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United States Tax Subsidies under DISC, FSC and ETI Legislation within the Framework of the WTO

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1. Introduction and Executive Summary

Since the 1970's a particular trade conflict between the United States and the European Union has been festering. This conflict concerns certain built-in fiscal subsidies in the US systems of corporation tax [under the DISC, FSC and the ETI legislation respectively] intended to promote US export trade. The trade conflict has been set against the different US and EU approaches to international taxation; and has been drawn out over the years in the form of a number of trade disputes, between the EU and the US, within the WTO dispute settlement system, and its predecessor the GATT 1947. However, although the disputes have arisen as between the EU and the US, the implications of the US fiscal subsidies, along with the WTO Panel and Appellate Body deliberations arising from the various disputes, are of concern to the wider membership of the WTO — including developing countries, and the Commonwealth membership as a whole. Thus, in the WTO cases involving the US FSC and ETI legislation Australia, Canada, India, Barbados, and Japan participated as third parties. Finally, this is a dispute involving two key players in international trade relations. How the dispute is ultimately resolved may have implications for the WTO system itself and its development.

Under the WTO, member States are prohibited from granting export subsidies. The DISC, FSC and ETI legislation, have been characterised as comprising tax subsidies for exports, generally on all goods and services. The subsidies operate not just for exports to Europe, but to all US exports worldwide. The subsidized exports may unfairly compete and reduce developing countries' market

Glossary

DISC	Domestic International Sales Corporation
ETI	Extraterritorial Income Exclusion Act
EU	European Union
FISC	Foreign Sales Corporation
GATT	General Agreement on Tariffs and Trade
IRC	Internal Revenue Code [US]
WTO	World Trade Organization

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share in their domestic and/or foreign markets. Further, the subsidies are of significant value. In the case of the FSC legislation, the subsidy has been calculated to amount to about 4 billion US dollars annually[2].

Generally, the fiscal subsidies, under the various US legislation, have boosted US exports, by lowering the income tax between around 15% to 30% on export-related profits[3].

Export Sales	1,000,000	750,000	500,000	250,000	100,000
Tax Liability without FSC	340,000	255,000	170,000	85,000	34,000
Tax Liability with FSC	289,000	216,750	144,500	72,250	28,900
Tax Savings	51,000	38,250	25,000	12,750	5,100
%	15%	15%	14.7%	15%	15%

[Simplified table using pricing formula 925 (a) (1) IRC rule and applying a corporate tax rate of 34%][4].

The fiscal subsidies established under the DISC, FSC and ETI regimes were in response to what the US perceived as built-in fiscal advantages in the territorial system of taxation used by certain European States, which when combined with certain general tax measures[5], conveyed to exports from European States an even greater fiscal subsidy[6].

States normally orientate their tax systems around two distinct approaches, or a combination of both, with respect to the taxation of foreign income. The two approaches involve, either taxing the worldwide income of the tax payer [and then giving relief for foreign tax paid on that income] known as the *worldwide* system; or taxing only income generated territorially, known as the *territorial* system. The United States adopts the former worldwide approach. The territorial system of taxation may lend itself to affording fiscal advantages for exports, in particular by availing the opportunity to place the "income receiving part" of the export process, for example a sales subsidiary of a manufacturing enterprise, outside the territory, and thus outside the system of taxation. This advantage can be reinforced through national transfer pricing policies, which facilitate the movement of the profits between related parties located in different jurisdictions, for example to the foreign subsidiary. Transfer pricing is the practice of pricing goods and services exchanged, as between related parties. If the market price is not the operative price as between the related parties located in different jurisdictions engaged in the export process, the tax burden of the related party engaged in the export process within the territory can be reduced, and shifted to the subsidiary engaged in the export process abroad. These fiscal advantages may be further buttressed by a system of taxation that is more reliant on indirect taxes rather than direct taxes. In accordance with WTO norms, indirect taxes need to conform to the destination principle. Under this principle, exports are exempted from indirect

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[2] United States –Tax Treatment for "Foreign Sales Corporations", Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement [WT/DS108/ARB] para 3.1.

