FIRST IN SERIES ON THE EXTRATERRITORIAL INCOME REGIME

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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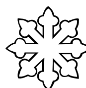

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FIRST IN SERIES ON THE EXTRATERRITORIAL INCOME REGIME

WEDNESDAY, APRIL 10, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:05 p.m., in room 1100 Longworth House Office Building, Hon. Jim McCrery, (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE
March 27, 2002
No. SRM–4

CONTACT: (202) 226–5911

McCrery Announces First in a Series of Hearings on the Extraterritorial Income Regime

Congressman Jim McCrery (R–LA), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold its first hearing on the extraterritorial income (ETI) regime. **The hearing will take place on Wednesday, April 10, 2002, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

On January 14, 2002, the World Trade Organization (WTO) Appellate Panel issued its report finding the United States' ETI rules to be a prohibited export subsidy. This marks the fourth time in the past two and one-half years that the United States has lost this issue, twice in the Foreign Sales Corporation case and now twice in the ETI case. There is no opportunity for the United States to appeal this latest determination.

On January 29, 2002, a WTO Arbitration Panel began proceedings to determine the amount of retaliatory trade sanctions that the European Union (EU) can impose against U.S. exports to the EU. The EU has requested $4.043 billion in sanctions. The United States has asserted that the proper measure of sanctions is no more than $1.1 billion. The Arbitration Panel will issue its determination by April 29, 2002.

In announcing the hearing, Chairman McCrery stated: "With the arbitration panel poised to rule on the level of sanctions which can be imposed by the EU, it is critical that we make a prompt, yet thorough inquiry into possible changes to the ETI system which are both WTO-compliant and foster the competitiveness of American companies. Witnesses at the hearing will help us explore the possibility of one approach—leaving ETI in place but making modifications to it that address the objections raised by the EU."

FOCUS OF THE HEARING:

The focus of the hearing will be to examine whether adjustments can be made to the existing ETI regime to bring it into compliance with WTO rules without undermining the competitiveness of U.S. businesses in the global marketplace.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610 by the close of business, Wednesday, April 24, 2002. Those filing written statements who wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Select Revenue Measures in room 1135 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse unopened and unsearchable deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov,* along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman MCCRERY. The Subcommittee will come to order.

We are told we are going to have a vote on the floor in about 10 or 15 minutes, so if we can get Members to take their seats as well as our guests, we will proceed and try to get through the first panel before that vote.

Good afternoon, everyone. Today the Select Revenue Measures Subcommittee begins its examination of the Extraterritorial Income (ETI) Exclusion Act which replaced the Foreign Sales Corp. (FSC) regime. I am glad that Chairman Thomas has asked our Sub-

committee to delve into this difficult issue and hope that we are up to the task of finding a way to untie this Gordian knot.

As Members of this panel are well aware, the United States has a world-wide tax regime, meaning U.S. companies pay tax on all of their income regardless of where it is earned. Some of the U.S.'s major competitors have territorial tax systems. Under such systems only income earned within the home country is taxed. Income earned outside of the home country generally is not.

Our international tax rules that provide for deferral for certain types of income earned abroad and which provide tax credits for income taxes paid to foreign countries are an endless source of complexity. Members of this Committee are interested in simplifying these rules to improve the competitiveness of U.S. multinational companies. I note that just last month Oversight Subcommittee Chairman Houghton introduced legislation on this difficult subject.

The ETI FSC rules are an attempt to address a slightly different issue impacting the ability of the U.S. companies to compete abroad. For reasons buried deep in the past, the agreement establishing the World Trade Organization (WTO) expressly permits countries to border adjust indirect taxes but not direct taxes, and upon this distinction lies the prospect of a trade war with Europe.

Many European countries have relied on value-added taxes, or VATs, for a significant share of their tax base. Under the terms of the WTO, the embedded VAT may be rebated when products are exported. By contrast, the United States raises most of its revenue from income taxes which are considered direct taxes and are not similarly rebatable on exported products.

In order to level the playingfield, the United States has provided a tax benefit to our exporters in an attempt to replicate the benefits of border adjustability. But what was offered in incentives to U.S. exporters lacked compliance with world trading rules.

Domestic sales corporations were replaced by foreign sales corporations in 1984. In 2000, the WTO ruled the FSC rules, the Foreign Sales Corporation rules, constituted an impermissible export subsidy. Working with the Clinton Administration, the Congress repealed FSC and replaced it with the extraterritorial income regime, which itself has been found to be in violation of those same WTO rules.

The case is now before an arbitration panel. That body will, by the 29th of April, set the amount of retaliation that the Europeans may impose to mitigate the impact of our Tax Code's impermissible export subsidy. We fervently hope the Europeans will not immediately exercise their right to impose sanctions and recognize the strong commitment of this Congress and the President to make the necessary changes to the Tax Code as soon as practicable.

Today's hearing explores one way to bring our Tax Code into compliance with the WTO ruling. Some observers have suggested that the WTO Appellate decision provides a road map for how the ETI regime could be narrowly modified to come into technical compliance with the WTO's rules while still providing the same benefits to the same set of taxpayers. Others, however, suggest the latest Appellate decision provides little wiggle room for cosmetic solution and believe the WTO will be very skeptical of supposed solutions that do not fundamentally revamp our Tax Code.

We have a distinguished group of witnesses to help us examine these difficult questions, and I am particularly pleased to welcome back to 1100 Longworth two good friends and long-time leaders of the Committee on Ways and Means, Chairman Bill Archer and Chairman Sam Gibbons.

Before I introduce them more fully, though, I would like to yield to my good friend from Massachusetts who is substituting for my good friend from New York today as acting Ranking Member, Mr. Neal.

[The opening statement of Chairman McCrery follows:]

Opening Statement of the Hon. Jim McCrery, a Representative in Congress from the State of Louisiana, and Chairman, Subcommittee on Select Revenue Measures

Good afternoon. Today, the Select Revenue Measures Subcommittee begins its examination of the Extra-Territorial Income Exclusion Act, which replaced the Foreign Sales Corporation regime.

I am glad Chairman Thomas has asked our Subcommittee to delve into this difficult issue and hope we are up to the task of finding a way to untie this Gordian Knot.

As Members of this panel are well-aware, the United States has a worldwide tax regime, meaning U.S. companies pay tax on all of their income, regardless of where it is earned. Some of the United States' major competitors have territorial tax systems. Under such systems, only income earned within the home country is taxed; income earned outside of the home country generally is not.

Our international tax rules that provide deferral for certain types of income earned abroad and which provide tax credits for income taxes paid to foreign countries are an endless source of complexity. Members of this Committee are interested in simplifying these rules to improve the competitiveness of U.S. multi-national companies. I note that just last month, Oversight Subcommittee Chairman Houghton introduced legislation on this difficult subject.

The ETI/FSC rules are an attempt to address a slightly different issue impacting the ability of U.S. companies to compete abroad.

For reasons buried deep in the past, the agreement establishing the World Trade Organization expressly permits countries to border adjust indirect taxes but not direct taxes. And upon this distinction lies the prospect of a trade war with Europe.

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In order to level the playing field, the United States has provided a tax benefit to our exporters in an attempt to replicate the benefits of border adjustability.

But what was offered in incentives to U.S. exporters lacked compliance with world trading rules. Domestic Sales Corporations were replaced by Foreign Sales Corporations in 1984. In 2000, the WTO ruled the FSC rules constituted an impermissible export subsidy. Working with the Clinton Administration, the Congress repealed FSC and replaced it with the Extra-Territorial Income Regime, which itself has been found to be in violation of those same rules.

The case is now before an arbitration panel. That body will, by the 29th of April, set the amount of retaliation that the Europeans may impose to mitigate the impact of our tax code's impermissible export subsidy.

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friends and long-time leaders of the Ways and Means Committee, Bill Archer and Sam Gibbons.

Before I introduce them, however, I would like to yield to the gentleman from New York for an opening statement.

Mr. NEAL. Thank you, Mr. Chairman.

I agree with you. You couldn't have met two finer people or two better Chairmen. It is a great opportunity for Members of this Committee to finally question two Chairmen of this Committee. It is a rare opportunity we get, finally.

I do want to thank you, Mr. Chairman, for holding this important hearing today on ensuring the competitiveness of U.S. multinational businesses.

I also want to thank you and your staff in working in earnest on another topic of interest to me, the corporate expatriate problem. I understand a hearing will be held perhaps as early as the end of this month when a U.S. Department of the Treasury report on the issue is expected to be released. Either way, if that report is not available, I think our hearing would certainly be instructive for the Treasury officials doing the report since there really has been no public debate on this issue thus far.

I do want to get to the question-and-answer period with our respective guests today. But I do also want to thank you Mr. Chairman publicly for agreeing to proceed with hearings on that expatriate issue.

Chairman MCCRERY. I thank the gentleman for his comments and look forward to working with him and other Members of the Subcommittee on that issue.

Our first two witnesses today are well known to this Committee and undoubtedly to our audience and our guests today. This week is Masters week, as some of you know, some of you golf addicts like me know. I am looking forward to it. It is my favorite tournament of the year. It is in the opinion of a great many people the best-running golf tournament in the world, and one of the great things about the Masters is the chance for past champions to come back and mingle with younger golfers, give them the benefit of their experience and their knowledge of the Masters Tournament and the game.

Certainly today we have two past masters with us to share with us their experiences and their knowledge of the game, so to speak; and we couldn't have chosen two finer examples of the greatness embodied in the Members of the Committee on Ways and Means which I think and most people believe is the greatest Committee in Congress. I don't get any disagreement with our panel or from the dais.

So, welcome, gentlemen. We very much welcome you back. We hope you won't make this your last visit to the Committee on Ways and Means. We hope to see much more of you. Certainly appreciate your taking time out of your schedules to join us today and try to help us with this issue.

We do have a vote on the floor—if it is just one vote. We could find out if it is just one vote. It is just one vote. So why don't I suggest that the Members of the Subcommittee run over and cast

this one vote. Then we will be right back, and that way we can go full on.

Thank you. The Subcommittee will be in recess.

[Recess.]

Chairman MCCRERY. The Subcommittee will come to order. Welcome back, everyone.

Our first two witnesses today are the Honorable Bill Archer and the Honorable Sam Gibbons. Mr. Archer is presently Senior Policy Advisor, Washington National Tax Services for Pricewaterhouse-Coopers. Mr. Gibbons is Chairman of Gibbons and Company. Gentlemen, once again, thanks for coming.

Today we will begin with Chairman Archer. Mr. Archer.

STATEMENT OF THE HON. BILL ARCHER, SENIOR POLICY ADVISOR, PRICEWATERHOUSECOOPERS LLP (FORMER MEMBER OF CONGRESS)

Mr. ARCHER. Mr. Chairman, thank you so much. Congressman Neal and other Members of the Subcommittee, I think this is a extremely important hearing today; and I am honored to be a part of it. Thank you for inviting me.

I have a longer written statement, Mr. Chairman, which I would like to have inserted in the record; and I will shorten for my verbal presentation.

Chairman MCCRERY. Without objection.

Mr. ARCHER. Today I will discuss briefly our current international tax system and the role of the ETI, and I will also offer for the Committee's consideration four fundamental principles for international tax reform that I hope you will find useful during the course of your work.

For the record, let me note that, as you mentioned, Mr. Chairman, I am currently serving as Senior Policy Advisor to the firm of PricewaterhouseCoopers, but today I testify on my own behalf and not as the representative of any organization.

I am extremely pleased to have the chance to discuss with my former beloved colleagues—and I mean that genuinely—in this auspicious environment of the Committee on Ways and Means hearing room the critical issue of ensuring that U.S. international tax rules provide a level playing field for U.S. businesses to compete globally; and I think that is what this issue basically is all about. As President Bush stated early in his Administration, and I quote, "Open trade fuels the engine of economic growth that creates new jobs and new income in the United States and around the world." I believe we must have a tax system that frees American workers and businesses to participate fully and fairly in the benefits of an open global trading system.

Achieving that goal in a manner that honors our international trade commitments is a fundamental imperative for our country and for the world. I am confident that the Committee on Ways and Means will address this challenge by once again demonstrating its longstanding bipartisan commitment to putting first the interests of American workers, farmers and businesses.

As we all know, the World Trade Organization ruled on January the 14th, for the fourth time, that the U.S. Tax Code is inconsistent

with our obligations to the WTO. I share the disappointment that you must have that Congress must once again confront this issue.

I had the distinct honor of chairing the Committee when we all worked together in a totally bipartisan manner to pass legislation in November 2000 that responded to an earlier WTO ruling when we repealed the FSC and enacted the ETI provisions. Unfortunately, the WTO ruled against the ETI; and by April 29th it will rule on sanctions. The amount and timing of any European Union (EU) retaliation remains unclear. What is clear are the serious risks posed by sanctions to our recovering U.S. economy and the orderly operation of the global trading system.

Chairman McCrery, when you announced this hearing you stated that it is critical that we make a prompt yet thorough inquiry into possible changes into the ETI system which are both WTO compliant and foster the competitiveness of American companies. I could not agree more. You asked for help in exploring the possibility of leaving the ETI in place but making modifications to it that address the objections raised by the European Union.

I have looked very carefully at the WTO decision, and let me state emphatically today that the Committee should not in my opinion consider another interim response to the WTO ruling. In my opinion, the ETI cannot be modified to preserve effectively its essential benefits and still be in compliance with the WTO.

I suppose that is really the guts of my comments today. I believe the Committee needs to consider fundamental reform of the ways that U.S.-based businesses are taxed. On this point I concur with Chairman Thomas, although I would add a note of caution that there will be winners and losers when you change the existing rules.

I believe that it is important to balance the needs of various affected industries and implement any proposed legislation in a manner that avoids disruption of current business plans and activities.

In my view, we force U.S.-based businesses to enter the global trading arena with one hand tied behind their backs relative to the Tax Codes of the countries where corporations are competing against us. The existing ETI provisions serve only in part to offset some of the anti-competitive features of U.S. international tax rules.

Under current law, a U.S.-based business operating internationally almost always pays a greater share of its income in foreign and U.S. tax than does a competing multinational corporation headquartered outside the United States.

In addition, the complexity and high compliance costs associated with U.S. international tax rules represent essentially an additional hidden tax on American businesses that operate abroad. It was most recently noted in a report that roughly 47 percent of the compliance costs under our Tax Code are a result of the way we tax foreign source income, and that should never be ignored. Because even though it is an administrative cost, it adds to the burden of our corporations that have to compete overseas.

You can witness the impact of an overly burdensome and complex tax regime on the U.S. economy in the area of corporate mergers and reorganizations. As this Committee knows from past hearings right in this room on international tax simplification, U.S.

international tax rules can play a key role in determining the location of a corporate headquarters.

This was clearly the situation in the case of Chrysler when it became, as a result of our Tax Code, DaimlerChrysler instead of ChryslerDaimler, a German corporation, with the result that the culture that now permeates that organization is directed out of Germany, not out of the United States of America.

I do not believe that is in the best long-term interests of our country. In fact, recent studies have shown that between 73 and 86 percent of large cross-border acquisitions involving U.S. companies have resulted in a merged company being headquartered abroad. Of the world's 20 largest corporations, the number headquartered in the United States has declined from 18 in 1960, the period of time when our current code was put on the books in the early sixties, to just 8 in 1996. So from 1960, 18 of the largest—of the 20 largest corporations in the world were in the United States. Today, only six. And that tells a story in itself.

In conclusion, let me say that we must consider the bigger picture when discussing the current U.S. international tax system. Achieving a high standard of living for American workers and their families ultimately rests on the productivity of U.S. investments. The challenge is to design a tax system that raises revenue with the least damage to investment and growth in productivity.

With these larger issues in mind, I would like to offer four fundamental principles that I hope you would consider during your deliberations. I believe that these bedrock guidelines should be a part of the core criteria by which any proposal is judged.

First, if and to the extent that the ETI regime is repealed, any scored positive revenues such action generates should be reserved for measures to improve the competitiveness of U.S. corporations operating in the world marketplace.

Second, in designing international tax reform measures, the Committee should balance the needs of various affected industries. All industries are not alike in the way they are impacted.

Thirdly, also, the Committee should seize every opportunity presented during this process to fashion international tax rules that U.S. businesses can understand and the government can administer.

Finally, any repeal of the ETI should be accompanied by an adequate transition period to avoid disruption of current plans and business activities.

A successful U.S. response to the WTO's ruling against the ETI has the potential to address two key priorities for our country. First, we must make the United States more competitive internationally; and, second, we must address the underlying problems with the U.S. international tax rules that are resulting in fewer and fewer global business headquarters being located in our country.

Finally, although Ambassador Zoellick is making efforts to have the European Union defer any retaliatory action while the United States works to comply with our WTO commitments, there remains the real possibility that some action may be required this year. Because of the potential magnitude of this issue, it would be highly desirable for the Congress to work with the White House to put in

place a joint bipartisan task force to make formal recommendations to the Congress on a solution. That task force should, in my opinion, include representatives of the White House, select Members of Congress from both parties, representatives of business, farmers and organized labor. I don't think it can come too soon to lay the groundwork for an ultimate solution to this problem.

For my part, I offer my assistance and the assistance of PricewaterhouseCoopers as the Committee considers any replacement of the ETI regime. I played a very big role, as you may remember, in the development of the ETI, working very closely with the Clinton Treasury and with both sides of the aisle. We did our best, but it was not upheld by the WTO. Now again it must be on the basis of full consideration on both sides of the aisle and the White House.

I thank you again for letting me come and testify, and I will be happy to answer any of your questions.

Chairman MCCRERY. Thank you, Chairman Archer.

[The prepared statement of Mr. Archer follows:]

Statement of the Hon. Bill Archer, Senior Policy Advisor, PricewaterhouseCoopers LLP (former Member of Congress)

Mr. Chairman, Congressman McNulty, and distinguished members of the Subcommittee, I appreciate the opportunity to appear at this hearing to discuss the future of the extraterritorial income tax regime. Today, after exploring the current state of our country's international tax regime, I would like to offer for your consideration four fundamental principles for international tax reform that I hope you will find useful during the course of the Committee's work.

For the record, let me note that while I am currently serving as Senior Policy Advisor to PricewaterhouseCoopers, I am testifying today on my own behalf and not as the representative of any organization.

First, I am extremely pleased to have this chance to discuss with my former colleagues the critical issue of ensuring that U.S. international tax rules provide a level playing field for U.S. businesses to compete globally. As President Bush stated early in his Administration, "Open trade fuels the engine of economic growth that creates new jobs and new income in the United States and around the world." We must have a tax system that frees American workers and businesses to participate fully and fairly in the benefits of an open global trading system.

Achieving this goal in a manner that honors our international trade commitments is a fundamental imperative for our country. I am confident that the House Committee on Ways and Means will address this challenge by once again demonstrating its longstanding bipartisan commitment to putting first the interests of American workers and businesses.

The Subcommittee has been charged with the responsibility for exploring options that respond to the January 14th World Trade Organization appellate ruling that the U.S. tax code is inconsistent with our obligations under the WTO. This decision marks the fourth time the WTO has ruled this way, twice in the Foreign Sales Corporation (FSC) case and now twice in the extraterritorial income (ETI) case.

I believe that I share the disappointment of each of you that Congress once again must confront this issue. I had the distinct honor of chairing the House Committee on Ways and Means when we all worked together in a bipartisan manner to pass legislation in November 2000 that responded to an earlier WTO ruling by repealing the FSC and enacting the ETI provisions.

Unfortunately, the most recent WTO rulings find that the current ETI, like the FSC provisions that preceded them, are inconsistent with our international trade commitments. A WTO Arbitration Panel is expected to rule by April 29 on the amount of sanctions the European Union can impose against U.S. exports to EU countries. The amount and timing of any retaliation remains unclear. What is clear are the serious risks posed by sanctions to our recovering U.S. economy and the orderly operation of a global trading system.

Chairman McCrery, in announcing this hearing, you stated that "it is critical that we make a prompt, yet thorough inquiry into possible changes to the ETI system which are both WTO-compliant and foster the competitiveness of American companies." You asked for help in exploring the possibility of leaving the ETI in place but

making modifications to it that address the objections raised by the European Union.

I do not think it is possible to design a replacement that will replicate the same benefits to the same taxpayers and still satisfy the WTO rules. On this point, I concur with Chairman Thomas. Thus, the Committee will need to recognize that there will be winners and losers with respect to any change to the existing rules. However, I believe that it is important to balance the needs of various affected industries and implement any proposed legislation in a manner that avoids disruption of current business plans and activities.

Let me state emphatically that the Committee should not consider another interim response to the WTO ruling. In my opinion, the ETI cannot be modified to preserve effectively its essential benefits and still be in compliance with the WTO. I believe the Committee needs to consider fundamental reform of the ways that U.S.-based businesses are taxed. As you all know, I have been a long-time advocate of fundamental tax reform. While reform of our overall tax system remains an issue for another day, it is vital that the Congress begin to consider comprehensive overhaul of U.S. international tax rules.

The current ETI provisions, like the earlier FSC provisions, are integral parts of a larger system of international tax rules under which U.S.-based businesses must compete internationally. The ETI and FSC provisions were designed to level the playing field at least partially for those U.S.-based businesses that are subject to those rules.

In my view, we force U.S.-based businesses to enter the global trading arena with one hand tied behind their backs relative to the tax codes of the countries where corporations are competing against us. The existing ETI provisions serve only in part to offset some of the anti-competitive features of U.S. international tax rules. It is important that we examine just how complex and burdensome those rules are.

First, current international tax rules are grossly outdated. The basic Subpart F rules, for example, were enacted in 1962. These rules reflect the economic climate of that time. In 1962, the United States was a net exporter of capital and ran a trade surplus. Imports and exports were only one-half of the percentage of GDP that they are today. As we all know, the world has changed. Our tax laws need to change too.

