TAX MANAGEMENT INTERNATIONAL JOURNAL

a monthly professional review of current international tax issues

What Tax Lawyers Should Know About Trade Law

by Jeffrey M. Lang,[*] Robert B. Stack,[**] Steve Charnovitz [†] and Joshua T. Brady [††]

Editor's Note: This article describes the background and litigation involving the WTO decision that the FSC regime constitutes an illegal subsidy under the SCM Agreement. Next month, TMIJ will publish an article that will provide an in-depth analysis of the FSC replacement regime.

What should tax lawyers and tax policy makers know about international trade law? Until recently, the answer would likely have been "not much." However, in February 2000 the Appellate Body of the World Trade Organization ("WTO") ruled that the Foreign Sales Corporation ("FSC") provisions of the U.S. Internal Revenue Code ("Code") constituted prohibited subsidies under Article 3.1(a) of the WTO's Agreement on Subsidies and Countervailing Measures.[1] Even after that decision, the tax community might be tempted to think of the FSC case as embodying a rare instance of the intersection of trade and tax law. But such thinking could prove misguided.

Consider the Appellate Body's statement in the FSC decision that "[a] Member of the WTO may choose any kind of tax system it wishes — so long as, in so choosing, that Member applies that system in a way that is

[*] Partner, Trade Group, Wilmer, Cutler & Pickering. B.A. Bowdoin College, 1964; LL.B. University of Virginia, 1967. Wilmer, Cutler & Pickering currently serves as counsel to various parties interested in the litigation discussed in this article.

[**] Partner, Tax Group, Wilmer, Cutler & Pickering. B.A. State University of New York at Albany, 1976; M.A. New York University, 1980; J.D./M.S.F.S. Georgetown University, 1984.

[†] Associate, Trade Group, Wilmer, Cutler & Pickering. B.A. Yale College, 1975; M.P.P. Harvard University, 1983; J.D. Yale Law School, 1998.

[††] Associate, Tax Group, Wilmer, Cutler & Pickering. A.B. Georgetown University, 1994; J.D. Yale Law School, 1999.

[1] Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Agreement Establishing the World Trade Organization [hereinafter WTO Agreement], Annex 1A, in The Results of the Uruguay Round of Multinational Trade Negotiations — The Legal Texts (WTO 1995) [hereinafter The Legal Texts] [hereinafter SCM Agreement].

consistent with its WTO obligations." [2] Whether from this seedling will grow a mighty oak of WTO review of national tax systems remains to be seen. But the statement should cause tax practitioners to begin to pay more attention to the interrelationship between trade and tax policy, with particular emphasis on how the rules of the WTO will govern.

In beginning to understand the links between the trade rules and their substantive area of expertise, tax lawyers will be joining the ranks of environmental lawyers, intellectual property lawyers, and food and drug lawyers, who have seen their specialties become topics of WTO agreements. Such linkages are likely to continue to increase.

This article is divided into two parts. The first part describes the structure of the WTO and its legal framework. This discussion includes a description of the primary agreements that affect Member countries' tax systems, specifically as they relate to trade in goods, services, and investment measures. Each section also includes a description of some of the tax cases that have arisen under each of these agreements, including the FSC decision. The second part draws relevant conclusions from the development of tax provisions and jurisprudence under the WTO of which tax practitioners should be cognizant.

THE WORLD TRADE ORGANIZATION AGREEMENTS

The Agreement Establishing the World Trade Organization ("WTO Agreement") grew out of the Uruguay Round of Multilateral Trade Negotiations held from 1986 through 1994.[3] The WTO Agreement, which came into force in 1995, provides a single institutional framework encompassing the General Agreement on Tariffs and Trade [4] and fifteen additional agreements and amendments concluded in the Uruguay Round. The constituent agreements contain a multiplicity of disciplines regarding national trade policy as well as other issues such as trade-related intellectual property rights, trade-related investment measures, technical standards, and sanitary measures affecting trade. All of these agreements are linked together by the WTO Agreement under which each WTO Member commits to adhere to each of the agreements. This contrasts with the format of the multilateral trading system before the Uruguay Round in which several agreements were optional.

The WTO oversees the WTO Agreement and its constituent agreements. At present, there are 138 Member governments, accounting for over 90% of the world's trade. The WTO's top level decision-making body is the Ministerial Conference that meets at least once every two years. Below that, the General Council oversees the operation of the WTO Agreement and ministerial decisions on a regular basis.

The WTO's Dispute Settlement Body — with participation of the Member governments — oversees the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU").[5] The DSU establishes an integrated system permitting WTO Members to bring claims based on any of the constituent agreements of the WTO framework. While the DSU emphasizes the importance of government-to-government consultations in securing dispute resolution, if such consultations fail, the agreement provides a detailed procedural framework for resolving conflicting governmental claims.

When a dispute is not settled through consultations, the DSU authorizes the establishment of a panel. Panels consist of three persons from countries not party to the dispute. Panel procedures are set out in detail in the DSU. When the panel issues its report, it is adopted by the Dispute Settlement Body within 60 days unless appealed by one of the Member parties. Upon appeal, an Appellate Body division composed of three Members of the seven-person Appellate Body is established to consider the case. The Appellate Body generally issues its report within two months. Unless rejected by consensus, the Dispute Settlement Body will adopt the report of the Appellate Body. Governments are supposed to comply with the Appellate Body recommendations to bring domestic law into compliance with WTO rules.

The WTO Dispute Settlement Body has sophisticated enforcement procedures. Actions taken to bring national laws into compliance can be reviewed by a reconstituted panel. If the defendant government does not bring its measure into compliance during the prescribed period, it must compensate the winning plaintiff or be at risk for retaliatory action by the plaintiff government.[6] In two disputes in which the European Communities ("EC") failed to comply with WTO

[2] *United States — Tax Treatment for "Foreign Sales Corporations,"* Report of the Appellate Body, ¶179, WTO Doc. WT/DS108/AB/R (Feb 24, 2000) [hereinafter Appellate Body Report].

[3] Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, in The Legal Texts.

[4] General Agreement on Tariffs and Trade 1994, Apr 15, 1994, WTO Agreement, Annex 1A, in The Legal Texts [hereinafter GATT].

[5] Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, WTO Agreement, Annex 2, in The Legal Texts [hereinafter DSU].

[6] The WTO stands in contrast to the operations of the Committee on Fiscal Affairs ("CFA") of the Organisation for Economic Co-operation and Development ("OECD"). The CFA and its various working groups consist of senior tax policy officials from the

ISSN 0090-4600

panel reports, the United States imposed retaliatory trade sanctions pursuant to WTO authorization.[7]

The WTO does not have an agreement specifically on tax measures. Indeed, the word tax does not appear in the title of any of the WTO's constituent agreements. But several of the agreements do contain disciplines on taxes. Together these disciplines might be viewed as the WTO ''tax code.'' The purpose of this article is to introduce this code to tax practitioners.

Trade in Goods: The GATT

The GATT contains rules supervising national trade policies that affect goods as they move in international commerce. Because domestic taxes applied to such products can impact or distort international trade, the GATT contains a provision relating to taxation in Article III, entitled ''National Treatment on Internal Taxation and Regulation.'' Article III is generally viewed as relating to ''indirect taxes,'' defined as sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, and the like.[8] The ''national treatment'' rule embodied in this article has two prongs. First, it prohibits discriminatory taxes by providing:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied directly or indirectly, to like domestic products.[9]

Second, in those instances in which imported products and domestic products are ''directly competitive or substitutable'' [10] — a much wider reach than ''like'' products — the GATT rule prohibits protective taxation by providing that a Member's internal taxes and other charges affecting the sale or use of products ''should not be applied to imported or domestic products so as to afford protection to domestic production.'' [11]

The reference to internal tax in Article III is in contrast to import duties or tariffs which are imposed at the border. The national treatment standard embodied in this article ensures non-discriminatory tax treatment to goods already imported and protects the anticipated benefits of lower tariffs.[12]

A central discipline in the GATT is the ''most favored nation'' (''MFN'') requirement that prohibits Member governments from discriminating according to the places of production or the destination of products. Specifically, Article I provides that, with respect to the non-discriminatory tax provisions of Article III, ''any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.'' [13] MFN, like national treatment, is a concept which permeates many WTO agreements.