[3] See FSC Panel report, p. 39, para. 4.211, 4.212. Note that the savings are comparable under the three regimes, see FSC Panel report where it is noted that "the FSC Legislation was designed to be functionally equivalent to the DISC while being easier to defend under the GATT, p. 34, para. 4.176 and 4.267.

[4] The tax savings would depend which administrative rule the taxpayer chooses to apply. The determination of the exempt foreign trading income can be arrived at via the application of two distinct administrative rules: (i) [23% x Export Sales] x 15/23 or (ii) [1.83% x Export Sales] x 15/23. The choice of the formulas would generally depend on the taxpayers' profit margin. Alternatively, taxpayers are allowed to use normal transfer pricing rules as laid down in section 482 IRC.

[5] E.g., transfer pricing policies and export expense deductions.

[6] GATT Panel Reports [1976]: Income Tax Practices Maintained by France, Belgium, Netherlands, BISD 23rd Supplement

taxes[7]. Finally, by adding a generous expenses regime related to export expenditures[8]; the fiscal advantages can be further expanded.

However, it is the case also that when a worldwide system of taxation is also combined with some of these features, or adapted to incorporate these features; it can produce a similar result as has been the case with the US DISC, FSC and ETI legislation. These fiscal advantages, either on their own, or through their combined operation, can effectively amount to tax subsidies contingent upon export, where a subsidy is defined in terms of revenue foregone by the government that is conditional upon export performance, as is the case in the WTO.

In 1971, the United States passed the DISC legislation under the Deficit Reduction Act 1971. The DISC legislation was the subject of a GATT Panel ruling, wherein the Panel determined the DISC legislation to be inconsistent with GATT prohibitions against export subsidies. In 1984, the United States passed the FSC legislation to replace the DISC system, in order to meet requirements of the GATT Panel decision. In 1997, the EU challenged the FSC legislation under the WTO, contending that it also constituted an export subsidy prohibited under the WTO. In 1999, a WTO Panel, and subsequently in 2000, the Appellate Body, ruled against the US. Consequently, the US passed legislation to repeal the FSC legislation and introduce a new system [the ETI regime] to replace it, under the Extraterritorial Income Act 2000. This attempt too was challenged by the EU in the WTO. A Panel ruled against the US, deliberating that the ETI constituted an export subsidy. The US appealed and the Appellate Body upheld the Panel decision. In the circumstances the EU sought to impose tariffs to the value of some $4 billion against the US for the US non-compliance with the WTO rulings in connection with the FSC legislation. The United States challenged the appropriateness of the proposed EU countermeasures. However, under a WTO Arbitration ruling issued on the 30th August 2002 the EU has been given the authority to take countermeasures and suspend concessions under the WTO, up to a maximum amount of $4,043 million per year of tariffs, as of the year 2000, the year when the United States was supposed to implement the WTO rulings on its FSC legislation[9].

The relevant WTO jurisprudence generated by the various disputes contains important lessons, for the membership of the WTO, in the formulation of national tax policy — particularly the reach of WTO obligations with respect to direct taxation, in addition to touching on certain systemic WTO issues, particularly related to subsidies. Most developing members of the WTO will have to bear the full weight of the WTO Subsidies Code after the end of the transitional period for exemption from the prohibition of export subsidies to non-agricultural products.

2. The DISC, FSC and ETI Legislation

In a nutshell, the DISC, FSC and ETI are three regimes under which qualified US exporters are offered substantial tax benefits on income derived from the export of "export property". Export property has generally been defined as property manufactured, produced, grown or extracted in the United States, and sold, leased or rented *for use outside the United States*, with no more than 50% of its fair market value attributable to imports. The value of the tax subsidy is comparatively similar under the different regimes, although the respective legal frameworks

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[7] The destination principle does not apply to direct taxes

