2000

United States -- Tax Treatment for "Foreign Sales Corporations" WTO Doc. WT/DS108/AB/R

Stanley Langbein
University of Miami School of Law, slangbei@law.miami.edu

INTERNATIONAL DECISIONS

EDITED BY BERNARD H. OXMAN

Income tax—U.S. foreign sales corporation tax practices—GATT Agreement on Subsidies and Countervailing Measures—GATT Agreement on Agriculture—effect on appeal of failure to raise issue before WTO dispute settlement panel

UNITED STATES—TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS." WTO Doc. WT/DS108/AB/R.
WTO Appellate Body, February 24, 2000.

In a report issued on February 24, 2000,[1] the Appellate Body (Body) of the World Trade Organization found that the exemptions from income permitted a foreign sales corporation (FSC) under United States income tax laws[2] violate provisions of the Agreement on Subsidies and Countervailing Measures (ASCM)[3] of the General Agreement on Tariffs and Trade (GATT), as well as the Agreement on Agriculture (AA)[4] of the GATT. The ruling upheld the panel report issued October 8, 1999.[5] The panel itself had been convened at the request of the European Communities, which had characterized FSC practices as illegal trade subsidies.

The Body affirmed the panel's finding that the FSC practices constitute a subsidy "contingent, in law or in fact . . . upon export performance," in violation of Article 3.1(a) of the ASCM. The Body rejected the arguments of the United States that the practices are protected by the Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade (Subsidies Code)[6] and a 1981 action by the GATT Council (Council action).[7] It did not address, however, the broader question

[1] United States—Tax Treatment for "Foreign Sales Corporations," WTO Doc. WT/DS108/AB/R (Feb. 24, 2000) [hereinafter Report], *reprinted in* 2000 TAX NOTES TODAY 38-12 (Feb. 25, 2000). Reports issued under the WTO's dispute settlement procedures are available online at <http://www.wto.org>.

[2] 26 U.S.C. §§921–927 (1994).

[3] Agreement on Subsidies and Countervailing Measures, Apr. 14, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS: THE LEGAL TEXTS 264 (1994) [hereinafter ASCM].

[4] Agreement on Agriculture, Apr. 14, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS: THE LEGAL TEXTS 39 (1994).

[5] United States—Tax Treatment for "Foreign Sales Corporations," WTO Doc. WT/DS108/R (Oct. 8, 1999), *reprinted in* 3 LAW & PRACTICE OF THE WORLD TRADE ORGANIZATION (Joseph F. Dennin ed. 1999).

[6] Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade, *opened for signature* Apr. 12, 1979, GATT BISD (26th Supp.) at 56 (1979), 31 UST 513 [hereinafter Subsidies Code]. The Subsidies Code was adopted by the GATT parties as part of the Tokyo Round of agreements on nontariff barriers.

[7] Tax Legislation (Dec. 7–8, 1981), GATT BISD (28th Supp.) at 114 (1982) [hereinafter Council action]. The Council action resolved disputes between the United States, on the one hand, and France, Belgium, and the Netherlands, on the other. Those disputes had concerned the domestic international sales corporation (DISC) provisions of U.S. law and the so-called "territorial tax systems" of the European states. *See infra* notes 9, 29. The Council action approved four panel reports that had been issued in 1976, one regarding the DISC provisions of United States law (Tax Legislation—United States Tax Legislation (DISC), *adopted* Dec. 7–8, 1981, GATT BISD (23d Supp.) at 98 (1976)) and the others involving the territorial tax systems of Belgium, France, and the Netherlands, and their failure to use the "arm's-length" standard (Tax Legislation—Income Tax Practices Maintained by France, *adopted* Dec. 7–8, GATT BISD (23d Supp.) at 114 (1976); Tax Legislation—Income Tax Practices

of whether U.S. exporters suffer a competitive disadvantage because European exporters are generally subject neither to European income tax on income earned abroad nor to European value-added tax on exports.

The ASCM provision at the center of the dispute is footnote 59 to Annex I of the ASCM, the "Illustrative List of Export Subsidies." Both the list and the language of the footnote are derived almost verbatim from the language of the 1979 Subsidies Code. Article 1.1(a)(1) of the ASCM provides that a subsidy is deemed to exist where "government revenue that is otherwise due is foregone or not collected." Article 3.1(a) of the ASCM prohibits subsidies "contingent, in law or in fact, . . . upon export performance, including those illustrated in Annex I." Included in Annex I as an example of an export subsidy is "[t]he full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises" (item e). Footnote 59 of the annex qualifies this item by providing that member states may take measures to avoid the double taxation of foreign-source income, but reaffirms the "arm's-length" principle, which allocates income among related corporations in accordance with the charges that would be charged between independent enterprises dealing at arm's length.[8]

The difference between the European Communities and the United States revolved around the interpretation of the footnote's final sentence concerning double taxation. The European Communities argued that the footnote was intended only to clarify that, for the purposes of item (e), basic features adopted by the national tax systems of member states to avoid international double taxation do not constitute the "exemption, remission, or deferral" of taxes "specifically related to exports."[9] Under this reading, the language does not permit a member state to adopt a method of avoiding double taxation *that is specific to foreign income from export activities,* and different from the general method of avoiding double taxation incorporated into that tax system.

