

Rethinking Tax-Based Export Incentives: Converting Repeated Defeats Before the WTO into Positive Tax Policy

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I. INTRODUCTION

To say that the U.S. tax system is complicated would be a gross understatement. Indeed, as one commentator accurately puts it, “[s]ome problems are so complex that you have to be highly intelligent and well informed just to be undecided about them.”¹ The degree of intricacy becomes even greater when dealing with international taxation, a situation that yields contrary results. On one hand, the convoluted nature of the international tax rules provides plentiful billing hours for tax attorneys, accountants, and other tax professionals. On the other hand, the complexity of the tax rules applicable to those operating in the global arena allows for obfuscation, which, in turn, leads to consequences that benefit particular U.S. companies to the detriment of the United States as a whole. In the words of one former international tax attorney with the Internal Revenue Service, “[w]e international tax practitioners have a tendency to get bogged down among

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1. Ron Pearlman, *Transition Issues in Moving to a Consumption Tax: A Tax Lawyer’s Perspective*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 393 (Henry J. Aaron & William G. Gale eds., 1996) (quoting PETER J. LAURENCE, PETER’S ALMANAC (1982)).

the trees (of which there are many) and seldom step back to view the forest as a whole.”² While this propensity to focus on details is normally a laudable characteristic for those in the tax field, it occasionally produces questionable tax policy. This article examines just such a situation.

The U.S. government has provided tax-based export incentives to certain companies for more than a half-century. Although the form of the incentives changes somewhat, the end result is the same: the World Trade Organization (WTO) has repeatedly ruled that each is an illegal export subsidy that violates the international obligations of the United States. As such, the WTO has directed the United States to revoke each export-promotion program or face retaliatory sanctions by major U.S. trading partners. To date, the United States has been notably averse to eliminating these programs, opting instead to slightly modify the law at issue, a strategy that has merely served to perpetuate the conflict between the European Union (EU) and the United States. Ironically, the overwhelming majority of literature on this tax/trade issue indicates that complying with the WTO rulings (i.e., completely eliminating tax-based export promotion programs) would actually benefit the U.S. economy as a whole. Unfortunately, those pesky trees continue to obscure the view of many.

In an attempt to see the entire forest, this article is organized in the following manner. Section II provides a brief history of the major tax-based export incentives used by the United States, focusing on the reasons why the WTO mandated their elimination, and why the United States must expeditiously identify and implement a new solution. In Section III, this article examines a variety of proposals triggered by the recent defeat of the Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act (ETI Act) before the WTO. These proposals include: (a) ignoring the WTO decision and simply risking retaliation by the EU; (b) overhauling the entire U.S. international tax system; (c) assuming an offensive position by challenging various EU tax systems before the WTO; (d) reaching a negotiated settlement between the United States and the EU outside the context of the WTO; (e) postponing resolution of the issue until the next round of WTO negotiations in 2005; (f) modifying the ETI Act in such a manner that it is in accordance with the WTO rules; (g) bringing the dispute before another forum such as the Organization for Economic Cooperation and Development (OECD); and (h) relying on floating exchange rates to rectify the problem. Based on this detailed review, Section III determines that each of these proposals is politically or economically unfeasible. After acknowledging the complexity of international tax law and the tendency to become engrossed in the minutiae, Section IV relies on an abundance of studies and commentary issued by legislative committees, academics, government agencies, reputable think tanks, economists, and trade specialists to identify and criticize the root of the problem: export incentives, tax-based or otherwise. In light of the implausibility of the solutions proposed thus far and cognizant of the significant lobbying power wielded by the beneficiaries of the ETI Act, Section V explores a two-part solution consisting of the immediate (but perhaps temporary) repeal of the ETI Act, and the establishment of a new multilateral forum designed to resolve conflicts involving fields that are often treated separately despite the tremendous amount of overlap between the two: international trade and international tax.

II. BRIEF HISTORY OF TAX-BASED EXPORT INCENTIVES

The United States has a long history of providing export incentives that serve to lessen the overall tax burden on export income, thereby enabling U.S. exporters to charge

2. *Impact of U.S. Tax Rules on International Competitiveness: Hearing Before the House Comm. on Ways and Means*, 106th Cong. 95 (1999) [hereinafter *Impact of U.S. Tax Rules*] (statement of Hermann B. Bouma, International Tax Attorney, Buchanan Ingersoll).

lower prices for their goods and services without reducing their net profit.³ The export incentives have come in several forms over the years, including tax reductions of various degrees, outright tax exemptions, and tax deferrals on some or all of the income earned from exportation.⁴ The first tax-based export incentive program involved Western Hemisphere Trade Corporations (WHTCs), which were eligible for a 14% reduction in the normal corporate tax rate provided they met a number of conditions.⁵ By passing the WHTC provisions in 1942, the U.S. government hoped that the tax-rate reduction would trigger increased U.S. direct investment throughout the entire Western Hemisphere. However, time reveals that the majority of WHTCs were simply export arms of U.S. manufacturers.⁶

With the goal of stimulating the exportation of American manufactured goods through U.S. affiliates rather than foreign affiliates, Congress created its second major tax-based export incentive program in 1971. By enacting Sections 991 to 997 of the Internal Revenue Code (Code), Congress granted special tax benefits to Domestic International Sales Corporations (DISCs).⁷ In short, these new provisions abandoned the traditional U.S. system of taxing domestic corporations on their worldwide income, taxing instead only a DISC's income that was distributed (actually or constructively) to its shareholders.⁸ This allowed the DISC to effectively defer the recognition of, and thus tax on, approximately 50% of its income.⁹ Shortly after its introduction, several General Agreement on Tariffs and Trade (GATT) signatories criticized and formally denounced the DISC for allegedly providing an illegal export subsidy by allowing an indefinite tax deferral on the income earned from activities located in the United States and not charging interest on the deferred tax.¹⁰ In 1976, a GATT panel upheld the validity of this complaint.¹¹ While the United

3. CHARLES H. GUSTAFSON ET AL., *TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXTS AND PROBLEMS* 853 (2d ed. 2001). According to these authors, "[o]ver the years Congress has followed a fairly consistent pattern of providing tax incentives to encourage exports. The most obvious examples have been the Western Hemisphere trade corporations, the export trade corporation, the DISC, the FSC and, most recently, the exclusion of qualifying foreign trade income." *Id.*; see also Mihir A. Desai & James R. Hines, Jr., *The Uneasy Marriage of Export Incentives and the Income Tax*, in 15 *TAX POLICY AND THE ECONOMY* 41, 55-59 (James M. Poterba ed., 2001). This study demonstrates that, regardless of one's personal feeling regarding the value of export incentives for society in general, these incentives substantially affect the behavior of U.S. exporters. *Id.* at 43-44. In support of this conclusion, this study examines the following: (i) the impact of the repeal of the DISC in 1984 and the transition to the FSC regime, (ii) the effect on the U.S. dollar when the EU submitted its complaint before the WTO in 1997 regarding the FSC regime, and (iii) the fluctuations on the U.S. stock market resulting from the WTO complaint. *Id.* at 79-91.

4. GUSTAFSON ET AL., *supra* note 3, at 853.

5. I.R.C. § 921 (1976). To qualify as a WHTC, a corporation had to meet the following conditions: (i) it must have been organized in the United States, thereby making it a domestic corporation, (ii) all of its business, with the exception of incidental purchases, must have been conducted within the Western Hemisphere (i.e., in North America, Central America, or South America) or the West Indies, (iii) 95% or more of its gross income during a three-year period must have been derived from foreign sources, and (iv) 90% or more of such income was attributable to the active conduct of a trade or business. *Id.*; see also Leo J. Rashkind, *The Western Hemisphere Trade Corporation: A Functional Perspective*, 16 *VAND. L. REV.* 1, 6-7 (1962).

6. BORIS I. BITTKER & LAWRENCE LOKKEN, *FUNDAMENTALS OF INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS* 71-73 (2002).

7. See I.R.C. §§ 991-997 (1994).

8. I.R.C. §§ 991, 995.

9. BITTKER & LOKKEN, *supra* note 6, at 71-76. In order to make the DISC program more efficient while continuing to provide the same incentives to export, in 1976 Congress modified the DISC provisions slightly. Under these adjusted rules, the privilege of deferring the taxation on income earned applied to approximately 50% of the amount by which the current earnings of a DISC exceeded 67% of its earnings during a four-year based period. *Id.*

10. STAFF OF JOINT COMM. ON TAX'N, 107TH CONG., *BACKGROUND AND HISTORY OF THE TRADE DISPUTE RELATING TO THE PRIOR-LAW FOREIGN SALES CORPORATION PROVISIONS AND THE PRESENT-LAW EXCLUSION*

States refused to concede that the DISC generated an illicit export subsidy, it nevertheless agreed in 1981 to adopt the reports issued by a GATT council decision.¹² Despite this apparent general accord, a vigorous debate ensued regarding the interpretation of the GATT decision and its applicability to DISCs. In response to the threat of retaliatory action by the EU, the United States agreed, albeit reluctantly, to eliminate the DISC and introduce a third export-incentive program that was designed to comply with its international obligations.¹³ The Foreign Sales Corporation (FSC) was thus born in 1984.

Normally, an FSC was a wholly-owned foreign subsidiary of a U.S. corporation.¹⁴ The FSC sold products supplied by its U.S. parent and elected to receive FSC treatment.¹⁵ Under the relevant provisions of the Code, a portion of the income that the FSC earned from “qualifying export transactions” with a U.S. affiliate was characterized as foreign-source income that was not connected with an American trade or business and thus not subject to U.S. tax.¹⁶ In addition, an FSC was not subjected to treatment under Subpart F of the Code.¹⁷ Consequently, the combined income earned by the FSC and its U.S. affiliate from qualifying export transactions was subject to a tax rate of less than 30%, whereas a tax equal to 35% of this income would have normally been imposed.¹⁸ Along with the reduced tax rate, dividends that were distributed by an FSC to a U.S. corporate shareholder qualified for a 100% dividends-received deduction, thereby allowing the FSC to repatriate its earnings to its U.S. parent corporation without incurring any U.S. tax liability.¹⁹

As if experiencing a distressing *déjà vu*, the United States again found its legislation criticized and legally challenged under the WTO by the EU. Just as it did in the case regarding the DISC, the WTO found in October 1999 that the tax benefits afforded by the FSC violated the relevant WTO rules (i.e., the Agreement on Subsidies and Countervailing Measures) since these benefits were contingent on export performance.²⁰

FOR EXTRATERRITORIAL INCOME AND A DESCRIPTION OF THESE RULES 2 (Comm. Print 2002) [hereinafter BACKGROUND].

11. *Id.*

12. *Id.*

13. *Id.* at 2–3.

14. See GUSTAFSON ET AL., *supra* note 3, at 815–16.

15. STAFF OF JOINT COMM. ON TAX’N, 106TH CONG., DESCRIPTION OF H.R. 4986 (THE “FSC REPEAL AND EXTRATERRITORIAL INCOME EXCLUSION ACT OF 2000”) 2 (Comm. Print 2000) [hereinafter DESCRIPTION]; see also BACKGROUND, *supra* note 10, at 8–9.

16. I.R.C. § 921(a) (2000).

17. I.R.C. §§ 951–964 (2000). In the parlance of international tax, the commonly-used term “Subpart F” refers to the following portion of the United States Code: Title 26 (Internal Revenue Code), Subtitle A (Income Taxes), Chapter 1 (Normal Taxes and Surtaxes), Subchapter N (Tax Based on Income from Sources within or without the United States), Part III (Income from Sources without the United States), Subpart F (Controlled Foreign Corporations). Enacted in 1962, Subpart F is designed to discourage U.S. taxpayers from using foreign corporations to defer paying U.S. taxes by accumulating income in foreign corporations that are located in low-tax jurisdictions. See, e.g., GUSTAFSON ET AL., *supra* note 3, at 407; *The WTO’s Challenge to the FSC/ETI Rules and the Effect on America’s Small Businesses: Testimony Before the House Comm. on Small Bus.*, 108th Cong. (May 14, 2003) (statement of Gary Clyde Hufbauer, The Reginald Jones Senior Fellow, Inst. for Int’l Econ.), available at <http://www.house.gov/smbiz/hearings/108th/2003/030514/hufbauer.html> (last visited Nov. 3, 2003). In short, if a foreign corporation is a “controlled foreign corporation” for a specified period of time, then each “U.S. shareholder” in this controlled foreign corporation must include in its gross income its pro rata share of any “Subpart F income.” I.R.C. § 951(a)(1). In effect, the U.S. shareholder is taxed on its proportionate share of the income generated by the foreign corporation that it controls even though, in reality, it never receives a dividend during that particular year. See I.R.C. § 951(a)(2). For a brief explanation of the operation of Subpart F, see RICHARD L. DOERNBERG, INTERNATIONAL TAXATION IN A NUTSHELL 294–311 (5th ed. 2001).

18. DESCRIPTION, *supra* note 15, at 3; see also BACKGROUND, *supra* note 10, at 8–9.

19. BACKGROUND, *supra* note 10, at 9.

20. *Id.* at 4–8.

In an effort to placate the EU, the United States, still unwilling to completely surrender its support of exports, enacted the ETI Act in November 2000.²¹ This new legislation repealed the FSC rules and replaced them with a tax exclusion for U.S. taxpayers on income that meets the definition of “qualifying foreign trade income.”²² Attempting to rectify the problem that the incentives under the FSC regime were deemed to be export contingent, this new tax exclusion was not limited to income from U.S. exports, did not require the use of a foreign corporation, and allowed the manufacturing to be conducted outside of the United States.²³ Upon promulgating the ETI Act, the official stance of the U.S. government was acquiescence with a healthy dose of indignation, as evidenced by statements from congressional committees:

The Committee [on Ways and Means] hopes and expects that the European Union will regard this legislation as a faithful and responsible implementation of the WTO rulings in this dispute, understanding that each WTO member enjoys a sovereign right to decide its own system of taxation within the parameters of its international obligations.²⁴

At that time, however, many warned that the changes in the ETI Act were superficial and would therefore be considered a continued violation of the WTO rules. This, they claimed, placed the United States “on shaky ground.”²⁵ In criticizing the passage of the ETI Act, other commentators were far less charitable, comparing the United States to an undisciplined and pathetic Charlie Brown from the Peanuts cartoon.²⁶ Self-serving statements and predictions by the U.S. government notwithstanding, the EU challenged the ETI Act shortly after its enactment, claiming, as it did both in the case of the DISC and the FSC, that this legislation violated the obligations of the United States under the WTO.²⁷ As expected, the United States exhibited increased exasperation and again requested that the

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

22. DESCRIPTION, *supra* note 15, at 5–6.

23. See generally *id.*; BACKGROUND, *supra* note 10.

24. H.R. REP. NO. 106-845, at 9, 15 (2000). This report explicitly states in multiple places that the changes to the tax code should place the United States in full compliance with its obligations under the WTO. It states, for instance, that “[t]o retain a competitive balance for U.S. businesses that compete in the world market, the bill modifies the taxation of foreign trade income to comply with the standards set forth in the decisions of the WTO dispute panel and Appellate Body.” *Id.* at 9.