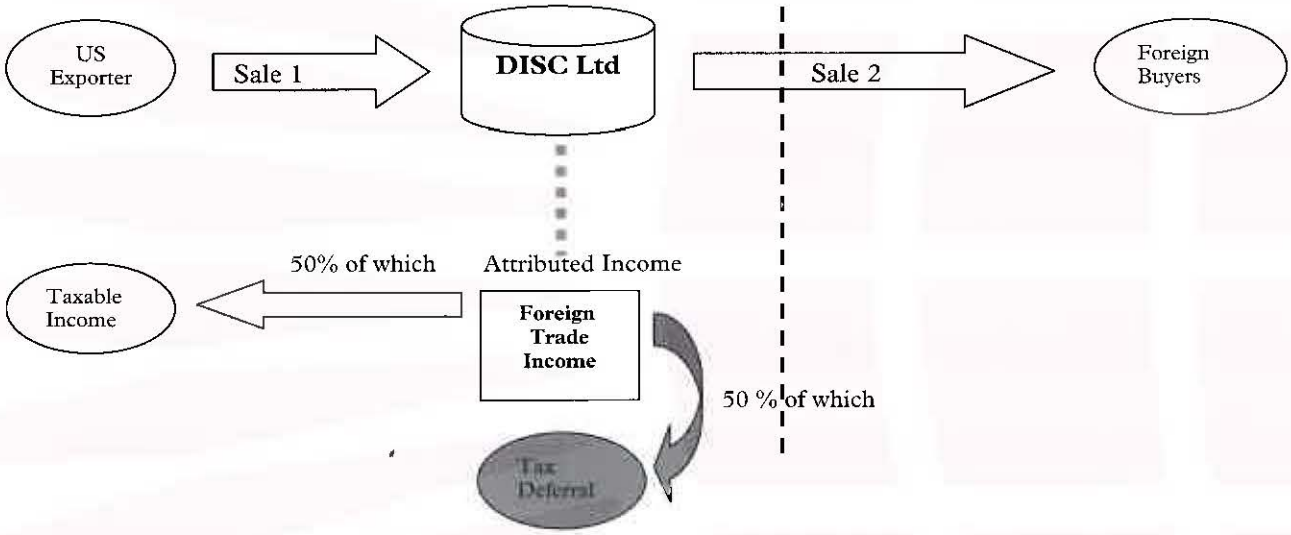
[8] For example in the DISC Case the GATT Panel held that the provision in the DISC regime allowing 10% of export promotion expenses assigned as a deductible expense to a DISC amounted to an additional pecuniary benefit. See GATT Panel Report on the ISC case BISD, 23rd Supplement.

[9] Op cit footnote 2.

have been amended to reflect the different WTO rulings. Thus, the tax benefits essentially take the form in the case of the DISC of a *deferral* of tax liability, in the case of the FSC of an *exemption* from taxation, and in the case of the ETI of an *exclusion* from taxation.

