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The Foreign Sales Corporation Drama: Reaching the Last Act?

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Historical Tour

Some trade disputes—like long Russian novels—never seem to end. The United States, Europe, and other trading nations have disputed the taxation of export earnings since the 1970s. To understand why the Foreign Sales Corporation (FSC) dispute is so hard to resolve, we must start with a historical tour.[1]

The 1960 Working Party Report

In 1960, a GATT (General Agreement on Tariffs and Trade) Working Party codified the ancient distinction (dating from the 19th century) between permissible and impermissible adjustments at the border for national taxes. The "origin principle" was prescribed for direct taxes, meaning that there could be no adjustments at the border—direct taxes could neither be imposed on imports nor rebated on exports. By contrast, the "destination principle" was prescribed for indirect taxes, permitting adjustments at the border—indirect taxes could both be imposed on imports and rebated (or not collected) on exports. But there is no GATT requirement for symmetry. A country can choose to rebate its indirect taxes on exports, yet not impose them on imports, or vice versa.

The United States, Europe, and other trading nations have disputed the taxation of export earnings since the 1970s.

The distinction between "direct" and "indirect" taxes made sense in the 19th century when only two types of taxation were widely used—excise taxes (indirect taxes) and property taxes (direct taxes). In that bygone world, it was reasonable to suppose that indirect taxes would be passed on in higher product prices and direct taxes would be borne by property owners. The major indirect taxes of the era were excise taxes on sumptuary goods like tobacco and spirits. If taxes on whisky, for example, could not be adjusted at the border, the taxing country would be flooded with imports of whisky, but local distillers could hardly sell their heavily taxed brew in for-

1. Readers interested in detailed legal analysis of the WTO decisions should consult Funk (2001). I disagree with some of Funk's legal analysis. More importantly, his treatment concentrates on scriptual detail and misses important economic drives behind the long-running dispute.

eign markets. In that context, destination-principle border adjustments made a lot of sense. Conversely, it made no sense to attribute property taxes to individual products and then adjust them at the border.

By 1960, public revenues were derived from many sources besides excise and property taxes. The question addressed by the Working Party was which of the "new" taxes could be adjusted at the border and which could not. The main taxes under consideration were social security taxes, corporate income taxes, and various kinds of sales taxes. Border adjustments were permitted for sales taxes, but ruled out for social security and corporate income taxes. Value added taxes (VAT) were then little used. Owing to the fact that several European countries replaced their cumbersome multi-stage sales taxes (cascade taxes) with VAT systems during the 1960s, it seemed a reasonable extension of the 1960 Working Party analysis to classify value added taxes as indirect taxes.

Whatever basis the simple direct/indirect dichotomy may have had in the bygone world of property and excise taxes, it lost its rationale when a line was drawn between permitted border adjustments for the VAT and the corporate income tax.

However—and this is an important historical point—under the US countervailing duty law of that era, the United States had the option of imposing countervailing duties (CVDs) against value added taxes that were rebated (or not collected) on exports. To maintain harmony in the trading system, the US Treasury (then the administering authority) decided in the early 1970s not to impose CVDs against VAT rebates. The critical US policy decision to classify VAT as an indirect tax eligible for border adjustment was not embodied in GATT jurisprudence until the Tokyo Round Code on Subsidies was ratified in 1979.

The classification scheme adopted by the 1960 Working Party, and subsequently extended to the VAT, was loosely justified by an appeal to "tax incidence." Indirect taxes are supposedly passed forward in higher product prices, direct taxes are supposedly passed back in lower factor earnings. But mere labels say nothing about the actual incidence of taxes in a modern economy. In a modern open economy, the actual incidence of taxes (whether forward in product prices or backward in factor earnings) depends on the uniformity of the tax, competitive conditions in the marketplace, and importantly whether or not the tax is adjusted at the border. In other words, tax incidence is as much a result of border adjustment rules as a reason for adopting any particular set of rules.

An example may help clarify thinking about tax incidence in an open economy. If country A imposes a 10 percent VAT on all manufactured products and does not adjust the VAT at the border, competition from imported manufactured goods will prevent local firms from passing their VAT forward to domestic consumers in the form of higher product prices. Nor will local firms be able to charge higher prices abroad to cover the VAT on exports. After all, competitive conditions did not change in foreign markets simply because country A decided to impose a nonadjustable VAT. Unable to pass the VAT forward in product prices, local firms will simply have to accept lower factor earnings—wages, profits, and rents will have to fall.

By contrast, if country A decides to adjust its VAT at the border, imported manufactures will pay the 10 percent tax, and local firms will be able to charge higher prices in the domestic market. Moreover, local firms will be able to export their manufactures free of VAT, so their net proceeds from sales abroad will not be affected. With an adjustable VAT, local firms can pass the tax forward in product prices, and avoid any reduction in factor earnings. Much the same analysis can be applied to the corporate income tax. Border adjustment rules largely determine whether the corporate income tax is passed forward in product prices or backward in factor earnings.

To be sure, in a general equilibrium framework, exchange rate changes and international capital movements come into play, ultimately shaping the incidence of various business taxes. From the standpoint of competing firms, however, exchange rate adjustments seem like the unsure promise of an academic economist. Businessmen are far more concerned about the here-and-now of border adjustment rules than the future possibility of compensating exchange rate changes. Tax adjustments at the border are almost always seen as an advantage to local firms, whatever the ultimate general equilibrium exchange rate outcome may be.

Seen in this light, whatever basis the simple direct/indirect dichotomy may have had in the bygone world of property and excise taxes, it lost its rationale when a line was drawn between permitted

border adjustments for the VAT and the corporate income tax.