25. Sarah Ostergaard, *The Third Strike: United States’ Attempts at Achieving Tax Parity Between Its Income Tax and the European Value-Added Tax*, 27 J. LEGIS. 421, 438 (2001).

26. Mark A. Luscombe, *What to Do About International Taxation?*, TAXES: THE TAX MAGAZINE, Mar. 2002, at 5. To describe his sentiment that a loss before the ETI Act was a foregone conclusion, this author makes the following comparison:

It looks like Lucy once again has pulled the football away from Charlie Brown just as he was prepared to kick one through the uprights. Lucy is in the guise of the World Trade Organization (WTO), Charlie Brown is in the guise of the United States, and the football is the dispute over the U.S. Foreign Sales Corporation (FSC) and Extraterritorial Income (ETI) regimes. The United States is now lying on the ground trying to figure out how the ball could have been pulled away again this year, while everyone watching from home knew full well that it would happen once again Most people thought the change to the ETI looked a little too cute to change the outcome, but Charlie Brown just had to give it one more try.

Id.

27. BACKGROUND, *supra* note 10, at 4–8.

EU accept the ETI Act by withdrawing its complaint.²⁸ To the chagrin of U.S. officials, this request fell on deaf ears. In August 2001, the WTO also decided in favor of the EU, holding that the ETI Act (i) involves forgoing revenue that is otherwise due and therefore is tantamount to a “subsidy”; (ii) includes subsidies that are contingent upon export performance; (iii) does not qualify for the exception from treatment under the WTO as an illegal export subsidy in order to avoid imposing double taxation on income from foreign sources; (iv) is inconsistent with other U.S. trade obligations since it offers less favorable treatment to imported goods than it does to domestic goods; and (v) did not completely repeal the FSC rules that were previously found to constitute an illicit tax-based export subsidy.²⁹ Despite an appeal filed by the United States, the WTO upheld its earlier decision in July 2002, and shortly thereafter the WTO determined that the EU was entitled to take retaliatory action against the United States.³⁰

In accordance with the WTO holding, in September 2002 the EU published a list that contemplated \$15 billion worth of U.S. exports that could potentially be subjected to tariff sanctions.³¹ Despite releasing this list that contains amounts far exceeding those authorized by the WTO in order to place American exporters and the U.S. government at unease, the EU officially announced its desire to avoid triggering a transatlantic trade war. According to the European Commission Delegation in the United States, “[i]n an attempt to minimize the negative consequences that any eventual countermeasures [by the United States] could create for European industry, the [European] Commission has selected only products for which US exports to the EU represent a maximum of 20% of total EU imports of that product.”³² Notwithstanding this supposed desire to avoid a trade war, the EU Trade Commissioner took pains to make several points absolutely clear. First, the EU expects the United States to fully comply with the WTO ruling by repealing the ETI Act.³³ Second, enacting appropriate legislation to bring the Code into compliance with America’s international obligations is “a matter of urgency,” and thus should be completed in 2003.³⁴ Third, the possibility of delaying this issue until the next round of WTO negotiations scheduled to occur in 2005 is unacceptable.³⁵ Finally, since the EU is not eager to impose

28. Press Release, Office of the United States Trade Representative, Statement by United States Trade Representative Charlene Barshefsky and Treasury Deputy Secretary Stuart E. Eizenstat (Nov. 17, 2000) (on file with author). The former U.S. Trade Representative and the Treasury Deputy Secretary issued the following statement:

We regret that the EU has not accepted our new legislation. We continue to strongly believe that it is WTO-compliant, as it neither constitutes a subsidy nor is it export-contingent. The EU’s view is particularly disappointing given that the legislation represents an extraordinary bipartisan effort whereby the [Clinton] Administration worked with both houses of Congress to draft legislation, under an extraordinarily tight schedule, that complies with the ruling of the WTO Appellate Body. We ask the EU to again consider our new legislation to avoid a confrontation.

Id.

29. BACKGROUND, *supra* note 10, at 4–5.

30. Myrna Zelaya-Quesada, *U.S. Disputes EU Claim of \$4 Billion as Compensation in FSC Trade Sanctions*, 28 DAILY TAX REP. G-10 (Feb. 11, 2002); *see also* Daniel Pruzin, *U.S. Says Up to \$1.1 Billion in Sanctions May Be Justified for FSC/ETI Retaliation*, 40 DAILY TAX REP. G-6 (Feb. 28, 2002) (explaining that the United States unsuccessfully argued that \$4 billion per year in retaliation was exorbitant and urged the WTO to reduce this amount to approximately \$1 billion per year).

31. Joe Kirwin & Alison Bennett, *EU Issues List of Up to \$15 Billion in U.S. Exports Facing Possible Sanctions*, 179 DAILY TAX REP. GG-1 (Sept. 16, 2002).

32. European Commission Delegation, *Foreign Sales Corporations: EU Commission Announces List of U.S. Products Subject to Countermeasures*, 2002 WORLDWIDE TAX DAILY 180-15, para. 4 (Sept. 17, 2002).

33. Pascal Lamy, *EU Tax Commissioner Lamy’s Letter to Ways and Means Chair Thomas*, 2002 WORLDWIDE TAX DAILY 187-26, para. 4 (Sept. 26, 2002).

34. *Id.* para. 6.

35. *See id.* para. 7.

retaliatory sanctions on U.S. exports and spark further escalation of this conflict, it will postpone retaliation as long as the United States demonstrates that it is making “steady progress” toward eliminating the ETI Act.³⁶

In response to the recent actions and statements by the EU, the Bush administration has announced that rectifying the ETI Act issue is a “priority.”³⁷ As a demonstration thereof, White House officials have publicly urged Congress to rapidly address this issue in order to avoid retaliation.³⁸ Notwithstanding the obvious importance of this topic, Congress, true to form, seems to have embarked on a contentious and lengthy voyage toward resolution. For example, the only realistic piece of legislation introduced so far that addresses this issue, the American Competitiveness and Corporate Accountability Act of 2002 (American Competitiveness Act), has not garnered the support necessary to proceed down the congressional path.³⁹ Meanwhile, there exists a relatively influential group that advocates the formation of a working group composed of lawmakers, officials from the Bush administration, and business leaders to further examine the ETI Act and explore other alternatives.⁴⁰ After this working group’s initial meeting in September 2002, representatives admitted that the American Competitiveness Act was a “good starting point,” but cautioned that crafting and implementing an acceptable solution would be a lengthy process.⁴¹ In more precise terms, the working group (which made its announcement before the war with Iraq and other major international events that will likely take priority) estimated that it would not issue its recommendations until spring 2003 at the earliest.⁴² Other lawmakers argue that legislative action is not the proper response in the first place and insist that the Bush administration continue to urge the EU to agree to a negotiated solution.⁴³ Special-interest groups, for their part, have capitalized on this opportunity to lobby for changes to the U.S. tax system, ranging from the complete elimination of the income tax to milder variations of, or supplements to, the existing tax structure.⁴⁴

36. Bengt Ljung, *European Commissioner Urges U.S. to Act on FSC/ETI Now That Elections Are Over*, 227 DAILY TAX REP. G-8 (Nov. 25, 2002).

37. Alison Bennett, *Subpart F, Foreign Tax Credit Rules Priorities in Updating International Regime*, Olson Says, 224 DAILY TAX REP. G-9 (Nov. 20, 2002). This statement was made by Assistant Treasury Secretary for Tax Policy, Pamela Olson. *Id.*

38. Alison Bennett, *Administration Urges Finance Action on ETI; WTO Retaliation Decision Pushed to August*, 147 DAILY TAX REP. G-11 (July 31, 2002).

39. David Benson et al., *Inside Washington*, INT’L TAX REV., Sept. 1, 2002, available at 2002 WL 15790712.

40. Alison Bennett, *Make New Law Top ETI Working Group Goal, Dam Says; Thomas Bill Wins Endorsement*, 186 DAILY TAX REP. G-10 (Sept. 25, 2002). Members of the group include Senator Max Baucus, Chairman of the Senate Committee on Finance; Senator Charles Grassley, Ranking Member of the Senate Committee on Finance; Robert B. Zoellick, U.S. Trade Representative; Kenneth Dam, Deputy Secretary of the U.S. Treasury Department; Representative Bill Thomas, Chair of the House Committee on Ways and Means; and Representative Charles Rangel, Ranking Member of the House Committee on Ways and Means. *Id.*

41. *Id.*; Alison Bennett, *Aide Says Grassley Sees Long Road Ahead in Finding Solution for Export Tax Regime*, 242 DAILY TAX REP. D-5 (Dec. 17, 2002) [hereinafter Bennett, *Aide*].

42. Bennett, *Aide*, *supra* note 41.

43. Myrna Zelaya-Quesada, *Baucus Pushes Negotiations with EU, not Legislation, to Resolve FSC Dispute*, 39 DAILY TAX REP. G-9 (Feb. 27, 2002).

44. See STAFF OF JOINT COMM. ON TAX’N, 104TH CONG., *IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX 66* (Comm. Print 1996) [hereinafter *IMPACT*]. This report contains a summary of several commonly discussed tax reform proposals.

III. A SURVEY OF EXISTING RESOLUTION THEORIES

As is true with all controversies, theories for resolving this issue abound. Examined below are the most prominent proposals, none of which appear politically or fiscally tenable.

A. *Simply Ignore the WTO Ruling and Risk Retaliation by the EU*

While there seems to exist a general consensus that simply ignoring the WTO ruling against the ETI Act and risking the multi-billion dollar retaliation by the EU would not be optimal,⁴⁵ this solution has been pondered by assorted tax experts and politicians. For instance, the current ranking member and former chairman of the powerful Senate Finance Committee, Senator Max Baucus, advocates (in apparent disregard for common kindergarten wisdom) the two-wrongs-do-make-a-right plan. Theorizing that the sole reason that the EU launched its complaints before the WTO against the FSC and the ETI Act was to vindicate its losses to the United States in earlier cases involving beef hormones and bananas, Senator Baucus implied that the United States should not alter its international tax regime to comply with the recent WTO ruling. According to this congressman:

The EU lost cases to the United States on beef hormones and on bananas. These were difficult issues for Europe. Yet, the EU did not seek a negotiated solution. Nor did they try to take corrective action. Instead, the EU used every legal and procedural trick in the GATT and WTO book to weasel out. They lost at every turn. This behavior of the EU, honoring the letter of the WTO while ignoring its spirit, is inappropriate and irresponsible. The EU should be a leader in ensuring that the credibility and integrity of the WTO process is maintained. They shouldn't be taking cheap legal dodges. Why should other WTO members comply promptly with WTO decisions if the EU thumbs its nose at the system?⁴⁶

In addition to this congressional support, the National Foreign Trade Council, a powerful lobbying group comprised of U.S. businesses engaged in all aspects of international business, trade, and investment, told key congressional committees that changes to U.S. tax law are not as urgent as they may appear since the EU is unlikely to impose sanctions in the near future regardless of U.S. inaction,⁴⁷ presumably because doing so would inevitably damage many European businesses. Concurring with this theory, others have compared the EU Trade Commissioner to the bewildered “dog who caught the bus,” since, in an ironic

45. Brenda O'Leary, *The Continued Viability of Foreign Sales Corporations (FSCs): An Analysis of the WTO Decision Declaring FSCs Incompatible with GATT Trading Rules*, 2 SAN DIEGO INT'L L.J. 149, 168–69 (2001); see also Hunter R. Clark et al., *The WTO Ruling on Foreign Sales Corporations: Costliest Battle Yet in an Escalating Trade War Between the United States and the European Union?*, 10 MINN. J. GLOBAL TRADE 291, 297 (2001).