Finally, Article XVI:4 of the GATT prohibits Members from granting subsidies for any product that ''result[ ] 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.'' [14] Though the term ''subsidy'' is not specifically defined in the GATT, the term has been elaborated upon twice with respect to taxes. A working group report in 1960 suggested that the definition include the ''remission, calculated in relation to exports, of direct taxes.'' [15] Later, during the Tokyo Round of trade negotiations, the Members adopted a Subsidies Agreement interpreting Article XVI:4 and incorporating an ''Illustrative List of Export Subsidies'' as an annex to the Agreement that included the ''full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or

---

OECD Member governments. The CFA is essentially a forum for exchanging views on tax policy issues whose activities include developing and monitoring guidelines, publishing model treaties and conventions, and collecting statistics. While the CFA establishes procedures whereby Member governments can discuss and resolve potentially conflicting tax policies, neither the CFA nor the OECD has any independent mechanism to resolve disputes between such governments absent a legally binding OECD code, none of which specifically applies to taxation.

[7] *See* Office of the U.S. Trade Representative, *USTR Announces Final Product List in Beef Hormones Dispute,* Rel. No. 99-60, (July 19, 1999); Office of the U.S. Trade Representative *WTO Authorizes U.S. Retaliation,* Rel. No. 99-38, (Apr. 19, 1999) (relating to bananas dispute with European countries).

[8] *See GATT Secretariat, Analytical Index: Guide to GATT Law and Practice* 133 (6th ed. 1994); *see also* fns. 15 – 18 and accompanying text.

[9] GATT art. III:2, first sentence.

[10] GATT Ad art. III, ¶2.

[11] GATT art. III:2, second sentence; art. III:1.

[12] *See* Qureshi, ''Trade-Related Aspects of International Taxation: A New WTO Code of Conduct?,'' *J. World Trade,* at 161, 169 (Apr. 1996).

[13] GATT art. I:1. Note that both national treatment and MFN are based on the concept of ''like'' products. Challenges brought under these provisions would have to identify like products that are treated dissimilarly under the internal tax rules of the importing nations.

[14] GATT art. XVI:4.

[15] Subsidies: Provisions of Article XVI:4, Nov. 19, 1960, GATT B.I.S.D. (9th Supp.) at 186.

ISSN 0090-4600

payable by industrial or commercial enterprises.'' [16] ''Direct'' taxes were defined therein to include ''taxes on wages, profits, interest, rents, royalties, and all other forms of income, and taxes on the ownership of real property.'' [17] This definition is in contrast to the definition of ''indirect'' taxes, which includes ''sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges.'' [18] The distinction between direct and indirect taxes — a distinction which is retained in the SCM Agreement — is important in that Members have interpreted the GATT to permit governments to refund certain indirect taxes upon export (e.g., value-added taxes).[19]

As discussed more fully below, the SCM Agreement has largely supplanted GATT disciplines with respect to subsidies, although the GATT provisions remain in place. Thus, it is unclear what role the GATT might play independent from the SCM in future tax subsidy cases.

GATT Tax Jurisprudence

A number of rulings were issued under the GATT with respect to various Members' internal tax systems. Generally, these cases have fallen within one of two categories. The first cases are those addressing direct taxes arising under the prohibition of export subsidies under Article XVI:4. Those cases are discussed below in more detail in the discussion of the FSC decision. The second type of cases are those addressing indirect taxes, such as excise and consumption taxes arising under the national treatment rule of Article III.

As noted above, the national treatment rule prevents Member governments from imposing discriminatory or protective taxes. From a procedural standpoint, the two types of prohibitions are distinct. In the case of discriminatory taxes falling under the first sentence of Article III:Z, complainants must establish first, that the imported and domestic goods are ''like products,'' and second, that the imported products are taxed ''in excess'' of any domestic like products. In the case of protective taxes falling under the second sentence of Article III:2 and Article III.1, complainants must establish that (i) the imported and domestic goods are ''directly competitive or substitutable goods;'' (ii) the imported products are ''not similarly taxed'' to the domestic ''directly competitive or substitutable goods;'' and (iii) the dissimilar taxation is ''applied . . . so as to afford protection to domestic production.'' [20]

Several panels of GATT and WTO have issued rulings under these provisions covering a variety of taxes, including taxes on tangible products such as alcoholic beverages,[21] petroleum products,[22] and automobiles,[23] as well as taxes on intangible products such as magazine advertising.[24] In most instances, the panel reports find in favor of the complainant, reflecting both the breadth of Article III, as well as the frequency with which Member governments enact indirect tax measures contrary to its provisions. Taken together, these reports and others like them indicate a vigorous enforcement policy under Article III of the GATT.

Tax Subsidies: The SCM Agreement

The SCM Agreement contains rules concerning government subsidies and the imposition of countervailing duties against such subsidies. The SCM Agreement is intended to build on those provisions of the GATT dealing with countervailing duties, export subsidies, and dispute resolution.

Unlike the GATT, the SCM Agreement provides a specific definition of the term ''subsidy,'' which includes ''government revenue that is otherwise due [that] is foregone or not collected (*e.g.*, fiscal incen-

---

[16] Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, Annex, Apr. 12, 1979, GATT B.I.S.D. (26th Supp.) at 80 [hereinafter 1979 Illustrative List].

[17] *Id.*

[18] *Id.*

[19] GATT Annex I, Ad Article XVI provides: ''The exemption of an exported product from duties on taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.'' *See also* SCM Agreement art. 1.1((a)(1)(ii) n.1; Oldman & Schenk, ''The Business Activities Tax: Have Senators Danforth & Boren Created a Better Value Added Tax?,'' 94 *Tax Notes Today* 250-33 (Dec. 19, 1994).

[20] *See Indonesia — Certain Measures Affecting the Automobile Industry*, Report of the Panel, at ¶14.103, WTO Docs. WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R (July 2, 1998) [hereinafter *Indonesia — Automobile Industry*].

[21] *See, e.g.*, *Chile — Taxes on Alcoholic Beverages*, Report of the Appellate Body, WTO Docs. WT/DS87/AB/R, WT/DS110/AB/R (Dec. 13, 1999); *Korea — Taxes on Alcoholic Beverages*, Report of the Appellate Body, WTO Docs. WT/DS75/AB/R, WT/DS84/AB/R (Jan. 18, 1999); *United States — Measures Affecting Alcoholic and Malt Beverages*, Report of the Panel, June 19, 1992, GATT B.I.S.D. (39th Supp) at 270.

[22] *See, e.g.*, *United States — Taxes On Petroleum And Certain Imported Substances*, Report of the Panel, June 5, 1987, GATT B.I.S.D. (34th Supp.) at 136.

[23] *See, e.g.*, *Indonesia — Automobile Industry*.

[24] *Canada — Certain Measures Concerning Periodicals*, Report of the Appellate Body, WTO Doc. WT/DS31/AB/R (June 30, 1997) (finding excise tax on the value of advertisements in ''split run'' Canadian editions of magazines a violation of GATT art. III:2).

ISSN 0090-4600

tives such as tax credits).'' [25] Thus, it is clear that tax expenditures or tax preferences can be deemed to be a subsidy.