As a consequence of the twists of tax history, however, destination-principle adjustments are prohibited for the corporate income tax on export earnings but permitted for the VAT. The distinction persists to this day, despite the obvious point that a VAT amounts to a combination of several direct taxes: a direct tax on profits earned by the corporation, a direct tax on interest and rent paid by the corporation, and a direct tax on wages.[2] In other words GATT alchemy transforms a series of direct taxes into a single indirect tax, eligible for adjustment at the border. Lacking this magical transformation, a single direct tax on corporate profits cannot be adjusted at the border.

From the standpoint of US exporters, their European competitors enjoyed a significant tax advantage. European exports arriving in US ports were free of VAT; US exports arriving in European ports paid both US corporate tax and the European VAT .

Subpart F

The tax tilt resulting from the 1960 Working Party Report was worsened by US legislation a few years later. To be sure, this was a self-inflicted injury. In 1962, the United States enacted Subpart F of the Internal Revenue Code. Before Subpart F was enacted, a US multinational firm could establish a selling subsidiary in a low-tax jurisdiction (for example, Switzerland) and US taxation of the profits earned through distribution activity could be "deferred" until the sales subsidiary decided to repatriate its income to the US parent. Repatriation might not happen for decades—and through the wonders of compound interest tax deferred for decades is almost the same as tax forgiven. Outright exemption or indefinite deferral of sales subsidiary income was then, and remains today, the normal practice among most industrial countries. The United States is one exception and France is another.[3]

The "antiabuse" provisions of Subpart F put US exporters at a tax disadvantage compared to other industrial country exporters. In 1962, this did not seem to matter because US manufacturing companies were dominant suppliers of nearly all industrial goods, and the United States then ran a persistent trade surplus (concentrated in manufactured goods). But the early postwar era of US industrial dominance and trade surpluses soon drew to a close.

The DISC and the Tax Legislation Reports

In 1971, faced with a growing trade deficit and a more competitive world market for manufactured goods, the United States introduced the Domestic International Sales Corporation (DISC)—partial tax deferral for the export earnings of a US corporation. DISC tax relief amounted to about 12 percentage points on export profits earned by the parent corporation and its DISC (the normal corporate tax rate was then 48 percent). Essentially the DISC was intended to soften the self-inflicted damage to US exporters arising from Subpart F.

The European Commission challenged the DISC in 1974, arguing that it was a prohibited export subsidy under the terms of GATT Article 16. The United States argued that Article 16 only prohibited tax exemption on export sales and that tax deferral under the DISC was not the same as tax exemption. The United States also invoked the "bi-level pricing test" of Article 16, arguing that the European Commission had not demonstrated that DISC exports were sold cheaper than comparable goods in the US home market.

GATT alchemy transforms a series of direct taxes into a single indirect tax, eligible for adjustment at the border. Lacking this magical transformation, a single direct tax on corporate profits cannot be adjusted at the border.

In addition to these defenses, the United States went on the offensive and challenged the European "territorial approach." Specifically, the United States challenged Belgium, France, and the Netherlands for exempting from their domestic corporate tax systems the export earnings of sales subsidiaries located in tax haven countries. None of the European countries then had an effective equivalent of

2. This description applies to a subtraction-method VAT. Most credit-invoice-method VAT systems impose the tax on sales, and allow a credit for VAT paid on purchased inputs. The base that gets taxed in credit-invoice-method systems is the difference between sales and purchased inputs, and this difference essentially amounts to wages, interest, rent, and profits. In economic substance, there is little distinction between a subtraction-method VAT (where purchased inputs are subtracted from the tax base) and a credit-invoice-method VAT (where VAT paid on purchased inputs are subtracted from VAT liability on sales). For a thorough description of VAT systems, see Ebrill et al. (2001).

3. While France has a generous territorial tax system, it does not allow deferral or exemption of foreign base company sales income. See National Foreign Trade Council (2001).

Subpart F for taxing the profits of foreign sales subsidiaries. (Only a few European countries have effective equivalents today.)

A single GATT panel decided all the four tax cases in 1976 (*Tax Legislation Reports*): the European case against the DISC and the US case against Belgium, France, and the Netherlands. All plaintiffs won and all defendants lost. The panel ruled that tax deferral was prohibited just like tax exemption, that territorial systems as well as DISC violated Article 16, and that it was up to the defendant to prove the absence of bi-level pricing (a very heavy burden) and thus the absence of any trade harm.

Upon reflection, the United States and the European Commission both concluded that the reasoning of the Tax Legislation Reports was too sweeping. Both parties used their authority in the GATT Council to block acceptance of the panel rulings for the duration of the Tokyo Round negotiations. Tax and trade experts agreed that the thorny issues needed to be resolved by negotiation.

The Tokyo Round Subsidies Code

The Tokyo Round Code on Subsidies and Countervailing Duties implicitly settled the tax cases, based on four principles:

- The ancient distinction between direct and indirect taxes was preserved and the indirect tax label was explicitly extended to VAT;
- The United States agreed to repeal the DISC, but not during the Carter Administration;
- Methods of avoiding double taxation—both the exemption method associated with European territorial system of taxation and the foreign tax credit method associated with the US worldwide system of taxation—are not prohibited subsidies when applied to export sales;
- However, the arm's length pricing standard is to be observed in transactions between parent exporting companies and their foreign sales subsidiaries.

The agreement on territorial tax systems was particularly important. As a major concession, the United States accepted the European territorial tax systems as applied to export sales (despite the contrary ruling of the GATT panel), provided that the United States could take advantage of a similar system for its own exports. Under the negotiated agreement, economic processes located outside the exporting country (foreign sales and after-service activities) need not be taxed by the exporting nation. However, arm's length prices must be observed between related parties in export transactions. Otherwise, a parent firm in the exporting country might shift production profits to a low-tax jurisdiction abroad. This agreement was codified in footnote 2 of the Illustrative List of export subsidies appended to the Tokyo Round Code on Subsidies and Countervailing Duties.

