UNITED STATES – TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS": SECOND RECOURSE TO ARTICLE 21.5 OF THE DSU BY THE EUROPEAN COMMUNITIES

WT/DS108

FIRST WRITTEN SUBMISSION OF THE UNITED STATES OF AMERICA

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US – FSC (Article 21.5) (Panel)	Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations" – Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/RW, adopted 29 January 2002, as modified by the Appellate Body Report, WT/DS108/AB/RW
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I. INTRODUCTION

1. It is with regret that the United States makes this written submission. In the *American Jobs Creation Act of 2004* ("AJCA"),[1] the United States repealed the income tax exclusion provided for in the *Extraterritorial Income Exclusion Act of 2000* ("ETI Act"). However, the European Communities ("EC") has sought to prolong this dispute by challenging the transition provisions contained in the AJCA – specifically, sections 101(d) and (f). The EC has done so notwithstanding the fact that these transition provisions are reasonable, are consistent with standard practice regarding major tax legislation, and are the product of close consultations between U.S. and EC officials.

2. Be that as it may, the EC's claims are unfounded. As demonstrated below, the transition provisions of the AJCA are not inconsistent with Article 4.7 of the *Agreement on Subsidies and Countervailing Measures* ("SCM Agreement") because, in the prior proceeding under Article 4 of the SCM Agreement and Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("DSU"), there was no recommendation or ruling, pursuant to Article 4.7, by the Dispute Settlement Body ("DSB") that the ETI Act tax exclusion should be withdrawn. Thus, while the United States has repealed the ETI Act tax exclusion, in the absence of any recommendation or ruling of withdrawal under Article 4.7, this Panel cannot find that the United States has failed to comply with a DSB recommendation or ruling to withdraw its prohibited subsidies within the meaning of Article 4.7 of the SCM Agreement.

3. In this submission, the United States first will describe the purpose of the transition provisions, and the process by which these provisions were developed. Thereafter, the United States will present its legal arguments.

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[1] Exhibit EC-1.

II. FACTUAL BACKGROUND

4. The purpose of transition provisions, such as sections 101(d) and (f) of the AJCA, is to provide a smooth and orderly transition in order to prevent the repeal of tax legislation from having a retroactive effect on taxpayers who entered into arrangements in reliance on pre-repeal law. As such, this basic principle of non-retroactivity is similar to the principles of "legal certainty" and "legitimate expectations" that play such an important role in the legal regimes of many WTO Members.

5. The rules embodied in sections 101(d) and (f) are consistent with the transition rules that are typically included in major U.S. tax legislation. Section 101(d) – the general transition provision – provides for a two-year phase out of the ETI Act tax exclusion. Section 101(f) – the "grandfather" provision – exempts certain pre-existing binding contracts from the repeal of the ETI Act tax exclusion.

6. During the development of the AJCA, U.S. officials consulted closely with officials of the European Communities at all levels. U.S. officials explained the types of transition rules that are standard in U.S. tax legislation, and emphasized that such rules were essential in order to obtain Congressional passage of the repeal of the ETI Act tax exclusion.

7. With respect to the general transition provision, the EC stated that its primary concern was that the transition period not exceed two years. Although there were legislative proposals then pending for transition periods as long as five years, Congress accommodated the EC's concerns by limiting the transition period to two years, and by reducing the amount of the tax

exclusion in each year. Congress did so with the understanding that, together with repeal, limiting the transition period to two years would resolve the dispute.

8. With respect to the grandfather provision of section 101(f), the EC officials never indicated to U.S. officials that they had a problem with a grandfather provision *per se*. In the AJCA, Congress limited the grandfather provision to certain transactions that occur pursuant to a binding contract (1) between the taxpayer and an unrelated party (2) entered into before September 17, 2003, and (3) which has been binding on both parties at all times since that date. Congress chose September 17, 2003, because that was the date legislation to repeal the ETI Act was submitted in the U.S. Senate. Because legislation to repeal the ETI Act tax exclusion previously had been submitted in the U.S. House of Representatives, as of September 17, 2003, taxpayers were on notice that there was legislation in both houses of Congress to repeal the ETI Act tax exclusion and that, when entering into new contracts, they no longer could count on the continued existence of the ETI Act tax exclusion. Adoption by the AJCA of an earlier date also would have been inconsistent with common practice regarding tax legislation that effectuates major changes in tax law. In any event, the cut-off date of September 17, 2003, significantly limited the availability of the grandfather provision, because the AJCA was not enacted until October 22, 2004.

