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The \$4 Billion Question: An Analysis of Congressional Responses to the FSC/ETI Dispute under WTO Export Subsidy Standards

*William Chou**

During the decade-long relationship between the United States and the World Trade Organization (WTO), perhaps no controversy has fomented as long and bitterly as the dispute over the U.S. tax benefits for exporters. This article analyzes two competing bills before the House of Representatives, both devised to bring the United States in compliance with the WTO's ruling against the U.S. Foreign Sale Corporation (FSC) and Exterritorial Income (ETI) tax regimes as prohibited export subsidies.¹ Hit with a \$4 billion retaliatory tariff by the European Union, the House sought new tax legislation that would preserve at least some of the tax benefits exporters have enjoyed since 1971.² One bill, proposed by Representatives Philip

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EDITOR'S NOTE: After this article was written, Congress passed the final version of the American Jobs Creation Act of 2004, H.R. 4520. ENR 108th Cong. (2004), on Oct. 11, 2004, and it was signed into law by President George W. Bush on Oct. 22, 2004. The provisions of the American Jobs Creation Act are substantially similar to the versions of the Thomas Bill analyzed in Mr. Chou's article. As such, the subsequent passage and enactment of legislation in this area does not affect the analysis of this article.

¹ Bills have also been introduced in the Senate. Both Senators Charles Grassley of Iowa and Orrin Hatch of Utah introduced bills (respectively S. 1637 108th Cong. (2003) and S. 1475 108th Cong. (2003)) to bring the United States into compliance with the WTO FSC/ETI ruling. Subsequently, Grassley and Hatch cosponsored the Jumpstart Our Business Strength (JOBS) Act, S. 1637 108th Cong. (2004), which was passed on May 11, 2004. This bill was included as an amendment (S. Amdt. 3562) to the House bill, H.R. 4520 108th Cong. (2004), which was passed on June 17, 2004. The Senate version of the bill bears many similarities to the Crane-Rangel Bill discussed *infra*. The House version of the bill, also known as the Thomas Bill, is discussed extensively in this article.

² *Bill to End Subsidies to U.S. Exporters Is a Boon for Special Interests*, KNIGHT RIDDER/TRIB. BUS. NEWS WASH. BUREAU (DC), June 18, 2004, available at 2004 WL 55575077. The sanctions began in March 2004 with an additional five percent duty on certain U.S.-exported goods, with the percentage rising by one percent each month. See *EU*

Crane of Illinois and Charles Rangel of New York (Crane-Rangel Bill or Crane-Rangel), provides tax credits for domestic manufacturers of up to ten percent for domestic production receipts.³ A second bill, proposed by Representative Bill Thomas of California, focuses on providing a broader range of tax initiatives that benefit both domestic manufacturers and multinationals with overseas operations.⁴ These initiatives include greater double-taxation relief for foreign sources of income, Alternative Minimum Tax (AMT) relief, domestic production incentives similar to those in the Crane-Rangel Bill, and new dividend deductions to induce companies to reinvest foreign earnings back in the United States.

The competition between these bills did not cut neatly across party lines; it reflected bipartisan ideological differences that pitted legislators of the same party against one another on how the revenues from the FSC/ETI repeal should be allocated. Not surprisingly, major corporations and organizations have aligned on opposite sides of this issue. Caterpillar, Boeing, Microsoft, and the AFL-CIO have lined up in support of the Crane-Rangel Bill.⁵ On the other side, Coca-Cola, Hewlett Packard, and Exxon-Mobil have put their weight behind the Thomas Bill.⁶ Ultimately, a second version of Congressman Thomas's Bill (Thomas Bill) prevailed, but only after compromise and the addition of special interest provisions to lure the votes of key Congressmen.⁷ Meanwhile, the Senate passed its own legislation, leading the way for the formation of a conference committee to reconcile the two bills in the fall of 2004.⁸

Parts I and II of this article provides a historical background of the FSC and ETI regimes, respectively. Part III summarizes the provisions of the Crane-Rangel Bill. Part IV discusses the relevant sections of the Thomas Bill. Part V analyzes the Thomas Bill and determines whether its provisions are likely to be found compliant by a dispute settlement body under current WTO legal standards.

Hails Latest U.S. Move to End Trade Dispute, REUTERS NEWS (London), June 18, 2004, available at <http://www.marketnewzealand.com/MNZ/news/story/4558/10782.aspx>.

³ H.R. 1769, 108th Cong. (2003).

⁴ H.R. 2896, 108th Cong. (2003).

⁵ See Juliet Eilperin, *Export Tax-Break Battle Grows Intense*, SEATTLE TIMES, July 8, 2003, at D3.

⁶ Deirdre Shesgreen, *Lawmakers, Corporations Pick Sides, Prepare for Fight on House Trade Bill*, ST. LOUIS POST-DISPATCH, Mar. 26, 2004, at A4.

⁷ H.R. 4520, 108th Cong. (2004).

⁸ S. 1637, *supra* note 1.

I. A HISTORY OF THE FSC TAX REGIME

A. Precursor to the FSC: the DISC

The FSC and ETI regimes trace their origin to 1971, when Congress enacted the Domestic International Sale Corporation (DISC) tax regime to provide tax incentives for U.S. exportation activity.⁹ To qualify as a DISC, a corporation must be incorporated within the United States,¹⁰ and it must ensure that (1) 95% or more of its gross receipts are “Qualified Export Receipts;”¹¹ (2) 95% of its assets are “Qualified Export Assets;”¹² and (3) the corporation has only one class of stock and a minimum of \$2,500 in capital.¹³ A corporation that meets the above requirements must also formally elect to be treated as a DISC for the taxable year.¹⁴ The purpose of implementing the regime was to allow for the deferral of taxes on income from exports; a DISC was able to defer income tax for up to one-half of its foreign profits.¹⁵ Those profits were not taxed unless they were distributed to shareholders in the form of dividends.¹⁶

⁹ Revenue Act of 1971, Pub. L. No. 92-178, S. 501, 85 Stat. 497 (1971). The DISC legislation was, in significant part, a result of complaints by businesses over the growing trade imbalance, as well as the impact of the anti-deferral rules imposed by subpart F (§§ 951-64) of the Internal Revenue Code (2002). See Harold S. Peckron, *Uniform Rules of Engagement: The New Tax Regime for Foreign Sales*, 25 HASTINGS INT’L & COMP. L. REV. 1, 5 (2001).

¹⁰ I.R.C. § 992(a)(1) (1973).

¹¹ *Id.* § 993(a). Qualified Export Receipts include gross receipts from the sale, exchange, or other disposition of “Export Property” and gross receipts from the lease or rental of Export Property.

¹² *Id.* § 993(b). Export Property is an example of a Qualified Export Asset. I.R.C. § 993(c)(1) (1973) defines Export Property as general property that is:

(A) manufactured, produced, grown, or extracted in the United States by a person other than a DISC,

(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a DISC, for direct use, consumption, or disposition outside the United States, and

(C) not more than 50% of the fair market value of which is attributable to articles imported into the United States.

¹³ *Id.* § 992.

¹⁴ *Id.* § 992(b).

¹⁵ See Robert E. Hudec, *Reforming GATT Adjudication Procedures: the Lessons of the DISC Case*, 72 MINN. L. REV. 1443, 1446 (1988).

¹⁶ As long as the profits were retained within the DISC and invested in “qualified export assets” under I.R.C. § 993(b)(7) (1973), the profits from the DISC remained untaxed. It was relatively easy for a U.S. manufacturer to participate in the DISC regime. For instance, many corporations set up DISC-eligible shell entities solely for the purpose of processing sales of export goods. Not surprisingly, the DISC regime enjoyed significant popularity. By March of 1972, there were 1,136 DISCs, and by 1981, the number of DISCs grew to 13,796. See

In 1973, European signatories to the General Agreement on Tariffs and Trade (GATT) protested that the DISC regime was an illegal subsidy under Article XVI of the GATT.¹⁷ Specifically, these nations argued that the DISC tax regime in effect provided tax exemptions because a corporation could potentially defer tax on its export earnings indefinitely through a DISC.¹⁸ In 1976, a GATT panel declared that the DISC regime constituted an illegal subsidy scheme under the GATT Agreement.¹⁹ The panel found that by examining the DISC legislation in terms of its substantive economic consequences, as opposed to form, it was a measure “essentially related to exports” that tended to lead to the expansion of export activity.²⁰ The United States agreed before the GATT Panel to withdraw the DISC scheme to avoid retaliatory tariffs, and in 1983, Congress adopted the FSC regime in its place.²¹

B. FSC Tax Regime

The FSC regime was implemented by the Tax Reform Act of 1984.²² Like the DISC regime, the FSC scheme afforded tax benefits to specifically-designated entities (FSCs) that met certain qualifications.²³

David L. Boren, *Boren on DISC and GATT*, 16 TAX NOTES 271 (1982).

¹⁷ The European signatories alleged, *inter alia*, that the DISC regime violated Article XVI:4 of GATT. This article provides that:

[C]ontracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.

General Agreement on Tariffs and Trade (GATT), art. XVI:4, Oct. 30, 1947, 61 Stat. A-11, A-51, T.I.A.S. 1700, 55 U.N.T.S. 194, 250 (amended 1962), *available at* <http://www.wto.org/english/>.

¹⁸ GATT Panel Decision Report on DISC United States Tax Legislation, Nov. 12, 1976, GATT B.I.S.D (23rd Supp.) ¶ 28 (1977).

¹⁹ *Id.* ¶ 80.

²⁰ *Id.* ¶ 67.

²¹ See Ronald D. Sernau, *The Foreign Sales Corporation Legislation: A \$10 Billion Boondoggle*, 71 CORNELL L. REV. 1181, 1190 (1986). The DISC regime still exists as an incentive for small exporters, though DISCs are assessed an interest charge in order to comply with GATT rules prohibiting the deferral of tax without interest. See Rosendo Lopez-Mata, *Income Taxation, International Competitiveness and the World Trade Organization's Rules on Subsidies: Lessons to the U.S. and to the World from the FSC Dispute*, 54 TAX LAW. 577, 596 (2001).

²² The FSC provisions of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984), was adopted into the Internal Revenue Code as §§ 921-27 (repealed 2000).

²³ See I.R.C. § 922 (1984) (repealed 2000), which defines an FSC. Like a DISC, a company must elect to become an FSC in order to be considered as such for the taxable year. *Id.* § 922(a)(2).

However, an FSC must be established in a foreign jurisdiction or in a possession of the United States, and it must also meet certain corporate governance requirements so as to maintain a substantial presence in that jurisdiction.²⁴

In order to receive tax benefits, FSCs were also required to meet both foreign management and economic process tests.²⁵ To meet the foreign management requirement, the FSC must: (1) hold all of its board of directors and shareholders meetings outside the United States; (2) maintain its principal bank account outside the United States for the taxable year; and (3) disburse dividends, legal and accounting fees, and salaries of officers and directors from bank accounts maintained outside the United States.²⁶ The foreign economic process test sets forth similarly stringent standards. An FSC met this requirement if for any transaction the FSC: (1) solicits, negotiates, or contracts outside the United States, and (2) the foreign direct costs attributable to such transaction constitute at least 50% of the total direct costs of the transaction.²⁷

Unlike the DISC regime, the FSC regime focuses its tax benefits on certain income derived from foreign sources, as opposed to using a blanket exemption on all the income generated by the qualified entity.²⁸ A portion of an FSC's earnings from "Foreign Gross Trading Receipts," also known as "Exempt Foreign Trade Income," was excluded from gross income, as it was considered "foreign source income not effectively connected with conduct of a trade or business within the United States."²⁹ Generally,

²⁴ In terms of corporate governance requirements, an FSC must for the taxable year:

- (i) maintain an office outside the United States . . . or in a possession of the United States;
- (ii) maintain a permanent set of books of account (including invoices) of such corporation at such office; and
- (iii) maintain at a location within the United States the records which such corporation is required to keep under section 6001

Id. § 922(a)(1)(D). In addition, § 922 required that the FSC not have more than twenty-five shareholders any time during the tax year and have at least one member of the board of directors who is not a resident of the United States.