The SCM Agreement distinguishes between three types of subsidy: (i) ''prohibited'' subsidies; (ii) ''actionable'' subsidies; and (iii) ''non-actionable'' subsidies. Prohibited subsidies, including tax subsidies, are those that are contingent upon export performance or the use of domestic over imported goods. Prohibited subsidies are subject to an expedited timetable for action by the Dispute Settlement Body, and, if it is found that the subsidy is indeed prohibited, the defendant government has an obligation to ''withdraw'' the subsidy. If this is not done within the specified time period, the complaining Member can be authorized to take countermeasures.

Actionable subsidies are those that cause adverse effects to the interests of other WTO Member governments, *i.e.*, injury to the domestic industry of another signatory, nullification or impairment of benefits accruing directly or indirectly to other signatories, and serious prejudice to the interests of another Member government. Members affected by actionable subsidies may refer the matter to the Dispute Settlement Body. In the event that it is determined that such adverse effects exist, the subsidizing Member must withdraw the subsidy or remove the adverse effects.

Non-actionable subsidies generally involve those subsidies that are not specific to an industry or group of enterprises or those subsidies involving industrial research and development activity, assistance to disadvantaged regions, or certain types of assistance for adapting existing facilities to new environmental requirements imposed by law.

One of the more important features of SCM Agreement Article 3.1(a) is its incorporation into the definition of prohibited subsidies those provisions listed in Annex I of the agreement, the ''Illustrative List of Export Subsidies.'' A number of these definitions relate specifically to taxes. The most important, relating to direct taxes, defines a subsidy as ''The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.'' [26] This provision is elaborated upon in an important footnote. Footnote 59 of the SCM Agreement, which played a key role in the FSC dispute, and may well have implications beyond FSC, provides three additional points relating to the definition of direct tax subsidies. First, it notes that tax deferral does not constitute an export subsidy if appropriate interest is subsequently collected. Second, it incorporates the arm's-length transfer pricing standard as follows:

> The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.

Finally, footnote 59 provides that the definition of direct tax subsidies ''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.''

Tax Subsidy Jurisprudence

Background: The Tax Legislation Cases

In order to fully understand the import of the FSC decision, it is necessary to consider the earlier tax subsidy jurisprudence. This begins with the controversies surrounding the U.S. domestic international sales corporations (''DISCs'') in the 1970s and early 1980s. The DISC provisions of the Code were originally enacted in 1971 as part of an effort to spur U.S. exports.[27] Those provisions enabled exporting companies to allocate export sales income between a DISC subsidiary and the parent company under special transfer pricing which generally split such income equally between the two companies.[28] One half of the DISC's earnings would then be taxed currently to the

[25] SCM Agreement art. 1:1(a)(1)(ii).

[26] SCM Agreement Annex I [hereinafter SCM Illustrative List], Item (e). This language is identical to that found in the language in the Tokyo Round 1979 Illustrative List, above at. fn. 16.

[27] §§991-97. All section references herein are to the Internal Revenue Code, as amended, and the regulations thereunder, unless otherwise stated. The DISC provisions have never been repealed, though their effectiveness has essentially been mooted by the FSC provisions enacted in 1984. For an excellent overview of the treatment of the DISC provisions under the GATT, see Hudec, ''Reforming GATT Adjudication Procedures: The Lessons of the DISC Case,'' 72 *Minn. L. Rev.* 1443 (1988).

[28] §994(a)(2). In order to qualify as a DISC under §992, the

ISSN 0090-4600

parent as a constructive dividend, while tax on the remainder would be deferred until actually distributed or until the parent disposed of the DISC stock.[29] Thus, the general net effect of these two provisions was that one quarter of the export earnings derived through the DISC enjoyed indefinite tax deferral.

In 1972, the EC charged that the DISC provisions violated the export subsidy prohibitions of GATT Article XVI:4. The United States responded by challenging the territorial features of the French, Belgian, and Dutch tax laws under the same provision.[30] After an impasse on consultations, the parties agreed to assign the disputes to the same set of panelists. In 1976, the panels issued their reports.[31]

In regard to the DISC, the panel concluded in a decision that rested heavily upon the 1960 working group illustrative list of export subsidies [32] that the lack of an interest charge on the tax deferral was itself a partial exemption from tax on exported goods.[33] Thus, according to the panel, "the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI:4." [34]

In regard to the U.S. counterclaims, the panel ruled in three similar reports that the failure to tax foreign earnings was an export subsidy to the extent that such earnings were derived from a domestic parent company's sale of goods to a foreign subsidiary that subsequently sold the products to third parties.[35] For example, in the French report, the panel stated that:

> [T]the particular application of the territoriality principle by France allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of French taxes. In this way France had forgone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries.[36]

The panel explained that even if the subsidy resulted from "an incidental consequence of French taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market." [37]

The panel's central holding was far-reaching, *i.e.*, that the basic territorial principles of three major governments' tax systems constituted an illegal export subsidy under the GATT. The three European governments did not have to comply with the reports, however. Because of objections by the European defendants at subsequent meetings among the GATT Members, the GATT Council adopted the reports in 1981, but in effect overturned the reports by stating:

> 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 [GATT]. 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.[38]

---

corporation was required to be organized in the United States and to derive at least 95% of its gross receipts from qualified export receipts (generally those arising from export sales or lease transactions and other export-related activities). Additionally, at least 95% of its assets had to consist of qualified export assets (generally, those assets that are export-related).

[29] §995.

[30] *See* Qureshi, above at fn. 12, at 184-87. The French system was based on a territorial principle such that domestic corporations were generally taxed on profits earned in France, but were exempt form taxation on income arising outside of France. With the exception of foreign subsidiaries effectively managed and controlled from France, income from foreign undertakings was exempt from tax. The Netherlands applied somewhat similar territorial concepts.

Under the Belgian system, profits from foreign subsidiaries were assessed for tax in Belgium (after a deduction for foreign tax paid) at one-quarter of the normal rate.

[31] *See* Hudec, above at fn. 27, at 1452-66. The combined reports of the panel are sometimes hereinafter referred to as the *Tax Legislation Cases*.

[32] See fn. 15 and accompanying text.

[33] *United States Tax Legislation (DISC)*, Report of the Panel, July 30, 1973, GATT B.I.S.D. (23d Supp) at 98.

[34] *Id.* at ¶74.

[35] *Income Tax Practices Maintained by France*, Report of the Panel, July 30, 1973, GATT B.I.S.D. (23d Supp) at 114; *Income Tax Practices Maintained by Belgium*, Report of the Panel, July 30, 1973, GATT B.I.S.D. (23d Supp) at 127; *Income Tax Practices Maintained by The Netherlands*, Report of the Panel, July 30, 1973, GATT B.I.S.D. (23d Supp) at 137.

[36] *Income Tax Practices Maintained by France*, at ¶47.

[37] *Id.* at ¶48.

[38] *Tax Legislation*, Dec. 7-8, 1981, GATT B.I.S.D. (28th Supp.) at 114 [hereinafter 1981 Council Decision]. The last two rules were drawn virtually verbatim from the 1979 Illustrative List; see fn. 16 and accompanying text. Note, however, that the 1979 Illus-

ISSN 0090-4600

While the 1981 Council Decision clearly legitimized the European territorial systems, it also provided a blueprint for adapting the Code to GATT rules. As part of the Tax Reform Act of 1984, Congress enacted the FSC provisions of the Code with the explicit purpose of complying with the GATT ruling and the exemption for foreign economic processes provided in the 1981 Council Decision. Notwithstanding these efforts, both the FSC and the scope of the 1981 Council Decision would eventually be challenged by the EC under the SCM Agreement.

