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GUEST EDITORIAL: THE FSC CHALLENGE

The recent decision of the WTO Appellate Panel regarding foreign sales corporations ("FSC") raises serious challenges for the U.S.-EU trade relationship and United States Trade Representative Bob Zoellick and EU Commissioner Pascal Lamy. The WTO had previously struck down the original foreign sales corporation provisions of the United States Internal Revenue Code and now has determined that the replacement legislation adopted in 2000 also provides for prohibited export subsidies.[1]

The decision also points to one of the great difficulties in utilizing the WTO dispute settlement mechanism. Trade issues have become increasingly political in nature. As quasi-judicial bodies, WTO panels are not equipped nor should they be equipped to take politics into account.

The following will look at the political nature of U.S.-EU trade issues, their effects on the WTO dispute settlement mechanism, and whether the FSC genie can be put back in the bottle without unduly damaging the U.S.-EU trade relationship.

Significant progress has recently been made in improving the U.S.-EU trade relationship. One need only look at the settlement of the banana case and our cooperation at Doha, which has made possible the beginning of a new WTO round. The events of 11 September have also given new perspective to our trade issues. But we still have issues and many ask "Why?". The simple

1. In a document prepared by the staff of Congress' Joint Committee on Taxation, titled the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000", foreign sales corporations are described as follows: "A foreign sales corporation must be located and managed outside of the United States, and must perform certain economic processes outside the United States. A foreign sales corporation is often owned by a U.S. corporation that produces goods in the United States. The U.S. corporation either supplies goods to the foreign sales corporation for resale abroad or pays the foreign sales corporation a commission in connection with such sales. The income of the foreign sales corporation, a portion of which is exempt from U.S. tax under the foreign sales corporation rules, equals the foreign sales corporation's gross markup or gross commission income, less the expenses incurred by the foreign sales corporation. The gross markup or the gross commission is determined according to specified pricing rules."

The FSC replacement legislation does not exempt foreign trade income but establishes a separate category of qualifying foreign trade income, beyond the reach of our income tax laws. Qualifying foreign trade income is not limited to export transactions and can include other activities such as manufacturing overseas provided there is a certain amount of domestic content. The requirement of establishing a separate foreign entity is eliminated as are the administrative pricing rules that had been designed to establish transfer prices between the parent and foreign entity.

response is that in an economic relationship that is so huge, it is only natural that we would have issues and that the overall relationship is strong. That response does not answer the real question, which is why can't we do an even better job in coming to reasonable resolutions of our issues?

There are a number of reasons relating to institutional structures, cultural differences and misperceptions that make resolution of issues difficult but, at the end of the day, the problem is basically "politics". For example, questions relating to beef hormones and genetically modified organisms strike an extremely sensitive chord particularly among European citizenry. The FSC decision has created an extraordinarily difficult political situation in the U.S. because of the thousands of exporters that have benefited from the programme. The political problem is potentially even more acute because of the downturn in the economy. Even "bananas" was ultimately a political controversy relating to the legitimate interests of corporate constituents and the disparate interests of various producing countries that were trying to protect their respective agricultural work forces. Whether or not the ultimate settlement was WTO compliant, it was basically a political settlement where the various interests after many years decided that something was better than nothing. There are important underlying substantive issues in all of these cases, but that is what creates political sensitivities.

Because so many of our disputes have such political overtones, they must be resolved in a political context taking into full account, economic, legal, scientific and technical questions. The answer is not the overhaul or the dismantlement of the WTO dispute settlement mechanism but that parties recognize what cases should and what cases should not be brought to the WTO. Once there is a panel decision, there is only a winner and a loser, and the winner often puts the loser in a difficult if not impossible political situation. Too often in the past when either side has brought a case, it has not thought about "what happens if we win?". The *FSC* case is the classic case. Our European colleagues would say that the same can be said for *beef hormones*, and this would also be the case if the U.S. brought a WTO action on genetically modified organisms. This is not to say that these issues should be swept aside; only that they must ultimately be resolved in a political context that recognizes that there are political realities and that there are no perfect solutions.

There are some cases that are appropriate to bring to the WTO. The WTO can serve as a court of last resort when no other solution has been reached and the complaining party has the political sensitivity to manage the dispute to a reasonable conclusion even after winning at the WTO. It may make sense to bring a case when the stakeholders on both sides are limited, thereby mitigating political ramifications. In addition, in a case when the level of potential sanctions is manageable, the losing side can make the calculation

that the sanctions are an acceptable alternative to complying with the decision. The EU has effectively done this in the *beef hormone* case. Ultimately, final resolution of this case may take the form of compensation to beef producers rather than compliance with the decision.

