# Beating Them at Their Own Game: A Solution to the U.S. Foreign Sales Corporation Crisis

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## INTRODUCTION

In the United States, both corporations and individuals pay federal taxes based on income.[1] In contrast, the majority of U.S. trading partner countries tax companies based on the value the companies add to the goods they sell.[2] The European Union's (EU) Value Added Tax (VAT) gives member countries tax breaks on exports, resulting in a cost advantage for European companies.[3] The United States is skeptical of the regressive nature of consumption taxes such as the VAT, but it wants to give exporting corporations tax advantages similar to those provided by the VAT.[4] To achieve those advantages, Congress created Foreign Sales Corporations (FSCs). FSCs allow corporations to defer tax on income that flows through subsidiaries located in foreign countries.[5] The EU successfully challenged the validity of the FSC tax scheme by lodging a complaint with the World Trade Organization (WTO).[6] The WTO found FSCs constituted an il-

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1. *See, e.g.*, I.R.C. § 1 (West Supp. 2002) (stating that the federal tax is imposed on the income of the taxpayer as defined in I.R.C. § 61).
2. Laura Dale, *The Economic Impact of Replacing the Federal Income Tax with a Federal Consumption Tax: Leveling the International Playing Field*, 9 CURRENTS: INT'L TRADE L.J., 47, 47 (2000).
3. Christopher Deal, *The GATT and VAT: Whether VAT Exporters Enjoy a Tax Advantage Under the GATT*, 17 LOY. L.A. INT'L & COMP. L. REV. 649, 649 (1995); Dale, *supra* note 2, at 52.
4. *See* Deal, *supra* note 3, at 651.
5. *See generally* I.R.C. §§ 921-27 (1994).
6. WTO Panel Report on the United States—Tax Treatment for "Foreign

legal export subsidy in violation of the GATT.[7]

Part I of this Note examines the current differences between the United States' tax on income and the EU's VAT and the recent WTO rulings invalidating FSCs. Part II discusses tax competition among other countries and analyzes how the competition affects tax revenue bases. Part III provides three possible solutions to the FSC dispute: (A) leaving the FSC provisions the way they are; (B) switching to a VAT for corporate taxation; and (C) changing the corporate tax policy to a territorial system by removing all taxes on foreign source income. Part IV concludes the third option is best in light of current economic conditions.

## I. THE CURRENT SITUATION INVOLVING TAX POLICY DISCREPANCIES BETWEEN THE UNITED STATES AND THE EUROPEAN UNION

### A. THE EUROPEAN UNION'S VALUE ADDED TAX

#### 1. *An Introduction to the VAT*

The EU's VAT is considered a consumption tax;[8] it taxes goods and services when consumed instead of taxing income.[9] A simple example of a consumption tax is a state or local sales tax. Consumers pay a sales tax when they purchase goods. The VAT uses a slightly more complicated method to tax businesses. To understand how the VAT applies to businesses, consider the process used in canning vegetables. First, the farmer buys seed and fertilizer to grow the vegetables. Next, she harvests the vegetables and sells them. The farmer must pay a tax on the amount she receives from the transaction. Under the VAT, she

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Sales Corporations," WT/DS108/R, ¶ 7.130 (Oct. 8, 1999), *at* http://www.wto.org [hereinafter October Panel Report].

7. *See id.*

8. *See* Alan Schenk, *The Plethora of Consumption Tax Proposals: Putting the Value Added Tax, Flat Tax, Retail Sales Tax, and USA Tax Into Perspective*, 33 SAN DIEGO L. REV. 1281, 1289-93 (1996); *see also* Alan Schenk, *Choosing the Form of a Federal Value-Added Tax: Implications for State and Local Retail Sales Taxes*, 22 CAP. U. L. REV. 291, 297-98 (1993).

9. *See Choosing the Form of a Federal Value-Added Tax*, *supra* note 8, at 297-98; *see, e.g.*, Value Added Tax Act, 1994, c. 23, § 1(1) (Eng.).

is entitled to deduct from her tax any taxes previously paid on her inputs,[10] such as any tax paid on products or services used by the farmer to grow the vegetables. For example, the farmer would deduct any amount of tax paid for seed or fertilizer. Continuing the example, if the vegetables are sold to a cannery where they are processed, canned, and sold to a store, the cannery must pay a tax based on the amount it received from the store. Under a VAT scheme, the cannery deducts the amount of any taxes already paid on the goods. The cannery's deductions include the tax paid by the farmer and any other deductions the farmer took. When the can of vegetables is sold at the store, the consumer pays the final tax, which is adjusted for all taxes previously paid by the farmer, the cannery, and so on.

*2. The VAT Does Not Impose a Tax on Exports*

From an international trade perspective, the key benefit of a VAT scheme is that exports are not taxed.[11] If the cannery in the previous example exported the cans of vegetables to a foreign country, the cannery would not pay a tax on the transaction.[12] The theory behind such a tax break is the "destination principle."[13]

Under the destination principle, a good or service is taxed where it is consumed.[14] If a good is not consumed in a country, it should not be taxed in that country. Instead, the tax should be placed on the good when it reaches its final destination. In a country with a VAT scheme, a tax is placed on all goods consumed within the country, including domestically produced goods as well as imports.[15]

The VAT system—under which goods leaving the country are not taxed, but imports are—creates significant disadvantages to countries with tax systems based on income.[16] Theoretically, when a good leaves a VAT country, it should be taxed by the foreign nation where it is consumed.[17] This is indeed what happens in international transactions within the EU.[18]

10. *See, e.g.*, Value Added Tax Act, c. 23, § 25(2).
11. Dale, *supra* note 2, at 50.
12. *See id.*
13. *Id.*
14. *Id.*
15. *E.g.*, Value Added Tax Act, 1994, c. 23, § 1(1) (Eng.).
16. Dale, *supra* note 2, at 50.
17. *E.g.*, Value Added Tax Act, c. 23, § 10.
18. *See id.*