The DISC Regime

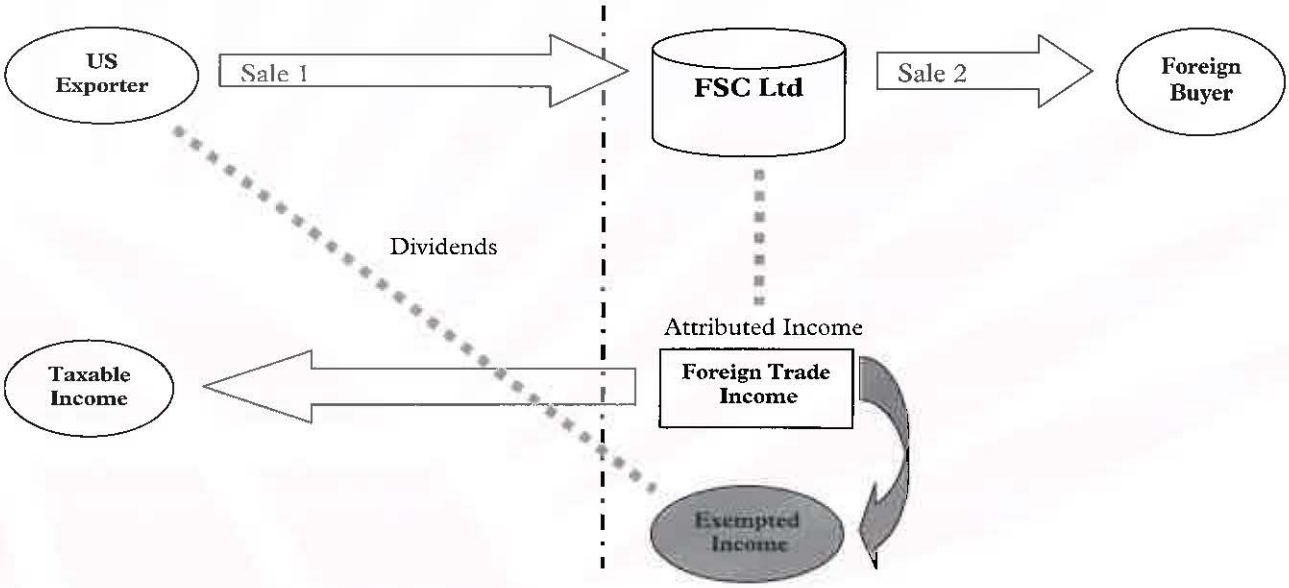
Under the DISC legislation[10], US companies were given the opportunity to benefit, *inter-alia*, from a tax deferral on a portion of the profits generated from export activities, for an indeterminate period of time. For this purpose, they were invited to set up a DISC, through which their exports would be channelled. The US exporter would first sell the goods or services to the US DISC, which would then resell them to the foreign buyer. A share of the exporter's profits would then be attributed to the DISC *via* the application of three administrative formulas, which at the discretion of the US exporters would yield the maximum subsidy[11]. Half of the DISC's profits were deemed redistributed to the US exporter and therefore subject to taxation. Taxation on the other half would be deferred for an indefinite period — effectively tax exempt. The primary function of a DISC was to reduce the fiscal liabilities of US exporters on the profits they realised from their exports.



The FSC Regime[12]

The FSC regime was more sophisticated, as it attempted to implement the DISC Panel decision and respond to the criticisms that the DISC regime was nothing other than a domestic tax haven. Under the FSC regime, while the transaction would involve two successive sales, the FSC had to be incorporated in an "accepted jurisdiction" i.e., outside the US. The FSC would then be attributed a share of the income derived from export activities. A portion of it would be deemed not connected with the conduct of business in the US, and therefore exempt from US taxation. The remaining portion would fall under the net of US taxation. In contrast to a DISC, the revenue of a FSC was based on the economic role it fulfilled — such as contract negotiation, solicitation, arranging deliveries, shipments, *etc.* Moreover, a FSC would have to bear some direct costs involved in the export transaction. Dividends distributed by the FSC to the US parent company would be eligible to a 100% deduction.

[10] Incorporated in Section 991-997 IRC.
[11] Similar to those mentioned in footnote 4.
[12] Incorporated in Sections 921-827 IRC.