²⁵ *Id.* § 924(b)(1).

²⁶ *Id.* § 924(c).

²⁷ *Id.* § 924(d)(1). Alternatively, an FSC could also meet the economic process test if the foreign direct costs attributable to at least two of the following activities related to the transaction constitute at least 85% of the total direct costs of the transaction: (1) advertising; (2) processing of customer orders; (3) transportation of goods from the FSC to the customer; (4) determination and transmission of a final invoice and receipt of payment; and (5) assumption of credit risk. I.R.C. § 924(d)(2) (1984) (repealed 2000).

²⁸ To be sure, a DISC still had to meet the 95% qualified export receipts and asset tests, and therefore a large proportion of that entity's income would be foreign source income.

²⁹ *Id.* § 921(a).

Exempt Foreign Trade Income is 30% of the gross income derived from each transaction attributable to Foreign Gross Trading Receipts.³⁰

Foreign Gross Trading Receipts consist of transactions involving the sale or lease of Export Property.³¹ Export Property must be property that is: (1) manufactured or produced in the United States by a person other than an FSC; (2) sold or leased for use, consumption, or disposition outside the United States; (3) with no more than 50% of the property's fair market value attributable to imports.³² The non-exempt portion is taxable to the FSC.³³ Overall, the FSC does not depart drastically from the general DISC framework, with the exception that the qualifying beneficiary must be established, maintained, and governed outside the United States—an attempt, no doubt, to make the measure appear more related to the taxation of foreign source income.

C. The FSC Dispute

1. *Substantive Law on Subsidies since GATT XVI:4*

In 1973, the GATT Council established four panels to hear disputes concerning the legality of the DISC legislation and the income tax practices of France, Belgium, and the Netherlands.³⁴ These disputes became collectively known as the Tax Legislation Cases.³⁵ In 1976, the panels concluded that each of these nation's practices were inconsistent with its

³⁰ *Id.* § 923(a)(2). An exception to this rule is when special administrative pricing rules apply. *See infra* note 31.

³¹ *Id.* § 924(a)(1). Sale of Export Property sold to an FSC by a related entity (e.g., domestic parent corporation), or a commission paid to the FSC by such party for a transaction involving export property, are subject to special administrative pricing rules in order to prevent abuse by the parent and FSC such that non-arms length pricing results in maximum tax advantage. *See id.* § 925. Transactions that require the application of special administrative pricing rules are subject to a different formula to determine the amount of income includible as Exempt Foreign Trade Income. Specifically, 15/23 of the income attributable to Foreign Gross Trading Receipts is considered exempt from an FSC's gross income. *Id.* § 923(a)(3).

³² I.R.C. § 927(a)(1984) (repealed 2000).

³³ *Id.* § 921(a). The non-exempt portion is also known as "Foreign Trade Income," which includes, *inter alia*, all dividends, royalties, and investment income of an FSC. *Id.* § 921(d). Another benefit of the FSC program was the general ability of the U.S. parent to apply a 100% dividends-received deduction for distributions from the FSC out of earnings attributable to Foreign Trade Income. STAFF OF J. COMM. ON TAXATION, 107TH CONG., BACKGROUND AND HISTORY OF THE TRADE DISPUTE RELATING TO THE PRIOR-LAW FOREIGN SALES CORPORATION PROVISIONS AND THE PRESENT-LAW EXCLUSION FOR EXTRATERRITORIAL INCOME AND A DESCRIPTION OF THESE RULES, (JCX-83-02), July 26, (2002).

³⁴ *See Rosendo Lopez-Mata, supra* note 21, at 592.

³⁵ *See id.*

obligations under Article XVI:4.³⁶ These reports and findings were formally adopted through a Memorandum of Understanding in 1981 between the parties (1981 Understanding), though the disputing parties agreed that there would be no formal recognition of any violation under Article XVI:4.³⁷ A key part of the 1981 Understanding states:

The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as a prohibited export subsidy (under Article XVI:4). . . Furthermore, Article XVI: 4 does not prohibit the adoption of measures to avoid double-taxation of foreign source income.³⁸

In 1979, GATT signatories convened in Tokyo for a round of negotiations on trade topics ranging from anti-dumping to export subsidies.³⁹ These negotiations culminated in the adoption of the Tokyo Round Codes in 1982, which were formally understood to be an agreement on the interpretation and application of the 1947 GATT Agreement.⁴⁰

In 1994, the Uruguay Round of negotiations resulted in the formation of another set of codes, designed to build upon the Tokyo Round Codes and the 1947 GATT Agreement. The portion of code from the Uruguay Round relating to export subsidies is known as the Agreement on Subsidies and Countervailing Measures (SCM).⁴¹ With the formation of the WTO via the Marakesh Protocol in 1994, the SCM became formally embodied in the WTO rules and regulations.⁴²

³⁶ 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 MINN. J. GLOBAL TRADE 291, 298 (2001).

³⁷ See Lopez-Mata, *supra* note 21, at 593-94.

³⁸ Tax Legislation, BISD 28S/114 Dec. 7-8 1981, GATT B.I.S.D. (28th Supp.) at 114 (1982). It is apparent that the United States relied heavily on this section of the 1981 Understanding in developing the FSC. For example, exempt income under the FSC was considered "not effectively connected with the United States," in large part to characterize this income as closely as possible to the concept of foreign source income. Moreover, the FSC regime's economic process requirements, *see supra* note 27, are consistent with the GATT Council's statement that a nation need not subject foreign economic processes to taxation.

³⁹ See Lopez-Mata, *supra* note 21, at 595.

⁴⁰ *See id.*

⁴¹ *Id.* at 580-81.

⁴² *See id.*

2. *The European Union's Legal Arguments*

As early as 1985, consultations were held between the United States and other key economic nations, including the European Union, Japan, Australia, and Canada over the alleged illegality of the FSC regime.⁴³ In November 1997, the European Union formally requested consultations with the United States over the FSC.⁴⁴ After conducting several rounds of negotiations to no avail, a WTO Dispute Panel convened in July 1998 to hear the case.⁴⁵

The European Union first argued that the FSC regime was a subsidy under Article 1.1 of the SCM. Article 1.1 of the SCM declares that a "subsidy" exists if "government revenue that is otherwise due is foregone or not collected"⁴⁶ and a "benefit is thereby conferred."⁴⁷ The European Union argued that the exemption of foreign source income from subpart F represented income to the U.S. Treasury that would have been otherwise due, and that clearly the result was a benefit conferred to the FSC, its corporate parent, and affiliates.⁴⁸

The European Union further argued that the FSC regime violated Articles 3.1(a) and 3.1(b) of the SCM because it constituted prohibited subsidies.⁴⁹ Article 3.1(a) prohibits subsidies that "are contingent in law or in fact upon export performance."⁵⁰ Article 3.1(a) refers to Annex I of the SCM for illustrations of proscribed export subsidies.⁵¹ Export contingency

⁴³ WTO Dispute Panel Decision Report on U. S. Tax Treatment for "Foreign Sales Corporations," WT/DS108/R (WTO) at 4.177 (Oct. 8, 1999) *available at* 1999 WL 973750 [hereinafter FSC Panel].

⁴⁴ *Id.* ¶ 1.1.

⁴⁵ *Id.*

⁴⁶ Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization – RESULTS OF THE URUGUAY ROUND, art. 1.1(a)(1)(ii), *available at* <http://www.wto.org> [hereinafter SCM].

⁴⁷ *Id.*

⁴⁸ FSC Panel, *supra* note 43, ¶ 4.294.

⁴⁹ *Id.* ¶ 3.2. The European Union also alleged violations of Articles 9.1(d), 10.1, and 10.3 of the Agreement on Agriculture, which is separate from the SCM.

⁵⁰ SCM, *supra* note 46, at art. 3.1(a).

⁵¹ Among the types of subsidies listed under Annex I, and hence prohibited under article 3.1(a) of the SCM are "the provision by governments of direct subsidies to a firm or an industry contingent upon export performance", and:

The provision by governments . . . either directly or indirectly through government-mandated schemes, of imported or domestic products or services for use in the production of exported goods, on terms or conditions more favourable than for provision of like or directly competitive products or services for use in the production of goods for domestic consumption, if (in the case of products) such terms or conditions are more favourable than those commercially available on world markets to their exporters.

may be found either in law or in fact, but a subsidy granted to exporting corporations is alone insufficient to constitute an export subsidy.⁵²

Article 3.1(b) prohibits subsidies that are contingent, “whether solely or as one of several other conditions,” upon using domestic over imported goods. Article 1 similarly circumscribes the meaning of “subsidy” in Article 3.1(b). The European Union argued alternatively that the limitations on Export Property, as defined in the Internal Revenue Code Section 927(e), put foreign manufacturers at a disadvantage vis-à-vis U.S. manufacturers, as not more than half of the fair market value of the export good can be attributable to imported goods in order to qualify as Export Property.⁵³

3. *U.S. Defenses*

The United States argued as a matter of first principle that if, under WTO rules, a nation is not obligated to tax certain categories of income, then the exemption of such income from taxation cannot constitute a subsidy.⁵⁴ To support its contention, the United States referred to footnote 59 of Annex I of the SCM Agreement, which qualifies the list of prohibited export subsidies and reaffirms the principle that member nations need not tax income from foreign sources.⁵⁵ From this footnote the United States argued that the “income forgone otherwise due” standard does not apply to the collection or non-collection of foreign source income because it was not “otherwise due” in the first place.⁵⁶

The United States also argued that the 1981 Understanding represented not only a set of agreements binding solely those parties privy to the disputes,⁵⁷ but also an authoritative interpretation of GATT Article XVI:4 which bound all GATT signatories.⁵⁸ The United States referred to Article 31(3)(b) of the Vienna Convention on the Law of Treaties, under which the 1981 Understanding qualified as a “subsequent practice,” and therefore

Id. at Annex I (a) and (d).

⁵² *Id.* at art. 3.1(a) n.4.

⁵³ FSC Panel, *supra* note 43, ¶ 4.180.

⁵⁴ *Id.* ¶ 4.526.

⁵⁵ SCM, *supra* note 51, annex I(e), n.59. Footnote 59 states that “Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected” and that “[p]aragraph (e) [barring deferral of taxes paid by commercial or industrial concerns] is not intended to limit a Member from taking measures to avoid the double-taxation of foreign-source income earned by its enterprises or the enterprises of another Member.” *Id.*

⁵⁶ FSC Panel, *supra* note 43, ¶¶ 4.526-4.527.

⁵⁷ *Id.* ¶ 4.379.

⁵⁸ *Id.* ¶ 4.380. The United States argued that “the 1981 Council Decision sanctified the differential tax treatment of foreign and domestic activities, even when those activities involve export transactions.” *Id.* ¶ 4.677.

should be instrumental to the interpretation of the SCM Agreement.⁵⁹

A parallel, and more general, argument advanced by the United States was that a ruling by the WTO against the FSC regime would in essence pass judgment on the type of taxation systems nations should adopt indirectly, and would thus contravene a WTO-stated principle of tax system neutrality.⁶⁰ The United States alluded to the disparities that exist between a worldwide taxation system (as implemented in the United States) and a territorial system (adopted by most E.U. nations). In the United States' opinion, the FSC was merely an attempt to level the playing field for all nations to compete on substantially the same terms.

4. *The WTO Dispute Panel's Decision*

On October 8 1999, the WTO Dispute Panel dealt a blow to the United States by ruling that the FSC was a prohibited export subsidy under 3.1(a). However, the Panel declined to rule on whether the FSC was also a prohibited subsidy under Article 3.1(b).⁶¹ In reaching its result, the Panel made several key findings of law that would be relevant for future disputes.

a. *The Legal Effect of the 1981 Understanding*

The WTO Dispute Panel rejected the United States' argument that the 1981 Understanding was an authoritative and binding restatement of GATT Article XVI:4.⁶² Instead, the Panel found the language of the 1981 Understanding inconclusive, and it was therefore necessary to examine the circumstances surrounding its adoption.⁶³ The WTO Dispute Panel referred to the GATT Council Chairman's statement that "the adoption of these reports together with the [1981] [U]nderstanding does not affect the rights and obligations of contracting parties under the General Agreement."⁶⁴ To the WTO Dispute Panel, the Chairman's statement was irreconcilable with the view that the 1981 Understanding should be binding upon WTO members or the WTO Dispute Panel for that matter.⁶⁵ For the very same reason, it would also be inconsistent to consider the 1981 Understanding a "subsequent practice" for purposes of the Vienna Convention on Treaties; to hold otherwise would alter rights and obligations from the 1947 GATT

⁵⁹ *Id.* ¶ 4.380.

