

REFORMING THE UNITED STATES EXPORT TAX POLICY: AN ALTERNATIVE TO THE AMERICAN TRADE WAR WITH THE EUROPEAN UNION

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INTRODUCTION

The end of the Cold War meant the end of a bipolar system in international relations. The United States emerged as the preponderant state, a victor with its accompanying spoils: the triumphs of capitalism and free-market principles. The United States enjoyed this success largely because of the North Atlantic Treaty Organization (“NATO”) and the strength of Western unity with Europe. But where is U.S. leadership positioned in relation to the continent today? The United States and the European Union remain divided beyond headline issues such as international security and foreign policy. This article focuses on the thorny relationship between Americans and Europeans in two distinct but overlapping fields: international trade and tax policy.

The European Union and the United States have disagreed over the

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United States' policy of subsidizing exports for over thirty years. In response to European formal complaints filed with the General Agreement on Tariffs and Trade ("GATT") and the World Trade Organization ("WTO"), the United States has done nothing but introduce variations on its tax rules. This has been ineffective in that it has only offered a temporary lull in an ongoing international trade war and has avoided a long-term solution.

The United States and Europe differ on their views regarding the importance of military strength and economic power. In his book, *Of Paradise and Power*, Robert Kagan argues that Europe's relative weakness has produced "a powerful European interest in building a world where military strength and hard power matter less than economic and soft power."¹ Soft power is a term used in international relations theory to describe the ability of a state to indirectly influence the behavior or interests of other political bodies through cultural or ideological means.² It differs from hard power, which is the ability to use economic and military power to achieve goals.³ Under this line of reasoning, Europe resorts to challenging American power through institutional structures rather than relying on might. For instance, the European Union recently threatened to impose \$4 billion worth of retaliatory measures in response to U.S. tax subsidization.⁴ At the core of the problem remains the fact that U.S. international tax rules are part of an arcane, dizzyingly complicated tax system.

Defying the wisdom of the European-American Business Council, the United States and the European Union have continued to escalate the trade dispute. According to the Council, American compliance with the WTO Foreign Sales Corporation ("FSC") and Extraterritorial Income Exclusion Act ("ETI") would ease tensions in the trade relationship.⁵ By continuing to escalate the trade dispute, both the United States and the European Union put the effectiveness of global companies at risk, ultimately harming global trade and consumers.⁶

¹ ROBERT KAGAN, *OF PARADISE AND POWER* 37 (2003) (stating that hard power refers to military force while soft power comes from economic or cultural means - a milder form of exerting influence).

² Joseph Nye, *The Benefits of Soft Power*, COMPASS: J. LEADERSHIP, Spring 2004, available at <http://hbswk.hbs.edu/archive/4290.html>.

³ Joseph Nye, *Propaganda Isn't the Way: Soft Power*, INT'L HERALD TRIB., Jan. 10, 2003, available at http://www.ihl.com/articles/2003/01/10/ednye_ed3_.php.

⁴ Amity Shlaes, *High Tax Rates at Root of Tariff Battles*, FIN. TIMES, Mar. 1, 2004, available at <http://www.amityshlaes.com/articles/2004/2004-02-29.php>.

⁵ Press Release, European-American Business Counsel, EABC Calls For U.S. Compliance With WTO FSC/ETI Decision (Nov. 12, 2003), available at <http://www.eabc.org/NewsItems/EABCCallsforUS-WTOCompliance.html>.

⁶ Shlaes, *supra* note 4.

The end to the tax dispute is far from near.⁷ The United States has not aligned its tax laws with WTO rulings.⁸ As a result, the WTO has ruled against the United States on numerous occasions.⁹

The United States must reconsider its corporate tax regime. As a nation, we must explore opportunities that favor the national interest and encourage both transparency and an international understanding on global tax rules. Part I of this article examines the history behind the American system of tax-based export incentives, starting with the Western Hemisphere Trade Corporations (“WHTC”) program. Part II discusses both immediate and long-term options that the United States faces in resolving this issue. This is a scenario where the United States’ national interest would benefit by ending costly and time-consuming standoffs with the European Union. Part III quells the support for a move to a territorial tax regime by arguing that it would damage our international standing, reduce government revenue, and harm domestic businesses. Part IV examines the most recent state of the dispute. While no solution appears imminent before the WTO, the European Union continues to ramp up its pressure to induce cooperation by the United States.

I. THE HISTORY BEHIND THE AMERICAN SYSTEM OF EXPORT SUBSIDIES

A. The GATT/WTO System

Multilateralism and trade liberalization trace back to the eighteenth century French doctrine of *laissez faire* and the British movement toward free trade following the Napoleonic Wars.¹⁰ France and Britain sought free trade among nations to reduce export prohibitions on agricultural products in order to benefit from their respective comparative advantages and achieve favorable trade balances.¹¹ But, despite centuries of liberalized trade, the international community lacked an organized system for free trade among nations and, instead, relied on trade amongst individual entrepreneurs.¹²

⁷ Brendan McGivern, *WTO Finds that the US Remains in Violation of Decision*, FIN. SERVICES ADVISORY UPDATE (White & Case LLP, Geneva, Switzerland) Mar. 2006, available at <http://www.whitecase.com/publications/detail.aspx?publication=832>.

⁸ Alix Nyberg, “A taxing dispute: the WTO ban on a U.S. export subsidy has pushed companies and congress into a battle over tax bills – Spotlight: Tax,” BNET.COM, Aug. 2003, http://findarticles.com/p/articles/mi_m3870/is_10_19/ai_106474424.

⁹ *Id.*

¹⁰ Charles Kindleberger, *The Rise of Free Trade in Western Europe*, in INTERNATIONAL POLITICAL ECONOMY: PERSPECTIVES ON GLOBAL POWER AND WEALTH 73, 74 (Jeffrey A. Frieden & David A. Lake eds., 2000).

