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## Congressional Response To WTO Sanctions: Turning Lemons Into Lemonade In The American Jobs Creation Act Of 2004

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**CONGRESSIONAL RESPONSE TO WTO SANCTIONS:  
TURNING LEMONS INTO LEMONADE IN THE  
AMERICAN JOBS CREATION ACT OF 2004**

*Robin Organek* \*

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**SUMMARY**

*A unique tension exists between the World Trade Organization's various desires to level the international commercial trading field, and the United States' periodic desires to prioritize its own domestic goods and, in some cases, protect its own corporate citizens. This article will explore various historical rifts and what the future is likely to hold in light of Congress' passage of the American Jobs Creation Act of 2004.*

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### A. INTRODUCTION

The World Trade Organization (“WTO”) was formed, in part, to end each country’s separate enforcement of its taxation and trade rules. Because the significant amount of trade between the United States and the European Union results in an enormous volume of taxable transactions, the WTO, *inter alia*, is necessary to reconcile the inconsistent taxation among the countries.

While the WTO appears to frown upon government-sponsored financial assistance in any form, only certain types of support are classified as subsidies under its terms. The WTO has ruled that many of the United States’ tax policies on foreign income constitute illegal subsidies. In 2002, the WTO authorized sanctions against the United States for illegal subsidies in violation of WTO agreements.<sup>1</sup> As a result, the United States has spent many years modifying its tax policies and Congress replaced the problematic legislation with the American Jobs Creation Act of 2004 (“Act”). The Act made numerous changes to the United States’ Tax Code (“Code”). Prior to the passage of the Act, Congress evaluated different approaches to comply with WTO regulations and determine whether or not a radical change in the Code was required. At the present time, it is unclear whether the Act violates WTO policy and standards.

#### *I. Overview of the United States Tax Structure*

While many different facets of United States tax law have evolved over time, since 1921 international income has generally been taxed at its source. Moreover, the definitions classifying a business entity as foreign or domestic were recognized as early as 1924.<sup>2</sup> Unlike European nations, the United States has a

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<sup>1</sup> Jeff Stancill, *Mending Fences: The Real Purpose of the American Jobs Creation Act of 2004*, 13 TUL. J. INT’L & COMP. L. 421, 423 (2005).

<sup>2</sup> David LeBron, *Attaining U.S. Effectively Connected Income in the Aftermath of the American Jobs Creation Act of 2004 and Its Aim to Repeal Extraterritorial Income Exclusion.*, 21 AKRON TAX J. 101 (2006).

worldwide tax system that allows it to tax individuals and companies on their worldwide income, regardless of where that income was earned.<sup>3</sup> The Code imposes income tax on United States citizens and residents, as well as on U.S. companies conducting business anywhere, and on most foreign corporations conducting business within the United States.<sup>4</sup> Additionally, the United States imposes taxes on foreign-source income when the income is “effectively connected with the conduct of a trade or business” within the United States.<sup>5</sup> The Code allows for credits against U.S. tax obligations by providing that “foreign income taxes [are] to be credited dollar-for-dollar against the United States income tax of United States citizens and residents,” thus avoiding double taxation of citizens and residents paying taxes in a foreign nation.<sup>6</sup>

## ***II. Worldwide Income Versus Territorial Income Taxation***

As previously noted, European nations generally have a territorial taxation policy, meaning the “taxing nation taxes only income earned within its borders, regardless of the taxpayer’s residence.”<sup>7</sup> Therefore, foreign source income earned by a resident in countries practicing territorial income taxation is exempt from taxation.<sup>8</sup> Most of these taxes are imposed through excise taxes, known as value added taxes (“VAT”), many of which are refunded if the goods leave the country.<sup>9</sup>

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<sup>3</sup> Kristin Byrd, *Can we Provide a Level Playing Field for U.S. Corporations and Increase U.S. Jobs While Repealing the Extraterritorial Income Act?* 5 HOUS. BUS. & TAX L.J. 338, 345 (2005).