So where does this leave the *FSC* case. The final chapter of the proceedings has not been written. The amount of sanctions to be awarded to the EU has yet to be determined. But for the purpose of this article let us assume that a large award is granted to the EU.

First, and most important, prior to the enforcement of the award the parties at the highest levels must work diligently to reach a constructive solution. To actually enforce an award in the form of substantially increased tariffs would ultimately be of no benefit to the EU. A large increase in tariffs would hurt EU importers as much as U.S. exporters and would risk retaliation in similar amounts. Such action would also be likely lead to a flood of WTO actions that would be brought by the U.S. against the EU in any number of areas including challenges to the existing tax system in several EU countries. To move forward would make Congressional resolution of this issue even more difficult than it is already.

The threat of imposing an award is at first glance a far more potent weapon. The EU could, in effect, adopt unilaterally the trade version of "mutually assured destruction" by directly stating or implying that if the U.S. brought any WTO actions, it would enforce the award. A more diplomatic version would be for the EU to say that it would not enforce the award at present, but that any future favorable U.S. decisions would simply be credited against the FSC award. This would be very difficult in this situation because the potential size of the EU award would create such a large disparity. The EU would in effect be setting up a bank where it had virtually all the capital. Such action by the EU would ultimately not be successful in reducing tensions, because the U.S. could not let itself be paralyzed for any significant period of time from bringing WTO actions against the EU when it effectively would not have the leverage of sanctions. The U.S. would still have to look at each case individually and legitimate interests could not be held hostage to what effectively would be a "gun to the head". For example, agricultural producers could not be denied the leverage of sanctions from a favorable WTO decision because of fear of triggering enforcement of the FSC decision. The FSC case cannot be linked to other WTO actions, and any attempt to do so would likely lead to the same results that would occur if sanctions were directly enforced.

To avoid such draconian ramifications the parties must reach a reasonable solution. There are any number of areas to explore. Some may be fruitful, some not - but the parties must work together until there is a solution. Messrs. Zoellick and Lamy have already shown that they are very capable of doing that.

The best solution would be new legislation that would be WTO compliant. Ambassador Zoellick has said publicly that the Bush Administration would consult with U.S. and EU tax experts as well as members of Congress to try to reach a solution that does not leave American business at a competitive disadvantage. That disadvantage arises because the WTO ruling applies to American companies which are taxed both inside and outside the United States, but does not apply to companies in countries with territorial tax systems, such as are found in EU member states. The distinction is that with a territorial tax system, revenues from outside the jurisdiction are not considered income for tax purposes; therefore the EU argues that no subsidy is being granted.

Ambassador Zoellick has also said that because of the extreme sensitivity of any changes in the tax code, he cannot predict the timeframe that would be necessary to make the changes. Commissioner Lamy has said publicly that the EU would like to resolve the issue without resorting to retaliation, but that the EU would reserve its rights. He has also made the point that the decision provides the leverage to move the process in the right direction.

Political realities may make the right direction from the European standpoint difficult to come by. It is unlikely, particularly in the present economy, that Congress would enact legislation that would reduce benefits; but it could broaden the beneficiary base to insure that the legislation was WTO compliant. Carried to the extreme an overall reduction in the corporate tax rate or an increase in research and development tax credits would not benefit the EU and would make U.S. companies even more competitive. Despite the difficulties, a legislative fix would still be the best solution and must be investigated.

Another area to look at is the form that retaliation would take as well as the amount. For example, a reduction in tariffs on European exports could be a lot more palatable than increasing tariffs on U.S. exports to the EU. It may also be possible to modify the "bank" concept so that the EU award would be implemented only to the extent that the U.S. was imposing sanctions in other cases now or in the future. This may not be an economically efficient solution in that overall tariffs would increase, but it would not limit the legitimate interests of stakeholders in other cases and might provide the incentive for a more rational solution.

Finally the parties should look at all potential cases on an individual basis; not to come up with a package deal that would fail to take into account the interests that vary with each case, but to reach rational solutions to different problems, as was done in the banana case, that might make resolution of the FSC case easier. This would not be an easy task, but it is also an avenue that should be explored.

Creative negotiators may find other ways to reach a solution.

The *FSC* case illustrates the danger of overly burdening the WTO dispute settlement mechanism, not fully considering the political sensitivities related to areas such as taxation and not sufficiently looking at the ramifications of winning the case. Having said this the genie can still be put back in the bottle and both sides must work diligently to reach a solution.

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