The 1981 GATT Council Decision

Following the conclusion of the Tokyo Round, in 1981 a GATT Council Decision disposed of the four tax cases, with a Chairman's note that reiterated the bargain struck in the Tokyo Round Subsidies Code. The Chairman's note stated:

> *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 export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.*

Based on the Chairman's note and the Tokyo Round Subsidies Code, in 1984 the United States repealed the DISC, and enacted the FSC.[4] The FSC allowed partial tax exemption for the income of a foreign corporate subsidiary derived from handling US export sales. The amount of FSC income exempted was calculated by a formula designed to approximate the arm's length pricing standard. Roughly it amounted to tax relief of about 5.25 percentage points on export profits earned by the parent corporation and its FSC (the normal corporate tax rate is now 35 percent, and the FSC benefit usually amounts to about 15 percent of the corporate tax rate).

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4. The transition from DISC to FSC was not entirely seamless. Late in 1980, the US Trade Representative renounced the "Hufbauer Understanding", reached in June 1979, regarding the disposition of the four Tax Legislation Reports. Nevertheless the Understanding served as the basis for the 1981 GATT Council Decision adopting the Tax Legislation Reports, the 1982 commitment by the United States to repeal the DISC, the actual repeal of the DISC in 1984, and the creation of the FSC in the same year. See Hufbauer and Erb (1984) and Hufbauer and Gabyzon (1996).

That is how things stood during the entire Uruguay Round of Multilateral Trade Negotiations (1986-94). Never during the Round did Europe challenge the FSC. US negotiators were lulled by the silence, innocently believing that the 1979 Tokyo Round Subsidies Code and the 1981 GATT Council Decision had settled the tax wars of the 1970s. In fact, footnote 59 of the Illustrative List of Export Subsidies appended to the Uruguay Round Code on Subsidies and Countervailing Measures (SCM Code) essentially reiterated the Tokyo Round agreement.[5]

First Round of WTO Litigation

In 1997, breaking 16 years of tax peace, the European Union challenged the FSC as a violation of the SCM Code. This was indeed a surprise. The European Union was motivated by a desire to create bargaining chips, not by a raft of complaints from European firms (in fact, the American subsidiaries of many European multinationals take advantage of the FSC). Sir Leon Brittan, then the chief trade negotiator for the European Union, reasoned that a victory against the FSC might be used to resolve World Trade Organization (WTO) disputes already lost by the European Union (particularly the beef hormones dispute). Further, it might forestall US challenges against a variety of EU practices: for example, trade barriers against genetically modified organisms (GMOs), Airbus subsidies, and agricultural export subsidies (these become vulnerable when the Uruguay Round "peace clause" expires in December 2003).

From the standpoint of the European Union, Sir Leon's legal strategy proved a masterstroke. Unlike the earlier DISC case, the United States did not attempt offensive tactics in the FSC litigation, even though aspects of European systems were susceptible to attack. Instead, the United States relied solely on defensive tactics. This reliance proved to be misplaced.

The first WTO FSC panel, in its October 1999 decision, gutted the understandings that the United States had relied on for nearly two decades. The panel stated that the 1981 Council Decision was not "a legal instrument" of the GATT-1947. Since the Council Decision was not "a legal instrument"—even though it was reached after more strenuous negotiation than any other Council Decision in GATT's history—the panel concluded that the 1981 Decision had not been adopted in the GATT-1994 by virtue of the grandfather clause.[6]

The WTO panel then went on to hold that the FSC is a prohibited export subsidy: (a) because revenue is foregone (Article 1 of the SCM Code); and (b) because exports are taxed more favorably than production abroad (a test newly invented by the panel). Along the way to this holding, the panel decided that footnote 59 of the SCM Code did not permit a territorial exemption applied solely to export earnings.[7] In February 2000, the WTO Appellate Body affirmed the panel report in all essential respects. Having tossed aside the 1981 Decision and narrowed footnote 59, the WTO's legal bodies awarded their verdict to the European Union.

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5. The Illustrative List of Export Subsidies in Annex I of the Uruguay Round Code on Subsidies and Countervailing Measures (SCM Code) identifies exemption or deferral of direct taxes as an export subsidy, reaffirms the arm's length principle, and permits measures (e.g., the territorial system) to avoid the double taxation of foreign source income. See relevant text in box 1 on p. 6.

6. GATT-1994 explicitly incorporated protocols, decisions, and understandings that had previously entered into force under GATT-1947. Specifically, Annex 1A to the WTO Agreement provides, in relevant part, that GATT-1994 shall consist of:

(a) the provisions in the General Agreement on Tariffs and Trade, dated 30 October 1947... as rectified, amended or modified by the terms of legal instruments which have entered into force before the date of entry into force of the WTO Agreement;
(b) the provisions of the legal instruments set forth below that have entered into force under the GATT 1947 before the date of entry into force of the WTO Agreement:
...
(iv) other decisions of the CONTRACTING PARTIES to the GATT 1947;
...

The GATT contracting parties spent ten years, launched four Tax Legislation Panels, and held numerous negotiating sessions before concluding their tax disputes. US and European differences were compromised in the carefully crafted 1981 GATT Council Decision. Yet the WTO panel and Appellate Body held that ten years of litigation and negotiation did not suffice to create a "legal instrument" as one of the "decisions of the CONTRACTING PARTIES" under the terms of paragraph (b)(iv) cited above.

