, any chance for a negotiated settlement, at least publicly, had to be put off. Notwithstanding the myriad of other trade issues between the U.S. and the EU, thus far no explicit plans have been announced regarding formal negotiations, except for ad hoc ministerial meetings.²¹³

When dealing with the U.S. in trade matters, Europe has several long-standing concerns, among them is the dominance of the U.S. in both the European and global markets and the corollary, the market share by European firms in both markets. Driven by competitiveness and fueled by domestic pressures to stem U.S. cultural hegemony, the EU was pressed into action by its large Member States, such as France, for example.²¹⁴ At the height of the Internet/dot-com boom, the U.S. extended FSC benefits to the American software industry, which the EU estimated would save the industry some \$600 million in taxes over a five year period.²¹⁵ With concerns over the U.S. preeminence in intellectual property industries being as great as they are, particularly in Europe, this announcement was almost too much for the EU to bear.²¹⁶ This tax subsidy to the U.S. software industry, a product of "adroit lobbying," was enthusiastically promoted.²¹⁷ Indeed today, Microsoft, Inc. is widely considered to be one of the FSC's greatest beneficiaries.²¹⁸ With this new addition to a subsidy that the EU estimated at \$2.5

212. Clark, *supra* note 67, at 306.

213. See Alden, *supra* note 11, at 10.

214. See *Interview - Lamy*, *supra* note 16; Alden, *supra* note 11.

215. Press Release, European Union, EU and U.S. Held WTO Consultations of FSC Export Subsidies (Dec. 17, 1997), available at <http://www.eurunion.org/news/press/1997-4/pr85-97.htm>.

216. See *id.*

217. Jonathan I. Feil & Mary Ann Ekman, *Foreign Sales Corporations: Tax Savings Opportunities for Software Exporters*, COMPUTER LAW., Sept. 1998, at 11, 11.

218. Les Blumenthal, *WTO Ruling Targets U.S. Tax Breaks for Exporters; Trade: Boeing, Microsoft Among Companies that WTO Says are Receiving Billions in Illegal Subsidies*, NEWS TRIB. (Tacoma), Aug. 26, 2001, at D1.

billion a year,²¹⁹ coupled with its losses before the WTO, the EU was prepared to use “tax policy as a sword.”²²⁰ Congress seemed convinced of this motivation and stated so in its report on the FSC repeal/ETIA legislation, calling it “deeply troubling and provocative.”²²¹ Moreover, the congressional report further noted that the impetus behind the EU’s challenge germinated not from its corporate citizenry but from the EU itself in a search for a sanctions bargaining chip with the U.S.²²² The EU governance is certainly not immune from corporate or popular influence. To be sure, European trade officials are keenly aware of the cries of their countrymen when it comes to trade matters.²²³ Furthermore, while the EU is pointing its finger at the U.S., its own hand is surely not unclean — many European firms receive government subsidies (“grants”) that are worth around \$200 billion.²²⁴ Additionally, the U.S. has claimed that several tax schemes of EU Members grant nearly the same “illegal subsidy” benefit as the FSC program, causing some EU Members to be concerned that the U.S. may soon challenge their tax schemes before the WTO.²²⁵

Exacerbating the already sensitive trade imbroglio with the EU, the Bush Administration announced on March 5, 2002 that

219. Press Release, European Union, WTO Panel Condemns U.S. Export Subsidies (Sept. 20, 1999), available at <http://www.eurunion.org/news/press/1999/1999058.htm>.