However, when EU goods are exported to a country where there is no VAT—such as the United States—the goods avoid a significant tax burden.[19] The European company pays no VAT on the export because the VAT is only levied on goods sold within the country.[20] Usually, the goods face a consumption tax when they are purchased.[21] But, when goods are sold to the United States, they are not subject to a federal consumption tax.[22]

Conversely, when goods leave a country like the United States and enter a VAT country, the destination state assesses its domestic consumption tax on the goods.[23] If a company in the United States exports goods to Europe, the company faces a tax imposed on the consumption of the goods when they are sold in Europe[24] in addition to the U.S. income tax based on the profits from the foreign sales.[25] In effect, this double-taxation system puts U.S. exporters at a disadvantage, and attempts to alleviate the resulting burden were sought.[26]

Countries in the European Economic Community (EEC) agreed to use the VAT in the Treaty of Rome.[27] The purpose of enacting a common form of consumption tax was to reduce the negative effects on trade arising from disparate taxation systems.[28] Before the countries settled on a VAT consumption tax, they considered alternative tax schemes.[29] Committees investigating tax options selected the VAT because it avoided many of the problems associated with a strict consumption tax.[30] The strict consumption tax problem the EEC sought to avoid was the cascade effect.[31]

The cascade effect occurs when a tax is levied at each stage

19. Since the exported goods (i) do not face a VAT in their originating country, *see* Value Added Tax Act, c. 23, § 1(1), and (ii) do not face a VAT in the United States where they are sold, *see supra* note 1, the exported goods circumvent considerable taxes.

20. *See supra* text accompanying note 15.

21. *See supra* text accompanying note 17.

22. *See* text accompanying note 1.

23. *E.g.*, Value Added Tax Act, 1994, c. 23, § 1(1)(c) (Eng.).

24. *Id.*

25. *See, e.g.*, I.R.C. §1 (stating that the federal tax is imposed on the income of the taxpayer as defined in I.R.C. §61).

26. *See* discussion *infra* Part I.B.

27. Craig A. Hart, *The European Community's Value-Added Tax System: Analysis of the Transitional Regime and Prospects for Further Harmonization*, 12 INT'L TAX & BUS. LAW. 1, 4 (1994).

28. *Id.*

29. *Id.*

30. *See id.*

31. *See id.*

of the production process and no tax deduction is allowed for taxes already paid.[32] In the can of vegetables example, a tax percentage would be applied at each stage of production when the vegetables change hands. No deduction would be allowed for taxes paid earlier in the production chain. If one company owned the seed producer, the farm, the cannery, and the distributor, the company could avoid most taxes. Such a company would be classified as vertically integrated. The vertically integrated company would only pay the tax levied on the sale of the product to the retail store. The VAT aims to avoid windfalls to vertically integrated companies by allowing deductions to each business involved in the production of a good equal to the amount of tax previously paid on the good.[33]

After the EEC decided on the VAT, its members chose to make the EEC tax system destination-based[34] by basing tax rates on the *final* sale price of goods to the ultimate consumer.[35] In order for the destination-based system to work, the countries seeking free trade had to agree on a common rate structure.[36] To adhere to the free trade concepts in the Treaty of Rome, each country needed to treat companies abroad similar to companies within their borders.[37] Thus, tax rates were harmonized during the implementation of the EU's VAT.[38]

## B. THE CREATION OF FOREIGN SALES CORPORATIONS IN THE UNITED STATES

### 1. *Problems with Implementing the VAT in the United States*

Instead of a consumption tax, the United States uses an income tax based on accessions to wealth.[39] The United States continues to tax income because it perceives problems with the VAT. The first problem with the VAT—as a consumption tax system—is its regressive nature.[40] The regressive features are illustrated in the following example involving two roommates.

32. *See id.*
33. *See* Hart, *supra* note 27, at 4.
34. *Id.* at 8.
35. *See id.* at 3.
36. *See id.* at 36.
37. *See id.*
38. *See id.*
39. *See* I.R.C. §§1, 61 (West. Supp. 2002).
40. Hart, *supra* note 27, at 5.

Taxpayer A earns $25,000 per year, and taxpayer B earns $100,000 per year. Taxpayers A and B evenly split the $20,000 cost of rent and utilities by paying $10,000 each. Taxpayer A spends another $10,000 on food and clothing. Since taxpayer B has more income, taxpayer B spends $15,000 on food and clothing. Under a consumption tax system, taxpayer A is taxed on the $20,000 spent during the year, and taxpayer B is taxed on the $25,000 spent during the year. The result is that 80% of taxpayer A's income is taxed, but only 25% of taxpayer B's income is taxed. The regressive nature of the tax means people with low incomes spend a much larger percentage of their income on taxes than people with higher incomes.

A second problem with the VAT is that goods are taxed at every sale regardless of whether the seller is making money.[41] Consider a country with a 25% consumption tax and a retail company that erroneously anticipated high consumer demand and paid $4 per unit for goods. When the goods do not sell for $5, the retailer is forced to reduce the price. If consumers will only pay a *total* of $4 for each good, the company must sell at that price. If there is a consumption tax of 25%, the company will effectively sell the goods for $3 each as $1 per item is given to the government. The company loses $1 on each good sold under the consumption tax system. If a retailer is taxed on income, it will not pay any tax, because at a price of $4, the company will not have any income from the sale. The company loses money under the consumption tax system, but it breaks even under the income tax system.