⁶⁰ *Id.* ¶ 7.121.

⁶¹ FSC Panel, *supra* note 43, ¶ 7.132.

⁶² *Id.* ¶ 7.74. In response to the sanctification argument advanced by the United States, *supra* note 58, the Dispute Panel noted that "[i]t is also striking to see the working of the [1981 Understanding] GATT Council assimilated to those of the Vatican and its like." *Id.* ¶ 4.842.

⁶³ FSC Panel, *supra* note 43, ¶ 7.66.

⁶⁴ *Id.* ¶ 7.68.

⁶⁵ *Id.*

Agreement.⁶⁶

Although the WTO Dispute Panel found that the 1981 Understanding was a “decision” under GATT Article XVI:1, the 1981 Understanding could not be extended so as to also become an interpretation of the SCM agreement.⁶⁷ Specifically, the WTO Dispute Panel found that the differences between Article XVI:4 and the SCM Agreement were sufficiently material to render the 1981 Understanding ineffective to provide any judicial gloss on the latter.⁶⁸

b. The Significance of Footnote 59

The Panel rejected the United States’ argument that because footnote 59 gives nations the freedom to tax or not tax income from foreign sources, such income could not be considered “otherwise due” for purposes of the Article 1 definition of a subsidy.⁶⁹ The Panel first examined the structure of the SCM Agreement, and found that though Article 1.1 should clearly not be read in isolation and without any consideration of footnote 59, the footnote’s use should nevertheless be exercised with “considerable caution” because it appears within an illustrative definition of a “subsidy.”⁷⁰ Next, the Panel found that when Article 1.1 is read in conjunction with footnote 59, the most one could reasonably conclude was that “a decision . . . not to tax any income arising from foreign economic processes would not represent the foregoing of revenue ‘otherwise due.’”⁷¹ However, this did not imply that member nations were free to selectively exempt some foreign source income and not others.⁷²

c. Income Forgone that is Otherwise Due and Benefit Conferred

The WTO Dispute Panel’s analysis then turned to whether there was income forgone by the United States that was otherwise due. The central question was what standard the Panel should apply to determine if there was income actually otherwise due under a member nation’s tax system.

⁶⁶ *Id.* ¶ 7.75.

⁶⁷ *Id.* ¶ 7.79.

⁶⁸ FSC Panel, *supra* note 43, ¶ 7.80. The Dispute Panel found that while the SCM Agreement concretely defines terms such as “subsidy,” “export subsidy,” “financial contribution,” and “otherwise due,” none of these terms were explicit, much less defined, in Article XVI:4. *Id.* ¶¶ 7.80-7.81. Indeed, the establishment of specific definitions of these terms was widely regarded as one of the more significant achievements of the formation of the WTO. *Id.* ¶ 7.80. Nevertheless, the WTO Dispute Panel found that Article XVI:4 could be used in certain instances to help interpret limited parts of the SCM Agreement. *Id.* ¶ 7.82.

⁶⁹ FSC Panel, *supra* note 43, ¶ 7.92.

⁷⁰ *Id.* ¶ 7.90.

⁷¹ *Id.* ¶ 7.92.

⁷² *Id.*

The European Union pointed to three specific tax benefits of the FSC regime that were each an example of the forgoing of income that was otherwise due. The first exemption was under Internal Revenue Code, Section 921(a), which deemed Exempt FSC Foreign Trade Income as “income which is not effectively connected with the conduct of a trade or business within the United States.”⁷³ The amount of an FSC’s Exempt Foreign Trade Income is based on the percentage of the FSC’s overall foreign trade income for the taxable year.⁷⁴ The second tax benefit raised by the European Union was the exemption of FSC foreign trade income from the anti-deferral rules under subpart F.⁷⁵ The third tax benefit brought before the Panel was the ability of FSC shareholders to deduct all dividend income received from an FSC.⁷⁶

The WTO Dispute Panel took a different view from the European Union, but nevertheless held that these three exemptions *in totality* represented an interconnected scheme to forgo revenue that was otherwise due. In arriving at this conclusion, the Panel ruled that its role was not to perform an exemption-by-exemption or benefit-by-benefit analysis, but rather to assess the effects of them taken together.⁷⁷ The Panel left open the possibility that revenue may not be otherwise due when an FSC in some cases receives less favorable treatment than under the prevailing default scheme.⁷⁸ However, the Panel found this possibility inapplicable in the instant case because a corporation can elect FSC status every year, and thus only miscalculation would result in an FSC being taxed on terms less favorable than default status.⁷⁹

d. Export Contingency under the FSC

The WTO Dispute Panel next turned to the question of whether the FSC regime provided prohibited export subsidies under Article 3.1(a). The Panel reasoned that because Exempt Foreign Trade Income requires the sale, exchange, lease, or rental of Export Property (or services “related and

⁷³ I.R.C. § 921(a) (repealed 2000).

⁷⁴ *See id.* I.R.C. § 923(a) sets forth specific percentages allocable to exempt foreign trade income depending on whether administrative pricing rules apply. *Id.* § 923(a).

⁷⁵ *Id.* § 951(e) (2004). Generally, taxes on foreign-source income for foreign subsidiaries of U.S. corporations are deferred until distributed back to the U.S. parent. However, under Subpart F, a domestic shareholder in a controlled foreign corporation must report as part of her gross income a pro rata share of the undistributed income of the controlled foreign corporation. *Id.* § 951(e).

⁷⁶ I.R.C. § 245(c) (2002).

⁷⁷ FSC Panel, *supra* note 43, ¶ 7.99.

⁷⁸ *Id.* ¶ 7.101.

⁷⁹ *Id.*

subsidiary” thereto),⁸⁰ and because such property by definition must meet both domestic production and foreign use/consumption requirements,⁸¹ the benefit was in fact contingent on export performance.⁸²

The WTO Dispute Panel once again rejected the United States’ argument that footnote 59 implied that a member nation was free not to tax income from foreign economic activity, and therefore income exempted by the FSC measures was not “otherwise due” and by definition not an export subsidy.⁸³ In the view of the Panel, there was no contradiction in a rule that allowed member states to exempt income from foreign sources, while at the same time prohibiting tax exemptions of income from export activity.⁸⁴ As a result of its ruling that the FSC scheme was an illegal export subsidy, the Dispute Panel ruled that the United States must withdraw the FSC provisions by October 1, 2000.⁸⁵

5. The WTO Appellate Body’s Decision

The Appellate Body upheld the Dispute Panel’s determination that the “income otherwise due” test was a comparison between the income under the exemption measure and how that same income would be treated absent that exemption.⁸⁶

The United States asserted on appeal that the Dispute Panel erred by not beginning its analysis under Article 3.1(a) with an examination of footnote 59, but instead proceeded directly to the definition of a subsidy in Article 1.1. The Appellate Body responded that whether one begins with

⁸⁰ I.R.C. § 924 (repealed 2000).

⁸¹ *Id.* § 927(a).

⁸² FSC Panel, *supra* note 43, ¶ 7.108.

⁸³ *See id.* ¶¶ 7.116-7.120.

⁸⁴ *Id.* ¶ 7.119. In addition to its fundamental claim that the FSC’s tax benefit’s were violative of Article 3.1(a), the European Union also argued that the administrative pricing rules, which allocated income between the FSC and its domestic parent, independently ran afoul of that same provision of the SCM. *Id.* ¶ 7.124. The Dispute Panel, however, found that these rules were not independent from the FSC tax regime (i.e., they had no separate existence apart from the general FSC exemption provisions). *Id.* ¶ 7.127. Because the Panel had already determined that the FSC as a whole was inconsistent with Article 3.1(a), it declined to rule on the legality of the administrative pricing rules separately. *See id.* ¶¶ 7.124-7.129.

⁸⁵ FSC Panel, *supra* note 43, ¶ 8.8.

⁸⁶ WTO Report of the Appellate Body on United States—Tax Treatment for “Foreign Sales Corporations,” WT/DS108/AB/R (WTO) ¶ 91 (Feb. 2000) [hereinafter FSC Appellate Body] available at 2000 WL 234553. The Appellate Body expressed concern that such a test would be easily circumvented in the future by “designing a tax regime under which there would be no general rule that applied formally to the revenues in question, absent the contested measure.” *Id.* However, it appears that with the broad reach of Internal Revenue Code section 61(a), it would be difficult for the United States to circumvent the “otherwise due” standard in this manner.

footnote 59 or Article 1.1 the outcome would be the same.⁸⁷ That footnote 59 sets forth measures that are not prohibited export subsidies does not mean that it serves to define what a “subsidy” is for purposes of Article 1.1 of the SCM.⁸⁸

The United States also contended that the Dispute Panel erred in its finding that the 1981 Understanding was not incorporated into footnote 59.⁸⁹ The Appellate Body, however, agreed with the Dispute Panel’s two-step analysis; the language of the 1981 Understanding was indeed ambiguous on whether it was intended to bind future signatories, and thus it was appropriate to look to the circumstances surrounding the 1981 Understanding’s adoption.⁹⁰ The Appellate Body concluded that the Panel was correct in finding that the Understanding was only meant to bind the parties privy to those negotiations, and that it cannot be incorporated into the SCM Agreement.⁹¹

A noteworthy assertion made by the United States, but ultimately dismissed on procedural grounds, was that the FSC regime was not an export subsidy by reason of footnote 59 because it was designed to avoid double-taxation.⁹² The Appellate Body ruled that because the issue was not previously raised before the Dispute Panel, it did not have the mandate to rule on that matter.⁹³ Despite the unfavorable ruling against the United States in this case, it opened a new avenue of argument for future disputes, as will be discussed below. The Appellate Body upheld the Panel’s decision not to rule on the E.U.’s claims under Article 3.1(b).⁹⁴

II. A HISTORY OF THE ETI TAX REGIME

In the aftermath of the FSC dispute, the United States was left with no recourse but to withdraw the FSC scheme, and to develop a replacement legislative program. On November 15, 2000, President Clinton signed the FSC Repeal and Extra-territorial Income Exclusion Act of 2000.⁹⁵ The ETI regime managed to preserve many of the FSC scheme’s benefits while at the same time reducing some of its burdensome requirements. Although

⁸⁷ FSC Appellate Body, *supra* note 86, ¶ 89.

⁸⁸ *Id.* ¶ 93.

⁸⁹ *Id.* ¶ 104.

⁹⁰ *Id.* ¶ 111.

⁹¹ FSC Appellate Body, *supra* note 86, ¶ 112.

⁹² *Id.* ¶ 101.

⁹³ *Id.* The Appellate Body cited *Canada-Aircraft*, where they declined to rule on a new argument because it would have required them to “solicit, receive, and review new facts.” *Id.* ¶ 102.

⁹⁴ *Id.* ¶ 176.