The United States' position was that the language of the footnote did not stand only as a qualification of item (e), but as a limitation of both the definition of "subsidy" in Article 1.1 and of "export subsidy" in Article 3.1 of the ASCM. Under this reading, if a measure could be justified as one to avoid double taxation, that measure could be "export contingent" without being considered a subsidy. Thus, a nation whose tax system employed a credit method to avoid double taxation of income could employ an exemption method with respect to income from export activities (or vice versa).

The Body held in favor of the European Communities with respect to Article 1.1: the "savings clause" in the footnote does not qualify the definition of "subsidy" in Article

Maintained by Belgium, *adopted* Dec. 7–8, 1981, GATT BISD (23d Supp.) at 127 (1976); Tax Legislation—Income Tax Practices Maintained by the Netherlands, *adopted* Dec. 7–8, 1981, GATT BISD (23d Supp.) at 137 (1976)).

[8] The full text of footnote 59 is as follows. For ease of reference to the text, a bracketed number gives the serial order of each sentence.

> [1] The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. [2] The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. [3] Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. [4] In such circumstances the Member shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.
>
> [5] Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

[9] Generally speaking, national income tax systems avoid double taxation under one of two methods—an exemption method or a credit method. An exemption method simply exempts income the source of which is "outside" the taxing jurisdiction. This method, employed by most continental countries, is called a "territorial" system of taxation. A credit method includes foreign-source income but allows a credit against the tax imposed by the home state for foreign taxes imposed on foreign-source income. The United States uses the credit method.

1.1(a)(1)(ii).[10] (The Body refrained, however, from deciding the issue with respect to Article 3.1.) In order to decide upon an interpretation of Article 1.1, the Body determined that it "need[ed] to examine footnote 59 sentence by sentence."[11] (The United States' argument was based principally on the second and fifth sentences.) The Body rejected the United States' argument that the reaffirmation of the arm's-length principle in the second sentence implied that member states had the right not to tax foreign income. The Body held that the second sentence required the use of the arm's-length method *if* a state decided not to tax foreign income, but that the sentence was silent on the question whether a member could carve out an exception for export income if the member taxed foreign income generally.

The fifth sentence provided the stronger basis for the United States' argument. But the Body declined to examine any question raised by the fifth sentence, holding that the United States had not presented that argument before the panel. The Body relied upon Article 17.6 of the Understanding on Rules and Procedures Governing the Settlement of Disputes, which confines the Body to considering either "issues of law covered in the panel report" or "legal interpretations developed by the panel."[12] It held that the United States' argument would require examination of two legal questions not addressed by the panel: whether the FSC regime was one intended to avoid double taxation of income, and, if so, whether the regime fell outside the general prohibition of export subsidies. The Body held that considering these questions would require it to address issues "quite different" from those that confronted the panel, and that addressing these different issues "may well" have required "proof of new facts."[13]

In its argument concerning the interpretation and scope of the ASCM, the United States also relied heavily upon the 1981 GATT Council action that resolved four disputes provoked by the enactment of the provisions for domestic international sales corporations (DISCs), predecessor of the FSC provisions.[14] In that action, the Council set forth statements similar to those in footnote 59 concerning the use of the arm's-length principle, and the right of member states to take measures to avoid double taxation. The Council action added that member states were not required to subject to tax the income arising from "foreign economic processes," and that those processes should not be regarded as export activity.[15]

[10] Article 1.1(a)(1)(ii) of the ASCM, *supra* note 3, provides that a subsidy "exists" wherever "government revenue that is otherwise due is foregone or not collected." The Body held, in effect, that if a country uses a credit method for avoiding double taxation, but substitutes an exemption method for certain income, it "subsidizes" that income. The Report recognizes that the international agreements do not require a member to impose tax. But the Report reasons that to determine whether revenue is "otherwise due" requires "some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation," and that the "basis of comparison must be the tax rules applied by the Member in question." Report, *supra* note 1, para. 90. Thus, if the United States taxes foreign income generally, a measure forgoing the taxation of foreign income in particular circumstances is a subsidy of those circumstances.