Although the United States maintains an income tax system to avoid the problems discussed above, the friction created between the VAT and income tax methods puts U.S. corporations at a disadvantage.[42] U.S. corporations that export to EU nations face the VAT import tax when the goods are consumed in Europe and face an income tax related to those sales in the United States.[43] Conversely, companies in the EU do not pay the VAT on exports, and no consumption tax is placed on the goods in the United States.[44]

41. Some commentators argue that small businesses already bear a significant cost burden due to the tax on income in the US. The burden stems from the high costs associated with calculating taxable amounts and complying with other internal revenue code policies. Dale, *supra* note 2, at 52-53.

42. Dale, *supra* note 2, at 52.

43. *See supra* text accompanying notes 17-25.

44. *See supra* text accompanying notes 16-24.

*2. The DISC*

In 1971, Congress attempted to put U.S. corporations on equal footing with those in the EU by enacting a law creating Domestic International Sales Corporations (DISCs).[45] The DISC legislation allowed corporations to create domestic entities through which their sales to foreign nations would flow.[46] Corporations set up these subsidiaries to meet the statutory requirements and elected to make them DISCs on their income tax returns.[47] Finally, corporations used the DISC to export goods to other countries.[48] Profits from DISCs were not taxed unless such profits were distributed to shareholders as dividends.[49] If corporations retained the profits and reinvested them within the company, taxes were conceivably avoided entirely.[50]

The European Community (EC) complained that DISC tax avoidance violated the GATT and eventually brought an action to prevent the United States from continuing the tax scheme.[51] The GATT panel agreed with the European members and found that DISCs were illegal subsidies under the treaty.[52] Rather than disputing the decision and risking further confrontation, the United States announced it would change the DISC legislation to fit the requirements of the GATT.[53]

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45. Revenue Act of 1971, Pub. L. No. 92-178, § 501, 85 Stat. 497 (1971); *see also* Cecelia B. Skeen, *Knick-Knack Paddy Whack Leave the FSC Alone: An Analysis of the WTO Panel Ruling That the U.S. Foreign Sales Corporation Program is an Illegal Export Subsidy Under GATT*, 35 NEW ENG. L. REV. 69, 72 (2000).

46. *Id.*

47. Hunter R. Clark et al., *The WTO Ruling on Foreign Sales Corporations: Costliest Battle Yet in an Escalating Trade War Between the United States and the European Union?*, 10 MINN. J. GLOBAL TRADE 291, 298 (2001). Corporations desiring to create a DISC and enjoy the tax benefits had to make the subsidiary meet certain prerequisites. First, a minimum of 95% of the gross receipts of the subsidiary had to come from exports. *Id.* Second, 95% of the subsidiary's assets had to fit a qualified definition. *Id.* Third, the subsidiary had to contain a capital investment of at least $2,500 and issue only one class of stock. *Id.* Finally, the company owning the subsidiary had to make the proper election. *Id.*

48. By 1979, the estimated increase in exports due to DISCs was $2.5 billion. *Id.*

49. *Id.* at 297.

50. *Id.*

51. *Id.* at 298.

52. *Id.*

53. Clark et al., *supra* note 47, at 298.

### 3. *The FSC*

In 1984, the United States created the Foreign Sales Corporation (FSC).[54] These entities were intended to solve the problems DISCs encountered yet still provide U.S. corporations with a tax reduction on export income.[55] Among other requirements, to qualify for tax breaks under FSC regulations, a company had to set up a corporation in another country and conduct "economic processes" there.[56] Economic processes were defined as: (1) promoting sales and advertising; (2) handling customer orders and organizing delivery; (3) transporting goods from the time the FSC received them until delivery; (4) accepting payment and producing final receipt; and (5) assuming credit risk.[57] A company needed to show either that 50% of its costs of completing the above processes were incurred outside of the United States, or that 85% of the total costs for only two of the above processes were incurred outside the US.[58] Most corporations could easily complete 85% of their order processing and payment acceptance in a foreign country and thus could qualify their FSC for tax benefits.[59]

Once the entity qualified for FSC status under the tax code, it could conduct business free from U.S. taxes.[60] The only taxes an FSC would face were those imposed by the country where the FSC was located.[61] When the FSC had profits, it could pay the profits to the parent company in the form of a tax-free dividend.[62] If the parent company then issued a dividend to its shareholders, the dividends would be treated like any other dividend and taxed as individual income to the shareholders.[63]

To illustrate the benefits of FSCs, consider again the can-

54. Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§801-5, 98 Stat. 494, 985-1003 (1984).

55. Skeen, *supra* note 45, at 73.

56. Stanley I. Langbein, *INTERNATIONAL DECISION: United States—Tax Treatment for "Foreign Sales Corporations"*, 94 AM. J. INT'L L. 546, 553 (2000).

57. *Id.*

58. *Id.*

59. *Id.*

60. Clark et al., *supra* note 47, at 299.

61. *Id.* U.S. tax code does not control the manner in which the country that hosts the FSC decides to tax the FSC. Generally, corporations choose foreign nations with little or no taxes as places to incorporate their subsidiary FSC. *See id.*

62. *Id.*

63. *See id.* When a citizen receives a dividend payment from a corporation in the form of a dividend, it is individual income taxed under federal law. I.R.C. § 61 (West Supp. 2002). However, the dividend is larger because the corporation did not have to pay taxes on the dividend, as it was earned through a FSC.

nery in the can of vegetables example. If the cannery exports its goods to Europe, the European VAT will impose an import tax when the vegetables are sold. The cannery must also pay the U.S. income tax on profits earned from the sale. Because the cannery faces both taxes, it is unlikely to produce a competitively priced export.

If the cannery sets up a subsidiary that qualifies as an FSC, it has a better chance of producing a competitively priced product. If the cannery sets up part of its operations so it can receive orders and payments and handle shipping or delivery in a foreign country, it can avoid the U.S. tax on income earned through foreign sales. Since the only tax the goods face is the consumption tax of countries where the goods are consumed, the cannery will be on equal footing with its competitors in VAT countries.

