Order Code RS20746
Updated April 4, 2005

CRS Report for Congress

Received through the CRS Web

Export Tax Benefits and the WTO: The Extraterritorial Income Exclusion and Foreign Sales Corporations

David L. Brumbaugh
Specialist in Public Finance
Government and Finance Division

Summary

The U.S. tax code's Foreign Sales Corporation (FSC) provisions provided a tax benefit for U.S. exporters. However, the European Union (EU) in 1997 charged that the provision was an export subsidy and contravened the World Trade Organization (WTO) agreements. A WTO ruling upheld the EU complaint, and to avoid retaliatory tariffs, U.S. legislation in 2000 replaced FSC with a redesigned export benefit, the "extraterritorial income" (ETI) provisions. The EU maintained that ETI was also not compliant, and WTO decisions again supported the EU while approving the EU's request for tariffs. After a delay, the EU began to phase in tariffs on U.S. goods in March 2004.

Congress considered ETI legislation throughout much of 2003 and 2004, and in Spring 2004, both the House and Senate approved versions of legislation that proposed to repeal ETI while implementing a mix of tax benefits for foreign and domestic investment not explicitly related to exports. The House and Senate approved a conference agreement on the legislation in October; the measure became P.L. 108-357. (For a summary of the measure, see CRS Report RL32652, *The 2004 Corporate Tax and FSC/ETI Bill: The American Jobs Creation Act of 2004*.) However, the EU lodged a complaint with the WTO, objecting to the repeal legislation's transition effects. A WTO panel has been established to assess the charge, but has not issued a ruling.

For its part, economic analysis suggests that FSC and ETI do little to increase exports but likely trigger exchange rate adjustments that also result in an increase in U.S. imports; the long-run impact on the trade balance is probably extremely small. Economic theory also suggests that export benefits likely reduce U.S. economic welfare. This report will be updated as events warrant.

History: DISC and the General Agreements on Tariffs and Trade

The FSC/ETI controversy has its roots in the legislative antecedent of both: the U.S. tax code's Domestic International Sales Corporation (DISC) provisions, enacted as part of the Revenue Act of 1971 (P.L. 92-178). Like FSC and the ETI provisions, DISC provided a tax incentive to export, although its design was different in certain respects. It was thought that a tax incentive for exports was desirable in order to stimulate the U.S. economy; to offset the tax code's "deferral" benefit, which posed an incentive for U.S. firms serving foreign markets to produce overseas rather than in the United States; and to offset export benefits other countries were thought to give their firms.[1]

DISC soon encountered difficulties with the General Agreement on Tariffs and Trade (GATT), a trade agreement to which the United States and most of its trading partners were signatories. Members of the European Community (EC) submitted a complaint to the GATT Council arguing that DISC was an export subsidy and therefore contravened GATT. The United States, however, filed a counter-claim, holding that the "territorial" income tax systems of France, the Netherlands, and Belgium themselves conferred export subsidies. Under a territorial tax system, a nation does not tax the income of its corporations if that income is earned by a branch located abroad. A GATT panel issued reports in 1976, finding that elements of both the territorial systems and DISC constituted export subsidies prohibited under GATT.

In 1981, the GATT council adopted the panel's findings, but with an understanding aimed at settling the dispute: countries need not tax income from economic processes that occur outside their borders. Territorial tax systems, in other words, do not by themselves contravene GATT. The understanding also held, however, that arm's length pricing[2] must be used in applying the territorial system to exports. Nevertheless, the controversy continued to simmer. The United States never conceded that DISC was a subsidy, but was concerned that the issue threatened breakdown of the dispute resolution process. To defuse the issue, the U.S. Treasury proposed the FSC provisions. FSC was designed to conform to GATT by providing an export tax benefit incorporating elements of the territorial tax system countenanced by the 1981 understanding. Although the United States does not operate a territorial system (it taxes U.S.-chartered corporations on their worldwide income), it taxes foreign corporations only on their U.S.-source income. Firms availed themselves of the FSC benefit by selling their exports through FSCs that were required to be chartered offshore.