[11] Report, *supra* note 1, para. 97.

[12] Understanding on Rules and Procedures Governing the Settlement of Disputes, Art. 17.6, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, *opened for signature* Dec. 15, 1993 [hereinafter DSU], *reprinted in* 33 ILM 112 (1994).

[13] Report, *supra* note 1, para. 103. The Body suggested that the United States sought to appeal from the failure of the panel to make a ruling with respect to the fifth sentence, and that this failure seemed to be due to "the failure of the respondent Member properly to litigate the matter before the Panel." *Id.*

[14] *See* Council action, *supra* note 7.

[15] The Council action, *id.* at 114, stated in full:

> The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., price for goods in transactions between exporting enterprise and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.

The Body held that the Council action did not constitute a decision of the contracting parties to the GATT that was binding under paragraph 1(b)(iv) of the agreement incorporating the 1994 GATT into the WTO Agreement.[16] The Body relied upon a prior decision that held that adopted panel reports do not constitute binding decisions under this provision, because they are binding only upon the parties to the dispute.[17]

The Body refused, further, to treat the Council action as a "decision" providing "guidance" as to the interpretation of the GATT 1994. The Council action interpreted only Article XVI:4 of GATT 1947, the relevant provision of which was much narrower in scope than the export-subsidy provisions of the ASCM or AA.[18] The Body also noted that, even had it accepted the 1981 Council action as guidance, that action did not support the United States' position. The Body held that the 1981 Council "was not addressing the issue of whether, having decided to tax a particular category of foreign source income, . . . the United States may provide an export contingent exemption from the category of foreign-source income that is taxed under its other rules of taxation."[19]

The Body also affirmed the panel's conclusion that FSC practices violate the AA, but the Body reached this conclusion via a different path than the panel. The panel had found a violation of Article 3.3 of the AA, which prohibits a member from "providing," with respect to agricultural products "scheduled" for a member, export subsidies listed in Article 9.1 of the AA[20] "in excess of the budgetary outlay and quantity commitment levels specified" in the schedule. Article 3.3 further specifies that none of the listed subsidies may be provided for unscheduled products. The Body rejected the panel's finding, however, that the FSC practices constituted provision of a subsidy "to reduce the costs of marketing exports of agricultural products" within the meaning of Article 9.1(d).[21] "[I]f income tax liability arising from export sales can be viewed as among the 'costs of marketing exports,' then so too can virtually any other cost incurred by a business engaged in exporting."[22]

The Body held, instead, that FSC practices violated Articles 8 and 10 of the AA.[23] Article 8 establishes an undertaking by members not to provide export subsidies otherwise than in conformity with the AA and the commitment specified in each member's schedule. Article

[16] Report, *supra* note 1, para. 108.

[17] Japan—Taxes on Alcoholic Beverages, WTO Doc. WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, para. 16 (Nov. 1, 1996); Chile—Taxes on Alcoholic Beverages, WTO Doc. WT/DS87/AB/R, WT/DS/110/AB/R, paras. 59–60 (Jan. 12, 2000).

The Body rejected the United States' argument that the words "in general" rendered the 1981 action an "authoritative interpretation" of the 1947 GATT. The Body relied upon the circumstances surrounding the adoption of the 1981 Council action, particularly a statement by the Council chairman, to determine that the action was not intended to bind all contracting parties to the GATT. Report, *supra* note 1, paras. 110–14.

[18] The Body relied upon two differences between the GATT 1947 and GATT 1994 provisions: the provisions of Article XVI:4 applied only to export subsidies that resulted in the sale of the product at a price lower than the price in the domestic market, and GATT 1947 did not include an explicit definition of the term "export subsidy." The Body also cited a statement by the chairman of the GATT Council with respect to the 1981 action, stating that the action interpreted only GATT 1947, not the 1979 Subsidies Code. The Body said it would be "incongruous" to extend the scope of the 1981 action to the 1994 ASCM. Report, *supra* note 1, para. 118.

[19] *Id.*, para. 120.

[20] The subsidies listed in Article 9.1 include [a] direct subsidies contingent on export performance; [b] selling by the government of products at a below market price; [c] payments upon export financed by virtue of government action; [d] subsidies to reduce the costs of marketing exports; [e] government-mandated internal transport or freight charges below those charged on domestic shipments; and [f] subsidies on products contingent on their incorporation in exported products.

[21] Report, *supra* note 1, paras. 130–32.

[22] *Id.*, para. 131.