The impact of U.S. tax rules on the international competitiveness of U.S. multinationals is much more significant an issue than it was forty years ago. Today, foreign markets provide an increasing amount of the growth opportunities for U.S. businesses. At the same time, competition from multinationals headquartered outside of the United States is becoming greater. Of the world's 20 largest corporations, the number headquartered in the United States has declined from 18 in 1960 to just 8 in 1996. Around the world, 21,000 foreign affiliates of U.S. multinationals compete with about 260,000 foreign affiliates of foreign multinationals.

If U.S. rules for taxing foreign source income are more burdensome than those of other countries, U.S.-based businesses will be less successful in global markets, with negative consequences for exports and jobs at home. I think a fair comparison of U.S. international tax rules and those of other nations shows that American businesses are increasingly put at a competitive disadvantage in the world marketplace.

First, about half of OECD countries have a territorial tax system under which a company generally is not subject to tax on the active income earned by a foreign subsidiary. By contrast, the United States taxes income of a U.S.-controlled foreign corporation either when repatriated or when earned in cases where income is subject to U.S. anti-deferral rules.

Second, the scope of U.S. anti-deferral rules under subpart F is unusually broad compared to those of other countries. While most countries tax passive income earned by controlled foreign subsidiaries, the United States stands out for taxing as a deemed dividend a wide range of active income under various subpart F provisions.

Third, the U.S. foreign tax credit, which is intended to prevent double taxation of foreign source income, has a number of deficiencies that increase complexity and prevent full double tax relief.

Taken all together, you find that a U.S.-based business operating internationally frequently pays a greater share of its income in foreign and U.S. tax than does a competing multinational company headquartered outside of the United States.

In addition to a comparatively higher effective tax rate, the U.S.-based business is burdened by tax rules that are among the most complex in the entire U.S. tax code. Economists who surveyed Fortune 500 companies found that 43.7 percent of U.S. income tax compliance costs were attributable to foreign source income even though foreign operations represented only 26–30 percent of worldwide employment, assets, and sales. The complexity and high compliance costs associated with U.S.

international tax rules represent essentially an additional hidden tax on American businesses that operate abroad.

One indication of the impact of an overly burdensome and complex tax regime on the U.S. economy is in the area of corporate mergers and reorganizations. As this Committee knows from past hearings on international tax simplification, U.S. international tax rules can play a key role in determining the location of a corporate headquarter. This was clearly the situation in the case of DaimlerChrysler. In fact, recent studies have shown that between 73 and 86 percent of large cross-border transactions involving U.S. companies have resulted in the merged company being headquartered abroad.

How we tax foreign source income will influence what kind of economy we have in the long run—specifically, whether we have a strong and vibrant economy with competitive workers and companies, and whether we can create more export-related jobs which pay on average 17 percent more to the workers of this country.

In conclusion, let me say that we must consider the bigger picture when discussing the current U.S. international tax system. Achieving a high standard of living for American workers and their families ultimately rests on the productivity of U.S. investments. Growing productivity in turn requires investment in plant and equipment and in the further development of knowledge through research and education.

The challenge is to design a tax system that raises revenue with the least damage. An overly complex and burdensome tax system can impose unnecessarily high costs to the economy by discouraging savings and investment, by causing investment to be allocated inefficiently, or by requiring excessive resources to be devoted to complying with and administering the tax rules.

With these larger issues in mind, I would like to offer four fundamental principles that I hope you would consider during your deliberations. I believe that the following bedrock guidelines should be part of the core criteria by which any proposal is judged:

Four fundamental principles to guide WTO response

1. If and to the extent that the ETI regime is repealed, any scored positive revenues such action generates should be reserved for measures to improve the competitiveness of U.S. corporations operating in the world marketplace;
2. In designing international tax reform measures, the Committee should balance the needs of various affected industries;
3. The Committee should seize every opportunity presented during this process to fashion simplified international tax rules that U.S. businesses can understand and the government can administer; and
4. If the ETI regime is repealed or substantially changed, there should be an adequate transition period to avoid disruption of current plans and business activities.

A successful U.S. response to the WTO's ruling against the ETI has the potential to address two key priorities for our country. First, we must make the United States more competitive internationally, and, second, we must address the underlying problems with the U.S. international tax rules that are resulting in fewer and fewer global business headquarters being located in our country.

As Chairman Thomas noted to the full Committee at the February 27th hearing, the task before you is not an easy one. It will require the collective effort of all Members from both parties to build a consensus on an approach that will meet U.S. international commitments while maintaining the competitiveness of American businesses and workers in the global marketplace. I am confident that the Members of the House Committee on Ways and Means, with the active leadership of the Bush Administration and the collaboration of Senate colleagues, will rise to the occasion once again.

Finally, I would note Ambassador Zoellick's efforts to have the European Union defer any retaliatory action while the United States works to comply with our WTO commitments. There remains the likelihood that some action may be required this year. Because of the huge potential magnitude of this issue, it would be highly desirable for the Congress to work with the White House to put in place a joint bipartisan task force to make formal recommendations to the Congress on a solution. That task force should include: (1) the Administration; (2) select Members of Congress from both parties; and (3) representatives of both business and organized labor.

For my part, I would like to offer my assistance, and the assistance of PricewaterhouseCoopers, as the committee considers any replacement of the ETI regime.

Thank you again for the opportunity to testify today. I will be happy to answer any questions you may have.

Chairman MCCRERY. Now another gentleman with a long track record of examining this Nation's tax laws and regulations and one who has put, I know, a lot of thought into our tax system, Mr. Gibbons. We are very thankful to have you also with us.

You might notice that we allowed Mr. Archer to go over the 5 minutes. We will extend that same courtesy to you. The panels that are following, don't get any bright ideas. We are doing this for two former distinguished Chairmen of this Committee.

We certainly will allow you to speak for however long you wish, Mr. Gibbons. Please address the Committee.

STATEMENT OF THE HON. SAMUEL M. GIBBONS, CHAIRMAN, GIBBONS AND COMPANY (FORMER MEMBER OF CONGRESS)

Mr. GIBBONS. Mr. Chairman and Members of the Committee, let me thank you for allowing me to come back here in this position as a witness before the Committee. It is a high honor for me. I will try to do my best.

Like I think Mr. Archer and I both feel, we would prefer to have a dialogue with you which we hope our direct testimony will stimulate so that we can really pure out the knowledge that we have and the thoughts that we have in that dialogue. So I will try to keep my remarks brief; and, Mr. Chairman, just slam me with the gavel when you think I have gone too far.

Mr. Chairman, I don't disagree with a thing that Mr. Archer has said. We talked about this when he and I were both on the Committee. We fundamentally understand the subject matter, and I feel that it is our job and I am sure he feels it is our job to try and impart some of that knowledge that we accumulated on our years here so that you all can take some affirmative action on it.

Let me go back to the beginning. How did we get in this predicament? Well, it is certainly not your fault. It is not our fault. It is the fault of a long time ago, an innocent decision that was made at that time. And there were no villains in the whole process at all. Let me paint the picture.

In 1947, I was a young lawyer down in Tampa, Florida. I had just graduated from law school, spent 5 years in the Army, and was not focused upon Washington at all. But the world was in shambles. Europe looked like it was—we knew it was prostate because we had destroyed it during World War II. We thought it was going Communist, because that was the emerging philosophy there. And Japan was in terrible shape, China. Every place on Earth except the United States of America was in terrible shape.

The leaders at that time decided to convene here in Washington in 1947 a conference on what to do about rebuilding the world. Everybody came to Washington from all over the world, knowing that America was the number one economic engine of not only the United States but of the world; and they had been defeated or had worked with us in defeating the rest of the world in the war. So they convened here in Washington in 1947, and they eventually

came out with something called the General Agreement on Tariffs and Trades (GATT) with its rules.

That graduated over a period of time into the World Trade Organization. But essentially the rules are the same as they started in 1947. They were rules that the United States of America imposed upon the rest of the world. Let's have no doubt about it. We are the ones that invented these rules that have us entrapped today.

The Europeans who had the strongest economy, such as it was, and it was in terrible shape, came along and in that 1947 agreement this distinction between indirect and direct taxes was made. And why was it made? Why did the United States impose that kind of rule? Well, that is the same kind of rule that we had developed in the United States in how we handle our sales tax. Today, and even then, if you buy something in New York with a high sales tax and you have it shipped to here in Washington, you don't pay any New York sales tax, and vice versa. If you buy something here in Washington with its relatively high sales tax and have it shipped to you in New York, you don't end up paying any Washington sales tax.

That is the same dilemma we are in this—the world rules today. We imposed that rule on the rest of the world in 1947, and it hasn't changed.

Now, why did we do it? Well, we were trying to get rid of subsidies. We realized that the Tax Code could be used to subsidize businesses. So we got rid of them in the direct subsidies; and when we got to the subsidies that are embedded in the tax law we said, well, we will adopt the same rule that we have for our own domestic sales tax. That is how we got where we are today, and that is the same rule that comes back to haunt us.

Now the Europeans weren't plotting against us when they agreed to do that. They had the same kind of tax system in Europe, such as it was, as we had in this country—high dependence upon excise taxes and a heavy dependence upon income taxes and various other nuisance taxes like alcohol and tobacco and excise taxes on fuel and things of that sort. So the tax systems were roughly the same.

In 1965, the French had had so much trouble with their own income tax system that they started experimenting, and they came up with something called a tax value added, TVA.

I first ran into it when I found myself without an overcoat in Paris with Martha, oh, sometime in the late 1960s or early 1970s. I had to go buy an overcoat. The embassy didn't want me shivering to death over there in that French weather, and I bought an overcoat.

Well, the fellow from the embassy who was with me jabbered off in French to the clerk there something about TVA. I didn't know what the heck they were talking about. Well, 2 months later I was sitting in my office in the Rayburn Building and in comes a check from a bank in New York for about 200 bucks. No letter going with it or anything else.

So I called the bank. I said, why did you send me $200? They said, well, that is the rebate on the French TVA tax that I had paid on the overcoat.

I called the colonel in who had been my escort. I said, how did we get into this? He said, I turned in all those papers that you

gave me at the border when we left France and you got the tax back that had been collected on your overcoat.

Well, that got me to scratching my head. Attending conferences in Europe, I would meet with the European Commission and the European Council, and I would complain about this rebate, this unfair advantage that they had against Americans. They would say, it is a sales tax, just you all have got in the United States, State level. You rebate that same thing when you make the sales.

So it dawned upon me that we are up against something that was a little different, and the severity of it didn't dawn on me until American businesses kept coming to me saying, complaining, well, we are at a disadvantage. The Europeans can rebate their cost of government at the border on their products when they export them into the world market, and we Americans can't.

Well, about the early 1970s, I think it was, the Treasury Department came in. There were only 25 of us on the Committee. There was no lower level down here. They took us over to H–208 and explained to us what the problem was. We came up with this way to get around it, we thought. It was highly controversial within H–208, but there were no newspaper reporters around, nobody else. The doors were all closed, and we were just plotting up a solution ourselves behind those closed doors.

After a few hours of arguing back and forth, we finally adopted this monster that you all are dealing with right now. It has had to be changed over the years as one time after another that the monster got chopped down, and we had to fess up that, yeah, we have committed a tax subsidy under the Income Tax Code. There isn't any way out of it. We imposed the rule on the world. It has come back to haunt us.

Everybody on Earth has gone to a value-added tax. Instead of a TVA, it is a VAT; and only our country and Australia have not gone that route. So it is us against the world. We are eventually going to have to conform to their set of rules or suffer the consequences. That means that they can levy offsetting duties against our products if we continue to be the scofflaw in the international situation, so there is no way out of it.

Maybe some kind of temporary something can be negotiated with the rest of the world. I doubt it, but you can try. It will be very frustrating, and you are not going to get very far. The rest of the world is going to say, you know, Americans, if you don't like the rules, you join the club. You change your rules, you change your tax laws, and you can join the same club we are all in.

Now, what is that club? That club is—let me take off these glasses, because they impede my ability to think.

If you manufacture these glasses in the United States and sell them abroad—and nobody does that, but if you did, when they went abroad, they would go with the full cost of the U.S. Government in here, the full tax cost of the U.S. government. It is a pretty substantial burden to have to carry and go overseas.

When you hit their border you would not only have your cost of government there, these glasses, but these glasses, when they pass that border, would pick up under their value-added tax, their cost of government. So these glasses would be burdened with two costs of government going from our country to their country. But coming

from their country to our country, it is just the opposite. They take off the value-added tax, their cost of government, at their border. We have got nothing that effectively intercepts it on our side.

So what are we doing? We are exporting American jobs. Let me repeat that. What are we doing? We are exporting American jobs, good American jobs, because of the way we collect taxes.

Now, there is no solution through the income tax. We have tried it for 20—almost 26, 27 years. Every time we have tried it, the World Trade Organization says, you know, that is a subsidy. And honestly it is, under the current rules. But—so, I don't know of anybody on this Committee that wants to continue to export American jobs, but that is what we are doing. That is what we have been doing for quite some time. That is what we are going to be doing at a greater rate unless we change our system.

So, men and women of the Committee on Ways and Means, the burden comes back to you. You can't judge it. You can't fix it. You can't flinch it. You got to do it. You have got to adopt some kind of tax system that will work in the world system.

We are a world power, but we are a limited world power. We are only 4 percent of the Earth's population, something that never dawns upon most Americans. We are only 4 percent of its population, but we possess and control about 30 percent of its wealth. We are bleeding that away, and we are bleeding it away primarily not because we are not a productive nation, but because of our tax system.

I don't know what it costs to collect taxes in the United States at the Federal level, but it is horrible. It is far greater than what we pay the Internal Revenue Service (IRS). Because also out there is tax deductible—are all of the tax firms that do tax law, all of the people that write books and write electronic programs and everything else. It is a huge, huge industry.

All of you, like Mr. Archer, who fill out your tax return—I did it for years until I finally got audited and wised up and found out it was better for me to hire an accountant rather than explain to the IRS why I didn't fill out a tax return properly——

Chairman MCCRERY. You are going into areas now that this Committee is not prepared to discuss.

Mr. GIBBONS. They audited my tax return when I was first a Member of this Committee; and, believe me, that is an exquisite feeling if you have never been through it. I don't recommend it for anybody.

I want to say right now I didn't get caught, and I was clean, and Martha didn't have to pay anything, and I didn't have to pay anything. But it is an exquisite feeling to have the people walk in from the IRS and say, we are from the government. We are here to help you, and we are going to audit your tax return. We want all your books and records. And a cold sweat, even if you are a Congressman, breaks out all over you when that happens.

So that, you know, I do know something about what the cost of collecting taxes is. It is a huge drag upon the American economy, one that we insist on imposing on our economy; and we are going to reduce ourselves to a third-world nation if we continue down this path. That is how critical this issue is.

I have talked longer than Bill Archer, and I have talked longer than most of you care to listen to me. But thank you very much. If I can ever come back and spend time with you or go on a retreat with you, Bill and I will be glad to go. There is a lot there that we won't be able to say because you just haven't got the time to listen. But we are here to help you. We are here to work with you.

Chairman MCCRERY. Thank you very much, both of you. And quite the contrary, Mr. Gibbons, I think it is helpful for particularly the younger Members of the Committee to hear the history of how we got to where we are. It is very helpful for us to hear from the two of you who were intimately involved in various efforts through the years to make our tax system work within the confines of the rules of the World Trading Organization, whether it was GATT or WTO.

I want to begin the questions by exploring a little bit those efforts that you went through. Just to use the most recent example, back in 2000, when Chairman Archer worked with Charlie Rangel and Members on both sides of the aisle and with the Clinton Administration to try to figure out a way to replace the FSC with something that was workable and permissible under the rules and they came up with ETI, that process took nearly a year. It would have taken a lot longer except for the fact that everybody involved agreed where we wanted to go and everybody was in agreement that something had to be done. Everybody was in agreement that we wanted to keep American workers and farmers and businesses competitive and to keep Americans working. So we all worked together very expeditiously to go from FSC to ETI.

My question to you, though, relates to where we are today vis-à-vis the sanctions that may be imposed upon us in the not-too-distant future. Do you believe that a similar—first of all, do you believe that a similar bipartisan effort is necessary to come up with any solution that we arrive at?

Mr. ARCHER. As I stated in my testimony, I believe that.

Chairman MCCRERY. Mr. Gibbons.

Mr. ARCHER. But I do not believe that it can be done in a rapid fashion. That is why I think you need to get started with the process by exploring the alternatives.

Chairman MCCRERY. That is my next question. Do you think we can get the parties together—not just political parties but all the parties that have to be involved in such a tremendous effort and get something done before the end of this month when retaliation is due to come from the WTO, from the Europeans?

Mr. ARCHER. I doubt it. But it is my understanding of the signals that we have been getting from the Europeans, as particularly articulated by Lamy, that if there is a process under way which shows good faith for us to reform our tax system that they will not immediately retaliate.

Chairman MCCRERY. Mr. Gibbons, do you have an opinion on how long it is going to take us?

Mr. GIBBONS. I think you could work out the bipartisan part in the Congress and with the President. I don't think that is the big problem. I think the problem is, what are you going to do with the rest of the world? When I say the rest of the world, you know there are almost 160 members of the WTO. Everybody on Earth that we

have allowed in is in the WTO, and you have got—and all of them have got a value-added type of system that they are working from, and we have got—we depend heavily upon the income tax. They are just—unless there is something within the psyche of those 157 other nations out there, I don't think you got much negotiating grounds.

Now, they want some things and we want some things, and maybe I think with a wink and a nod and a handshake you could work out something that would delay the impending execution of those dates if you could show good-faith effort that you were moving ahead. It isn't going to be easy. And the biggest part of the problem is not the technical problem but the political problem within the United States of moving from an income-based tax and a payroll tax to an indirect tax. That is the problem. And it is not an easy problem.

But, friends, they have got the goods on us. We have got to show some good-faith effort that we are ready to move and are willing to move. I don't know of any other short-term thing that could have happened. We have got to go to the WTO and tell them we would like to sit down and work this thing out and show some good-faith effort that we are willing to work it out. I don't think we can pass any more changes in the income tax law that will stand up more than to take the time to file a case in the WTO.

Chairman MCCRERY. Thank you. Mr. Neal.

Mr. NEAL. That was fine testimony, Mr. Chairman. I do not have any questions at this time.

Chairman MCCRERY. Mr. Hayworth.

Mr. HAYWORTH. Thank you, Mr. Chairman.

Mr. Chairman, thank you for returning; and we appreciate your insight.

Chairman Archer, as you laid out the four principal ideas and guidelines for us in responding to the WTO, I was wondering, sir, if you could elaborate a bit more on principle number two: In designing international tax reform measures the Committee should balance the needs of various affected industries. For purposes of illustration only, could you elaborate a little bit on that?

Mr. ARCHER. That becomes the very difficult part of this process. I think politically, as you begin to move in to restructuring the Tax Code, you are going to find domestic winners and losers. You cannot duplicate as we did with ETI the benefits so that everybody was a winner. That was a big advantage that we had with the ETI. I don't think as you begin to move into a WTO-compatible system that you are going to be able to do that.

But I think you need to give very strong consideration to businesses where the differences are great, for example, between an extractive industry and a manufacturing industry. The differences are great between an industry that has to go overseas for most of its business because that is where the markets are and one that depends more upon the U.S. markets.

That is going to make your job very difficult. But I think you have to look at it, and you have to carefully assess it and reach the best possible result that you can.

Now, there are any number of options that you can use to address this problem. Again, the only thing that I don't think you can

do, as I mentioned, is replicate the benefits for all of the people who are exporting from this country who benefit under the ETI and do it with a WTO-compatible result. I don't think that is possible. Today we don't have time to try to brainstorm all of the alternatives, and that is where both Mr. Gibbons and I—and, by the way, I associate myself with his remarks, which I think were beautifully stated—are available to the Committee in any way we can help.

Then I would add also that all of the technical expertise of PricewaterhouseCoopers is also available to you should you wish to draw on it.

But if you see ultimately fit—and I am not recommending that you abolish the ETI, but if you come to the point where you have to do that, then whatever revenues result in the estimates that you will get from the Joint Committee on Taxation, you should put back as best you can into the system to reduce the barriers in our Tax Code to our corporations that are operating overseas.

Now, just to reach out and talk about one or two things, the way our subpart F operates, for example, can be changed to be very, very helpful. The way we require interest allocations can be changed. That will be very helpful. These will not duplicate the current benefits under the ETI, but they will move in the right direction. So there are things that can be done within the current system.

I must say that I agree completely with Chairman Gibbons that in the long term you are going to have to throw out the income tax system that we currently use in the corporate level and replace it. Because, to me, we must in a competitive global marketplace, have a Tax Code that at least gives us a level playingfield against our foreign competitors.

What I have ascertained by looking at a number of different corporate structures is that, on average, our corporations pay an effective tax rate of around 39 percent. Now that is both Federal and State taxes. There are foreign competitors who, on average, pay a tax rate of about 24 percent. Now, that is a 15 percent margin of difference, and that goes against the bottom line.

If our corporations are faced with this type of competition over a long period of time, one of two things is going to happen: They are either going to go out of business because they can't sell their goods and services competitively in the world marketplace with this extra cost—and I am not yet including what Mr. Gibbons and I referred to as the compliance cost, which are somewhere around $250 billion a year in this country. Now, not all of that is corporate, but that is an overall figure. But either they will decline and be defeated by their foreign competition or, what is more likely, is they will be taken over by foreign corporations like Chrysler was, like Amoco and Arco were, like Bankers Trust was by Deutsch Bank. Then the entire culture of that corporation is going to be removed into a foreign country, and I think that is the worst of all worlds for the United States of America.

Mr. GIBBONS. May I add it would not only be their headquarters, it will be American jobs that are removed——

Mr. ARCHER. Yes.