## C. THE CONFRONTATION MOVES INTO THE WTO DISPUTE RESOLUTION PROCESS

### *1. Dispute Resolution Process*

The WTO dispute resolution process is designed to solve disputes between countries and create a better environment for free trade.[64] The dispute resolution process begins with a WTO consultation during which government representatives from each country directly involved review the disputed issue.[65] The consultation usually lasts less than four hours,[66] and if it does not result in a resolution, the countries can move forward in the WTO system.[67]

Next, the countries request the creation of a Panel to hear the dispute and make a recommendation.[68] After the Panel has issued its decision, the losing party must file notice of its intent to appeal or persuade member countries of the Dispute Settlement Body to vote against the Panel's decision.[69] The winning

64. Mark Clough, *The WTO Dispute Settlement System – A Practitioner Perspective*, 24 FORDHAM INT'L L.J. 252, 252 (2000).

65. Settling Disputes, *in* Trading Into the Future: The Introduction to the WTO, *at* http://www.wto.org/english/thewto_e/whatis_e/tif_e/tif_e.htm (last visited Feb. 21, 2002).

66. Clough, *supra* note 64, at 254.

67. *Id.* at 259.

68. Settling Disputes, *supra* note 65.

69. *Id.*

party has the option of rejecting the Panel's decision.[70] If the decision of the Panel is appealed, the Appellate Body hears the dispute and can affirm or reverse the Panel's decision.[71] The Appellate Body is unlikely to overturn the decision of the Panel.[72]

If either the Panel or the Appellate Body finds the disputed law violates trade agreements and decides it should be removed, the country has one month to inform the Dispute Settlement Body of its intentions.[73] The violating country is then given a reasonable time to resolve the issue.[74] After the resolution, if the winning country wants to challenge the actions of the violating country as inconsistent with the WTO decision, the original panel is called upon to deliver a decision about the sufficiency of the violating country's remedy.[75] If the Panel finds the violating country's attempt to remedy the problem was not sufficient, the violating country may appeal once again to the Appellate Body.[76]

### 2. *The WTO Decisions Regarding FSCs*

On November 18, 1997, the EU challenged the FSC provisions of the U.S. tax code, asserting the provisions violated the GATT.[77] The parties did not settle in the consultation stage, so the Dispute Settlement Board established a Panel to hear the issue.[78] On October 8, 1999, the Panel distributed its report, finding the FSC provisions violated multiple trade agreements.[79] The United States promptly declared its intention to appeal.[80]

The Appellate Body issued its findings on February 24, 2000.[81] Although it disagreed with some of the Panel's findings,

70. Clark et al., *supra* note 47, at 300.
71. Settling Disputes, *supra* note 65.
72. Kimberly J. Pinter, *Diplomacy Along with Tax Law Change Needed to Resolve Dispute with European Union Over U.S. Export Tax Breaks*, 20 TAX MGMT. WKLY. REP. 1235 (2001) (discussing how the WTO's Appellate Body is unlikely to reverse the decision of the Panel in the Foreign Sales Corporation dispute).
73. Clough, *supra* note 64, at 260.
74. *Id.*
75. Settling Disputes, *supra* note 65.
76. *Id.*
77. Clough, *supra* note 64, at 266.
78. *Id.*
79. *See id.* (discussing the panel's finding that the FSCs violated Article 3.1(a) of the SCM Agreement and Article 3.3 of the Agreement on Agriculture).
80. *Id.* at 266.
81. *Id.*

the Appellate Body found the U.S. laws providing tax breaks to FSCs violated trade agreements.[82] The United States then informed the WTO of its plans to remedy the situation and bring the tax scheme into compliance with trade agreements.[83]

In November of 2000, Congress followed through with its plans by passing the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.[84] The EU viewed the repeal as an insufficient change to the original FSC provision,[85] so it brought a complaint to the WTO Panel and won again.[86] This time, the EU won the opportunity to retaliate with approximately $4 billion in sanctions.[87] The United States appealed, but the Appellate Body agreed that the new legislation still violated trade agreements.[88]

After the Appellate Body ruled, the EU revealed a list of items that might be subject to the sanctions.[89] The list included: "steel, meat products, cereals, textiles, and aircraft."[90] The threat of sanctions is not immediate due to the turbulent world economy and an associated reluctance to enter a trade war.[91]

In sum, the current WTO Appellate Body ruling provides that FSCs are in violation of the GATT.[92] However, without a mechanism such as FSCs, U.S. corporations are at a comparative disadvantage relative to their foreign competitors.

82. *Id.* The U.S. tax provisions violated trade agreements because they were too similar to export subsidies. *Id.* The tax code normally requires a tax payment levied on all income earned by U.S. corporations. However, the tax code sections at issue provide a special tax absolution to income earned outside the United States through FSCs. *Id.* Thus, the WTO believes the U.S. government is unfairly subsidizing exports by providing exporting corporations a significant tax break. *Id.*

83. Clough, *supra* note 64, at 267.

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

85. Clark et al., *supra* note 47, at 293-94.

86. *See* WTO Panel Report on United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/RW (Aug. 20, 2001), *at* http://www.wto.org [hereinafter August Panel Report].

87. *Id.*

88. *See id.* at 60-61.

89. Barry James, *U.S. and EU Seek to Cool Trade Fires After Ruling But Internal Pressures on Both Sides Resist Compromise on WTO,* INT'L HERALD TRIB. (New York), Jan. 16, 2002 at 4.