[23] *Id.*, paras. 137–54. The Body declined to rule on two issues that the panel had not reached. The first involved the claim of the European Communities that the administrative pricing rules of the FSC provisions constitute an independent violation of the GATT. The second involved a claim by the European Communities against an aspect of the FSC provisions that limits the application of those provisions if more than 50% of the value of property is attributable to articles imported into the United States. In both cases, the European Communities made a conditional appeal with respect to the issue, to be considered only if the Body modified or reversed some aspect of the panel's finding. Because the Body did not modify or reverse any aspect of the panel finding, however, the Body found no need to rule on the appeals. *Id.*, paras. 172–76.

10 provides that export subsidies not listed in Article 9.1 may not be applied in "a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments." In reaching this conclusion, the Body relied upon a prior decision[24] establishing a two-part test of what constitutes an "export subsidy" for purposes of the AA: a measure must involve a "transfer of economic resources from the grantor" and confer an economic benefit on the recipient. The Body found that revenue forgone constituted a transfer of resources if the revenue was "otherwise due" within the meaning of Article 1.1(a)(1)(ii)[25] of the ASCM. On the second question, the Body again referred to the ASCM. It held that there is a benefit if there is a "financial contribution" within the meaning of Article 1.1(a)(1)(ii). Since forgone revenue that is "otherwise due" constitutes a financial contribution within the meaning of Article 1.1(a)(1)(ii), the Body found the test of a benefit satisfied.

Article 1(e) of the AA defines export subsidies as subsidies "contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement." The Body held that the term "contingent upon export performance" should be interpreted in the same manner under both the AA and the ASCM.

Finally, the Body found that the FSC regime involves the "application" of an export subsidy in a manner that "*results in*, or which *threatens to lead to, circumvention of*" export-subsidy commitments.[26] The Body discussed this matter quite briefly. It held that "[m]embers would certainly have 'found a way round', a way to 'evade', this prohibition if they could transfer, through tax exemptions, the very same economic resources that they are prohibited from providing in other forms."[27]

* * * *

The Appellate Body's decision concerning the FSC regime—which involves tax savings estimated to be over $4 billion annually—is of a magnitude far greater than any previous trade decision lost by the United States.[28] The decision marks, moreover, a new stage in a controversy between the United States and its major trading partners that has spanned over thirty years. The larger controversy had been quiescent since the early 1980s, when a partial, though ambiguous, resolution was achieved through the 1981 GATT Council action and the adoption of the Subsidies Code under the Tokyo Round. It would appear, nevertheless, that the decision of the Appellate Body neither resolves the controversy definitively nor dispels the ambiguities that were more or less deliberately incorporated into the agreements of the 1979–81 period, and carried forward to the 1994 ASCM. The decision requires the United States to eliminate the FSC provisions by October 1, 2000. The ambiguities of the relevant international agreements, however, coupled with the ambiguities of the Body decision itself, leave ample room for the United States to substitute for the FSC provisions other measures that would have comparable effects but would not in any clear manner violate those agreements.

The Body's substantive conclusions relate to three sets of issues: first, the interpretation of the ASCM, its relation to the Subsidies Code, and the timeliness of certain arguments raised by the United States; second, the significance, for the purposes of interpreting the ASCM, of the 1981 GATT Council action; and third, whether the FSC subsidy "threatens . . . circumven-

[24] Canada—Measures Affecting the Importation of Milk and the Exportation of Dairy Products, WTO Doc. WT/DS103/AB/R, WT/DS113/AB/R, para. 87 (Oct. 27, 1999).

[25] *See supra* note 10.

[26] Report, *supra* note 1, para. 150.

[27] *Id.*

[28] *See* Joseph Kahn, *U.S. Loses Dispute on Export Sales*, N.Y. TIMES, Feb. 24, 2000, at A1. Among the hundreds of corporations that have been taking advantage of the FSC provisions are Boeing, General Motors, and Microsoft. *Id.*

tion" by the United States of its commitments under Article 9 of the AA. In all three areas, the Body's conclusions rest upon strikingly frail legal and logical foundations.

The Body is on weak ground when it concludes that the United States had not raised before the panel the argument that footnote 59 permits an export-contingent special method of avoiding double taxation. The Body was able to reach that conclusion only by making the artificial—and illogical—supposition that each sentence of the footnote can and should be treated "separately." Both analytically and historically, the second and fifth sentences of footnote 59 are linked. Both are grounded in the intention of the parties in 1979 and 1981 to permit the long-standing territorial tax systems of the European states to continue, subject to the requirement that they be administered with adequate transfer-pricing restrictions.[29] A careful reading of the panel's opinion suggests, too, that the panel considered the issue with some care, although it did not proceed in the same manner as the Body by treating each sentence as analytically distinct.