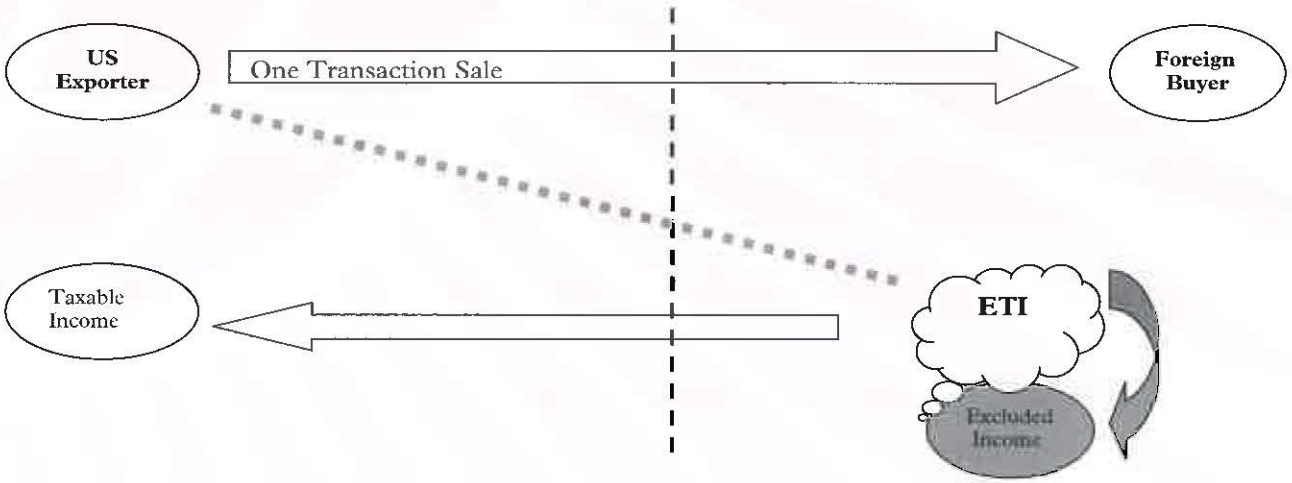


The ETI Regime[13]

Under the ETI regime, a portion (Excluded Income) of the income that can be attributed to foreign economic processes (Extraterritorial Income or ETI) is *excluded* from gross taxable income. The ETI and the Excluded Income are calculated in very similar ways to the Foreign Trade Income and the Exempted Income under the FSC regime.

The ETI is an "income" concept rather than corporate entity-related. The main difference with the previous regimes is that the benefit is made directly available to US exporters, in the sense that the export property need not be channelled through a specifically created separate entity (e.g., a FSC or a DISC). Moreover, US exporters wishing to benefit from ETI benefits are not required to notify the IRS or elect to be treated under the ETI regime. However, ETI rules may not be used in conjunction with foreign tax credits.

The ETI benefits have been extended to foreign companies, provided that they elect to US fiscal residence. The ETI benefits are also made available in relation to property produced outside the US, whereas previous regimes had restricted the subsidy to property produced within the US. However, the ETI benefits remain contingent upon the consumption of the export property outside the US.



[13] Section 114 IRC.

3. The WTO Panel and Appellate Body Deliberations

In 1976, a GATT Panel[14] ruled that the DISC legislation:

- Conferred a tax benefit by way of a subsidy [through a *deferral* of tax payment, the manner of allocation of profits between parent companies and DISCs, and the allowance of export promotion expenses], that was related to US exports, and thus not consistent with US obligations under Article XVI: 4 of GATT 1947.

This GATT Panel Report was adopted, *inter-alia,* on the basis of the 1981 GATT Council Understanding that:

- *"...in general, economic processes 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."*[15]

In other words, if the DISC fulfilled an economic function, and its income was generated outside the US, then the US could exempt the whole or a part of that income.
To comply with the GATT ruling on DISC, as conditioned by the 1981 Understanding, the US adopted in 1984 the FSC legislation.[16] Some fourteen years later, the FSC was challenged by the EU (1998).[17] The WTO Panel and Appellate Body found:

- the FSC regime to constitute an export subsidy contingent upon export performance, contrary to both the WTO Subsidies Code, and the Agreement on Agriculture[18].
- The FSC tax exemptions were considered "*financial contributions*", as the US government had foregone revenue otherwise due. This conclusion was arrived at by applying the "*but for test*" — i.e. through a comparison between the revenues due under the FSC and the revenues due without the FSC measure. This comparison was made on the basis that what is "otherwise" due is informed by the rules of taxation that each member of its own choice establishes. In this instance, it was clear that US exporters derived between 15% and 30% tax saving as a result of the measure[19].
- US claims that the issue at hand concerned transfer pricing — which in accordance with footnote 59 of the WTO Subsidies Code "*should normally*" be resolved "*using the facilities of existing bilateral treaties or other international mechanisms*" were rejected[20].
- Similarly, the US claim that the FSC legislation should be read in the light of the 1981 Council Understanding was rejected, as it did not form part of the law of the GATT 1994, nor did it constitute subsequent practice in the application of GATT 1947 of the contracting parties to the GATT[21].