90. *Id.*

91. *See id.*

92. August Panel Report, *supra* note 86, at 60.

## II. TAX COMPETITION

Tax competition among countries stems from the increasing liquidity of business capital and the global differentiation in tax rates.[93] Companies have the ability to select their place of incorporation.[94] When a company can receive capital investments from foreign markets in the chosen country, it will select the country that imposes the smallest burdens.[95]

Individual investors can also choose the corporations in which to invest their money based on the amount of taxes the corporations incur.[96] Many countries, unlike the United States,[97] do not tax citizens' income earned in a foreign country. Because of that, taxpayers base investment decisions on the tax liability they will face in a foreign country. For example, consider a taxpayer living in country 1, which does not tax income earned in foreign countries. The taxpayer can choose between two investments: company A in country 2 or company B in country 3. Companies A and B each produce profits of $100 million per year. However, company A faces the tax system of country 2 that imposes a 40% tax on corporate income, and company B faces the tax system of country 3 that imposes a 25% tax on corporate income. Thus, after taxes, company A will have $60 million to distribute to shareholders, and company B will have $75 million. Rational investors will choose company B because of its smaller tax burden. This example shows how a country's corporate tax scheme can affect capital investment in that country's corporations.

Although taxation is one factor in deciding where to incorporate, companies make significant tradeoffs in picking the

93. *See generally* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000); *see also* Harry Grubert and John Mutti, *Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision Making*, 73 REV. OF ECON. AND STAT. 285 (1991) (concluding that tariffs and taxes have significant effects on decisions of multinational corporations).

94. Robert Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 18 (1993).

95. *Id.*

96. Increasing amounts of information available to investors regarding foreign investment opportunities have led to dramatic changes in the investment behavior of average investors. No current portfolio is complete unless it has at least one international security or fund. *See* Christopher Farrell, *Global Investing: Global Strategies*, BUSINESS WEEK, Sept. 11, 2000, at 160.

97. The United States taxes all income from whatever source derived. I.R.C. §§ 1, 61 (West Supp. 2002). Even United States citizens living abroad are assessed an income tax. They do, however, receive tax credits for any income taxes they pay in the foreign nation. I.R.C. § 861 (West Supp. 2002).

country with the smallest income tax.[98] Companies considering low tax nations need to take into account the education level of potential workers to determine whether additional training will be needed, public transportation infrastructure to ensure input materials can be shipped to production facilities and goods can be shipped out to customers, and the availability and cost of resources needed to produce goods.[99] Companies must also consider potential government interference and corruption.

Finally, capital is not completely liquid, yet. As stated above, companies have the luxury of deciding where to incorporate due to greater capital availability.[100] Companies in some countries have access to capital markets sufficient to obtain financing for their businesses, but others do not.[101] The countries with insufficient capital markets do not have adequate banking and securities regulations to entice foreign investment.[102] Still, the United States needs to remain mindful of the tax competition it faces abroad. The U.S. tax base could shrink if corporations flee to other nations that offer smaller tax burdens and sufficient resources.[103] The resulting decreased tax base would force Congress to increase rates to sustain tax revenue or cut spending for federal programs.

## III. POSSIBLE SOLUTIONS TO THE FSC DISPUTE

Due to international tax competition, it appears that tax breaks for U.S. exports are necessary. However, recent cases brought against the United States by the EU resulting in holdings that tax breaks funneled through FSCs are in violation of the GATT.[104] Thus, the United States must decide whether to disregard the WTO's decisions, remove tax breaks on exports, or

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98. Avi-Yonah, *supra* note 93, at 1627.

99. *See id.* at 1627.

100. *See supra* note 96.

101. Some corporations simply follow the U.S. securities laws and obtain capital through U.S. stock exchanges. Nokia, a company based in Finland, is listed on the NYSE under NOK. Other countries have their own securities markets. *See* The World Federation of Exchanges, *at* http://www.worldexchanges.org (last visited Apr. 3, 2002).

102. *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 801-13 (2001) (explaining how laws and institutions are essential for the development of a securities market in any country before minority shareholders can be protected).

103. *See* Mitchell B. Weiss, *International Tax Competition: An Efficient or Inefficient Phenomenon?*, 16 AKRON TAX J. 99, 112 (2001).

104. *See supra* Parts I , II.

change the form of the tax breaks.[105]

## A. IGNORE THE WTO RULING

The United States could choose to ignore the WTO.[106] Instead of acquiescing with and obeying the WTO's ruling, the United States could continue to use FSCs in their current form.[107] Although $4 billion in sanctions are looming, there will most likely be a significant delay before the EU actually imposes them.[108] Notably, FSCs allow corporations in the United States to save about $4 billion per year in taxes.[109]

Disobeying the WTO may buy the United States some time, but it is not the best long-term solution.[110] Due to the new war on terrorism,[111] the EU will likely grant the United States more time to deal with the FSC problem.[112] The EU is unlikely to entirely forget about the issue. Any sympathy will be temporary, and the $4 billion in sanctions could further depress a slowly recovering U.S. economy.

The events of September 11 have also created a situation in which the United States needs allies.[113] To wipe out terrorist groups throughout the world, the United States needs cooperation from many countries. If the United States ignores the WTO ruling, countries aiding the war against terrorism may second-guess their support of the United States.

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105. *See* Ernest R. Larkins, *WTO Appellate Body Rules Against FSCs: The Search for Alternatives begins*, 11 J. INT'L TAX'N 14, 16-18 (2001) (briefly identifying the alternatives available to the United States). Another option is negotiating a settlement with the EU. *Id.* However, that option does not appear likely because the United States does not have a $4 billion bargaining chip, and if it did, it would have negotiated instead of proceeding with Congress' unsuccessful modification of the FSC provisions. *Id.*

106. Clark et al., *supra* note 47, at 298; Larkins, *supra* note 105, at 16.

107. See Larkins, supra note 105, at 16.

108. Ryan J. Donmoyer, *U.S. May Tax International Corporations Differently: WTO Wants Changes, Saying U.S. Provides Unfair Tax Breaks*, CHICAGO SUN-TIMES, Aug. 5, 2001, at 33 (explaining that the EU is unlikely to impose the trade sanctions any time soon because it will hurt large European companies that have significant operations in the United States, such as Daimler-Chrysler.).