¹¹ *Id.*

¹² *Id.*

After decades of shifting between protectionism and cooperative international trade, there appeared to be some consensus in the international economic community with the 1948 negotiation of the General Agreement on Tariffs and Trade ("GATT"). Supporters commonly call the GATT the most important mechanism for promoting and regulating world trade."¹³ As an international regime, the GATT incorporated the principles of nondiscrimination, unconditional reciprocity, and transparency.¹⁴ In forming the GATT, the United States and its primary trading partners aimed to support a qualitative advancement in free trade.¹⁵ They premised the GATT on their goal to extend trade rules without prejudice to its members, all of whom agreed to reduce formal tariffs.¹⁶ Based on the rules of reciprocity, members agreed to the treatment of all trading partners under "most favored nation" status.¹⁷

The GATT fostered inter-state harmony and liberalized markets. For one, it included provisions for the arbitration of disputes.¹⁸ These provisions were a major accomplishment in that they reduced trade barriers.¹⁹ The GATT members also created regulations to further liberalize exchanges and ultimately allow markets to determine trade patterns.²⁰ Markets opened and the international community embraced agreements, breaking away from unilateral actions. Consensus emerged, based on general reciprocity.²¹ According to some commentators, the GATT founders wanted "a steady progression toward an open world economy, with no return to the cycle of retaliation and counter-retaliation that had characterized the 1930s."²²

While the GATT offered a forum for discussion and represented a growing worldwide consensus for all states, it needed improvement. Among its primary deficiencies were limited authority and scope of responsibilities, a dispute settlement forum that needed improvement and narrow

¹³ A. LEROY BENNETT & JAMES K. OLIVER, INTERNATIONAL ORGANIZATIONS: PRINCIPLES AND ISSUES 272 (Prentice Hall, 1991).

¹⁴ ROBERT GILPIN, GLOBAL POLITICAL ECONOMY: UNDERSTANDING THE INTERNATIONAL ECONOMIC ORDER 219 (Princeton University Press, 2001). The term "transparency" includes the use of formal tariffs and the publication of trade regulations. *Id.*

¹⁵ *Id.* at 218.

¹⁶ *Id.*

¹⁷ *Id.* The term "most favored nation" ("MFN") refers to nondiscriminatory status in trade. Essentially, MFN is the status representing the best tariff treatment that countries can award one another. *Id.*

¹⁸ See generally, JAGDISH BHAGWATI, THE WORLD TRADING SYSTEM AT RISK (Princeton University Press, 1991).

¹⁹ GILPIN, *supra* note 14, at 218.

²⁰ *Id.*

²¹ Specific reciprocity refers to a more micro product-by-product approach, whereas general, or unconditional, reciprocity does not distinguish particular goods.

²² GILPIN, *supra* note 14, at 220.

jurisdiction.²³ These deficiencies spurred the renegotiations of the GATT in the Uruguay Round. Trade negotiations began in 1986 and ended in 1994,²⁴ and were the largest in history.²⁵ Negotiations included 123 countries and covered “almost all trade, from toothbrushes to pleasure boats, from banking to telecommunications, from the genes of wild rice to AIDS treatments.”²⁶

Labeled as the most significant accomplishment of the Uruguay Round, the creation of the WTO represented a major step toward completing a framework of international institutions originally planned at Bretton Woods in 1944.²⁷ The WTO was prepared to take on a larger role in international governance and facilitation of trade. Its primary objective was to promote cooperation in the realm of economics. The WTO had stronger authority than the GATT, particularly with regard to dispute settlement.²⁸ Under the GATT, disputing nations could delay and even deny the legal effect of panel reports by blocking their adoption by the trade organization council.²⁹ To end such delays, the WTO established a Dispute Settlement Body (“DSB”) to oversee a new dispute resolution mechanism called Dispute Settlement Understandings.³⁰ The DSB may impose WTO-authorized sanctions in the form of compensation or trade retaliation.³¹ Thus, the WTO far enhanced the breadth of the legal capabilities of the regime. The legal basis of the WTO provides nations with wide-ranging rights and obligations, and

²³ *Id.* The GATT did not have the authority to deal with agriculture, services, intellectual property rights, or foreign direct investment. Furthermore, it lacked the authority to deal with customs unions - international associations that establish a uniform tariff policy toward non-member nations - and other preferential trading arrangements. *Id.*

²⁴ *Id.* at 218, 221–22.

²⁵ The World Trade Organization Website, Understanding the WTO: The Uruguay Round, http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact5_e.htm (last visited Apr. 13, 2008).

²⁶ *Id.*

²⁷ GILPIN *supra* note 14, at 222. A series of meetings took place at Bretton Woods in July 1944, setting up the World Bank and the International Monetary Fund, with the goal of a more even distribution of wealth throughout the world. What is Bretton Woods?, <http://external.worldbankimflib.org/Bwf/whatisbw.htm> (last visited Apr. 13, 2008).

²⁸ Robert E. Hudec, *The Role of the GATT Secretariat in the Evolution of the WTO Dispute Settlement Procedure*, in THE URUGUAY ROUND AND BEYOND: ESSAYS IN HONOR OF ARTHUR DUNKEL 101, 115 (Jagdish Bhagwati & Mathias Hirsch eds., 1998).

²⁹ *See generally*, ROBERT E. HUDEC, THE GATT LEGAL SYSTEM AND WORLD TRADE DIPLOMACY (2d ed., Butterworth Legal Publishers, 1990).