220. See Agnew, *supra* note 15; Alden, *supra* note 11.

221. See H.R. REP. NO. 106-845, *supra* note 41, at 14.

222. *Id.*

223. See, e.g., ECONOMIST, *supra* note 156.

224. Keith Marsden, *On Trade, the EU Is Economical with La Verite; A Top EU Trade Negotiator Makes His Case Without Acknowledging its Flaws*, WALL ST. J. EUR., Nov. 30, 2000, 2000 WL-WSJE 27827580. The EU trade official responded to the accusation of hypocrisy in the discussion of government subsidies by insisting that the EU subsidies conform to EU treaties and WTO rules, “countries must play by the rules.” Finally the unnamed official concluded that “countries can always complain to the WTO if they are not satisfied.” *Id.*

225. See Cecelia B. Skeen, Note, *Knick-Knack Paddy Whack Leave the FSC Alone: An Analysis of the WTO Panel Ruling that the U.S. Foreign Sales Corporation Program Is an Illegal Export Subsidy Under GATT*, 35 NEW ENG. L. REV. 69, 113 (2000); Geoff Winestock & Neil King, Jr., *WTO Rules Against Law Giving Big Tax Breaks to U.S. Exporters*, WALL ST. J. EUR., Jan. 15, 2002, 2002 WL-WSJE 3382894; U.S. Appellant Brief – ETIA, *supra* note 50, at 17.

it was imposing temporary tariffs of up to 30% on steel imports from Europe and elsewhere in order to protect the domestic steel industry from depressed prices.²²⁶ Though currying favor with the domestic steel industry, the decision by President Bush did nothing but rile the EU. Ironically, such a move has made future trade negotiations that much more difficult but all the more necessary.

Tactically, if the EU winds up using its tax policy defensively, then the U.S. should consider earnestly pursuing negotiations towards a sanctions settlement. If, however, the EU is behaving offensively, the U.S. should consider a WTO challenge of its own regarding the EU's tax subsidies.²²⁷ In any case, the U.S. must proceed cautiously. Any offensive action that ends in an "awarding" of sanctions, should be understood as "fine[s] . . . that both parties pay but nobody collects."²²⁸

The FSC dispute is one of many trade conundrums between the U.S. and EU. Annually, each government publishes a report that comprises a summary of the foreign trade barriers that it encounters with the other (as well as with other nations). The EU's *Report on United States Barriers to Trade and Investment*, for example, lists among its contentions with the U.S., the Helms-Burton Act, the Iran-Libya Sanctions Act, "Buy America" provisions, restrictions on the satellite communications market and of course the FSC dispute, to name but a few.²²⁹ The U.S. insists that each dispute is to be treated as a separate challenge.²³⁰ Yet this may be an exercise in futility as

226. See Proclamation No. 7529, 67 Fed. Reg. 10,553 (Mar. 5, 2002), available at <http://www.whitehouse.gov/news/releases/2002/03/20020305-7.html>; Geoff Winestock, *EU Wields a New Weapon in Trans-Atlantic Steel Fight*, WALL ST. J. EUR., Jan. 11, 2002, 2002 WL-WSJE 3352413; Neil King, Jr. & Geoff Winestock, *Bush's Proposed 30% Tariffs May Spark Trade Battle or Derail Other Efforts*, WALL ST. J., Mar. 7, 2002, at A3; Winestock, *supra* note 166.

227. Agnew, *supra* note 15, at 141.

228. Griswold, *supra* note 167.

229. See EUROPEAN COMM'N, REPORT ON UNITED STATES BARRIERS TO TRADE AND INVESTMENT 2001 (2001), available at http://www.europa.eu.int/comm/trade/bilateral/usa/pr_usrbti.htm; UNITED STATES TRADE REP., THE 2001 NATIONAL TRADE ESTIMATE REPORT ON FOREIGN TRADE BARRIERS (2001), available at http://www.ustr.gov/html/2001_contents.html.