109. *See* Pinter, *supra* note 72, at 1235 (stating that the United States would effectively raise corporate income tax revenues by $4 billion if the FSC provisions were removed from the tax code).

110. *See* Larkins, *supra* note 105, at 16.

111. Michael Elliott, *Hate Club: An In-depth Look at al-Qaeda*, TIME, Nov. 12, 2001, at 58; Michael Hirsh & John Barry, *How to Strike Back*, NEWSWEEK, Sept. 24, 2001, at 36.

112. *See* James, *supra* note 89.

113. Hirsh & Barry, *supra* note 111, at 36-37; *see* Elliott, *supra* note 111, at 58.

Finally, ignoring the WTO ruling could weaken possibilities of future beneficial trade agreements and weaken the reputation and power of the WTO.[114] 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. China's recent membership in the WTO[115] helps to make the organization the best possibility for true free trade on a global basis. China also offers the best growth market for U.S. exports, so relations with China in particular should be handled with care.[116]

Ignoring the WTO ruling is not a feasible method of dealing with the FSC problem. The United States cannot afford to lose allies during its war against terrorism, and it should not disrupt the global trend towards free trade. Congress needs to change the tax code to a system that puts U.S. corporations on a level playing field with the rest of the world.[117] Two options are discussed below.

### B. SWITCH TO A VALUE ADDED TAX

To prevent further violations of the GATT, the United States could move to some form of value added taxation. Current international tax competition has made the United States' income tax system unfavorable to exporting businesses in comparison to businesses in VAT countries.[118]

Some commentators have argued that income taxes in general are behind the times.[119] As discussed above, the U.S. income tax system creates disadvantages for corporations headquartered in America. Corporations can relocate their headquarters, obtain capital from foreign markets and continue operations while saving taxes.[120] These factors compound prob-

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114. *See* Larkins, *supra* note 105, at 16.

115. WTO, *Trading intp the Future: An Introduction to the WTO, at* http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm (last visited Apr. 3, 2002) (listing China as a new member of the World Trade Organization on December 11, 2001).

116. *See* Bill Nichols & James Cox, *Backers Hope China Pact Will Promote Reform*, USA TODAY, Sept. 20, 2000, at 10A.

117. *See supra* Part II.

118. Weiss, *supra* note 103, at 104-107, 106 n.20 (explaining how tax competition is here to stay and how this competition led Congress to enact FSC legislation to contend with other nations).

119. *Id.* at 130.

120. *See* Ferdinand P. Schoettle, *Big Bucks, Cloudy Thinking: Constitutional*

lems of the current income tax.

Experts argue a consumption tax would help solve other problems presented by the current income tax.[121] The current internal revenue code's provisions for business taxation are a confusing mess of exceptions and definitions.[122] Experts argue taxing consumption permits easier collection because taxing consumption of goods or services by actual people is easier than taxing a legal entity with no real physical existence.[123] Further, they argue that moving to a consumption tax is better than trying to patch together another export quasi-subsidy that will only add to tax code complexity.[124] Taxing consumption would also allow the United States to place a tax on imports.[125] Taxing imports is probably the most desirable benefit of a consumption tax. The goods that leave EU countries (and face no export tax) would be subject to the same consumption tax that goods produced in the United States face when sent to EU countries.

The United States could impose a VAT on businesses and keep the income tax on individuals. Corporations would pay a tax based on the amount of value they add to their products. Thus, a company would pay a federal sales tax based on the price at which goods are sold.[126] The company would deduct taxes previously paid in the line of production, thereby reducing the tax paid by the company.[127] Citizens would still pay a progressive income tax as well as the new federal sales tax. Keeping the progressive individual income tax would reduce the regressive effects of a consumption tax on purchases.[128] Congress could also create exemptions for inelastic goods and place higher rates on luxury goods in order to further reduce regressive effects. This type of tax scheme would anger taxpayers who would be paying a consumption tax on purchases in addition to their

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*Challenges to State Taxes—Illumination from the GATT*, 19 VA. TAX REV. 277, 338-39 (1999).

121. *See generally* Gary C. Hufbauer, *Income vs. Consumption Taxation: Domestic and International Reforms*, 26 BROOK. J. INT'L L. 1555 (2001) (explaining why consumption taxation should win the longstanding debate between advocates for income taxation and consumption taxation).

122. *See* I.R.C. §§ 341(e)(1), 382, 501(a) (2000).

123. *See* Hufbauer, *supra* note 121, at 1557.

124. *Id.*

125. *Id.* at 1561.

126. *See, e.g.*, Value Added Tax Act, 1994, c. 23, § 2 (Eng.) (assessing a 17.5% tax on all goods and services sold within the United Kingdom).

127. *See, e.g.*, Value Added Tax Act, c. 23, § 25.

128. *See* discussion *supra* Part I.B (discussing regressive taxes).

personal income taxes.[129]

Congress is unlikely to remove the corporate income tax and impose a VAT. If the United States changed to a VAT, consumers would pay a national consumption tax, otherwise titled a federal sales tax, on goods they purchase. Consumers would likely be upset that their elected officials changed the revenue code to benefit corporations.[130] Theoretically corporations would reduce the price of their goods to reflect income tax removal, but prices would almost certainly remain the same immediately after the change and slowly move downward toward market equilibrium.[131]

State and local governments would probably balk at the notion of a federal sales tax. Traditionally in the United States, state and local governments generate revenue through sales taxes.[132] Local governments rely on sales tax revenues for large portions, or sometimes all, of their budgets.[133] If the federal government adds its own sales tax, local governments will be under more pressure to keep taxes low. To maintain their budgets, local governments may have to increase existing sales taxes or rely more heavily on other taxes for revenue such as property or state individual income taxes. Although the Constitution does not prevent the federal government from levying a national sales tax,[134] state and local governments would likely argue that principles of federalism should prevent Congress from invading a resource that has been traditionally left to local governments.[135]

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129. Theoretically, taxpayers' anger would be dissipated by lower prices. Since under a VAT corporations would pay little or no income tax, corporations would lower their prices. Ideally, consumers would pay about the same amount for goods with the VAT consumption tax as they would pay under a corporate income tax system.