³⁰ Linda C. Reif, *NAFTA, WTO, and FTAA: Choice of Forum*, in NAFTA IN THE NEW MILLENNIUM 450 (Edward J. Chambers & Peter H. Smith eds., 2002). *See also*, WTO, Introduction to the WTO Dispute Settlement System, http://www.wto.org/english/tratop_e/dispu_e/dispu_settlement_cbt_e/c1s1p1_e.htm.

³¹ Reif, *supra* note 30. This attached greater legitimacy to the organization for it sanctioned reprimands of its violations.

establishes a permanent forum for negotiation.³² As a rules-based system, the WTO could not be as effective without dispute settlement procedures to enforce the rules governing its multilateral trading system.³³

B. The Debates Regarding the FSC and the ETI

Tax-based export incentives have long served the purpose of lessening the overall burden on income. The Western Hemisphere Trade Corporations ("WHTC") program of 1942 was the first involving this form of tax relief.³⁴ Under this plan, WHTCs qualified for a 14% reduction of the normal corporate tax rate.³⁵ Its aim was to stimulate U.S. investment throughout the Western Hemisphere. However, WHTCs did little but serve as "export arms of U.S. manufacturers."³⁶

In 1971, Congress passed its second significant tax-based export incentive program. Sections 991 through 997 of the Internal Revenue Code granted special tax benefits to Domestic International Sales Corporations ("DISCs").³⁷ The Internal Revenue Service ("IRS") taxed DISCs on earnings distributed only to shareholders.³⁸ By not taxing them on worldwide income, the IRS allowed DISCs to defer taxes on roughly 50% of their income.³⁹ By doing so, the United States took a step toward territorializing U.S. firms' export taxes, and the GATT labeled the move a protectionist non-tariff barrier. Signatories criticized DISCs as being an illegal export subsidy for allowing an "indefinite" tax deferral on foreign activity income.⁴⁰ The United States denied these accusations, but in 1981 it agreed to adhere to the GATT rulings.⁴¹

³² GILPIN, *supra* note 14, at 223.

³³ *Id.* The WTO website discusses the procedure of the DSB in greater detail. See The World Trade Organization Website, Understanding the WTO: Settling Disputes, http://www.wto.org/english/thewto_e/whatis_e/tif_e/disp1_e.htm (last visited Apr. 13, 2008).

³⁴ Hale E. Sheppard, *Rethinking Tax-Based Export Incentives: Converting Repeated Defeats Before the WTO into Positive Tax Policy*, 39 TEX. INT'L L. J. 111, 113 (2003).

³⁵ I.R.C. § 921 (1976); Sheppard, *supra* note 34 at 113. In order to qualify as a WHTC, a corporation needed to satisfy the following requirements: (1) it must be a domestic corporation, organized in the US, (2) all of its business must be conducted in the Western Hemisphere or the West Indies, (3) at least 95% of the corporations income must come from foreign sources, and (4) at least 90% of such income must be attributable to trade. *Id.* at 112.

³⁶ Sheppard, *supra* note 34, at 113.

³⁷ John C. Wagner, Foreign Sales Corporation Act Replaces DISC Tax Incentive, BUS. AM., Aug. 6, 1984, available at http://findarticles.com/p/articles/mi_m1052/is_v7/ai_3381418.

³⁸ Sheppard, *supra* note 34, at 113.

³⁹ *Id.*

⁴⁰ *Id.* (stating that United States tax law for DISCs did not charge interest on deferred tax - GATT formally upheld this complaint in 1976).

⁴¹ *Id.* at 114.

The United States established the concept of Foreign Sales Corporations (“FSC”) three years later.⁴² An FSC is an offshore, wholly-owned subsidiary of a U.S. corporation.⁴³ A portion of FSC profits is exempt from taxation.⁴⁴ This is done by routing the sale of an item from its American source to an offshore production site and, ultimately, to its final destination: the foreign consumer.⁴⁵ For example, if an American company sells a computer made in California to a buyer in France, the United States firm must first sell that computer to its FSC located offshore.⁴⁶ This entity, in turn, sells the item to the ultimate buyer.⁴⁷ The FSC garners a tax exemption on 15/23 of its profit from that sale.⁴⁸

Another example is an American company that produces a computer for \$1,500 in the United States and sells it to France for \$2,000. If the American company sells directly, it is taxed at the full corporate tax rate of 35%.⁴⁹ Alternatively, if the American producer funnels the transaction through a FSC subsidiary, then it significantly reduces its taxes.⁵⁰ The FSC can purchase the computer for \$1,885 and sell it to France for \$2,000.⁵¹ The FSC’s profit of \$115 is shielded from corporate income tax.⁵² The American exporter is then required to pay taxes on only \$385, its export profits.⁵³ Diagram 1 illustrates this example.

⁴² Wagner, *supra* note 37.

⁴³ Sheppard, *supra* note 34, at 114. See also Foreign Sales Corporation FAQ, http://trade.ec.europa.eu/doclib/docs/2006/february/tradoc_127478.pdf (last visited Apr. 13, 2008).

⁴⁴ Sheppard, *supra* note 34, at 114.

⁴⁵ *Id.*

⁴⁶ Mihir A. Desai & James R. Hines, *The Uneasy Marriage of Export Incentives and the Income Tax* (Mich. Sch. of Bus. Office of Tax Policy Research, Working Paper No. 2000-12, 2000). These offshore locations were not necessarily “active” places where business was conducted. They simply served part of the laborious paper trail required to get around heavy export taxes. Common offshore sites included Guam or the Barbados. *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² Desai and Hines call this a 23% commission for the FSC ($\$115/\$500=0.23$). Desai & Hines, *supra* note 46.