46. 146 CONG. REC. S11454 (daily ed. Nov. 1, 2000) (statement of Sen. Max Baucus); see also *The Role of the Extraterritorial Income Exclusion Act in the International Competitiveness of U.S. Companies: Hearing Before the S. Comm. on Fin.*, 107th Cong. 2 (2002) [hereinafter *Role*] (opening statement of Sen. Max Baucus, Chairman, Senate Comm. on Fin.). In accordance with earlier statements, Senator Baucus continues to utilize the sour-grapes argument. In particular, Baucus maintains that the EU's recent challenges reflect disguised vengeance for its own losses in the WTO. *Role*, *supra*, at 2. From the time that the DISC was dismantled in 1981 until the FSC was challenged in 1996, the EU brought no challenges. *Id.* Only after losing cases involving beef hormones and bananas did it submit a complaint against the United States. *Id.*

47. Alison Bennett, *EU Unlikely to Impose Near-Term Sanctions in Export Tax Dispute, NFTC Tells Congress*, 176 DAILY TAX REP. G-4 (Sept. 11, 2002).

and unexpected turn of events, the imposition of sanctions on U.S. exports by the EU may end up hurting European companies to a significant degree.⁴⁸

This solution of ignoring the WTO ruling and risking the multi-billion dollar retaliation is implausible for a number of reasons. First, in response to the claim by the National Foreign Trade Council and others, the EU emphatically stated that it would indeed impose sanctions if necessary, even if this maneuver would result in injury to certain European businesses. Specifically, EU officials reprimanded the lobbying group for making such misleading and self-serving statements, and warned that “[f]alse reassurances that the EU would not be in [a] position to retaliate effectively send a very unfortunate message [and] [d]ecreasing the incentive for the US to comply with WTO decisions simply renders the risk of retaliation greater.”⁴⁹

Second, allowing a single tax/trade dispute to jeopardize the economic and political relationship between the United States and the EU would be absurd. In support of its argument that a strong transatlantic relationship is absolutely vital to both the EU and the United States, the European-American Business Council highlighted several findings from a recent annual study.⁵⁰ It found that (i) approximately 6.5 million U.S. jobs depend on European investment in the United States, and 3.2 million Americans are directly employed by European-owned companies; (ii) U.S. merchandise exports to the EU support some 1.4 million U.S. jobs; (iii) nearly one-fourth of all U.S. exports are destined for the EU; (iv) cross investment between the United States and the EU is valued at nearly \$890 billion, which is evenly split between U.S. investment in Europe and European investment in the United States; and (v) the EU is the largest foreign investor in forty-one of the fifty U.S. states, and is the first or second largest export market for forty-four U.S. states.⁵¹ Alluding to the FSC dispute and others recently brought before the WTO, representatives of the European-American Business Council further explain that the historical cooperation between the United States and the EU dwarfs the current conflicts, thus requiring the parties to resolve these narrow, sectoral problems expeditiously.⁵² To dispel any myth that this partnership benefits only those parties that are directly involved, representatives from the U.S. Department of Commerce emphasize that the relationship between the United States and the EU has a positive global impact.⁵³ For example, government officials have testified that “[n]ot only is our bilateral commercial relationship the largest worldwide, the

48. Edward Alden, *Congress Looks at Tax Advantages of Foreign Companies*, FIN. TIMES (London), June 7, 2002, at 3; see also Marc Rosenberg, *How a Taxing Problem Has Taken Its Toll: A Common Person's Guide to an International Taxation Dispute*, 20 B.U. INT'L L.J. 1, 29 (2002) (noting that if the WTO forces the United States to end tax breaks for large exporters, the Bush administration may consider eliminating tax advantages enjoyed by foreign-owned companies); Carl Mortished, *Sanctions Could Hit UK Nuclear Industry*, TIMES (London), Sept. 12, 2002, at 27 (pointing out that since many European companies based in the United States also take advantage of the FSC/ETI regimes, “[t]he impact of penalising imports of products from such [U.S.] companies would be almost as great for Europe as it would be for America”).

49. See Gunter Burghardt, *EU Letter to National Foreign Trade Council*, 2002 WORLDWIDE TAX DAILY 193-32, paras. 6-7 (Oct. 4, 2002).

50. *Transatlantic Trade Agenda: Conflict or Cooperation?: Hearing Before the House Subcomm. on Int'l Econ. Pol'y and Trade of the Comm. on Int'l Relations*, 106th Cong. 49 (1999) [hereinafter *Trade Agenda*] (statement of Willard Berry, President, Eur.-Am. Bus. Council).

51. *Id.*

52. *Id.* at 49-50; see also *id.* at 34-35 (statement of Hon. Ileana Ros-Lehtinen, Chairwoman, House Subcomm. on Int'l Econ. Pol'y and Trade) (stating that the strong interrelationship between the EU and the United States is manifested in the New Transatlantic Agenda, which addresses “a wide range of commitments in foreign policy, security, . . . law enforcement,” and economic and trade issues).

53. See *id.* at 34-35 (statement of Hon. Ileana Ros-Lehtinen, Chairwoman, House Subcomm. on Int'l Econ. Pol'y and Trade); *id.* at 37 (statement of Charles M. Ludolph, Deputy Assistant Secretary for Europe, Market Access and Compliance Unit, Int'l Trade Admin., U.S. Dep't of Com.).

United States and the EU also are partners in working for liberalized trade and investment throughout the world—in Asia, Latin America, and in Africa.”⁵⁴ Albeit in a more sensationalistic manner, many others have warned that allowing the ETI Act dispute to escalate by ignoring the recent WTO ruling may ignite a full-scale “trade war” between the United States and the EU, which would doubtlessly yield negative effects on businesses and consumers on both sides of the Atlantic.⁵⁵

Third, in the aftermath of the terrorist attacks of September 11, 2001, and the ensuing war on terrorism that is currently centered in the Middle East, the United States cannot afford to blatantly ignore its worldwide trade obligations and risk offending its existing or future allies. The global nature of the war on terrorism requires that the United States, which is presently spearheading this initiative, avoid imprudently irritating other members of the WTO by disregarding the recent decision regarding the ETI Act. If it were to do so, “countries aiding the war against terrorism may second-guess their support of the United States.”⁵⁶ Agreeing with this position, other commentators have characterized avoiding a trade war as “the single most important challenge facing trans-Atlantic relations.”⁵⁷ Fortunately, this message has been conveyed to Congress recently by individual politicians⁵⁸ and the Bush administration alike.⁵⁹

Fourth, as a major participant in and promoter of global trade, disregard by the United States of the recent WTO ruling would set a dangerous precedent and undermine the free trade agenda that this nation has pursued for decades. Perhaps this argument is better understood as a basic syllogism: the Bush administration supports free trade; free trade is maintained in large part by the WTO; therefore, the Bush administration should abide by the rulings of the WTO in order to preserve its policy of free trade. This course of thought is described in greater detail below.

Since its inception, the Bush administration has touted itself as a free trade advocate. For example, in April 2001, the president emphasized the benefits for the United States in aggressively participating in the multilateral trading system. He explained, in particular,

54. *Id.* at 36–37 (statement of Charles M. Ludolph, Deputy Assistant Secretary for Europe, Market Access and Compliance Unit, Int’l Trade Admin., U.S. Dep’t of Com.).

55. Candace Carmichael, *Foreign Sales Corporations: Subsidies, Sanctions, and Trade Wars*, 35 VAND. J. TRANSNAT’L L. 151, 205 (2002).

56. John Seiner, *Beating Them at Their Own Game: A Solution to the U.S. Foreign Sales Corporation Crisis*, 11 MINN. J. GLOBAL TRADE 395, 408 (2002).

57. Bruce Stokes, *Fixing the Foreign-Profits Tax*, 34 NAT’L J. 1329, 1329 (2002). This author is disappointed that, despite the seriousness of this issue, the controversy is being handled by the wrong parties. “[T]he solution to this economic squabble lies not in diplomacy in Geneva or in Brussels, but in good old-fashioned logrolling tax politics in Washington.” *Id.*

58. *U.S. and Europe: The Bush Administration and Transatlantic Relations: Hearing Before the House Subcomm. on Eur. of the Comm. on Int’l Relations*, 107th Cong. 2–3 (2002) [hereinafter *Transatlantic Relations*] (statement of Rep. Elton Gallegly, Chairman, Subcomm. on Eur.). This congressman testified that “[s]ince September 11th, our partnership with Europe has become even more vital as we seek common strategies and solutions for the plague of global terrorism.” *Id.* at 1.

59. *Id.* at 3–7 (statement of A. Elizabeth Jones, Assistant Secretary, Bureau of Eur. and Eurasian Aff., U.S. Dep’t of St.). In her capacity as a representative of the Bush administration, this government official recently testified that

[s]uccess in addressing transnational problems is more important than ever in pursuing America’s transatlantic agenda. Stable countries able to withstand terrorist and other threats are based on respect for the rule of law, human rights, religious freedom, and open media. Stable countries have vibrant civil societies. They are committed to the principles of free market economies. The [Bush] Administration’s attention to these values with our European and Eurasian friends is even more critical as we pursue the war on terrorism with our coalition partners.

Id. at 7.

that open trade fuels overall economic growth, creates new jobs, spurs the process of economic and legal reform, dismantles protectionist bureaucracies that invite corruption, and helps sustain democracy in the long run.⁶⁰ Based on these positive aspects, the Bush administration has repeatedly announced its intention of assuming a leadership role in fomenting free trade.⁶¹ Furthermore, as a manifestation of the importance of increased hemispheric unity, the Bush administration has identified the negotiation and completion of the Free Trade Area of the Americas by 2005 as one of its primary goals on the international trade agenda.⁶² Lest there be any ambiguity, the president recently affirmed his support for free trade in the 2002 National Export Strategy, where he stated that “[t]he advancement of trade around the world is one of the highest priorities of my Presidency.”⁶³

The WTO is designed to protect and enhance free trade on a global scale. As a founding member of the WTO and one of the world’s largest international traders, the United States has assumed a leadership role in this area. As the adage goes, with power comes responsibility, and, in this case, responsibility includes adhering to the WTO’s recent decision regarding the ETI Act, even though the United States disagrees with the outcome. This idea of magnanimity has enjoyed support by various politicians and tax experts. For example, at least one commentator warned that “any reluctance [by the United States] to fulfill its WTO obligations hinders and perhaps destroys future efforts that the U.S. will undertake toward the global objective of free trade.”⁶⁴ Delivering the same message with considerably more passion, certain lawmakers explained:

[W]hat we do is much more important than what we say. Other countries look to us to lead, and to set an example. If we don’t comply fully with WTO rules, we only weaken the WTO. A weak and ineffectual WTO helps no one, and hurts us all. A weak WTO will allow protectionism to gain a stronger foothold around the world. We must not let this happen.⁶⁵

In short, based on the multiplicity of sources espousing the same view, it seems clear that hypocritical or sanctimonious behavior by the United States in this situation will serve to imperil the WTO, which, in turn, will undermine the free trade policy of the Bush administration.⁶⁶

60. WTO, TRADE POLICY REVIEW: UNITED STATES 2001, at 139 (Jan. 2002).

61. United States Trade Representative Robert B. Zoellick, Remarks at the Council of the Americas (May 7, 2001) (on file with author). U.S. Trade Representative Zoellick stated that, “[i]t is up to us [the United States] to champion the values of openness and freedom, to honor the vital linkages among economic liberty, free trade, open societies, successful democracies, individual opportunity and peaceful security.” *Id.*

62. OFFICE OF THE U.S. TRADE REPRESENTATIVE, 2001 INTERNATIONAL TRADE LEGISLATIVE AGENDA I (2001), available at <http://www.ustr.gov/agenda.pdf> (last visited Oct. 24, 2003); OFFICE OF THE U.S. TRADE REPRESENTATIVE, 2001 ANNUAL REPORT OF THE PRESIDENT OF THE UNITED STATES ON THE TRADE AGREEMENTS PROGRAM 102–04 (2002), available at <http://www.ustr.gov/reports/2002.html> (last visited Oct. 24, 2003).

63. TRADE PROMOTION COORDINATING COMM., THE 2002 NATIONAL EXPORT STRATEGY: THE ADMINISTRATION’S TRADE PROMOTION AGENDA—UNLOCKING AMERICA’S POTENTIAL, at v (2002) [hereinafter 2002 NATIONAL EXPORT STRATEGY], available at <http://www.trade.gov/media/Publications/pdf/nes2002FINAL.pdf> (last visited Oct. 24, 2003).

64. Ernest R. Larkins, *WTO Appellate Body Rules Against FSCs—The Search for Alternatives Begins*, 11 J. INT’L TAX’N 14, 16 (2000).

65. Senator Charles Grassley, Opening Statement, The Role of the Extraterritorial Income Exclusion Act in the International Competitiveness of U.S. Companies: Hearing Before the S. Comm. on Fin. 2 (July 30, 2002), available at <http://www.senate.gov/~finance/hearings/statements/073002cg.pdf> (last visited Oct. 26, 2003).

66. See, e.g., Paul Magnusson, *The New Trade Rep Won’t Get Much Sleep*, BUS. WK., Jan. 29, 2001, at 38 (quoting U.S. Trade Representative Robert B. Zoellick who queries, “[i]f the U.S., with all of its advantages, is unwilling to liberalize trade, what can we expect from other nations?”); *WTO’s Extraterritorial Income Decision: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 4 (2002) [hereinafter *Extraterritorial Income*].

B. Overhauling the U.S. Tax System

The recent defeat of the ETI Act before the WTO has triggered considerable domestic debate, spawning various legislative proposals to change the tax system. However, as demonstrated below, none of these proposals has managed to attain the support necessary to definitively resolve the dispute.

Various persons and groups have suggested that the United States radically change its current tax system by adopting, in effect, the European system of territorial-based taxation.⁶⁷ The United States and other countries use a worldwide tax system under which all of a domestic taxpayer's income, irrespective of the country in which the taxpayer makes the income, is subject to taxation in the United States. In order to avoid having multiple taxes imposed on the same income, the United States grants the domestic taxpayer a credit for the income taxes that the domestic taxpayer is obligated to pay a foreign government on income that was earned in that foreign country. In addition, under certain conditions, the domestic taxpayer may be allowed a tax exemption on particular types of foreign-source income. In contrast to the tax system used in the United States, other countries, including EU members, use a territorial tax system under which the majority, if

Decision] (statement of Rep. Bill Thomas, Chairman, House Comm. on Ways and Means) ("Given our global leadership, it is important that America complies with the established rules of engagement that the World Trade Organization (WTO) referees. It is in our interest that others follow the rules and therefore it is imperative that we follow the rules as well."); Frederick J. Bradshaw, *Tax Relief and the Competitiveness of U.S. Exporters*, 2002 WORLDWIDE TAX DAILY 199–21 (Oct. 15, 2002) ("[F]ailure to honor the WTO's decision would strike a blow for protectionism and severely undermine the authority of a major international institution that serves America's long-term economic and political interests of promoting free trade. Therefore, the United States should honor the WTO ruling and refrain from taking any unilateral actions contrary to its international agreements."); *Dangerous Activities*, ECONOMIST, May 11, 2002, at 64 (predicting that, "[i]f the disputes [between the United States and the EU] accumulate, the WTO risks being clogged up as hundreds of inconsistencies and loopholes in numerous agreements are taken to litigation. At worst, this could undermine the WTO's entire dispute-settlement system. The WTO, after all, is still young, an institution in need of nurturing rather than smothering with work"); Seiner, *supra* note 56, at 409 ("The United States wants to be involved in agreements with other countries that will expand free trade. If the United States begins to disregard rulings of the WTO, other countries will doubt U.S. commitment to trade agreements in general."); Rosenberg, *supra* note 48, at 30 ("[I]f the U.S. wishes to pursue the goal of global free trade, it should not simply ignore a rule that has gone through the proper international legal channels."); Clark et al., *supra* note 45, at 318 (considering the timing of the FSC/ETI dispute rather inopportune since it comes "at a time when some American scholars and policy-makers are questioning the value and even the legality of continued membership in the WTO").