7. The relevant language of SCM Code footnote 59 reads: "...Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member." The *FSC Panel Report* conceded that footnote 59 recognizes that territorial tax systems do not amount to *per se* export subsidies. The *Report* then went on to invent a distinction that never existed in the Tokyo Round Subsidies Code or the Uruguay Round SCM Code. It distinguished a territorial system that provides a "broad exemption of income deriving from foreign economic activities" from a territorial system that provides an exemption "specifically related to exports." The former system does not grant export subsidies, says the *Report*, whereas the latter does. This distinction rendered the FSC inconsistent with the SCM Code, while insulating the European territorial systems that usually exempt a larger share of export profits from home country corporate taxation than the FSC ever did. US business firms find it anomalous that the WTO condemns a partial territorial system like the FSC that might exempt 30 percent of export profits, but exonerates a full territorial system that usually exempts 50 percent of export profits.

Box 1 Annex I: Illustrative List of Export Subsidies

[Among prohibited export subsidies, the Illustrative List includes]

(e) The full or partial exemption, remission or deferral specifically related to exports, of direct taxes [58] or social welfare charges paid or payable by industrial or commercial enterprises. [59]

58. For the purpose of this Agreement:
The term "direct taxes" shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;
The term "import charges" shall mean tariffs, duties, and other fiscal charges not elsewhere enumerated in this note that are levied on imports;
The term "indirect charges" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;
"Prior-stage" indirect taxes are those levied on goods or services used directly or indirectly in making the product;
"Cumulative" indirect taxes are multi-stage taxes levied where there is no mechanism for subsequent crediting of the tax if the goods and services subject to tax at one stage of production are used in a succeeding stage of production;
"Remission" of taxes includes the refund or rebate of taxes;
"Remission or drawback" includes the full or partial exemption or deferral of import charges.

59. The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices charged for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be prices which would be charged between independent enterprises acting at arm's length... Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

In their decisions, however, neither the Panel nor the Appellate Body ruled on the EU claim that FSC violates the SCM Code because exports are taxed more favorably than production for the US home market. This omission seemingly left the United States an opening to alter the contours of the FSC while preserving much of its substance. It appeared that the United States could avoid the charge of granting an export subsidy by extending its partial territorial tax system to the foreign production of US firms the same way it was applied to exports—thereby meet the newly created parity test.

The Extraterritorial Income Exclusion Act

Seizing this apparent opening, in November 2000 the US Congress passed the Extraterritorial Income Exclusion (ETI) Act. Under the ETI Act, the benefits of the FSC are phased out. The ETI Act then goes on to exclude from the US definition of gross income certain foreign source income—namely a portion of export earnings, and a portion of earnings from production abroad. In other words, the United States adopted a partial territorial system, providing some relief from double taxation both for exports and foreign production. However, corporate taxpayers could only use the territorial method by renouncing their foreign tax credits with respect to the same earnings. The benefits of the ETI Act were further conditioned on the use of less than 50 percent foreign inputs of goods and services.

The United States contended that the ETI Act conformed to the Appellate Body decision because: (a) revenue was no longer foregone—ETI income was no longer part of gross income subject to corporate tax; (b) both export earnings and foreign production earnings were similarly taxed under the ETI Act.

Second Round of WTO Litigation

The European Union brought a second case to the WTO asserting four claims: (a) notwithstanding the ETI Act, revenue was still foregone; (b) the export contingency remained, even if foreign production was, in some circumstances, covered; (c) the foreign content limitation for US exports under ETI violated WTO Article 3 (national treatment); (d) the FSC phaseout did not respect the first Appellate Body deadline (October 2000).

In reaching its second decision, the WTO panel expanded its earlier interpretation of footnote 59. The ETI exclusion failed, according to the panel, partly because it was too broadly drawn (it could exempt income not taxed by another country) and partly because it was too narrowly drawn (only exports and selected foreign production are covered). Along the way to this decision, the panel asserted that *any* exclusion from gross income could depart

from the "normative benchmark" of the US tax system, and thus could amount to a relief from tax "otherwise due" (SCM Code Article 1.1(ii)), and hence could be designated a subsidy.

The panel went on to hold that the ETI exemption was "contingent on" exports—in other words, that exporting was a condition for receiving the subsidy—and thus was prohibited by SCM Code Article 3. The fact that the ETI exclusion reached foreign production in limited circumstances was not a saving feature.

As expected, the panel found that the foreign content limitation violated the national treatment standard, and that the FSC phaseout did not meet the Appellate Body's deadline. These features were, however, secondary to the ETI Act, and could easily have been corrected.

In 1997, breaking 16 years of tax peace, the European Union challenged the FSC as a violation of the SCM Code. This was indeed a surprise. The European Union was motivated by a desire to create bargaining chips, not by a raft of complaints from European firms.

The Appellate Body affirmed the panel decision, but with two important twists. In the first twist, the Appellate Body abandoned the Panel's "normative benchmark" and instead defined "revenue otherwise due" by referring to the alternative taxation of ETI income when the taxpayer elects to claim a foreign tax credit rather than the ETI. Since the rational taxpayer will only elect the ETI when its US taxes are lower than they would be under the foreign tax credit method, the Appellate Body concluded that the US Treasury has foregone "revenue otherwise due."

In its second twist, the Appellate Body delved into ETI Act rules that determine the division of export income between domestic and foreign sources. The ETI allows a formula division rather than case-by-case application of the arm's length standard. Using simple-minded examples, the Appellate Body found circumstances where the formulas could improperly characterize domestic source income as foreign source income. Improper characterization could in turn lead to tax exemption for domestic profits earned on export production—another violation of the SCM Code.