⁹⁵ FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, HR 4896, 114 Stat. 2423 (2000).

the United States proclaimed that this legislation would allay the concerns of the European Union,⁹⁶ the E.U. response was less than enthusiastic.⁹⁷

The ETI Act creates the concept of “Extraterritorial Income.”⁹⁸ Unlike the FSC regime, a foreign entity vehicle is not necessary to obtain tax benefits under ETI; the Extraterritorial Income of a U.S. corporation is excludible from gross income to the extent it qualifies as “Qualifying Foreign Trade Income.”⁹⁹ Qualifying Foreign Trade Income is defined generally as the amount of gross income for each transaction, if excluded, that would reduce the taxable income of such transaction equal to the greatest of: “(A) 30 percent of the foreign sale and leasing income derived from such transaction, (B) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction, or (C) 15 percent of the foreign trade income derived by the taxpayer from such transaction.”¹⁰⁰

Extraterritorial Income is defined as the gross income of a taxpayer attributable to “Foreign Trading Gross Receipts.”¹⁰¹ Foreign Trading Gross Receipts are, in turn, measured by the amount of transactions involving “Qualifying Foreign Trade Property.”¹⁰² The requirements for Qualifying Foreign Trade Property closely track those in order to satisfy the definition

⁹⁶ Statement on Signing the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, 36 Weekly Comp. Pres. Doc. 2885 (Nov. 20, 2000). After signing the bill, President Clinton stated, “[w]e believe that this legislation specifically addresses the concerns raised by the WTO Appellate Body and will be found to be WTO-compliant. *Id.*

⁹⁷ See *EU/US: Americans Contest EU Demand for USD4 Billion Sanctions*, EUR. REP., Dec. 2, 2000, available at 2000 WL 24320190. European Trade Commissioner Pascal Lamy called the ETI Act “even worse” than the FSC. *Id.*

⁹⁸ I.R.C. § 114(e) (2004).

⁹⁹ See *id.* §§ 943(e) and 941(a). Not surprisingly, Internal Revenue Code section 114, subsections (c) and (d) disallow foreign tax credits and deductions in connection with any Extraterritorial Income that is excluded from gross income pursuant to Internal Revenue Code section 114(a). *Id.* § 114(a), (c), (d).

¹⁰⁰ *Id.* § 941(a)(1)(A)-(C). Foreign Trade Gross Receipts are defined in section 942(a) of the Internal Revenue Code. *Id.* § 942(a); see *infra* note 102. Foreign Sale and Leasing Income is defined in Internal Revenue Code section 941(c)(1). *Id.* § 941(c)(1). Foreign Trade Income is defined in Internal Revenue Code section 941(b)(1) as “the taxable income of the taxpayer attributable to foreign gross trading gross receipts of the taxpayer.” I.R.C. § 941(b)(1).

¹⁰¹ *Id.* § 114(e).

¹⁰² *Id.* § 942(a)(1). Specifically, gross receipts must be, *inter alia*:

- (A) from the sale, exchange, or other disposition of qualifying foreign trade property,
- (B) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States,
- (C) for services which are related and subsidiary to – (i) any sale, exchange, or other disposition of qualifying foreign trade property, or (ii) any lease or rental of qualifying foreign trade property described in subparagraph (B) by such taxpayer. . . .

of Export Property under the FSC. One significant difference however is that Qualifying Foreign Trade Property may be manufactured within or *outside* the United States.¹⁰³ However, Qualifying Foreign Trade Property still must be held for sale, lease or rental, for use or consumption outside the United States.¹⁰⁴ Like the FSC, the ETI regime requires that no more than fifty percent of the fair market value of the property be attributable to articles manufactured outside the United States.¹⁰⁵ Thus, although there could still be manufacturing overseas sufficient to constitute Qualifying Foreign Trade Property, at least some component or input to that property must trace its origin back to the United States.

Transactions involving Qualifying Foreign Trade Property must also meet foreign economic process requirements. This requirement is satisfied if for each qualifying transaction, the corporation solicited, negotiated, or contracted outside the United States, and the foreign direct costs of certain activities meet a specific proportion of the total direct costs of the same set of activities.¹⁰⁶ The activities calculated into direct costs include:

(A) advertising and sales promotion, (B) the processing of customer orders and the arranging for delivery, (C) transportation outside the United States in connection with delivery of the property to the customer, (D) the determination and transmittal of a final invoice or the receipt of payment, and (E) the assumption of credit risk.¹⁰⁷

A. ETI Dispute

Not long after adoption of the ETI legislation, the European Union lodged a complaint to challenge the legality of the ETI regime.¹⁰⁸ On December 7, 2000, after a month of consultations, the European Union requested the establishment of a Dispute Panel.¹⁰⁹

The arguments advanced by the European Union were substantially similar to those raised in the FSC Dispute: (a) the ETI regime was a subsidy under Article 1.1; (b) the ETI regime was a prohibited subsidy under Article 3.1(a) because it was export contingent; and (c) the ETI regime was a

¹⁰³ *Id.* § 943(a)(1)(A).

¹⁰⁴ I.R.C. § 943(a)(1)(B) (2004).

¹⁰⁵ I.R.C. § 943(a)(1)(C) (2002).

¹⁰⁶ *Id.* § 942(b).

¹⁰⁷ *Id.* § 942(b)(3).

¹⁰⁸ WTO Report of the Panel on United States—Tax Treatment for “Foreign Sales Corporations”—Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW (Aug. 20, 2001), *available at* <http://docsonline.wto.org/DDFDocuments/t/WT/DS/108RW-00.DOC> through 108RW-06.DOC [hereinafter ETI Panel].

¹⁰⁹ *Id.* ¶ 1.8.

prohibited subsidy under Article III:4 of GATT because the tax structure favored the use of domestic manufacturing inputs over foreign ones.¹¹⁰

The United States countered that the tax exemption under the ETI regime was not the forgoing of income otherwise due, and the corresponding tax benefit was not export contingent.¹¹¹ Even if the ETI regime was deemed to be an export subsidy, the United States argued that the ETI measure was not prohibited because footnote 59 expressly permits measures implemented to avoid double-taxation.¹¹²

1. Forgoing of Income Otherwise Due and Benefit is Conferred

The first part of the Panel's opinion applied the familiar "otherwise due" test. The Panel found that extraterritorial income was essentially carved out of income that was not shielded from taxation.¹¹³ Although there was nothing in the Internal Revenue Code that specified that in the absence of the ETI Act such income would be taxable, the Panel found the language of Internal Revenue Code Section 61(a) sufficiently broad to militate for such a result.¹¹⁴ Based on considerations of "the degree of conditionality [of the measure], the range of limitations, and the manner in which the measure at issue related to the overall regime,"¹¹⁵ the Panel had little difficulty finding that the United States was indeed forgoing revenue that would have been due.¹¹⁶

2. Export Contingency

Despite the fact that Qualifying Foreign Trade Property could be in significant part manufactured overseas, the Panel found that fact alone insufficient to render the regime not "export contingent."¹¹⁷ Specifically, it noted that a scheme need not be entirely export contingent in all its conditions in order to be an illegal export subsidy.¹¹⁸ The Dispute Panel

¹¹⁰ *Id.* ¶ 3.1. In addition, the European Union alleged that the United States failed to comply and withdraw from the FSC regime as ordered by the Appellate Body, and thus violated Article 4.7 of the SCM (requires members to withdraw prohibited subsidies without delay). *Id.*

¹¹¹ *Id.* ¶ 3.3.

¹¹² *Id.* ¶ 8.76. This point was raised previously before the Appellate Body in the FSC Dispute, but was not ruled on because the issue was not properly raised before the Dispute Panel in that case.

¹¹³ ETI Panel, *supra* note 108, ¶ 8.25.

¹¹⁴ I.R.C. § 61(a) states that gross income includes income from "whatever source derived." I.R.C. § 61(a) (2004).

¹¹⁵ ETI Panel, *supra* note 108, ¶ 8.29.

¹¹⁶ *Id.* ¶ 8.30.

¹¹⁷ *Id.* ¶ 8.61.

¹¹⁸ *Id.* ¶ 8.64.

cited the precedent *Canada-Aircraft*, where the Appellate Body ruled that “[i]t is enough to show that one or some . . . contributions do constitute subsidies ‘contingent . . . in fact . . . upon export performance’” to render the entire scheme illegal under Article 3.1(a).¹¹⁹ The Panel noted that as long as there is differential tax treatment between domestically-produced goods that are sold abroad and those that are sold domestically such that the former is more tax-advantageous than the latter, export contingency is not eliminated.¹²⁰ Nevertheless, the ETI’s apparent defect could be cured by extending the subsidy to goods of U.S. origin that are consumed in domestic and foreign markets.¹²¹ In other words, it is the disparate treatment between the two consumption markets that makes ETI contingent upon export performance.¹²²

3. *Double-Taxation Defense*

The Panel found that although the ETI regime potentially relieved some transactions from double-taxation, the scheme as a whole was not a measure designed to achieve such an end, and therefore did not enjoy an exemption under footnote 59.¹²³ In reaching this conclusion, the Appellate Body emphasized that the exemption need not entirely eliminate double-taxation to fall within footnote 59.¹²⁴ Nor did the Appellate Body require that the exemptions be designed to address an actual double-taxation situation (i.e., exemptions could be prophylactic in purpose).¹²⁵ Nevertheless, the Appellate Body found several key flaws in the ETI which in totality made footnote 59 unavailable. First, it found that the ETI was both over and under-inclusive to be considered a double-taxation elimination measure. It was overly broad in that it included income that was unlikely to be taxed by another jurisdiction.¹²⁶ An example would be income for a corporation that makes a sale of goods in another country without having a permanent establishment in that jurisdiction.¹²⁷ Yet, the Panel also left the door open by stating, “[w]e do not mean to suggest that

¹¹⁹ ETI Panel, *supra* note 108, ¶ 8.64 (citing WTO Report of the Appellate Body Report – *Canada-Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R).

¹²⁰ *Id.* ¶ 8.67.

¹²¹ *Id.* ¶ 8.72.

¹²² *Id.*

¹²³ *Id.* ¶ 8.97.

¹²⁴ *Id.* ¶ 8.95. (“[W]e do not view footnote 59 as requiring that a measure ‘to avoid’ the double-taxation of foreign-source income must avoid double-taxation entirely, exclusively or precisely.”).

¹²⁵ ETI Panel, *supra* note 108, ¶ 8.103.

¹²⁶ *Id.* ¶ 8.98.

¹²⁷ *Id.* ¶ 8.102. The Panel specifically referred to the OECD Model Tax Convention, which would tax profits of a corporation only in jurisdictions where it maintained a permanent presence.

the absence of a permanent establishment requirement in the Act in itself means that the Act is not a measure to avoid double-taxation within the meaning of footnote 59.”¹²⁸

At the same time, the Panel found that the ETI scheme was overly narrow in that a corporation could have a permanent establishment overseas (and thus fall within that nation’s taxing jurisdiction), but fail to meet the exemption requirement because foreign economic process requirements were not met, or the value of domestic inputs into the property did not meet the 50% requirement.¹²⁹ In addition, the Panel noted that the United States already had bilateral tax treaties with a number of nations that addressed double-taxation.¹³⁰

B. ETI Appellate Body Ruling

In response to the Dispute Panel’s adverse ruling, the United States appealed to the WTO Appellate Body, but was once again defeated.¹³¹ In arriving at its judgment, the Appellate Body made several findings of law that have potential precedent value for future cases before the WTO.¹³²

The first finding pertained to the “otherwise due” standard. The Appellate Body further refined the test by ruling that what should be examined under the default standard is “comparable income” exempted under the measure in question.¹³³ Therefore, the proper category of income that should be analyzed in the ETI dispute should be foreign-source income and how it would be treated under other extant rules.¹³⁴ The Appellate Body nonetheless held that because Section 61 does not differentiate between foreign and domestic sources of income, and because a corporation can elect to have some of its income treated as extraterritorial income, it followed that the United States did forgo revenue that was otherwise due.¹³⁵

Secondly, the Appellate Body rejected the U.S. argument that the ETI measure was export-neutral because the tax benefit was available to those who produce goods outside the United States. According to the United States, the Dispute Panel inappropriately bifurcated its analysis by ruling only on the component of the ETI regime that bestowed exemptions for goods produced domestically. The Appellate Body responded, “[o]ur conclusion that the ETI measure grants subsidies that are export contingent

¹²⁸ *Id.* ¶ 8.103.

¹²⁹ *Id.* ¶ 8.104.

¹³⁰ *Id.* ¶ 8.105.

¹³¹ ETI Dispute Appellate Body Decision, WT/DS 108/AB/RW (WTO) (2002), *available at* 2002 WL 44907 [hereinafter ETI Appellate Body].