The US was therefore requested to bring its legislation in line with its WTO obligations by October 1, 2000.[22] In November 2000, the US Congress passed the ETI Act, and repealed the

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[14] United States Tax Legislation [DISC] Panel Report 12th November 1976 [L/4422] BISD, 23rd Supplement.
[15] BISD 28S/114. The 1981 GATT Council action represents the adoption by the GATT CONTRACTING PARTIES of four controversial Panel reports regarding tax measures of France, Belgium, the Netherlands and the United States.
[16] Income Tax Reform Act 1984, incorporated in sections 921-927 IRC
[17] EU sought consultation under Art. 4 DSU, Art. XXIII. 1 GATT 1994 and Art. 4 SCM Agreement, 18 November 1997, WT DS108/1, 28 Nov. 1997.
[18] WTO Panel Report [1999]: United States -Tax treatment for "Foreign Sales Corporations" [WT/DS108/R]. WTO Appellate Body Report [2000]: United States –Tax treatment for "Foreign Sales Corporations" [WT/DS108/AB/R].
[19] ibid Panel Report paragraphs 7.41-7.85 and 7.86-7.119.
[20] ibid paragraphs 7.12-7.22.
[21] ibid paragraph 7.85.
[22] US-Tax Treatment for Foreign Sales Corporations, WT/DS108/AB/R 2000. The deadline was later extended to November 1 then November 17 with the consent of the EU.

FSC legislation. However, the EU alleged that this legislation was not in conformity with the WTO ruling on the US FSC legislation, and violated *inter-alia* the WTO Subsidies Code. In a similar reasoning to that applied in the FSC dispute, a WTO Panel and the Appellate Body:

- Found that the ETI regime constituted a prohibited export subsidy, because the export contingency remained for property produced within the US[23].
- Moreover, the transition rules laid down by the ETI were found in violation of Article 4.7 of the WTO Subsidies Code, and the previous WTO ruling on the FSC, in that it remained perfectly possible for operating and established FSC's to be used until 31 December 2001.[24]
- The US argument that the ETI legislation was a measure to eliminate double taxation was rejected, because the ETI excluded income that could not possibly be legitimately taxed in any other jurisdiction[25].
- The ETI was also found to violate the Agreement on Agriculture and the national treatment standard under GATT 1994[26].

Finally, the US challenged the appropriateness of the level of the proposed EU countermeasures for its non-implementation of the WTO rulings on the FSC legislation. The Arbitration Panel dealing with the US challenge authorised the EU to suspend concessions under GATT 1994 "in the form of the imposition of a 100 per cent *ad valorem* charge on imports of certain goods from the United States in a maximum amount of $4,043 million per year"[27], until the US complies with the WTO rulings on its FSC legislation[28]. The award was calculated using the year 2000 as the year of assessment, it being the year when the US should have implemented the WTO ruling on the FSC legislation. The award was justified on the following grounds:

- Under the WTO Subsidies Agreement the countermeasures had to be "appropriate" i.e., the countermeasures "must be suitable or fitting" in the particular circumstances in question[29]. Further, the countermeasures should not be "disproportionate[30]" i.e., disproportionate in the light of the fact that the subsides under the provision are prohibited. In other words, the appropriateness of the countermeasure is to be informed by the "nature and legal status of the particular underlying measure in respect of which the countermeasures are applied"[31]. In the particular case the subsidy is a prohibited subsidy and therefore it informs by aggravating rather than mitigating the appropriateness of the countermeasure[32].
- "Appropriate countermeasures" under the Subsidies Agreement, in the circumstances in question involving prohibited subsidies, are not limited to measures equivalent to the "trade effect" on the complaining WTO member, rather they are informed by the nature of the illegality in question, so as to induce compliance[33]. However, where the

[23] US-Tax Treatment for Foreign Sales Corporations, WT/DS108/AB/R 2000. The deadline was later extended to November 1 then November 17 with the consent of the EU.
[24] Ibid. The transition rules preclude the establishment of FSCs after 30 September 2000.
[25] Ibid.
[26] Ibid.
[27] Op cit footnote 2 para 8.1.
[28] ibid para 5.5.
[29] ibid para 5.12.
[30] ibid para 5.15.
[31] ibid para 5.22.
[32] ibid 5.23.
[33] ibid paras 5.30 and 5.60.

trade effect is greater than the subsidy, the trade effect has a role in the determination of the "appropriateness" of the countermeasure[34].