130. *See* Kirk J. Stark, *The Right to Vote on Taxes*, 96 NW. U. L. REV. 191, 191 (2001) (discussing Americans' traditional distain for taxes).

131. Ideally, corporations would lower their prices because they do not have to pay income taxes. *See supra* note 129. However, companies will probably squeeze as much profit as they can out of the market. Once the first movers lower their prices, others will have to follow suit, but the amount of time it might take is indeterminable. During the period of normal prices with the additional new tax, public approval of the new system would likely be extremely low.

132. FERDINAND SCHOETTLE, STATE AND LOCAL TAXATION AND FINANCE (Lexis Publishing 2001) (discussing how historically, the federal government has left transactional taxes, such as a standard sales tax, largely to the states).

133. *See, e.g.*, State and Local Tax Receipts of Florida, *available at http://*www.eog.state.fl.us/ dor/tables/f2fy0001r.html (last visited Apr. 3, 2002).

134. U.S. CONST. art. I, § 8, cl. 1.

135. *See* U.S. v. Lopez, 514 U.S. 549, 610-11, 115 S. Ct. 1624, 1655 (1995).

Price distortion and related market inefficiencies from the consumption tax[136] would occur as well if a federal sales tax was enacted. Corporations would have to pay a consumption tax on sales even if they are not making a profit.[137] Corporations would have to add the tax amount into the selling price of their goods, thus distorting price equilibrium.[138] Consumers would pay what the good is worth on the market; producers would receive the market price minus the consumption tax.[139] Despite some desirable results, the undesirable consequences of a value added tax make it an unlikely option.

### C. USE A TERRITORIAL SYSTEM TO CHANGE THE CORPORATE TAX CODE FROM TAXING ALL FOREIGN SOURCE INCOME TO TAXING ONLY DOMESTIC INCOME

If the United States does not find a legitimate way to allow tax breaks on exports, large multinational corporations will have a significant incentive to incorporate elsewhere.[140] For example, when U.S.-based Chrysler Corporation merged with the German-based Daimler Benz, the new entity, Daimler Chrysler, incorporated in Germany.[141]

The United States does not need to have the lowest taxes to attract and retain corporations, but it does have to remain competitive.[142] Tax competition among nations is healthy because it helps keep government spending in check.[143] Corporations will not simply run to incorporate in the country that provides the best tax situation. They will search for the best overall mix of

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136. *See* discussion *supra* Part I.B.

137. *See* discussion *supra* Part I.B.

138. *See* discussion *supra* Part I.B.

139. *See* discussion *supra* Part I.B.

140. *See* Grubert & Mutti, *supra* note 93, at 285-93; *see also* Weiss, *supra* note 103, at 112; *see also* Larkins, *supra* note 105, at 16. "The Treasury Department estimated that the FSC program increased U.S. exports in 1992 by $150 billion." Larkins, *supra* note 105, at 16. (citing U.S. Treasury Department, The Operation and Effect of the Foreign Sales Corporation Legislation (Nov. 1997)). If all export encouragement were removed, export growth would suffer greatly. *Id.*

141. *See* Donmoyer, *supra* note 108, at 33. However, Chrysler's operations located in the United States still pay American income taxes. Arguably this tax burden discourages the company from having offices and production factories in the United States because these business units can be placed in areas with cheaper labor and lower taxes.

142. Avi-Yonah, *supra* note 93, at 1632-39 (discussing how developed countries, including the United States, need to remain tax competitive and still maintain revenue to cope with the welfare needs of an aging population).

143. Weiss, *supra* note 103, at 128.

tax burden, government services, government stability, access to capital, access to talented employees, natural resources, and so on.

As the recent WTO decisions regarding FSCs prove, the United States cannot have a system that taxes all income earned from foreign sources and then gives tax breaks to corporations when they earn income outside the United States.[144] This form of tax relief is an illegal export subsidy,[145] or it is too similar to an illegal export subsidy for the WTO to allow.[146]

The United States can switch its corporate tax scheme to a tax that is only levied on income earned in America. Foreign source corporate income would be tax-free. Since the tax would levy on income based on the territory in which it is earned and no longer be premised on taxing all income wherever earned, this scheme would not be an illegal export subsidy.[147]

The United States can emulate the tax system of France. The French corporate tax does not impose a tax on profits earned in a foreign country.[148] France's system is based on territoriality, as explained by the following:

> The French system of taxation of companies or enterprises is governed by the principle of territoriality under which only income realized by enterprises carried out in France is taxable. Conversely, profits realized by enterprises carried out outside France are not taxable in France, whatever the nationality or the place of location of the head office.[149]

The key to the French system is that it is based on the principle that only income earned in France is subject to tax.[150] Thus, it

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144. *See supra* text accompanying notes 6, 86.

145. The GATT makes export subsidies illegal. General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, 1867 U.N.T.S. 190, 33 I.L.M 1153 (1994).

146. Langbein, *supra* note 56, at 546.

147. See WTO Appellate Report, United States—Tax Treatment for Foreign Sales Corporations, WT/DS108/AB/R ¶ 179, (Feb. 24, 2000), *at* http://www.wto.org, *discussed in* Larkins, *supra* note 105, at 19 (explaining that using a territorial system is an "acceptable means of exempting export profits from taxation," under WTO law, though foreign-source activities other than exporting would then also be exempt).