67. See, e.g., Carmichael, *supra* note 55, at 206 (reporting that Congressman Bill Thomas, Chairman of the House Committee on Ways and Means, favors a territorial-based system of taxation); Rosenberg, *supra* note 48, at 30–31 (discussing the strategic advantages of a territorial system of taxation); Myrna Zelaya-Quesada & Chris Rugaber, *Congress, Administration Vow Cooperation to Resolve Dispute with EU over FSC/ETI*, 40 DAILY TAX REP. G-5 (Feb. 28, 2002) (reporting that the Coalition for Tax Competition—among whose members include many prestigious think tanks and interest groups, such as the Center for Freedom and Prosperity, the Heritage Foundation, the Competitive Enterprise Institute, the Institute for Policy Innovation, and Americans for Tax Reform—advocates a territorial system); Daniel J. Mitchell, *The Flawed WTO Tax Decision*, EUR. J., Mar. 2002, at 28 (taking the optimistic approach to the United States' recent defeat before the WTO, Mitchell states that, "[t]he EU began this attack on America's tax code in hopes of forcing America to raise corporate taxes and become less competitive. But if US lawmakers shift to territorial taxation, the Brussels-based paper-pushers will have given us lemons and we will have turned them into lemonade"), available at <http://www.freedomandprosperity.org/Articles/mitchell3.pdf> (last visited Oct. 27, 2003); Ashley Redd Commins, *The World Trade Organization's Decision in United States—Tax Treatment for "Foreign Sales Corporations": Round Three in the Transatlantic Tax Dispute*, 27 N.C. J. INT'L L. & COM. REG. 363, 386 (2001) (stating that some advocates strongly support a shift from the United States' current system of taxation to the territorial model); Larkins, *supra* note 64, at 19 (discussing the pros and cons of U.S. conversion to a territorial system); Seiner, *supra* note 56, at 412–15 (finding overall benefit in a U.S. conversion to a territorial system); *Extraterritorial Income Decision*, *supra* note 66, at 46 (statement of Gary Hufbauer, Senior Fellow, Inst. for Int'l Econ.) (arguing that Congress should remove the tax on foreign income created by American exports and production abroad).

not all, of a domestic taxpayer's income from foreign sources is exempt from tax in the taxpayer's country of residence.⁶⁸ Abandoning the policy of worldwide taxation that the United States has historically used and adopting a system based on territoriality would be an enormous, drastic change. As such, this proposal has been severely criticized.⁶⁹ Furthermore, since the benefits provided by the ETI Act and its predecessors represent merely one consideration among many in evaluating the wisdom of instituting a fundamental reform of the entire U.S. tax system, the Joint Committee on Taxation, the preeminent government authority on tax issues, recognizes the benefit of incremental steps as opposed to drastic changes such as implementing a territorial tax system.⁷⁰

Instead of maintaining the income tax system and simply altering the basis on which the income is taxed (i.e., the residence of the taxpayer vs. the country in which the income was earned), others suggest perhaps a more radical departure from the current tax system. In particular, a second idea raised by some tax practitioners and theorists is replacing the national income tax with a consumption tax, such as a sales tax or a value-added tax,⁷¹ or with a cash flow tax, which would be collected from taxpayers based on their earnings minus their savings.⁷² Many of these proposals may appear novel, but they have been unsuccessfully raised for years in various contexts,⁷³ and there is little, if any, evidence to suggest that their chances of success this time are any greater.

A third proposal involves converting the corporate income tax from a "direct" tax into an "indirect" tax, thereby complying with the WTO ruling.⁷⁴ The WTO treats direct taxes (e.g., income taxes) differently from indirect taxes (e.g., value-added taxes). Indirect taxes,

68. GUSTAFSON ET AL., *supra* note 3, at 15.

69. See STAFF OF JOINT COMM. ON TAX'N, 107TH CONG., BACKGROUND MATERIALS ON BUSINESS TAX ISSUES PREPARED FOR THE HOUSE COMMITTEE ON WAYS AND MEANS TAX POLICY DISCUSSION SERIES 58 (Comm. Print 2002) [hereinafter BUSINESS TAX ISSUES]. This report includes arguments against the adoption by the United States of a territorial system. For instance,

if the United States and other major home countries of multinational enterprises were to adopt territorial tax systems, tax competition would intensify. Without the constraint of some residence-based taxation of foreign-source income, a major barrier to tax competition would be removed, and a "race to the bottom" would arguably ensue.

Id. Moreover, since the United States has an extensive network of bilateral tax treaties that are "premised on the fact that the United States has a worldwide tax system[, switching] to a territorial system would require existing tax treaties to be renegotiated, creating uncertainty in taxation of business investments for a lengthy period of time." *Id.*; see also *Extraterritorial Income Decision*, *supra* note 66, at 57 (statement of Peter R. Merrill, Principal and Director, Nat'l Econ. Int'l Consulting Group, PricewaterhouseCoopers LLP, and Consultant, Int'l Tax Pol'y F.) (discussing the competitiveness of U.S. tax policy on foreign income); *Second in Series on the Extraterritorial Income Regime: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 47 (May 9, 2002) [hereinafter *Second in Series*] (testimony of William G. Gale, Senior Fellow, Brookings Inst.) (describing the problems of the current U.S. international tax system and suggesting appropriate responses); Skadden, Arps, Slate, Meagher & Flom LLP and Washington Council Ernst & Young, *Territorial Tax Study Report 3, 4* (Nat'l Foreign Trade Council, June 11, 2002) (evaluating the effects of alternative international tax systems and international tax reform on U.S. companies and U.S. competitiveness).

70. BUSINESS TAX ISSUES, *supra* note 69, at 60.

71. *Second in Series*, *supra* note 69, at 7–8 (testimony of Eric M. Engen, Resident Scholar, Am. Enterprise Inst.); *id.* at 13–14 (testimony of Herman Cain, Chief Executive Officer, Godfather's Pizza); *id.* at 24–26 (testimony of Michael J. Graetz, Professor of Law, Yale Law School).

72. *Id.* at 33 (testimony of Stephen J. Entin, President and Executive Director, Inst. for Res. on the Econ. of Tax'n).

73. See, e.g., IMPACT, *supra* note 44, at 66–91. This report describes five alternatives for replacing the current system, including a national retail sales tax, a value-added tax, a consumption-based flat tax, a cash flow tax, and a "pure" income tax. *Id.* at 2.

74. *Second in Series*, *supra* note 69, at 18 (testimony of Ernest S. Christian, Chief Legal Counsel, Ctr. for Strategic Tax Reform).

which are used by the majority of the nations in the EU, can legally be reduced on exported goods. By contrast, lowering direct taxes upon exports is held to violate the WTO. Relying on this distinction, the WTO ruled that the ETI Act, which served to reduce income taxes on exports, constituted an illegal subsidy. While this concept has received some support from other tax experts, consensus regarding its effectiveness has yet to be reached.⁷⁵

Fourth, the National Foreign Trade Council has recently issued an extensive study in which it urges a “significant modernization” of existing tax rules as they relate to income from foreign subsidiaries and the foreign tax credit.⁷⁶ This proposal, however, has been expressly rejected by the Treasury Department because, from its perspective, the proposal is (i) “inconsistent with the substance and the spirit of the WTO’s analysis . . . in the ETI case”; (ii) contrary to the goals of the Treasury Department because the proposal involves retaining “a lengthy set of rules that would serve only a relatively narrow purpose”; and (iii) injurious to the U.S. economy since the provisions may afford unintentional incentives and tax-minimization opportunities.⁷⁷

A fifth approach is offered by a tax academic, who recommends that Congress consider a solution based on the experience of U.S. states, that is, implementing a formulary apportionment of consolidated worldwide operations of multinational corporation groups.⁷⁸ The virtual nonexistence of debate (oral or written) on this particular approach calls into question its virtue.

Congressmen Charles Rangel and Phillip Crane are ostensibly on the verge of presenting a sixth proposal. In particular, these lawmakers claim to be in the process of developing a legislative alternative to the American Competitiveness Act, which would include, among other things, the repeal of the ETI Act in exchange for a 1% across-the-board reduction in the corporate tax rate.⁷⁹ It is difficult to assess the validity of this approach, however, since these lawmakers have not yet presented the bill.

The most recent legislative proposal, and the only one that is accompanied by actual draft legislation, is the American Competitiveness Act.⁸⁰ The bill contains three separate

75. Gary Clyde Hufbauer, *The Foreign Sales Corporation Drama: Reaching the Last Act?*, 2002 WORLDWIDE TAX DAILY 230-18, paras. 42-47 (Nov. 29, 2002) [hereinafter Hufbauer, *FSC Drama*]. According to Hufbauer, this novel solution “has considerable merit both as a means of leveling the tax field and as a way of ending the tax battle.” *Id.* para. 53.

76. NATIONAL FOREIGN TRADE COUNCIL, INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY 2-3 (2001); see also *Third in Series on the Extraterritorial Income Regime: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 37-40 (June 13, 2002) [hereinafter *Third in Series*] (testimony of William A. Reinsch, President, Nat’l Foreign Trade Council). Reinsch’s testimony contains a clear summary of the proposals by the National Foreign Trade Council. See *id.*

77. Pamela F. Olson, *Pam Olson Letter to William M. Thomas on ETI Replacement*, 2002 WORLDWIDE TAX DAILY 181-35, paras. 2, 14 (Sept. 18, 2002).

78. Lorence L. Bravenec, *Connecting the Dots in U.S. International Taxation*, 2002 WORLDWIDE TAX DAILY 155-19, para. 23 (Aug. 12, 2002). “Under this method, each MNC Group will determine its worldwide income from its consolidated operations. The United States would then apportion to itself . . . and tax, part of this worldwide taxable income, based on several apportionment factors.” *Id.* para. 24. This method does not seek to tax a Multinational Corporation Group’s consolidated worldwide taxable income. *Id.* para. 32. Instead, it only taxes the U.S. share based on the apportionment factors. Accordingly, this method is a form of territorial taxation, which could be accurately described as a “territorial-apportionment” method as opposed to a “territorial-separate accounting method,” which has already been suggested to Congress by many others. *Id.* Since this method is territorial, Bravenec claims that enacting it would eliminate the need for a special tax subsidy for exports. See *id.* para. 33.

79. Alison Bennett, *With Future Unclear for Thomas Bill, Rangel, Crane, Mull Tax Cut Alternative*, 240 DAILY TAX REP. G-1 (Dec. 13, 2002); see also Howard Gleckman, *Tax Multinationals: The Donnybrook Ahead*, BUS. WK., Sept. 9, 2002, at 86 (discussing possible reforms to the current tax regime).

80. See generally H.R. 5095, 107th Cong. (2002), available at <http://www.pmstax.com/gen/shelter/hr5095.pdf> (last visited Oct. 26, 2003). Other bills have been drafted in response to the recent WTO

sections, each of which addresses a perceived problem with the current U.S. international tax rules: tax shelters, corporate inversions, and the international competitiveness of U.S. businesses.⁸¹ Unlike other proposals consisting solely of fiscal theories, this newest bill would seem to lend itself to an actual provision-by-provision review. However, before a true debate on this legislation is conducted, there must first be a consensus, or at least a reluctant general concession, among the key parties that a legislative solution is the correct path. To date, unfortunately, the requisite degree of accord on this issue has not been attained, a fact which has stalled advancement on the American Competitiveness Act.⁸² Put differently, “[w]hen Congress adjourned in October 2002, the FSC/ETI debate was at an impasse: a Senate approach [i.e., resolving the dispute by reaching a negotiated settlement with the EU], a House approach [i.e., finalizing a legislative solution], discontented exporters, and no winning coalition.”⁸³

C. Challenge Various EU Tax Systems Before the WTO

Rather than complying with the recent WTO ruling and thereby effectively recognizing that the U.S. tax system is not in accordance with certain international standards, some suggest that the United States could assume an offensive posture by challenging before the WTO the legality of various EU tax systems.⁸⁴ The magnitude of the support for this proposal is still unclear, but at least one reputable journal reports that “[s]everal congressmen have already muttered that, if you look closely enough, European countries may have tax provisions that are illegal under WTO rules.”⁸⁵ Other experts alluding to the possible noncompliance of EU tax rules explain that certain actions by the EU appear to be somewhat hypocritical. More specifically, commentators point out that the EU has recently taken a fairly “aggressive approach” in the WTO by raising various disputes, including a case against the U.S. Antidumping Act of 1916, dispute settlement consultations regarding a Massachusetts law that limited procurement from companies doing business in Burma, and the multi-decade squabble involving the ETI Act and its predecessors.⁸⁶ The existence of legal and technical merit for initiating such actions before the WTO notwithstanding, the prudence of doing so has been scrutinized: “the wisdom of this wide-ranging assault on large swaths of U.S. law is questionable—especially in view of the EU’s large trade surpluses with the United States, its own failure to comply with WTO rulings, and the spotty record it brings to market enforcement within the [European] Union.”⁸⁷

decision. Among them are the Fairness, Simplification, and Competitiveness for American Business Act and the International Tax Simplification and Fairness for American Competitiveness Act. See H.R. 4151, 107th Cong. (2002); H.R. 4047, 107th Cong. (2002). Neither of these bills, though, attained the congressional backing necessary to advance in the legislative process.

81. *Summary of House Ways and Means Committee Chairman Thomas’s American Competitiveness and Corporate Accountability Act (H.R. 5095)*, 134 DAILY TAX REP. L-13 (July 12, 2002); see also *American Competitiveness and Corporate Accountability Act (H.R. 5095) Introduced by Ways and Means Committee Chairman Thomas*, 134 DAILY TAX REP. L-16 (July 12, 2002).