Mr. GIBBONS. And members. They are flowing out of this country like a flood right now. There is not a day that you pick up the news media that you don't see American jobs flying overseas. We have got to stem the flood. It is not the productivity of American labor that is at fault, it is not the productivity of our other systems, it is the tax system that is at fault, and there is no way we can escape that. The tax system has got to be changed.

Mr. HAYWORTH. Thank you both.

Chairman Gibbons, when you come to Arizona, chances are you won't have to buy an overcoat. We look forward to your visit.

Mr. GIBBONS. I spent some very happy hours in Arizona as a soldier. I kept all the Japanese out and not a single one of them penetrated our defense line.

Mr. HAYWORTH. We are very grateful for that; and, on a more serious note, we are very grateful for your service on June 6, 1944, and, subsequently, in the European theater, too, sir.

Mr. GIBBONS. I was adequately paid for it. And thank you, sir.

Chairman MCCRERY. Mr. Lewis.

Mr. LEWIS. Chairman Archer and Chairman Gibbons, it really is good to see you back here. I think we are hearing you loud and clear that there is not a Band-aid approach to this, to solving the problem. The ultimate answer is a change in the Tax Code.

I know, Chairman Archer, you have been a big advocate of a national sales tax and in doing away with the income tax. But that is what I am hearing you say. The only way we are going to solve this and solve it for good is to change the Tax Code. Is that what you are saying?

Mr. ARCHER. Well, first, let me say that I have been for replacing the income tax with another system that makes better sense for this country. I have not spoken out in favor of a vehicle that is a retail sales tax, but that is one way to do it.

In this instance, though, it seems to me that you have a great opportunity because you can address this problem in a limited way to the corporate Tax Code without having to get into all of the more difficult ramifications of the individual income tax; and, hopefully, you make a decision that will help this country and the workers, as Mr. Gibbons said, the standard of living of the workers and the jobs in this country for the next several generations.

Mr. GIBBONS. You see when all this first started the way you measured America's wealth was through the gross domestic product. Foreign trade or foreign commerce was an insignificant part of America's gross domestic product in the 1940s. Today, it is a huge amount of America's gross domestic product; and it is growing all the time. Like it or not, stop it or not, you can't stop it. We are internationalizing. We have got to be in the world system or we are going to suffer if we are not.

Let me say—I will do a little advertising here—when I could see the beginning of the end of my career here in Congress, I left you a heritage. I wrote it all out. It is all in the 1996 Congressional Record, complete with legislation and an explanation of what ought to be done. Now, I won't take up your time today because it is not the purpose of this hearing to explain how it could be done. But it can be done, and it will be done. It is a question as to how much longer we are going to bleed before we do it.

Mr. LEWIS. Thank you, sir. Thank you.

Chairman MCCRERY. In fact, Mr. Gibbons, another way of saying, your previous statement, that we represent only 4 percent of the world's population is 96 percent of the world's customers live outside the United States.

Mr. GIBBONS. Correct. That is it.

Chairman MCCRERY. Mr. Brady.

Mr. BRADY. Thank you, Mr. Chairman. And I want to welcome my fellow Texan, and Houston area Member of Congress, Bill Archer to the hearing.

To let you know how strong his heritage is, Mr. Chairman, in our part of the area I have the good fortune to represent a good part of the former part of Mr. Chairman Archer's district. And when you ask people there who your Congressman is, they will say, well our representative is Kevin Brady, but my Congressman is Bill Archer. That will continue for decades to come.

Two questions. Chairman Archer, a task force you recommend. How soon could a group meet, really thoroughly, examine the issue and report back a good substantive change to Congress? How long do you imagine that would take to really do a good job but move quickly?

Mr. ARCHER. I think that will depend on how rapidly there is the decision to put in place that task force.

I don't think it is too early, for example, for leaders of the Congress to talk to people in the White House as a first step and see about how this should be structured and how it should be moved forward. And by leaders, I mean, both Democrats and Republicans in the Congress.

What obviously will make it more unwieldy is to be able to take into consideration the views of organized labor, the views of the business community and the views of farmers. But I think that needs to be done before any final decision is made.

Mr. BRADY. Sort of a follow-up to that, that second question. How do we both stress the importance of bipartisanship and move in a timely way? How do we educate Members of both parties and leaders of both parties that not only is this a problem, but this is an opportunity to help make American companies more competitive and an opportunity to slow the merge than move overseas trend that is occurring?

How, in a period that can get pretty tense up here in Washington? How do we make sure that message gets heard and accepted by both parties?

Mr. ARCHER. Well, one method obviously is your intention to hold hearings on this issue. Well, actually there is a hearing right now. But the Chairman of the full Committee, I understand, plans on holding hearings on how is our foreign—how do we tax foreign source income? What can we do about it, and so forth?

And I think at those hearings, obviously you are going to have witnesses who are going to be testifying. And hopefully the media will cover those events and that information will be made available to the American public. But, as so often is the case in Washington, that both Mr. Gibbons and I found over the years, and which you find today, is it is very, very difficult to let light overcome heat on

issues. And the light is the information that is presented as objectively as possible for people to understand.

But, Mr. Gibbons is absolutely right. When all of this started, particularly back in the early sixties, we were the receptacle of investment capital, here in the United States. And we had just come through the Marshall Plan period, and we had extended our capital to the rest of the world. We had massive trade surpluses. And we didn't need to be so concerned about the negative aspects of our Tax Code. We weren't really looking overseas. We didn't have a global marketplace as we do today. And today it is very different.

And if our corporations again have to compete with one hand tied behind their back, and their net is reduced by the extra operating cost that is represented both by taxes and compliance, then their cost of capital is going to go up.

As their net revenues and net profits go down, their cost of capital goes up and it just becomes a compounding problem over time. And I think this is a great window of opportunity. It will not be easy.

Mr. BRADY. Thank you, Mr. Chairman. Chairman Gibbons, anything to add?

Mr. GIBBONS. You know, excuse me. We often think of this as just a problem of the export industries in the United States who manufacture here. It is far beyond that. It is every American who works and sweats in the system. High-tech industry, low-tech industry, any kind of job that is at a competitive disadvantage because of the way our tax system works in the international marketplace.

Whether you are a person who is trying to fight against a losing a market overseas because your product is overtaxed when it goes to consumption overseas, or whether you are working in an industry, it might be the same industry who is competing against an import, you are affected by this.

Everybody that works is affected by this. It is not just an isolated problem that affects only the export industries. It is everybody that is involved in it.

That is what they have got to understand. I am talking about the great electorate out there. This is not a brandnew problem. The Reagan Administration attempted to phase this in early in President Reagan's Administration. If you go back, you will find that they did a deep study into all of this. And they started to recommend to the Congress that we go to some kind of value-added tax system then.

But the Congress was in control of the Democrats. The White House was in control of the Republicans. They just didn't feel like that they could take that kind of political risk at this time. I don't know when we are ever going to get out of that political risk situation. But, you know, something has got to be done about it unless we are content to allow our system to continue to bleed, and us to become a third-rate economic power in the world. It is the tax system.

Mr. BRADY. That message is getting through loud and clear today. I hope we can replicate it. Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. Brady. And now a representative from one of our other greats, represented by the panel today, Mr. Foley from Florida.

Mr. FOLEY. Thank you very much, Mr. Chairman. I am trying to focus on FSC. But I can't get my mind off this coat you bought in 1960 where you got a $200 refund. I hope you still have that coat.

Mr. GIBBONS. That was a good French overcoat. I wore it for years.

Mr. FOLEY. Because I am a consumer, I want to see that coat.

Mr. GIBBONS. That was just the rebate. They kept most of the money over in France. But it was—you know, prices have changed a lot since the late sixties.

Mr. FOLEY. I am still remembering Dick Nixon's Pat analogy of the plain cloth coat. So I just want to see this coat, Sam.

Chairman MCCRERY. Mr. Foley, let's try to restrict our questions to the matter at hand.

Mr. FOLEY. The Chairman and I get along well. We are both Floridians. And I just wanted to enjoy a moment.

But you just mentioned something, Sam, that is very, very important. And I think it underscores the complexities here. Because a bipartisan group, after the WTO's refusal of FSC, when to the ETI, spent a lot of time on it.

I think the Europeans would like us to change our Tax Code, and they may help us do it. It seems like the only thing acceptable to them is a VAT concept.

It seems like everything else we create or try and put our hands around fails. So I would like both of the participants, Mr. Archer particularly, good to see you, both of your answers on, is the VAT system the only acceptable mechanism by which the WTO will give us a final resolution?

Mr. ARCHER. I think they would love for us to keep our system with the income tax system so they have an advantage on us. I don't think they want to force us into any other form of taxation.

They are sitting smiling like a Cheshire cat now, because as Sam mentioned, we created a system many, many years ago to which we didn't give adequate thought. And then we exacerbated it in 1986 in tax reform and made an absolute disaster out of the way that we tax foreign source income. I am not going to go back into all of that history.

But, we created this odium taxing our own corporations. And then the only way out for us was to create an export subsidy. And there is no doubt about it. We thought we were Okay because we had an informal agreement with the Europeans back in the early eighties that we weren't going to attack each other's tax systems and all of that. But that was before the WTO was created.

And we put ourselves in the position that in order to have a level playing field, we had to put into our code an export tax subsidy. And we have got to remove that in some way or another and we have got to replace it with something that gives us a better chance to compete.

A VAT is not the only way to do it. And we can, you know—if you want me to continue to work with you personally, I will be glad to do it. There are a lot of options that can be considered. But, in the long term, and you have heard me say this on this Committee,

and I say it because I personally believe it and have believed it. I am not like one of our colleagues who told me one day I am a very fair individual, all I want is a fair advantage.

I want a fair advantage for the United States of America. I wished we would not stop at a level playing field. I wish we would adopt a system that would give us a fair advantage under the WTO rules. And that can be constructed. But again, we don't have the time today to go into all of the details.

Mr. FOLEY. I would welcome that engagement because I think it is important. And I respect your expertise.

Chairman MCCRERY. If the gentleman will yield. We are going to have a hearing later at which we will explore some of those alternatives.

Mr. FOLEY. Thank you, Mr. Chairman. Mr. Gibbons.

Mr. GIBBONS. Well, sitting here trying to respond to your first observation. At that time, the French had a number of different rates at which they taxed under their TVA system, which is really a VAT system. But the French called it a TVA system. And I would imagine they classified my French overcoat bought somewhere near the embassy as a luxury item. And the tax on it may have been 50 or 60 percent.

Mr. NEAL. Mr. Chairman. Would you yield for 1 second, Mr. Foley? Mr. Gibbons, can I ask you a question? It is on everybody's mind in this hearing room. What did you pay for the coat?

Mr. FOLEY. That was the crux of my earlier observation.

Mr. GIBBONS. Damn if I know.

I remember Martha and I didn't have much spending money for the rest of the trip. And, you know, I—at that time, the TVA might have been 50 or 60 percent. Because, they—the French at the time were administering their code under—they were taxing various items at different rates.

Mr. FOLEY. Well, it continues today because when you travel——

Chairman MCCRERY. Mr. Foley, your time is up. Thank you very much.

Mr. GIBBONS. The final voice has spoken.

Chairman MCCRERY. Thank you very much for your testimony. We appreciate again your willingness to work with us to try to get through this problem that we have got with our Tax Code. And we welcome you back any time.

Mr. ARCHER. Mr. Chairman, if can I have one last quick thing. I know you have got other witnesses coming. I don't think that Mr. Gibbons and certainly I mean to imply that the European credit invoice value-added tax system would ever be right for the United States. I do not believe it would be. And I want to make that very clear. That is an option that I do not think is a realistic one for this country.

Chairman MCCRERY. Thank you very much. And we look forward to seeing you again soon.

Our next witness is Ms. Barbara Angus, International Tax Counsel for the U.S. Department of the Treasury. Ms. Angus.

Ms. Angus, we will certainly put in the record any written testimony that you have for us. But if you would try to summarize that within 5 minutes. You may proceed.

STATEMENT OF BARBARA ANGUS, INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Ms. ANGUS. Thank you, Mr. Chairman, Congressman Neal, and distinguished Members of the Subcommittee. I appreciate the opportunity to appear today at this hearing on whether the existing ETI regime can be modified in a manner that brings it into compliance with WTO rules without undermining the internal competitiveness of U.S. businesses and their employees.

Mr. Chairman, I would like to request your permission to read a letter that Assistant Secretary Weinberger sent to you yesterday regarding the matter that is before the Subcommittee today and that states the administration's views.

Chairman MCCRERY. You certainly may do that.

Ms. ANGUS. To read the letter:

"Dear Chairman McCrery:

"Thank you for the opportunity to have a representative of the Treasury Department appear before the Select Revenue Measures Subcommittee on April 10, 2002, as your panel begins examining possible legislative solutions to the current FSC/ETI dispute. As representative of the administration have said repeatedly, this is a very serious matter requiring immediate attention and we must pursue all available avenues to achieve an appropriate final resolution, a resolution that protects America's interests and satisfies our obligations under the WTO. We must continue to seek every opportunity to address the underlying issues in the ongoing trade dialog. At the same time, we must begin work toward meaningful changes to our tax rules to respond to the decision in the FSC/ETI case.

"We want to applaud you for the work your Subcommittee is doing. With the possibility that the European Union could move to impose trade sanctions against exports from the United States as early as May, the urgency of the situation is clear. At the same time, we must not lose sight of the objective served by the ETI provisions and the FSC provisions that preceded them, which is to help level the playingfield for U.S.-based businesses that are subject to the U.S. system of international tax rules.

"We understand your hearing will explore whether minor changes can be made to bring the current ETI regime into compliance with WTO rules. Given the analysis of the current WTO rules reflected in the decisions in the FSC/ETI case, we do not believe legislation that simply replicates FSC or ETI benefits will pass muster in the WTO.

"We must pursue all routes to resolving this matter promptly and fairly so that American workers and the businesses that employ them will not be disadvantaged. Addressing the decisions through the tax law without adversely affecting the competitive position of U.S.-based businesses in the global marketplace will require consideration of meaningful changes to our current international tax laws. We need to explore a whole range of possible tax legislative options. This includes consideration of changes that will help rationalize key components of our international tax rules within the existing framework. It also includes consideration of comprehensive and fundamental reforms of our international tax system.

"While we work toward the needed changes to our international tax rules, we also must continue to maintain a dialog with the European Union. Given the importance of this matter, we must pursue a multifaceted approach to resolving it, including both tax and trade approaches. It is essential that we achieve a resolution of this matter that is clear, fair and final. We must take every step needed to ensure that this does not further escalate to the detriment of the global trading environment.

"Mr. Chairman, thank you again for this opportunity to discuss this matter and for the work your Subcommittee is doing. We look forward to working closely with Congress and all interested parties to develop and implement a solution that will protect America's interests and honor our obligations in the WTO.

Sincerely,

MARK A. WEINBERGER,
Assistant Secretary (Tax Policy)."

Given the particular focus of this hearing, let me reiterate that we believe legislation that simply replicates FSC or ETI benefits will not pass muster in the WTO. We need to work together toward

meaningful changes in our international tax rules in order to protect the competitive position of American businesses and workers and meet our WTO obligations.

I would be happy to answer any questions. Thank you.

Chairman MCCRERY. Thank you, Ms. Angus. And I gather from the letter that you read from Mr. Weinberger and from your own statements that the administration is spending some time now looking at possible solutions to this matter on both the legislative front and the trade front, and you are actively pursuing within the Administration some recommendations that could be forthcoming sometime in the future on this matter?

Ms. ANGUS. Yes, Mr. Chairman. The Administration and all of the agencies are working together to explore all options for resolving this critically important matter. It is a complex matter that cuts across areas of expertise and we need to bring together all of that expertise to contribute to finding a solution now.

We believe the administration, Congress and all interested parties must work together to resolve this matter. We intend to consult closely with Congress on consideration of the types of meaningful changes to our international tax rules that will be needed to address the decisions. We applaud you and Chairman Thomas for holding those hearings on this matter at this critical time.

Chairman MCCRERY. Thank you. Mr. Neal.

Mr. NEAL. Thank you very much, Mr. Chairman.

Ms. Angus, at a recent mark-up of this Committee where your colleague from Treasury, Pam Olson was in the witness chair, the Chairman of the full Committee stated his desire to have this Subcommittee investigate the expatriate issue and to report back fairly quickly on why and how these companies are leaving the United States, and why they are avoiding U.S. income taxes.

Your colleague, Ms. Olson, said at that time that the Treasury study would be a preliminary report with recommendations coming later. Is that still the expectation of your report on the corporate expatriate problem?

Ms. ANGUS. Yes. We intend to release our preliminary views by the end of April. This is a matter of priority for the Treasury Department. We believe that a detailed technical study can help to inform the debate over the appropriate response to these developments and will ensure that the government can act promptly and effectively.

Mr. NEAL. Thank you. When we last met, it was, I believe, the day before Treasury announced the study of the corporate expatriate issue. Since then, my staff has performed some research on a handful of these expatriate companies. And it has come to my attention that these expatriate companies enjoy in excess of $2 billion a year in Federal government contract money.

In fact, one of these expatriates has a $40 million contract to help the IRS collect more tax revenue. Now, I find that more than a little ironic that we are awarding Federal tax revenues to companies who have decided they are exempt from paying it. I wonder if you can comment on whether the Treasury Department has considered a review of these particular contracts or the policy of awarding these Treasury contracts to expatriate companies?

Ms. ANGUS. Congressman, that is certainly something that I can look into and we can provide you a response. It is not something that is within my area of expertise. From my perspective, the work that we are doing within my group involves looking at these transactions from a technical perspective to understand the implications for our tax law, the implications for our economy, and to work to develop an appropriate response.

Mr. NEAL. I tried to be very precise in my questioning so as to not appear irresponsible. But with April 15th looming, and September 11th just behind us, it seems to me that there is an ideal opportunity to examine this question. Mr. McCrery has said he is going to hold hearings on it. The Chairman of the full Committee has indicated he is going to hold hearings on it. But this is a large issue that looms for the American people. The President, in the end, is going to get most of the defense buildup that he desires, rightly so. It is also, I think, understandable that the American people would ask: Who is going to help to pay for all of this?

So we have companies that are winning large contracts, and at the same time setting up foreign addresses so that they don't have to pay corporate income tax.

Ms. ANGUS. As I indicated earlier, we are studying this issue. We expect to have preliminary views by the end of this month. We do believe that we need to determine whether there are any inadequacies in our tax law that companies can take advantage of or exploit through those transactions. If those inadequacies exist, we need to know about that. And we certainly intend to work with the IRS and Congress to address those.

At the same time, we also believe we need to look at whether there are aspects of our international tax rules that are driving companies to feel they need to consider these transactions for competitiveness reasons. If that is the case, we also need to understand that and consider our approach to that issue as well.

Mr. NEAL. Thank you.

Chairman MCCRERY. Mr. Lewis.

Mr. LEWIS. Thanks, Mr. Chairman. Ms. Angus, last week an EU spokesman stated what we urgently need is a road map of what kind of measures the American Government plans to take to comply with the WTO ruling.

What does the—what kind of road map can you give us today about what the Administration plans to do in moving forward on this?

Ms. ANGUS. Well, as Ambassador Zoellick has said, Commissioner Lamy wants to see us making progress toward resolving this matter. It is critically important that the administration and the Congress work together with all interested parties to address this matter now.

This is an urgent matter requiring immediate attention. These hearings represent a very important first step. We must work together toward consideration of meaningful changes to our international tax rules. We need to do so as soon as possible in order to demonstrate real progress toward meeting our WTO obligations.

And as we do that, we believe it is important that we keep in mind the objective of ensuring that we don't adversely affect the competitiveness of American-based businesses.

Mr. LEWIS. Okay. Thank you.

Chairman MCCRERY. Thank you very much, Ms. Angus. And we look forward to working with you and others in the Administration as we wrestle with this problem.

Ms. ANGUS. Thank you.

Chairman MCCRERY. And now the third panel. LaBrenda Garrett-Nelson, Terrence Chorvat, and Michael McIntyre. If you would come to the front. Welcome. Our first witness on the third panel is LaBrenda Garrett-Nelson. She is a Partner with Washington Council, Ernst & Young.

And then Terrence Chorvat, Assistant Professor of Law at George Mason University. And Mr. Michael McIntyre, Professor of Law at Wayne State University, School of Law.

Ms. Garrett-Nelson, we will begin with you. You may proceed. Please summarize your testimony for us within about 5 minutes.

STATEMENT OF LABRENDA GARRETT–NELSON, PARTNER, WASHINGTON COUNCIL ERNST & YOUNG

Ms. GARRETT-NELSON. Thank you, Mr. Chairman and Members of the Committee.

I am LaBrenda Garrett-Nelson. And I am appearing today on my own behalf and not as a representative of any organization. The testimony that I offer relates to the legislative drafting implications of the WTO Appellate panel's report on ETI. I do not offer any specific legislative proposals. Rather, my testimony highlights three aspects of the Appellate body report that will become relevant if the decision is made to pursue a legislative solution to the FSC/ETI dispute.

First, that the legal analysis in the Appellate body report would prevent the United States from coming into compliance simply by making cosmetic changes to ETI.

Second, but significantly, for the first time, the Appellate body has provided guidance regarding the extent to which an export tax subsidy could be provided for foreign source income.

And last, but importantly, it should be kept in mind that there is nothing in the Appellate body report that would prevent the United States from amending its tax laws in a manner that could provide a benefit to the same general class of taxpayers that utilize the ETI regime. And that is relevant to the decision whether to pursue a legislative solution.

The Congress clearly retains the ability to develop legislation that would preserve the competitiveness of American companies.