230. See Alden, *supra* note 11. Commenting on the two disputes:

many of these trade disputes are not only interrelated but have both systemic and underlying causes that must be addressed if there is to be any lasting resolution and compromise. Case-in-point, quoting an EU official, the *Wall Street Journal* reported that while the FSC dispute and the U.S. steel tariffs are “not directly linked, ‘the steel case will influence the political climate.’”²³¹

IV. CONCLUSION

A. *Economics of the FSC*

With all the international legal trouble that is attached to FSCs, why does the U.S. insist on holding on to it so fervently? Primarily, as suggested by this Note, it is because the exporting corporations, which mostly utilize this program, have saved so much money from using FSCs. Through their well-packaged lobbying efforts, they are convincingly able to seduce the political decision-makers that this is a matter of sovereignty and equity. These corporate beneficiaries tout the U.S. Treasury department statistics that the FSC program increased U.S. exports by \$150 billion alone in 1992.²³² However, a report by the Congressional Research Service of the Congress finds that though the FSC attracts investment to exporting activities, the program probably distorts the market and artificially boosts exporting beyond what the natural market forces would have accomplished otherwise.²³³ More significantly, adjusting for currency exchange rates, the FSC’s effect of increasing exports also has the effect of increasing *imports* and thus does not diminish the negative trade balance the U.S. has with the EU.²³⁴

Some trade specialists have speculated that the steel and tax issues may become entwined, with the United States backing off on protective steel tariffs in exchange for Europe relenting in its pursuit of the tax dispute. But that would risk arousing fury among U.S. steel companies, steelworkers, and their allies, and a U.S. official declared flatly, “These are separate issues.”

Blustein, *supra* note 161.

231. See Winestock, *supra* note 166.

232. See Larkins, *supra* note 28, at 14-16.

233. DAVID L. BRUMBAUGH, LIBRARY OF CONG., CONG. RESEARCH SERV. REPORT, EXPORT TAX BENEFITS AND THE WTO: FSCS AND THE ETIA REPLACEMENT PROVISIONS 5 (2001).

234. *Id.* at 5.

This is a surprising economic result considering that the FSC and its antecedent programs were created specifically to narrow the trade deficit and balance of payments. The impact on forgone revenues to the U.S. Treasury was estimated by the Joint Committee on Taxation at \$2.7 billion for the fiscal year 2000.²³⁵ This statistic tells the real story since the foregone tax revenue is in effect a subsidy to these corporate exporters — an enormous sum, albeit comparatively modest to the subsidies received by EU firms.²³⁶ Though complicated and beyond the scope of this Note, the economic analysis is telling in that it exposes the fallacies propagated by the corporate lobbyists about the supposed benefits of the FSC.

The evidence is clear: the FSC program is nothing more than a camouflaged subsidy. The WTO decisions that declared the FSC and ETIA to be an illegal subsidy under GATT merely confirm this obvious fact. The options for the U.S. are sobering. It will either have to: (1) accept the WTO decision and dismantle this export subsidy in its present form (which will displease the corporate benefactors); (2) ignore the decision and accept the EU sanctions (equally displeasing to both consumers and corporations); or (3) restructure its tax code (a challenging but possibly long overdue endeavor).

The FSC (and its successor the ETIA) is nothing more than the classic product of pork barrel politics. It is not an essential core of U.S. tax law and policy. Notwithstanding all of the arguments supplied by the lobbyists, the FSC can and should be abandoned.²³⁷ The U.S. should respect its international legal obligation by either drafting a new legislative device replacing the FSC (ETIA) that meets WTO scrutiny or a through a total reform of the U.S. tax code. The latter option should be contemplated with a goal of permitting U.S. firms to achieve

235. *Id.* at 6.

236. *See* Marsdan, *supra* note 224.