82. Hufbauer, *FSC Drama*, *supra* note 75, paras. 48–53.

83. *Id.* para. 52.

84. *WTO Ruling Throws Trade Relations Up in the Air*, INT’L TAX REV., Feb. 1, 2002, at 5. This comment was attributed to Tom Stout, director of federal tax, legislative, and regulatory services at KPMG in Washington, D.C. *Id.*

85. *Dangerous Activities*, *supra* note 66, at 64.

86. John Van Oudenaren, *E Pluribus Confusio: Living with the EU’s Structural Incoherence*, NAT’L INT., Oct. 1, 2001, at 28–29.

87. *Id.* at 29.

Putting aside the initial appeal of switching from a defensive to an offensive posture in this ETI Act dispute, further reflection reveals that such a maneuver would be imprudent for at least two reasons. First, irrespective of its validity, any complaint brought by the United States before the WTO necessarily requires a significant amount of time and money. For a nation that currently confronts serious problems such as a slowing economy, one of the highest unemployment rates in years, and war in the Middle East, dedicating considerable economic and human resources to an international tax/trade issue with absolutely no guarantee of victory seems unwise. Second, instigating further confrontation over an issue on which the United States has been continuously defeated for nearly three decades may simply escalate the problem, possibly resulting in a costly trade war with the EU.⁸⁸

D. Reach a "Negotiated Settlement" Outside the WTO

The battle over the ETI Act and its forerunners has been carried out within the parameters of the WTO for many decades. Now that this international body has decided in favor of the EU yet again, certain groups propose that this official mandate be disregarded, resolving the issue instead by arriving at a "negotiated settlement" between the United States and the EU.⁸⁹ For instance, some commentators claim that the preferred solution consists of a negotiated arrangement between the two parties, whether it be in the form of a narrow accord that is applicable solely to the issue of taxation of U.S. exports or a broader agreement that would encompass all pending tax/trade disagreements between the EU and the United States.⁹⁰ Similarly, citing the importance of maintaining the U.S./EU relationship, other experts have suggested that an ideal solution is a comprehensive and "mutually-beneficial settlement" that takes into account not just the victory of the EU regarding the ETI Act, but also recent U.S. victories in the WTO.⁹¹ Taking this proposal one step further, other tax experts speculate that the United States could trade off sanctions it is entitled to impose against the EU under the WTO, agree not to challenge objectionable EU tax-based incentives, or severely limit the ETI Act by removing the provisions that the EU finds most egregious.⁹²

Support for a negotiated settlement also comes from various business groups, the most notable of which is the European-American Business Council, an organization composed of over forty-eight major European and American companies dedicated to lobbying in the areas of transatlantic tax, trade, and investment.⁹³ According to this organization, a rapid resolution of this dispute by way of negotiation outside the WTO is the only sensible solution since, regardless of how the EU decides to impose the annual retaliatory tariffs of \$4 billion, businesses and consumers on both sides of the Atlantic will suffer.⁹⁴ American companies would obviously be negatively impacted as their exports to

88. Carmichael, *supra* note 55, at 205; *see also* Rosenberg, *supra* note 48, at 29.

89. Carmichael, *supra* note 55, at 209–10.

90. Rosenberg, *supra* note 48, at 31. This author concludes, "[t]he best hopes of the global economy, however, lie in an agreement between the two great parties." *Id.* at 32.

91. O'Leary, *supra* note 45, at 169–70.

92. Larkins, *supra* note 64, at 16.

93. *See* European-American Business Council, *Who We Are*, at <http://www.eabc.org/welcomeEABC.htm> (last visited Nov. 5, 2003).

94. *See* Press Release, European-American Business Council, EABC Appeals for Continued Negotiations for Settlement of FSC Dispute, Warns Against Impact of Escalation (Jan. 14, 2002), *available at* <http://www.eabc.org/FSCappealpressrelease.doc> (last visited Oct. 26, 2003); Press Release, European-American Business Council, Scenarios for Possible EU Retaliation in the FSC Dispute (May 2001), *available at* <http://www.eabc.org/FSCStudy.doc> (last visited Oct. 26, 2003); Press Release, European-American Business

the EU would either face extremely high tariff rates or outright prohibition. Less apparent, though, is the injury that European companies and consumers may incur. As the European-American Business Council puts it, “the US and European economies are so closely integrated, so much of the bilateral trade is intra-company, and there is so much cross-investment, it would be impossible for the EU to retaliate without harming its own most competitive industries.”⁹⁵

The idea of a negotiated settlement is also championed by other industry groups such as the U.S. Council for International Business⁹⁶ and by some major accounting and consulting firms. Theorizing that the other alternatives of paying the sanctions or simply repealing the ETI Act would be unappealing to the Bush administration, Ernst & Young concludes that “[t]he first and most desirable of these [limited options for the United States] would be to achieve a negotiated settlement of the ETI dispute with the EU outside of the WTO process.”⁹⁷ As part of this argument for reaching a negotiated settlement, several tax experts, including a former U.S. Treasury deputy secretary, suggest that the first step is to effectuate a temporary truce between the United States and the EU during which neither side would impose, or threaten to impose, sanctions authorized by the WTO.⁹⁸

In spite of this support for a negotiated settlement beyond the scope of the WTO, the governments of the EU and the United States have outright rejected this idea. With respect to Europe, the EU Trade Commissioner acknowledged that the imposition of the \$4 billion in annual retaliatory sanctions might cause collateral damage to businesses and consumers located in the EU.⁹⁹ Nonetheless, this government official clarified that the EU would not refrain from imposing the multi-billion dollar sanctions authorized by the WTO even though such action may have unintended negative effects on certain Europeans.¹⁰⁰ For its part, while the Bush administration acknowledges that the Trade Act of 2002¹⁰¹ (which contains the renewal of “fast track” authority) explicitly requires the United States to obtain a revision of the WTO rules regarding certain international tax issues, it says that a negotiated solution now is untenable due to timing issues: the EU was authorized to impose sanctions in 2002 and the next round of WTO negotiations is not scheduled until 2005.¹⁰²

Even if the United States were willing to attempt a negotiated settlement with the EU, experts conjecture that, due to the repeated losses suffered by the United States in the WTO regarding the ETI Act and its antecedents, such an attempt would be fruitless. In the words of one commentator, “[t]here are those who think that we can sit down with the EU and work through this disagreement through negotiations. Yet, at this point, we would be coming to the negotiating table from a position of weakness and might end up on the short

Council, House Failure to Act on FSC Bill Threatens Billions of Dollars of Transatlantic Trade (Nov. 2, 2000) [hereinafter House Failure], available at <http://www.eabc.org/fsc11200.htm> (last visited Oct. 26, 2003).

95. House Failure, *supra* note 94.

96. See Letter from Daniel A. Nichols & Richard M. Hammer, U.S. Council for International Business, to William M. Thomas, Chairman, House Comm. on Ways and Means (July 8, 2002), at <http://www.uscib.org/index.asp?documentID=2196> (last visited Oct. 26, 2003).

97. Ernst & Young—International Tax Services Group, *World Trade Organization Set to Rule Against U.S. in FSC Successor Case—Impact and Options*, ITS INSIGHTS, June 28, 2001, at 3.

98. Chuck Gnaedinger & Natalia Radziejewska, *Baucus Demands WTO Dispute Settlement System ‘Kangaroo Court’ Against U.S.*, 2002 WORLDWIDE TAX DAILY 188-1 (Sept. 27, 2002).

99. See, e.g., Daniel Pruzin, *EU’s Lamy Says Ball in U.S. Court to Resolve FSC/ETI Trade Dispute*, 12 DAILY TAX REP. G-1 (Jan. 17, 2002) (noting that EU businesses have “mixed interests,” since some have incorporated subsidiaries in the United States that could be harmed).

100. See *id.*

101. Pub. L. No. 107-210, 116 Stat. 933 (codified at 19 U.S.C. § 3801 (2002)).

102. Christopher S. Rugaber, *Baucus Criticizes Administration for Refusing to Negotiate International Tax Rules at WTO*, 226 DAILY TAX REP. G-7 (Nov. 22, 2002).

end of those negotiations.”¹⁰³ With regard to the idea of effectuating a provisional truce as an initial step, this proposal was likewise rebuked. For example, a spokesperson for the European Commission Delegation recently announced that the EU was not interested in the idea of a U.S./EU truce and reiterated its desire to see some “real progress” on passing legislation that would allow the United States to comply with the WTO ruling.¹⁰⁴

E. Resolve the Issue During the Next Round of WTO Negotiations in 2005

The fourth ministerial conference of the WTO was held in Doha, Qatar, in November 2001. At this time, the members of the WTO agreed to launch a new round of WTO negotiations that are scheduled to culminate in 2005.¹⁰⁵ With this event in mind, various groups have suggested that the United States simply disregard the recent ruling by the WTO regarding the ETI Act, thereby postponing any action until the multinational discussions in 2005. The National Association of Manufacturers, for example, has indicated that the best solution consists of renegotiating the Agreement on Subsidies and Countervailing Measures exclusively in Qatar.¹⁰⁶ Likewise, although Senator Baucus later moderated his position by establishing a congressional working group to identify potential solutions, he originally argued vehemently for delaying discussions of this issue.¹⁰⁷ Delay tactics have also been endorsed by assorted tax experts, some of whom have already set forth specific proposed changes to the general WTO structure.¹⁰⁸

The suggestion of delaying the resolution of this issue for many years is, to put it lightly, unpalatable to many government and trade officials. For instance, Supachai Panitchpakdi, who assumed the position of director-general of the WTO in September 2003, expressed his fervent opposition to resolving the ETI dispute in the context of the next round of WTO talks.¹⁰⁹ Similarly, the U.S. Trade Representative has emphasized that, despite its initial appeal, procrastination of this issue is not a workable solution for several reasons.¹¹⁰ First, even if the WTO negotiations were to conclude on schedule (which is unlikely based on recent history), the United States would be exposed to potential multi-billion dollar retaliatory sanctions during a three-year period.¹¹¹ Second, the idea of changing the rules of the WTO before first paying the penalty in accordance with the

103. Luscombe, *supra* note 26, at 5.

104. Chuck Gnaedinger, *EU Still Hopes for U.S. Compliance in ETI Act Dispute*, 2002 WORLDWIDE TAX DAILY 194-4 (Oct. 7, 2002).

105. WTO, Ministerial Declaration, 4th Sess., para. 45 (Nov. 20, 2001), available at http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.pdf (last visited Nov. 13, 2003).

106. Myrna Zelaya-Quesada, *Resolution of FSC/ETI Dispute to Influence International Tax Simplification Efforts*, 22 DAILY TAX REP. S-32 (Feb. 1, 2002).

107. See 140 CONG. REC. S11454 (daily ed. Nov. 1, 2000) (statement of Sen. Max Baucus).

108. See R.K. Morris, *The FSC, The Box & The Cave*, GLOBAL POSITIONS, Mar. 18, 2002, at 2, available at <http://www.gbdinc.org/pdfs/2002march18.pdf> (last visited Oct. 26, 2003). This article not only addresses the ETI Act under the WTO, but also makes other general changes to the WTO. In particular, it suggests that authorized retaliation under the WTO should be of the use-it-or-lose-it variety such that if a country fails to exercise retaliatory rights within one year, then it permanently loses these rights. As the author explains,

[w]hen . . . retaliatory rights are simply part of the stockpile of threats that one member of the WTO can use against another, they begin to corrode the system. When that happens, WTO cases cease to serve the function they should serve. They don't resolve disputes in the sense of clearing them out of the system. Instead, they add pernicious complexities that fuel the feuds of member countries.

Id.

109. Rossella Brevetti & Gary G. Yerkey, *Zoellick Urges Congress to Take Up FSC/ETI Solution to Avoid Retaliation*, 26 DAILY TAX REP. G-7 (Feb. 7, 2002).

110. *Role*, *supra* note 46, at 6 (testimony of Robert B. Zoellick, U.S. Trade Representative).

111. *Id.* at 77 (prepared statement of Robert B. Zoellick, U.S. Trade Representative).

existing rules is akin to the despicable playground behavior of taking your marbles and leaving. Even as a child, nobody likes a “spoil sport.” Stated more eloquently, the U.S. Trade Representative explained:

[W]e are faced with a WTO finding that the United States is in violation of the current rules. We cannot justify non-compliance on the grounds that we are attempting to negotiate a change in the rules by which we lost. If the shoe were on the other foot, we would not accept such an approach.¹¹²

Third, if the United States were to request a major change to the WTO rules during the next round of negotiations in 2005, logic dictates that this country would be required to make significant concessions in other areas. To date, however, no such concessions have even been discussed.¹¹³

F. Modify the ETI Act to Comply with WTO Agreements

After the FSC regime was rejected by the WTO, many were those who doggedly argued that the solution was to simply tweak the legislation to comply with the WTO ruling, while not detracting from the true tax benefits received by certain U.S. exporters.¹¹⁴ Likewise, there are those today who, despite the four losses suffered by the United States on this issue before the WTO, claim that this situation can be rectified by manipulating slightly the ETI Act.¹¹⁵ As headstrong as the U.S. government may often be, after the repeated losses on this issue and in light of the multi-billion dollar sanctions, it appears that it is willing to concede that making minor adjustments to the existing legislation constitutes a woefully inadequate solution. As evidence of this concession, officials of the Treasury Department recently stated before Congress,

We understand your hearing will explore whether minor changes can be made to bring the current ETI regime into compliance with WTO rules. Given the analysis of the current WTO rules reflected in the decisions in the FSC/ETI

112. *Id.*

113. *Id.*; see also Robert B. Zoellick, *U.S. Trade Representative's Letter to W&M Member Charles Rangel on WTO Sanctions Threat on FSC/ETI Incentives*, 2002 WORLDWIDE TAX DAILY 188-34, para. 3 (Sept. 27, 2002). Along with making these three arguments against delaying the ETI issue, the U.S. Trade Representative recently drafted a letter to Congressman Charles Rangel, which clearly demonstrates his opposition to any delay. In his letter, the U.S. Trade Representative stated the following:

I do not believe that the United States will be able to avoid trade retaliation by the EU if we try to solve this problem through changes in the WTO rules to be negotiated in the recently launched global trade negotiations, the Doha Development Agenda. The Doha negotiations are not scheduled to be completed until 2005, assuming the schedule goes as planned. Although I have worked with Commissioner Lamy of the EU to delay trade retaliation by emphasizing the United States intent to comply with the WTO ruling—and by explaining the complexity and timing difficulties of Congressional action—I would do you a disservice to leave an impression that we can defer this problem until 2005.