Turning first to the basis for my conclusion that it will not be possible to simply make adjustments to ETI. Two of the principal legal issues before the Appellate body were, is there a subsidy? If so, is the subsidy export contingent? The Appellate body broke new ground, and in doing so, invalidated legal conclusions that had been formed as the basis of drafting decisions in developing the ETI statutory provisions.

On the threshold issue of whether a subsidy exists. When the Appellate body reviewed the FSC case, it applied a but-for test. It looked to see whether the FSC was an exception to a general rule with the result that more tax would been paid but-for the FSC.

In light of that but-for test, the ETI regime was drafted as a general rule with taxation cast as the exception. But when the Appellate body reviewed ETI, it decided that the but-for test should be limited to cases where the measure at issue is an exception and instead applied a new test, a test that compared the treatment of income under the ETI regime to comparable foreign source income.

And particularly because the ETI regime is elective, on that basis the Appellate body held that the ETI regime confers a subsidy.

On the question of export contingency. Before the Appellate body report on the ETI regime, it was unclear whether export contingencies could be cured by expanding the universe of beneficiaries. And in that regard, the ETI Act was drafted to apply to nonexport foreign sales of certain property produced abroad.

So the ETI regime is legally not contingent on exportation because the operative rule could apply to nonexport sales. Well, the Appellate body also decided against the United States on this issue on the grounds that for property produced within the U.S. exportation was required.

So, apparently to avoid a finding of export contingency, it would be necessary to apply a single operative rule without regard to whether property is produced within or without the United States. Now, there was the one instance in which the Appellate body did agree with an interpretation offered by the United States. That was on the ruling that there is an exception to the prohibition on export subsidies for a measure to avoid double taxation of foreign source income. And that is the exception based on what you may hear referred to as Footnote 59 in the relevant trade agreement.

I would point out with respect to Footnote 59, that it remains to be seen to what extent Footnote 59 would allow anything that looks like a replication of ETI. I say that for two reasons: First, because of the Appellate body's definition of foreign source income that could be treated under such an exception, and also because of the related requirement that with respect to export sales, arms-length pricing methods would be required to allocate income between foreign and domestic sources.

So in addition to the drafting possibilities presented by Footnote 59, I would remind the Committee again, that nothing in either the Appellate body report or the applicable trade agreements would prevent the United States from considering options for amending general tax rules that affect the competitiveness of American exporters.

It is clear, however, that either of these possible drafting approaches would take time to implement and develop. This ends my prepared statement. I would be happy to respond to questions you may have.

[The prepared statement of Ms. Garrett-Nelson follows:]

Statement of LaBrenda Garrett-Nelson, Partner, Washington Council Ernst & Young

My name is LaBrenda Garrett-Nelson and I am a partner in Washington Council Ernst & Young, a division of the National Tax Practice of Ernst & Young. I am also a consultant to the National Foreign Trade Council's FSC–ETI Coalition; however, I am testifying today on my own behalf and not as a representative of any organization.

Introduction

The January 14, 2002, WTO Appellate Body Report in *United States—Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities* (the "AB Report") upheld the decision of the WTO panel that the FSC Replacement and Extraterritorial Income Exclusion ("ETI") Act confers prohibited export subsidies in violation of the international trade obligations of the United States. Consistent with the focus of today's hearing, my statement is based on my analysis of the legislative drafting implications of the AB Report. My statement does not presuppose that a legislative response is the only response to the FSC–ETI dispute, nor does it offer any specific legislative proposals. Rather, my testimony highlights three aspects of the AB Report that will become relevant if the decision is made to pursue a legislative solution to the FSC–ETI dispute (either alone or in combination with trade initiatives). These three aspects are as follows:

(1) By providing definitive interpretations of the substantive provisions that impose the prohibition on export subsidies, the AB Report precludes a drafting approach that merely "tinkers" with the ETI regime;

(2) Significantly, however, the AB Report also allows for the consideration of an alternative legislative response that targets exports in the context of a measure to avoid double taxation of foreign-source income; and

(3) Nothing in the AB Report would prevent the United States from amending rules of general application in a manner that could benefit exporters, among other taxpayers.

Discussion

The FSC–ETI case—brought under the 1995 World Trade Agreement—is the latest chapter in a long-running dispute between the United States and the European Commission over the legality of export tax incentives. This, however, was a case of first impression, as there were no WTO precedents involving export subsidies delivered through an income tax system.[1] As in the original FSC dispute, three legal issues were presented under the Agreement on Subsidies and Countervailing Measures (the "SCM Agreement") and the Agreement on Agriculture:[2] (1) whether the ETI Act provides a subsidy; (2) whether the subsidy confers a benefit; and (3) whether the subsidy is contingent on export performance.

Article 1.1(a)(1)(ii) of the SCM Agreement provides that a "subsidy" exists if "government revenue that is otherwise due is forgone or not collected." In turn, Article 3.1(a) prohibits "subsidies contingent in law or in fact, whether solely or as one of several conditions, upon export performance, including those illustrated in Annex I" (the Illustrative List of Export Subsidies that appears at the end of the SCM Agreement). Paragraph (e) of Annex I lists as an export subsidy "the full or partial exemption remission, or deferral specifically related to exports, of direct taxes . . . paid or payable by industrial or commercial enterprises." Importantly, however, the fifth sentence of "Footnote 59" to Paragraph (e) provides that "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.

Additionally, the AB Report addressed the issue whether the ETI Act is inconsistent with the General Agreement on Tariffs and Trade 1994 ("GATT 1994") by reason of the limitation on the use of foreign articles and labor. Note that the Appellate Body upheld the adverse "findings," as opposed to the rationale, of the WTO panel that considered the validity of the ETI Act. Thus, it is the AB Report that provides dispositive guidance on the drafting parameters of any replacement legislation.

While the basic legal issues addressed in the AB Report were identical to those presented by the original FSC dispute,[3] the Appellate Body broke new ground by fleshing out the analytical framework that was used to draft the ETI Act. In clarifying the application of the applicable trade agreements, the AB Report invalidated legal conclusions that supported drafting decisions reflected in various provisions of

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[1] The European Community's challenge of the 1971 DISC legislation and the United States' counter-claims based on the tax exemptions for foreign-source income provided by Belgium, France, and the Netherlands were brought under GATT 1947.

[2] Because the Appellate Body's treatment of the three, principal issues under the SCM Agreement also determined the outcome under the Agreement on Agriculture, the following discussion focuses on the drafting implications of the SCM Agreement.

[3] *See United States—Tax Treatment for "Foreign Sales Corporations"* ("*US—FSC*"), WT/DS108/AB/R, adopted 20 March 2000 (the "FSC Case").

the ETI Act. Moreover, these new pronouncements "fixed" the parameters of any legislative response that the United States might consider.

I. The analysis underlying the AB Report precludes a drafting apporach that merely "tinkers" with the ETI regime.

The AB Report altered the legal landscape by clarifying the extent to which a Member state can refrain from taxing foreign-source income without creating a subsidy, and providing substantive interpretations of provisions in the SCM Agreement.

A. First, in the context of defining a "subsidy," the Appellate Body rejected the notion that there might be a general category of foreign-source income that WTO Member states are free not to tax.

In the original FSC dispute, the Appellate Body indicated that "in principle, a Member is free not to tax any particular category of income it wishes, even if this results in the grant of a "subsidy" under Article 1.1 of the SCM Agreement, provided that the Member respects its WTO obligations with respect to the subsidy."[4] In the AB Report, however, this statement was "explained away" as follows: "Article 1.1 of the SCM Agreement does not prohibit a Member from foregoing revenue that is otherwise due under its rules of taxation, even if this also confers a benefit under Article 1.1(b) of the SCM Agreement. However, if a Member's rules of taxation constitute or provide a subsidy under Article 1.1, and this subsidy is specific under Article 2, the Member must abide by the obligations set out in the SCM Agreement with respect to that subsidy, including the obligation not to 'grant [] or maintain' any subsidy that is prohibited under Article 3 of the Agreement."[5]

B. Additionally, the AB Report includes adverse interpretations of relevant provisions in the SCM Agreement

1. Regarding the threshold issue of whether a subsidy exists, the Appellate Body limited use of the "but for" test to the facts of the FSC case.

As in the original FSC dispute, the Appellate Body interpreted the phrase "otherwise due" (in Article 1.1(a)(1)(ii) of the SCM Agreement) as implying a comparison with a "defined, normative benchmark.[6]" In the FSC proceeding, the Appellate Body approved the use of a "but for" test formulated by the WTO panel.[7] Under the "but for" test, whether revenue forgone is "otherwise due" was determined by examining the tax liability that would exist under a Member's tax regime in the absence of the measures at issue. In light of this "but for" test, the ETI Act was drafted as a general rule of U.S. taxation whereby the income excluded from taxation was outside U.S. taxing jurisdiction.[8]

In the AB Report, however, the Appellate Body indicated that the "but for" test is limited to situations where the measure at issue is an "exception" to a general rule of taxation, adding that "Article 1.1(a)(1)(ii) does not always require panels to identify, with respect to any particular income, the 'general' rule of taxation prevailing in a Member."[9] Instead, the Appellate Body concluded, "panels should seek to compare the fiscal treatment of legitimately comparable income to determine whether the contested measure involves the foregoing of revenue which is 'otherwise due,' in relation to the income in question."[10] Under this standard, the Appellate Body compared the treatment of income excluded under the ETI Act with the taxation of other foreign-source income, and upheld the finding that the United States through the ETI regime "foregoes revenue that is otherwise due" and thus grants a subsidy within the meaning of under Article 1.1(a)(1)(ii) of the SCM Agreement.[11] Also, the Appellate Body opined that a taxpayer's ability to "elect" application of the ETI regime "confirms that the United States will forgo revenue . . . that would be 'otherwise due,'"[12] (assuming that a taxpayer will elect the rules of taxation that result in the payment of the lowest amount of tax).

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[4] Appellate Body Report. WT/DS70/AB/RW, adopted August 4, 2000, ¶90 (hereafter, the "FSC Case").
[5] The AB Report at ¶86.
[6] AB Report at ¶89.
[7] Note that, in the original FSC case, the Appellate Body did express a reservation about applying the "but for" test in all cases (although it acknowledged that the test worked in that case); and none of the parties raised this issue. (FSC Case at page 31)
[8] United States' appellant's submission, ¶71.
[9] AB Report at ¶91.
[10] *Id.*
[11] AB Report at ¶106.
[12] AB Report at ¶104.

Thus, under the AB Report's interpretation of the phrase "otherwise due," any elective, replacement regime that departs from an otherwise applicable general rule would be viewed as granting a subsidy.

2. The AB Report also makes clear that "export contingency" can be found if exporting is required of any beneficiary.

Although ETI involves a general rule that excludes a category of income that is broader than exports, it clearly defines U.S. exports as covered transactions. In this regard, prior to the AB Report, it was unclear whether expanding the universe of taxpayers eligible for a subsidy could cure "export contingency."

The ETI Act was drafted to apply to income earned from certain non-export foreign sales of property produced outside the United States. Thus, the ETI regime is not legally contingent on exportation because exportation is not mandatory. Notwithstanding the existence of a single operative rule, the Appellate Body bifurcated the provisions of the ETI Act, on the grounds that the "conditions for the grant of subsidy with respect to property produced *outside* the United States are distinct from those governing the grant of subsidy in respect of property produced *within* the United States."[13] Viewing the two situations separately, the Appellate Body upheld the finding—but only with respect to property "manufactured, produced, grown, or extracted" within the United States—that the ETI regime grants subsidies contingent in law upon export performance within the meaning of Article 3.1(a) of the SCM Agreement (without opining on the alleged export contingency of the subsidy in relation to property "manufactured, produced, grown, or extracted" outside the United States).[14]

Apparently, to avoid a finding of export contingency, it would be necessary to devise an operative rule that applies a single set of conditions to property produced within and without the United States.[15]

II. Significantly, however, the Appellate Body ruled that Footnote 59 provides an exception to the prohibition on export subsidies for a measure to avoid double taxation of foreign-source income.

The Appellate Body ruled that Footnote 59 permits a WTO Member state to adopt a measure taken to avoid the double taxation of foreign-source income. In the present case, however, "even though parts of the ETI measure may be regarded as granting a tax exemption for foreign-source income, . . . the United States [did not meet] its burden of proving that the ETI measure, viewed as a whole, falls within the justification available under the fifth sentence of footnote 59 of the SCM Agreement."[16] Nevertheless, the AB Report is instructive because it provides guidance regarding the extent to which foreign-source income from exports could be exempted in a WTO-compliant manner.

A Footnote 59 approach could be used in the context of legislation that explicitly confers an (otherwise prohibited) export subsidy, or in combination with amendments to rules of general application. In either case, however, the ability to replicate the benefits of the ETI regime would be circumscribed by the AB Report's definition of "foreign-source income" and the related requirement that arm's length pricing be used to allocate income between foreign and domestic sources. Moreover, a Footnote 59 approach would not permit the Unites States to grant an exemption to small exporters without demonstrating that the income is foreign-source, or exempt income from services that may be performed within the United States (as discussed below).

A. For purposes of Footnote 59, the AB Report requires that foreign-source income be defined by reference to "widely recognized principles of taxation."

The term foreign-source income, as used in footnote 59, "cannot be interpreted by reference solely to the rules of the Member taking the measure to avoid double taxation of foreign-source income."[17] Rather, the Appellate Body deemed "it appropriate . . . to derive assistance from . . . widely recognized principles" from bilateral tax treaties and multilaterally developed model tax conventions dealing with double taxation—noting that the majority of bilateral treaties adopt the principles of the OECD and U.N. Model tax treaties.[18]

[13] AB Report at ¶114–115.
[14] AB Report at ¶120.
[15] Trade lawyers caution, however, that export contingency could be found in any event if beneficiaries under a replacement regime are "predominantly exporters."
[16] AB Report at ¶186.
[17] AB Report at ¶140.
[18] AB Report at ¶142.

A taxpayer need not be required to maintain a permanent establishment in a foreign country to establish a sufficient link,[19] although the Appellate Body did identify one common element that would be required of any definition of foreign-source income:

"Although there is no universally agreed meaning for the term "foreign-source income" in international tax law, . . . there seems to us to be a widely accepted common element to these rules. . . . The common element is that a 'foreign' State will tax a non-resident on income which is generated by activities of the non-resident that have some link with that State." [20]

There are, however, other statements of the Appellate Body's views that suggest other, possible meanings, including the statements that "the word "source", in the context of the fifth sentence of footnote 59, has a meaning akin to "origin" and refers to the place where the income is earned," [21] and "the term 'foreign-source income' in footnote 59 refers to income which is susceptible of being taxed in two States." [22]

B. Nevertheless, Footnote 59 would allow a degree of flexibility in targeting the income to be exempted.

There is no need to show that income is actually taxed in another jurisdiction. The Appellate Body recognized that "the avoidance of double taxation is not an exact science. Indeed, the income exempted from taxation in the State of residence of the taxpayer might not be subject to a corresponding, or any, tax in a 'foreign' State." [23] The AB Report also makes clear that a partial exemption would pass muster: "[W]e do not believe that measures falling under footnote 59 must grant relief from *all* double tax burdens. Rather, Members retain the sovereign authority to determine for themselves whether, and to what extent, they will grant such relief." [24]

C. On the other hand, an allocation between domestic and foreign sources would be required for income from export transactions.

"[U]nder footnote 59 . . . the 'foreign-source income' arising in such a transaction is only that portion of the total income which is generated by and properly attributable to activities that do occur in a 'foreign state.'" [25] In the case of a sale of goods, the Appellate Body suggested that arm's length pricing rules would be an acceptable basis for distinguishing between domestic and foreign-source income. The manufacturer would be treated as if it had sold the goods to an independent distributor at arm's length prices, who in turn resold the goods. This would "dissect" the transaction on the basis of the place where the different activities occurred.[26] In the case of "a sale or lease transaction," however, the AB Report indicates that income may be attributable to activities such as research and development, manufacturing, advertising, selling, transport, and administration," [27] suggesting the possible need to allocate beyond manufacturing *versus* sale and distribution income.

In allocating income to a foreign source, exportation would not be a sufficient basis: "[S]ales income cannot be regarded as 'foreign-source income', under footnote 59, for the sole reason that the property, subject-matter of the sale, is exported to another State, for use there. The mere fact that the buyer uses property outside the United States does not mean that the seller undertook activities in a 'foreign' State generating income." [28]

Similarly, the "foreign economic process requirements" utilized under the ETI regime would not suffice.[29] In the view of the Appellate Body, the ETI regime falls short of adequately identifying foreign-source income, to the extent that the ETI allocation rules apply fixed percentages to amounts that may include domestic-source income, with the result that taxpayers can obtain a tax exemption for income that is domestic-source income.[30] The only aspect of ETI that passes muster is the general rule for Foreign Sale and Leasing Income ("FSLI"). For independent distribu-

[19] Footnote 122 in the AB Report.
[20] AB Report at ¶141 and 143.
[21] AB Report at ¶137.
[22] AB Report at ¶138.
[23] AB Report at ¶146.
[24] AB Report at ¶148.
[25] AB Report at ¶154.
[26] *See* Footnote 133.
[27] AB Report at ¶154.
[28] AB Report at ¶176.
[29] Regarding the ETI measure, the AB Report notes that, "the foreign economic process requirement establishes a link between some part of the qualifying transactions covered by the ETI measure and a 'foreign' state.' This does not necessarily mean that *all* of the income generated by such a transaction will be 'foreign-source income.' At ¶153–4.
[30] AB Report at ¶183.

tors that sell to unrelated parties using arm's length pricing, FSLI is limited to the "foreign trade income properly allocable to activities" that are performed . . . *outside* the United States in satisfaction of the foreign economic process requirement described in sections 942(b)(2)(A)(i) and 942(b)(3).[31] With respect to this category of income, the Appellate Body opined as follows:

"By requiring such a process of separating domestic- and foreign-source income, on the basis of the locus of the activities generating the income, Section 941(a)(1)(A) IRC includes in the calculation of FSLI only income which may properly be regarded as "foreign-source income" under footnote 59 of the *SCM Agreement.* In other words, Section 941(c)(1)(A) IRC separates out, or unbundles, the domestic- and foreign-source income that are combined in foreign trade income."[32]

The Appellate Body did not, however, approve of the treatment of FSLI that is lease or rental income, as a "proper" allocation is not required of that type of FSLI.[33]

D. Footnote 59 would not, however, permit any special provisions for small exporters or services performed within the United States.

The Appellate Body made clear that Footnote 59 would not allow an exemption, such as the $5 million exception for small exporters in section 942(c)(1), unless the income is demonstrated to be foreign-source income under the principles outlined above.[34] Similarly, where the ETI Act does not state expressly that subsidiary and related service activities need to be performed outside the United States, the AB Report indicates that this would be a requirement of a regime based on Footnote 59.[35]

E. Other issues that were decided against the United States.

However flexible Footnote 59 proves to be, it is not at all clear that the United States would be able to address every identified issue through legislative amendments.

1. The Appellate Body upheld the finding "that, by virtue of the fair market value rule, the measure accords less favourable treatment within the meaning of Article III:4 of the GATT 1994 to imported products than to like products of United States origin."[36]

The GATT 1994 was not at issue in the original FSC dispute; rather, a claim was made that the prior-law limitation on the use of foreign articles rendered the "subsidy" contingent on the use of U.S. goods over imported goods, contrary to Article 3.1(b) of the SCM Agreement. A claim that the foreign articles/labor limitation violates Article 3.1(b) of the SCM Agreement was also made with respect to the ETI Act, as a conditional appeal, but the Appellate Body declined to consider any conditional appeals (leaving this issue open).

The Appellate Body's analysis of the "national treatment" principle under Article III:4 of GATT 1994 indicates that any similar provision might fail if it provides an impetus for manufacturers to use domestic products, rather than like imported ones: "[T]he . . . conclusion is not nullified by the fact that the fair market value rule will not give rise to less favourable treatment for like imported products in each and every case."[37] Note also that there is no indication that Footnote 59 provides an exception to this trade agreement.

2. The Appellate Body flatly rejected the inclusion of transition rules in any replacement legislation.

In the view of the Appellate Body, the inclusion of transition rules covering FSC users means that the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies.[38] The AB Report includes the statements that "a Member's obligation under . . . the SCM Agreementto withdraw prohibited subsidies 'without delay' is unaffected by contractual obligations that the Member itself may have assumed under municipal law. Likewise, a Member's obligation to withdraw prohibited export subsidies, . . . cannot be affected by contractual obliga-

[31] All references to "sections" are to the Internal Revenue Code of 1986, as amended.
[32] AB Report at ¶170.
[33] AB Report at ¶171.
[34] AB Report at ¶177. Thus, section 942(c)(1) was viewed as defective because it dispenses entirely with the foreign economic process requirement, treating "a portion of the taxpayers' income—as exempt foreign-source income even though it—need not be established—that the taxpayer undertook any activities outside the United States." AB Report at ¶175.
[35] AB Report at ¶179–80.
[36] AB Report at ¶222.
[37] AB Report at ¶221.
[38] AB Report at ¶231.

tions which private parties may have assumed *inter se* in reliance on laws conferring prohibited export subsidies. Accordingly, we see no legal basis for extending the time-period for the United States to withdraw fully the prohibited FSC subsidies."[39]

III. Nothing in the applicable trade agreements would prevent the United States from responding to the AB Report by replacing ETI with rules of general application.

There is nothing in the AB Report that would preclude a direct response to the Appellate Body's findings. As noted by the Appellate Body, "each Member is free to determine the rules it will use to identify the source of income and the fiscal consequences—to tax or not to tax the income—flowing from the identification of source."[40] By way of example, and quite apart from the Footnote 59 exception for foreign-source income, the United States remains free to amend any of its general rules for the taxation of income earned abroad.