The Body's interpretation of the 1981 Council action is even less persuasive. It is true that Article XVI:4 of GATT 1994 is narrower than Article 3.1 of the ASCM, and that the former provision had no explicit definition of an export subsidy.[30] It is not clear why those differences warrant any difference in the outcome, under the two provisions, of the question addressed in the 1981 action: whether the exemption of income from "foreign economic processes" constitutes an export subsidy. The Body's statement that the Council action did not address that precise question is all but groundless. Unless the portion of the Council action permitting the treatment of income from "foreign economic processes" as foreign income was gratuitous, the Council established in that passage that a method of avoiding double taxation specific to that category of income was permitted.

The Body's ruling on the AA issue is no less questionable and may well have more far-reaching legal consequences. The Body is on sound ground in interpreting the term "export subsidy" as it appears in the AA, and in concluding that members could "evade" commitments if they could provide through tax benefits what they are prohibited from providing through direct payments. But the Body's approach does considerable violence to the structure of the AA. The AA does not impose an outright prohibition of export subsidies. Only the subsidies listed in Article 9.1 are included in the prohibition; other subsidies are restricted *only* to the extent that they undermine the commitments with respect to the listed subsidies.

The AA thus contemplates that *some* subsidies are permitted. The Body concluded, however—apparently as a matter of law—that any forgoing of revenue (or, by implication, any

[29] Footnote 59 arose from three complaints filed by the United States in response to the complaint of Belgium, the Netherlands, and France against the domestic international sales corporation (DISC) practices of the United States. The United States charged that those nations' territorial systems, coupled with their failure to enforce the "arm's-length" principle, constituted an export subsidy in violation of Article XVI(4) of the GATT. In 1976, to the surprise of virtually everyone, the GATT panel upheld the three United States complaints, as well as the complaint against the United States, finding that both the DISC and the territorial practices of the three European nations violated Article XVI:4.

The 1979 Subsidies Code contains an illustrative list of subsidies. That list is carried forward in Annex I to the ASCM. Footnote 59 is based on a footnote set forth in connection with the list in Subsidies Code. The intention of the negotiators in adopting both the list and the footnote was to (1) all but concede the GATT-incompatibility of the DISC, and (2) concede the GATT-compatibility of the territorial tax systems, subject to the requirement that "arm's-length pricing" be observed. The viscosity of the language used reflected the political circumstances surrounding the adoption of the Subsidies Code. The draftsmen knew that a code explicitly condemning the DISC while explicitly blessing the territorial systems would have difficulty securing congressional approval; Congress wanted the negotiators to "get something" in exchange for repeal of the DISC provisions. At the same time, the United States negotiators believed that the language in the footnote sanctioning the territorial systems could legitimate a more limited DISC-like program that approximated the effect of the European territorial systems on export activity.

In 1981, the parties, subject to their "understanding" regarding the effect on their domestic tax practices, moved to resolve the still-outstanding dispute before the GATT by means of the GATT Council action that adopted the reports. *See supra* note 7.

[30] *See supra* note 18.

other measure that constitutes a "financial contribution" within the meaning of Article 1.1(a)) constitutes the "provision" of that which members "are prohibited from providing through direct payments." This approach comes close to implying that *no* measure constituting a "subsidy" within the broad meaning of the ASCM would be permitted under the AA.

The fact is, of course, that although the FSC regime does "forgo" revenue that is, in the sense adopted by the Body, "otherwise due,"[31] the regime does not therefore "provid[e] what the members are prohibited from providing by direct payments." In any given case, it may be quite difficult to determine the financial benefit derived from the use of an FSC. The tax law is complex. In lieu of an FSC, the taxpayer may have been able to use other devices to reduce tax liability; the FSC benefits may involve the sacrifice of some other benefits, such as foreign tax credits; and the savings from the FSC benefit might be reversed in a later year. Although the tax benefit may have some correspondence to a direct grant, it is hardly the same thing, even from the point of view of the government, much less from that of the taxpayer.

It thus appears that the Body reached the wrong result, as a legal matter, in interpreting Article 10.1 of the AA. Despite the interpretive deficiencies of the Body's report, however, there may have been considerable practical wisdom in the course it followed. By failing (or refusing) to resolve the central interpretive difficulty posed by Article 3.1(a) of the ASCM and by footnote 59, the Body has provided disputants with the opportunity to resolve the AA issue by agreement. Moreover, because the resolution of this issue has been long deferred—and because a simple prohibition of FSCs (or any alternatives) without any change in European tax practices may well leave a situation that *is* preferential—this approach probably does provide the greatest promise of achieving a result that is as fair, stable, and administrable as possible.