Background to the FSC Rules

The FSC provisions were procedurally important in light of the fact that Congress specifically amended the Code to comply with the GATT. Nevertheless, the stated intent of the FSC was to preserve many of the same benefits of the DISC,[39] and substantively, the eligibility rules work in a somewhat similar fashion. To qualify as a FSC, a corporation must satisfy several requirements described in §922(a). Among other requirements, a corporation (i) must be organized under the laws of a foreign country or U.S. possession; (ii) must have no more than 25 shareholders at any time during the year; (iii) may not have any preferred stock outstanding during the year; (iv) must maintain an office outside the United States or in a U.S. possession and keep permanent books of account at that office; (v) must maintain U.S. tax records in the United States; (vi) must have a board of directors that includes at least one non-U.S. resident; and (vii) must make an election to be taxed as a FSC. FSCs generally are non-U.S. corporations formed to carry out sales activities relating to goods produced in the United States.

The FSC rules modify the general scheme of U.S. taxation of income earned abroad. In general, U.S. international tax rules subject foreign corporations to U.S income tax on their income that is effectively connected with the conduct of a U.S. trade or business. Further, the Subpart F provisions of the Code are designed to prevent the deferral of tax on certain items of income earned by foreign subsidiaries of domestic companies. The FSC provisions modify these two rules by exempting a portion of a FSC's export-related foreign source income from U.S income tax. The exemptions apply only with respect to a FSC's "foreign trade income." Foreign trade income, as defined in §§923(b) and 924, is generally the foreign-source income of a FSC attributable to certain transactions that relate to the export of goods from the United States.

The exemptions with respect to a FSC's foreign trade income operate on three levels. First, the exempt portion of a FSC's foreign trade income [40] is not subject to the usual factual inquiry whether foreign-source income is effectively connected with the conduct of a U.S. trade or business; instead, the FSC rules automatically treat a FSC's exempt foreign trade income as not effectively connected with the conduct of a U.S. trade or business.[41] Second, the foreign trade income of a FSC is exempt from the anti-deferral rules of Subpart F of the Code.[42] Third, notwithstanding the general rule that subjects to tax dividends received by a U.S. corporation that are derived from foreign-source income of a foreign corporation, unless the income already has been taxed under the Subpart F rules, U.S. corporate shareholders of a FSC generally may deduct 100% of dividends received from distributions made out of the foreign trade income of a FSC.[43]

Background of FSC Dispute: The EC's Arguments

Although the EC claims to have never formally accepted the FSC provisions as being consistent with the GATT and the 1981 Council Decision, U.S. trade negotiators of the period recall a more reassuring stance by the EC at the time the FSC was proposed and adopted. In any event, the EC did not formally challenge the FSC until November 1997, 13 years after it was enacted. The EC and the United States held consultations on this between December 1997 and April 1998, but failed to reach an agreement. On July 1, 1998, the EC requested the establishment of a panel of the Dispute Settlement Body. Subsequently, on September 22, 1998, the body established a panel in accordance with Article 6 of the DSU.

In its brief filed on December 21, 1998, the EC made three main substantive arguments regarding the status of the FSC under Articles 1.1 and 3.1(a) of the

---

trative List was part of the voluntary Tokyo Round Subsidies Code, and thus was not binding on all GATT Members.

[39] *Id.* at 1501 & fn.192 (citing Treasury cover letter in "Treasury Explains Foreign Sales Corporation Proposal," *Tax Notes,* 440 (2/6/84)).

[40] Under §921, foreign trade income is divided into exempt foreign trade income and non-exempt foreign trade income. Under §923, "exempt foreign trade income" is the amount of the tax benefit that is granted with respect to the FSC's gross income attributable to foreign trading gross receipts. This exemption depends on whether the FSC's income is determined under the special administrative transfer pricing rules of §925. If those rules are used, then the exempt amount is 16/23 of foreign-trade income; if not, then the exempt amount is 32%. *See* Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶15.23[3][e] (7th ed. 2000).

[41] §921(a).

[42] §951(e).

[43] §245(c).

ISSN 0090-4600

SCM Agreement and the SCM Illustrative List.[44] First, it maintained that the FSC provisions were a subsidy under Article 1.1 of the SCM Agreement under which ''government revenue that is otherwise due is foregone or not collected'' and a ''benefit is thereby conferred.'' [45] The EC analyzed the FSC as consisting of two separate subsidies, the first consisting of three parts: (i) the exclusion of foreign trade income from Subpart F, (ii) the exemption of tax on such foreign trade income,[46] and (iii) the 100% dividends received deduction for dividends received from a FSC that are attributable to foreign trade income.[47] The EC maintained that the administrative pricing rules constituted a second subsidy which shifted profits from the parent to the FSC in derogation of the arm's-length pricing rules.[48] Moreover, the EC argued that the FSC constituted a ''contribution'' by the U.S. government to the extent that the operation of its provisions resulted in ''revenue foregone'' that would otherwise be taxed under other provisions of the Code.[49] Finally, the EC argued that the tax exemption provided by the FSC constituted a ''benefit'' in the form of reduced taxes that could be translated into price advantages for exported products.[50]

The second prong of the EC's argument asserted that the FSC was a prohibited subsidy under Article 3.1(a) of the SCM Agreement as a subsidy contingent upon export performance. The EC noted that the definition of exempt foreign trade income under §923(a)(1) was a de jure export contingency insofar as it depended upon the sale or lease of exported property under §927(a).[51]

Third, the EC argued that that the FSC was a prohibited export subsidy under Item (e) of the SCM Illustrative List as an exemption specifically related to exports of direct taxes payable by industrial or commercial enterprises. Moreover, the EC maintained that administrative pricing rules violated the arm's-length principles affirmed in footnote 59 to the SCM Illustrative List.[52]

The U.S. Arguments

The United States filed its reply brief on January 25, 1999. It responded to the EC by arguing, first, that the FSC and its administrative pricing rules are not prohibited export subsidies under Article 3.1(a) of the SCM Agreement and the SCM Illustrative List, second, that the FSC is not a subsidy at all under Article 1.1, and third, that the EC had not carried its burden of proof.

The United States divided its first argument into two parts. First, it responded to the EC's arguments that the general exemptions from tax under the FSC (as apart from the administrative pricing rules) constituted a prohibited export subsidy under Article 3.1(a) and Item (e) of the SCM Illustrative List. According to the United States, the EC's argument that the FSC is a prohibited export subsidy under Article 3.1(a) and Item (e) of the SCM Illustrative List assumed that the prohibition effectively required Members to tax income ''attributable to foreign economic processes.'' [53] In the U.S. view, the incorporation of the arm's-length standard in footnote 59 proves that ''[t]he necessary predicate . . . is that income from foreign economic processes may be exempted from direct taxes. Were that not the case, the arm's length principle would be irrelevant.'' [54] In support of this conclusion, the United States cited the GATT 1981 Council Decision, arguing that its holding was implicit in the 1979 Illustrative List — the precursor to the SCM Illustrative List.

The U.S. government argued further that the administrative pricing provisions of the FSC did not in themselves constitute an export subsidy under Article 3.1(a) or Item (e) of the Illustrative List. It noted that the EC had not demonstrated that such mechanisms in fact resulted in transfer prices that fell outside of the arm's-length range, nor had the EC demonstrated that the administrative pricing mechanisms resulted in ''significant savings,'' as required under footnote 59.[55]

The United States second argument asserted that the FSC did not even constitute a subsidy under the definition of Article 1.1 as ''government revenue that is otherwise due [that] is foregone or not collected.'' [56] According to the United States, if under the 1981 Council Decision '' 'economic processes (including transactions involving exported goods) located outside of the territorial limits of the exporting country need not be subject to taxation by the export-

[44] The EC also argued that the FSC violated Article 3.1(b) of the SCM Agreement as well as the WTO Agriculture Agreement, though these arguments were secondary to those discussed herein.

[45] *See United States — Tax Treatment for ''Foreign Sales Corporations,''* Report of the Panel, at ¶4.268, WTO Doc. WT/DS108/R8 (Oct.8, 1999) [hereinafter Panel Report] (quoting SCM Agreement art. 1.1(a)(1)(ii) and (b)).