FSC, ETI, and the World Trade Organization

The European countries were not fully satisfied of FSC's GATT-legality. Still, the controversy remained below the surface until November 1997, when the EU requested consultations with the United States over FSC, thereby taking the prescribed first step in

---

[1] U.S. Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1971*, (Washington: GPO, 1972), p. 86.

[2] Arm's length pricing is a method of allocating income between different parts of the same firm that is based on the prices the different parts would charge each other if they were unrelated.

the dispute settlement process established under the new WTO.[3] The United States and the EU held consultations without reaching a solution, and in July, 1998, the EU took the next step in the WTO-prescribed dispute-resolution process by requesting a panel to examine the issue. The panel made its findings public on October 8, 1999.

The panel generally supported the EU, holding that FSC was indeed a prohibited export subsidy, and that FSC violated subsidy obligations under the WTO Agreement on Subsidies and Countervailing Measures. In particular, Articles 3.1 and 1.1 of the Subsidies and Countervailing Measures (SCM) Agreement prohibit subsidies "contingent on export performance" and provide that a subsidy exists if "government revenue that is otherwise due is forgone or not collected ... and a benefit is thereby conferred." The panel found that the FSC provisions carved out particular exceptions to various parts of U.S. tax law that would otherwise have generally resulted in taxation of the FSC export income.[4] The WTO's Appellate Body essentially upheld the initial finding on appeal by the United States. In the United States, replacement legislation was developed to head off retaliatory measures; its basic provisions received bipartisan support in Congress and were supported by the Administration. The final version of legislation revamping the tax benefit was passed by Congress in November 2000 as H.R. 4986, the FSC Repeal and Extraterritorial Income Exclusion Act. The President signed the bill, and it became P.L. 106-519.

Even before the ETI provisions were passed, the EU made known that it was skeptical of their WTO-compatibility and maintained that, like FSC, they provide a tax subsidy that is contingent on exporting.[5] The EU asked the WTO to authorize imposition of $4 billion in tariffs on U.S. products, and asked the WTO to rule on whether the ETI provisions are WTO-compliant. On August 20, 2001, a WTO panel issued a report concluding that the ETI provisions contravene the WTO agreements; the WTO Appellate Body denied a U.S. appeal. On August 30, a WTO arbitration panel authorized the EU to impose up to $4 billion of tariffs on U.S. imports.

In the 107th Congress, Chairman Thomas of the House Ways and Means Committee introduced H.R. 5095, which proposed both repeal of ETI and a range of tax reductions for the overseas business operations of U.S. firms, but the bill was not taken up by the full House. In the 108th Congress, Representatives Crane and Rangel and Senator Hollings introduced a bill (H.R. 1769/S. 970) that would have replaced ETI with a tax benefit linked to domestic U.S. production income rather than to foreign investment. Chairman Thomas introduced H.R. 2896, which contained provisions similar to H.R. 5095 in the 107th Congress, but with the addition of several tax benefits for domestic investment along with the bill's benefits for foreign investment. In October 2003, the Senate Finance Committee approved S. 1637, containing its own mix of benefits, and the House Ways and Means Committee approved H.R. 2896.[6] Congress did not act on the bills in 2003, but in May 2004, the Senate approved an amended version of S. 1637. In the House,

---

[3] For information on the WTO's dispute settlement process, see CRS Report RS20088, *Dispute Settlement in the World Trade Organization: An Overview*, by Jeanne J. Grimmett.

[4] World Trade Organization, *United States — Tax Treatment for "Foreign Sales Corporations": Report of the Panel*, WT/DS108/R (n.p., October 8, 1999), p. 275.

[5] BNA *Daily Tax Report*, November 24, 2000, p. G-1.

[6] For a description and analysis of the bills, see CRS Report RL32066, *Taxes, Exports, and International Investment: Proposals in the 108th Congress*, by David L. Brumbaugh.