Similarly, consideration could be given to the development of legislation that might benefit classes of taxpayers that currently utilize the ETI regime (*e.g.*, small exporters) without requiring exportation. Alternatively, some have argued that it is possible to model a replacement regime on the footnote in the SCM Agreement on which the EU relies in concluding that rebates of indirect taxes (such as Value Added Taxes) do not violate WTO rules—which footnote is based on the rationale that indirect taxes are passed on to consumers, but direct taxes (such as income taxes) are not. It seems clear, however, that any of these possible, legislative responses would take time to develop and implement.

Conclusion

To summarize the principal drafting implications of the AB Report, it will not be possible to draft a single replacement regime that complies with the trade obligations of the United States and replicates the tax benefits of the ETI statute. It is now clear, however, that a WTO Member can provide an export subsidy in the form of a tax exemption if it is a measure to avoid double taxation of foreign-source income. Moreover, there is no prohibition on a Member State's ability to liberalize rules of general application that have the incidental effect of benefiting exporters. Thus, relevant to the decision whether to pursue a legislative resolution of the FSC–ETI dispute, the Congress retains the ability to develop legislation that preserves the competitiveness of American companies.

Chairman MCCRERY. Thank you. Mr. Chorvat.

STATEMENT OF TERRENCE R. CHORVAT, ASSISTANT PROFESSOR OF LAW, GEORGE MASON UNIVERSITY SCHOOL OF LAW, FAIRFAX, VIRGINIA

Mr. CHORVAT. First of all, I would like to thank Chairman McCrery and the Members of the Subcommittee for inviting me here to talk about the extraterritorial income regime and possible modifications to it.

My name is Terrence Chorvat, and I am Assistant Professor of Law at George Mason University. And for the record, I am testifying today on my own behalf and not as a representative of any organization.

As all prior witnesses have testified, the WTO panel has held that the FSC and the ETI regime violate the GATT Treaties. If the ETI and FSC regimes are not permitted under the GATT Treaties, what types of rules that promote exports are permitted? As described below, there are quite a number of ways the country can promote exports and not, at least as of yet, be held to violate free trade agreements.

[39] AP Report at ¶230.
[40] AB Report at ¶139.

As a number of commentators have pointed out, there have not been many decisions by the WTO with respect to income tax rules. And, therefore, we do not know how this jurisprudence will develop. Consequently any conclusions we express today are dependent upon how this body of law will develop in the future. In the last 10 to 15 years the European countries have been reducing their corporate taxes and their place relying more heavily on consumption taxes, like the value added taxes or VATs.

Under European VATs, when the product leaves the country or taxing jurisdiction then the VAT is refunded. This is because such taxes are intended to tax consumption that occurs within the country. If such consumption does not occur in the jurisdiction, it is not taxed there.

One can argue that this has the effect of encouraging exports, because exported products are not subject to the VAT. Importantly, because these taxes are indirect taxes, such export adjustment are permitted under the GATT Treaties. Such indirect taxes are viewed as being imposed on the ultimate consumer rather than on the producer, therefore, they are not viewed as export subsidies.

In addition, it appears that having an income tax system which exempts all foreign source income is also permissible. Such a system would impose lower taxes on exports than on domestically sold goods because income earned abroad would not be subject to tax. Many European countries have adopted territorial tax systems.

One of the key arguments for a regime like the ETI is that it would merely level the playing field for U.S. corporations selling abroad. Because European producers are able to receive tax deductions on some of the products they export, it seems U.S. producers should also receive tax concessions on exports to prevent distortions in the market.

Another set of rules which seems immune to challenge are the source rules found in section 863(b) of the Internal Revenue Code. These rules define the source of income for the sale of property which is manufactured in the United States and sold abroad. They are often said to be export subsidies, because they allow U.S. taxpayers to increase their use of foreign tax credits, which can decrease the tax paid to the United States.

However, because those rules are fundamental source rules which apply both to imports and exports, they do not constitute a special regime. These are the only source rules that apply to these products manufactured in one country and sold in another. Hence, these rules should not fun afoul of the GATT Treaties as interpreted by the WTO.

The fundamental purpose of the deferral regimes found in the Tax Code, such as subpart F, is to eliminate a taxpayer's ability to avoid U.S. tax by shifting income to low-tax jurisdictions.

Generally, the United States allows income earned by foreign subsidiaries to be deferred until the income is repatriated to the United States. The exception to deferral are primarily related to passive income and other types of income that are easily manipulated. Active business income of a controlled foreign corporation or CFC is generally only subject to U.S. tax where there is an insufficient economic connection with the jurisdiction in which the CFC is organized.

On the other hand, the FSC and the ETI regimes were intended to exempt from U.S. taxation income from good manufactured in, or extracted from, the United States and sold abroad. Under the FSC regime, this required an exception to the subpart F rules. These two important portions of the U.S. system are in conflict.

Conflicts like this allow the Europeans to argue that the ETI and the FSC provisions are exceptions to the general patterns of taxation.

While then, what are our alternatives? There are four basic ones. First, repeal the ETI provisions and use the revenue to reduce other taxes. While this is the simplest response, it does not address the concerns that created the Domestic International Sales Corporation (DISC), the FSC, and the ETI regimes in the first place.

The second would be to adopt a territorial system. This would seem to be allowed under the GATT Treaties. However, it seems that as such a small portion of it, like the FSC or the ETI regimes changing our entire system of taxing foreign source income, just based on this seems a little bit extreme, although there might be good reasons for doing that.

The third is to adopt a system that involves significant reliance on indirect taxes such as VATs. That has also been discussed. But again moving to that system merely because of the ETI holding again seems a bit extreme, although there may be good reasons for doing that.

And the fourth is to repeal or to significantly alter subpart F. There are a number of provisions which one could either change within subpart F or get rid of entirely, that would—probably be viewed as not an export subsidy, because they are, instead of adding something additional, they are paring away from what we already have.

However, again, we are not confident as to how the WTO panel would view that because there has not been much jurisprudence in that area.

None of these alternatives are simple replacements for the ETI regime. They all involve a change in rules as they apply to all taxpayers and not simply U.S. manufacturers.

And I would be happy to answer any questions on this.

[The prepared statement of Mr. Chorvat follows:]

Statement of Terrence R. Chorvat, Assistant Professor of Law, George Mason University School of Law, Fairfax, Virginia

I would like to thank Chairman McCrery, Ranking Member McNulty, and the members of the Subcommittee for inviting me here to talk about the Extraterritorial Income Regime and the possible modifications to it.

I. Introduction

My name is Terrence R. Chorvat, and I am an assistant professor of law at George Mason University. For the record, I am testifying today on my own behalf and not as a representative of any organization.

II. Background of the FSC and ETI Cases

The dispute over whether the United States gives impermissible export subsidies through the income tax code has been going on for thirty years. It began in 1972 with a challenge by what was then called the European Economic Community (EC) to the Domestic International Sales Corporation (DISC) regime then in place. The GATT Dispute Settlement Panel ruled that the DISC regime was a prohibited export subsidy. In 1984, after negotiations with various members of the EC, the United States enacted the Foreign Sales Corporation (FSC) regime. This was

thought to overcome the problems with the DISC rules because it required significant foreign activity.

In 1995, the World Trade Organization (WTO) came into existence. In 1997, the European Union (EU), the successor of the EC, requested WTO dispute settlement consultations with respect to the FSC rules. In 1999, the WTO panel found that the FSC was a prohibited export subsidy. On November 15, 2000, Congress enacted the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 which repealed the FSC regime and put in its place the Extraterritorial Income Regime (ETI). The ETI allowed for the exemption of income from products which had a higher level of foreign produced content than did the FSC. In addition, the number of persons eligible for the new regime was greatly expanded. It was thought that these and other changes would overcome the problems the WTO had with the FSC regime.

However, on August 20, 2002, WTO panel issued a report that held the ETI regime violated the GATT Code on Subsidies and Countervailing Measures (SCM). The United States appealed this decision. On January 14, 2002, the WTO Dispute Settlement Unit issued a report which found against the United States. On January 29, 2002 the WTO Dispute Settlement Body (DSB) adopted the two earlier reports. There are no further avenues of appeal for the United States. Currently, the WTO panel is determining the damages they will assess against the United States. The damages will be somewhere between about a $1 billion to $4 billion in potential trade sanctions against the United States by the EU. This does not include the amounts that might have to be paid to Australia, Canada, Japan and India who had all filed briefs against the ETI regime in this case, and who will be able to petition the WTO for relief from damages that they arguably suffered from the ETI regime.

III. Analysis of the WTO Ruling and the Current U.S. Tax Rules

A. The Report Issued by the WTO

The report issued on January 14, 2002 was based an the interpretation of the DSM that tax provisions must not "forego revenue" otherwise due and this "reduction in taxes must not be contingent. . . . upon export performance." The report held that because the exemption in section 114 of the Internal Revenue Code was conditioned both upon the "use [of the products] outside of the United States" and upon at least 50% of the value of the product being generated by economic processes that occurred within the United States, the ETI provision was a prohibited export subsidy. Furthermore, it held that the exception to the general rules that allows for tax provisions that attempt to avoid double-taxation, did not apply and so nothing prevented the ETI regime from being held a prohibited subsidy.

While many have criticized these decisions, both that their interpretation of the term "subsidy" is incorrect and that the policy of allowing income tax decisions to be determined by international organizations is troubling, the interpretation of the treaty provisions adopted by the WTO is clearly a defensible reading of the GATT treaties. There is little question that the ETI regime does reduce tax revenue (at least on a short-term basis) and that this reduction is to some degree based upon property being exported from the United States. Hence, the decision of the WTO in this matter is far from arbitrary or capricious.

B. Permitted Export Favorable Rules

If the ETI and FSC regimes are not permitted under the GATT treaties, what types of rules that promote exports are permitted? It cannot be the case that the GATT treaties require countries to adopt rules which are exclusively neutral or discourage exports. As described below, there are quite a number of ways a country can promote exports and not (at least as of yet) be held to violate free-trade agreements.

As a number of commentators have pointed out, there have not been many decisions by the WTO with respect to income tax rules. Therefore, we do not know how this jurisprudence will develop. Consequently, the conclusions expressed below are dependent upon how this body of law will develop in the future.

In the last ten to fifteen years, the European countries have been reducing their corporate taxes and in their place relying more heavily on consumption taxes like the value added taxes (VATs). Under European VATs, when the product leaves the country or taxing jurisdiction, then the VAT is refunded. This is because such taxes are intended to tax consumption that occurs within the country. If such consumption does not occur in the jurisdiction, it is not taxed there. One can argue that this has the effect of encouraging exports because exported products are not subject to the VAT. Importantly, because these taxes are indirect taxes such export adjustments are permitted under the GATT treaties. Such indirect taxes are viewed as being imposed on the ultimate consumer, rather than on the producer. Therefore, they are not viewed as export subsidies.

In addition, it appears that having an income tax system which exempts all foreign source income is also permissible. Such a system would impose lower taxes on exports than on domestically sold goods because income earned abroad would not be subject to tax. Many European countries have adopted territorial tax systems.

One of the key arguments for a regime like the ETI is that it would merely level the playing field for U.S. corporations selling abroad. Because European producers are able to receive tax reductions on some of the products they export, it seems U.S. producers should also receive tax concessions on exports to prevent distortions in the market.

Another set of rules which seems immune to challenge are the source rules found in Section 863(b) of the Internal Revenue Code. These rules define the source of income for the sale of property which is manufactured in the United States and sold abroad. They are often said to be export subsidies because they allow U.S. taxpayers to increase their use of the foreign tax credits, which can decrease the tax paid to the United States. However, because these rules are fundamental source rules which apply both to imports and exports, they do not constitute a special regime. These are the only source rules that apply to products manufactured in one country and sold in another. Clearly, it is necessary to define what the source of the income is in this situation, and the approach the rules take, which generally results in a half of the income being treated as foreign source income and half U.S. source, is easily defensible. Hence, these rules should not run afoul of the GATT treaties as interpreted by the WTO.

C. Inherent Conflict between ETI and Subpart F

The fundamental purpose of the anti-deferral regimes in the U.S. tax code, such as subpart F, is to eliminate a taxpayer's ability to avoid U.S. tax by shifting income to low tax-jurisdictions. Generally, the U.S. allows income earned by foreign subsidiaries to be deferred until the income is repatriated to the United States. The exceptions to deferral are primarily limited to passive income and other types of income that are easily manipulated. Active business income of a controlled foreign corporation (CFC) is generally only subject to U.S. tax where there is an insufficient economic connection with the jurisdiction in which the CFC is organized.

On the other hand, the FSC and ETI regimes were intended to exempt from U.S. taxation income from goods manufactured in or extracted from the United States and sold abroad. Under the FSC regime, this required an exception to the subpart F rules. These two important portions of the U.S. system (Subpart F and the ETI) are in conflict. Conflicts like this allow the Europeans to argue that the ETI and FSC provisions are exception to our general patterns of taxation.

IV. Alternatives to the ETI Regime

The structure of the U.S. tax system makes it more difficult to encourage exports than other systems. By basing our tax system on income taxes which have, at least in principle, a worldwide reach, it is difficult to draft provisions which do not run afoul of the GATT treaties and which give our multinationals benefits comparable to those enjoyed by European multinationals.

While, as discussed below, a number of possible solutions exist, there are some approaches that clearly will not be approved by the WTO. Merely increasing the amount of foreign content allowable for the exemption, or any other proposal which only slightly alters the provisions in the ETI rules, is unlikely to be ruled upon favorably. Any attempt to replace the ETI regime will require a fundamental re-thinking of the approach taken. The replacement cannot be something which can be thought of as a special exemption or a "loophole." It needs to be something which is an integral part of the system. It will have to apply to foreign corporations and other non-U.S. taxpayers with the same force it applies to U.S. manufacturers.

The following are the basic alternatives:

A. Repeal of the ETI Provisions and Use the Revenue to Reduce Other Taxes. The additional revenue raised by the repeal of the ETI could be used for other purposes like repealing the Corporate AMT etc. While this is the simplest response, it does not address the concerns which created the DISC, FSC and ETI regimes, in the first place.

B. Adopt a Territorial System. This would seem to be allowed under the GATT treaties. Furthermore, by defining U.S. source income as products that are sold here, (i.e. retaining the 863(b) source rule or something like it), this would reduce the tax on products which are exported and would likely not run afoul of the GATT

provisions as interpreted by the WTO. I myself have argued for a territorial system in the past.[1]

C. Adopt a System that Involves a Significant Reliance on Indirect Taxes (such as VATs). If we adopted a VAT that only applied to consumption within the United States, (sometimes referred to as a destination-based VAT) we would be able to exempt exported property from these taxes. Such a change would involve a large restructuring of the current federal tax system. While the response to the WTO ruling on the ETI regime is very important, it seems that an issue which involves between four or five billion dollars annually should not be the chief reason for making a change as large as this.

D. Repeal or Significantly Alter Subpart F. If the Foreign Base Company Sales and Services rules were repealed, much of the profit from products produced in the United States and sold abroad could be deferred (which amounts to a tax cut if the foreign subsidiary is incorporated in a low-tax jurisdiction). U.S. businesses could sell the products produced in the United States through foreign subsidiaries and the profits allocated to the subsidiaries would not be taxed in the United States until they are repatriated to the United States. Currently, relatively little money is raised from the Foreign Base Company Sales and Services provisions. As discussed above, these provisions are fundamentally in conflict with the ETI provisions. Repealing these rules is unlikely to run afoul of the GATT provisions because it would apply to all transactions by U.S. subsidiaries whether the products had a direct U.S. connection or not. If this alternative is chosen, we could still retain the Foreign Personal Holding Company provisions which tax passive income earned by controlled foreign corporations. This approach would not have quite the same effect as ETI because it would give tax benefits to U.S. multinationals to produce in any of the high tax jurisdictions in which they operate.

E. Retain Subpart F, but Loosen the Manufacturing Exception to Subpart F. One alternative would involve allowing foreign subsidiaries of U.S. corporations to manufacture in the United States without being treated as being engaged in a U.S. trade or business and without being subject to the Foreign Base Company Sale and Services Income rules, which would in either case result in the income being taxable in the United States in the year in which it is earned. Products produced in this fashion would not be subject to U.S. tax and would only be taxed in the jurisdictions where the company is organized or a resident and where the products are ultimately sold. In order to not violate the GATT provisions, such a regime would have to apply to subsidiaries of corporations headquartered in other countries with the same force as it applies to subsidiaries of U.S. corporations. In conjunction with this or in the alternative we could allow foreign corporations to use contract manufacturers in the United States and allow such activities to not be treated as a U.S. trade or business and to be treated as manufacturing for purposes of the subpart F definitions. This would imply overturning the ruling position of the I.R.S. announced in Revenue Ruling 97–48.

None of these alternatives have are simple replacement for the ETI regime. They all involve a change to the rules as they apply to all taxpayers, not simply U.S. manufacturers.

Chairman MCCRERY. Thank you. Mr. McIntyre.

STATEMENT OF MICHAEL J. McINTYRE, PROFESSOR OF LAW, WAYNE STATE UNIVERSITY, DETROIT, MICHIGAN

Mr. MCINTYRE. Thank you. I have a prepared statement that I would like to submit for the record.

Chairman MCCRERY. Without objection. Is your microphone on, Mr. McIntyre?

Mr. MCINTYRE. I believe it now is. Thank you.

I am here in part to make a plea for free trade. I was invited to a panel back in 1975 when DISC legislation was being considered. I said at that time that the DISC legislation was inconsistent with free trade, that it would be so found by GATT, and that even

[1] Terrence R. Chorvat *Ending the Taxation of Foreign Business Income* 42 ARIZ. L. REV. 835 (2000)

if it weren't, it would not be in the interests of the United States to be promoting an export subsidy. All theorists on free trade believe that tax subsidies for exports and tax impediments to imports make countries poorer.

If we want our country to be competitive in world markets, we need to embrace free trade. I have heard a lot of rhetoric today about free trade. But, when we get down to it, we have people telling us that the United States should want a "fair advantage," or at least some advantage, over our competitors. The implicit message we are getting is that we need to do something special in violation of free trade to help our economy and to help our businesses or we are going to end up as a third world country.

I don't think we are at risk of being a third world country. And if we were actually facing such a risk, there is nothing we could do with a small subsidy of this nature that would change that fate.

This is the strongest economy in the world. If people in other countries were listening to the kind of worry about competitiveness that we are hearing today they would be quite shocked. They think we are formidable competitors.

All over the world, countries are wanting to emulate the American success. We have just come out of a decade of enormous growth, enormous vigor. And to have us be considering this free-trade issue as if we were at the bottom of the heap or just about to tumble off the top of the heap strikes me as missing the mark entirely.

I am very pleased, however, to see that everyone who has been involved in this discussion agrees that we cannot simply let the situation with ETI stand. Everyone seems to agree that this legislation, which was found to be in violation of our international agreements, has to be repealed. So that is the number one task, I believe, of the Congress—to get rid of this legislation and to get rid of it as quickly as possible before it sours our relationships with our trading partners.

There are other options, of course, that one might consider in addition to the repeal of ETI. All of those options are more complex, they take a lot of time, they involve tradeoffs, they involve political battles over who pays the tax and who gets the benefits.

Those battles are necessarily prolonged. All of the proposals that I have heard in this discussion, both today and in previous periods, have enormous effects on our State governments. And I am sure that our 27 Republican Governors and our 21 Democratic Governors and our independent Governors would like to be heard on these issues.

These complex measures cannot be done quickly. We should take this opportunity to immediately repeal a subsidy that is in violation of our WTO agreement, and then in our leisure, we can examine the range of options that are before us.

In considering options, I think that we have to put the full set of options on the table, not simply that small set of options that are particularly appealing to a few of our multinational companies that have the ear of some people.

I think that we need to look at options that protect the American economy, not simply American business. American business is not synonymous with America. It is merely an important part of Amer-

ica. We need to have tax rules that are fair and reasonable and enforceable for our business interests. But, we don't want to have taxes that are driven only by the interests of business.

Our tax rules need to be driven by our concerns for the well-being of Americans generally. And I think that when we look at the full plate of options, what we would be looking for is some simplification in our system and for more coordination with our trade partners. When we look at trade issues, we always look at them as a cooperative matter. When we look at our income tax issues that related to trade, we also should look at them in a cooperative manner. Thank you very much.

[The prepared statement of Mr. McIntyre follows:]

Statement of Michael J. McIntyre, Professor of Law, Wayne State University, Detroit, Michigan

My name is Michael J. McIntyre, and I teach international tax and various other tax courses at Wayne State University in Detroit, Michigan. I thank the subcommittee for inviting me to participate in this hearing. In the time allotted to me, I will explain why I believe the United States should promptly repeal what the World Trade Organization has found to be an illegal export subsidy. I also will explain why I believe it best serves the interests of the American people and the American economy for Congress to support free trade by refraining from adopting any type of replacement for that subsidy.

History of U.S. Export Subsidies

The United States has provided a tax subsidy for exports since 1971. The subsidy was initially provided by granting tax deferral for export income earned through a U.S. corporation that qualified as a Domestic International Sales Corporation (DISC). In 1984, Congress largely replaced the DISC subsidy with an subsidy for export income channeled through a foreign corporation that qualifies as a Foreign Sales Corporation (FSC). The FSC legislation was adopted in an attempt to avoid conflicts with U.S. trading partners under the General Agreement on Tariffs and Trade (GATT).

In 1997, the European Communities, with support from Canada and Japan, challenged the FSC legislation before the World Trade Organization (WTO), asserting that it constituted an impermissible export subsidy. That FSC was an export subsidy was beyond debate. The issue was whether the United States would be able to get the WTO to accept certain technical arguments that the particular type of subsidy was not inconsistent with the language of the GATT. A final decision against the FSC subsidy was issued on February 24, 2000.