Zoellick, *supra*, para. 3.

114. O'Leary, *supra* note 45, at 164; Larkins, *supra* note 64, at 18.

115. *First in Series on the Extraterritorial Income Regime: Hearing Before the House Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, 107th Cong. 53 (Apr. 10, 2002) [hereinafter *First in Series*] (statement of Stephen D. Cifrulak, Jr., Sewickley, Pa.).

case, we do not believe legislation that simply replicates FSC or ETI benefits will pass muster in the WTO.¹¹⁶

Similar to those addressing the tax issues, government officials charged with handling trade matters also acknowledge that a quick-fix is unfeasible. Referring to the recent WTO decision rejecting the ETI Act, the U.S. Trade Representative optimistically stated that “[t]he upshot is that it has become clear that simply altering the FSC/ETI regime through a new mechanism for delivering the same benefits will not be found compliant with the WTO rules. Instead, we need real legislative reform.”¹¹⁷ This realization that petty changes to the ETI Act will not resolve the problem seems pervasive. Indeed, even those in Congress and the business community who are incensed by the fact that the elimination of the ETI Act may cause a negative impact on U.S. employment levels have openly admitted that drastic actions are necessary. Business leaders, for example, have challenged Congress to make the requisite changes to the U.S. tax system, irrespective of how painful that may prove to be: “You can’t judge it. You can’t fix it. You can’t flinch it. You got to do it. You have got to adopt some kind of tax system that will work in the world system.”¹¹⁸ For their part, certain politicians have recognized as a fatal flaw the desire to start with the theory that the former tax systems can be reworked. Congressman Bill Thomas emphasized, for instance, that “no discussion of history, no attempt to justify the correctness of the U.S. position can be a beginning [A] beginning begins with the realization that previous attempts have failed. One chapter has been closed. We need to open a new one.”¹¹⁹

G. *Resolve the Dispute Within a Different Forum*

As examined previously in this article, some experts have advocated resolving the issue outside of the WTO (and outside of any organized international organization) vis-à-vis personal negotiations between the United States and the EU.¹²⁰ In contrast, others have recommended reaching a solution within the confines of the WTO since this dispute has been adjudicated by this international body for several decades.¹²¹ Agreeing more with this latter position, still others suggest that, while resolving the quarrel before an organized body is preferable, perhaps the ideal setting is somewhere other than the WTO. For instance, one former Treasury deputy secretary suggested that the tax-based export incentive debate may be more effectively addressed before the OECD or during the regularly scheduled U.S./EU Summits.¹²² The scarcity of written documents on this particular issue indicates that these proposed dispute-resolution venues lack considerable support.

116. *Id.* at 25 (statement of Barbara Angus, International Tax Counsel, U.S. Dep’t of the Treas.).

117. *Role, supra* note 46, at 75 (prepared statement of Robert B. Zoellick, U.S. Trade Representative).

118. *First in Series, supra* note 115, at 16 (statement of the Hon. Samuel M. Gibbons, Chairman, Gibbons and Co.).

119. *Extraterritorial Income Decision, supra* note 66, at 4–5 (statement of Rep. Bill Thomas, Chairman, House Comm. on Ways and Means).

120. *See supra* Part III.D.

121. *See supra* Part III.E.

122. Treasury Deputy Secretary Stuart E. Eizenstat, Remarks to European-American Business Council (Sept. 27, 2000), at <http://www.ustreas.gov/press/releases/ls921.htm> (last visited Oct. 26, 2003).

H. *Rely on Floating Exchange Rates*

Certain scholars posit that the solution to this tax/trade dispute already exists: the system of floating exchange rates. They argue, in short, that any advantage that European companies enjoy because of their territorial tax systems will ultimately be offset by a stronger euro.¹²³ Tax experts discount this argument for two principal reasons. First, those championing the idea have yet to convince the public of its validity because it depends on too many variables.¹²⁴ In particular, “floating exchange rates do not ensure that trade deficits and surpluses revert to zero”; rather, macroeconomic theory dictates that “national trade deficits and surpluses . . . are ultimately determined by national savings and investment balances.”¹²⁵ Tax policy by itself only modifies exchange rates when changes in the tax system affect these two items, and the evidence set forth thus far does not clearly demonstrate that the EU’s border tax adjustments affect these two items.¹²⁶ According to one incredulous tax expert:

To put it bluntly, the argument that European border tax advantages have been eliminated by a strong Euro and a weak dollar seems laughable to American exporters. If the exchange rate argument was persuasive, European firms might allow their governments to abandon border tax adjustments for the VAT [value-added tax]. This is not going to happen. European firms see a mercantile advantage in the current tax rules, whatever scholars may say.¹²⁷

Second, the notion of disregarding tax competition in a world of floating exchange rates has not been adequately supported by recent research.¹²⁸

IV. EXPORT SUBSIDIES: GETTING TO THE ROOT OF THE PROBLEM

As mentioned in the introduction of this article, tax law in general, and international tax law in particular, is so complex that it is easy to become lost in the minutiae and forget about the bigger picture.¹²⁹ While it is paramount to understand the details, if one fails to constantly keep the broader goal in mind, then he or she is more susceptible to accepting arguments of questionable merit. This is often the case with tax-based export subsidies such as those offered under the DISC, FISC, and ETI.

The virtues of free trade have been widely known as early as, and likely long before, the publication in 1776 of *Wealth of Nations* by Adam Smith. In general, the concept of free trade dictates that the general well-being of all people in all countries is improved if they are able to purchase goods and services at the lowest possible prices on the world market. The opportunity to produce and obtain items at low costs is predicated on the idea of “comparative advantage.” According to this notion, if a country specializes in producing a particular good or service that it generates more efficiently than other countries, and

123. Hufbauer, *FSC Drama*, *supra* note 75, para. 44. Displaying his disdain for the idea, Hufbauer poses the following satirical question: “[w]hy fuss over ‘tax fairness’ when floating exchange rates will mop up any tax advantage or disadvantage?” *Id.*

124. *Id.* para. 45.

125. *Id.*

126. *Id.* para. 46.

127. *Id.*

128. Hufbauer, *FSC Drama*, *supra* note 75, para. 47.

129. *Impact of U.S. Tax Rules*, *supra* note 2, at 95 (statement of Hermann B. Bouma, International Tax Attorney, Buchanan Ingersoll).

subsequently trades those goods and services for goods and services produced in other countries, then the overall welfare of mankind is enhanced. Conversely, the general state of well-being is lessened if the price that people must pay for a particular good or service is artificially distorted due to the existence of government tariffs, subsidies, taxes, regulations, quotas, etc.¹³⁰ With regard to subsidies, governments afford this advantageous treatment directly by way of overt government expenditures or indirectly through preferential provisions in the tax code.¹³¹ As this article firmly established earlier, the Bush administration, like many before it, has repeatedly championed the concept of free trade and identified it as one of its highest priorities.¹³²

Notwithstanding the positive attributes of free trade and the White House's endorsement thereof, there are certain industries that continue to request, and often receive, various export subsidies.¹³³ To accomplish this, defenders of export subsidies offer many justifications for supporting export-promotion efforts, including the fact that exports create and preserve domestic jobs, help nascent industries, improve the U.S. trade balance, and "level the playing field" for U.S. exporters when their foreign competitors receive government support.¹³⁴ Since the creation-and-preservation-of-domestic-jobs argument is perhaps the easiest to comprehend (and definitely the easiest for politicians to sell to their constituents), proponents of the FSC and ETI regimes have relied on it heavily. For instance, according to one legislator:

It is critical for the continued U.S. competitiveness in the global marketplace. It is critical for our nation's economic security. Most important, it is critical to preserve as many as 5 million jobs for American workers and their families. That is right, almost 5 million jobs hang in the balance.¹³⁵

130. ALAN C. SWAN & JOHN F. MURPHY, *CASES AND MATERIALS ON THE REGULATION OF INTERNATIONAL BUSINESS AND ECONOMIC RELATIONS* 404-09 (2d ed. 1999).

131. 19 U.S.C. § 1677(5) (2000). Under U.S. trade law, examples of "subsidies" include a direct rebate by a company for items to be exported, interest-free or below-market interest rate loans, cash grants, loan guarantees, currency retention schemes, favorable internal transport and freight charges on export shipments, and tax exemptions or reductions. *Id.*

132. 2002 NATIONAL EXPORT STRATEGY, *supra* note 63, at v.

133. See Chris Rugaber, *Bush Administration Releases First National Export Strategy*, INT'L TRADE REP., May 23, 2002, at 908. The Trade Promotion Coordinating Committee is an interagency committee headed by the Secretary of Commerce that was established pursuant to the Export Enhancement Act of 1992 to create a unifying framework to coordinate export promotion and financing by the U.S. government. On May 14, 2002, the Trade Promotion Coordinating Committee of the Bush administration released its first National Export Strategy, which makes sixty recommendations aimed at better promoting U.S. exports by, among other things, combating tied aid offered by other countries, developing various inter-agency efforts and programs, showcasing exportable services, streamlining the trade-finance process, and partnering with state and local governments to improve outreach. See 2002 NATIONAL EXPORT STRATEGY, *supra* note 63, at xiii-xvi.

134. Aaron Lukas & Ian Vásquez, *Rethinking the Export-Import Bank 2-3* (Cato Inst. Briefing Paper No. 15, Mar. 12, 2002), available at <http://www.freetrade.org/pubs/briefs/tbp-015.pdf> (last visited Oct. 27, 2003). These authors are staunch opponents of granting export-subsidies. As such, this article refutes all of the traditional justifications for government assistance. See *generally id.*

135. 146 CONG. REC. H11881 (daily ed. Nov. 14, 2000) (statement of Rep. Bill Archer); see also 146 CONG. REC. H11891 (daily ed. Nov. 14, 2000) (statement of Sen. Carl Levin). Referring to the FSC bill, Senator Levin explained that

[e]nactment of this bill is critical to U.S. businesses, workers and farmers. The cloud of the WTO decision affects everyone from airplane manufacturers and manufacturers of other industrial products to software developers, to wheat growers, and so on. If we fail to enact this bill, there is a serious risk that the EU will go back to the WTO. It would cause great harm to U.S. businesses, to workers, and to farmers.

146 CONG. REC. H11891 (daily ed. Nov. 14, 2000) (statement of Sen. Carl Levin).

In addition to general arguments about potential job loss, many particular industries that receive export subsidies warn that the withdrawal of such government aid could jeopardize their very existence. Among those delivering comments to this effect are the software industry,¹³⁶ the shipping industry,¹³⁷ the defense industry,¹³⁸ agricultural equipment manufacturers,¹³⁹ electronics manufacturers,¹⁴⁰ small and mid-sized businesses,¹⁴¹ major retail stores,¹⁴² and the aerospace industry.¹⁴³ Based on this cursory review of those testifying most vehemently before Congress for the perpetuation of export subsidies, it comes as little surprise that the top beneficiaries of the FSC regime, ranging in the amount of taxes saved from \$1.2 billion to \$158 million from 1991 to 2000, are Boeing Co., General Electric Co., Motorola Inc., Honeywell International, Caterpillar Inc., Cisco Systems Inc., Applied Materials Inc., Monsanto Co., Archer Daniels Midland, Raytheon Co., and Oracle Systems Corp.¹⁴⁴

At first glance, the arguments to continue supporting export subsidies are, one must admit, somewhat compelling. After further examination, however, it becomes clear that these arguments are flawed. Exports in general are both good for the United States and in accordance with the theory of free trade. Among the principal benefits that a country may obtain from exporting its goods and services are a reduction of the trade deficit; creation of domestic jobs characterized by superior productivity and wages; enhanced economic diversification and stability; inexpensive products of higher quality triggered by increased competition; and strengthened commercial diplomacy as both exports and exporters act as effective disseminators of technological, cultural, and political information to foreign markets.¹⁴⁵

On the other hand, government-funded export subsidies (such as the tax breaks contained in the ETI Act and its predecessors) are neither beneficial to the overall U.S.

136. *Third in Series*, *supra* note 76, at 50 (testimony of Gary D. Sprague, Partner, Baker & McKenzie); Alison Bennett et al., *Changes to International Tax Bill Possible, Thomas Says; Still No Date for Markup*, 138 DAILY TAX REP. G-14 (July 18, 2002) (discussing concern expressed by representatives of the Software Finance & Tax Executives Council over potential negative impacts on this industry).

137. *Third in Series*, *supra* note 76, at 54 (testimony of Robert Cowen, Senior Vice President and Chief Operating Officer, Overseas Shipholding Group).

138. *Role*, *supra* note 46, at 20–21 (testimony of Pierre Chao, Managing Director, Credit Suisse First Boston); see also *Current U.S. International Tax Regime: Hearing Before the House Subcomm. on Oversight of the Comm. on Ways and Means*, 106th Cong. 51–53 (1999) (statement of Gary McKenzie, Vice President of Tax, Northrop Grumman Corp.). In an attempt to make it appear that withdrawing export subsidies will be more damaging to individual stockholders than the company in general, Chao argues that if the ETI Act is repealed without a replacement, then the stock prices of major exporters such as Boeing, United Technologies, Dupont, Archer Daniels Midland, and Caterpillar will drop significantly. As he puts it, “[t]hat’s quite a kick in the teeth to battered investors who have already suffered a stock market meltdown. This is a time when I believe we should be reassuring investors and trying to get them to invest in solid American firms, not giving them a reason to flee.” *Role*, *supra* note 46, at 21. Chao then outlines the potential reactions of those companies affected by the legislative repeal, including (1) raising the price of goods to offset impact of increased taxes, (2) accepting lower earnings, which hurts an entity’s ability to attract capital in the investment markets, or (3) lowering costs to offset increased taxes, which would come in the form of domestic layoffs or moving to lower-cost areas abroad. *Id.*

139. *Role*, *supra* note 46, at 21–22 (testimony of F. Lynn McPheeters, Vice President and Chief Financial Officer, Caterpillar).