<sup>4</sup> *Id.* at 344.

<sup>5</sup> I.R.C. § 882(b) (2007).

<sup>6</sup> I.R.C. § 901. (2007).

<sup>7</sup> See Byrd at 346, *supra* note 3.

<sup>8</sup> See Staff of Joint Comm. on Taxation, 108<sup>th</sup> Cong., *The U.S. Int’l Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Bus. Abroad* JCX-68-03, at 2 ( “The U.S. Int’l Tax Rules”) (Comm. Print 2003), available at [www.house.gov/jct/x-68-03.pdf](http://www.house.gov/jct/x-68-03.pdf).

<sup>9</sup> *Id.*

One of the rationales for a worldwide income tax is that a “pure worldwide tax system arguably promotes economic efficiency, in that it does not distort the decision of whether to locate investment at home or abroad.”<sup>10</sup> On the other hand, territorial income taxation is arguably less complicated from an administrative and compliance perspective. Additionally, territorial taxation may promote economic efficiency better than a worldwide tax system, “because a territorial system treats all investment within a particular source country the same, regardless of the residence of the investor.”<sup>11</sup> Further, United States corporations may have a distinct disadvantage when competing globally against corporations in territorial income tax countries, as United States corporations are taxed at the rate of the country in which the goods are produced and are still required to pay federal corporate income tax in the United States, which even after credits for foreign tax, may be higher.

#### **B. TRADE RELATIONS BETWEEN THE UNITED STATES AND THE EUROPEAN UNION**

The European Union is an organization of European countries, originally formed after World War II, designed to economically intertwine Europe and help prevent another European war.<sup>12</sup> Trade between the United States and the European Union accounts for a significant share of the respective economic activity of each and has been steadily increasing.<sup>13</sup> In fact, the European Union and the United States are each other's single largest trading partner in goods and services.<sup>14</sup> Further, they form “the world's most important bilateral investment relationship, and they are each other's most important source and destination for

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<sup>10</sup> The U.S. Int'l Tax Rules, *supra* note 8 at 2.

<sup>11</sup> *Id.* at 4.

<sup>12</sup> Stancill, *supra* note 1 at 423.

<sup>13</sup> U.S. Census Bureau, U.S. Trade Balance with European Community (Dec. 9, 2006), available at <http://www.census.gov/foreign-trade/balance/c0011.html>.

<sup>14</sup> European Commission, EU-US Bilateral Economic Relations (June 25, 2003), [hereinafter Bilateral Economic Relations], available at [http://ec.europa.eu/trade/issues/bilateral/countries/usa/index\\_en.htm](http://ec.europa.eu/trade/issues/bilateral/countries/usa/index_en.htm).

foreign direct investments.”<sup>15</sup> Still, “[t]he United States and the twenty-five member states of the European Union are members of the WTO, and, therefore, must abide by its agreements and decisions.”<sup>16</sup> WTO members, of course, remain in control of their own tax regulation, however they must honor their WTO obligations.<sup>17</sup>

### ***I. The World Trade Organization***

The World Trade Organization was founded in 1995 and developed from the General Agreement on Tariffs and Trade (“GATT”). It is an international organization that includes some 150 member-states, including the United States and all members of the European Union. The WTO member-states account for over 97% of the world’s trade.<sup>18</sup> It “is the only international organization dealing with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.”<sup>19</sup> The goal of the WTO “is to improve the welfare of the peoples of the member countries.”<sup>20</sup> The WTO trade policy is now dictated largely by GATT.<sup>21</sup> The WTO’s “multilateral trading system employs international negotiations and agreements to lower trade barriers among member nations.”<sup>22</sup> The Dispute Settlement Understanding (“DSU”) provides a hub for WTO meditative endeavors. The DSU addresses alleged violations of WTO agreements “with detailed procedures

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<sup>15</sup> European Parliament Fact Sheet: The United States and Canada, available at [http://www.europarl.europa.eu/facts\\_2004/6\\_3\\_6\\_en.htm](http://www.europarl.europa.eu/facts_2004/6_3_6_en.htm).