- The countermeasures proposed by the EU mirror the total amount of the US fiscal subsidy. The financial contribution by the US in the subsidy reflects accurately its involvement in the subsidy; and therefore that fact has an important and fundamental role with respect to the evaluation of the countermeasure[35]. The proposed EU countermeasures are proportionate in relation to the amount of the US export subsidy[36].
- The US obligation not to engage in prohibited subsidies is not mitigated by the fact that some of the subsidy impacts on its other trading partners. The US obligation is *erga omnes* owed in its entirety to any WTO member[37].
- In the circumstances in question the EU was the only complainant. However, had there been multiple complainants, that fact would be relevant in evaluating what constitutes "appropriate countermeasures"[38]. Similarly, in the event of future complaints under these circumstances, those complaints would give rise to a different situation for assessment of "appropriateness", and conceivably give rise to the allocation of the amount of countermeasures amongst the complainants[39]. In this respect the Arbitration Panel noted the EU willingness to share the task of applying the countermeasures against the US with other members[40].

4. National and International Implications

The US fiscal subsidies and the consequent WTO rulings touch upon a number of trade, as well as taxation issues; and which have an impact for national systems, as well as the international trading order.

Taxation:

- Direct Taxes: Taxation being the hand-maiden for national policy makers to secure a universe of national economic and social objectives, including trade policy — its interface with international trade regulation is consequently somewhat inevitable. In the context of the WTO the focus on this interface has hitherto been more pronounced in terms of indirect taxation. However, the WTO rulings on the US fiscal subsidy cases provide ample demonstration that direct taxes can equally be the subject of WTO disciplines.
- National sovereignty in taxation: Apart from border taxes, the WTO Agreements do not limit the fiscal sovereignty of a member in raising revenue. Members in fact enjoy a broad range of discretion in relation to their internal tax policy. This involves the freedom to decide the objectives, level, principles and methods of the system of internal taxation as it affects goods and services.
- Limits on national fiscal sovereignty: National fiscal sovereignty is constrained by the WTO agenda of trade liberalization i.e., the trade-related aspects of international

[34] ibid para 6.33 and footnote 84.
[35] ibid para 6.20.
[36] ibid para 6.15.
[37] ibid para 6.10.
[38] ibid para 6.27.
[39] ibid para 6.29.
[40] ibid

taxation. In particular, the national remit has been limited by the WTO prohibitions on discriminatory and protective taxation, subsidies through taxation, and allied fiscal obstacles related to the flow of goods and services.

- Measures to avoid double taxation: Members have a wide degree of discretion in adopting measures to avoid double taxation, but the national measures to avoid double taxation must be in relation to *foreign-source income* and not just any income. Thus, only income that can be taxed in a foreign State as well as the State taking measures to avoid double taxation, qualifies[41].
- Harmful tax competition: At a time when the OECD has been at the forefront of fighting harmful tax competition, the exploitation by the US of tax havens and low tax jurisdictions, as part of its apparatus for the maintenance of its fiscal subsidies for exports, raises questions in terms of the further development of an international code on harmful tax competition. It is the case though that in so far as the WTO rulings are concerned, they do not touch upon the international efforts to deal with harmful tax competition as such.