⁵³ $\$1,885$ sale price to offshore site – $\$1,500$ production cost = $\$385$. *Id.*

Diagram 1**Without FSC, the company is taxed 35% on profits:**

<u>Producer</u>	→	<u>Consumer</u>	=	<u>Pre-Tax Profit</u>	→	<u>U.S. Tax on \$500 profit</u>
(\$1,500)		\$2,000		\$500		(\$175)

With FSC, the company realizes savings of \$26.25:

				8/23 FSC		
<u>Producer</u>	→	<u>FSC</u>	=	<u>FSC Profit</u>	→	<u>Taxed Profit</u>
(\$1,500)		\$1,885		\$115		(\$40)
						→ <u>U.S. Tax on \$385 profit</u>
						(\$148.75) ⁵⁴

The key benefit of the FSC is that the profit earned is not attached to any extra foreign taxes. Direct trade with the consumer, however, is taxed at the full 35% U.S. corporate tax rate as well as the tax rate in the foreign country.⁵⁵ The FSC lessens the burden of corporations being taxed twice. Additionally, dividends distributed by an FSC to an American corporate shareholder are eligible for a 100% dividends-received deduction.⁵⁶ This deduction allows the FSC to repatriate its earnings to the original U.S.-based corporation without facing any tax consequences.⁵⁷

Numerous American companies benefit from the relief provided by FSCs.⁵⁸ By 1997, sixteen years after the complaint filed against the United States for the practice of granting tax breaks to DISCs, the European Union alleged that these savings were anticompetitive trade measures that harmed them.⁵⁹ The European Union viewed tax exemptions for FSCs as providing an unfair export subsidy.⁶⁰ The United States responded by enacting the FSC Repeal and Extraterritorial Income Exclusion Act ("ETI") of 2000.⁶¹ The ETI phased out the benefits of the FSC and ultimately adopted a

⁵⁴ $\$148.75 = [(385)(0.35)] + [(0.35)(8/23)(115)]$. By using the FSC, a corporation saves \$26.25 ($\$175 - \$148.75 = \26.25).

⁵⁵ *Id.*

⁵⁶ Sheppard, *supra* note 34, at 114.

⁵⁷ *Id.*

⁵⁸ Hunter R. Clark, Amy Bogran & Hayley Hanson, *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, 291 (2001).

⁵⁹ *Id.* at 303.

⁶⁰ The Levin Institute, *Long Running Trade Dispute Over U.S. Tax Breaks May Be Ending*, GLOBALIZATION101, July 21, 2002, <http://www.globalization101.org/index.php?file=news1&id=62>.

⁶¹ FSC Repeal and Extraterritorial Income Exclusion Act of 2000, H.R. 4986, 106th Cong. (2d Sess. 2000).

territorial tax system, providing some relief from double taxation for both exports and foreign production.⁶² Many viewed the new law as an effort to “placate the EU without surrender[ing] support of exports.”⁶³ The ETI retracted FSC rules and substituted them with tax subsidies for U.S. taxpaying corporations on “qualifying foreign trade income.”⁶⁴ Essentially, they removed the exclusivity of tax subsidies on exports by broadening the scope of tax relief to extend to any income earned abroad.⁶⁵

Shortly after the ETI’s introduction in November of 2000, the European Union brought a second case against the United States before the Appellate Body of the WTO. The European Union argued that the ETI did nothing to meet its concerns directly.⁶⁶ Specifically, the European Union maintained four claims: (1) despite the ETI Act, revenue was still being shielded;⁶⁷ (2) the United States export contingency was not eliminated, even though foreign production was covered in some instances;⁶⁸ (3) U.S. exports classified under the ETI violated Article 3 of the WTO (a section that deals with the national treatment of foreign content limitation);⁶⁹ and (4) the FSC “phaseout” missed the first deadline of the Appellate Body in October 2000.⁷⁰

After examining the WTO ruling, the United States realized that it could avoid being charged with granting an illegal export subsidy after it extended its partial territorial tax system to the foreign production of U.S. firms.⁷¹ The United States undoubtedly knew the European Union would soon file its third binding complaint with the WTO.⁷² The WTO’s Subsidies and Countervailing Measures Code (“SCM”) entitled the European Union to \$4.043 billion of annual countermeasures against the United States.⁷³ The

⁶² Gary Clyde Hufbauer, *The Foreign Sales Corporation Drama: Reaching the Last Act?*, PETERSON INST. FOR INT’L ECON., No. PB02-10 (2002).

⁶³ Sheppard, *supra* note 34, at 115.

⁶⁴ *Id.*

⁶⁵ FSC tax benefits were only granted to exports. Furthermore, the ETI did not demand the use of a foreign corporation, and permitted manufacturing to be carried out beyond U.S. borders. According to President Clinton, the FSC Repeal and ETI Act was “necessary” to deal with the WTO Appellate Body ruling that the FSC provisions of U.S. tax law did not honor the WTO Agreement on Subsidies and Countervailing Measures as well as the Agreement on Agriculture. See generally, Clark, Bogran & Hanson, *supra* note 58.

⁶⁶ Hufbauer, *supra* note 62.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² The first in 1981 was under the GATT, which was not binding. The other two were under the WTO.

