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FSC/ETI Transition Relief in the New JOBS Act: Does the U.S. Have to Quit Cold Turkey?

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Introduction

The U.S. policy on taxing exports has taken more twists and turns than a movie by M. Night Shyamalan. The American Jobs Creation Act (a.k.a. "JOBS Act" or "FSC/ETI repeal") recently passed by Congress was supposed to be the last scene of the movie. Like a villain in a bad horror thriller, however, the export tax issue just will not die. The European Union (EU) challenged the transition relief in the JOBS Act (soon after its passage) as a violation of World Trade Organization (WTO) law.[1] Though the U.S. has tried to block the challenge, it is almost certain that a new WTO panel will review and rule on the transition relief by the end of the year.

The JOBS Act eliminated Extraterritorial Income (ETI) tax benefits that the WTO had branded as illegal export subsidies. The JOBS Act allowed those benefits to continue, however, for certain companies that entered into contracts for long-term sale, lease and delivery of goods and services. The JOBS Act also slowly phases out ETI benefits over a two-year period, meaning that new transactions can still partially benefit from ETI benefits until full repeal in 2007.

Despite the reasonableness of these measures from a U.S. tax policy perspective, the EU is challenging the transition relief as a separate violation of WTO law. Some U.S. lawmakers, like Senator Max Baucus (D-MT), think the EU will use this new challenge as leverage in a separate WTO dispute over EU subsidies for Airbus Industries.[2]

Based on previous WTO decisions on transition relief, it seems likely that the EU will prevail. If the U.S. fails to persuade the WTO that the transition relief is legal, the EU could re-impose trade sanctions on U.S. goods sold in Europe, putting us back to square one with regard to making our export tax policy competitive with Europe. Although this would be unfortunate, Congress would do well to respond by accelerating the tax cuts in the JOBS Act and otherwise seek to shield U.S. exporters (and all U.S.-based companies) from the potential damage of an adverse WTO decision on transition relief.

A Synopsis of the Problems with U.S. Export Tax Policy

The Foreign Sales Corporation (FSC) and Extraterritorial Income (ETI) tax regimes, like

[1] *See* United States — Tax Treatment for "Foreign Sales Corporations", WT/DS108/29, Request for the Establishment of a Panel, January 14th, 2005.

[2] *See* Joe Kirwin, Alison Bennett, and Daniel Pruzin, "EU to End Sanctions in Wake of Export Bill But Plans Appeal of Grandfather Provisions," *International Trade Reporter Current Reports* (October 28, 2004) ("Senate Finance Committee ranking Democrat Max Baucus (Mont.) openly criticized the plan to appeal, however, and said the European Union is simply trying to gain political points in a separate dispute over subsidies to Boeing.").

the former Domestic International Sales Corporation (DISC), were intended to offset the perceived disadvantage that U.S. firms face when they sell abroad. This disadvantage comes principally from two factors. First, the U.S. generally taxes the worldwide income of a resident corporation, while European countries generally tax only income earned inside national borders (a territorial tax system). Second, U.S. exports into the EU are charged a value added tax (VAT) while EU products shipped to the U.S. are not because the U.S. does not levy one and because the EU exempts its own exports from VAT taxation. This gives a distinct advantage to EU exports to the U.S. not enjoyed by U.S. exports to the EU.

These two factors, U.S. lawmakers have consistently argued, create disadvantages for U.S. exporters and make remedial legislation like DISC, FSC and ETI necessary. Despite warnings from economists that export subsidies, whether illegal or not, do little to enhance productivity and economic growth,[3] Congress has forged ahead with four separate measures in the past thirty years to bolster export performance.

DISC was enacted in the early 1970s, and allowed a parent corporation to set up a DISC subsidiary, separately incorporated in the United States, which would sell the parent's exports.[4] Export income could be assigned to the DISC, which was itself tax-exempt. DISCs and their parent corporations were also subject to looser transfer pricing rules, allowing export income to be transferred to the parent corporation in a way that generated a tax benefit. In addition to boosting international competitiveness, DISC allowed a domestic manufacturer to have the same export benefits enjoyed by U.S. corporations with foreign subsidiaries.

