



## Preservation of Benefits of Current FSC/ETI Regime

### Issue

The World Trade Organization (“WTO”) Appellate Body has decided that the Extraterritorial Income Exclusion (“ETI”) regime enacted by Congress in 2000 is a prohibited export subsidy violating U.S. international treaty obligations. Potential sanctions equating to \$4.043 billion may be imposed in the near future.

### Background

In November 2000, Congress enacted the Extraterritorial Income Exclusion Act (the “Act”) as a replacement for the U.S. Foreign Sales Corporation (“FSC”) rules, which had been ruled a prohibited export subsidy under WTO trade rules. In response to a challenge by the European Union (“EU”), the WTO Dispute Settlement Panel (the “Panel”) held on August 20, 2001 that the Act is also inconsistent with WTO agreements. On October 19, 2001, the U.S. appealed the Panel decision.

On January 14, 2002, the WTO Appellate Body upheld the Panel’s ruling that the ETI regime constitutes a prohibited export subsidy under international trade law. Following a WTO dispute settlement panel ruling authorizing the EU to impose countermeasures of \$4.043 billion in sanctions, the EU announced a list of products that could be subject to trade retaliations. The EU is expected to finalize the list of U.S. products in early 2003.

EU officials have continued to indicate that there is no intent to impose sanctions as long as the U.S. continues to make progress on compliance. An important step in this regard has been accomplished with the introduction of the Thomas bill (H.R. 5095) in the 107th Congress; this Bill is manifestly intended to bring the U.S. into compliance.

In August 2002, then-Senate Finance Committee Chairman Max Baucus (D-MT) and then-Ranking Member Charles Grassley (R-IA) announced the creation of an ETI “working group” to develop a bipartisan solution that both Congress and the White House can support. The ETI working group includes representatives of the House Ways and Means Committee, the Senate Finance Committee, the Joint Committee on Taxation, the Treasury Department, and the U.S. Trade Representative. The ETI working group is continuing to meet and develop a legislative solution.

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### Background (cont.)

Sen. Grassley, now Chairman of the Finance Committee, and Sen. Baucus, now Ranking Member, also have suggested a negotiated solution. Trade legislation enacted last year directs the Administration to address the distinction between direct and indirect taxes in the Doha Round of WTO trade negotiations. The Administration opposes a negotiated solution. With the Doha Round expected to last until 2005, the Administration says the EU is unlikely to wait that long before imposing retaliatory trade sanctions. A negotiated solution also would require concessions in other trade disputes with the EU, the Administration says.

### Policy Considerations

The ETI regime and that of its predecessors were designed to offset a competitive disadvantage faced by U.S. exports vis-à-vis goods from other countries that have more favorable systems for taxing exports. The ETI regime merely provides the same type of tax breaks already offered by European countries through value-added tax exemptions on EU exports. The WTO ruling could potentially undermine the U.S. tax system, and would require extensive reform to maintain parity with other countries' tax systems.

### Recommendation

The ETI Working Group and the Senate Finance Committee International Tax Working Group are important complimentary efforts to the H.R. 5095 initiative. These initiatives take on added significance because negotiations between the United States and European Union may not otherwise resolve the ETI issue in a timely or acceptable manner, avoiding highly detrimental trade retaliation.

H.R. 5095 included important simplification measures and provisions addressing U.S. competitiveness. The Silicon Valley Tax Directors' Group believes that the passage of an international reform bill is possible with H.R. 5095 as a starting point, further enhancing it with provisions that more effectively and completely address the loss of ETI tax benefits. While not necessarily providing a full offset for the loss of ETI nor uniformly doing so, a package that includes provisions regarding U.S.-incurred R&D, an exclusion for distribution income earned offshore from sales of U.S. manufactured or developed products, and an exclusion from subpart of software royalties, will closely align future benefits with U.S. activities that currently generate ETI benefit – U.S. R&D, U.S. manufacturing, and U.S. software development. The SVTDG would support a bill similar to H.R. 5095 that includes this package of proposed additions.