Along the way to these findings, the Appellate Body returned to some elements of the bargain struck in the 1981 GATT Council Decision. The Appellate Body reaffirmed the arm's length principle for distinguishing between domestic source and foreign source profits earned on export sales. The Appellate Body confirmed that foreign source income, properly computed, could be exempt from tax (the territorial system) and the exemption would not automatically amount to an export subsidy prohibited by the SCM Code. However, the Appellate Body continued to insist (unlike the 1981 Decision and footnote 59) that exemption created a problem when it was limited to some foreign source income (the ETI Act) rather than all, or nearly all, foreign source income (the European territorial systems).[8]

The Arbitration Award

The European Union hit the jackpot with the arbitration award. Under the SCM Code, an Arbitral panel decides "appropriate countermeasures" (Articles 4.10 and 4.11)—in the event that the offender does not "withdraw the subsidy without delay." The Arbitral panel's ruling cannot be appealed. In August 2002, the Arbitral panel announced that the European Union was entitled to $4.043 billion of annual countermeasures against the United States—a level of retaliation that far exceeds anything previously authorized in the GATT system. The $4.043 billion figure is simply the amount of FSC tax ben-

8. The key elements of the two WTO decisions can be summarized in five propositions:

- Under Article 1 of the SCM Code, the FSC/ETI system amounts to a subsidy because the US Treasury foregoes revenue "otherwise due."
- Under Article 3 of the SCM Code, the FSC/ETI system amounts to a prohibited export subsidy because it is a subsidy under Article 1 and because its benefits are contingent on export activity.
- The 1981 GATT Council Decision that permitted a territorial tax system that is limited to export activity (such as the FSC) was not incorporated in the GATT-1994.
- SCM Code footnote 59 permits a territorial tax system that exempts all, or nearly all, foreign source income—both exports and foreign production. But it does not permit a territorial tax system limited to export income.
- The arm's length pricing rule must be observed in distinguishing between domestic and foreign source income.

WTO members that so choose can draw on these propositions to bring numerous tax cases against other WTO members, both as offensive and defensive trade strategies. Export processing zones, widely used by developing countries, are vulnerable. So is the US export-source rule. Some of the territorial tax systems applied in Europe and elsewhere may not be sufficiently broad to meet the WTO's "all-or-nothing" test.

efits in a recent year (2000).[9] It has nothing to do with trade harm inflicted on the European Union—estimated by the United States at $1.110 billion. Indeed, the Arbitral panel abandoned any effort at measuring trade harm. Under the panel's peculiar logic, another WTO member could also bring a claim against the FSC and gain an award on top of the $4.043 billion granted to the European Union.

Before the FSC award, punitive damages were not part of the GATT enforcement apparatus. Indeed the cornerstone of the GATT is the contractual "balance of concessions" between members. The standard remedy for any contractual breach is a damage award equal to the harm actually imposed. If one member violates the GATT rights of another, thereby diminishing the injured member's exports or increasing its imports, the injured member can therefore withdraw an equivalent amount of market access. By contrast with this established precedent, the FSC Arbitral panel created a new measure of damages for prohibited export subsidies—the worldwide value of the subsidy itself, not the trade damage inflicted on the complaining country. While punitive damages of this sort are familiar to American tort lawyers, they were previously unknown to the GATT.

US Exporters in the Briar Patch

This string of adverse WTO decisions has thrown US exporters in the briar patch. If the ETI is not repealed, the European Union can fire at will from its ample arsenal of retaliatory ammunition. The European Union has already published a trial "hit list" of products, heavily featuring agriculture. No one expects the European Union to poison the Doha Round by indiscriminate retaliation.[10] But until the ETI is repealed, the arsenal will at the very least dampen US initiatives aimed at curbing EU agricultural subsidies or opening EU markets to GMOs.

But if the ETI is repealed, with nothing to take its place, US exporters will again compete on a tilted tax field. Not only will they have to pay VAT on sales into Europe, Canada, Mexico, and other countries, they will also have to pay full corporate income tax on their export earnings. Meanwhile competitors based in Europe and elsewhere will export their goods into the US market free of VAT and take advantage of selling subsidiaries located in low-tax jurisdictions. This kind of tax tilt was a driving force behind enactment of the DISC in 1971, the FSC in 1984, and the ETI in 2000. It seems unlikely that the tax discontent harbored by US exporters will melt away if ETI is repealed in 2003.

The House and Senate have different approaches to solving the FSC/ETI problem and extricating US exporters from the briar patch.

Some scholars contend that a cure-all balm already exists for tax discontent: the system of floating exchange rates. Any business tax advantage enjoyed by European firms—whether springing from VAT border adjustments or different corporate tax systems—will ultimately be offset by a stronger euro. Why fuss over "tax fairness" when floating exchange rates will mop up any tax advantage or disadvantage?

Among its shortcomings, the floating exchange rate argument fails the Missouri test ("show me"). Floating exchange rates do not ensure that trade deficits and surpluses revert to zero in the short or medium term. That observation is too crude to determine whether tax disadvantages are washed away by exchange rate changes. Macroeconomic analysis teaches that national trade deficits and surpluses—and corresponding equilibrium exchange rates—are ultimately determined by national savings and investment balances. Tax policy alters exchange rates only when changes in the tax system affect national savings and investment behavior. Who knows whether VAT adjustment rules alter European savings and investment behavior? If the rules promote European investment, with no effect on savings, the euro will appreciate to restore macroeconomic equilibrium. If the rules have no effect on European savings and investment, nothing much will happen to the foreign exchange value of the euro.