Through a series of challenges and disputes, GATT ultimately held that DISC was an illegal export subsidy.[5] GATT also held, at the urging of the U.S., that territorial tax systems were also illegal subsidies unless accompanied by reasonable transfer pricing rules.[6] Both rulings were subject to an official understanding that countries do not have to tax income earned outside their own borders.[7] Despite this ruling and Understanding, the U.S. and the European Community (EC) could not come to a political agreement on the future of DISC and territorial taxation.

The U.S. enacted the FSC regime in 1984 as an alternative to the DISC regime.[8] FSC allowed a parent corporation to create a subsidiary, incorporated in a foreign country, to which the corporation could assign a portion of its foreign-source income from exports. The parent could then fully deduct the dividends received from the FSC subsidiary from its U.S. taxable income. The major difference between FSC and DISC was that the DISC subsidiary had to be incorporated in the U.S., while the FSC subsidiary was incorporated abroad. This system approximated the territorial tax system commonly used in Europe without actually changing the U.S. to a territorial tax system, since foreign-sourced income from a non-FSC subsidiary would continue to be fully taxed by the U.S.

The EU waited thirteen years to challenge FSC as an illegal export subsidy under WTO law (see Table 1 for a chronology of the DISC/FSC/ETI controversy). The EU argued that FSC granted "subsidies contingent in law upon export performance" in violation of the Agreement on Subsidies and Countervailing Measures (SCM Agreement).[9] The SCM Agreement itself was new and, presumably, gave the EU new legal ammunition to challenge U.S. export tax benefits. Specifically, the EU alleged

3 *See* William Orzechowski, "Border Tax Adjustments and Fundamental Tax Reform," *Tax Foundation Background Paper,* No. 39 (November, 2001).
4 *See* Revenue Act of 1971, Pub. L. No. 92-178, § 501, 85 Stat. 935 (prior to all amendments).
5 *See* United States Tax Legislation (DISC), November 12, 1976, GATT B.I.S.D. (23rd Supp.) at 98 (1981).
6 *See, e.g.,* Income Tax Practices Maintained by France, November 12, 1976, GATT B.I.S.D. (23rd Supp.) at 114 (1981); Income Tax Practices Maintained by Belgium, November 12, 1976, GATT B.I.S.D. (23rd Supp.) at 127 (1981); Income Tax Practices Maintained by The Netherlands, November 12, 1976, GATT B.I.S.D. (23rd Supp.) at 137 (1981).
7 *See* Tax Legislation, GATT B.I.S.D., (28th Supp.) at 114 (1981).
8 *See* Deficit Reduction Act of 1984, § 801(a), 26 U.S.C. §§ 921-927 (1984) (repealed 2000).