9. Sections 101(d) and (f) did not contain any surprises for the EC. Each element of these provisions was contained in either the House or Senate versions of the legislation, and each element had been explained to EC officials prior to passage of the AJCA. In particular, by limiting the general transition period to two years, Congress accommodated what EC officials

had indicated was their primary concern. In so doing, Congress understood that this would resolve the dispute. Regrettably, however, the EC has chosen to prolong the dispute.[2]

III. LEGAL ARGUMENT

A. In the Absence of Any Recommendation of Withdrawal under Article 4.7, this Panel Cannot Find that the United States Has Failed to Withdraw Its Prohibited Subsidies Within the Meaning of Article 4.7 of the SCM Agreement

10. In commencing this proceeding against sections 101(d) and (f) of the AJCA, the EC, as it did in the first Article 21.5 proceeding, has alleged that the United States has "failed to implement the DSB's recommendations and rulings, as specified by the DSB on 20 March 2000 and on 29 January 2002" because it has "failed to withdraw its prohibited subsidies as required by Article 4.7 of the SCM Agreement."[3] However, the United States has not failed to comply with the DSB's recommendations and rulings, and the transition provisions of the AJCA are not inconsistent with Article 4.7 of the SCM Agreement, for the simple reason that, as explained below, there was no DSB recommendation or ruling under Article 4.7 to withdraw the subsidy insofar as the ETI Act tax exclusion is concerned.

11. This dispute began with an EC challenge to the Foreign Sales Corporation ("FSC") provisions of U.S. tax law. The original Panel found that the FSC provisions constituted export subsidies that were prohibited by Articles 3.1(a) and 3.2 of the SCM Agreement.[4] Pursuant to Article 4.7 of the SCM Agreement, the original Panel recommended that the United States

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[2] While the United States is not in a position to speculate on the EC's reasons for prolonging this dispute, such speculations have appeared in the press. *See Lamy Links Airbus Case to EU Willingness to Accept FSC Repeal Bill*, INSIDE U.S. TRADE (Oct. 1, 2004), page 23.

[3] WT/DS108/29 (14 January 2005), page 2.

[4] *US – FSC (Panel)*, para. 8.1(a).

withdraw the FSC subsidy with effect from October 1, 2000.[5] The Appellate Body subsequently modified the original Panel's reasoning, but affirmed the original Panel's findings under the SCM Agreement.[6]

12. Subsequently, the United States enacted the ETI Act. The ETI Act repealed the FSC tax exemption, but also contained a general transition provision and a grandfather provision that allowed the FSC tax exemption to be claimed after November 1, 2000. The EC initiated a proceeding under Article 4 of the SCM Agreement and Article 21.5 of the DSU in which it essentially complained of two things. First, it claimed that the ETI Act's transition provisions resulted in a failure to withdraw the FSC tax exemption as required by the original Panel's recommendation pursuant to Article 4.7. Second, it alleged that the ETI Act tax exclusion constituted an export subsidy in its own right.

13. With respect to the ETI Act's transition provisions relating to the FSC tax exemption, the Article 21.5 Panel found that these provisions resulted in a failure on the part of the United States to withdraw the FSC subsidies found to be prohibited in the original proceeding and, thus, to implement the recommendations and rulings of the DSB pursuant to Article 4.7 of the SCM Agreement.[7] The Appellate Body affirmed this finding.[8] The EC acknowledges that the transition provision has expired and is not at issue in this dispute.[9]

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[5] *US – FSC (Panel)*, para. 8.8. The DSB later modified the withdrawal deadline to November 1, 2000.
[6] *US – FSC (AB)*, para. 177(a).
[7] *US – FSC (Article 21.5) (Panel)*, paras. 8.170 and 9.1(e).
[8] *US – FSC (Article 21.5) (AB)*, para. 256(f).
[9] *First Written Submission of the European Communities* (19 May 2005), para. 36.