Congress responded in 2000 to the WTO decision against the FSC legislation by repealing FSC and enacting a new export subsidy called the Extraterritorial Income Exclusion Act of 2000 (ETI). ETI borrowed many features of FSC, but it avoided those features of FSC that the WTO had specifically cited as objectionable. Not surprisingly, the ETI legislation was again challenged by the European Communities, this time with support from Australia, Canada, India and Japan. The WTO again rejected the U.S. attempt at subsidizing exports in a broad-gauged opinion that evaluated the legality of ETI by reference to its substance rather than its form.

Congressional Options

The Congress of the United States must now decide how it should respond to the decision of the WTO. I suggest that Congress has the following four options:

(1) *Do Nothing*. Congress can do nothing and simply allow the United States to remain in violation of its international trade agreements. This option would open the United States to sanctions by our trading partners. More fundamentally, it would undermine the movement towards free trade that the United States has championed for over half a century.

(2) *Support Free Trade*. The most attractive option, from a public policy perspective, would be to support free trade by repealing the ETI provisions without any replacement. The virtues of free trade have been well known at least since the publication of *Wealth of Nations* by Adam Smith in 1776. Free trade—the removal of export subsidies and import barriers—strengthens a nation's economy and lifts the living standards of its workers. These benefits of free trade have been touted by politicians from both of our major parties in every election I can remember. As an added bonus, support for free trade and honoring our international agreements will foster

improved relations with U.S. allies. Avoiding needless conflicts with our trading partners is particularly important at a time when we must rely on them for support in our efforts at combating international terrorism.

(3) *Grandson of FSC*. A third option, which is not really a practical option at all, would be to develop some revised version of ETI that would subsidize exports without violating the WTO agreements. The game of disguising a trade subsidy as a normal part of the tax code, however, is no longer winnable. The ETI legislation is skillfully drafted. It adopts a mechanism for delivering a subsidy to exporters that is export-neutral in form. It might even have been approved by adjudicators in some forums. It had little chance of approval, however, in a forum that is dedicated to upholding the substance of free trade against the inevitable pressures from governments to obtain an unfair trade advantage over their trading partners. It should now be clear that the WTO is not prepared to uphold a U.S. export subsidy, however well disguised it may be. Further legislative efforts at hiding the subsidy will simply antagonize our trading partners.

(4) *Radical Reform*. The fourth option is to repeal ETI as part of a plan to repeal or radically modify the corporate income tax. One radical reform plan floated by some commentators is to adopt what they characterize as a "territorial" tax as a replacement for the corporate income tax. Another plan would substitute a broad-based consumption tax for the corporate income tax. The United States would not have a problem with the WTO if it repealed the corporate tax completely, and the territorial system also would be acceptable to the WTO as long as it was clear that it was not intended as a disguised export subsidy. These radical proposals, nevertheless, are disproportionate and inappropriate responses to the ETI problem, for reasons discussed in detail below. They also would not be helpful in dealing with the ETI problem unless they could be enacted quickly, before the ETI problem provokes a trade conflict that would be harmful to the U.S. economy and to U.S. interests abroad.[1]

Option 2 is the free-trade option, and options 1 and 3 are the anti-free-trade options. The case for adopting option 2 depends, therefore, on the strength of the case for free trade. I set forth that case below. I argue that the United States policy over the past half-century of fostering free trade has enriched Americans and strengthened the U.S. economy. I also argue that under the widely accepted theory of free trade, export subsidies distort trade patterns, resulting in a decline in worldwide welfare. Export subsidies do not produce, however, a net increase in jobs or economic activity in the exporting country even ignoring the likelihood that they would provoke retaliatory measures. In brief, free trade makes America richer, and export subsidies make us poorer.

The radical reform proposals that I have labeled Option 4 should not be evaluated only or even primarily with respect to their potential for dealing with the ETI issue. Those proposals should be accepted or rejected—and I would hope rejected—based on their substantial impact on the distribution of U.S. tax burdens generally, with the trade issue being a relatively minor consideration.[2]

The only reason for considering the radical reform proposals in the context of a discussion of ETI is the claim of their proponents that enactment of one or the other proposal would stimulate U.S. exports. If the radical reform proposals would stimulate exports, they become variants of option 3. As a result, they are not an appropriate response to the ETI issue because, according to the theory of free trade, they would make America poorer rather than richer.

The radical reform proposals are also an inappropriate response to the ETI issue for another reason, namely that they are unlikely to actually stimulate U.S. exports. The impact on exports of income tax concessions is a complex issue, which I address in some detail below. I conclude that the impact of the radical reform proposals on exports is likely to be negligible. I reach a similar conclusion with respect to ETI itself. That is, I believe that income tax concessions directed at profits derived from exports or from foreign activities are likely to have little or no impact on the overall level of exports. Lobbyists seeking to retain or replace ETI apparently agree, for it

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[1] I have two reasons for believing that radical reform of the corporate tax is unlikely in the near term. First, the radical reform proposals are likely to attract serious opposition from one or both political parties as their economic and political implications become better understood by Congress. Second, the radical proposals, if enacted in a revenue-neutral way, would shift tax burdens significantly—increasing taxes on some taxpayers and lowering them on others. I believe that Congress would find some difficulty in acting swiftly to raises taxes on a large segment of the voting public.

[2] In my view, these radical proposals have nothing to do with genuine tax reform. As the Enron debacle illustrates, the starting point for genuine corporate tax reform is to close off opportunities for offshore tax avoidance and evasion. The effect of both radical reform proposals, however, would be to enhance and legitimize those opportunities.

seems unlikely that they would be working so diligently to preserve a tax subsidy if most or all of the benefits of the subsidy were being passed on to foreign consumers.

The Virtues of Free Trade

The primary purpose of the WTO is to promote and safeguard free trade. In playing a major role in the establishment of the WTO, the United States showed its commitment to free trade. It recognized that some international institution is needed to get national governments to give up their predilection to manage trade for the benefit of the few and to allow the free market to operate as Adam Smith envisioned.

In the ETI case, the WTO has operated exactly as it was designed to operate. It correctly labeled ETI as an export subsidy and determined that the continued operation of ETI was inconsistent with U.S. treaty obligations. Any other decision would have struck a blow for protectionism and undermined the credibility of a major international institution that serves America's long-term economic and political interests and the long-term interests of its trading partners.

Some advocates of managed trade contend that ETI is necessary to allow American companies to compete against foreign firms that are obtaining export subsidies in their home country. They become vague to the point of incoherence, however, when they are asked to identify these foreign subsidies. If there are identifiable foreign subsidies, the proper U.S. response is to point them out and bring an action for relief to the WTO. The United States should not ignore the rule of law and take unilateral actions contrary to our international agreements. The precedent set by the WTO's decision in the ETI case should make it quite easy for any member of the WTO to challenge successfully any export subsidy that it is able to identify.

According to free-trade theory, export subsidies benefit the recipients of the subsidies at the expense of the general population and the national economy. If that theory is correct—and most commentators believe it is—then the WTO decision against the U.S. government will actually advance the best interests of the American public and the American economy if it leads to the demise of ETI. That is, the WTO decision can be a major victory for free trade and therefore a victory for America if Congress simply repeals ETI.

As a simplified illustration of the case for free trade, assume that Country A decides it wants to stimulate exports by providing a subsidy of $25 per spool for each spool of copper wire that is exported, provided that the exporter demonstrates that it lowered the price of copper wire in the foreign market by the full amount of the subsidy. XCo manufactures wire in Country A. It takes advantage of the subsidy to lower the unit price of its wire in foreign markets by $25, resulting in an increase in its exports. To meet the new demand, it hires some additional employees in Country A. So far, the subsidy seems to be working.

A trade subsidy, however, is unlikely to have just one effect. Assume that YCo is a domestic company that manufactures electric motors in Country A and sells them domestically and abroad. Copper wire is a major component of an electric motor. YCo's price for wire, which it buys from XCo, is not changed by the export subsidy. Its foreign competitors, however, can now buy copper wire at the subsidized price. As a result, they are able to reduce their price for electric motors in Country A and in foreign markets, creating competitive problems for YCo. As a result of the new competition, YCo experiences a reduction in its domestic and foreign sales of motors and is forced to reduce the number of employees at its production plant in Country A. Whatever jobs were gained from the expansion of XCo's business might be lost from the contraction of YCo's business. In addition, Country A is now paying the bill for an export subsidy that probably has added no new jobs and certainly has distorted normal trade patterns.

The above example may appear to be something of a special case. In a world of floating exchange rates, however, an export subsidy is likely to have negative effects on domestic production of unsubsidized products. The reason is that an export subsidy is likely to cause an increase in the relative value of a country's currency when currency exchange rates are set by the market. That increase obviously would affect trade flows. In general, the changes in trades flows would tend to wash out any economic benefits that a country would hope to obtain from pursuing a beggar-thy-neighbor trade policy.[3]

[3] When the DISC legislation was first under consideration in 1969, the value of the dollar was fixed as $32 per ounce of gold. When DISC was adopted in 1971, however, the United States had replaced the gold standard with a floating rate system. This change to floating rates made DISC obsolete just as it was going into effect. See Michael J. McIntyre, "DISC After Four Years:

To illustrate the above point, assume that no companies in Country A manufacture electrical motors or anything else using copper wire. In that case, Country A would not have to be concerned that the export subsidy for wire would harm its domestic industries directly. Because of the currency-exchange effect, however, Country A almost certainly would be harmed by the export subsidy. The subsidy, by increasing the demand for the products of Country A in foreign markets, almost certainly would increase the value of Country A's currency relative to other currencies. As the following example illustrates, the expected result of the higher exchange rate would be an increase in imports into Country A and a loss of jobs in the businesses in Country A that make products in competition with the new imports.

The facts of this example are similar to the facts in the example above, with the additional facts that Country A uses the dollar as its currency, and Country B uses the franc. The exchange rate before the export subsidy for copper wire was one dollar for two francs. After the subsidy was granted and exports of wire increased, the value of a Country A dollar rose so that it now commands three francs. Country B produces apples, which it sells for 30 francs a crate. The price of apples in Country A is 14 dollars (28 francs at the pre-subsidy exchange rate). Before the export subsidy caused the exchange rate to change, apples produced in Country B were not competitive with apples produced in Country A. After the exchange rate adjustment, however, a producer in Country B that sold apples in Country A for 10 dollars a crate could convert the proceeds into 30 francs. As a result, apples produced in Country B are now competitive in Country A, and exports of apples from Country B should be expected to go up. Producers of apples in Country A would lose sales, and jobs in the apple business in Country A would be lost.

In the above examples, the violation of free trade by Country A produced a bad result, for it and the rest of the world, even without any retaliation by Country A's trading partners. The worldwide economic costs of Country A's conduct would be magnified many times if other countries responded by erecting barriers to trade or by adopting their own export subsidies. One of the major purposes of the United States in helping to establish the WTO was to keep countries from making themselves poorer by behaving like Country A. Another major purpose was to prevent the almost inevitable disputes over trade practices from escalating out of control.

Why the Radical Proposals Do Not Solve ETI Problem

There are two major proposals for radical reform of the corporate income tax currently being floated. One is to convert the corporate income tax into a "territorial" system. The basic idea is that U.S. corporations would be exempt from tax on dividends, rents, royalties, interest, and other receipts from their foreign affiliates, and they would be able to more fully utilize foreign tax havens to avoid both U.S. taxes and the income taxes imposed by our trading partners. I call the territorial system "Enron on stilts" because of its clear potential for promoting unbridled tax avoidance and evasion.[4]

The tax revenue cost of moving to a territorial system would be many, many times the tax savings from the repeal of ETI.[5] As a result, its adoption would require a sharp increase in other taxes or a sharp increase in the budget deficit.

The other proposal for radical reform is to adopt some form of consumption tax as a replacement for the corporate income tax. One variant of this proposal is a European-style value-added tax (VAT). The European VAT is a tax on domestic retail sales collected in stages from manufacturers, wholesalers and retailers.[6] Another variant is a business activity tax (BAT), similar to the business-tax component of the Hall-Rabuska flat tax.[7] Both the VAT and the BAT have economic effects simi-

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Reassessment Needed," 3 Tax Notes 9–14 (September 29, 1975) (Based on testimony as invited witness before Ways and Means Committee, July 23, 1975).

[4] Some proponents of a territorial system assert, contrary to fact, that Canada operates a territorial system. For a discussion of the Canadian international tax system by a leading Canadian commentator and a clear refutation of the arguments being advanced for a territorial system, see Brian J. Arnold, "Comments on the Proposed Adoption of a Territorial Tax System in the United States," 25 Tax Notes Int'l 1091–94 (March 11, 2002).

[5] A detailed revenue estimate of adopting a territorial system is not possible at this point, due in part to the lack of specificity about the intended features of the system. Some idea of the costs can be gotten by realizing that Enron enjoyed the benefits of a self-help territorial system through mechanisms that would become perfectly legal under a territorial system.

[6] In Europe, the VAT is imposed in addition to a corporate income tax.

[7] This business activity tax was promoted by the Kemp Commission in its 1996 report. Its appeal is due in part to the fact that it is likely to be a hidden tax on consumers. Quite comically, the particular form of value-added tax proposed by the Kemp Commission called for the imposition of the tax on exports and the exemption of imports from the tax. See Michael J. McIntyre,

Continued

lar to a retail sale tax. That is, the burden of a VAT or a BAT would be passed on to consumers in the form of higher prices.

Advocates for these radical reform proposals obviously have agendas that extend well beyond ETI. They attempt to link their proposals to ETI by claiming that elimination of the corporate income tax on profits earned abroad would stimulate foreign sales of goods and services produced in the United States by making those goods and services cheaper in foreign markets. This claim is unsupportable. The U.S. corporate tax on foreign profits is not currently being paid by foreign consumers, so its elimination would not lower the price of goods and services in foreign markets.

To be sure, in some quarters it seems to be an article of faith that the corporate income tax is passed on to consumers through higher prices.[8] There is little in the tax literature, however, to support that belief. According to standard economic theory, the price of goods and services in a market is set by supply and demand in that market. The U.S. corporate tax paid by a U.S. corporation is highly unlikely to affect significantly either the supply or the demand for goods and services in foreign markets. Consequently, the tax would not affect the price of those goods and services significantly.

Consider, for example, PCo, a U.S. manufacture of children's clothing that manufactures dresses in the United States for $10 and sells them in France for $20. French, German, Dutch and Italian companies are selling similar dresses for $20. Their cost of producing a dress is also $10. Now suppose the U.S. Congress adopts a corporate income tax that requires PCo to pay a tax of $3.50 (35% of $10) on the profits it earns on each dress sold in France. The officers and shareholders of PCo are unhappy with the tax and would like to pass some or all of the tax on to consumers. PCo can attempt to do so by advertising its dresses for a price above $20.[9] If it refuses to sell the dresses for the market price of $20, however, it will end up making no sales at all in the French market because it cannot control the supply or demand for dresses in that market. Because it is still making a good profit on its sales of dresses in France at $20, it has no incentive to forgo those sales.[10]

An argument I have heard on occasion in support of the proposition that an income tax cut on export profits would result in lower prices for exports is that business executives set their prices so as to obtain a target after-tax profit. According to that argument, if the tax rate is cut, then business executives would cut their prices so as to maintain the same after-tax rate of return. I have not seen any empirical support for the argument. Its implausibility is illustrated by the following example.

Assume that Country A has an income tax with a top marginal rate of 39.6 percent. Among those paying at this rate are some wealthy doctors and lawyers. The legislature of Country A cuts the top marginal rate to 30 percent, resulting in a big tax reduction for the doctors and lawyers. How likely is it that the doctors and lawyers will respond to the tax rate cut by lowering their prices for medical and legal services in the hope of attracting more customers? I expect that few people would anticipate that the price for medical and legal services would be dropped. There is little reason to believe, moreover, that corporate executives seeking to maximize their profits would be more inclined than the doctors and lawyers to share their new-found tax benefits with their customers.

Conclusion

Of the four options available to Congress, only the second option—repeal of ETI without any replacement—is consistent with free trade and offers Congress an honorable and effective solution to its ETI problem. It is mistaken to think that some drafting wizard can come up with a new export subsidy that will reward the current beneficiaries of ETI and still pass muster with the WTO. It is equally mistaken to think that some embryonic plan for radical tax reform will suddenly solve the prob-

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"International Aspects of the Kemp Commission Report," 70 Tax Notes 607–609 (Jan. 29, 1996), reprinted in 12 Tax Notes Int'l 417–420 (Feb. 5, 1996).

[8] In allowing U.S. corporations to claim a credit for foreign income taxes, Congress has implicitly treated those corporations as having paid the tax. If the tax is passed on to consumers, no credit should be allowed. See Michael J. McIntyre, The International Income Tax Rules of the United States, Lexis Publishing (2000) at ch. 5/G.2.

[9] To fully pass on a 35% corporate income tax, PCo would need to sell its dresses for $25.39 each. That amount is determined as follows: If N equals the pre-tax profit on a dress and $10 is the after-tax profit, then N—(35% of N) = $10. Thus N = $10/0.65 = $15.3846, and the price necessary for PCo to bear no net tax burden would be $15.39 pre-tax profit + $10 cost = $25.39.

[10] The example is intended as a counter to the claim made by some supporters of export subsidies that U.S. corporate taxes paid with respect to profits on export sales are routinely passed on to foreign customers. The incidence of the corporate income tax is a complex and controversial issue. My own view is that the tax generally is paid by equity investors, although some portion of the tax may be shifted to workers and even to consumers under some circumstances.

lem. The clear reality is that ETI must go if the United States is to satisfy its obligations under international law and maintain its position as a leader of the free-trade movement. It is equally clear that any alternative mechanism for stimulating exports, even one that is acceptable to the WTO, will simply distort trade patterns without increasing U.S. jobs or strengthening the U.S. economy. The best course of action for Congress is to stay the free-trade course that the United States chartered more than a half-century ago.

Although free trade can provide many economic benefits, it is not a free lunch. It can bring dislocations to communities and to workers when established businesses are unable to compete with foreign-based competitors. Many proponents of free trade, myself included, support the use of government authority to ameliorate hardships resulting from robust international competition. Programs that provide job retraining, unemployment benefits and community support are all consistent with a commitment to free trade. Free trade provides major economic benefits to the U.S. economy, and those benefits should be shared equitably. Fortunately, the revenue generated from repeal of ETI is fully adequate to deal with the short-term dislocations of American workers that may result from that repeal.

A repeal of ETI presents Congress with a political dilemma. The costs to U.S. consumers and U.S. companies from the ETI export subsidy are substantially greater in aggregate than the benefits to the users of ETI. Those costs, however, are often hidden and diffused. In contrast, the benefits to the companies that use ETI are palpable and large. For example, a handful of U.S. airplane manufacturers garnered hundreds of millions of dollars in tax savings from FSC and presumably are benefiting similarly from ETI. I do not pretend to have a solution to this political dilemma. The best that those of us in the academic community can do is to make the case for repeal of ETI as forcefully and clearly as we can, with the hope that our defense of free trade will be helpful to Congress in resisting the inevitable political pressures for protectionism.

Chairman MCCRERY. Thank you, Mr. McIntyre.

Well, I think what I have heard from all three of you is that in your opinion, it is impossible to exactly replicate the FSC or the ETI in terms of those American companies that will be advantaged under the current system; is that correct?

Ms. GARRETT-NELSON. I think that is correct, Mr. Chairman. It would be impossible to replicate the essential features of ETI, the targeted prescribed tax rate reduction for U.S. exports is clearly not permissible under the Appellate Panel opinion.

Mr. MCINTYRE. I agree with that fully. I would also say that it not be in the interests of the United States and the U.S. economy to try to replicate it, even if it were possible. But, I certainly agree it cannot be done consistent with our international obligations.

Mr. CHORVAT. I also second that. Any real attempt to try and replicate it I think is only going to irritate the WTO, because they will see through what we are trying to do. And they will rule against us and maybe even give us greater sanctions.

Chairman MCCRERY. Mr. McIntyre, I agree with your favor of free trade. And I admire your saying so.

Mr. MCINTYRE. Thank you.

Chairman MCCRERY. However, I don't think I agree with your conclusion that the ETI or FSC has nothing to do or should have nothing to do with our trade situation. And giving our domestic companies a level playingfield in the arena of free trade.

Mr. MCINTYRE. It was not my intention to suggest that ETI or its equivalents had no effect on the particular companies that were trying to export. In large measure, I think that the tax benefits were not passed on to foreign consumers by way of lower prices,

and, therefore, they had very little effect on total production in the United States.

I certainly agree that ETI and FCS were of assistance to U.S. exporters, probably reduced their capital costs to some degree. But, the problem is that if you provide a stimulus for exports and it actually works in increasing exports, there is a currency exchange affect. That always happens.

What that means is that imports now become cheaper. So if we have a business in the United States that is absolutely competitive right now making bread, and suddenly we have changed the exchange rate so that Canadian bread can come over here at a lower price, we have helped, perhaps, our aircraft industry with the export subsidy, but we have also hurt our bread industry.

The point about free trade is that there are all of those tradeoffs. Any benefit that you get for one industry you are almost certainly going to lose in another industry.

Chairman MCCRERY. I don't disagree with that. And we all know that there are great many things that affect exchange rates, and we can't control all of those things. But what we can control is our own tax system. If we know that our domestic manufacturers who want to take advantage of foreign markets by selling in those markets are having to imbed in the cost of the product to the ultimate consumer a tax that we impose that their foreign competitors are not having to bear because of their nation's tax system, it seems to me we would want to address that.

Mr. MCINTYRE. That is a very clear statement of the issue, Congressman, and I appreciate that. Let me give you a couple of points on that. First, Australia was cited a little bit earlier as a country without a value-added tax. They very recently adopted one. No one thinks this has helped their exports. We should look at that. I think the Committee ought to have someone on the staff talk to some people involved in Australian government on that issue. I think that you will see that it is not the view of the Australians that adding this tax changed their export position at all. That is one part of the answer.