<sup>16</sup> Colleen Klanchnik, *United States-European Union Dispute on Foreign Source Income, Export Activity, and the Extraterritorial income Exclusion Act*, 33 HOFSTRA L. REV. 331, 334 (2004) (internal citation omitted).

<sup>17</sup> *Id.*

<sup>18</sup> WORLD TRADE ORGANIZATION, THE WTO . . . IN BRIEF 7 (2008), [http://www.wto.org/english/res\\_e/download\\_e/inbr\\_e.pdf](http://www.wto.org/english/res_e/download_e/inbr_e.pdf).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> See Stancill, *supra* note 1, at 423.

for complaints and settlements of different violations.”<sup>23</sup>

The DSU “developed out of the panel system of the GATT.”<sup>24</sup> The underlining purpose of the subject system is to create a universal hub for dispute resolution.<sup>25</sup> It “ended the *de facto* veto over the panel decision by instituting a reverse-consensus rule: The panel decision would be accepted unless every contracting member voted to reject the panel’s determination.”<sup>26</sup> The WTO’s system was designed to adjudicate all cases, including appeals, within fifteen months.<sup>27</sup>

Additionally, the WTO aimed to end individual countries’ enforcement of trade rules. Members cannot impose sanctions for violation of trade rules, “unless the sanctions are authorized to do so by the WTO.”<sup>28</sup> Unilateral action by member states is prohibited under GATT; however, this prohibition was often ignored due to the ineffectiveness of other means of enforcement.<sup>29</sup> The end result of this system is that temporary violations are more likely to occur and go unpunished because the contracting parties have agreed to refrain from sanctions until authorized by the WTO, and sanctions are not authorized until the WTO’s judicial process has concluded.<sup>30</sup> On the other hand, continuing violations are more costly because sanctions are more certain; countries such as the United States can no longer use their influence to retaliate against the retaliation against aggrieved countries.<sup>31</sup>

## ***II. The WTO’s Policy on Government Subsidies***

The WTO unequivocally disapproves of government

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<sup>23</sup> *Id.* at 423-24.

<sup>24</sup> See Rachel Brewster, *Rule-Based Dispute Resolution in International Trade Law*, 92 VA. L. REV. 251, 253 (2006).

<sup>25</sup> *Id.* at 256.

<sup>26</sup> *Id.*

<sup>27</sup> Understanding the WTO: Settling Disputes, [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/disp1\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/disp1_e.htm) (last visited Nov. 1, 2008).

<sup>28</sup> See Brewster, *supra* note 24, at 256.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 258.

<sup>31</sup> *Id.* at 259.

subsidies provided to domestic producers of goods, with a few enumerated exceptions. The Agreement on Subsidies and Countervailing Measures (“SCM”) “proclaims that a subsidy exists when a government or other public body’s financial contribution results in a benefit conferred in a circumstance where:

- (i) a government practice involves a direct transfer of funds (e.g., grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g., loan guarantees);
- (ii) government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits);
- (iii) a government provides goods or services other than general infrastructure, or purchases goods;
- (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.”<sup>32</sup>

However, subsidies are only illegal if “(a) subsidies [are] contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance... , [and] (b) subsidies [are] contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.”<sup>33</sup>

If a member country accuses another country of a violation of the SCM, the WTO may allow the accuser to investigate the accused nation’s policies.<sup>34</sup> After examining the evidence, the WTO may find the suspect country to be in violation of the SCM

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<sup>32</sup> World Trade Organization, AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES 229 (1994), [http://www.wto.org/english/docs\\_e/legal\\_e/24scon.pdf](http://www.wto.org/english/docs_e/legal_e/24scon.pdf).

<sup>33</sup> *Id.* at 231.