⁷³ Hufbauer, *supra* note 62, at 7. This is the highest amount of retaliation granted under

United States now faces yet another deadline and must choose an action from an array of alternatives.⁷⁴

II. SHORT-TERM OPTIONS FOR THE UNITED STATES

There are three immediate options. First, the United States could comply with the WTO and repeal the tax advantages offered by the ETI. This would impose a large tax burden on U.S. exporters and lead to unchecked double taxation, as demonstrated in the table below.⁷⁵

How U.S. Companies Suffer a Competitive Disadvantage				
	Profit	Local Tax	“Home Country” Tax	Total Tax
U.S. Company	\$100	\$10	\$25 to IRS	\$35
Local Company	\$100	\$10	N/A	\$10
Dutch Company	\$100	\$10	\$0	\$10

Second, the United States could refuse to comply with the WTO's binding rulings. Although this is entirely within the sovereign rights of the United States, it is not without its consequences. If the United States chose not to act on the WTO's measures, Europe could levy heavy tariffs on a range of U.S. goods in response.⁷⁶

Third, the United States could attempt to delay the effect of the measures by not responding. If the United States amends the FSC and ETI tax benefits through temporary measures that are subject to penalty under the SCM Code, the Appellate Body will likely sanction the United States.⁷⁷ The immediate options serve neither the United States' interests nor the global best interest. In order to gain the benefits of free trade, the United States must look at a longer-term solution to its complicated tax regime.

the GATT/WTO system. The billion dollar figure is equivalent to the amount of FSC benefits in a given year - it is not related to the trade harm inflicted on the EU, which the United States estimates at \$1.110 billion.

⁷⁴ *Id.* at 6.

⁷⁵ Daniel Mitchell, *Making Tax Lemonade Out of WTO Lemons*, HERITAGE FOUND., Sept. 18, 2002, <http://www.heritage.org/Research/Taxes/em834.cfm> [hereafter Mitchell, *Lemons*].

⁷⁶ Daniel Mitchell, *The Flawed WTO Tax Decision*, 9 EUR. J. 28, 28 (2002), available at <http://www.freedomandprosperity.org/Articles/mitchell3.pdf> [hereafter Mitchell, *Flawed*].

⁷⁷ Gary Clyde Hufbauer, *The Foreign Sales Corporation Drama: Reaching the Last Act?*, INT'L ECON. POL'Y BRIEFS 8 (Number PB02-10, 2002).

There are long-term possibilities for amending the U.S. tax system. The United States could reduce its corporate tax rate.⁷⁸ However, there is no guarantee that a cut in corporate taxes would resolve the issue. If the ETI was problematic because it simply broadened tax relief, then a sweeping cut in corporate tax rates arguably may not be any different. In the event that the United States reduced the corporate tax rate, the European Union would most likely file a complaint because the WTO clearly states that “lowering direct taxes upon exports is [a violation].”⁷⁹

Apart from the issue of WTO-compatibility, however, it is uncertain whether such a reduction would even be economically and politically feasible. Despite the powerful influence of the corporate lobby, individual taxpayers would likely resent the lowering of the corporate tax rate, claiming unfairness. The issue could likely affect an election. Moreover, even if Congress wanted to change its corporate tax rate, it might be challenging to predict the correct extent of the cut. As rational decision-makers, corporations will relentlessly seek tax reductions.⁸⁰ Consequently, their lobbying for export breaks would continue. There is also the question of depleted government revenue. Corporations are responsible for approximately 14.4% of government tax revenue.⁸¹ These uncertainties make a corporate tax cut a difficult pill to swallow.

III. UNDERSTANDING THE TERRITORIAL TAX REGIME AND WHY IT IS AN UNWORKABLE SOLUTION

Prominent individuals in tax policy advocate the adoption of a territorial system of taxation to mirror the system used in the European Union.⁸² The present system taxes U.S. corporations on their profits earned worldwide.⁸³ They have the obligation of paying taxes to two governments, the United States government and the foreign government housing the firm’s subsidiaries.⁸⁴

It is worth noting the historical context of these rules. In 1962,

⁷⁸ Daniel Mitchell, *Corporate Rate Reduction and International Tax Reform*, HERITAGE FOUND., Mar. 1, 2004, <http://www.heritage.org/Research/Taxes/wm437.cfm> [hereafter Mitchell, *Corporate*].

⁷⁹ Sheppard, *supra* note 34, at 124.

⁸⁰ MARTIN J. OSBORNE & ARIEL RUBINSTEIN, *A COURSE IN GAME THEORY* 4 (1994).

⁸¹ Congressional Budget Office, Preliminary Analysis of the President’s Budget Request for 2009 (Mar. 3, 2008), *available at* http://www.cbo.gov/ftpdocs/90xx/doc9015/Selected_Tables.pdf (including tables showing how corporate income taxes accounted for 370 billion of total revenues of 2,568 billion for 2007 and projections for future years).

⁸² *See, e.g.*, Mitchell, *Corporate*, *supra* note 78.

⁸³ *Id.*

⁸⁴ *Id.*

Congress enacted Subpart F of the IRC, aiming to reduce opportunities for tax avoidance.⁸⁵ Subpart F subjected profits from offshore sales subsidiaries to immediate taxation.⁸⁶ Congress did this primarily to decrease the incentives for using tax havens by stemming excessive investment in low-tax foreign countries.⁸⁷

The European form of corporate territorial taxation is more pro-competitive than the American form because Europeans “are smart enough not to hamstring their companies that are competing for business in other nations.”⁸⁸ A worldwide system taxes all of a domestic taxpayer’s income wherever earned.⁸⁹ This is in contrast to the territorial tax system used by some European Union members.⁹⁰ Under such a system, a majority of a domestic corporation’s foreign source income is exempt from tax in the home country.⁹¹

At first blush, switching to a territorial regime seems appealing. First, it would “level the playing field” with the European Union and, presumably, end the debate.⁹² The United States would no longer need to resort to establishing special rules for exempting foreign source income. Consequently, the WTO would have no grounds for ruling against an illegal subsidy. Second, the United States’ painful anti-competitive scheme of double taxation would end and the dispute would end with it: there would be no need for punishment or costly tit-for-tat retaliatory measures. Third, U.S. corporations would save time and energy by eliminating the tracking of FSC tactics or double accounting of foreign income. As the tax code becomes more complex, the IRS has difficulty keeping up, meaning fewer audits and less revenue collected.⁹³

Finally, the United States and European Union would move closer to a level playing field, as most European nations only tax income earned within their borders.⁹⁴ Proponents claim that a territorial regime holds the greatest appeal because it would enhance the opportunities for transparency and

⁸⁵ James R. Hines & R. Glenn Hubbard, *Coming Home to America: Dividend Repatriations by U.S. Multinationals*, in TAXATION IN THE GLOBAL ECONOMY 161, 163 (Assaf Razin & Joel Slemrod eds., Univ. of Chicago Press 1990).