Trade:

- Generally, the US DISC/FSC and ETI fiscal subsidies have involved substantial subsidies — to the tune of about 4 billion US dollars a year.
- The subsidies have allowed US exporters to lower the prices of their exports in the domestic markets of other countries, as well as their respective foreign markets [i.e., third country markets].
- The subsidies have been very wide ranging, involving both goods and the services sector.
- The subsidies benefit export sectors which raise moral, social and political concerns, for example, armament and tobacco exports. In US Congress debates relating to the FSC/ETI legislation, it has been pointed out, based on US IRS statistics that US tobacco companies have enjoyed FSC tax breaks to the tune of more than $100 million a year.
- The subsidies benefit some of the largest and most profitable corporations in the world, for example Boeing, General Motors, R.J.Reynolds, Motorola, Cisco Systems, Monsato and Microsoft. Indeed, according to reports in the US congress, 78% of FSC tax benefits have gone to companies with assets exceeding $1 billion.
- Some of the subsidies are in sectors where the need for such assistance has been questioned[42]. Thus, US armament exports, it has been observed, are already very competitive in the international market. Similarly, it has been claimed, the US pharmaceutical sector benefits already from substantial research and development tax credits. Some drug companies have been noted to have been amongst the most profitable enterprises.
- The FSC system necessitated the establishment of offshore companies. The repeal of FSC has had some impact on the economies where these were set up, normally low or

[41] See United States – Tax Treatment for "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the EU [WT/DS108/AB/RW] paragraphs 138-186.

[42] See statements made in US Congress in the context of repeal of the US FSC legislation in particular statements by Mr Stark [106th Congress, 2nd Session, 146 Cong Rec H 7416, vol.146, No.106.

no tax jurisdictions. These economies benefit from licence fees, remuneration for attorneys and other professionals, including bank deposits and funds generated by the use of hotels and restaurants etc. Most of the FSCs were however incorporated in the US Virgin Islands and Guam[43]. The revenue implications therefore for the Caribbean financial centres are relatively smaller than that for the US possessions[44].

- The continued maintenance of these US fiscal subsidies will challenge the international trading system. In particular, the ability of the WTO to manage trade wars rather than concentrating its attention to the liberalization of international trade. The circumstances have entitled the EU to impose the largest retaliatory sanctions in the history of international trade. Although such retaliatory punitive sanctions, if actually enforced by the EU, will only exacerbate international trade relations.

Developing countries:

- The subsidies have been wide ranging and have included, in particular, sectors that are of especial interest to developing countries, for example agriculture, pharmaceuticals, and the software industry. On the other hand the subsidies exclude sectors in which subsidies might be beneficial to developing countries, for example fiscal subsidies in the intellectual property rights sphere, petroleum and unprocessed timber.
- The subsidies benefit export sectors [for example tobacco and armaments] which challenge in particular the moral, social and political vulnerabilities of developing countries.
- The Arbitration Award of 4 billion countermeasures in favour of the EU[45], although in theory does not preclude other complainants from pursuing litigation in the WTO against the US in respect of the same fiscal subsidies, leaves some uncertainty as to the precise mechanisms involved in relation to the allocation of the countermeasures for future WTO member litigants. Indeed, by making such an award to the EU the Arbitration Panel raises the question whether *de facto* it has handed the lead policing role of WTO norms to the EU in respect of the US fiscal subsidies in question. In particular, the award raises the question whether the litigation choices for WTO members generally, and more particularly developing members, have been complicated in relation to these specific US fiscal subsidies. Developing members may well be more prone to allowing the EU to take the leadership role here.

[43] According to one set of statistics for 1992 found on the US IRS website some 74 percent of FSCs were incorporated in US possessions. See Sarah E.Nutter "Statistics of Income Studies of International Income and Taxes", WWW.IRS.USTREAS.GOV

[44] In the case of Barbados at the end of 2000, the total number of FSCs was 2,975 [WTO Trade Policy Review Barbados 2002: Report of Barbados]. Following the WTO Panel and Appellate Body rulings on the FSC the number of new FSCs declined to 118 in 2000, down from 384 licensed during 1997. As a consequence the Barbados authorities estimated a decline in income from licensing fees. For about 2,500 FSCs in 1999, the contribution to government revenue in terms of licence fees was about BDS$3.6 million [See WTO Trade Policy Review Barbados 2002: Report of the Secretariat]

[45] Op cit footnote 2

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