Table 1: Historical Chronology of the DISC/FSC/ETI Dispute

Date	Event
1947	General Agreement on Tariffs and Trade (GATT) created
December 1971	Domestic International Sales Corporation (DISC) signed into law by President Nixon
February 1972	European Community (EC) requests consultations with U.S. on legality of DISC; U.S. requests consultations with Netherlands, France, Belgium on legality of their territorial tax systems
May 1973	EC and U.S. file formal complaint with GATT over DISC and territorial tax systems; GATT forms panels
November 1976	GATT panel report declares: 1) DISC is an illegal export subsidy; 2) the existence of a subsidy in the EC does not justify the existence of DISC; 3) territorial tax systems without reasonable transfer pricing rules subsidize export sales
1976-1981	Disagreement between EC, U.S. over DISC panel report; U.S. willing to give up DISC in exchange for territorial tax system changes suggested by panel report; EC not willing to make territorial tax changes
1978	President Carter proposes unilateral DISC repeal but withdraws proposal after criticism
December 1981	DISC panel report adopted by GATT, subject to an Understanding that: 1) countries do not have to tax transactions occurring outside their borders; 2) arm's length pricing should be standard practice in assigning income to related entities; 3) GATT does not forbid measures to alleviate double-taxation of foreign-source income
1982	EC, U.S., debate whether DISC meets the requirements of the Understanding
1982-1984	U.S. sees little hope of winning DISC dispute; Foreign Sales Corporation (FSC) regime developed as alternative
August 1984	President Reagan signs FSC into law
January 1 1995	WTO replaces GATT (with new Agreement on Subsidies and Countervailing Measures clarifying prohibited export subsidies)
November 1997	EU begins process of challenging FSC under WTO law by requesting consultations with the U.S.
December 1997	
February 1998	
April 1998	EU and U.S. hold talks to settle the dispute over FSC
July 1998	EU claims talks unsatisfactory and officially requests the formation of a panel to review legality of FSC
October 1999	WTO panel holds that FSC is an illegal export subsidy, orders U.S. to repeal FSC by October 1, 2000; U.S. appeals panel decision
February 2000	WTO appellate body upholds panel decision
October 2000	U.S. requests that it have until November 1, 2000, to repeal FSC; extra time granted
November 2000	ETI signed into law by President Clinton
	EU expresses its sense that ETI is a prohibited export subsidy, and requests consultations with the U.S.
December 2000	EU and U.S. hold talks to settle the dispute over ETI
	EU claims talks unsatisfactory and officially requests the formation of a panel to review legality of ETI
August 2001	WTO panel holds that the ETI is an illegal export subsidy and that U.S. has not complied with October, 1999 panel decision
October 2001	U.S. appeals panel decision on ETI
January 2002	WTO appellate body upholds panel decision on ETI
August 2002	WTO arbitrator rules that EU may levy over $4 billion in retaliatory sanctions against the U.S. due to failure to withdraw FSC/ETI
March 2004	EU begins imposition of retaliatory trade sanctions
October 2004	JOBS Act signed into law by President Bush
November 2004	EU expresses its sense that the transition relief in the JOBS Act has failed to fully withdraw the FSC/ETI benefits and requests consultations with the U.S.; EU withdraws retaliatory sanctions pending outcome of talks on transition relief
January 2005	EU claims talks unsatisfactory and officially requests that the WTO declare that the transition relief in the JOBS Act has not fully withdrawn the illegal FSC/ETI benefits
	U.S. blocks EU request for panel

Source: David L. Brumbaugh, "A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy," Congressional Research Service (November 9, 2004).

[9] *See* United States — Tax Treatment for "Foreign Sales Corporations," WT/DS108/R, Report of the Panel, ¶ 3.2(a), October 8, 1999. Specifically, the EU charged that the FSC regime violated Articles 3.1(a) and 3.1(b) of the SCM Agreement as well as other violations of WTO rules on agricultural subsidies.

[10] *See* Agreement on Subsidies and Countervailing Measures, Article 1.1(a)(1)(ii), Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Results of the Uruguay Round of Mulitlateral Trade Negotiations: The Legal Texts 264 (1994) ("SCM Agreement").

that FSC illegally exempted export-related income that was "otherwise due"[10] and in doing so conferred a benefit on U.S. exporters in violation of the SCM Agreement.

The WTO panel sided with the EU, ruling that a carve-out of foreign-source income attributable to exports from a worldwide income taxation system was still a prohibited subsidy, contingent on export performance, even if countries were free to generally adopt systems that taxed only territorial income.[11]

In response, the U.S. repealed FSC and replaced it with the Extraterritorial Income Exclusion (ETI) regime.[12] This was an attempt to exclude all foreign-sourced income, not just income attributable to exports, from the U.S. tax base. This, it was hoped, would reduce the likelihood that the ETI regime would run afoul of the WTO restriction on foregoing tax revenue that would be "otherwise due" and granting subsidies "contingent on export performance."[13] ETI generally tried to exclude all extraterritorial income from the U.S. tax base, but made certain exceptions.