[46] See fns. 40 – 42 and accompanying text.

[47] *Id.* at ¶4.270; see fn. 43 and accompanying text.

[48] *Id.* at ¶4.272; see fn. 40 and accompanying text.

[49] *Id.* at ¶¶4.277-84.

[50] *Id.* at ¶¶4.285-88.

[51] *Id.* at ¶¶4.297-99.

[52] *Id.* at ¶4.303; see text accompanying fn. 26 for a discussion of the SCM Illustrative list and fn. 59 thereto.

[53] *Id.* at ¶4.361.

[54] *Id.* at ¶4.366.

[55] *Id.* at ¶¶4.386-95, 4.407-28.

[56] SCM Agreement art. 1.1(a)(1)(ii).

ISSN 0090-4600

ing country. . . .,' taxes on that income cannot be considered as 'otherwise due.' " [57]

Finally, the United States argued that the EC had not carried its burden of proof under the SCM Agreement. It asserted that the EC's arguments failed in light of the fact that a tax exemption in itself cannot be considered a subsidy as revenue foregone as the EC did not prove that it was "otherwise due" under the terms of the SCM Agreement, and that the EC had not demonstrated that the administrative pricing rules did not approximate arm's-length results.[58]

The Responses of the Parties

The EC's main response to the U.S. arguments was that the U.S. focus on footnote 59 "turns the whole system on its head." [59] The EC argued that the arm's-length standard incorporated therein should not be read to imply that an exporting country has the right to "*exempt from tax* income from an export transaction which would otherwise bear tax." [60] Further, the EC argued that the 1981 Council Decision was not, as the United States had asserted, the "controlling legal standard" because the understanding reflected therein is not applicable to the SCM Agreement.[61] Finally, the EC argued that it had presented a prima facie case that the FSC was an export subsidy insofar as it granted a benefit to U.S. exporters merely by giving them a choice to utilize its provision, as many of them actually did.

The United States responded that, in the absence of a clear statement to the contrary in the SCM Agreement, the 1981 Council Decision should be applied in interpreting the SCM. The United States noted that the EC had recently made a similar assertion about precedent in the *Indonesia-Automobile Industry* case.[62]

The Panel Report

After holding hearings in February and March 1999 and issuing a confidential interim ruling against the United States in July of that year, the Panel issued its final report on October 8, 1999. The FSC Panel considered the arguments largely in the same order presented by the EC. First, it considered whether the FSC provisions were a subsidy under the definition of Article 1.1. The Panel began adopting the construction of the term "otherwise due" as "refer[ring] to the situation that would prevail but for the measure in question." [63] Further, the Panel rejected the U.S. argument that the 1981 Council Decision addressing income from foreign economic processes provided the appropriate legal standard. The Panel concluded that the decision was not "*relevant*" because the GATT provision there in question "differs dramatically from the export subsidy disciplines in the SCM Agreement. . . ." [64] The Panel noted:

> Although the United States would have us look to the 1981 understanding to derive the meaning of this provision, the phrase "otherwise due" nowhere appears in Article XVI:4 of the GATT. . . . In fact, nowhere in Article XVI of GATT. . . is there any definition whatsoever of the term "subsidy." Rather, that term is first defined in the GATT/WTO context only in Article 1 of the SCM Agreement. . . . Under these circumstances, it would in our view be inappropriate to place any weight in interpreting the definition of subsidy found in Article 1 of the SCM Agreement on an understanding regarding Article XVI:4 of GATT . . . which was adopted more than a decade before that definition was formulated.[65]

The Panel next addressed the effect of footnote 59 of the SCM Agreement. While the Panel expressed its reservations in relying upon the footnote in light of the fact that it refers to the SCM Illustrative List of "*export*" subsidies, *i.e.*, an Article 3 question, it accepted the U.S. assertion that the arm's-length standard expressed in the footnote " 'is predicated on the assumption that income from foreign economic processes may be exempted from direct taxes.' " [66] Nevertheless, the Panel concluded:

> [W]e consider that the United States has made an unwarranted leap of logic from the proposition that "income arising from foreign economic processes may be exempted from direct taxes" to the proposition that "if countries are under no obligation to tax income from foreign economic processes, then they should be free to exempt all such income or just part of it. . . ." There is in our view . . . nothing in footnote 59 which would lead us to conclude that a Member that decides that it will tax income arising from foreign eco-

---

[57] Panel Report, cited in fn. 45, at ¶¶4.432-33 (quoting 1981 Council Decision, cited above at fn. 38).

[58] *Id.* at ¶¶4.440-44. The U.S. government also lodged more procedural objections not discussed herein.

[59] *Id.* at ¶4.457.

[60] *Id.* at ¶4.472 (emphasis in original)

[61] *Id.* at ¶¶4.473-85

[62] *Id.* at ¶¶4.712-13 & fn. 347.

[63] *Id.* at ¶7.45.

[64] *Id.* at ¶7.79.

[65] *Id.* at ¶7.80.

[66] *Id.* at ¶7.91.

ISSN 0090-4600

> nomic processes does not forego revenue ''otherwise due'' if it decides in a selective manner to exclude certain limited categories of such income from taxation.[67]

In concluding the first part of its decision that the FSC constituted a subsidy under Article 1.1 of the SCM Agreement, the Panel ruled that, in light of the source rules and the Subpart F provisions of the Code, ''[a]pplying the 'but for' test to the FSC scheme, there can be no doubt that, in the absence of the FSC scheme, income which is shielded from taxation by that scheme would be subject to taxation,'' and hence, constituted revenue ''otherwise due'' that provides a readily apparent benefit.[68]

The Panel next considered whether the FSC exemptions constituted a prohibited export subsidy under Article 3.1(a) of the SCM Agreement. After stating that the FSC provisions were indeed contingent upon export and fell within the purview of Item (e) of the SCM Illustrative List (*i.e.*, the ''full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises''), the Panel once again considered the effect of footnote 59. The Panel held that, even if (as the United States argued) the footnote implied that ''income from foreign economic activity may be exempted from direct taxes,'' such an interpretation ''does not mean that a Member is also entitled to choose to assert its taxing authority over income derived from foreign economic activities generally and then create an exemption from such taxation specifically for income derived from export activities.'' [69]

Finally, in a somewhat anti-climactic ruling, the Panel refused to rule on whether FSC administrative pricing rules are consistent with WTO arm's-length standards. It stated that ''having found that the exemptions provided by the FSC scheme are an export subsidy inconsistent with the SCM Agreement, it would be neither necessary nor appropriate for us to make a further and independent ruling on the consistency of that scheme's administrative pricing rules.'' [70]

The U.S. Appeal

On November 26, the United States filed its appeal and argued that the Panel erred in not beginning its analysis with footnote 59 to the SCM Illustrative List of the U.S. Argument. According to the Appellate Body's formulation:

> As regards the substantive interpretation of Article 1.1 of the SCM Agreement, the United States accepts*, as a general proposition*, the Panel's interpretation of the term ''otherwise due'' as establishing a ''but for'' test; however, the United States argues that this standard ''is not unqualified'' and ''must yield'' in situations where a specific standard exists for determining whether revenue is ''otherwise due''. In the view of the United States, footnote 59 provides such a ''controlling'' standard in this dispute. The United States argues that this footnote provides the ''most relevant context'' for interpreting the term ''otherwise due'' because, under footnote 59, the FSC measure does not involve the foregoing of revenues ''otherwise due.'' The United States submits that this reading of footnote 59 is ''confirmed'' by the 1981 Council [Decision]. In that regard, the United States appeals against the Panel's finding that the 1981 Council [Decision] is not part of the GATT . . . and, in any event, has no relevance to this dispute.[71]

Further, the United States contended that the Panel Report failed to appreciate the argument that the FSC is not an export subsidy under Article 3.1(a) by virtue of the final sentence of footnote 59, which provides that Item (e) of the SCM Illustrative List ''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.'' [72]

The Appellate Body Report

On February 24, 2000, the Appellate Body issued its decision affirming the Panel Report. The Appellate Report largely confirmed the reasoning of the Panel below. First, the Appellate Body upheld the Panel's finding that the FSC provisions constituted a subsidy under the definition of Article 1.1(a)(1)(ii) of the SCM Agreement where ''government revenue that is *otherwise due* is foregone or not collected.''[73] While expressing some reservations about the Panel's use of the ''but for'' standard,[74] the Appellate Body reasoned:

---

[67] *Id.* at ¶7.92.