The particular approaches taken by the panel and the Body enabled them to avoid examining the ASCM issue in a light that might well have been most prejudicial to—and most embarrassing for—the United States. There is considerable doubt whether the FSC regime would comply with the ASCM even if one accepted the interpretation of the ASCM espoused by the United States. The United States argued that footnote 59 permits a nation to adopt an "export-specific" method of avoiding double taxation of foreign-source income, but the FSC regime goes considerably beyond protecting only "foreign-source" income from U.S. taxation. That is, although the United States argued that the 1981 Council action permitted states to forgo taxation of income arising from "foreign economic processes," the FSC regime is not confined to exempting income arising from such processes.

The FSC provisions create an exemption system limited to "exempt foreign trade income." But "exempt foreign trade income" is not income that would necessarily be treated as "foreign-source" under generally applicable (or any) economic principles. When property is produced (grown, extracted, manufactured) in the United States and sold abroad, the amount that would be foreign-source under ordinary rules would reflect the economic functions performed in the United States and those performed abroad. The FSC provisions, however, permit United States exporters to treat 32 percent of the income attributable to the FSC as exempt, and in certain circumstances the provisions permit two artificial methods of imputing income to the FSC.[32] Moreover, as detailed below, the "foreign economic pro-

[31] *See supra* note 10.

[32] The FSC treats 32% of the foreign trade income of the FSC as exempt income. The income allocated to the FSC in the first place (the "foreign trade income") is determined under generally applicable transfer-pricing principles. 26 U.S.C. §923(a)(2). But the FSC provisions also permit the "foreign trade income" of the FSC to be determined under two essentially arbitrary methods. *Id.*, §925(a). Under these methods, the "foreign trade income" of the FSC may be determined either as 23% of the combined income from the export transaction (that is, income attributable to *both* production and marketing activity), or as 1.83% of the gross receipts of the FSC; the exempt income is then calculated as 16/23 of the "foreign trade income" so determined. *Id.* §923(a)(3). These funny numbers (and confusing terms) may (and may be intended to) obscure the real nature of the FSC provisions, namely, that they represent the DISC provisions reduced by about one-third.

cess" requirements may be met with relatively little foreign involvement. Accordingly, there is no necessary connection between the amount of income treated as "exempt foreign trade income" and the magnitude of the "foreign economic processes" undertaken by the FSC.

As to foreign economic processes, the legislation requires that the FSC be a foreign corporation, and conditions the exemption upon the FSC's conducting certain "economic processes" outside the United States.[33] On inspection, however, the requirement that "economic processes" be conducted outside the United States proves to be something of a smoke screen. The statute defines five economic processes: advertising and sales promotion; processing of customer orders and arranging delivery; transportation from the time of acquisition by the FSC to the time of delivery; transmission of the final receipt (or invoice), and receipt of payment; and assumption of credit risk.[34] The law generally considers these processes to have been conducted outside the United States if 50 percent or more of their total direct costs are incurred outside the United States.[35] But an "alternative test" permits the foreign economic process requirement to be met if 85 percent or more of the direct costs of *two* of the processes are incurred outside the United States.[36] Two of the processes—the second (processing orders and arranging delivery) and the fourth (transmitting receipts and invoices and receiving payment)—are largely ministerial functions that presumably generate few costs and that, without inconvenience, can be located anywhere. By electing to use the 85 percent test with respect to these two "processes," an FSC could meet the requirement of conducting economic processes abroad even though the overwhelming preponderance of its marketing activities are performed domestically.

In light of the above, there was considerable merit to the Body's conclusion that the U.S. legal position in connection with the fifth sentence of the footnote would have required the Body to inquire into matters that had not been sufficiently presented to the panel. And although an inquiry into such matters before the panel might have raised complex questions about the content, implementation, and consequences of an intricate U.S. legal regime, the likely conclusion would have been that the FSC regime violated the ASCM even under the interpretation of the ASCM advanced by the United States. From the standpoint of the United States, the resolution reached by the panel was therefore less harsh than it might have been: it left the United States with the opportunity both to adopt new legislation and to negotiate with its trading partners without its preferred legal interpretation having been rejected by the Body.[37]

As indicated, however, by refraining from deciding the interpretive question the United States presented, the Body left open to the United States the option not only of repealing the FSC provisions, but of replacing them with a different measure designed to avoid double taxation and used only in connection with export activity. Such a measure could resemble

[33] *Id.* §§922(a), 924(b)(1)(B).