The second point is, I don't think I agree with the economic theory that you implied—that was embedded in your comment—that the corporate tax is passed on to consumers in the way of higher prices.

I think that the price of goods in foreign markets is determined by supply and demand. The U.S. corporate tax generally has no effect either on the supply or the demand in foreign markets, and, therefore, it has very little to do with foreign prices. For the most part, the corporate tax is absorbed in lower profits which is the intent, of course, of a profits tax.

Chairman MCCRERY. Well, we will have just have to disagree on that. There is no question in my mind that the level of taxation that a corporation has to pay is reflected, to some extent, in the price that they have to charge for the product. You are right, there are a great many other factors that determine the price that the market will bear.

But, it just may be that because of the price that the market will bear, our producers are unable to compete because they can't sell

their product at a profit at the price that the market will bear there.

Mr. MCINTYRE. It is not my place, of course, to ask you a question. But, rhetorically, we just cut taxes on some high income people and some middle income people as well. But let's look just at the high income people. Some doctors received a substantial tax reduction. Is it your expectation that this tax cut has been reflected in lower fees that doctors are now charging?

Chairman MCCRERY. That could happen. But it could also happen that they would consume more and create more jobs. So there could be a good result in any number of ways by that tax cut. I thank you for asking that question.

Mr. Chorvat or Ms. Garrett-Nelson, do you have any comment on this discussion, before I go to Mr. Neal?

Ms. GARRETT-NELSON. Well, I don't know. Should I comment on the Australian VAT tax system? I would agree with you on that. I would take issue with you and I think—I am not an economist and never want to be one. But I think some economists would also disagree with you, though, on the correlation or the degree to which there is a correlation between exchange rates and exports.

And I read something recently, I think by Huffbauer suggesting that that view has been somewhat discredited. But I think your point, though, that we can agree on was that all options, legislative options should be viewed and reviewed at this time. I would strongly disagree that the ETI provisions should be repealed before the Congress determines that there is an appropriate legislative solution to replace it.

Chairman MCCRERY. Mr. Chorvat.

Mr. CHORVAT. Just one comment on essentially the incidence of the corporate tax. In other words, who is really paying the tax. That is one of the most knotty empirical problems that—the odds are that it is probably allocated amongst consumers and labor and capital. Some of it—we don't really know how much, but they probably think some of it.

Chairman MCCRERY. Thank you. Fortunately we don't have an economist on this panel who would take the time to explain that to us.

Mr. Neal.

Mr. NEAL. Thanks, Mr. Chairman.

Mr. McIntyre just three easy questions for you. Isn't it true that no major developed nation has a pure territorial tax system?

Mr. MCINTYRE. No country that I know of has a territorial system, as I have heard it described today. Certainly some of the discussion I have heard has suggested that Canada, for example, has a territorial system. That is a substantial misstatement of the Canadian system. It has some elements that some might properly be described as territorial, but it is essentially a global income tax system.

And an income tax by its very nature is a global tax—an origin tax and not a territorial tax.

Mr. NEAL. Let me follow up on that. Isn't it true that a territorial system is of no benefit to the U.S. companies with only domestic operations?

Mr. MCINTYRE. Yes. Well, I would have to give a qualified yes to that. A territorial system, as I have seen it described, and I am not being cute on that, it is just that there is a variety of territorial systems out there, does create a lot of opportunities for tax advance. So I think even a purely domestic company would almost certainly set up offshore leasing arrangements and the like to substantially reduce its U.S. source income when a territorial system.

So I would say that a domestic company, a purely domestic one, might engage in some forms of tax avoidance that we would find inappropriate and would cost the government some revenue, but the territorial system would certainly not improve its economic performance.

Mr. NEAL. Is it possible that under a territorial tax system that some companies actually might have a higher tax burden than they do now?

Mr. MCINTYRE. Again, that would depend on the territorial system. If we were having a territorial system that was very strict on not allowing deductions that related to foreign source income, some companies would pay higher taxes. There are lots of ways that one could design a territorial system that, for some taxpayers, would result in substantially a higher tax burden.

But, again, the impact would depend on the technical rules that were designed. In a paper that my colleague here, Mr. Chorvat, wrote sometime ago looking at a territorial system, he tried to keep some elements of anti-avoidance rules in the system. And that is a commendable thing if you are going to adopt such a system.

On the other hand, I see from the testimony today Professor Chorvat was suggesting that Congress might manipulate the source rules so that some U.S. source income—what we would generally think of as U.S. source income—would not be taxed. So if you are going to manipulate the source rules so that a manufacturer in the United States doesn't produce U.S. income for us to tax, then, of course, the territorial system would be a very substantial drain on revenue and wouldn't raise taxes on people.

So you have to look to see the details of the particular proposal. But, a genuine effort at fully taxing territorial or U.S. source income would very likely raise taxes on some taxpayers.

Mr. NEAL. In fairness, let me ask the other panelists if you would like to comment.

Ms. GARRETT-NELSON. I am sorry. I was trying to follow your questions. And when Professor McIntyre started talking about tax avoidance I thought I perhaps didn't hear the question correctly. But he is correct that no two countries have the same type of territorial system. And it would depend entirely on how it is structured.

I would point out that the issues that would determine results like whether tax liability would be higher would depend entirely on the kinds of choices that are made, including the level of anti-deferral rules that might be employed in the context of such a system.

And those are the very same decisions that could be made within our current system. The underlying issues are the same. The source of income would be very important, for example. And you would face the same issues whether we have a territorial system or our current worldwide system.

Mr. NEAL. Okay. Mr. Chorvat.

Mr. CHORVAT. Actually in the article that Professor McIntyre was referring to, I basically argued that the difference between a territorial system and the system that we have now effectively for most U.S. multinational corporations isn't all that great for most of them. And that we would still have to have rules essentially like what we have now to get rid of the antiabuse—to prevent abuse so that a pure territorial system—very few, if any, countries have, and I don't think we would have a pure territorial system.

Mr. NEAL. Thank you all very much.

Chairman MCCRERY. Mr. Brady.

Mr. BRADY. Thank you, Mr. Chairman. Actually I agree with Professor McIntyre. There are a number of companies that don't pass their corporate taxes down to the consumers. I think we call them failed businesses. Overhead is overhead.

I hear consensus about the fact that it is not possible to replicate the ETI regime in a way that is WTO compliant. So it is important not only to know what to do, which is to bring about real change, but what not to do. I know that each of you have looked at and rejected a number of proposals that we are going to hear about for just tinkering. Can you share some of the proposals that you think will come to Congress to be considered as a tinkering and what you find objectionable to them?

Ms. GARRETT-NELSON. Well, I am not prepared to share conclusions about particular proposals. But, I can say that under the legal analysis in the Appellate body report, it is clear that whatever is put in place of ETI, assuming that that is the route the Committee goes down, much more economic substance will be required, or I should say, more substance would be required than has been required under the DISC or the FSC or ETI.

Even under a Footnote 59 approach, for example, it is clear that a requirement for export transactions that arms-lengths pricing be used, would mean that something would actually have to occur overseas. Some value would have to be maintained overseas in a way that is not required under current law.

And for that reason, we are clearly talking about going beyond what current law requires pure exporters to do.

Mr. BRADY. Great. Thank you. Mr. Chorvat.

Mr. CHORVAT. Yeah, just to sort of amplify that a little bit, if something is done it is going to have to be something that would also permit tax advantages, I guess in the most broad sense, to products which are entirely produced overseas and have nothing to do with what occurred here, I think that is part of what is going on is that we were giving tax advantages for things that were, to some degree, produced here and were used overseas.

Whatever happens, if it is going try to be compliant with the WTO, is not going to have to be focused on exports per se, but on something else, possibly in connection with the United States or being foreign sourced or something like that. But it cannot be something which has the word "export" in it or anything that could arguably be exports.

Mr. MCINTYRE. I would agree with that assessment that anything that was seen as providing a benefit primarily to U.S. businesses engaging in export activities would have some issues with the WTO. That is, anything that I would think that this Committee

would be interested in doing in this area as a replacement for ETI would create a problem. But as was noted earlier, we have only had a few opinions from the WTO. I think we have got one clue, and that is that if the WTO thinks that this latest legislation is a runaround, we will lose. I thought we would lose with ETI, even though I admire the drafting skill of its authors. I was very confident that we would lose, and so told my students, because it seemed to me that the WTO's message was not that it had this little technical problem with FSC, it was that the WTO would not permit free trade to be undermined. That is, the WTO did not want to be the body that undermined free trade.

The Appellate body was saying that free trade is important to us, and we will make decisions based on whether we think they further free trade. I think that there was no doubt that they felt, and many others felt, and virtually everyone outside the United States felt, that the prior FSC legislation was inconsistent with free trade.

Mr. BRADY. I see my time is up. Thank you, Mr. Chairman. Thank you, members of the panel.

Chairman MCCRERY. Thank you Mr. Brady. And I want to thank all of the members of the panel for your excellent testimony and responses to our questions and for your excellent questions also.

Mr. MCINTYRE. Thank you very much.

Chairman MCCRERY. We hope you will continue to work with us as we try to get through this.

Mr. MCINTYRE. I am sure I will, and I am sure other panelists will be happy to do that.

Chairman MCCRERY. Thank you very much. Before the Committee adjourns, I would like to, without objection, introduce for the record the statement of my colleague from New York, Mr. McNulty, who unfortunately was ill today and had to miss the Subcommittee hearing. And with that, the hearing is adjourned.

[The statement of Mr. McNulty follows:]

Statement of the Hon. Michael McNulty, a Representative in Congress from the State of New York

Historically, there has been a broad bipartisan commitment to preserve the Foreign Sales Corp. (FSC) tax code provision and later the extraterritorial income (ETI) regime. We have worked together on the FSC–ETI issue in the past and I hope that we will continue to do so in the future.

I believe that the Administration should take the lead on this important issue just as prior Administrations have done. We had the opportunity to hear from officials from the Treasury Department and U.S. Trade Representative Office on this issue during a full Committee hearing on February 28, 2002. It is now the time for the Administration to develop a strategy for resolving this issue.

It is clear that we must respond to the World Trade Organization (WTO) ruling. However, the right solution is not an obvious one. As is often the situation, generalized or theoretical solutions may sound good, but the "devil is in the details." I look forward to the witnesses' discussion of the direction this Committee may take in the coming weeks.

Finally, I would suggest that the Committee Chairman and others not use the FSC–ETI controversy as an opportunity to quickly push-through proposals that would fundamentally alter our corporate income tax system. There is no consensus on a proposal to repeal the corporate income tax and substitute in a consumption tax, nor is there a consensus to limit our corporate income tax only to activities in the United States.

Such alternatives merit thorough evaluation of the potential impact on U.S. competitiveness worldwide and whether this action might result in creating unintended incentives for U.S. companies to move operations overseas. As time has proven, it is unlikely that the Congress could act on such proposals any time soon and the

World Trade Organization is poised to issue its determination of sanctions at the end of this month.

I look forward to the expert testimony we will hear today on these and related issues. And, of course, I want to thank Subcommittee Chairman McCrery for setting up this important series of hearings.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]
[Submissions for the record follow:]

Statement of Stephen D. Cifrulak, Jr., Sewickley, Pennsylvania

I. EXECUTIVE SUMMARY:

On January 14, 2002, an Appeals Panel of the World Trade Organization (WTO) held that the Foreign Sales Corporation (FSC) Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106–519) is inconsistent with international trade agreements. As a result, it is expected that, on or around June 17, WTO arbitrators will impose sanctions against the US in an amount less than $4 billion, but probably more than $1 billion. The EU, however, is not expected to *immediately* impose sanctions because to do so might negatively impact EU businesses (and possibly initiate a US–EU trade war.) Thus, the EU may agree to a 2 to 3 year "cease-fire" . . . provided that the US works in "good faith" to resolve the issue on a long-term basis. For that reason, on April 8, the EU requested a "road map" from the US detailing how it plans comply with the WTO ruling. The House Ways and Means Committee then held a public hearing on April 10 to discuss various options for changing America's extraterritorial income (ETI) regime. In that hearing, virtually every commentator agreed that "it will not be possible to draft a single replacement regime that complies with the trade obligations of the United States and replicates the tax benefits of the ETI statute." I respectfully disagree with such commentary. Indeed, the purpose of this paper is to provide a "road map" of at least one "good faith" measure that the US can pursue in order to preserve its export benefits.

In short, this paper will hopefully demonstrate that, **while the WTO's interpretation of *footnote 59* may effectively preclude ETI reform, it nonetheless seems to re-open the door for continued FSC use. After all, everyone seems to have forgotten that the WTO has never specifically interpreted *footnote 59* in a FSC-only context. Rather, the WTO actually "decline[d] to examine the US argument that the FSC measure is a measure to avoid double taxation within the meaning of *footnote 59*" because the WTO said that the US had ultimately failed to properly raise the matter as an affirmative defense in the original suit. As such, it may be premature for commentators to proclaim that "it will not be possible to draft a single replacement regime that complies with the trade obligations of the United States and replicates the tax benefits of the ETI statute." An alternate solution might be for the US to now apply the WTO's interpretation of *footnote 59* back to the old FSC regime in order to see if any conforming modifications can be made.** If this is done, then this paper suggests that the US may find additional innovative ways to solve some of its other international tax problems (such as deferral, corporate inversions, Subpart F abuse, and various tax avoidance schemes.)

II. *FOOTNOTE 59*

(1) Background/Explanation

Footnote 59 of the SCM Agreement provides an exemption for measures taken to avoid the double taxation of foreign-sourced income. This is true even if the measure is determined to be an "export-contingent subsidy" (such as was determined for both FSC and ETI benefits).

The standard of analysis for determining if a Member State might prevail with a *footnote 59* argument is that, the WTO must determine that: [1]

> 1. The Act is a measure to avoid the double taxation of foreign-source income within the meaning of the [last] sentence of *footnote 59* of the SCM Agreement as an exception to Article 3.1(a); and that,

[1] See § 8.80 of the WTO Panel report entitled "United States—Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities." 20 August 2001. Document # WT/DS108/RW.

2. the [last] sentence of *footnote 59* falls within the scope of *footnote 5* of the SCM Agreement.

In relation to requirement 2, the WTO "found that [since] the [ETI] Act does not fall within the scope of the fifth sentence of *footnote 59*, [it did] not believe that it [was] necessary to reach the issue of whether the fifth sentence of ***footnote 59*** also falls within the scope of *footnote 5* of the SCM Agreement."[2] In any case, **the EU ultimately stipulated that it saw "no reason to contest that the last sentence of *footnote 59* may be an exception to Article 3.1(a)."**[3] As such, requirement 2 seems to be a moot point.

Conversely, in interpreting requirement 1, the WTO focused on three main terms in both its initial ETI-Panel Report,[4] and in its subsequent ETI-Appeals Report[5]—"Avoid", "Double Taxation", and "Foreign Source Income"—which were defined as follows:

Term	"ETI-Panel Report" Comments	"ETI-Appeals Report" Comments
"Avoid"	• The purpose of the measure (or at least one of its purposes) must be to avoid (i.e. "prevent" or "obviate") the double taxation of foreign-source income. (§ 8.94). • We do not view ***footnote 59*** as requiring that a measure "to avoid" the double taxation of foreign-source income must avoid double taxation entirely, exclusively or precisely. However, we consider that the relationship between the measure and its asserted purpose—i.e. "to avoid the double taxation of foreign-source income . . ."— must be discernable . . . [in relation to] the overall structure, design, and operation of the Act in the broader context of the US tax system. (§ 8.95).	• The avoidance of double taxation is not an exact science. Indeed, the income exempted from taxation in the State of residence of the taxpayer might not be subject to a corresponding, or any, tax in a "foreign" State. Yet, this does not necessarily mean that the measure is not taken to avoid double taxation of foreign-source income. Thus, we agree with the panel, and the United States, that measures falling under ***footnote 59*** are not required to be perfectly tailored to the actual double tax burden. (Para. 146)
"Double Taxation"	• The term "double taxation" refers to the situation where the same income is taxed in more than one jurisdiction. (§ 8.92).	• "double taxation" occurs when the same income, in the hands of the same taxpayer, is liable to tax in different States (Para. 137)

[2] *Id.* at § 8.108.

[3] *Id.* at § 8.77.

[4] The original WTO Panel report versus ETI. Entitled "United States-Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities. Report of the Panel." 20 August 2001. Document # WT/DS108/RW.

[5] The subsequent WTO Appeals Panel report versus ETI. Entitled "United States-Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities. Report of the Appellate Body." 14 January 2001. Document # WT/DS108/RW (AB–2001–8).

Term	"ETI-Panel Report" Comments	"ETI-Appeals Report" Comments
"Foreign Source Income"	• . . . it is not clear to us that the term has obtained a universally agreed upon special meaning . . [and] no such definition or meaning has been included in the SCM Agreement as a common understanding among WTO Members. Therefore . . . we do not impose a single rigid definition or interpretation of the term "foreign-source income" nor do we import into the WTO Agreement any definition of the term that may exist in other international instruments or fora. Nor are we of the view that the meaning of the term "foreign-source" as used in ***footnote 59*** need necessarily be determined purely by reference to the domestic laws of the Member invoking the footnote. . . . We understand the term "foreign source income" as used in ***footnote 59*** to refer to certain income susceptible to "double taxation". (§ 8.93).	• In our view, "foreign source income" in ***footnote 59*** to the SCM Agreement refers to income generated by activities of a non-resident taxpayer in "foreign" State which have such links with that State so that the income could properly be subject to tax in that State. (Para. 137)

Based on the above interpretations, the WTO expressly stated that its test for analyzing compliance with *footnote 59* will ultimately hinge on "whether legislators concerned with avoiding the double taxation of foreign-source income might reasonably have been expected to draft legislation such as the Act."[6] This test is important because, as the recent House Ways and Means Committee hearing revealed, many commentators seem to agree that:

> A *footnote 59* approach could be used in the context of legislation that explicitly confers an (otherwise prohibited) export subsidy, or in combination with amendments to rules of general application. In either case, however, the ability to replicate the benefits of the **ETI regime** would be circumscribed by the AB Report's definition of "foreign source income" and the related requirement that arm's length pricing be used to allocate income between foreign and domestic sources."[7] (*Emphasis added.*)

As highlighted above, the relevant question now seems to be whether "the ability to replicate the benefits of the ***FSC regime*** would be circumscribed by the AB Report's definition of "foreign source income" and the related requirement that arm's length pricing be used to allocate income between foreign and domestic sources." After all, the WTO has never specifically interpreted *footnote 59* in a FSC-only context. Instead, the WTO actually "decline[d] to examine the US argument that the FSC measure is a measure to avoid double taxation within the meaning of *footnote 59*"[8] because the WTO said that the US had ultimately failed to properly raise the matter as an affirmative defense in the original suit.

It therefore seems to be premature for commentators to proclaim that "it will not be possible to draft a single replacement regime that complies with the trade obligations of the United States and replicates the tax benefits of the ETI statute."[9] After all, now that the WTO has more clearly interpreted *footnote 59*, a better course of action might be to apply this interpretation back to the old FSC regime in order to see if any conforming modifications are necessary concerning (1) the definition of "foreign source income"; and/or (2) the requirement for arm's length pricing.

(2) Criteria for Determining Footnote 59 Compliance in a FSC-only context

As previously noted, the WTO Appeals Panel Report for ETI states that:

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[6] ETI-Panel Report. *Id.* at § 8.106.

[7] Statement of LaBrenda Garrett-Nelson. Partner, Washington Council Ernst & Young On the Extraterritorial Income Regime. Hearing before the Subcommittee on Select Revenue Measures. Committee on Ways and Means. On April 10, 2002. Page 5.

[8] *See* Para. 103 of the subsequent WTO Appeals Panel report versus FSC. Entitled "United States—Tax Treatment for "Foreign Sales Corporations"—Report of the Appellate Body." AB–1999–9. (24 Feb 2000).

[9] *Id.* at Page 10.

> In our view, "foreign source income", in *footnote 59* to the SCM Agreement, refers to income generated by activities of a non-resident taxpayer in a "foreign" State which have such links with that State so that the income could properly be subject to tax in that State.[10]

This statement is significant because, under the old FSC regime, there was in fact a "link with a foreign State" via a separate entity (i.e., the FSC). In addition, these links were such "so that the [FSC's] income could properly be subject to tax in that [foreign] State." In practice, however, most foreign states did not ultimately choose to tax FSC income. Instead, they levied an annual registration fee of a fixed amount against the FSC. The more important point, however, is that these foreign states clearly could have taxed FSC income if they had so desired and therein lies the first hurdle concerning FSC compliance with *footnote 59*. For example, if a given foreign State did choose to tax FSC income, then the FSC rules are clearly deficient in that they do not allow for a corresponding US foreign tax credit. As a result, the FSC rules may not be viewed by the WTO as a means of preventing "double taxation." (After all, as previously noted, the WTO's test for determining *footnote 59* compliance is "whether legislators concerned with avoiding the double taxation of foreign-source income might reasonably have been expected to draft legislation such as the Act.")[11]

As for the second problem cited by commentators—"that arm's length pricing be used to allocate income between foreign and domestic sources"—the FSC regime, once again, seems to be guilty as charged. For example, in the original FSC-only Appeal, the WTO noted that:

> There is no limitation on the amount of exempt foreign trade income that may be earned by a FSC. Therefore, the legal entitlement that the FSC measure establishes is unqualified as to the amount of export subsidies that may be claimed by FSCs. There is, in other words, no mechanism in the measure for stemming, or otherwise controlling, the flow of FSC subsidies that may be claimed.[12]

In the light of *footnote 59*, this original FSC-only argument now seems to be a moot point. After all, as previously noted, *footnote 59* of the SCM Agreement provides an exemption for measures taken to avoid the double taxation of foreign-sourced income. This is true, for example, even if the measure is determined to be an "export-contingent subsidy. Seemingly then, the actual amount of the subsidy is probably irrelevant . . . provided, of course, that the measure is otherwise in compliance with *footnote 59*.