[68] *Id.* at ¶¶7.93-103.

[69] *Id.* at ¶7.119.

[70] *Id.* at ¶7.127. The Panel further ruled that the FSC constituted a subsidy under other provisions of the SCM Agreement as well as the Agriculture Agreement. *Id.* at ¶¶7.131-77.

[71] Appellate Body Report, cited in fn. 2, at ¶85 (footnotes omitted) (emphasis in original).

[72] *Id.* at ¶26 (citing Panel Report at ¶4.348)

[73] *Id.* at ¶85

[74] See fn. 82, below, and accompanying text.

ISSN 0090-4600

> Even if footnote 59 means — as the United States also argues — that a measure, such as the FSC measure, is not a prohibited export subsidy, footnote 59 does not purport to establish an exception to the general definition of a ''subsidy'' otherwise applicable throughout the entire SCM Agreement.
>
> . . . .
>
> In light of the above, we do not accept the United States' argument that footnote 59 qualifies the general interpretation of the term ''otherwise due.'' [75]

The Appellate Body next rejected the second U.S. argument on appeal that the FSC provisions were designed to avoid double taxation of foreign-source income as permitted under the last sentence of footnote 59. According to the Appellate Body, ''the United States did not indicate that, in its substantive arguments to the Panel, it had justified the FSC measure as a measure 'to avoid double taxation' under footnote 59.'' [76]

Finally, the Appellate Body considered the import of the 1981 Council Decision in light of the U.S. government's assertion that it confirmed the general interpretation of footnote 59 as permitting Members to exempt foreign economic processes from tax. The Appellate Body noted particularly the statement of the Chairman of the GATT Council at that time that the 1981 Council Decision ''*does not affect the rights and obligations of the contracting parties under the* [GATT].'' [77] In light of such considerations, the Appellate Body stated that it ''share[d] the Panel's view that, in these circumstances, it would be incongruous to extend the scope of the action, beyond that intended, to the SCM Agreement.'' [78] Upon this reasoning, the Appellate Body concluded that the FSC provisions constituted a prohibited export subsidy under Article 3.1(a) of the SCM Agreement.

The Future of Tax Subsidy Jurisprudence in Light of the FSC Decision

On March 20, 2000, the Dispute Settlement Body of the WTO formally adopted the Appellate Body's ruling that the FSC regime violates the SCM Agreement. Although the United States criticized the decision, the U.S. ambassador to the WTO told the organization on April 7 that the United States intended to comply with the ruling. Indeed, the Clinton administration in the spring announced an alternative to the FSC rules that it said will bring the United States into compliance with the WTO rules. The House Ways and Means Committee, with the support of the Treasury Department, on July 27 approved a bill intended to bring the U.S. tax system into compliance with the WTO ruling by October 1.

Yet, even as Congress and the administration race to pass a measure that is compliant with the U.S. obligations under the various WTO agreements, certain questions raised by the FSC debate will persist. We take a brief look at such issues below.

What Is the Proper Baseline for Determining When Revenue Is Otherwise Due?

First, of course, in order to violate the SCM Agreement a ''subsidy'' must be involved. As noted above, a subsidy is defined to include ''foregoing of government revenue that is otherwise due.'' The determination of what is ''otherwise due'' is not well-defined — thus making this initial determination highly contentious except in the most obvious cases. In the FSC case, for example, the United States argued that the general scheme of the Code taxes domestic corporations on their worldwide income, but does not tax foreign corporations on their income earned outside the United States.[79] The CFC regime, pursuant to which foreign corporations are taxed on certain foreign income, was described by the United States as a ''targeted exception[] to the general norm of deferral.'' [80] The logic would seem to be that at least with respect to deferral permitted by the FSC, tax on income earned by a FSC is not otherwise due.

The Panel agreed to use a ''but for'' test to determine whether revenue is ''otherwise due.'' Specifically, it stated ''we took the term '*otherwise due*' to refer to the situation that would prevail but for the measures in question. It is thus a matter of determining whether absent such measures there would be a higher tax liability.'' [81] Of course, this formulation merely begs the question — absent which measures? Absent Subpart F, the Code would permit deferral with respect to all foreign earnings of U.S. corporations, including the income of FSCs. On the other hand, absent the FSC rules, FSCs would not be permitted deferral. The appropriate baseline will plainly be the subject of future dispute. Indeed, the Appellate Body recognized as much when it refused to adopt ''but for'' as the test for all circumstances. Rather, it stated:

---

[75] Appellate Body Report, cited in fn. 2, at ¶¶93-94.

[76] *Id.* at ¶101.

[77] *Id.* at ¶112.

[78] *Id.* at ¶118.

[79] *See* Panel Report, cited in fn. 45, at ¶¶4.314-17.

[80] *Id.* at ¶4.317.

[81] *Id.* at ¶7.45.

ISSN 0090-4600

> [W]e would have particular misgivings about using a "but for" test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure. It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be no general rule that applied formally to the revenues in question, absent the contested measures. We observe, therefore, that, although the Panel's "but for" test works in this case, it may not work in other cases.[82]

The Appellate Body's reservations about using the "but for" tests suggest that the interpretation of the phrase "otherwise due" will be subject to varying interpretations in the future. It is not too far a stretch to say with respect to a territorial system of a particular country, but for the exemption for foreign source income, the worldwide income of a multinational would be subject to tax in that country. This is a critical ambiguity because once a claimant can demonstrate a subsidy it need only demonstrate that it (i) confers a benefit, and (ii) that it is contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance. While the first of these prongs should be fairly easy to establish, the second "contingent" prong is also not a paradigm of clarity. One might argue that some benefit of any territorial regime may be contingent, at least in part, on exports.

The Illustrative List provides a separate set of semantic hurdles, because an item on the Illustrative List of export subsidies constitutes a prohibited export subsidy under Article 3.1(a) of the SCM Agreement. Here too, the required nexus to exports is vaguely stated; the test is "full or partial exemption, remission, or deferral specifically related to exports of direct taxes." Thus, it would appear that even before proceeding to analyze the meaning of footnote 59, a potentially offending provision would have to be found to be one "specifically related to exports." Of course the nexus between the provision and exports has yet to be established, but the phrase "specifically related," would suggest that something more than a casual connection will be required, but that will be up to later case law development.

What Is the Future Relation Between Existing GATT Jurisprudence and the SCM Agreement?