All that said, the fact that huge trade imbalances persist in a world of floating exchange rates colors

9. The FSC Arbitral panel followed the precedent set in the *Brazil-Aircraft (Article 22.6)* arbitration. There the arbitrator held that "appropriate countermeasures" means "the full amount of the subsidy to be withdrawn"—not the level of trade impairment to Canada (as Brazil had argued). However, in the Brazil-Aircraft case, both Brazil and Canada were competing head-to-head in the same markets (principally the US market) for mid-range civil aircraft sales. Circumstances in the FSC case were entirely different.

10. It appears that the United States and the European Union have reached an informal retaliation-standstill agreement while the Doha Round goes forward. In 2002, the European Union did not retaliate (as it had threatened) against US safeguard tariffs on steel, and the United States did not launch (as some agricultural firms wanted) a new case on EU barriers to GMOs.

the political debate over border tax adjustments.[11] To put it bluntly, the argument that European border tax advantages have been eliminated by a strong euro and a weak dollar seems laughable to American exporters. If the exchange rate argument was persuasive, European firms might allow their governments to abandon border tax adjustments for the VAT. This is not going to happen. European firms see a mercantile advantage in the current tax rules, whatever scholars may say.

At a more sophisticated level of debate, the prescription to forget about tax competition in a world of floating exchange rates overlooks recent research.[12] According to John Mutti's (2003) work, the response of export-oriented business activity to corporate taxation may be an elasticity coefficient as high as 4.0. In other words, a 5 percentage-point reduction in the corporate tax rate may increase export-oriented activity by as much as 20 percent. Even half that amount would be significant. In most countries, the export sector pays better wages and offers more stable employment than other sectors.[13] In a world economy of high tax response coefficients, a country taxes its export sector at the expense of its own prosperity.

The core idea [of the new approach] is US repeal of the FSC/ETI and simultaneous adoption of an elective alternative corporate tax that fits the WTO definition of a value added tax.

House Says Legislate, Senate Says Negotiate

The House and Senate have different approaches to solving the FSC/ETI problem and extricating US exporters from the briar patch. Congressman Bill Thomas (R-CA), chairman of the House Ways and Means Committee, advocates a legislative solution. His initial proposal offered a package of international tax reforms: repeal the ETI, modify Subpart F to permit US firms to operate sales subsidiaries from low-tax jurisdictions, deter "corporate inversions," reform the allocation of interest expenses between US and foreign operations, and simplify the system of multiple foreign tax credit baskets.

Senator Max Baucus (D-Montana), chairman of the Senate Finance Committee, instead advocates a negotiated solution. He proposes to change WTO rules so as to level the tilt in the tax playing field. While Baucus has not staked out a negotiating agenda, one solution might be a simple reinstatement of the 1981 GATT Council Decision, thereby permitting a territorial system for exports alone. A more fundamental solution would be to revisit the ancient distinction between border adjustability of direct and indirect taxes.[14]

For the moment, the US Treasury and the European Union have lined up with the House approach. The Treasury sees no room for maneuver within the existing text of the SCM Code and EU Commissioner Pascal Lamy opposes negotiated changes.[15] The combined forces of the House Ways and Means chairman, the US Treasury, and the European Union might seem to settle the debate. But a key constituency is missing: US exporters.

Many US exporters, particularly small and medium-sized firms, believe that Subpart F reform (Chairman Thomas's approach) will not help them. Their cash requirements are centered in the United States, where their operations are based. Profits distributed from a foreign sales subsidiary to the US parent firm would be fully taxed at the US corporate rate. For these firms there would be no tax advantage from establishing a foreign sales subsidiary, even after Subpart F is reformed.

When Congress adjourned in October 2002, the FSC/ETI debate was at an impasse: a Senate approach, a House approach, discontented exporters, and no winning coalition.

11. See Bergsten and Williamson (forthcoming 2003) for a broad survey of dollar overvaluation issues.

12. Another weakness of the floating exchange rate argument is that it assumes tax rates are uniform across all sectors of the economy. VAT and corporate taxes are anything but uniform. Unless they are adjusted sector by sector, an exchange rate offset will be too generous to lightly taxed sectors and not generous enough to heavily taxed sectors. See Hufbauer and Gabyzon (1996).

13. See Richardson and Rindal (1996). In the United States, export jobs pay about 15 percent higher on average than other sectors.

14. In a serious negotiation, for example, the distinction between direct and indirect taxes might be replaced by a more rational distinction between business and personal taxes. Border adjustments, under the destination principle, might be permitted (not required) for business taxes, but not for personal taxes. With this change, business firms, wherever located, could compete on the same tax terms in all markets. Many details would need to be worked out. For example, countries might negotiate limits on their border adjustments, both for exports and imports. Conceivably, after several rounds of negotiations, border adjustments would be significantly reduced and only peak taxes would be rebated on exports and imposed on imports.

15. See *Inside U.S. Trade*, vol. 20, no. 39, September 27, 2002, 28-31.

The Last Act: An Alternative Corporate Tax?

Behind the scenes, a new approach has attracted some attention outside the halls of Congress and the Treasury.[16] The new approach has considerable merit both as a means of leveling the tax field and as a way of ending the tax battle. The core idea is US repeal of the FSC/ETI and simultaneous adoption of an elective Alternative Corporate Tax (ACT) that fits the WTO definition of a value added tax.