Nonetheless, in its ETI-Appeals Report, the WTO further refined its argument concerning the need for arm's length pricing in a *footnote 59* context by specifically noting that:

> Related parties are able to "sweep into" the calculation of QFTI income from purely domestic transactions, involving in that example domestic-source manufacturing income. In the absence of this provision, the separate transactions between the manufacturer and related distributor, and between the distributor and unrelated foreign buyer, would have operated as a means of separating out some domestic-source and foreign-source income in those separate transactions. In other words, the domestic source income in the first transaction would not be included in the calculation of QFTI.[13]

If the US therefore attempts to revive FSC use, it is clear that certain modifications will be required, but unlike ETI (which does not utilize a separate entity), these modifications will not necessarily be "deal killers". Rather, they might actually provide the US with creative alternatives for solving some of its other international tax problems (such as deferral, corporate inversions, Subpart F abuse, and various tax avoidance schemes.)

III. CONCLUSION: A "ROAD MAP" FOR FSC COMPLIANCE

Based on the above analysis, I therefore suggest that the US immediately provide the EU with the following "road map" that outlines at least one "good faith" measure that the US can pursue to preserve export benefits:

> 1. The ETI Statutes will be repealed as soon as possible; at the same time, however,

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[10] ETI-Appeals Panel report. *Id.* at Para. 137.
[11] ETI-Panel Report. *Id.* at § 8.106.
[12] Summarized from the subsequent WTO Appeals Panel report versus FSC.
[13] ETI—Appeals Panel report. *Id.* at Para. 167.

2. The FSC Statutes will be re-instated, but with the following modifications . . .

a. All restrictions prohibiting the application of US foreign tax credits to FSC income will be removed. (Indeed, the stated goal of this new FSC regime will be "to facilitate the repatriation of certain US-related income by implementing measures designed to avoid (and/or significantly reduce) the double taxation of foreign-source income.")

b. The US will also immediately begin to research ways in which it can make its FSC administrative pricing rules conform to the "arm's length" concerns outlined in the WTO's recent ETI-Appeals decision. The US will keep the EU informed concerning the status of this research. Moreover, the US will pledge to complete this research in a reasonable amount of time, and to ultimately bring its pricing rules in compliance with WTO standards.

3. In exchange for a reasonable amount of time to implement the above changes, the US will also agree not to bring future WTO suits which characterize the various EU VAT regimes as "prohibited export subsidies regimes not in compliance with WTO rules."

If the EU agrees to the above "road map", then from a "policy" standpoint, the benefits of the suggested changes would be as follows:

- A trade war could be averted (both now and in the future);
- The US and the EU will both preserve certain export benefits on a long-term basis;
- The existing tenets of US international tax policy—such as the foreign tax credit, subpart F, and section 863(b)—could all remain in place;
- Treasury could continue its commitment to the doctrine of capital export neutrality;
- The dual issues of anti-deferral and hybrid use would, most likely, become less of a problem. (Indeed, the current focus on the precise details of Subpart F reform could probably be somewhat avoided. After all, if FSCs are allowed to utilize US foreign tax credits, then presumably, US taxpayers would have a legitimate means of repatriating certain qualified income at rates that are more in line with worldwide standards, e.g., 12.17% to 29.75%.); and finally,
- US businesses could continue in their pursuit of "globalization." (Moreover, they would now have less of an incentive to renounce US incorporation status.)

At any rate, I hope the analysis contained herein will re-energize the current FSC/ETI debate. More importantly, I hope that it demonstrates that there is at least one *as-of-yet unexplored* solution for resolving this seemingly complex problem; and that this solution may actually allow all parties involved to save face in this matter.

As for more specific details concerning other aspects of FSC reform, I have some thoughts concerning these matters as well . . . but alas, that is a battle best saved for another day.

Statement of MTI Services Limited, Princeton, New Jersey, and Western Growers Association, Irvine, California

MTI Services Limited, acting through its Tax Committee, and the Western Growers Association submit the following written testimony to the Subcommittee for its consideration. MTI Services Limited's Tax Committee is represented by Ms. Deborah Fehr-Niswanger (Military Truck Parts, Inc., Many, Louisiana), Brian Ward (Cortland Line Company, Inc., Cortland, New York), and John Andrews (QSC Audio Products, Inc., Costa Mesa, California).

We appreciate this opportunity to make our views known, and we would be pleased to work with Congress, the Treasury Department and the Internal Revenue Service over the coming weeks and months to overcome the current problem posed by the WTO's decisions.[1]

[1] We have previously commented to the full Committee on the World Trade Organization's decision that the United States' Extraterritorial Income Exclusion Act is a prohibited export subsidy, at the Committee's hearing on Wednesday, February 27, 2002. On that occasion we addressed the History of the FSC–ETI Dispute—The Role of Decisions Made in the 1960s; The

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THE POSITION OF SMALL AND MEDIUM-SIZE EXPORTERS

We support the proposition put forward by some large multinational corporations that Congress and the Administration should carefully consider changing from a "worldwide tax system" to a "territorial tax system" and amending the Subpart F and related rules. It must be emphasized, however, that NONE OF THE STEPS BEING DISCUSSED WOULD BENEFIT SMALL AND MEDIUM-SIZE EXPORTERS. Smaller companies, unlike many large corporations, do not have plants outside the U.S., and they have no incentive or desire to move any part of their operations to a foreign jurisdiction. They typically "sell out the back of the plant," and the plant is here in this country. Agricultural businesses grow, pack and sell from their farms, again here in this country.

Realistically, we think it should be acknowledged that wide-ranging changes in the way the United States taxes international business, including exporting, will not come quickly. Also, these changes may not come by themselves but as part of a very broad reform of the Internal Revenue Code, which, frankly, has not changed to reflect today's business practices and life styles.

Our point is simple and straightforward: Small and medium-size exporters do not want Congress to "trade off" the ETI provisions for enactment of these or any other new rules. The tax treatment of export income under DISC, FSC and ETI was and is important, and we want to keep ETI or something like it in one form or another.

As explained briefly below and in greater detail in memoranda prepared for the Congressional and Treasury Department staffs, we believe that the tax treatment afforded under FSC and ETI can be replicated under existing non-FSC, non-ETI law without violating trade obligations and without doing injury to generally-accepted tax principles. This approach to the problem is not for small and medium-size companies only; large companies can join in. Also, since it relies upon rulings, in the form of Pre-Filing Agreements ("PFAs") or Private Letter Rulings ("PLRs"), it is a simple matter, in effect, to "sunset" them when more comprehensive changes are enacted.

We would add that our Representatives in Congress, we believe, should be as attentive to the views of small and medium-size exporters as they are to large exporters. Smaller exporters, including agricultural exporters, represent a disproportionate number of "users" of the subject tax provisions. Of the 4,363 FSC returns filed in 1996, for example, the largest 40% of the exporter population, by size of total assets, filed 1,659 returns, while the remaining 60%—the smaller companies—filed 2,704 returns. Smaller exporters employ a large number of people. And the tax savings, frankly, can be critical to the company's efforts to export.

As the owner of one of our companies recently wrote to the Chairman of this Subcommittee:

> *Our company does a good deal of export business, and the FSC/ETI program has assisted us in being competitive in international markets where the negotiations for contracts can be intensely challenging. In a new venture outside basic truck parts, I have just completed a two-year negotiation for American-made ambulances, fully equipped with American-made medical equipment for Egypt. This negotiation was successfully completed with direct low-margin profits, but it should be kept in mind that the advantage with the FSC/ETI program made it possible to compete and win. These provisions have helped us grow our export market and increase the number of employees as we have grown.*

Letter from Deborah L. Fehr-Niswanger, President, Military Truck Parts, Inc. to Congressman Jim McCrery dated April 8, 2002.

To our fellow taxpayers that are larger companies, we point out that the exporting community has only succeeded in making their case to Congress and the Executive Branch when as a group we have been able correctly to say that the provisions in question do not merely help the largest 10–20% of exporters. Otherwise, the approach is too lopsided and takes on the appearance of corporate welfare. Keeping smaller exporters in the game is the rationale behind numerous provisions in the statute, such as the exemption from the foreign economic processes requirements and the shared provisions, and in the Treasury Department regulations.

WTO Appellate Body's Decision—A Misconception of the Nature of U.S. Tax Rules; Impact of Changes in the FSC–ETI Rules—Effects on Medium-Size and Smaller Taxpayers; The EU's Request for Sanctions—A Proposal for Attacking the Numbers; and Multiple Ownership—Need for Continued Support. During the development of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, we were active in contributing proposals and comments to the tax-writing committees, the Joint Committee on Taxation and the Treasury Department.

LEAVING ETI IN PLACE BUT MAKING MODIFICATIONS

The Chairman's announcement asks that persons submitting testimony help the Subcommittee *"explore the possibility of one approach—leaving ETI in place but making modifications to it that address the objections raised by the EU. * * * The focus of the hearing will be to examine whether adjustments can be made to the existing ETI regime to bring it into compliance with WTO rules without undermining the competitiveness of U.S. businesses in the global marketplace."*

In summary, our suggestion is that ETI be kept in place and, at the same time, exporters be encouraged to set up operations under existing non-ETI law so as to dramatically reduce the revenue cost of the ETI provisions. It is this figure that the European Union has fixed on in its request for authorization to impose sanctions. Put differently, we need to focus on reducing the ETI revenue cost figure, not making amendments to the ETI provisions.

The United States, As A Matter Of Technical Tax And Trade Law, Probably Cannot Enact Yet Another Version Of Exporter Tax Rules That Will Be WTO-Compliant

Having worked with the FSC and ETI provisions in great detail since as far back as 1984 and studied the various WTO reports and decisions, we believe that it would be extremely difficult if not impossible to solve the current problem by enacting yet another version of the exporter tax rules. This is because the World Trade Organization's FSC and ETI reports and decisions have been written quite purposefully to make this as difficult as possible.

Without reviewing each of the numerous problem areas in what runs to over 500 pages of writing, including the original FSC report and decision, and over twice this amount taking into account the various submissions, questions and comments, we will look at two by way of example.

First, in finding that the ETI provisions constitute a subsidy, the Appellate Body found that the ETI exclusion amounted to a forgoing of revenue that is "otherwise due." In doing so, it opined that the normal or "benchmark" rule under U.S. law is that U.S. persons are taxable on their foreign source income and, therefore, ETI operates as an exception. By characterizing the U.S. tax system in these terms and labeling as a subsidy anything that diverges from the proclaimed norm, the WTO has made it very difficult to do anything that does not tax the foreign source income of exporters.[2]

It is odd that the United States should be constrained by competitors' characterization of its own laws. This is especially true where the characterization is overly broad to the point of being simplistic. As Congress and the Treasury Department are well aware, the U.S. tax system is not that sheer or pristine. To take just one example, Americans residing abroad are exempt from U.S. tax, up to the level of $80,000, on their foreign earned income.[3] Also, should Congress wish to rethink anti-exporting measures that it put in place in the past, must it be barred from acting?[4]

Secondly, in finding that the ETI provisions did not qualify for the exception in Footnote 59 of the Agreement on Subsidies and Countermeasures for measures to avoid double taxation, the Appellate Body characterized income falling within the purview of the ETI rules as not solely foreign-source income but also U.S. source income. Here it opines on the definition of foreign source income, what degree of foreign presence must exist for the exception to come into play, and whether formulae can be employed to allocate income.[5] This treatment makes it difficult to construct simple, easily administered rules and, instead, pushes tax writers toward the arm's-length, case-by-case standard. Incidentally, it also ignores qualitative factors and the existence of electronic commerce, which was almost nonexistent when the foreign economic processes were first drafted in the early to mid-1980s.

We note that the Appellate Body seems to have a great deal of difficulty dealing with the 30% of foreign sale and leasing income method in section 941(a)(1). With FSC, there was the possibility using the sale price actually charged, subject to section 482 pricing. Also, with FSC, there was the possibility of arm's length pricing between the related supplier and the FSC. These possibilities, in effect, fell away

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[2] United States—Tax Treatment For "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/AB/RW dated Jan. 14, 2002, Report of the Appellate Body, pp. 26–33.

[3] Section 911.

[4] For example, the exception for export property to the rule that taxes foreign controlled corporations on amounts reinvested in U.S. property looks a little anemic, and Congress may wish at some time to broaden it. Section 956(c)(2) (United States Property Defined; Exceptions).

[5] *Id.* at pp. 41–59.

with ETI. While with hindsight one is tempted to say that it might have been better to move farther away from formulaic approaches, we doubt that it would have made a difference.[6]

Looking at the Appellate Body's work as a whole, it is safe to say that in addition to making it very difficult for the United States to comply, the authors very much wanted also to avoid creating a "roadmap" for that compliance.

The United States Should Not Even Try To Enact New Legislation

We think that having changed our rules twice—once from DISC to FSC in 1984 and again from FSC to ETI in 2000—and done so in good faith in order to try to comply with the views of our trade competitors, "enough is enough." It is simply inappropriate for this country—Congress, the Administration, the export community—to go through that process again, especially since it can be predicted that those who will sit in judgment of the work product are strongly inclined against its success.

It is far preferable for exporters to fall back upon existing law that does not tie to the ETI provisions. Congress and the Administration can facilitate this course of action by urging Treasury Department and the IRS to act expeditiously.

At the same time, the U.S. Trade Representative can pursue one or more avenues to ameliorate the problem, negotiating an acceptable approach to sanctions and/or compensation, trading off some items in the mix of trade issues, and, most importantly, taking tax issues out of the disputes settlement process. When dealing with the question of sanctions, it needs to be made clear that since the European Union is tying its figures to the ETI tax cost figure, as this number drops, the authorized sanctions number drops as well.

Congress Should Not Repeal ETI

The U.S. has never wanted simply unilaterally—without the Europeans and others dropping their subsidization of their exporters—to drop its tax rules favoring exporters. President Nixon and Congress helped exporters in 1971 with DISC; President Reagan and Congress helped in 1984 with FSC; President Clinton and Congress, with remarkable unanimity, helped exporters in 2000 with ETI.[7] President Bush and this Congress should not be the ones to preside over defeat.

Some might say that encouraging exporters to proceed under existing non-ETI is an unusual step under these circumstances. But one should recall that DISC was a highly unusual step in 1971, on the heels of enactment of Subpart F and the changes in the section 482 regulations. The conversion of DISC to FSC in 1984 was probably the most remarkable of all the steps because it necessitated constructing from whole cloth a unique set of statutory rules, followed by hundreds of pages of regulations. Enactment of ETI and the effort that went into accommodating the concerns of our competitors was, as we all know, truly extraordinary. In this light, avoiding the current problem, which is pressed on us by our competitors, and reducing tensions among the parties by fostering a set of rulings or Pre-Filing Agreements is not very remarkable. It is relatively simple. It does not require a great deal of time and effort; indeed, very little effort on the part of Congress is called for. And in a very appropriate way it "buys time" for the development of more comprehensive measures.

Exporters Should Be Encouraged To Solve The Problem Under Existing, Non-ETI Law

Treasury and the IRS should work with groups of exporters, such as trade associations and groups sponsored by State Development Offices, to conclude Pre-Filing Agreements or Private Letter Rulings with the IRS. These PFAs or PLRs would determine how exporters that operate through a multiple ownership or "shared" foreign corporation will be taxed. The resulting business structure is similar to that used with Shared FSCs, under the FSC provisions, and Shared Partnerships, under the new ETI rules. Companies successfully used Shared FSCs over a 14-year period. The two tax-writing committees, the House Ways and Means Committee and the

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[6] In fact, while only a small percentage of companies used, with FSC, a method other than one of the administrative pricing methods, significant amounts of income travelled through these "nonadministrative" routes, that is, the section 482 method and the arm's length method. C. Belmonte, "Foreign Sales Corporations, 1996," SOI Bulletin (Spring 2000).

[7] ETI was adopted by the Senate by Unanimous Consent and by the House on a vote of 316 to 72. The House Ways and Means Committee, led by Chairman Archer and ranking Democrat Congressman Rangel, adopted it with only one member, Congressman Stark, voting against. Two other Members, Congressman Doggett and Congressman Lewis, expressed concerns about benefiting some types of exporters.

Senate Finance Committee, together with the Administration, should encourage this approach.

By joining in groups, the companies can best deal with the pricing and allocation rules and the rules in section 245(a) for a 70% dividends-received deduction. The details can be worked out in the context of the PFA or PLR.[8]

Foreign countries, including Barbados, have expressed a willingness to work with these groups in order to arrive at a practical solution.

This approach springs from the fact that the United States has repeatedly argued that FSC, and now ETI, is not a radical departure from our "normal" international tax rules. These provisions made it easier for U.S. companies to comply, but they are not the only avenues available.

Since Exporters Would Not Be Relying Upon The ETI Provisions And No New Special Tax Rules Would Be Needed, There Is No Subsidy For Our Trade Competitors To Complain About; Nor Would There Be Any Special Treatment Afforded In The Form Of A Ruling Or Audit Practice

Under the proposed approach, the U.S. would be in a position to demonstrate, using actual tax numbers taken from taxpayers' returns, that the amount of tax benefits claimed under ETI (section 114 of the Code) has dropped dramatically. It will have dropped because exporters will have gone through the PFA or PLR process.

If the EU wishes to continue to raise objections, we strongly recommend that the U.S. attack the notorious rulings practices of The Netherlands, France and other countries, which help their exporters.

This Approach Is Not For Smaller And Medium-Size Companies Only

While only a handful of large companies in the past participated in any form of shared entity, the approach being suggested certainly applies to large companies as well as smaller companies. Large companies can form their own groups based on any number of factors, joining with unrelated companies near their geographic location or in their industry. If they wish, they can help with the day-to-day operations of the entity; in fact, this can be a significant contribution to the effort.

When this approach was first "floated" in 2000, companies thought that the ETI changes would provide the solution. This has turned out, unfortunately, not to be the case. Now a number of large exporters have indicated a willingness to travel down this road.

MULTIPLE OWNERSHIP; THE NEED FOR CONTINUED SUPPORT

It needs to be reiterated that whatever approaches are contemplated in the future, these approaches should accommodate U.S. exporters that wish to band together in a shared entity of some sort. These provisions have always existed—with DISCs, FSCs and the ETI regime. They should continue to exist. They help medium size and smaller companies that cannot afford the time and expense of "going it alone." It is a way of "outsourcing," in a fashion, some of the international aspects of their business. Also, these provisions are used by trade associations and state trade development offices to help their members and constituents.

Shared FSCs and Shared Partnerships under the ETI rules, by their nature, perform greater services for the exporters and have a greater presence in the foreign jurisdiction.

> It is interesting that neither the ETI Panel Report nor the ETI Appellate Body decision makes any mention of shared partnerships or shared FSCs. The FSC Panel Reports simply states: In addition many US States, regional authorities, trade associations, or private businesses sponsor "shared FSCs" for their companies, members or customers. A "shared FSC" is a FSC which is "shared" by 25 or fewer unrelated exporter "shareholders", so as to reduce the costs while obtaining the full tax benefit of a FSC. Each exporter-shareholder owns a separate class of stock and each runs its own business as usual. The US Department of Commerce grants written Export Trade Certificates to shared FSCs that allow US exporters to engage in joint export conduct with other US companies. Certified exporters are virtually immune from all federal and state government antitrust action.

The FSC Appellate Body report pays the subject even less attention: "We note here that special rules apply *inter alia* in the case of agricultural cooperatives, small

[8] There may well be more than one way of achieving this end. Also, there doubtless will need to be modifications for different situations, including ones involving leasing and cooperatives.

FSCs, shared FSCs, FSCs owned by individual rather than corporate shareholders, and transactions involving military property.”

The WTO appears not to be aware of the potential for shared or grouped entities to perform the operations of a true trading company, much like a trading company acting on behalf of Dutch, French or Japanese companies.

MTIS is a FSC-ETI management company that manages solo and shared entities, some of which are “sponsored” by organizations, such as the Delaware Economic Development Office, the Pennsylvania Office of International Trade and the National Association of Manufacturers. Over the last 16 years, MTIS and its subsidiary have helped approximately 500 exporters utilize the relevant benefits. Annually its companies export around $500 million in total. These companies represent a broad spectrum of exporters from small (a couple of million dollars of gross receipts from exports) to medium size (approximately $50 million gross receipts from exports). The items of export range from automobile parts to fishing line, and they include agricultural and forest products.

The Tax Committee of MTIS is represented by Ms. Deborah Fehr-Niswanger (Military Truck Parts, Inc., Many, Louisiana), Brian Ward (Cortland Line Company, Inc., Cortland, New York), and John Andrews (QSC Audio Products, Inc., Costa Mesa, California). Military Truck Parts, Inc. sells and services specialty vehicles including trucks and Hummers. Cortland Line Company, Inc. manufactures and sells fishing line and related equipment. QSC Audio Products, Inc. manufactures, sells and installs professional audio equipment including fully integrated audio systems.

WGA, which is headquartered in Irvine, California, is the largest and most active regional fresh produce trade association in the United States. Its members grow, pack and ship over 90% of the fresh vegetables and 60% of the fresh fruit grown in California and Arizona. The actual items (carrots, tomatoes, broccoli, citrus, lettuce, etc.) number in excess of 250; and they constitute over 50% of the fresh produce grown in the United States. They are shipped throughout Europe and Asia, as well as Canada and Mexico. WGA began creating shared FSCs for its members in 1992. Since that time, it estimates that its members have shipped over $1.5 billion through its shared entities. Approximately 95 companies participate in the WGA export program. The smallest of these has exports of around $400,000.

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