The legal relationship between the different provisions of the GATT and the SCM Agreement is set forth in various parts of the WTO Agreement. The exact nature and scope of this relationship — which was addressed extensively by the Panel and the Appellate Body — is not always clear and is far too complicated to be covered in this article. Nevertheless, there are a few main distinctions of which tax lawyers should be aware. These distinctions were highlighted in the Appellate Body Report:

> It is clear from even a cursory examination of Article XVI:4 of the GATT . . . that it differs very substantially from the subsidy provisions of the SCM Agreement, and, in particular, from the export subsidy provisions of . . . the SCM Agreement. . . . First of all, the SCM Agreement contains an express definition of the term "subsidy" which is not contained in Article XVI:4. In fact, as we have observed previously, the SCM Agreement contains a broad package of new export subsidy disciplines that "go well beyond merely applying and interpreting . . . the GATT". . . . Next, Article XVI:4 prohibits export subsidies only when they result in the export sale of a product at a price lower than the "comparable price charged for the like product to buyers in the domestic market." In contrast, the SCM Agreement establishes a much broader prohibition against any subsidy which is "contingent upon export performance." To say the least, the rule contained in Article 3.1(a) of the SCM Agreement that all subsidies which are "contingent upon export performance" are prohibited is significantly different from a rule that prohibits only those subsidies which result in a lower price for the exported product than the comparable price for that product when sold in the domestic market. Thus, whether or not a measure is an export subsidy under Article XVI:4 of the GATT . . . provides *no guidance* in determining whether that measure is a prohibited export subsidy under Article 3.1(a) of the SCM Agreement.[83]

Obviously, for lawyers who are attempting to fashion tax rules that comply with the export subsidy provisions of the SCM Agreement, the Appellate Body's assertion that the GATT provides "no guidance" is somewhat disconcerting. Clearly, the extent to which lawyers can rely on what was seen as precedent under the GATT remains to be seen under the WTO and the SCM Agreement and, as the FSC dispute proved, will remain a point of controversy.

It may not be long before the WTO has to consider these questions again. In May 1998, the U.S. govern-

---

[82] Appellate Body Report, cited in fn. 2, at ¶91.

[83] *Id.* at ¶117 (footnotes omitted) (emphasis added).

ISSN 0090-4600

ment instituted its own WTO dispute settlement consultations regarding tax measures maintained by EC member states which it believes are inconsistent with WTO subsidy rules, including: (1) French provisions allowing companies to deduct start-up expenses of foreign operations through a tax-deductible reserve account; (2) Dutch provisions allowing for the establishment of a special "export reserve," apparently designed for small and medium-sized businesses; (3) Greek tax deductions on export sales; (4) Irish "special trading house" companies that assume all international marketing responsibility for product manufacturers and qualify for a 10% corporate tax rate in respect of trading income from the export sale of goods; (5) Belgian provisions allowing corporations special tax exemptions for recruiting personnel with export-related functions; and (6) Spanish provisions that permit deductions from corporate income tax for 25% of the value of foreign investments that are directly related to exporting goods and services.[84] Thus far, the United States has not decided to bring these disputes before a WTO panel, but if it does, the WTO will once again get tangled in knotty tax questions.

Are Territorial Tax Systems Inconsistent with WTO Rules?

The FSC decision raises the question of the WTO compatibility of income tax laws that omit to tax income accrued in foreign countries when that income is generated, at least in part, from exports. The circular nature of the FSC decision vis-à-vis the GATT 1981 Council Decision is ironic in two respects. First, it is ironic that the EC denied the legal force of the decision because it was originally demanded by European countries to overturn the panel report so that these countries could avoid rewriting their income tax laws to remove the putative export subsidies. It is also ironic that the WTO Appellate Body ruled against the 1981 Council Decision. The 1981 Council Decision was written to correct the GATT panel decisions in *Tax Legislation Cases* which many observers agreed had gone too far in positing a requirement to tax foreign income. The need for such an understanding reflected in the 1981 Council Decision is no less today than it was when it was originally issued. Yet, the Appellate Body determined that the 1981 Council Decision is not part of the SCM Agreement. Thus, it may be that WTO jurisprudence has retrogressed to what it was before the 1981 Council Decision, when the *Tax Legislation Cases* panel found territorial tax practices to be export subsidies. This, of course, should worry governments that exempt from tax certain types of foreign income. It should also worry the WTO because it may become embroiled in many complex income tax cases in which the WTO will be accused of overreaching its mandate.

Although the 1981 Council Decision was long accepted as clarifying the GATT's jurisprudence on tax subsidies, the EC repudiated the decision in the FSC litigation by claiming that it did not carry forward into the WTO. Because the panel and Appellate Body agreed with the Commission about the status of the 1981 Council Decision, it can no longer serve as a shield from the conclusions reached in the *Tax Legislation Cases* that territorial tax practices are export subsidies.

It is interesting to note both the Panel's and the Appellate Body's statements regarding the possible effect of the decision beyond the FSC context. For instance, in considering the scope of Item (e) of the SCM Illustrative List, the Panel stated:

> Arguably, a broad exemption of income deriving from foreign economic activities from taxation would not be an exemption "specifically related to exports," because it would exempt income derived from any foreign economic activity, whether involving the exportation of goods to a foreign market, the importation of goods from a foreign source, or other economic activities not related to trade in goods between the Member in question and a third country.[85]

In a similar vein, but in a more explicit fashion, in ruling that the FSC was a prohibited export subsidy under Article 3.1(a) of the SCM Agreement, the Appellate Body stated:

> We wish to emphasize that our ruling is on the FSC measure only. As always, our responsibility under the DSU is to address the legal issues raised in an appeal in a dispute involving a particular measure. Consequently, this ruling is in no way a judgement on the consistency or the inconsistency with WTO obligations of any other tax measure applied by any Member. Also, this is not a ruling that a Member must choose one kind of tax system over another so as to be consistent with that Member's WTO obligations. In particular, this is not a ruling on the relative merits of "worldwide" and "territorial" systems of taxation. A Member of the WTO may choose any kind of tax system it wishes — so long as, in so choosing, that Member applies that system in a way that is consistent with its

[84] Office of the U.S. Trade Representative, *2000 National Trade Estimate Report on Foreign Trade Barriers,* 104-06.

[85] Panel Report, cited in fn. 45, at ¶7.119

ISSN 0090-4600

> WTO obligations. Whatever kind of tax system a Member chooses, that Member will not be in compliance with its WTO obligations if it provides, through its tax system, subsidies contingent upon export performance that are not permitted under the covered agreements.[86]

This last sentence is most noteworthy for its unstated implication that a Member government's tax system must be designed and applied so as to be consistent with WTO rules, especially in light of the Appellate Body's somewhat equivocal stance on determining the proper baseline for measuring what type of revenue is "otherwise due."

What Is the Scope of the Double Taxation Provision of Footnote 59 to the SCM Illustrative List?

The final sentence of footnote 59 of the SCM Illustrative List provides that measures to avoid the double taxation of foreign-source income will not be considered an illustrative export subsidy. The exact implications of this provision are unclear. First, the SCM contains no rules on sources of income. Second, the footnote does not define specifically what constitutes a measure to avoid double taxation. Although this double taxation provision came up in the FSC case, it was given little analysis by the Appellate Body, which ruled that it had not been argued sufficiently at the first-level panel.

The issue of double taxation will surely arise in future WTO cases and the scope of this exemption will likely be litigated. For example, can one government successfully challenge under the WTO subsidy prohibitions another government's liberal foreign tax credit regime that permits the averaging of low taxed and high taxed foreign income to reduce higher domestic taxes? Will it be a successful defense merely to state that the foreign tax credit provision is not "specifically related to export?" On a more fundamental level, is a measure to avoid the double taxation of foreign source income suspect to the extent that the foreign source income to which it relates is not taxed in another jurisdiction, or is taxed but at a lower rate? Finally, would an exemption from domestic taxation of income that is previously taxed in a foreign country satisfy the requirements of SCM? We will have to await the answers to these and other questions.

What Is the Scope of the Arm's-Length Standard Incorporated in Footnote 59 to the SCM Illustrative List?

Footnote 59 provides that the WTO Members reaffirm that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. The provision goes on to say that governments shall normally attempt to resolve their differences using existing bilateral treaties or other international mechanisms, but notes that this is without prejudice to rights under the GATT. This procedural aspect of this provision was raised in the FSC case, but the substantive requirement was not addressed. Future WTO panels may delve into the issue of whether transactions actually meet the arm's-length standard.