¹³² *Id.*

¹³³ *Id.* ¶ 91.

¹³⁴ *Id.* ¶ 101.

¹³⁵ *Id.* ¶ 105.

in the first set of circumstances is not affected by the fact that the subsidy can also be obtained in the second set of circumstances.”¹³⁶

As to whether ETI was a measure designed to prevent double-taxation of foreign income, the Appellate Body first looked to the text of footnote 59. It rejected the notion that it was for member nations to determine what constitutes foreign source income; such an interpretation would obviate the purposes of the prohibition on export subsidies and provide too easy of a loophole.¹³⁷ Absent a definition of foreign source income in the SCM itself, the Appellate Body looked to bilateral treaties among nations and examined the types of income those treaties sought to address.¹³⁸ From this investigation, the Appellate Body concluded, “The common element is that a “foreign” State will tax a non-resident on income which is generated by activities of the non-resident that have some link with that State.”¹³⁹

From this conclusion, the Appellate Body found that although a measure need not be entirely precise, the ETI regime systematically misallocated income between foreign and domestic sources of income and thus could not be reasonably deemed as a double-taxation prevention scheme within the meaning of footnote 59.¹⁴⁰ It found particularly problematic Section 942(b)(4), also known as a “deeming provision.” Under this rule, “[a] taxpayer shall be treated as meeting the requirements of this subsection with respect to any sales transaction involving any property if any related person has met such requirements in such transaction or any other sales transaction involving such property.”¹⁴¹

The Appellate Body used the example of a transaction between a domestic manufacturer and a domestic distributor.¹⁴² For this transaction, none of the profit is deemed to qualify as exempt territorial income. However, if the distributor in turn sells some the same product to foreign purchaser, then the deeming provision becomes effective and integrates the two transactions as one, thus qualifying a proportion of the *total* profits as extraterritorial income. To the Appellate Body, the result creates a disproportionate benefit between the first and second transactions relative to the actual amount of foreign source income.¹⁴³

¹³⁶ *Id.* ¶ 119.

¹³⁷ ETI Appellate Body, *supra* note 131, ¶ 140.

¹³⁸ *Id.* ¶ 141.

¹³⁹ *Id.* ¶ 143.

¹⁴⁰ *Id.* ¶ 166.

¹⁴¹ I.R.C. § 942(b)(4) (2002).

¹⁴² ETI Appellate Body, *supra* note 131, ¶¶ 157-66. The Appellate Body presented a sample transaction assuming that a domestic corporation elects to use a 1.2% or 15% exemption from the qualifying foreign trading income. The 30% exemption option, in contrast, distinguishes between foreign source and domestic source income. *See* I.R.C. § 941(a)(1) (2002).

¹⁴³ ETI Appellate Body, *supra* note 131, ¶ 161.

For the foregoing reasons, the Appellate Body struck down the ETI regime and ordered that the United States remove the legislation or otherwise face a \$4 billion retaliatory tariff.¹⁴⁴ Facing both the threat and the ultimate imposition of punitive tariffs on March 1, 2004,¹⁴⁵ Congress went back to the drawing board to devise a new legislative scheme to replace the ETI. Two of the more noteworthy proposals considered in the House were the Crane-Rangel and Thomas Bills.

III. A SUMMARY OF THE CRANE-RANGEL BILL

In April 2003, Representatives Philip Crane (Republican-Illinois) and Charles Rangel (Democrat-New York) introduced a bill to replace the ETI regime.¹⁴⁶ Attempting to capitalize on the prevailing economic climate of worry over unemployment, the bill was aptly titled the "Job Protection Act of 2003."¹⁴⁷ The overall purpose of the legislation is to reduce the corporate tax rate for domestic manufacturers.¹⁴⁸ The Crane-Rangel Bill is similar to the ETI regime in that the corporate taxpayer does not have to establish a separate entity to become a beneficiary of the program's tax benefits.¹⁴⁹ Also like the ETI regime, the amount of tax benefit under Crane-Rangel is tied directly to the value of transactions dealing with a specified category of production property.¹⁵⁰ However, Crane-Rangel does not impose restrictions on where the domestically-produced property may be used or consumed.¹⁵¹ In addition, there are no restrictions on where

¹⁴⁴ See Paul Meller, *Europeans Seek \$4 Billion in Trade Sanctions against U.S.*, N.Y. TIMES, Nov. 18, 2000, at C1. See also *After Success on Steel, EU Warns over US Tax Breaks*, AGENCE FR. PRESSE, Dec. 5, 2003 available at 2003 WL 69782232 (reporting that the European Union set a Mar. 1, 2004 deadline for the United States to comply with FSC/ETI rulings).

¹⁴⁵ William Newkirk, *Europe Hits U.S. Goods with Tariffs in Tax Spat; EU Demands End to Export Subsidy*, CHI. TRIB., Mar. 2, 2004.

¹⁴⁶ H.R. 1769, *supra* note 3. The bill was also introduced by Representatives Donald Manzullo (Republican-Illinois) and Sander Levin (Democrat-Michigan). For convenience, when this article refers to a section number of the Crane-Rangel Bill, it is technically referring to the section number of the Internal Revenue Code that the bill proposes to change.

¹⁴⁷ See *id.*

¹⁴⁸ The expected effect of the Crane-Rangel Bill on a company that has 100% domestic production is for its 35% tax rate to decrease to 31½%, resulting in a 3½% deduction. See Phil Crane and Charles Rangel, *Building a Level Playing Field for U.S. Exporters*, at <http://www.taxfoundation.org/frontandcenter-cranerangel.html>.

¹⁴⁹ See I.R.C. § 943(e), *supra* note 99.

¹⁵⁰ H.R. 1769, *supra* note 3, § 250. See also I.R.C. § 942(a) (setting forth the amount of tax benefit for exporters under the ETI regime).

¹⁵¹ H.R. 1769, *supra* note 3, § 250. See also I.R.C. § 943(a)(1)(B), *supra* note 104, (provides for foreign use or consumption requirements under the ETI regime). Indeed, the lack of a geographic use or consumption requirement reflects the United States' desire to

inputs for qualifying domestic production property can originate.¹⁵² Moreover, Crane-Rangel is void of any foreign economic process requirements; it does not matter whether solicitation, advertising or contracting takes place within the United States or abroad.¹⁵³

The centerpiece of the Crane-Rangel Bill is a tax deduction equal to 10% of a corporation's income from "qualified production activities" for the tax year.¹⁵⁴ The term "qualified production activities income" is defined as "the product of: (1) the portion of the modified taxable income of the taxpayer which is attributable to domestic production activities, and (2) the domestic/foreign fraction."¹⁵⁵

The Crane-Rangel Bill would add a new Internal Revenue Code Section 250(d)(1), which would define "modified taxable income of a taxpayer attributable to domestic production activities" as equal to "domestic production gross receipts" less the sum of:¹⁵⁶ (i) the cost of goods allocable to such receipts,¹⁵⁷ and (ii) deductions, expenses, or losses directly allocable to such receipts.¹⁵⁸ "Domestic production gross receipts" are only those receipts from the sale or lease of "qualified production property."¹⁵⁹ Such property can be: "(A) any tangible personal property, (B) any computer software, and (C) any films, tapes, records, or similar reproductions."¹⁶⁰ In whatever form, "qualified production property" must

avoid the legislation found to be an export contingent subsidy under Article 3.1(a) of the SCM.

¹⁵² H.R. 1769, *supra* note 3, § 250. See also I.R.C. § 943(a)(1)(C)(2002), *supra* note 105, (setting limitations under the ETI regime on the percentage of fair market value that can be attributable to products originating outside the United States.).

¹⁵³ H.R. 1769, *supra* note 3, § 250. See also I.R.C. § 942(b), *supra* note 106 (setting forth economic requirements under the ETI regime).

¹⁵⁴ H.R. 1769, *supra* note 3, § 250(a). Crane-Rangel provides for a transition where the FSC/ETI benefit is reduced gradually and the new tax benefit is increased. Under § 250(e), the FSC/ETI benefit is pegged to the 2001 amount indexed to inflation (adjusted base amount), and the taxpayer receives 100% of the base amount in 2004 and 2005, 75% thereof in 2006 and 2007, 50% thereof in 2008, and 0% thereof in 2009 and thereafter. Under § 250(b), the Crane-Rangel tax benefit for domestic manufacturers is also phased-in over a five-year period: a deduction of up to 1% of "qualified production activities income" in 2006, 2% thereof in 2007, 4% thereof in 2008, 9% thereof in 2009, and 10% thereof in 2010 and thereafter.

¹⁵⁵ *Id.* § 250(c).

¹⁵⁶ *Id.* § 250(d)(1)(A).

¹⁵⁷ *Id.* § 250(d)(1)(B)(i).

¹⁵⁸ *Id.* § 250(d)(1)(B)(ii).

¹⁵⁹ *Id.* § 250(e)(1)(A),(B). In addition, under § 250(e)(2)(A), replacement parts, no matter where manufactured, are covered under domestic gross production receipts, provided the parts are for qualifying production property.

¹⁶⁰ See H.R. 1769, *supra* note 3, § 250(f)(1)(A)-(C). Certain types of goods are excluded under § 250(e)(2) including "consumable property that is sold... by the taxpayer as an integral part of the provision of services."

be manufactured, grown, or produced, in whole or significant part, by the taxpayer within the United States.¹⁶¹

The other relevant number in calculating a manufacturer's tax deduction under Crane-Rangel is the "domestic/foreign fraction," defined in Section 250(g) of the bill. The numerator consists of the "domestic production value,"¹⁶² and the denominator the "value of worldwide production."¹⁶³ "Domestic production value" is equal to the value of domestic production gross receipts less the costs of the "purchased inputs" allocable to such receipts.¹⁶⁴ Worldwide Production is simply the same formula with the inclusion of international gross production receipts and the costs allocable to them.¹⁶⁵

The domestic/foreign fraction works to affect a manufacturer's decision where to produce and market goods. By multiplying this fraction with domestic production gross receipts, Crane-Rangel effectively discounts the amount of income eligible for deduction by a factor proportionate to the amount of overseas production. Theoretically, the Crane-Rangel Bill would induce a manufacturer to increase export activity where the marginal benefit of the tax deduction is greater than the marginal costs of manufacturing domestically—including increased shipping, operating, and labor costs.

IV. A SUMMARY OF THE THOMAS BILL

In July 2003, Representative Bill Thomas, chairman of the Joint Committee on Taxation, introduced a competing bill to replace the ETI tax regime.¹⁶⁶ Originally introduced in July of 2003, the Thomas Bill has since undergone several rounds of revisions,¹⁶⁷ culminating in the passage of the

¹⁶¹ *Id.* § 250(e). One question that arises from this definition is the level of activity within the United States that would satisfy the "significant part" threshold.

¹⁶² *Id.* § 250(g)(1)(A).

¹⁶³ *Id.* § 250(g)(1)(B).

¹⁶⁴ *Id.* § 250(g)(2),(3). Purchased Inputs include: "(i) services used in manufacture or production activities, (ii) items consumed in connection with such activities, (iii) items incorporate as part of the property being manufactured, produced, grown, or extracted."

¹⁶⁵ *Id.* § 250(g)(4). Crane-Rangel § 250(g)(5) provides that if a taxpayer is part of an affiliated group, the domestic/foreign fraction shall be calculated by treating all the members of such group as a single corporation.

¹⁶⁶ H.R. 4520.EH, 108 Cong. (2004). The first version of the Thomas Bill was introduced as the American Jobs Creation Act of 2003, H.R. 2896.IH 108 Cong. (2003).