Despite these changes, the EU immediately challenged ETI as a violation of WTO trade law. The arguments made against the ETI system were similar to those made against FSC: that ETI gave illegal subsidies to U.S. corporations and the subsidies were contingent on export performance.[14] The EU also charged that the ETI, among other things, gave tax preference to the use of domestic goods in production.[15] Generally, the EU argued that ETI imposed so many conditions on the availability of ETI exemptions that in reality it was an export subsidy.

The WTO panel once again agreed with the EU charges against ETI. The panel decision was once again upheld on appeal, despite the arguments of the U.S. that, if a country need not tax income earned from foreign sources, as the 1981 Understanding declared, then carving out foreign-source income from an otherwise worldwide tax system was appropriate as well.[16]

The U.S. delayed addressing the WTO ruling on ETI, and the EU indicated that it would impose retaliatory tariffs if a legislative response were not adopted quickly. The EU ran out of patience in 2004 and began phasing in WTO-sanctioned retaliatory tariffs that would eventually have totalled over $4 billion.[17] This spurred the U.S. Congress to pass legislation to provide export relief but also comply with the WTO rulings on FSC/ETI.

The American Jobs Creation Act of 2004 (JOBS Act) was signed into law by President Bush on October 22, 2004.[18] The JOBS Act repealed ETI and replaced it with a cacophony of tax provisions benefiting U.S. domestic production, chiefly a corporate tax deduction for U.S.-based manufacturing (see Table 2 for a more specific breakdown of JOBS Act tax relief). The JOBS Act also contained a number of tax and fee increases, including different tax treatment of certain leasing transactions and extension of certain Custom User fees. The JOBS Act overall was expected to reduce federal tax revenues by approximately $8.5 billion over ten years.

The EU accepted all the changes in the JOBS Act except for two: the gradual phase out of ETI and the grandfathering of certain contracts under the old ETI system. The EU requested consultations with the U.S., a precursor to a formal challenge that the transition relief in the

[11] *See* id. at ¶ 7.102-7.103.

[12] *See* FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, 114 Stat. 2423 (2000).

[13] *See* SCM Agreement, supra note 10, at Article 3.1(a).

[14] *See* United States — Tax Treatment for "Foreign Sales Corporations," Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, ¶ 3.1(a)-(b), August 20, 2001.

[15] *See* id. at ¶ 3.1(e).

[16] United States — Tax Treatment for "Foreign Sales Corporations"—Appellant Submission of the United States, ¶ 11, November 1, 2001.

[17] *See* David L. Brumbaugh, *A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy,* Congressional Research Service (November 9, 2004), http://www.taxhistory.org/thp/readings.nsf/0/d1e0dcc337b8048385256f860068159e?OpenDocument.

[18] Pub. L. No. 108-357, 118 Stat. 1418 (2004).

[19] *See* United States — Tax Treatment for "Foreign Sales Corporations," — Second Recourse by the European Communities to Article 21.5 of the DSU, WT/DS108/27, Request for Consultations, November 10, 2004.

Table 2: Revenue Impacts of Major Provisions of the JOBS Act ($Millions)

Provision	2005-2014
Repeal of ETI exclusion	$49,199
U.S.-based manufacturing deduction	($76,509)
Straight-line depreciation for certain leaseholds	($1,523)
Repeal of 4.3.-cent excise taxes on railroad and inland waterway fuel	($1,532)
Pay all excise tax credits from general fund	$5,890
Interest expense allocation rules	($14,376)
Recharacterize overall domestic loss	($5,585)
Base differences and certain foreign credit adjustments	($7,862)
Foreign tax credit carryforward/carryback	($2,126)
Deduction of state and local sales taxes	($4,995)
Reform tax treatment of certain leasing transactions	$26,560
Extension of certain custom user fees	$18,614

Source: Joint Committee on Taxation (JCX-69-04).