237. *See* Evelyn Iritani, *U.S. Must Rewright Tax Law, WTO Says*, L.A. TIMES, Aug. 21, 2001, at C1 (“Rep. William M. Thomas, chair of the House Ways and Means Committee, which writes tax policy, said the WTO ruling is evidence that America’s tax system is ‘antiquated,’ and needs a major overhaul to lessen the burden on U.S. multinationals without violating international trade rules.”).

greater competitiveness in global trade while neither sacrificing tax neutrality nor progressive equity.²³⁸

In the final analysis, the U.S. will probably attempt to have it all. Washington has signaled that it wants to retain the export benefit but make it WTO compliant.²³⁹ This reaching out by the U.S. will probably be ignored by the WTO since it will not want to appear to furnish policy guidance that may appear to impinge on national sovereignty. In other respects, the timing for a major overhaul of the U.S. tax code may be inopportune while the nation is engaged in its pursuit to quash international terrorism.²⁴⁰ Moreover, some members of Congress are concerned that there may be hidden political objectives lying in wait over any tax code reform.²⁴¹ But that aside, when is there ever an opportune time to engage in such a complex endeavor? Congress should embrace this challenge and begin to formulate a tax code for the 21st century. This leads to the only practical short term tactic for resolution — negotiation.

B. Negotiate

No comprehensive effort to engage in a summit over the fundamentals underlying the various EU/U.S. trade imbroglios has occurred to date.²⁴² These substantive issues have taken a backseat to the procedural gamesmanship of the trade negotiators, bent on achieving victory at any cost in order to win a sanctions award.²⁴³ EU Trade Minister Pascal Lamy recently urged the U.S. and the EU to search hard for collaborative and comprehensive solutions to bilateral trade problems.²⁴⁴ Mr.

238. *See id.*

239. *See Mann, supra note 159.*

240. *See CONGRESS DAILY, supra note 155.*

241. *See Norton, supra note 204* (Rep. Charles Rangel, ranking Democrat member of the House Ways and Means Committee, “expressed concern that Republican interests in changing . . . the tax code will simply be a launching point for taking on more fundamental tax reform and a push for options that he warned could lead to inequities in tax policy.”).

242. *See Lamy – Address, supra note 172.*

243. *Id.* (Alluding to this situation, EU Trade Minister Pascal Lamy acknowledged that “bilateral EU/U.S. trade needs to be fixed, and particularly the trade negotiators, locked in mortal combat, shrieking with joy at each new negotiating strategy that undercuts the other players, forcing one to ‘pay twice,’ another to be demandeur.”).

244. *See id.*

Lamy recognized that the WTO settlement mechanism is not “a faceless enforcer” to be used to litigate case after case in order to “secure a fair outcome for our companies” lest the U.S. and EU destroy their “credibility as negotiators.”²⁴⁵ Mr. Lamy’s advice hopefully points to a way out of the FSC impasse for the U.S. and the EU. The announced “Millennium Round” of trade talks commenced at the WTO Ministerial Meeting in Doha potentially holds such promise.²⁴⁶ The political leaders in Congress as well as the loose coalition of corporate associations clearly would prefer negotiation to sanctions.²⁴⁷ In fact, the U.S. procedural tactics of appealing at each step of this dispute in the WTO was practically engineered to permit the parties opportunity to negotiate.²⁴⁸ Unfortunately local politics on both sides has continually plagued this effort.

While many commentators and officials trumpet this dispute as one of the most significant trade conflicts to date, especially in light of the potentially devastating punitive sanctions, its rhetorical value is greater than any de facto harm that may result.²⁴⁹ Although the issue is being driven by the self-interested concerns of both European and American multinational corporations, seeking to increase their respective profits, exports and market shares, they do have a legitimate grievance. This grievance, however, stems not from traditional claims of unfair competitive practices or traditional protectionism (tariffs), but from a fundamental difference between the American and European tax systems and compliance with WTO treaties and obligations.²⁵⁰ The U.S. has argued that nations for decades have been free to choose their own taxation system free from foreign challenge.²⁵¹ The EU responds that

245. *Id.*

246. For more details on the objectives and goals of these new rounds of trade talks, see WTO, at <http://www.wto.org> (last visited May 31, 2002).