Outline of the ACT

The ACT would be akin to a subtraction-method VAT.[17] The ACT base would be sales within the United States by an affiliated group of US corporations (netting out purchases and sales between group members), minus purchases from unrelated firms. The ACT base would resemble the VAT base. By comparison with the existing corporate income tax (CIT), the ACT would have these differences:

- Like the VAT, export sales of goods and services would be excluded from the tax base.
- Like the VAT, production abroad for sales to foreign markets would be excluded from the tax base.
- Like the VAT, employee compensation (wages and fringe benefits) would be included in the tax base.
- Like the VAT, interest, rents, dividends, and retained corporate earnings would be included in the tax base.
- Unlike many VAT systems, the ACT would be nonrefundable.[18] A company that had a negative tax base (for example, because most of its output was exported, and its purchased inputs exceeded its domestic sales) would get no ACT refund. At best, it would pay zero ACT.
- Unlike the VAT, the ACT would not tax imports (either explicitly or by disallowing a deduction from the tax base). This feature should be welcomed by US trading partners. In any event, the GATT does not require symmetrical border adjustments for exports and imports.
- To prevent abuse, however, the ACT base would include sales into the US market by controlled foreign corporations (CFCs) of the affiliated US corporate group, when the CFC sales included a substantial amount of US exports that benefited from that group's ACT exclusion.[19]
- OASDHI payroll taxes (Social Security taxes) paid by the corporation would be credited against its ACT liability. Just as VAT revenues are used by many European countries to fund their social security systems, so ACT revenues would be used indirectly, in part, to fund the US system.

The alternative corporate tax would appear to be immune from a fresh WTO challenge, because it would be designed to fit with the WTO definition of a value added tax. Under the Uruguay Round SCM Code, value added tax can be adjusted at the border. Period.

The ACT rate would be designed to achieve revenue neutrality, taking into account the revenue gains from repeal of the FSC/ETI. Detailed calculations would be required to establish the tax rate, but a figure of about 15 percent seems possible, compared to the existing corporate rate of 35 percent.

Because it excludes foreign source income (export sales and foreign production for sales abroad), the ACT would prove especially attractive for US firms oriented toward the international market. The ACT system could be adopted by any firm, large or small. Its advantages do not depend on operating an offshore sales subsidiary in a low-tax jurisdiction, much less on producing offshore.

Election to use the ACT would apply to all members of an affiliated corporate group (the group that files a consolidated federal tax return), even those

16. The leading proponent is Ernest Christian, General Counsel of the Committee for Strategic Tax Reform, based in Washington, DC.

17. For an exposition of different methods of imposing VAT, see Ebrill et al. (2001).

18. On the refundability of VAT, see Ebrill et al. (2001), chapter 15. The reason (apart from a concern about lost revenue) to make the ACT nonrefundable is to avert a possible WTO challenge that the refund amounted to a prohibited export subsidy. Since firms that supplied purchased inputs to the ACT corporation may have paid taxes under the normal CIT system, their tax payments could not be characterized as VAT. Hence a refund of ACT on such inputs might be characterized, under the Uruguay Round SCM Code's Illustrative List of Export Subsidies as an excessive remission, in violation of paragraph (g).

19. In the absence of an antiabuse rule, US corporations would be tempted to engage in "round-trip" transactions. They might export products from the United States and benefit from the ACT exclusion, then import the same products (or slightly transformed versions) back into the United States and sell them free of tax to US purchasers.

corporate members that only serve the domestic market. Moreover the election would be irreversible. The purpose of such rules is to preclude "gaming" the two tax systems, by switching between the ACT and the CIT.

ACT and the WTO

The ACT would appear to be immune from a fresh WTO challenge, because it would be designed to fit with the WTO definition of a value added tax. Under the Uruguay Round SCM Code, VAT can be adjusted at the border. Period. There is no requirement that the VAT apply to all sectors of the economy or that the VAT be applied at a uniform rate.[20] Moreover, the nonrefundable feature of the ACT should ward off any complaint that ACT entails an "excessive remission" of taxes on export sales.

Yet nothing is certain in the realm of WTO jurisprudence. The WTO judicial machinery has already stretched the limits in its FSC and ETI decisions. Given this record, no one can say with certainty that ACT would survive a fresh WTO challenge. In particular, the WTO judicial machinery might distinguish between a subtraction-method VAT (which the ACT emulates) and a credit-method VAT. Despite the economic similarity of the two value added taxes, the WTO Appellate Body might claim that destination-principle border adjustments are permitted for a credit-method VAT but not for a subtraction-method VAT.

Alternatively, the WTO judicial machinery might apply its "but for" test to the ACT. Firms will presumably elect the ACT only when they perceive a long-run tax advantage. Hence the WTO Appellate Body might say that, in creating the ACT system, the US Treasury has foregone "revenue otherwise due," because the US tax law now permits an election—and rational firms will only make the election if they expect to pay lower taxes.

Because of these judicial hazards, a belt-and-suspenders approach has much to commend it. To insulate the ACT from a new WTO challenge, the Congress should add two supplementary provisions in the enabling legislation.

First, Congress should instruct the US Treasury and the US Trade Representative to bring a WTO case against any foreign country that challenges the ACT, if elements of that country's tax system arguably violate the WTO. This instruction would reinvigorate the successful offensive/defensive strategy that ultimately resulted in tax peace at the conclusion of the Tokyo Round.

Second, Congress should give the US Commerce Department a "big gun" that advertises US seriousness—especially to the Europeans. Here's the design. In the event the WTO upholds a challenge against the ACT and authorizes another member to retaliate, at the discretion of the Commerce Department the United States will accept a countervailing duty (CVD) petition against VAT rebates on exports from that country. To be sure, the imposition of CVDs would be the last resort. If ever imposed against a VAT rebate, CVDs could trigger another wave of WTO-sanctioned retaliation. A true trade war could erupt. But US authorizing legislation would put potential challengers on notice that the United States no longer accepts a tilted tax field.