[34] *Id.* §924(e).

[35] *Id.* §924(d)(1).

[36] *Id.* §924(d)(2).

[37] DSU Art. 21(3) requires a member to inform the Dispute Settlement Board at a DSB meeting of its "intentions in respect of the implementation of recommendations and rulings of the DSB." DSU, *supra* note 12. On April 7, 2000, the United States indicated that it intended to implement the recommendations "in a manner which respects our WTO obligations" but is "consistent with our goal of ensuring that U.S. exporters are not placed at a disadvantage in relation to their foreign competitors." *See U.S. Will Comply with WTO Ruling on FSCs,* 2000 TAX NOTES TODAY 70-3 (Apr. 10, 2000).

In early May, the United States offered to the European Communities a proposal that apparently would have (1) extended FSC benefits to foreign income earned from sales, rentals, and licenses without regard to whether the income was earned from export activity, (2) retained the features of the FSC that restrict benefits to property bearing too great a degree of "foreign content," and (3) retained the administrative pricing rules to which the European Communities had objected. By late May, the European Communities had reportedly rejected the proposal. The administration nevertheless expressed an intention to work with Congress to adopt the proposal by October 1. *See* Statement by Deputy Secretary of the Treasury Stuart Eizenstat, May 29, 2000, *reprinted in* 2000 TAX NOTES TODAY 106-21 (June 21, 2000).

the FSC regime without replicating it—for instance, by eliminating the provision for a separate corporation, and by simply using rules like the current administrative pricing rules of the FSC to determine the source of income or the allocation of deductions for purposes of the foreign tax credit. Indeed, the United States may amend the tax laws in ways that accomplish the effects of the FSC regime without resorting to an export-contingent method of avoiding double taxation. Footnote 59 permits "measures" to avoid the "double taxation of foreign-source income." Nothing in it or in the ASCM suggests any limitation on the power of a member state to define "foreign-source income."[38]

The rules for determining when income is foreign-source are complex, as are the equally significant rules for allocating items of deduction among foreign- and domestic-source income.[39] The United States could achieve effects substantially similar to those of the FSC by what appear to be relatively minor changes in those rules.[40] Any such responses, of course, are likely to evoke counterresponses from the United States' trading partners.

The decision is unlikely to be the end of the controversy. In particular, in a world where different jurisdictions place differing degrees of reliance upon direct and indirect taxes, the inflexible application of the "destination principle"[41] can create disadvantages for any nation (for example, the United States) that relies primarily upon direct taxes, such as income taxes, rather than indirect taxes, such as value-added taxes (VATs).

There are few available conceptual methods for determining how the destination principle might be modified or limited in ways that would mitigate the hardships the principle creates. It is nevertheless possible to construct a means by which the impact of direct taxes on transactions can be assimilated to indirect taxes on the same transactions. Relationships between applicable indirect and direct tax rates can be estimated, permitting an assessment of the differential effects on trade of different jurisdictions' relative degree of reliance on the two types of tax systems.

Analysis along these lines would in all likelihood lead to the conclusion that, for a trading system in which some countries rely upon indirect taxes to a significantly greater degree than do others, the most neutral course would be to permit a mild degree of tax exemption or remission of direct taxes by the nations relying principally on those taxes. The development of this kind of arrangement may, in fact, have been the intention of the compromise reached in the 1979–1981 period. That compromise appeared to contemplate that the United States would be permitted to adopt some export subsidy through the U.S. income

[38] Provisions of double-taxation conventions may suggest such limitations, but in the case of the United States, the conventions typically reserve the right of the United States to tax its citizens and corporations as if the convention were not in effect. Thus, any limitation that the double-taxation conventions impose on the United States' right to define foreign-source income would apply principally to the taxation of nationals of convention partners with respect to their United States activities.

[39] With respect to United States-based multinationals, characterizing income as foreign, rather than domestic, income can have the effect of exempting the income. The reason is that multinationals tend to be in an "excess credit" position, that is, they have available foreign tax credits in excess of what their current foreign-source income permits them to claim. Treating income that had been domestic-source as foreign-source thus has the consequence of permitting the corporation to claim additional foreign tax credits, offsetting the United States tax that would be collected if the income continued to be characterized as domestic-source.