JOBS Act violates WTO law.[19] After talks with the U.S. in Geneva stalled, the EU formally requested that the WTO form a panel to declare the transition relief illegal.[20]

WTO Law on Transition Relief

WTO law contains few rules on transition relief, and disputes on transition relief have arisen in few WTO cases. Article 4.7 of the SCM Agreement requires countries to withdraw prohibited subsidies "without delay," but it also requires that a dispute panel shall specify the "time-period within which the measure must be withdrawn." A note to the agreement says the time-period for withdrawal of prohibited subsidies may be extended by mutual agreement of the parties.[21]

In a dispute between Canada and Brazil over the Brazilian export financing system for aircraft, a WTO appellate panel had an opportunity to expound on what it meant to withdraw a prohibited subsidy.[22] The appellate panel, citing the *Oxford English Dictionary* and *Black's Law Dictionary,* said that withdraw "…has been defined as remove or take away, and as to take away what has been enjoyed; to take from."(internal quotations omitted).[23] Applying this standard to the case of the Brazil aircraft export financing system, the appellate body ruled that Brazil had not taken away its prohibited subsidies since it continued to provide the subsidy to commitments firms had made prior to a certain date (i.e. Brazil had grandfathered in certain contracts made before the date of its prospective repeal of the prohibited subsidies).

The issue of transition relief was also important in the WTO dispute between the EU and the U.S. over the ETI tax regime. In switching from the FSC to the ETI system, the U.S. provided a transition phase where U.S. corporations could continue to benefit from the FSC subsidies for approximately one year while the new ETI system was implemented. In the case of long-term binding contracts entered into by U.S. corporations before the FSC repeal, the ETI legislation permitted FSC subsidies to continue indefinitely.[24]

The EU argued that this transition relief violated Article 4.7 of the SCM as well as the WTO panel's decision that the FSC regime was an illegal export subsidy that had to be withdrawn by November 1, 2000.[25] The U.S. defended the transition relief, arguing that private U.S. corporations had entered into binding contracts in

20 *See* WT/DS108/29, supra note 1. Some have argued that contracts covered by FSC/ETI that deal with the delivery of services are outside the scope of GATT and thus within the proper scope of FSC/ETI benefits. See Letter from Chuck Grassley, United States Senator, to Pascal Lamy, Member of the European Commission (Nov. 18, 2004) (on file with author) ("…to the extent these contracts are leases they are not implicated by the WTO decisions on FSC/ETI. Leasing is a service and the WTO decisions do not address services."). This argument, however reasonable, is beyond the scope of this study, which is concerned with the transition relief itself and not the substance of the contracts covered by the transition relief.

21 *See* SCM Agreement, supra note 10, at note 20.

22 *See* Brazil—Export Financing Program for Aircraft—Recourse by Canada to Article 21.5 of the DSU, WT/DS46/AB/RW, July 21, 2000.

23 *See* id. at ¶ 45 (internal quotations omitted).

24 *See* FSC Repeal and Extraterritorial Income Exclusion Act of 2000, supra note 12, at § 5.

25 *See* WT/DS108/RW, supra note 14, at ¶ 8.164-8.165.

reliance on the FSC regime and fairness dictated that they not be punished for relying on heretofore valid U.S. tax law, particularly when taking into account that thirteen years had elapsed between the U.S. enactment of FSC and the EU challenge of FSC.[26] The ETI panel agreed with the EU, relying on the text of Article 4.7 of the SCM as well as the previous decision concerning Brazil's export financing program for aircraft.[27]

The U.S. appealed the decision. The WTO appellate panel upheld the ruling on transition relief, and responded more bluntly than the lower panel to the U.S. claim that transition relief was appropriate because of the settled expectations of private parties:

> "…a Member's obligation under Article 4.7 of the *SCM Agreement* to 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, under Article 4.7 of the *SCM Agreement,* cannot be affected by contractual obligations 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."[28]

The transition provisions in the JOBS Act mirror those in the ETI Act. One set of provisions incrementally phases out ETI exclusions in 2005 and 2006.[29] Another transition rule allows ETI benefits to continue for binding contracts entered into before September 17, 2003.[30] These two provisions led to the EU's request for consultations with the U.S. and are almost identical to the transition provisions in the original ETI bill already invalidated by the WTO.