⁸⁶ *Id.*

⁸⁷ See generally, Desai & Hines, *supra* note 46. Poor export performance led to the DISC and foreign tax credits in order to alleviate pressure from corporations.

⁸⁸ Mitchell, *Flawed*, *supra* note 76.

⁸⁹ Sheppard, *supra* note 34, at 122.

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² Mitchell, *Flawed*, *supra* note 76; Mitchell, *Lemons*, *supra* note 75.

⁹³ MacNeil-Lehrer *News Hour* (PBS television broadcast June 4, 2004), available at http://www.pbs.org/newshour/bb/business/jan-june04/tax_6-04.html.

⁹⁴ Mitchell, *Flawed*, *supra* note 76.

simplified tax rules.⁹⁵ However, adopting a territorial system could actually complicate the rules of the game and adversely affect the United States.

This territorial proposal faces a similar obstacle regarding how the territorial tax regime will be affected. A switch to a territorial system would involve a difficult process of untangling the complicated web of U.S. tax laws and international tax agreements. Overhauling the tax system would require a complete renegotiation of the “extensive network of bilateral tax treaties” accompanying the United States’ worldwide tax system.⁹⁶

Although renegotiating treaties presents a considerable obstacle, it is not reason enough to abandon the idea of a territorial system. The United States is engaged in numerous bilateral income tax treaties.⁹⁷ The treaties’ most important function “is to limit the jurisdiction that each treaty country may exercise to tax income from domestic sources.”⁹⁸ The purpose of these treaties is to avoid double taxation of income derived from international transactions.⁹⁹ Therefore, it would be in the greatest national interest of the United States and its corporations to renegotiate these treaties based on the best option for alleviating tax pressures.

When the United States Congress enacts a statute that conflicts with an existing treaty provision, the statute overrides the treaty provision.¹⁰⁰ Thus, the United States neither is bound by nor benefits from the treaty provision. If the United States changed its worldwide tax system to a territorial system, the aforementioned mechanism of “treaty override” would accommodate such a change.¹⁰¹ However, adopting a territorial tax system could have an adverse impact on U.S. global political and economic relations. This article outlines four specific concerns.

⁹⁵ *Id.*

⁹⁶ Sheppard, *supra* note 34, at 123 n.69. The author uses quotes from the Joint Committee on Taxation, 107th Congress, Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series, 2002. Renegotiating tax treaties would create an “uncertainty in taxation of business investments for a lengthy period of time.” *Id.* The author quoted another argument: “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.*

⁹⁷ CHARLES H. GUSTAFSON & RICHARD C. PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS 1991-1993 CASES AND MATERIALS 449 (Chicago: Commerce Clearing House, 1991).

⁹⁸ *Id.* at 450.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at 479.

¹⁰¹ See Anthony C. Infanti, *Curtailing Tax Treaty Overrides: A Call to Action*, 62 U. PITT. L. REV. 677 (2001) (discussing how the tax treaty override process lowers the integrity of the treaty making process).

A. The Effect on Direct Exporters

Indirect exporters, who work with foreign subsidiaries, are “subject to foreign tax on at least some of their export-related income.”¹⁰² In contrast, direct exporters are U.S. corporations that sell their products to unrelated foreign clients.¹⁰³ Virtually all of their production takes place domestically and they “are rarely subject to tax in any other jurisdiction.”¹⁰⁴ These exporters benefited from the ETI, which excludes income derived from a broad range of overseas transactions “whether the goods are manufactured in the United States or abroad.”¹⁰⁵ While the ETI was semi-territorial in nature, the European Union deemed it unacceptable.¹⁰⁶

The United States intended the ETI to help both direct and indirect exporters.¹⁰⁷ A shift to a territorial system, however, would not be fair to both types of exporters. A territorial system benefits indirect exporters who are involved in arm’s length transfer pricing transactions with foreign subsidiaries.¹⁰⁸ A “traditional territorial exemption system is premised on significant foreign economic activity . . . [whereas] income from *direct* exports is unlikely to be taxed elsewhere.”¹⁰⁹ Essentially, repealing the ETI and replacing it with a territorial system would tremendously benefit indirect exporters while leaving direct exporters, who are likely to be small to medium-sized businesses, out in the cold.¹¹⁰

B. Transfer Pricing Tax Consequences

Switching to a territorial tax regime would exacerbate problems caused by transfer pricing. Transfer pricing involves tactical arrangements of transactions among related corporations – that is, parent corporations and their subsidiaries and brother-sister corporations.¹¹¹ These related corporations strategically plan their transactions with a view toward mitigating taxation.¹¹² In the international context, domestic parent companies commonly utilize transfer pricing tactics to allocate their profits

¹⁰² NATIONAL FOREIGN TRADE COUNCIL, TERRITORIAL TAX STUDY REPORT 20 (2002), available at <http://www.nftc.org/default/tax/Territorial%20Report.pdf> [hereafter NFTC].

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 15.

¹⁰⁶ *Id.* at 15–16.

¹⁰⁷ *Id.* at 20.

¹⁰⁸ NFTC, *supra* note 102 at 20.

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 20–21.

¹¹¹ Jones Day: Transfer Pricing Overview, http://www.jonesday.com/transfer_pricing/ (last visited Apr. 13, 2008).