Representative Thomas introduced a modified ETI bill as H.R. 4520, and the full House approved the measure on June 17. In July, the Senate prepared the legislation for conference by approving its own version of H.R. 4520, amended to include the tax language of S. 1637 along with tobacco buy-out provisions. (The House bill also contained buy-out provisions.) A conference committee approved a version of the bill on October 6. For its part, the EU indicated it would not apply tariffs as long as the United States made progress towards WTO-compliance. However, in November 2003, it set a deadline of March 2004 and on March 1 began a phased-in application of tariffs on U.S. products. The tariffs began at an initial rate of 5% but were scheduled to increase by 1% each month for a year, reaching a ceiling of 17% in March 2005.[7]

Upon U.S. enactment of legislation phasing out ETI in October 2004, EU officials announced their intent to suspend tariffs in January 2005. They also indicated, however, their intention of lodging a complaint with the WTO regarding the legislation's transition rules providing for a two-year phaseout rather than immediate repeal of ETI and provisions allowing ETI to apply to exports made under existing contracts. On February 17, 2005, a WTO panel was formed, but it has yet to rule on the matter.

How FSC Worked

In general, the United States taxes corporations chartered in the United States on their worldwide income, and ordinarily a U.S. corporation could expect to be taxed on its export income, regardless of whether the income were adjudged to have a foreign or domestic source. In contrast, the United States taxes corporations chartered abroad only on income from the conduct of a U.S. business. U.S. firms used the FSC benefit by selling their exports through specially qualified subsidiary corporations (FSCs) organized abroad. As foreign corporations, FSCs would ordinarily be subject to U.S. tax on the part of their export income determined to be from U.S. sources. However, the FSC rules deem a specified portion of FSC income not to be from the active conduct of a U.S. business, and thus to be exempt from U.S. tax. The size of the FSC benefit resulted from rules governing how much of the FSC's income was tax exempt, and on the rules governing how the combined parent-and-FSC export income was allocated between the two. As a result of these rules, a firm could exempt 15-30% of export income from taxes.

The FSC provisions and its successor are only one of two alternative tax benefits for exporting in the U.S. tax code. The second benefit, known variously as the "sales source rule," the "inventory source rule," or the "export source rule," permits export firms in some cases to exempt 50% of their export income from U.S. tax, but its use is dependent on an exporter possessing a surfeit of foreign tax credits generated by foreign taxes on non-export income. Thus, the sales source rule can be used only by firms that have foreign operations and income that have borne foreign taxes.

---

[7] For further information on the application of tariffs, see CRS Report RS21742, *European Trade Retaliation: The FSC-ETI Case,* by Raymond J. Ahearn.

The Extraterritorial Income (ETI) Exclusion

The ETI provisions provide a tax benefit of the same basic magnitude as FSC: firms can exempt between 15% and 30% of export income from tax using the ETI provisions. The ETI provisions, however, go beyond FSC and also provide their 15-30% tax exemption to a limited amount of income from foreign operations. It is the extension of the exemption to foreign-source income that is apparently designed to incorporate elements of territorial systems and on which the U.S. officials based their belief in the provisions' WTO-compatibility. The mechanics of ETI provisions also differ from FSC. No longer must an exporter sell through a subsidiary to obtain a tax benefit. The ETI benefit results from two rules: one specifies the type of income to which its tax exemption applies; the second dictates the size of the applied tax exemption. The provisions set the scope of tax-favored income by first stating that "extraterritorial income" is exempt from U.S. tax, and go on to define extraterritorial income as income from the sale of property that is sold for use outside the United States. The provisions also stipulate that not more than 50% of the value of qualifying property can be attributable to articles produced abroad and foreign labor costs. Thus, the amount of foreign-source income that qualifies as "extraterritorial" cannot exceed the amount of export income that qualifies. Or, viewed another way, the ETI benefit applies to a firm's exports and a matching amount of its foreign-produced goods. The provisions set the size of the tax exemption by specifying that only part of "extraterritorial income" is tax-exempt. The provisions set forth several percentages and rules that have the effect of limiting the exemption to between 15% and 30% of qualified income, depending on the circumstances of the exporter.

The Economics of FSC and the ETI Provisions

Both FSC and the ETI provisions increase the after-tax return of investment in the export sector and thus attract investment to exporting. As a consequence, U.S. exports are probably higher than they would be without the provisions. How much higher depends on the extent to which export supply increases in response to the tax benefit (that is, how much of the tax benefit U.S. suppliers pass on to foreign consumers as lower prices) and on how responsive foreign consumers are to the reduced prices.