The Legitimacy of Transition Relief

In the appeal of the WTO panel decision declaring ETI an illegal export subsidy, the U.S. brief urged the court to allow for reasonable transition relief from illegal to legal export subsidies.[31] The U.S. did not rely on a particular provision of WTO law, or a prior decision in a dispute, but asked the appellate body to interpret Article 4.7 of the SCM to allow for an "orderly shift" from one tax system to another.[32] The U.S. argued that transition relief is typical when the U.S. changes its own tax system and that abrupt changes cause uncertainty for taxpayers and create unacceptable transaction costs for private parties.[33]

Article 4.7 does seem open to the U.S. conclusion. While the text of 4.7 says that prohibited subsidies shall be withdrawn "without delay," it also says that the panel "…shall specify in its recommendation the time-period within which the measure must be withdrawn."[34] Note 20 also allows the parties in a dispute to extend the time period for withdrawal by mutual agreement, though mutual agreement on this issue has not yet been reached between the EU and U.S. Thus, WTO law indicates that there is some latitude in scheduling the elimination of a prohibited subsidy.

In fact, when a WTO panel declared FSC to be a prohibited subsidy on October 8, 1999, it recognized that the legislative changes required to repeal FSC would take at least a year or more to implement (particularly if the U.S. appealed the panel decision), and allowed the U.S. until

26 *See* id. at ¶ 8.166.
27 Id. at ¶ 8.170.
28 *See* United States—Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/AB/RW, ¶ 230, January 12, 2002.
29 American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 101(d)(1)-(2), 118 Stat. 1418 (2004).
30 *See* id. at § 101(f).
31 *See* United States—Tax Treatment for "Foreign Sales Corporations"—Appellant Submission of the United States, § 4(G), November 1, 2001.
32 *See* id. at ¶ 262.
33 Id. at ¶ 265.
34 *See* SCM Agreement, supra note 10.
35 *See* WT/DS108/R, supra note 9, at ¶ 8.8.
36 *See* id.

October 1, 2000, to repeal the FSC subsidies.[35] The panel noted that this was the first "practicable" date that the U.S. could make the change.[36] This still leaves room for transition-related issues to play a part in the repeal of subsidies that the WTO has prohibited.

There are also good policy reasons for WTO panels to allow nations to provide reasonable transition relief while repealing prohibited export subsidies.

One policy argument in favor of transition relief is the reliance of the private sector on the previous FSC and ETI tax regimes. Many U.S. corporations entered into long-term contracts at least partly based on the future availability of benefits under FSC and ETI. Removing these benefits changes the rules in the middle of the game, and it could make delivery on those contractual obligations much more difficult. It is likely that some firms will have to restate their earnings to take into account the lack of future FSC/ETI benefits under existing contracts, an action that could lead to lower stock prices.[37]

This was particularly important in the case of FSC, which was in place for more than a decade before the EU challenged it as a prohibited export subsidy. If FSC was accepted as a perfectly valid export tax system for more than ten years, it made little sense for the WTO to disallow reasonable transition rules out of that system and insist that the U.S. quit FSC cold turkey.

To do otherwise has the effect of making retroactive changes in law. Avoiding retroactive tax policy is one of the fundamental aspects of a well-designed tax system:

> "In making their decisions, taxpayers must … be able to rely on their reasonable interpretation of the tax law. While the law is always subject to change, taxpayers must have confidence that such changes will apply on a prospective basis only and not be applied retroactively to activities previously undertaken."[38]

Legislation passed in 1996 barred the Internal Revenue Service (IRS), with certain exceptions, from enacting regulations that retroactively applied to taxpayers.[39] The major exception in the legislation was a measure by the IRS to prevent taxpayer abuse.[40] Retroactive tax law changes should be reserved to those situations where taxpayers are abusing the system by taking unreasonable positions that violate the text or intent of tax laws. Retroactive changes should not apply to those situations, like contracts enacted in reliance on the FSC/ETI system, where the taxpayer made a good faith reliance on a provision of U.S. tax law long believed to be compliant with WTO law.[41]