247. See Larkins, *supra* note 28, at 14-16; CONGRESS DAILY, *supra* note 155.

248. See *Business & Finance: U.S. Asked to Revamp Tax Regime*, IRISH TIMES, Aug. 21, 2001, at 15.

249. See, e.g., *supra* note 5 (statement of Rep. Archer, calling the potential showdown with the EU over FSCs the “mother of all trade wars”).

250. See Renato Ruggiero, *Wither the Trade System Next?*, in THE URUGUAY ROUND AND BEYOND 123, 133 (Jagdish Bhagwati & Mathias Hirsch eds., 1998).

251. Magnusson, *supra* note 195, at 103.

the U.S. has challenged it on the traditionally domestic areas of food safety and environmental regulation.²⁵²

There are many structural differences among the WTO members with regard to their domestic labor, environmental policies, agriculture, anti-trust, cultural policies and economic systems. These parochial differences are the next great barrier that must be contemplated if the goal of greater trade cooperation is to be realized. In the thought-provoking essay, *Wither the Trade System Next?*, former WTO Director-General Renato Ruggiero, advanced the idea that in the highly-integrated world of the early 21st century, "deeper integration [among states] is . . . giving rise to . . . frictions based not on pressures for economic competition or protection but on clashes between distinct national systems . . . investment rules, anti-trust and competition laws, taxation, and labour, environmental and cultural policies."²⁵³ It is from these systemic "frictions" that governments are being challenged, on the one hand, to harmonize the differences internationally and to preserve a sense of sovereignty and control over its national destiny, on the other.²⁵⁴ Nowhere has this systemic "friction" been more keenly felt than in the FSC dispute.

The U.S. has generally taken the view that multilateral trade agreements should not impact national tax systems.²⁵⁵ Moreover, the U.S. considers that bilateral tax treaties are the appropriate vehicles in which to coordinate tax policy.²⁵⁶ The EU, to the contrary, has been more enthusiastic in bringing harmony between both trade and tax rules.²⁵⁷ The U.S. should accept this more comprehensive approach toward coordination between trade and tax rules. Professor Paul McDaniel argues in *Trade and Taxation* that "subsidies provided through a tax system . . . should be subject to scrutiny under trade agreements, just as are direct subsidies affecting trade or competition" but "provisions of a country's tax system that comprise the normative . . . structure of a tax should be outside the scope

252. *Id.*

253. Ruggiero, *supra* note 250, at 133.

254. *See id.* at 134.

255. *See* Paul R. McDaniel, *Trade and Taxation*, 26 BROOK. J. INT'L L. 1621, 1621 (2001).

256. *Id.*

257. *Id.*

of trade agreements and procedures.²⁵⁸ If the U.S. was to adopt this posture, it may provide the theoretical undercarriage necessary to enable policymakers to craft coordinated trade and tax policy that meets with WTO scrutiny.

One final consideration, as suggested by William M. Funk, a tax attorney, in his article *The Thirty-Years Tax War*, is that during negotiations, the U.S. and EU must be realistic.²⁵⁹ The parties should first recognize that in this world there exists both the territorial and worldwide tax systems, and then fashion rules for sheltering extraterritorial income.²⁶⁰ By accurately reflecting the "international economic balance of power" any compromise forged in such an acknowledgement will have a sturdier foundation upon which to move forward.²⁶¹ Thus, apart from politics and moneyed interests, the EU and the U.S. should lead by example and take up the challenge in the FSC/ETIA dispute in order to bring harmony to the global trading system and establish a permanent economic peace.²⁶²

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258. *Id.* at 1638 (note that Professor McDaniel, in light of these observations, believes that the WTO made a correct decision in the FSC case).

259. See Funk, *supra* note 167, at 76.

260. *Id.*

261. *Id.*

262. Advocating greater cooperation and global leadership for the sake of the international trading system, see Pascal Lamy & Robert B. Zoellick, *In the Next Round*, WASH. POST, July 17, 2001, at A17.

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