14. With respect to the ETI Act tax exclusion, the Article 21.5 Panel found that the exclusion constituted an export subsidy inconsistent with Article 3.1(a) of the SCM Agreement.[10] The Appellate Body affirmed this finding.[11] However, while the Article 21.5 Panel found that the ETI Act tax exclusion constituted a prohibited export subsidy, it did not make a recommendation pursuant to Article 4.7 that the subsidy be withdrawn, notwithstanding the fact that the EC had initiated the panel proceeding pursuant to Article 4 of the SCM Agreement.[12]

15. For its part, the Appellate Body recommended that the DSB request the United States to bring the ETI measure into conformity with its obligations under Article 3.1(a) of the SCM Agreement, as well as provisions of the *Agreement on Agriculture* and Article III:4 of the *GATT 1994*.[13] However, with respect to the ETI Act tax exclusion, the Appellate Body did not make any recommendations pursuant to Article 4.7 of the SCM Agreement. To the extent that the Appellate Body made a recommendation referencing Article 4.7, it recommended "that the DSB request the United States to implement fully the recommendations and rulings of the DSB in *US – FSC*, made pursuant to Article 4.7 of the *SCM Agreement*."[14] By citing to the original proceeding regarding the FSC provisions, the Appellate Body clearly was referring to the recommendation that the FSC subsidy – not the ETI Act subsidy – be withdrawn.

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[10] *US – FSC (Article 21.5) (Panel)*, paras. 8.75 and 9.1(a).

[11] *US – FSC (Article 21.5) (AB)*, para. 256(b).

[12] WT/DS108/16 (8 December 2000). The absence of a recommendation appears to have been the result of the EC's insistence that the Article 21.5 Panel not make any recommendation, notwithstanding the fact that it was the EC that had invoked Article 4 of the SCM Agreement. *US – FSC (Article 21.5) (Panel)*, para. 7.5 (discussing EC comment on the Article 21.5 Panel's interim report).

[13] *US – FSC (Article 21.5) (AB)*, para. 257.

[14] *US – FSC (Article 21.5) (AB)*, para. 257.

16. Thus, the DSB did not recommend or request pursuant to Article 4.7 that the ETI Act subsidy be withdrawn or that it be withdrawn within a particular time. In the absence of any such recommendation or request, it cannot be found that by including reasonable transition provisions in the AJCA – which pertain to the ETI Act tax exclusion, not the FSC tax exemption – the United States has failed to comply with some DSB recommendation or ruling to withdraw, within the meaning of Article 4.7, the ETI Act tax exclusion.

17. The jurisdiction of a panel under Article 21.5 of the DSU is limited - it is limited to "measures taken to comply with the recommendations and rulings." Here, the EC has chosen to invoke the aspect of the Panel's jurisdiction involving the alleged failure of the United States to comply with a DSB recommendation or ruling concerning Article 4.7 of the SCM Agreement. However, there is no such recommendation or ruling.

18. Article 4.7 of the SCM Agreement provides as follows:

> If the measure in question is found to be a prohibited subsidy, the panel shall recommend that the subsidizing Member withdraw the subsidy without delay. In this regard, the panel shall specify in its recommendation the time period within which the measure must be withdrawn.

19. Any obligation to withdraw the ETI Act tax exclusion, or to withdraw it within a particular period of time, had to be triggered by a recommendation under Article 4.7. Because no such recommendation was made, the United States was not under an obligation to withdraw the ETI Act tax exclusion. Therefore, while the United States has repealed the ETI Act, it was not precluded from adopting reasonable transition provisions to govern the phase-out of the ETI Act tax exclusion. Furthermore, there is no basis for an Article 21.5 panel to make a finding of compliance or noncompliance with a DSB recommendation or ruling under Article 4.7 of the

SCM Agreement in this dispute, and thus the Panel should reject the EC's claims under Article 4.7 of the SCM Agreement.

B. Section 5 of the ETI Act Is Not Within the Panel's Terms of Reference

20. The measures before this Panel are sections 101(d) and (f) of the AJCA, the transition provisions concerning the ETI Act tax exclusion. In its panel request, the EC does not allege that other provisions of the AJCA are inconsistent with U.S. obligations under the WTO agreements.[15] Moreover, while the EC makes references in its first written submission to section 5 of the ETI Act,[16] which included transition provisions for the FSC tax exemption, section 5 is not mentioned in the EC's panel request, and, thus, is not within the Panel's terms of reference.[17]

IV. CONCLUSION

21. For the foregoing reasons, the United States respectfully requests that the Panel reject the EC claims.

[15] WT/DS108/29 (14 January 2005).
[16] *See, e.g., First Written Submission of the European Communities* (19 May 2005), paras. 36-37.
[17] WT/DS108/29 (14 January 2005).