A second policy argument is the length and intensity of this dispute. The WTO should consider the history of the dispute, dating back to the DISC system enacted in the early 1970s, and the length of time between the enactment of FSC and the EU challenge. The United States has consistently tweaked its tax system to address the concerns of the EU while still maintaining its sovereign decision to tax worldwide income. The 1981 Understanding also explicitly states that a country may, in its discretion, tax or not tax income earned from foreign operations.[42]

The U.S. made a good faith reliance on this understanding when it enacted the FSC regime in 1984. It also did so when it enacted ETI, which sought to remove, in most instances, all

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37 For an example of how this is particularly important for long-term lease contracts, *see* Statement of Coalition of Service Industries, infra note 41, at 9.

38 *See* J.D. Foster, Ph.D., "Sound Tax Policy v. Retroactivity," *Tax Foundation Extra Point* (August 1997).

39 *See* Taxpayer Bill of Rights of 1996, Pub. L. No. 104-168, §1101, 1101 Stat. 1452, 1468 (1996).

40 *See* id. at § 1101(b)(3) ("The Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.").

41 A statement in Congress by the Coalition of Service Industries also claims that retroactive tax provisions—which a FSC/ETI repeal without the grandfathering of existing contracts would be—are usually reserved for tax positions considered to be "abusive" and not for benefits received pursuant to legitimate tax provisions of the U.S. code. See The Role of the Extraterritorial Income Exclusion Act in the International Competitiveness of U.S. Companies: Hearing Before the Committee on Finance of the United States Senate, 107th Cong. 92 (2002) (statement of Coalition of Service Industries).

42 *See* Tax Legislation, supra note 5.

foreign-sourced income (whether related to exports or not) from the U.S. tax system. It strains credibility to maintain, as the EU and WTO do, that the U.S. must not only eliminate this tax system, which partially excludes foreign-based income from U.S. taxation, but must also do so immediately, with no allowance for reasonable transition relief into the new system.

Conclusion

The U.S. can make reasonable arguments in favor of transition relief out of the FSC/ETI system, based on the text of the SCM and policy arguments favoring such an interpretation. Given the U.S. track record in arguing these issues in the WTO, however, the EU will likely prevail. The WTO will then attempt to force the U.S. to eliminate both the continuing FSC/ETI benefits for contracts enacted prior to the repeal as well as the gradual phase outs of other FSC/ETI benefits. U.S. failure to comply with this ruling could lead to a re-imposition of EU retaliatory sanctions against U.S. exports.

Thus, a WTO ruling against the transition relief in the JOBS Act will force the U.S. to revisit the JOBS Act. While the transition relief will most likely have to be eliminated, the affected companies could be compensated if Congress were to accelerate, and perhaps enhance, the other tax reductions scheduled in the JOBS Act. In particular, Congress could accelerate the phase-in of the deductions for qualified production activities income, not scheduled to be fully implemented until 2009.[43] Congress should also consider making the tax relief available to all U.S. corporations, not just those industries heavily engaged in manufacturing (a proxy for export-intensive).

In the future, U.S. negotiators need to insist that WTO panels take reasonable transition relief into account when making decisions on the time frame for eliminating prohibited subsidies. The U.S. also needs to insist that the SCM agreement be changed to allow for reasonable transition relief when eliminating prohibited export subsidies. If the U.S. has official policy prohibiting retroactive tax regulations by the IRS, then it owes its own taxpayers a duty to fight for the same standards in WTO law.

One of the lessons we should learn from this entire saga is that piecemeal tax reform can often have disastrous results. The U.S. tinkering with its tax system to give exporters a benefit gave the EU and the WTO an obvious chance to cry foul over export subsidies. More fundamental tax reform would help alleviate these types of challenges in the WTO. In this regard, one is hopeful that President Bush's Tax Reform Panel will study the impact that the U.S. tax code has on the international competitiveness of U.S. exports.

[43] *See* American Jobs Creation Act, supra note 29, at § 102(a).

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