Assuming that deviation from the arm's-length principle would result in a violation of the SCM, the use of the WTO dispute resolution mechanism in this area could have broad-reaching implications. What if one government believes that another government administers its transfer pricing rules in such a manner as to grant an impermissible export subsidy? The plaintiff government would appear to be entitled to bring an action under the GATT (as well as the WTO). Indeed, it further appears that under the DSU, a panel would be entitled to conduct fact finding concerning an arm's-length price, in effect challenging the defendant government's administration of its own laws.

Conclusion

As the first tax case to be considered under the SCM Agreement, the FSC dispute has engendered numerous questions about how the Agreement will be applied to income taxes. This uncertainty will make it harder for tax policymakers to know even what the WTO rules are, not to mention the added difficulty of complying with these rules. These complexities regarding the treatment of taxes under the SCM Agreement are further complicated by the ever increasing breadth of WTO agreements. As discussed in the following sections, the Uruguay Round added two new agreements governing services and investment that potentially can also have ramifications on Members' tax systems.

Trade in Services: The General Agreement on Trade in Services

The General Agreement on Trade in Services ("GATS")[87] is a broad agreement supervising governmental measures — including taxes — affecting trade in services. The scope of the GATS covers four basic modes of service delivery: (1) cross-border services supplied from the territory of one party to the

[86] Appellate Body Report, cited in fn. 2, at ¶179.

[87] General Agreement on Trade in Services, Apr. 15, 1994, WTO Agreement, Annex 1B, in The Legal Texts [hereinafter GATS].

ISSN 0090-4600

territory of another; (2) services supplied in the territory of one party to the consumers of any other (*e.g.*, tourism); (3) services provided through the presence of service-providing entities of one party in the territory of any other (*e.g.*, banking); and (4) services provided by natural persons of one party in the territory of any other (*e.g.*, construction projects or consultancies).[88]

Like the GATT, the GATS requires both MFN and national treatment. With regard to MFN, Article II states that each party ''shall accord immediately and unconditionally to services and service providers of any other Party, treatment no less favourable than that it accords to like services and service providers of any other country.'' However, Member countries may deviate from the MFN standard in those instances where the Member has listed such measures in the ''Annex on Article II Exemptions'' and the conditions for such exemptions have been met. Over 60 countries and the EC have filed lists of such exemptions, many of which include tax provisions.[89] For instance, the United States has listed tax measures relating to favorable treatment for Mexican and Canadian residents and companies, the Caribbean Basin Initiative, international transport income derived by residents of countries with reciprocal measures, and denials of deductions for residents of countries participating in international boycotts or maintaining discriminatory tax regimes.[90]

In addition, Article XIV(e) of the GATS permits Members to adopt measures inconsistent with the MFN requirement contained in Article II if ''the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which a Member is bound.''

In contrast to the GATT, the GATS contains a somewhat porous national treatment standard. While Article XVII provides that ''each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers,'' the GATS limits the application of the national treatment standard to those sectors specified in each Member's Schedule of Concessions, and allows Members to set forth conditions therein. While over 95 countries and the European Communities have filed concessions, many contain conditions related to taxation similar to those set forth in the Article II exemptions.[91]

Further, Article XIV provides that Members may diverge from Article XVII's national treatment standard ''provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members. . . .'' [92] Footnote 6 to the GATS provides that such measures include taxes which:

> (i) apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items sourced or located in the Member's territory; or
>
> (ii) apply to non-residents in order to ensure the imposition or collection of taxes in the Member's territory; or
>
> (iii) apply to non-residents or residents in order to prevent the avoidance or evasion of taxes, including compliance measures; or
>
> (iv) apply to consumers or services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Member's territory; or
>
> (v) distinguish service suppliers subject to tax on worldwide taxable items from other service suppliers, in recognition of the difference in the nature of the tax base between them; or
>
> (vi) determine, allocate or apportion income, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member's tax base.[93]

Clearly, this footnote gives Member governments broad latitude to safeguard their tax base. Moreover, it gives Members a virtual right to define its scope by

---

[88] GATS art. I.

[89] *See, e.g.*, *European Communities and Their Member States: Final List of Article II (MFN) Exemptions*, at 7, WTO Doc. GATS/EL/31 (Apr. 15, 1994) (detailing Italian measure to defer income earned on services in Eastern European countries); *Canada: Final List of Article II (MFN) Exemptions*, at 3, WTO Doc. GATS/EL/16 (Apr. 15, 1994) (detailing exemption from taxes on income of nonresidents from international transport on basis of reciprocity with the resident country).

[90] *United States of America: Final List of Article II (MFN) Exemptions*, at 2-11, WTO Doc. GATS/EL/90 (Apr. 15, 1994).

[91] *See, e.g.*, *The United States of America: Schedule of Specific Commitments*, at 9-10, WTO Doc. GATS/SC/90 (Apr. 15, 1994) (setting forth limitations on national treatment for foreign employee benefit trusts and excise taxes on transfers to foreign entities).

[92] GATS art. XIV(d).

[93] *Id.* art. XIV(d), fn. 6.

ISSN 0090-4600

providing that its ''[t]ax terms or concepts'' are to be determined ''according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure.'' [94]

The extensive exemptions provided in the GATS raise the question of whether it really will have any effect on taxation. Unlike the GATT or the SCM Agreement, the GATS does not contain an explicit provision affecting subsidies. Will Members attempt to apply the SCM Agreement's prohibitions on tax subsidies to fill the interstices of the GATS? Thus far, there have been no cases on this point.

Investment Taxation: The Agreement on Trade-Related Investment Measures

The Agreement on Trade-Related Investment Measures (''TRIMS'')[95] provides a bare-bones set of rules regarding trade-related investment measures. Though TRIMS does not contain any specific provisions relating to taxation, it incorporates other provisions applicable to taxes such as the GATT national treatment standard to prohibit protectionist investment measures.[96] TRIMS also requires governments to notify the WTO of any nonconforming trade related investment measures.[97] The agreement requires countries to eliminate such measures, developed countries within two years of adoption and developing countries within seven years of adoption. To date, only 25 developing countries made such notifications. Of those measures which have been identified, few relate to taxes, and those that do are essentially tariff-related measures.[98]

The jurisprudence regarding the scope of the TRIMS in relation to existing tax provisions is only in its nascent stages. Thus far, the only case considering the TRIMS in relation to a Member government's tax provisions is the *Indonesia — Automobile Industry* case. In that ruling, the Panel affirmed the panel's ruling that the Indonesian sales tax on automobiles that did not meet local content requirements violated the national treatment requirement of TRIMS Article 2.[99]

CONCLUSIONS

This article has been designed to provide tax practitioners an introduction to some of the more important aspects of those WTO agreements that affect domestic tax rules. As discussed above, the relevant jurisprudence is hardly settled. Thus, tax lawyers must keep abreast of changing developments as well as develop a knowledge of the existing law. The FSC dispute is certain not to be the last time that the WTO will assert its authority over a domestic tax provision. Still, the decision shows the difficult challenge in achieving a coherent set of WTO rules regarding taxes.

---

[94] *Id.*

[95] Agreement on Trade-Related Investment Measures, Apr. 15, 1994, WTO Agreement, Annex 1A, in The Legal Texts [hereinafter TRIMS]

[96] TRIMS, art. 2.1.

[97] *Id.,* art 5.1

[98] *See, e.g.*, *Uruguay: Notification under Article 5.1 of the Agreement on Trade-Related Investment Measures*, WTO Doc. G/TRIMS/N/1/URY/1 (Apr. 10, 1995) (explaining reductions in tariffs on automobiles as replacement for tax drawback).

[99] *See Indonesia — Automobile Industry* at ¶15.1(a), cited in fn. 20.

ISSN 0090-4600