¹¹² *Id.*

to their foreign subsidiaries.¹¹³ The United States government suffers a loss in tax revenue when corporations successfully utilize transfer pricing.¹¹⁴ By suddenly resorting to a drastically different tax system, the United States risks aggravating already complicated sourcing issues.

A territorial tax regime in which the United States would not tax corporations on their profits abroad would encourage corporations to utilize transfer pricing. Parent companies would be more likely to use their subsidiaries for transfer pricing purposes. For example, the Hoover Company is a multinational corporation (“MNC”). Assume it costs Hoover \$99 to produce a vacuum cleaner in the United States. Hoover can sell the vacuum cleaner to a subsidiary in a Caribbean low tax rate jurisdiction, for example, for \$99.01. The subsidiary can then sell that vacuum cleaner to a European retailer for its market rate of \$150. The subsidiary would reap a profit of \$49.99 on that sale. Hoover would realize a tremendous tax break on this transaction, given the low tax rate in the Caribbean jurisdiction.

The consequences of providing an exemption under a territorial system are similar to those posed by a sweeping corporate tax cut. One consequence is the erosion of government tax revenue. Under a static analysis, an exemption proposal would have cost \$5.2 billion U.S. dollars per year based on 1996 data; under a dynamic analysis, this number would be even higher.¹¹⁵ One could logically infer that a territorial system would provide greater incentives to avoiding U.S. taxation. Furthermore, small firms that are based and taxed in the United States would face a significant competitive disadvantage. Over time, many of them would presumably go out of business because of this competitive disadvantage. This would translate into tremendous domestic job losses.

C. The Disallowance of Foreign Tax Credits

The U.S. worldwide taxation system provides foreign credits for firms that are taxed abroad to partially relieve the pain of double taxation.¹¹⁶ However, a switch to a territorial system can hurt firms that rely on foreign subsidiaries that have low tax rates. The following example illustrates how these firms would be disadvantaged:

U.S. car manufacturer “X” produces trucks that are very popular in left-hand driving countries. “X” invests heavily in production facilities in the United Kingdom, the most prosperous left-hand driving country, and exports from there to other left-hand

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ NFTC, *supra* note 102, at 23 n.51.

¹¹⁶ *Id.* at 13.

driving countries. However, the United Kingdom has a relatively high corporate tax rate of 30%.¹¹⁷

By disallowing any foreign tax credit, these firms would pay more for basing operations in a high tax country, even though the location would help them compete globally. They would no longer have the benefit of any credits. Under this proposed system, firms are allowed to earn tax credits for interest and research and development expenses accrued abroad.¹¹⁸ This form of relief aids corporate innovation without entirely eliminating U.S. government proceeds.

A territorial tax system would not provide the same benefits. Disallowing credits for these expenses must be weighed against the advantage of foregoing domestic taxation. This change would attach incentives to headquartering activities abroad in countries with lower corporate taxes. Again, this exacerbates the problem of tax haven advantages. If corporations shift their base companies abroad, the United States could lose even more jobs.

D. Tax Treaties

Once a MNC has heavily invested capital in a host country, the host country improves its bargaining position because the investor has poured money and resources into that country thereby tying it to its investment.¹¹⁹ By switching to a territorial system, the United States would have to renegotiate its tax treaties, which are premised on a worldwide system of taxation.¹²⁰ Renegotiating all of these treaties means facing the possibility that some of the treaty countries would increase their corporate tax rates. Countries where U.S. capital expenditure is already high have every reason to raise their rates when given the chance, and renegotiation would represent the ideal opportunity.¹²¹ This is exemplified by the treaty renegotiation between Indonesia and the Netherlands.¹²² Indonesians requested a renegotiation of their treaty with the Netherlands in order to raise tax rates for the oil and gas sectors.¹²³ If the United States overhauled its tax system entirely, it would anger trade participants and highlight other countries'

¹¹⁷ UK Trade & Investment, Tax in the UK (Dec. 18, 2007), <http://www.ukinvest.gov.uk/United-Kingdom/4016067/en-GB.html>.

¹¹⁸ NFTC, *supra* note 102, at 3.

¹¹⁹ See generally Jeffrey A. Frieden & David A. Lake, eds., *INTERNATIONAL POLITICAL ECONOMY: PERSPECTIVES ON GLOBAL POWER AND WEALTH* (2000).

¹²⁰ The National Foreign Trade Council estimates that we have entered into 62 treaties at the moment. NFTC, *supra* note 102, at 12.

¹²¹ See, e.g., NFTC, *supra* note 102, at 12 n.26.

¹²² *Id.*

¹²³ *Id.*

strong bargaining positions. This would harm American MNCs.

IV. IMPROVING GLOBAL EFFICIENCY

In 2005, the United States Congress passed the American Jobs Creation Act (also known as the “JOBS Act” or the “FSC/ETI Repeal”).¹²⁴ The JOBS Act eliminated extraterritorial income tax benefits that the WTO had deemed illegal.¹²⁵ However, the remaining issue of contention was that the Jobs Act still allowed ETI benefits to continue, for the repeal contained a grandfather clause.¹²⁶ That is, the repeal did “not apply to any [contractual] transaction in the ordinary course of a trade” entered into before September 17, 2003.¹²⁷ The JOBS Act’s retention of these WTO-inconsistent provisions “left the United States virtually without a defense”¹²⁸ At the hearing before the Appellate Body, the United States did not contest the Panel’s findings that these JOBS Act provisions were WTO-inconsistent.¹²⁹ The United States unsuccessfully argued to the appellate body “that the Compliance Panel had failed to make a ‘new’ recommendation to withdraw the prohibited subsidies.”¹³⁰

No solution appears imminent. The WTO has authorized the European Union to impose duties. However, “the European Commission has chosen to impose sanctions on a gradual and increasing basis.”¹³¹ By increasing pressure gradually, the European Commission hopes to “induc[e] U.S. compliance, rather than choking off trade for the affected products by imposing 100% duties.”¹³² The United States, however, does not appear ready to amend its laws to conform to the WTO. Nevertheless, change is imminent.