148. Charles G.G. Campbell et al., *Business Operations in France*, 961-2nd TAX MGMT. FOREIGN INCOME PORTFOLIOS (BNA) A-36 (1999). Unlike the United States, France uses a less encompassing definition of corporate income. The French tax system only taxes corporate income earned in France. *Id.*

149. Bruno Gouthière, *Transfer Pricing Rules and Practice in France*, 895 TAX MGMT. FOREIGN INCOME PORTFOLIOS (BNA) A-3 (1997).

150. *See* Raj Bhala & David Gantz, *1 WTO Case Review*, 18 ARIZ. J. INT'L & COMP. L. 1, 53 (2000) (explaining how the French tax system differs from the U.S. system in that only income earned from sales in France is taxable).

does not violate the GATT because it does not operate as an illegal export subsidy.[151]

In contrast, the current FSC provisions of the United States' tax code are viewed as an illegal export subsidy because they are based on the principle of taxing income from whatever source derived but then providing a tax break to exporters.[152] If the United States would change its form of corporate income tax to a system under which only income from sales in the United States is taxed, corporations in the United States would be on an equal playing field. Under such a system, corporations that operate in the United States would not be taxed on profits earned abroad.

Individual income tax rules would be unaffected by the foreign source income rules for corporations.[153] Individuals who earn profits from investment overseas could still be taxed on their gains. Ideally, multinational corporations would remain or originate in the United States because of the new beneficial tax system and the developed economy. Setting up the system so it is beneficial for corporations to stay in or come to the United States will provide benefits that outweigh the foregone revenue an income tax on foreign profits would have earned.

A territorial tax scheme is not problem-free. There are two problems with such a system.[154] First, the United States would lose significant tax revenue. Although FSC regulations allow corporations to earn some foreign income tax-free, tax revenue is still raised by taxing foreign profits.[155] Not all exporting corporations have set up FSCs to defer their income, and some corporations cannot meet the requirements to become an FSC.[156] The revenue the government earns from these sources would disappear if Congress decided to absolve foreign income from taxation. To prevent this problem, Congress could enact a lower tax rate on corporate foreign source income instead of exempting

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151. *See supra* text accompanying notes 6, 86, and 143.

152. October Panel Report, *supra* note 86, ¶ 8.64; *see also id.* ¶¶ 8.119-22, 8.159, 9.1(a), 9.1(d) (finding FSCs inconsistent with the SCM Agreement and the GATT 1994).

153. The proposed change would only affect the corporate tax structure of the revenue code. Individuals would still pay a tax on income from whatever source derived.

154. A third problem not discussed in this article is the question of how the new tax system would comply with the income tax treaties the United States has with other countries. Larkins, *supra* note 105, at 19.

155. I.R.C. § 61 (West Supp. 2002).

156. *See* Langbein, *supra* note 56, at 553 (discussing requirements for FSC exemption).

it entirely from taxation. The tax rates could be set up in parallel so that profits earned domestically in the United States would be subject to the old corporate income tax, and profits earned abroad would be taxed under the new foreign source income tax system. In order to provide export support, the foreign source income tax rates would be less than the domestic rates. The new rates would have to be low enough to allow U.S. corporations to compete with EU companies, but the rates would have to be high enough to provide sufficient funds to the U.S. government. Using a lower tax rather than totally wiping out a corporate tax on foreign income is more likely to gain public support.

The second problem with a territorial system is that setting up the new regulations calls for separate and complicated rules regarding the definition of foreign source income.[157] Currently, corporations are treated the same as individuals under the tax code.[158] Creating a separate definition of taxable income for corporations would require bifurcation of the tax code. However, corporate taxpayers, not individuals, would have to deal with the complexity. Most multinational companies have tax accountants and attorneys on staff to deal with complicated tax issues. Additionally, the companies will have an incentive to figure out the complexities because doing so will save them money.

In sum, a territorial system that exempts foreign source income or taxes it at a reduced rate appears to be the best solution to the current tax problem in the United States.

## CONCLUSION

When the WTO ruled against FSC's, a looming problem with the U.S. tax policy was exposed: the current tax regulations provide an illegal export subsidy.[159] The roots of the problem are the inconsistency between tax systems in the EU and

157. Under a territorial tax system profits earned outside the country would not be subject to taxation. Thus, the Internal Revenue Service would have to precisely define which income is deemed earned outside the United States and thus subject to the exemption or reduced rate. The I.R.C. already contains rules defining foreign source income for the Foreign Tax Credit. *See* I.R.C. §§ 861 and 904 (West Supp. 2002).

158. *See, e.g.*, AJF Transp. Consultants, Inc. v. Commissioner, 77 T.C.M. (CCH) 1244 (applying I.R.C. § 61 to corporation). *See generally* I.R.C. § 61 (West Supp. 2002).

159. *See* October Panel Report, *supra* note 6.

the United States, and increasing tax competition from small and developing nations. Because of the tax discrepancies, exporting corporations in the United States are at a disadvantage compared to their EU counterparts. Without FSCs, corporations in the United States pay taxes on profits from exported goods that are also taxed in the destination country. Accordingly, the United States needs to change its treatment of foreign source income so that American corporations are not at a disadvantage and the new policy does not violate trade agreements.

Ignoring the WTO or changing to a value added tax both fail to solve the impending problems. Ignoring the WTO fails because it is a bad political move and may hurt future multinational agreements. Changing to a VAT consumption tax is unlikely because it would not gain political support, it would have price distorting effects, and it would not fit a service driven economy. Instead, the United States should exempt from taxation or apply reduced rates to all corporate foreign source earnings. With a territorial approach, the United States can give corporations the benefit of tax-free exports without violating trade agreements.