[40] One potential candidate for change would be the statutory rule that treats income from the sale of inventory property produced in the United States and sold abroad (or produced abroad and sold in the United States) as partly foreign- and partly domestic-source. 26 U.S.C. §863(b). That rule could be eliminated, permitting the general rule for the sale of inventory property to govern these cases—which treats the income as foreign-source. 26 U.S.C. §§861(a)(6), 862(a)(6), 865(b). This change would permit corporations to claim foreign tax credits for income that current law imputes (without any international norm requiring it to do so) to domestic activities. Other limited, but GATT-compliant, measures to achieve FSC effects without violating the ASCM have been suggested. See Charles M. Bruce, *The WTO's FSC Ruling: Let's All Relax*, 86 TAX NOTES 1927 (Mar. 27, 2000).

[41] Value-added taxes involve "border tax adjustments" that rebate prior-stage taxes at the point goods are exported from the jurisdiction imposing the VAT, and that impose taxes on prior stages when goods are imported into a VAT jurisdiction. Border tax adjustments are permitted under the "destination principle," a rule of international law that accords the right to impose *indirect* taxes to the jurisdiction in which the transaction subject to the indirect tax is completed—in most cases, the state into which goods are imported.

tax system, although not as large a subsidy as that effected by the DISC provisions. The United States' mistake, perhaps, was to attempt a subsidy not significantly different from that effected by the program it had agreed to replace.

In the short-term future, the United States may have to accept a significantly scaled-down program. But in the end, the major trading nations that rely substantially on VATs will have to accept that some adjustment of the income taxation of export activity by nations relying upon income taxes, rather than VATs, is appropriate within the framework of existing trade relations.

STANLEY I. LANGBEIN
University of Miami School of Law

Individual rights under Vienna Convention on Consular Relations—duty to inform detained foreign nationals of right to seek consular assistance—protections against arbitrary deprivation of life—advisory jurisdiction of Inter-American Court of Human Rights

THE RIGHT TO INFORMATION ON CONSULAR ASSISTANCE IN THE FRAMEWORK OF THE GUARANTEES OF THE DUE PROCESS OF LAW. Advisory Opinion OC-16/99. <http://corteidh-oea.nu.or.cr/ci/PUBLICAT/SERIES_A/A_16_ING.HTM>.
Inter-American Court of Human Rights, October 1, 1999.

On October 1, 1999, the Inter-American Court of Human Rights (Inter-American Court) issued its Advisory Opinion OC-16/99 (Advisory Opinion), *The Right to Information on Consular Assistance in the Framework of the Guarantees of the Due Process of Law.* The Advisory Opinion was requested by Mexico to clarify the rights and obligations established by the Vienna Convention on Consular Relations (Vienna Convention), with particular attention to its application in death penalty cases.[1] The Inter-American Court concluded that the duty to notify detained foreign nationals of the right to seek consular assistance under the Vienna Convention is owed to individuals as part of the corpus of human rights; that such notice must be given at the moment individuals are deprived of liberty and, in any case, before they make their first statements to the authorities; and that failure to provide such notice in death penalty cases constitutes a violation of the right to be free from arbitrary deprivation of life.

The Vienna Convention was adopted in 1963 and entered into force in 1967. Article 36(1)(b) provides that detained foreign nationals must be informed of their right to communicate with consular officials "without delay." Any communication addressed to consular officials must also be forwarded without delay. Article 36(1)(c) grants consular officials the right to visit with detained nationals and to arrange for their legal representation. The United States ratified the Vienna Convention in 1969, but many state and local law-enforcement officials have failed to ensure that detained foreign nationals are notified of their right to communicate with consular officials. Accordingly, numerous detained foreign nationals have challenged their convictions arguing, inter alia, that U.S. law-enforcement officials failed to notify them of their right to seek consular assistance. Several governments have also sought relief from these violations in U.S. courts and international tribunals.[2]

On December 9, 1997, Mexico submitted a request for an advisory opinion to the Inter-American Court of Human Rights concerning the interpretation of several treaties re-

[1] Vienna Convention on Consular Relations, Apr. 24, 1963, 21 UST 77, 596 UNTS 261.

[2] *See, e.g.,* Federal Republic of Germany v. United States, 526 U.S. 111 (1999); Republic of Paraguay v. Allen, 134 F.3d 622 (4th Cir.), *aff'd sub nom.* Breard v. Greene, 523 U.S. 371 (1998). *See generally* William J. Aceves, Case Report: Case Concerning the Vienna Convention on Consular Relations (Federal Republic of Germany v. United States) [LaGrand Case], 93 AJIL 924 (1999) [hereinafter Aceves, Case Report: LaGrand]; William J. Aceves, Case Report: Application of the Vienna Convention on Consular Relations (Paraguay v. United States), 92 AJIL 517 (1998) [hereinafter Aceves, Case Report: Paraguay v. United States]; *Agora:* Breard, 92 AJIL 666 (1998).