This is an auspicious time to work toward a unified supranational interest. Inherent in the idea of a globalized economy is the notion of dependency and multilateral negotiation. The United States is reluctant to

¹²⁴ Chris Atkins, Special Report, *FSC/ETI Transition Relief in the New JOBS Act: Does the U.S. Have to Quit Cold Turkey?*, TAX FOUND., Mar. 28, 2005, at 1 available at <http://www.taxfoundation.org/research/show/317.html>.

¹²⁵ *Id.*

¹²⁶ *Id.* at 4–5.

¹²⁷ Press Release, European Union, Delegation of the European Commission to the United States, WTO Condemns US Tax Subsidies; EU Calls on US to End Illegal Tax Breaks for Boeing, Others (Feb. 13, 2006), available at <http://www.eurunion.org/News/press/2006/20060014.htm>.

¹²⁸ McGivern, *supra* note 7.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.* “The EC regulation authorizing the retaliation provides for the reintroduction of additional customs duties at a rate of 14%, up from the earlier, pre-suspension rate of 5%.” *Id.*

¹³² *Id.*

resort to collaborating with others in resolving issues.¹³³ One commentator, Robert Kagan, analogizes the United States and the European Union to hunters.¹³⁴ In Kagan's vision, the United States bears a rifle and the European Union holds a knife:

A man armed only with a knife may decide that a bear prowling the forest is a tolerable danger, inasmuch as the alternative – hunting the bear armed only with a knife – is actually riskier than lying low and hoping the bear never attacks. The same man armed with a rifle, however, will likely make a different calculation of what constitutes a tolerable risk.¹³⁵

This analogy illustrates the argument that because the European Union holds a relatively weak military position, it will probably resort to a multilateral forum for resolving disputes. In a position of relative power, the United States is less likely to follow the will of an international organization.

The United States will safeguard its sovereignty, regardless of who follows or agrees.¹³⁶ However, the United States cannot ignore its relationships with its trading partners. A territorial tax system in line with WTO prescriptions would benefit the United States.¹³⁷ However, switching to the territorial tax regime is not a feasible solution because it represents a drastic change, which would also be accompanied by the additional transaction costs inherent with a change in a tax system.¹³⁸ This is not to say that the United States should put down its *rifle* and resort to the whims of other states. Instead, the United States must examine what also works for the international order. American long-term interest dovetails with the establishment and support of effective multilateral institutions.

States defend their sovereignty, or territorial integrity — and safeguarding their tax structures is one such example of defending sovereignty.¹³⁹ The United States and the European Union must transcend the myopic position of preserving sovereignty in the near-term and must champion free trade for the future. They presently face a perfect opportunity to discuss the establishment of rules that would address the inequities of tax systems that inevitably lead to conflict. Countries must commit to

¹³³ See generally, KAGAN, *supra* note 1.

¹³⁴ *Id.*

¹³⁵ *Id.* at 31.

¹³⁶ This is evidenced by the present day eschewing of UN approval for the war on Iraq and the establishment of a U.S. “coalition of the willing.”

¹³⁷ See generally Mitchell, *Flawed*, *supra* note 76.

¹³⁸ See NFTC, *supra* note 102, at 18–22.

¹³⁹ See, e.g., Cezary Mik, *State Sovereignty and European Integration: Public International Law, EU Law and Constitutional Law in the Polish Context*, in SOVEREIGNTY IN TRANSITION 367, 373 (Neil Walker ed., Hart Publishing 2006).

consensus and abandon the pessimistic notion that “no agreement is better than a bad agreement.”¹⁴⁰

CONCLUSION

The United States’ basic short and long-term tax and trade options are counterintuitive. If the United States government is to make changes, it must make them incrementally. The options of reducing the tax rate and altering our worldwide taxation system have obvious appeal. Realistically, however, no drastic alteration is feasible.

In order to achieve the goal of improving the tax system overall, there must first be a greater understanding between nations. The WTO operates on this principle, stating that “the first step is to talk.”¹⁴¹ The WTO is an arena where member governments attempt to resolve the trade problems they face with each other.¹⁴²

However, tax experts acknowledge that the WTO’s rules on the crossover of tax and trade are “utterly inadequate.”¹⁴³ As this article shows, the United States is vulnerable to the Europeans’ use of “soft” economic power. The Appellate Body formed by the WTO provides an appropriate forum for discussion and dispute. United States compliance with WTO rulings would yield the best outcome for the United States, for domestic shareholders, and for the global trading system overall.

Furthermore, the dispute over taxes should serve a longer-term purpose of establishing a consensus on international tax laws. The United States’ use of export subsidies was a response to address the inequities of its own tax complexities. Undoing these wrongs is the right course of action. Creating a better tax structure in the United States can be done and future trade wars can be averted by coming to an intercontinental understanding.

¹⁴⁰ Joseph E. Stiglitz, *It Is Time for a True Development Trade Round*, FIN. TIMES, June 20, 2004, available at <http://search.ft.com/ftArticle?queryText=true+development+stiglitz&y=0&aje=false&x=0&id=040620002535&ct=0>.

¹⁴¹ The World Trade Organization Website, Understanding the WTO: The First Step is to Talk, http://www.wto.org/english/thewto_e/whatis_e/tif_e/tif_tncpic_e.htm (last visited Apr. 13, 2008).

¹⁴² *Id.*

¹⁴³ Sheppard, *supra* note 34, at 140.