Beyond this effect, however, traditional economic theory indicates that the export benefits produce effects that are perhaps surprising to non-economists. First, because of exchange rate adjustments, the FSC/ETI-induced increase in exports is diminished, and U.S. imports also are increased; sales of U.S. import-competing industries thus fall. Economic theory indicates that while the provisions increase the overall level of U.S. trade, they do not change the balance of trade or reduce the U.S. trade deficit. The adjustments work as follows: the tax benefits increase foreign purchases of U.S. exports, but to buy the U.S. products, foreigners require more dollars. The increased demand for U.S. dollars drives up the price of the dollar in foreign exchange markets, making U.S. exports more expensive. This partly offsets the effect FSC and ETI have in increasing U.S. exports, but it also makes imports to the United States cheaper, which causes U.S. imports to increase. The result is a higher level of both imports and exports, but no change in the balance of trade. This result is better seen by stepping back from the exchange rate mechanisms and recognizing that when a country runs a trade deficit, it is using more goods and services than it produces. To do so, it must necessarily borrow from abroad by importing more foreign investment than it exports. A country's trade deficit, in other words, is mirrored by a deficit on capital account. And a country's trade balance changes only if the balance on capital account changes. Thus, if we assume that the export benefits do not change the balance on capital account, they cannot change the trade balance.

The export benefits also affect U.S. economic welfare. Traditional economic analysis indicates that they reduce overall U.S. economic welfare because at least part of the tax benefit is passed on to foreign consumers in the form of lower prices. This price reduction can be viewed as a transfer of economic welfare from U.S. taxpayers in general to foreign consumers. These effects, however, are probably not large. According to CRS estimates based on 1996 data, FSC increased the quantity of U.S. exports by a range of two-tenths of 1% to four-tenths of 1% and increased the quantity of imports by a range of two-tenths of 1% to three-tenths of 1%. The shift of economic welfare to foreign consumers is equal to an estimated one-tenth of 1% of exports.[8] The impact on the trade balance was probably negligible. The Joint Committee on Taxation has estimated ETI's cost in forgone tax revenue at $4.8 billion for FY2003.

The ETI provisions introduce a new wrinkle to this economic analysis, but probably not a large one: their extension to a limited amount of foreign-source income likely provides a tax incentive for some exporters to increase their overseas investment. The size of this new incentive, however, is probably not large, because of several factors. First, the amount of foreign-source income that receives the benefit is limited by a firm's exports. Second, existing U.S. tax law provides an alternative tax benefit for investing abroad in the form of an indefinite deferral of U.S. tax on income reinvested abroad by foreign subsidiaries of U.S. companies. For some exporters, this deferral benefit is probably larger than that available under the ETI provisions. If economic analysts are generally critical of tax benefits like FSC and ETI, support for them can be found in the business community. A reason for the divergence in views may be perspectives: economic analysis looks at the benefits' impact from the perspective of the economy as a whole, attempting to account for its full range of effects and adjustments in all markets. Supporters of the provision, however, are frequently businessmen whose exporting firms would likely face declining sales, profits, and employment if provisions were to be eliminated. For economists, there is no denying that FSC and ETI boost employment and increase incomes in certain sectors of the economy. But it also results in contraction of other parts (for example, firms that compete with imports) and transfers economic welfare to foreign consumers.

FSC and the ETI provisions have also been defended on the grounds that they counter subsidies provided to foreign producers by their own governments. A purported subsidy that is sometimes cited is the practice among European (and other) countries of rebating the value-added taxes (VATs) that would otherwise apply to export sales. However, from an economic perspective such "border adjustments" do not distort trade and are in fact necessary if exported goods are to be part of the same relative price structure as other goods in the importing country. In addition, U.S. sales and excise taxes do not apply to exports, while European countries do not have a formal system for forgiving corporate income tax on exports. (However, under territorial tax systems, lax administration of transfer pricing rules may result in export subsidies.)

---

[8] CRS Report RL30684, *The Foreign Sales Corporation (FSC) Tax Benefit for Exporting: WTO Issues and an Economic Analysis,* by David L. Brumbaugh.