¹⁶⁷ A significant provision contained in the first version of the Thomas Bill, but subsequently dropped, pertained to the repeal of CFC rules on "foreign base" income within subpart F. H.R. 4520.EH § 1101, 108 Cong. (2004). A major source of contention among multinational corporations has been the calculation of "foreign base income," which includes "foreign sales income" and "foreign services income." These were designed to prevent corporations from moving income from one jurisdiction to another for the sole purpose of

American Jobs Creation Act of 2004 by the House on June 17, 2004.¹⁶⁸

Overall, the Thomas Bill takes a significantly different approach towards replacing the ETI regime.¹⁶⁹ Whereas Crane-Rangel's benefits were directed solely towards manufacturers that produce their goods entirely within the United States, the Thomas Bill offers benefits to a much broader range of corporations, most notably multinationals with significant manufacturing and services operations overseas. Unlike the FSC and DISC regimes, the Thomas Bill does not require a taxpayer to formally elect a special status in order to receive the bill's tax benefits. Instead, much of the Thomas Bill's reforms are implemented by directly affecting the extant provisions of the Internal Revenue Code.

Since its passage, the Thomas Bill has achieved much notoriety—unfortunately for the wrong reasons. Commentary concerning the more substantive and far-reaching provisions of the legislation has been overshadowed by criticism and even ridicule over the litany of special interest provisions contained in the bill.¹⁷⁰ These special interest provisions include subsidies for alcohol fuels,¹⁷¹ repeal of excise taxes on fishing tackle boxes,¹⁷² simplification of excise taxes on bows and arrows,¹⁷³ and benefits for manufacturers of SONAR devices used for finding fish.¹⁷⁴ The pork-laden controversy of the Thomas Bill notwithstanding, the following discussion focuses instead on the broader measures of the Thomas Bill that

taking advantage of a lower-tax jurisdiction. For example, a U.S. manufacturer sells goods to a foreign buyer. Prior to “foreign sales income,” that manufacturer could set up a pass-through entity in a low-tax third jurisdiction in order to have taxes on profits assessed there. Under the “foreign sales income,” the entire income previously allocated to the third nation was counted as income in the United States, unless the property considered was manufactured in that third jurisdiction. Section 1101 of the first version of the Thomas Bill repeals the addition of “foreign services income” and “foreign sales income” to domestic source income for the U.S. corporate taxpayer.

¹⁶⁸ H.R. 4520.EH, 108th Cong. (2004). As will be discussed *infra*, much of the impetus behind revising the Thomas Bill has been the addition of special interest provisions. One of the key Congressmen who ultimately co-sponsored the Thomas Bill was Representative Crane himself.

¹⁶⁹ The Thomas Bill contains a wide variety of provisions, including ones that address issues other than those posed by the FSC/ETI dispute. Some other key provisions include: *See* H.R. 4520.EH, *supra* note 166, §§ 611-21 (increasing penalties with respect to tax shelters); *id.* §§ 601-606 (explaining additional measures to reduce corporation expatriation); *id.* §§ 221-31 (revising rules for S corporations); *id.* § 402 (extending tax credits for research and development); *id.* § 701-25 (proposing market reform for tobacco growers).

¹⁷⁰ *See, e.g.,* William Newkirk, *Omnibus Tax Bill Indulges Lobbyists, Eager Shredding of Tax Code by Lawmakers is Boon for NASCAR, General Electric Co. and Tobacco Farmers*, CHI. TRIB., July 21, 2004, at C1.

¹⁷¹ H.R. 4520.EH, *supra* note 166, § 252.

¹⁷² *Id.* § 290.

¹⁷³ *Id.* § 289.

¹⁷⁴ *Id.* § 291.

are most relevant to the FSC/ETI dispute.¹⁷⁵

A. General Tax Relief for Small Corporations

The Thomas Bill reduces the tax burden of small corporations through a gradual reduction of marginal tax rates beginning in 2005. By 2012, corporations with \$20 million or under in taxable income will be taxed at a maximum marginal rate of 32%,¹⁷⁶ compared to the present 35% top marginal rate.¹⁷⁷ To offset some of the revenue lost from this reduction, higher income corporations, specifically those with taxable income in excess of \$20 million (or \$15 million for taxable years until 2012) have their tax liability increased by the lesser of (a) 3% of taxable income in excess of aforementioned thresholds, or (b) \$610,250 (or \$100,000 for the taxable years until 2012).¹⁷⁸

B. Tax Relief for Domestic Production Activities Income

The Thomas Bill reduces and limits the tax burden of companies that derive income from “Qualified Domestic Production Activities.”¹⁷⁹ If a corporation has any taxable income from these Qualified Production Activities for the taxable year, then its tax shall not exceed the sum of (i) the tax on the portion of total income not derived from Qualified Production Activities, and (ii) 32% (or 34% for taxable years before 2007) on “Qualified Production Activities Income” (or taxable income if it is less). Qualified Production Activities Income is defined as the company’s “Domestic Gross Production Receipts” less the costs of selling the goods allocable to these receipts.¹⁸⁰ Domestic Gross Production Receipts, in turn, means proceeds from the disposition of “Qualifying Production Property” that is manufactured “in whole or in significant part . . . within the United States.”¹⁸¹ The definition of Qualifying Production Property is quite broad as it includes all tangible personal property, computer software and sound

¹⁷⁵ The Senate amended the Thomas Bill following its passage by the House and as a result many of the special interest provisions have been stricken from the legislation. This development offers at least some indication that removing the same type of provisions from the final joint bill will be a focus of the conference committee.

¹⁷⁶ H.R. 4520.EH, *supra* note 166, § 103(a) (creating a new I.R.C. § 11(b)(2)).

¹⁷⁷ I.R.C. § 11(b)(1).

¹⁷⁸ H.R. 4520.EH, *supra* note 166, § 103(a) (creating a new I.R.C. § 11(b)(5)(B)).

¹⁷⁹ *Id.* § 102. Interestingly, domestic production-specific tax relief was not present in the 2003 version of the Thomas Bill. The notion of tax relief based on domestic production is derived from the Crane-Rangel Bill. Without much doubt, these provisions were a concession to gain the support of Congressman Crane and other Congressmen previously aligned with his bill.

¹⁸⁰ H.R. 4520.EH, *supra* note 166, § 102(a).

¹⁸¹ *Id.* In addition, “domestic gross production receipts” include any construction or architectural services performed in the United States for projects within the United States.

recordings.

C. AMT Relief

Generally, the AMT works to prevent a corporation that derives a significant portion of its profits abroad from paying little or no U.S. income tax.¹⁸² If a company is subject to AMT, the Internal Revenue Code assesses a tax in addition to any regular income tax.¹⁸³ The Thomas Bill raises the income threshold above which corporations are required to pay AMT from \$7.5 million to \$20 million in average gross receipts for the past three taxable years.¹⁸⁴ Furthermore, the Thomas Bill eliminates the 90% limitation on the use of operating losses and foreign tax credits against the AMT.¹⁸⁵ The motivation behind these reforms appears to be the creation of greater investment incentives for multinationals that derive a significant portion of their revenues abroad, regardless of whether those revenues are reinvested abroad or repatriated back to the United States.

D. Deduction for Dividends from Foreign Controlled Corporations¹⁸⁶

To allow foreign controlled corporations to distribute foreign earnings back to their U.S. corporate shareholders, and to promote investment of foreign earnings in the United States, the Thomas Bill offers corporate taxpayers a one-time election to receive a deduction of up to 85% for

¹⁸² The AMT provisions are found in I.R.C. §§ 55-59. See Tax Foundation, "Eliminating the AMT's Limitation on the Use of Foreign Tax Credits," at <http://www.taxfoundation.org/internationaltax/amtandforeigntaxcredit.html>. See also Terrence R. Chorvat & Michael S. Knoll, *The Case for Repealing the Corporate Alternative Minimum Tax*, 56 SMU L. REV. 305 (2003). The AMT was enacted by the Tax Reform Act of 1986, in large part because of reports that certain large corporations, such as General Electric, were paying relatively little tax despite high levels of profits.

¹⁸³ Chorvat & Knoll, *supra* note 182, at 309.

¹⁸⁴ H.R. 4520.EH, *supra* note 166, § 242(a). This provision expands coverage of the small business exemption from the AMT under I.R.C. § 55(e)(1). Interestingly, the Thomas Bill still preserves the original and comparatively very low \$5 million threshold if the small business exemption test involves examining the corporation's first three-year period, or some portion thereof.

¹⁸⁵ *Id.* § 241. Specifically, this is done by striking out I.R.C. § 59(a)(2), which limits the AMT foreign tax credit to the excess of the pre-credit tentative minimum tax for the year over ten percent of the amount which would be the pre-credit tentative minimum tax irrespective of the AMT operating loss deductions.

¹⁸⁶ Other subpart F reforms include § 307 (U.S. property not to include certain assets of controlled foreign corporations (CFCs)), § 309 (repeal of withholding tax on dividends from certain foreign corporations), § 312 (look through treatment of sale of partnership interests), § 313 (repeal of foreign personal holding company and foreign investment company rules), § 315 (repeal of foreign base shipping income regarding aircraft leasing and shipping income), and § 316 (additional exceptions for active financing under subpart F). H.R. 4520.EH, *supra* note 166.

dividends distributed during the first six-month period of the taxable year.¹⁸⁷ The deduction must not exceed the greatest of (i) \$500 million; (ii) the amount of earnings permanently reinvested outside of the United States as shown in a certain financial report; or (iii) an amount prescribed by the Secretary of the Treasury.¹⁸⁸ The dividends that are distributed from the controlled foreign corporation back to the U.S. shareholder must be reinvested in the United States pursuant to a plan approved by the chief executive officer and the Board of Directors of the U.S. shareholder that describes the expenditures to be made from these dividend proceeds.¹⁸⁹

E. Reduction of Foreign Tax Credit Baskets

To limit the extent to which foreign source income can be combined so as to maximize the amount of foreign tax credit, corporate taxpayers are permitted to combine foreign source income only within nine separate foreign tax credit baskets.¹⁹⁰ The Thomas Bill, however, rearranges and reduces foreign tax credit baskets from nine to two: "Passive Category Income" and "General Category Income."¹⁹¹ General Category Income is defined as all income other than Passive Category Income.¹⁹² Passive Category Income is defined as passive income and "Specified Category

¹⁸⁷ H.R. 4520.EH, *supra* note 166, § 271(a) (adding a new I.R.C. § 965 within subpart F).

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ The current nine foreign source income baskets are: (1) passive income; (2) high withholding tax interest; (3) financial services income; (4) shipping income; (5) dividends from each non-controlled I.R.C. § 902 corporation; (6) dividends from a DISC or former DISC; (7) taxable income attributable to foreign trade income; (8) certain FSC distributions; and (9) all other income. I.R.C. § 904(d)(1)(A)-(I). The Tax Foundation offers an example of how absent these credit baskets, a corporate taxpayer could behave strategically in order to maximize the tax credit by "cross-crediting:"

For instance, two items of foreign source income, each equal to \$100. The first is taxed abroad at a 10% rate and the second at a 45% rate, in a year in which the U.S. tax rate is 35%. If we were to apply the foreign tax credit limit to each foreign source separately, the first item would have a U.S. tax of \$35, less a foreign tax credit of \$10, resulting in \$25 payable to the U.S. government. Similarly, the second item would have a U.S. tax of \$35, with a foreign tax credit of \$45, resulting in no payment to the U.S. government because the foreign tax credit is limited to the amount of U.S. tax. However if the corporate taxpayer was allowed to combine the two sources of income together so as to create a single income item of \$200, the U.S. tax would be \$70, less a foreign tax credit of \$55, and as a result, only \$15 would be owed the U.S. government.

Tax Foundation, "Reducing the Number of Foreign Tax Credit 'Baskets,'" at <http://www.taxfoundation.org/internationaltax/reducingtaxcredit.html>.

¹⁹¹ H.R. 4520.EH, *supra* note 166, at § 303(a).

¹⁹² *Id.* § 303(b).

Passive Income.”¹⁹³ Specified Category Passive Income is defined as: “(I) dividends from a DISC or former DISC . . . to the extent such dividends are treated as income from sources without the United States, (II) taxable income attributable to foreign trade income. . . and (III) distributions from an FSC (or former FSC) out of earnings and profits attributable to foreign trade income . . . or interest or carrying charges.”¹⁹⁴ The anticipated effect of lowering the number of foreign credit baskets is two-fold. As illustrated above, fewer baskets enable corporations to combine more of their foreign source income together in order to achieve greater foreign tax credit amounts and reduced U.S. tax liability. Second, the reduction of baskets should also reduce the costs associated with calculating a taxpayer’s foreign tax credit in general, especially among large multinational corporations.