140. *Id.* at 23–25 (testimony of Daniel Kostenbauder, General Tax Counsel, Hewlett-Packard).

141. *Id.* at 25–26 (testimony of Dwight Messinger, President and Chief Executive Officer, Power Curbers).

142. *Id.* at 27–28 (testimony of David Bullington, Vice President for Tax, Wal-Mart Stores).

143. *Id.* at 28–30 (testimony of James H. Zrust, Vice President of Tax, Boeing Co.).

144. David R. Baker, *Tech Giants Profit from Tax Break; European Union Calls U.S. Law Unfair Subsidy, Might Retaliate*, S.F. CHRON., Sept. 12, 2002, at B1.

145. J. David Richardson, *Exports Matter . . . and So Does Trade Finance*, in *THE EX-IM BANK IN THE 21ST CENTURY: A NEW APPROACH?* 58–65 (Gary Clyde Hufbauer & Rita M. Rodriguez eds., 2001), available at http://www.iie.com/publications/chapters_preview/323/5iie3004.pdf (last visited Oct. 27, 2003).

economy nor respectful of the notion of free trade. To the delight of certain lawmakers, industries, and lobbyists, this important distinction is often overlooked amid a contentious debate. While export subsidies undoubtedly favor those particular companies that receive the benefits, such government assistance is actually detrimental to the U.S. society as a whole. Even a momentary review of the related literature demonstrates that this argument has widespread support, counting among its proponents legislative committees, politicians, academics, government agencies, reputable think tanks, economists, trade gurus, and assorted tax experts. In an attempt to minimize the reader's boredom, only a sample of such commentary is provided below.

Governmental support for the idea that the FSC and ETI in particular, and export subsidies in general, are detrimental to the U.S. economy as a whole is plentiful. The Congressional Research Service (CRS) is a branch of the Library of Congress that conducts and provides nonpartisan research reports to those members of Congress requesting particular information. According to recent CRS reports, the tax exemption available under the FSC and the ETI Act does attract investment to the exporting sector, which results in increased U.S. exports.¹⁴⁶ The extent of the increase in exports depends on "how much of the tax benefit U.S. suppliers pass on to foreign consumers as lower prices—and on how responsive foreign purchasers are to reduced prices for U.S. exports."¹⁴⁷ Besides this somewhat limited effect, however, the CRS studies indicate that the FSC and ETI Act generate many effects that would surprise those unfamiliar with economic theory. In particular, the studies find that, despite claims to the contrary by industries that benefit from these tax-based export subsidies, the FSC and ETI increase the overall level of U.S. trade, but they do not improve the national trade balance, reduce the U.S. trade deficit, increase domestic employment levels, or benefit the U.S. economy as a whole.¹⁴⁸ To illustrate these conclusions, the CRS reports explain that the FSC and ETI Act increase foreign consumption of U.S. exports. However, to buy these exports, foreign purchasers must have U.S. dollars. The enhanced demand for U.S. dollars increases the price of the U.S. dollar in foreign-exchange markets, thereby making U.S. exports more expensive. This phenomenon partially counterbalances the effect that the programs have of increasing U.S. exports, while at the same time making imports into the United States less expensive and thus more appealing. The net result is a notable increase in both imports into the United States and exports out of the United States, which yields no change in the overall U.S. trade balance.¹⁴⁹ In addition, the CRS studies explain that, unbeknownst to many, the FSC and ETI Act actually reduce the economic welfare of the United States in its entirety because at least part of the tax benefit is passed to foreign consumers in the form of lower prices on U.S. goods and services.

Irrespective of these negative consequences for the nation as a whole, the CRS reports acknowledge that, while economists are uniformly critical of these programs, there is considerable support for the FSC and ETI within the business community. From the perspective of the CRS, the reason for this polarization of opinions is quite obvious:

146. David L. Brumbaugh, *Export Tax Benefits and the WTO: Foreign Sales Corporations and the Extraterritorial Replacement Provisions* CRS-5 (Cong. Res. Serv., Rep. No. RS20746, Jan. 24, 2002) [hereinafter Brumbaugh, *Export Tax*], available at <http://www.fas.org/asmp/resources/govern/crs-RS20746.pdf> (last visited Nov. 5, 2003).

147. David L. Brumbaugh, *The Foreign Sales Corporation (FSC) Tax Benefit for Exporting and the WTO* (Cong. Res. Serv., Rep. No. RS20571, Oct. 11, 2000), at <http://www.ncseonline.org/NLE/crs/abstract.cfm?NLEid=16655> (last visited Oct. 27, 2003); see also Brumbaugh, *Export Tax*, *supra* note 146, at CRS-5.

148. See Brumbaugh, *Export Tax*, *supra* note 146, at CRS-5 to CRS-6.

149. *Id.* at CRS-5.

economic analysis looks at the benefits' impact from the perspective of the economy as a whole, attempting to account for its full range of effects and adjustments in all markets [whereas] [s]upporters of the provision, however, are frequently businessmen whose exporting firms would likely face declining sales, profits, and employment if provisions were to be eliminated.¹⁵⁰

Speaking more broadly, along with criticizing the overall effects of tax-based exports subsidies such as those afforded by the FSC and ETI Act, other CRS reports have denounced export subsidies in general. For instance, the CRS indicates that economic policies established by particular nations determine interest rates, capital flows, and exchange rates. These factors, in turn, basically decide the overall level of exports of a nation.¹⁵¹ As a result, the CRS concludes that subsidizing exports simply serves to shift production among different sectors within a country rather than enhancing the overall level of economic activity. It logically follows that export subsidies will not permanently raise the level of employment in the economy, but it will simply alter the composition of employment among the various sectors.¹⁵²

The Joint Committee on Taxation (JCT) also supports the proposition that export subsidies fail to help a nation's overall economy.¹⁵³ A recent study by the JCT recognized that a fundamental decision of any U.S. company is whether to locate a portion of its production facilities abroad, which is often influenced by the existence or magnitude of tax-based export incentives.¹⁵⁴ This JCT study points out, however, that export inducements tend to lower global economic welfare. Moreover, while such incentives doubtlessly benefit the export sector or the particular businesses that are the recipients thereof, "they generally can be expected to reduce the overall economic welfare of the nation providing the subsidy."¹⁵⁵

Concurring with the conclusions of the CRS and JCT, the U.S. General Accounting Office (GAO) has issued reports and provided congressional testimony on repeated occasions discounting arguments in support of subsidies that are commonly made by special-interest groups and clarifying that the supposed virtues of export subsidies for the

150. *Id.* at CRS-6.

151. James K. Jackson, *Export-Import Bank: Background and Legislative Issues* CRS-6 (Cong. Res. Serv., Rep. No. 98-568 E, Nov. 14, 2001), available at <http://www.cnie.org/nle/crsreports/economics/econ-114.pdf> (last visited Oct. 27, 2003).

152. *Id.*

153. Established under the Internal Revenue Code of 1986, the Joint Committee on Taxation is composed of ten members, consisting of five persons from the Senate Finance Committee and five persons from the House Committee on Ways and Means. The Joint Committee on Taxation is closely involved in every aspect of the tax legislative process and its duties include (i) preparing hearing pamphlets, committee reports, and conference reports; (ii) assisting the Office of Legislative Counsel in drafting statutory language; (iii) assisting congressional members with the development and analysis of various legislative proposals; (iv) performing revenue estimates of all revenue legislation that Congress considers; (v) reviewing proposals for significant income tax refunds; and (vi) conducting investigations of various aspects of the federal tax system. See Staff of the Joint Comm. on Tax'n, *General Explanation of the Joint Committee on Taxation, How the Joint Committee Fulfills its Statutory Mandate*, available at <http://www.house.gov/jct/fulfhist.htm> (last visited Oct. 31, 2003).

154. STAFF OF JOINT COMM. ON TAX'N, 106TH CONG., DESCRIPTION AND ANALYSIS OF PRESENT-LAW RULES RELATING TO INTERNATIONAL TAXATION § IV.B.5 (Comm. Print 1999) [hereinafter PRESENT-LAW RULES], available at <http://www.house.gov/jct/x-40-99.htm> (last visited Oct. 28, 2003); STAFF OF JOINT COMM. ON TAX'N, 102D CONG., FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES 256 (Comm. Print 1991) [hereinafter FACTORS].

155. PRESENT-LAW RULES, *supra* note 154, § IV.B.5; FACTORS, *supra* note 154, at 256.

U.S. economy have yet to be adequately proven.¹⁵⁶ According to the GAO, “[t]here is no definitive empirical work that demonstrates unequivocally the net impact on the nation—positive or negative—of government funding for export promotion programs,” but it is certain that such programs do not substantially improve the U.S. trade balance or increase domestic employment.¹⁵⁷

The Treasury Department has also provided governmental support for these arguments. Upon warning that the repeal of the ETI Act may be harmful to certain companies, the Treasury Deputy Secretary recently announced that “[w]e need to focus on making the U.S. economy—and that means U.S. enterprises as a whole—better off as a result of the legislative changes. That is what a level playing field is all about.”¹⁵⁸

Along with the significant governmental disapproval of export subsidies, many reputable think tanks have disseminated concurring opinions. Representatives of the well-respected Brookings Institution, for example, testified that the ETI Act should be immediately repealed irrespective of the recent decision by the WTO since doing so would improve national welfare.¹⁵⁹ In support of its argument that export subsidies have “little economic rationale,” this think tank cited the fact that export subsidies do not improve the trade balance. Instead, they provide some benefit to foreign companies that are able to take advantage of certain programs and encourage companies to make economically inefficient decisions by favoring projects with lower total returns (but higher after-tax returns) “over domestic projects with higher total return but lower after-tax return.”¹⁶⁰ Based on these arguments, Brookings representatives conclude that “[g]iven the ineffectiveness of export subsidies, their minor role in international economic transactions of the United States, [and] their violation of . . . the valid objects of the WTO, the most sensible policy would be to abolish the export incentives.”¹⁶¹

Other highly-regarded think tanks such as the CATO Institute¹⁶² and the Institute for Policy Studies share the position of the Brookings Institution. Representatives of the Institute for Policy Studies argue that the “smorgasbord of assistance offered to U.S. exporters” is regretful since they often violate multilateral free trade agreements, benefit wealthy exporters to the detriment of normal taxpayers, add to the federal deficit, and make a mockery of recent reductions in government programs for poorer persons.¹⁶³ Taking a more tempered approach than that proposed by the Brookings Institution, this think tank reluctantly acknowledges that “[i]n today’s contradictory world, mercantilistic trade promotion activities coexist with efforts to reach multinational agreements that would curtail those practices.”¹⁶⁴ Accordingly, the Institute for Policy Studies recommends that

156. The U.S. General Accounting Office is “the audit, evaluation, and investigative arm of Congress[which] exists to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government . . .” U.S. General Accounting Office, *GAO*, at <http://www.gao.gov> (last visited Oct. 31, 2003). Among other things, the “GAO examines the use of public funds, evaluates federal programs and activities, and provides analyses, options, recommendations, and other assistance to help the Congress make effective oversight, policy, and funding decisions.” *Id.*

157. *Export Promotion: Rationales For and Against Government Programs and Expenditures: Testimony Before the House Subcomm. on Procurement, Exports, and Bus. Opportunities of the Comm. on Small Bus.*, 104th Cong. (1995) (statement of Allan I. Mendelowitz, Managing Director for International Trade, Finance, and Competitiveness, Gen. Gov’t Div., U.S. Gen. Acct. Off.).

158. Kenneth M. Dam, *U.S. Treasury’s Dam Remarks on WTO-Induced Issues in U.S. Taxation of International Taxation*, 2002 *WORLDWIDE TAX DAILY* 197-24, para. 34 (Oct. 10, 2002).

159. *Second in Series*, *supra* note 69, at 40 (testimony of William G. Gale, Senior Fellow, Brookings Inst.).

160. *Id.* at 46.

161. *Id.*

162. Lukas & Vasquez, *supra* note 134, at 2-3.

163. Janice C. Shields, *Export Promotion Programs*, 2 *FOREIGN POLICY IN FOCUS* 1 (1997), available at <http://www.fpif.org/pdf/vol2/34ifexpt.pdf> (last visited Oct. 28, 2003).

164. *Id.* at 3.

the United States (i) reduce trade-promotion activities unilaterally; (ii) avoid retaliatory trade-promotion activities and threats thereof; (iii) select products and countries targeted for . . . trade-promotion activities based on criteria designed to enhance global well-being, (iv) establish codes of conduct for all export promotion programs; and (v) regularly report to Congress on all of the export-promotion activities.¹⁶⁵

Like the government sources and think tanks examined above, many tax and trade experts question the underlying wisdom of export promotion.¹⁶⁶ For example, citing his support for the notion of free trade that has been embraced by the United States for more than a half-century, one educator summarized his point for members of Congress with remarkable conciseness: “free trade makes America richer, and export subsidies make us poorer.”¹⁶⁷ His free-trade-at-all-costs theory notwithstanding, this law professor acknowledges that eliminating export-promotion programs is difficult because the benefits to those companies that take advantage of the ETI Act are “palpable and large,” whereas the cost to the U.S. taxpayers who in fact economically support this program are “hidden and diffused.”¹⁶⁸ Seconding the idea that export subsidies distort natural trade patterns and thus create inefficiencies that damage the global economy, one commentator made a plea to eliminate government-assistance programs as antiquated notions of little present merit. In particular, the author quips that the perpetuation of subsidies relies on the interests of industries whose scope and life they have extended, and thus “[i]t is time for trade ministers to take a keener interest in social welfare—or in other words, to wake up and smell the artificially priced coffee.”¹⁶⁹

Finally, various lawmakers have offered criticism of export subsidies. For instance, in congressional debate regarding the FSC program, Representative Pete Stark cited Microsoft as an example of a successful company that was, in his opinion, unnecessarily enriched by this export subsidy. Stark shared these remarks:

Now, software was mentioned. Those poor folks in Seattle. Software? Do members [of Congress] know how much Microsoft paid in taxes last year? Zero, Mr. Speaker, a goose egg. This big or this big, zero is still zero. Yet, they get a subsidy which gets them down to zero for all the software they sell overseas. Is that a gift? And this poor overtaxed Bill Gates is walking around, so we subsidize his sales overseas. Mr. Speaker, we have been doing this for generations. For 25 years, we have been giving \$5 billion a year away in subsidies to corporations who would do the same thing whether or not they got this subsidy So all we are doing is giving a break, a tax break, a subsidy, to the richest corporations in this country, rewarding those corporations who gyp our senior citizens by overcharging in this country, by rewarding them.¹⁷⁰

Several other politicians have also proffered support for this position.¹⁷¹ For his part, Congressman Peter DeFazio outlines several reasons why the FSC program should have

165. *Id.*

166. GUSTAFSON ET AL., *supra* note 3, at 856. This text identifies as the fundamental policy question whether tax-based export incentives are justifiable when viewed in the context of the economic welfare of the United States as a whole. *Id.*

167. *First in Series*, *supra* note 115, at 43 (testimony of Michael J. McIntyre, Professor of Law, Wayne St. Univ.).