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20. Annex I, The Illustrative List of Export Subsidies, of the Uruguay SCM Code contains the provision that allows destination-principle adjustments for value added taxes:

> g) The exemption or remission, in respect of the production and distribution of exported products, of indirect taxes [58] in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.
>
> [58] For the purpose of this Agreement:
>
> ...
>
> The term "indirect taxes" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges; ...

Appendix A: Possible Details of an Alternative Corporate Tax

Adapted from a proposal by Ernest Christian, General Counsel to the Committee for Strategic Tax Reform

The Goal

The objective is good jobs in America, both in manufacturing and other sectors of the economy. Therefore, the tax code should encourage companies to "make it here and sell it there" instead of needlessly forcing them offshore.

The Proposal

The proposal is to replace the existing FSC/ETI provision with a new system that is (a) WTO-legal and (b) more beneficial to exporters and other firms that compete in international markets. A corporation will be allowed to elect an Alternative Corporate Tax (ACT) that excludes from tax:

- All US-source income from producing goods and services in the United States that are sold to foreigners, and
- All foreign-source income from producing goods and services abroad that are sold to foreigners.

The Tax Base

Because ACT has a base equal to value added instead of net income, its tax base differs from the current Corporate Income Tax (CIT). As with the CIT and VAT systems, the corporation is allowed to deduct purchases from unrelated firms. However, the corporation is not allowed to deduct compensation paid to employees. The corporation is allowed no deduction for interest paid on debt. In other words, earnings accrued (or paid) to shareholders and interest paid to bondholders are both part of the ACT base. Interest and dividends received are, however, excluded from the tax base. (An ACT corporation's tax base is therefore not affected if it receives and pays the same amount of interest.) Overall, the tax base under ACT would tend to be larger than under CIT, and therefore the ACT rate can be lower.

The Rate of Tax

The ACT would be designed to be revenue neutral (taking into account the revenue gained from repeal of the FSC/ETI). Because of its broader tax base, the tax rate under ACT would be lower than under CIT—in the area of 15 percent.

Nonrefundable

The ACT would be nonrefundable. An ACT corporation that has a negative tax base (for example, because it exports most of its production, and its purchased inputs exceed its domestic sales) would not be entitled to a refund of ACT tax. Nor could a negative tax base in year one be carried to successive tax years.

Credit for OASDHI

OASDHI payroll taxes (Social Security taxes) paid by the corporation would be credited against its ACT liability.

Application of WTO

Under WTO rules, the CIT and other taxes on net income are classified as direct taxes that cannot be adjusted at the border. ACT has a base equal to value added instead of net income. The ACT base is calculated in the same manner as a subtraction-method VAT base. Under the WTO, taxes on value added are classified as indirect taxes and are expressly eligible for adjustment at the border. In Europe and elsewhere, value added taxes neither reach exports nor production abroad. Like VAT, the ACT is territorial in nature and does not apply to sales that occur outside the territory of the United States. Since ACT is nonrefundable, it cannot be claimed that ACT allows an "excessive remission" of taxes on exported goods and services.

ACT is Elective

ACT applies only to corporations that elect the new system rather than the CIT. If made, the election applies to all members of an affiliated corporate group (the group that files a consolidated federal return) and the election is irrevocable. When an ACT corporation merges with a CIT corporation, the new corporation would be automatically subject to ACT, unless more than 75 percent of the merged corporation's assets were attributable to the old CIT corporation.

Drafting Model

The drafting model would be the Simplified USA Tax in H.R. 86, modified to eliminate the USA tax on inbound transactions (imports), with depreciation instead of expensing for capital goods, and with regular CIT inventory accounting instead of the cash accounting system in H.R. 86. The overall goal is to bring the ACT within the WTO definition of a value added tax.

Repatriation of Foreign Earnings

Post-election foreign-source income of an ACT corporation would be free of US tax and therefore could readily be repatriated and reinvested in the

US economy—instead of having to be reinvested abroad as a means of deferring US tax, as happens under the CIT. Similarly, because post-election foreign-source income is exempt from US tax, no foreign tax credits would be allowed on those earnings.

Preelection Foreign Earnings

Many ACT corporations would have preelection tax-deferred foreign-source income. Some might have preelection foreign tax credits that were unused under CIT. Under the ACT, electing companies would be allowed to repatriate all preelection tax-deferred income upon paying a toll charge, say 10 percent. However, all preelection foreign tax credits would be forfeited.

Guarding Against Abuse

Every tax system is subject to abuse and needs antiabuse rules. A few areas require special attention under the ACT system:

- *Exception to exemption for foreign sales of goods and services.* In general, the ACT would exempt foreign sales by members of the affiliated group, whether export sales or production abroad. However, sales that essentially amount to "round trip" transactions—exports from the United States, followed by US imports—would be included in the ACT base, even if some value is added by processing abroad.
- *Importation from controlled foreign corporations (CFCs).* CFCs are not part of the affiliated US group; they do not file a consolidated federal tax return with the US members. Normally, the afiliated group can deduct the cost of imported inputs purchased from its CFCs. In fact, intrafirm trade is a source of enormous efficiency in the world economy, and should not be discouraged. However, in situations where imported inputs amount to "round trip" transactions, the deduction would be disallowed.
- *Lease transactions.* Interest payments are not deductible under the ACT, but lease payments are deductible. Obviously, capital equipment can be acquired under lease arrangements that build in an interest charge, as well as under traditional borrowing and purchase arrangements. In exceptional circumstances, an ACT corporation may find a tax advantage in leasing equipment from a related CIT corporation (where the CIT corporation is owned in part by the ACT corporation, but is not a member of the affiliated corporate group). In these circumstances, the lease payment may be recharacterized as a nondeductible interest expense.

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