F. Interest Expense Allocation Rules Reform

Another area of the Internal Revenue Code that the Thomas Bill addresses is interest expense allocation.¹⁹⁵ Currently, the interest expense of an affiliated group of corporations is allocated between foreign and domestic sources based on the location of assets.¹⁹⁶ A problem occurs, however, when the same rules allocate U.S. interest expense to foreign source income, which in turn lowers the amount of foreign tax credit available for the affiliated group.¹⁹⁷ Corporations and trade industry groups have complained that this method of allocation is imprecise and flawed.¹⁹⁸ In effect, and to the extent that a foreign tax credit is unavailable, an additional “double-tax” is levied on a certain percentage of foreign source income that cannot be offset by foreign tax credits.¹⁹⁹ As a result, the Internal Revenue Code actually creates a disincentive to invest in the United States.²⁰⁰

¹⁹³ *Id.*

¹⁹⁴ *Id.* at § 303(c).

¹⁹⁵ See *Reforming Interest Expense Allocation Rules*, Tax Foundation, at <http://www.taxfoundation.org/internationaltax/interestallocationrules.html> (last visited Mar. 2, 2004).

¹⁹⁶ I.R.C. § 864(e)(1) states that “the taxable income of each member of an affiliated group shall be determined by allocating and apportioning interest expense of each member as if all members of such group were a single corporation.” The actual apportionment formulae for allocating interest expense are supplied by Treas. Reg. §§ 1.163-8 to 1.163-12.

¹⁹⁷ *Id.*

¹⁹⁸ See, e.g., Letter from the Securities Industry Association to Congressman Bill Thomas, supporting H.R. 4520 (June 8, 2004), available at http://www.sia.com/2004_comment_letters/1524.pdf.

¹⁹⁹ See Kenneth A. Froot & James R. Hines, Jr., *Interest Allocation Rules, Financing Patterns, and the Operations of U.S. Multinationals*, in *THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS* 277, 279-281. (Martin Feldstein, et al. eds., 1995).

²⁰⁰ See H.R. REP. NO. 108-548, pt. 1, at 183-84 (2004).

The Thomas Bill creates a new Section 864(f)(1)(A) which allows a corporate taxpayer to make a one-time election²⁰¹ as a “Worldwide Affiliated Group” and subject itself to a different set of interest allocation rules.²⁰² A new Section 864(f)(1)(B) sets forth new rules for allocating interest if a taxpayer makes such an election.²⁰³ Specifically, the allocation of total interest expense of a Worldwide Affiliated Group allocable to foreign source income of domestic members is equal to the excess of (i) the interest expense of the Worldwide Affiliated Group multiplied by the percentage of total assets represented by foreign assets, over (ii) the interest expense of all foreign members “to the extent such interest expense of such foreign [members] would have been allocated and apportioned to foreign source income if this subsection were applied to a group consisting of all the foreign [members] in such [W]orldwide [A]ffiliated [G]roup.”²⁰⁴

V. THE THOMAS BILL UNDER WTO LEGAL STANDARDS

Based on the decisions of the WTO Dispute Settlement Body in the FSC and ETI cases, it would be difficult for the United States to argue that none of the Thomas Bill’s provisions excludes income that would otherwise be due under Article 1.1 of the SCM.²⁰⁵ Once again, the broad reach of I.R.C. Section 61 imposes a nearly insurmountable obstacle for the United States to overcome given the high threshold set forth by the WTO Appellate Body.

The United States could, however, raise an interesting argument with

²⁰¹ H.R. 4520.EH § 301(a), under which § 864(f)(5)(D) would require the domestic parent of the group to make the election for the first taxable year after December 31, 2008. The election would continue to apply to all subsequent taxable years.

²⁰² H.R. 4520.EH § 301(a), under which § 864(f)(1)(A) would provide that “[t]he taxable income of each domestic corporation which is a member of a worldwide affiliated group shall be determined by allocating and apportioning interest expense of each member as if all members of such group were a single corporation.” (emphasis added). Generally, new § 864(f)(1)(C) defines a Worldwide Affiliated Group, which includes an Affiliated Group, set forth under I.R.C. § 1504, along with affiliated controlled foreign corporations that meet certain ownership requirements.

²⁰³ *Id.*

²⁰⁴ *Id.* § 301(a), under which § 864(f)(1)(B)(ii) would be amended.

²⁰⁵ Indeed, it matters little whether a Dispute Panel would use the “prevailing standard” test used by the FSC Appellate Body, *supra* note 86, ¶ 91, or the “comparable income” test adopted by the ETI Appellate Body, *supra* note 131, ¶ 91. Not only would a WTO Dispute Panel find the Thomas Bill to exclude foreign sources of income otherwise due, but it would also likely find that it excludes domestic sources of income as well (such as the bill’s tax relief for domestic production activities). In that case, there would not likely be a specific universe that would be analyzed under SCM Article 1.1. Because the Thomas Bill consists of several independent sets of provisions, it would be highly unlikely that all of it would be struck down by the WTO Dispute Settlement Body. Rather, it is more plausible for a WTO Panel to view the bill as several legislative programs under its umbrella.

respect to the bill's foreign credit basket reduction and interest allocation provisions. Although the foreign credit basket reduction would in effect lead to lost revenue that would otherwise have been collected by the I.R.S. absent the provisions in question, the context under which this exclusion is effected is distinguishable from the direct exclusions granted by the FSC and ETI schemes. Instead, the foreign tax credit basket reduction represents a change in how foreign tax credits are calculated, and the extent to which they can be used to offset foreign source income. The additional income excluded as a result of the basket reduction was conceptually never due in the first place, since it is generally the policy of the I.R.C. to provide foreign tax credits for foreign taxes paid in order to avoid double-taxation of the same income. The creation of different foreign tax credit baskets was done in order to prevent abuse and limit the extent to which foreign taxes paid on active foreign source income could be credited towards foreign taxes paid on passive foreign source income. Moreover, a finding that the foreign basket reduction provisions do not constitute a subsidy would not present the slippery slope problem that appeared to concern the FSC Dispute Panel if nations were free to categorize income and then in turn argue that any newly excluded income from a legislative scheme was never otherwise due as a result of that categorization.²⁰⁶ The universe of income that is used in determining the amount of foreign tax credit available does not expand, i.e., there are no new sources of income that are incorporated in this analysis that would result in a gaping loophole for nations to circumvent Article 1.1.²⁰⁷

The United States can also defend the Thomas Bill's interest allocation provisions on similar grounds. It is apparent that the ETI Appellate Body opened some leeway for nations to define on their own what foreign source income means, provided that such a definition remained within the bounds of general prevailing and widely-accepted standards such as the Model OECD Tax Convention.²⁰⁸ Implicit in this argument is that nations also possess some degree of flexibility to determine their own rules on what constitutes an allowable deduction to foreign source income, provided they fall within similarly reasonable constraints. The United States has a colorable argument that the interest allocation provisions, specifically how they allocate between foreign and domestic sources of income, are not only reasonable, but that they represent a significant improvement over the

²⁰⁶ FSC Panel, *supra* note 43, ¶ 4.1064.

²⁰⁷ Moreover, the character of the income used in determining the foreign tax credit is still foreign source income as defined by such general standards as the OECD Model Tax Convention.

²⁰⁸ ETI Appellate Body, *supra* note 131, ¶ 139. The context in which this point arose was in relation to the double-taxation defense that the United States tried to assert using footnote 59.

previous rules in that they better reflect the economic reality of what are real expenses and decreases in wealth on the domestic taxpayer that earns income abroad. Any additional tax benefit or deduction provided under these rules, therefore, is meant to further the interest of preventing the collection of tax revenue, and taxation of any underlying income not meant to be taxed (and therefore not otherwise due) is a result of any imperfections in the existing interest allocation rules.²⁰⁹

Ultimately the success of the above arguments would hinge on whether the WTO Dispute Panel takes a conceptual approach or mechanical approach in determining what “otherwise due” means. The latter would simply observe that under the Thomas Bill, income that was previously taxed and collected by the United States is now excluded. Based on the WTO Dispute Settlement Body’s previous rulings in the FSC and ETI dispute and their mechanical application of Article 1.1, there is a significant likelihood that the above provisions of the Thomas Bill would be declared subsidies.

The above analysis notwithstanding, a subsidy is not illegal unless it is specifically proscribed by another provision of the SCM, which for the purposes of this article would fall under Articles 3.1(a) and 3.1(b). The question of whether any part of the Thomas Bill represents a subsidy “contingent upon export performance” would likely call for an examination of the domestic production activities provisions. Nothing in these provisions, however, explicitly conditions tax benefit on where the articles are sold, used, or consumed. Nor can it be directly implied from the express terms of the domestic production activities provisions that there is invariably a requirement of export performance.²¹⁰ Indeed, both the

²⁰⁹ Admittedly, such an interpretation of “otherwise due” with respect to the foreign credit basket and interest allocation provisions would emasculate much of the double-taxation defense under footnote 59, discussed *infra*. That is, where relevant, a nation could simply argue that the income was never otherwise due, and thus the measures in question would never need to be examined under footnote 59 as it would never be a subsidy in the first place. This line of reasoning assumes that footnote 59 essentially concedes a subsidy but then exempts that subsidy on grounds of prevention of double-taxation. The WTO Dispute Settlement Body would be well-served to provide further clarification on these matters of law.

²¹⁰ To be sure, the WTO Dispute Settlement Body has not specified how far export contingency “in fact” should be construed. As discussed *supra*, export contingency in fact can be found by implication directly from the express terms of the legislation. Yet, the FSC and ETI disputes do not answer the question of whether legislation can be found export contingent in fact based on its empirical effects. In the *Subsidies on Upland Cotton* dispute, the Dispute Panel provided some clarification:

This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to

Thomas and Crane-Rangel Bills appear to heed the advice of the ETI Dispute Panel by extending tax benefits to domestic manufacturers categorically, regardless of whether the goods they produce are consumed in the United States or abroad.²¹¹ Because the Thomas Bill follows the explicit instruction of the WTO Dispute Settlement Body on how to cure an otherwise export contingent subsidy, the Thomas Bill would likely escape an adverse finding against its domestic production tax relief provisions under Article 3.1(a).

Even if the foreign credit basket reduction and interest allocation provisions are declared subsidies by a Dispute Panel, the United States can present a persuasive and ultimately convincing argument that they do not constitute subsidies contingent upon export performance because they are specifically exempted by footnote 59 of Annex I as permissible measures designed to prevent double-taxation. As previously discussed, the foreign tax credit basket reduction provisions benefit a taxpayer only to the extent that it pays taxes to foreign jurisdictions, and by definition only foreign source income is subject to such taxation.²¹² The interest expense allocation provisions would raise the more difficult question of whether they are adequately isolated to offset only foreign source income. In the ETI dispute, the Appellate Body opined that the provisions in question need not be entirely exact in the implementation of its double-taxation prevention measures.²¹³ Yet at the same time, it required such measures to be reasonably proximate to some general and widely-accepted convention of foreign source income.²¹⁴ The question then becomes essentially whether the interest expense allocation rules work to offset an appropriate universe of income (i.e., income that would likely be subject to foreign taxation). Section 301 of the Thomas Bill enables domestic members of a worldwide affiliated group to offset against foreign source income interest expense of an amount determined generally by a formula that captures the difference between (i) the proportion of interest expense allocable to foreign assets, and (ii) the interest expense of foreign corporations within the Worldwide Affiliated Group. This difference appears to be a rough, but reasonably accurate, approximation of the amount of interest expense that should offset

enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

Subsidies on Upland Cotton Dispute, WT/DS267/R (WTO) (2004), ¶ 7.699 n.4., available at 2004 WL 2075353.

²¹¹ See ETI Panel, *supra* note 108.