168. *Id.*

169. *Going Too Far in Support of Trade*, *ECONOMIST*, Dec. 16, 2000, at 88 (emphasis added).

170. 146 CONG. REC. H11892 (daily ed. Nov. 14, 2000) (statement of Rep. Pete Stark).

171. *See, e.g.*, 146 CONG. REC. H11893–94 (daily ed. Nov. 14, 2000) (statement of Rep. Lloyd Doggett).

been eradicated years ago. First, citing the reports by the CRS, DeFazio argues that there is no economic justification for export subsidies. Second, export subsidies discriminate against mom-and-pop stores that do not have the resources to be able to export, and preordain the winners (i.e., large U.S. exporters and foreign consumers who enjoy lower-priced products) and the losers (i.e., small businesses, U.S. taxpayers, and domestic industries that compete with foreign imports). Third, the U.S. subsidiaries of European companies take advantage of U.S. taxpayers through their use of the FSC program.¹⁷² Like Congressmen Stark and DeFazio, Senator John McCain, a fervent advocate of free trade, argued for the elimination of the FSC since it was, in his view, simply an “unnecessary federal subsidy that does not provide a fair return to the taxpayers.”¹⁷³

V. A POTENTIAL SOLUTION

As discussed earlier in this article, the recent defeat of the ETI Act before the WTO has resulted in many proposals, including ignoring the WTO decision and simply risking retaliation by the EU, overhauling the entire U.S. international tax system, assuming an offensive position by challenging various EU tax systems before the WTO, reaching a negotiated settlement between the United States and the EU outside the context of the WTO, postponing resolution of the issue until the next round of WTO negotiations in 2005, modifying the ETI Act in such a manner that it is in accordance with the WTO rules, bringing the dispute before another forum such as the OECD, and relying on floating exchange rates. The problem with these proposed solutions is two-fold. First, as explained throughout this article, each of these proposals is politically or economically unfeasible. Discussing them further therefore may prove interesting, but it would do little to truly advance the situation. Second, continuing attempts to legitimize or implement tax-based export incentives simply leads to the familiar trap—that is, failing to see the forest for the trees. As mentioned previously, if one fails to constantly maintain sight of the broader goal, he or she is more vulnerable to accepting arguments of dubious value. With this in mind, this article presents a two-part solution.

Although export subsidies undoubtedly favor the particular companies that receive the benefits, they are actually detrimental to the U.S. economy as a whole. This conclusion is clearly confirmed in the studies and documents by politicians; academics; government groups such as the CRS, JCT, and GAO; reputable think tanks; economists; trade gurus; and assorted tax experts that were examined earlier in this article.¹⁷⁴ National trade and tax policy should be designed to improve the U.S. economy in its entirety, as opposed to favoring limited groups at the expense of the majority. Accordingly, the first part of the solution is to immediately repeal the ETI Act.

The proposal to repeal the ETI Act enjoys support from various free-trade advocates. For instance, one international law professor recently explained to members of Congress that “[t]he most attractive option, from a public policy perspective, would be to support free trade by repealing the ETI provisions without any replacement.”¹⁷⁵ Likewise, a recent report by the CRS also suggests that simply repealing the ETI Act would be beneficial to the U.S. economy. This report concludes, specifically, that revocation of the ETI Act

172. 146 CONG. REC. H11896 (daily ed. Nov. 14, 2000) (statement of Rep. Peter DeFazio). Congressman DeFazio indignantly stated that “this legislation is not about the competitiveness of large, wealthy, multinational corporations based in the United States. It is about wealthy campaign contributors wanting to keep and expand their \$5 billion-plus tax subsidies and elected officials willing to do their bidding.” *Id.*

173. 146 CONG. REC. S11454 (daily ed. Nov. 1, 2000) (statement of Sen. John McCain).

174. See *supra* Part IV.

175. *First in Series*, *supra* note 115, at 46 (testimony of Michael J. McIntyre, Professor of Law, Wayne St. Univ.).

would lower the overall level of U.S. trade (i.e., both in terms of exports and imports). However, since export subsidies generally reduce the total economic welfare of the subsidizing country, “repeal of the ETI provisions would likely increase U.S. economic welfare.”¹⁷⁶ This CRS study goes on to say that economic theory indicates that the economic well-being of the United States does not depend on maximizing exports in general or on maximizing the competitiveness of U.S. businesses operating abroad.¹⁷⁷ Instead, the economic welfare of the United States is contingent upon whether locations are distorted in inefficient ways because of export subsidies, or upon whether the benefit of these export subsidies ultimately accrues to U.S. taxpayers or flows out of the United States.¹⁷⁸ With respect to the tax-based export subsidy that exists under the ETI Act, the CRS study concludes that “its repeal would, in isolation, increase the economic welfare of the United States on both counts.”¹⁷⁹

Industry leaders that did not benefit from the ETI Act also support the notion of immediately eradicating it. For example, one businessperson told congressional members that the WTO ruling should be deemed “a victory for Americans,” provided that it forces the United States to repeal the ETI Act and use the tax revenues formerly saved thereunder for a more worthwhile policy objective.¹⁸⁰ Among the benefits of repealing the ETI Act are avoiding the multi-billion dollar retaliation that the EU is authorized to impose; demonstrating U.S. leadership in the WTO at a time when worldwide support for this institution may be waning; upholding the Bush administration’s professed goal of free trade; preserving sound diplomatic relations with our European allies who may prove essential during the war on terrorism; and improving the U.S. economy as a whole. In addition, eliminating the ETI Act would be in harmony with the fundamental international tax principles that guide the Treasury Department, which include (i) meeting the revenue needs determined by Congress in an adequate and fair manner; (ii) minimizing compliance and administrative burdens; (iii) decreasing distortion of investment decisions through tax considerations; (iv) conforming with international norms to the extent possible; and (v) avoiding placing an undue burden on the competitive position of U.S. companies.¹⁸¹

Although this constitutes the optimal solution, completely eliminating the ETI Act at this juncture may be politically implausible for several reasons. First, those companies (both American and European) that currently benefit from the ETI Act have powerful lobbying groups in Washington that will work diligently, and probably successfully, to preserve some type of export subsidy.¹⁸² In short, what began decades ago as an obscure trade dispute between the EU and the United States has transformed itself into a “political brawl” that is pitting many of the largest American companies against each other.¹⁸³ The attempts at political persuasion are so intense and business interests are so polarized that “Congress has become all but paralyzed over the issue [and] many of Washington’s high-

176. David L. Brumbaugh, *U.S. Congressional Research Service Report Focuses on International Tax Provisions in H.R. 5095*, 2002 WORLDWIDE TAX DAILY 188-31, para. 3 (Sept. 27, 2002).

177. *Id.* para. 74.

178. *Id.*

179. *Id.*

180. *Third in Series*, *supra* note 76, at 66 (testimony of T. Scott Newlon, Managing Director, Horst Frisch).

181. OFFICE OF TAX POL’Y, U.S. DEP’T OF THE TREAS., *THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS* viii (2000), available at <http://www.ustreas.gov/offices/tax-policy/library/subpartf.pdf> (last visited Oct. 29, 2003). In the opinion of then Assistant Secretary for Tax Policy, there is no “significant controversy over what policy principles are appropriate.” *Id.* at vii.

182. See Judy Dempsey, *EU Industry Gears Up to Limit Sanctions Fallout*, FIN. TIMES (London), Sept. 14, 2002, at 7.

183. Edmund L. Andrews, *A Civil War Within a Trade Dispute*, N.Y. TIMES, Sept. 20, 2002, at C1.

priced tax lobbyists have clients on both sides of the fight.”¹⁸⁴ As one commentator accurately concludes, a total revocation of the ETI Act at this time seems unlikely “since U.S. exporters include large corporations with extremely powerful lobbying groups.”¹⁸⁵ Moreover, a reduction in U.S. exports as a result of scrapping the ETI Act could trigger economic contraction, which would constitute a very unwelcome event at a time when the U.S. economy is already experiencing a significant recession.¹⁸⁶ Finally, tradition and obstinacy may play a role: the United States has a long history of using tax policy to encourage the exportation of U.S. goods and services, and it has been quite reluctant to relinquish this practice.¹⁸⁷

In light of the political improbability of immediately and *permanently* repealing the ETI Act, a more realistic first part of the solution may be to immediately and *temporarily* repeal this legislation. More specifically, in order to comply with the WTO ruling and avoid the imposition of multi-billion dollar sanctions by the EU, it may be recommendable to suspend these tax-based export incentives until at least the next round of WTO negotiations in 2005. At that time, the United States and the EU may manage to renegotiate the agreements regarding subsidies and countervailing duties in order to achieve increased parity between the rules that are applied to “direct” taxes (like the income taxes imposed by the United States) and “indirect” taxes (like the value-added taxes utilized in the EU). If these nations reach an agreement on this issue, then the benefits under the ETI Act may be made available again, thereby eliminating the enormous expenditure of human, economic, and diplomatic resources necessary to enact new legislation now. Support for this solution is scant thus far, but should increase as long as the WTO negotiations in 2005 serve as a supplement to, and definitely not a substitute for, immediate congressional action to repeal the ETI Act.¹⁸⁸

Thinking more in the long-term, the second part of the solution is to create an appropriate multilateral forum designed to resolve conflicts involving two fields that are often treated separately, yet have a tremendous amount of overlap: international trade and international tax. “Tax treaties and trade agreements share the same underlying goal of facilitating international trade and investment, and they employ analogous rules to achieve it.”¹⁸⁹ Moreover, the two disciplines are obviously interrelated since, as the dispute over the ETI Act clearly illustrates, one nation can introduce preferential or discriminatory tax measures that subvert commitments made in international trade agreements. Despite this connection between tax and trade, with the exception of the WTO, these two areas are generally not encompassed by one multilateral agreement.¹⁹⁰ Tax experts acknowledge the uniqueness of the WTO but claim that the current rules addressing the crossover of tax and trade are utterly inadequate.¹⁹¹ According to one observer, the FSC/ETI dispute has yielded

184. *Id.*

185. Carmichael, *supra* note 55, at 206; *see also* O’Leary, *supra* note 45, at 168 (claiming that repeal of the ETI Act is infeasible because “once Congress creates a tax benefit for one segment of society, it is nearly impossible to take that benefit away”).

186. Carmichael, *supra* note 55, at 206.

187. Clark et al., *supra* note 45, at 319. Clark speculates that, while eliminating the FSC would be a wise solution, “American lawmakers are unlikely to eliminate or significantly reduce the offending FSC tax breaks any time soon—not if recent history is any indication.” *Id.*

188. *Extraterritorial Income Decision*, *supra* note 67, at 46.

189. Robert A. Green, *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 YALE J. INT’L L. 79, 80 (1998) (analyzing the issue of why tax treaties and trade agreements employ distinct methods of dispute resolution).

190. *See id.* at 87–89 (discussing the relationship between income tax treaties and trade agreements).

191. Rosendo Lopez-Mata, *Income Taxation, International Competitiveness and the World Trade Organization’s Rules on Subsidies: Lessons to the U.S. and to the World from the FSC Dispute*, 54 TAX LAW. 577, 614–16 (2001). This author argues that the decision by the WTO regarding the FSC dispute conformed to the strict language of the Agreement on Subsidies and Countervailing Measures (“SCM Agreement”), but it did not generate

several “lessons for the world,” one of which is that now is time for policymakers to close the existing gap between international tax law and international trade law by designing a multilateral regulatory framework capable of handling both issues simultaneously.¹⁹² Postulating that the problem is partially due to the fact that trade agreements historically have been negotiated by “trade people,” whereas tax treaties have remained the domain of “tax people,” other commentators also suggest the creation of a new international accord capable of covering both disciplines.¹⁹³ Other experts who entertain the possibility of establishing a new multilateral tax/trade regime clearly see the appeal of this endeavor but predict that any negotiations thereof will be “contentious” and determined in large part by the degree of political will that each nation has to reach any meaningful consensus.¹⁹⁴ If this new regulatory body fails to come to fruition, then the future may include “a full-fledged tax-based trade war, where the main losers are the backbone of every tax system—the taxpayers.”¹⁹⁵

sound policy. Based on this, Lopez-Mata concludes that “one could fairly ask whether the WTO is an appropriate forum, or [whether] the SCM Agreement is comprehensive enough, to deal with notably complex tax issues . . . [that] affect international trade.” *Id.* at 616.

192. *Id.* at 613.

193. Tom Field & Chuck Gnaedinger, *FSC/ETI Compliance Effort May Spur Far-Reaching U.S. International Tax Changes*, 2002 *WORLDWIDE TAX DAILY* 238-3 (Dec. 11, 2002). Playing on the General Agreement on Tariffs and Trade, this author notes that a Commerce Department undersecretary suggested the new accord be called the General Agreement on Tax and Trade. *Id.*

194. Derek Devgun, *International Fiscal Wars for the Twenty-First Century: An Assessment of Tax-Based Trade Retaliation*, 27 *LAW & POL’Y INT’L BUS.* 353, 421 (1996).

195. *Id.*