²¹² As one point of reference, the foreign credit basket reduction provisions comport to the OECD Model Tax Convention, which the ETI Dispute Panel alluded to as a persuasive source of a definition of foreign source income. See *supra* note 108.

²¹³ ETI Appellate Body, *supra* note 131, ¶ 139.

²¹⁴ *Id.*

the category of income that runs the greatest risk of double-taxation. The use of location of assets to approximate the amount of interest expense that is deductible against foreign source income can admittedly be subject to inaccuracies. Whether the formula ultimately works precisely enough to provide the proper types of investment incentives for multinationals is a question separate and distinct from the compliance issue. Unfortunately, neither the ETI Panel nor Appellate Body gave any concrete guidance on how much imprecision is allowable under footnote 59 in order to be within its ambit. Needless to say, there will be some uncertainty though these provisions appear to be a significant improvement over those that the United States tried to defend during the ETI dispute.

The question of whether the domestic production activities provisions of the Thomas Bill would violate Article 3.1(b) cannot be answered by using precedent from the FSC and ETI disputes because the Dispute Settlement Body declined to rule when it already found violations of Article 3.1(a). Article 3.1(b) of the SCM states, “subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods [are prohibited].”²¹⁵

The domestic production activities provisions do not explicitly require that property be composed of a minimum percentage of domestic inputs (in contrast to the 50% domestic production requirement imposed by the ETI regime); it only requires that the goods themselves be manufactured or produced within the United States. The use of the word “goods” in Article 3.1(b) implies that the provisions cannot be assailed on grounds that it expresses a preference for domestic *services*, e.g. labor, over foreign ones, which would include manufacturing. The question then becomes whether it is logically deducible that domestic inputs are given preference. Based on the language of Article 3.1(b) itself, such a conclusion does not necessarily follow without introducing empirical evidence that has been or is currently the result. The introduction of such evidence, however, would shift the analysis to whether an import subsidy exists *de facto*. The language of Article 3.1(b) is silent on whether a subsidy can be contingent in law or in fact. However, it is probative and likely persuasive to a Dispute Panel that the clause immediately before it, Article 3.1(a), explicitly states that a subsidy can exist whether it is “contingent, in law *or* in fact.”²¹⁶ If the drafters had meant the same to apply to 3.1(b), it would have likely done so.²¹⁷

²¹⁵ SCM, *supra* note 46, art. 3.1(b).

²¹⁶ *Id.* at art. 3.1(a) (emphasis added).

²¹⁷ The Crane-Rangel Bill provided an additional wrinkle, the domestic/foreign fraction, which adjusted the taxpayer’s benefit upward or downward depending on the proportion of domestic production to overall production. Therefore, where two corporations have different levels of domestic production, it is possible that the corporation with higher domestic

VI. CONCLUSION

Unlike predecessor legislative schemes, the Thomas Bill adopts a broad, multifaceted approach towards resolving the long-running dispute with the European Union over export subsidies. It attempts to reform parts of the existing Internal Revenue Code, particularly those pertaining to foreign tax credits and interest expense, while at the same time providing direct subsidies to a segment of corporate taxpayers that have received heightened attention in the prevailing economic climate. The Crane-Rangel Bill, on the other hand, focuses exclusively on subsidizing domestic manufacturers' activities. This dichotomy is reminiscent of what gave rise to the DISC in the first place. Today, these issues have come full circle, and Congress once again stands at the same crossroads as it did 1971.

At least with respect to WTO compliance, Part IV of this article concludes that the Thomas Bill would likely be found to be within the bounds of SCM.²¹⁸ Yet, the ultimate success of the Thomas Bill (or successor legislation passed by Congress) will hinge on whether it achieves two main policy objectives: (1) tax reform to remove distortions caused by the Internal Revenue Code, and (2) revitalization, or at least increased competitiveness, of domestic manufacturers. To the drafters' credit, the Thomas Bill breaks through the mold of predecessor regimes and recognizes that distortions caused by the Internal Revenue Code can be, and should be, addressed by reforming the Code itself, rather than introducing new direct subsidies that benefit only a narrow, though powerful, segment of the United States corporate taxpayer base.²¹⁹ Today, it is not only U.S. manufacturers that face intense global competition; other U.S. corporations that sell and operate abroad experience similar competitive pressures. It is therefore doubtful that Crane-Rangel alone would significantly shift investment activity back to the United States or make U.S. companies in

production would receive less favorable tax treatment, *ceteris paribus*, than the lower domestic production taxpayer.

²¹⁸ Unlike the DISC, FSC, ETI and the Crane-Rangel Bill, the Thomas Bill cannot be described as a single legislative program with interdependent components. This unique feature provides the United States, and more importantly corporate taxpayers, with some measure of risk diversification against having all the tax benefits repealed by a WTO Dispute Panel. Some provisions, such as general tax relief for small businesses and dividend received deductions from controlled foreign corporations, are likely to stay intact, even if some of the more controversial provisions are challenged by other nations. Stability, if not usually a desired policy interest, takes even greater importance considering the legislative turnover that has occurred in this area the past three decades.

²¹⁹ Reforming the idiosyncratic provisions of the Internal Revenue Code also reduces the likelihood of retaliatory action by other nations, as they would not be able to replicate the exact provisions of the Thomas Bill but could only attempt to replicate its effects. Should a foreign nation choose to pursue the latter replication strategy, it risks overcompensating for the Thomas Bill's effects, and in turn subjects itself to either reciprocal action by the United States or dispute settlement process before the WTO.

general more competitive abroad, much less provide an appreciable stimulus to the U.S. economy. Because of its broader coverage, the Thomas Bill represents a superior approach towards resolving the FSC and ETI dispute.²²⁰

Though the Thomas Bill appears to be an improvement over the Crane-Rangel Bill, there are still broader tax reforms that the Congressional committee or Congress could pursue in order to further reduce the distorting effects of some provisions of the Internal Revenue Code, most notably subpart F. For instance, the Thomas Bill missed the opportunity to reform foreign base sales and services income rules and corresponding Treasury regulations, which currently do not sufficiently differentiate between passive and active income. These provisions effectively treat sales between foreign affiliates, even on arms-length pricing terms, as taxable dividends back to the U.S. affiliate.²²¹ For this reason, a change with respect to foreign base sales and services income would seem to be a broader and overall better policy to pursue than a one-time temporary windfall for multinationals to repatriate their earnings at significantly lower tax rates. Though the latter measure can be defended as an economic stimulus program, a permanent adjustment in dividend rates would be more likely to affect the domestic investment behavior of multinationals in the long run. Therefore the one-time dividend rate reduction appeals more to special interest influence than to sensible tax policy.

After extenuated negotiations for over a year, the final version of the Thomas Bill incorporated a significant portion of the Crane-Rangel Bill's

²²⁰ Larry Lindsey, former director of the National Economic Council, argues that an important source of disadvantage for the United States vis-à-vis many E.U. nations is that the latter employs an indirect, Value-Added Tax (VAT) system with respect to export earnings, while the former taxes earnings from exports directly via income taxation. Lawrence B. Lindsey, *Editorial, How to Start a Trade War*, WALL ST. J., June 25, 2003, at A12. The importance of this distinction is that under WTO rules, exemption from indirect taxation (VAT) is not subject to the same scrutiny as exemption from direct income taxation. A separate Financial Times editorial calls for the WTO to end such differential treatment, as it has no basis in economic reality, and consistently and significantly disadvantages nations that choose to adopt a direct taxation system. Ernest Christian & Gary Hufbauer, *End This Damaging Tax and Trade Charade*, FIN. TIMES, Mar. 9, 2004, at 11. Until the WTO eliminates this distinction, direct export income tax relief, such as that provided under the FSC and ETI, will continue to be struck down. Therefore, it becomes necessary for the United States to look elsewhere to provide tax relief for the same group taxpayers.

²²¹ See Tax Foundation, *Reforming Foreign Base Company Rules*, at <http://www.taxfoundation.org/internationaltax/basecompanyrules.html> (last visited Jan. 5, 2005). See also *supra* note 167 for an expanded description of how the foreign base sales and service income provisions work. To be sure, the Thomas Bill does make some progress in reforming subpart F. The Senate amended version, H.R. 4520.EAS, § 212, increases the de-minimis limit for exemption from subpart F income to \$5 million. The House version, H.R. 4520.EH, § 313 repeals the rules concerning foreign personal holding company and foreign investment company rules.

provisions. Although there are plenty of policy reasons to question the wisdom of the Crane-Rangel Bill, it is also clear that manufacturing jobs have become, and continue to be, a major political issue.²²² Realistically, Congress cannot ignore the steady erosion of U.S. manufacturing activity and employment opportunities.²²³ To that end, the Thomas Bill has also heeded to these very same interests and concerns. This is embodied not only in the domestic production activities provisions imported from the Crane Rangel bill, but also in the reduction in tax rates of small businesses, which should further reduce the burden of some manufacturers. Without much prior experience to guide us on what the future will hold, it appears that at least upon first glance the Thomas Bill represents some positive aspects of legislative compromise: it will achieve broad-based tax reform while at the same time ensuring that domestic manufacturers retain some additional benefits apart from those enjoyed by other corporate taxpayers.

Yet, it can certainly be said that the Thomas Bill also reflects some of the worst of legislative compromise, as is apparent from the litany of special interest provisions contained in it.²²⁴ These pork provisions serve no general purpose other than to appease select Congressmen and their constituents. Whereas one can make sense of general tax relief on manufacturers in general, lavishing narrow benefits upon bow and arrow manufacturers, NASCAR track owners, dog racing track owners, major Hollywood film studios, and ceiling fan manufacturers, does not appear to

²²² See e.g., Daniel J. Mitchell, Heritage Foundation, *FSC/ETI Conference Should Not Waste Opportunity for Real Tax Reform*, available at <http://www.heritage.org/Research/Taxes/bg1779.cfm> (July 15, 2004). Pragmatically, FSC/ETI compliance legislation that only creates tax reform would not likely survive in either chamber of Congress. However, there appear to be legitimate concerns about whether manufacturing subsidies are likely enough to shift the cost differential between foreign and domestic production that it will affect location decisions at the margin. Moreover, such foregone revenue could be used to enact broad-based tax relief (either through reduction in tax rates or reform and simplification of existing provisions) that could be used to further reduce the competitive tax disadvantage that U.S. corporations face when operating and earning income abroad.

²²³ The Bureau of Labor Statistics reported that nearly three million manufacturing jobs have been lost since 1998, available at <http://www.bls.gov> (last visited Jan. 5, 2005). Of course these same statistics do not break out the percentage of job loss attributable to increased domestic productivity (which reduces the need for labor), as opposed to globalization (which shifts domestic labor to foreign locations). The Economic Policy Institute estimates that about 59% of the aggregate manufacturing job loss is explained by free trade. Josh Bivens, *Shifting Blame for Manufacturing Job Loss: Effect of Rising Trade Deficit Should Not Be Ignored*, Economic Policy Institute Briefing Paper, at http://www.epinet.org/content.cfm/briefingpapers_bp149 (Apr. 8, 2004).

²²⁴ A reason why the Thomas Bill has been such an attractive target for special interests is that there is a manifest urgency to pass new tax legislation in order to comply with the WTO ruling. Realizing that the Thomas Bill is likely to be passed, special interests have capitalized on this opportunity to add their provisions, knowing that the bill will very likely be enacted soon.

any broad policy interest.²²⁵ Removing these infirmities will present a significant and formidable challenge for the Congressional conference committee in fall 2004. If the final version of the bill offers a pound of pork for every ounce of sensible policy, then in the larger context the international tax reforms may not be worth the steep price paid.

The question of how to best provide tax incentives to U.S. exporters without running afoul of international trade laws has evaded resolution for over three decades. With the European Union's tariffs against U.S. exporters rising each month by 1%, and by latest count now at 12%, there is little doubt that Congress should now have the requisite sense of urgency to act swiftly towards achieving a long overdue resolution.

²²⁵ The need to scale back special interest provisions is especially apparent given the ninety billion dollar price tag of the myriad of tax breaks provided under the Thomas Bill. See Newkirk, *supra* note 170.