<sup>34</sup> See Stancill, *supra* note 1, at 426.



and order the violating member to change its policy.<sup>35</sup> If the violating member fails to modify its policies, “the adversely affected nation may impose countervailing measures to compensate for the competitive advantage of the foreign firm,” and these measures will remain in effect until the violating country changes its policies.<sup>36</sup>

### C. EVOLUTION OF THE FSC AND ETI TAX REGIME

The United States Foreign Sale Corporation (“FSC”) and Exterritorial Income (“ETI”) tax regimes were deemed to be prohibited export subsidies by the WTO.<sup>37</sup> The FSC and ETI originated in 1971 when Congress enacted the Domestic International Sale Corporation (“DISC”) tax policy.<sup>38</sup> The purpose of the DISC was to provide tax incentives for the United States export industry.<sup>39</sup> In order to be eligible to qualify under the DISC, “a corporation must be incorporated within the United States, and it must ensure that (1) 95% or more of its gross receipts are ‘Qualified Export Receipts;’ (2) 95% of its assets are ‘Qualified Export Assets;’ and (3) the corporation has only one class of stock and a minimum of \$ 2,500 in capital.”<sup>40</sup> Corporations that met these classifications could defer the payment of taxes on income from exports, and a DISC entity could defer paying tax on up to one-half of its foreign profits.<sup>41</sup> The deferred profits would not be taxed “unless they were distributed as to shareholders as dividends.”<sup>42</sup>

Europe first challenged the DISC policy in 1973, when European members of the GATT objected to it as an illegal

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<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> William Chou., *The \$4 Billion Question: An Analysis of Congressional Responses to the FSC/ETI Dispute under WTO Export Subsidy Standards*, 25 NW. J. INT'L L. & BUS. 415, 417 (2005).

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 417 (internal citations omitted).

<sup>41</sup> See Chou, *supra* note 38, at 417.

<sup>42</sup> *Id.*

subsidy under Article XVI of the GATT.<sup>43</sup> The protesting nations argued that the DISC was essentially a tax exemption, as “corporations could potentially defer the tax on export earnings indefinitely,” since the DISC did not place a time limit on the deferral.<sup>44</sup> In 1976, a panel of GATT members found the DISC to be an illegal subsidy scheme under GATT, and the United States subsequently agreed to amend the DISC to avoid tariffs.<sup>45</sup>

Congress passed the Tax Reform Act of 1984, replacing the DISC with the FSC.<sup>46</sup> Similar to the DISC, the FSC was designed to give tax benefits to organizations that met specific criteria. In order for a corporation to qualify as an FSC entity, it was required to meet a foreign management and economic process test.<sup>47</sup> A corporation must: “(1) hold all of its board of directors and shareholders meetings in locations outside of the United States; (2) maintain its principal bank account outside of the United States for the taxable year; and (3) disburse dividends, legal and accounting fees, and salaries of officers and directors from the bank accounts maintained outside of the United States.”<sup>48</sup> Additionally, a corporation must comply with a foreign economic process test, which is satisfied if the corporation: “(1) solicits, negotiates, or contracts outside the United States and (2) the foreign direct costs attributable to such transaction constitute at least 50% of the total direct costs of the transaction.”<sup>49</sup>

“The FSC focused its tax benefits on “certain income derived from foreign sources, as opposed to using a blanket exemption on all the income generated by the qualified entity.”<sup>50</sup> Additionally, the FSC allowed for up to 30% of gross income derived from each transaction to be classified as earnings from

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<sup>43</sup> *Id.* at 418.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* at 419.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

“Foreign Gross Trading Receipts,” also known as “Exempt Foreign Trade Income.”<sup>51</sup> These earnings could be deducted from gross income for tax calculation purposes as “foreign source income not effectively connected with conduct of a trade or business within the United States.”<sup>52</sup>

In 2000, after continuous complaints from the European Union, the WTO found that the United States FSC tax regime violated the SCM Agreement, and it ordered the United States to modify or repeal the illegal subsidy so that it complied with the SCM.<sup>53</sup> The WTO found that the United States FSC tax regime violated Article 3.1(a), which prohibits subsidies that “are contingent in law or in fact upon export performance.”<sup>54</sup> In November 2000, the United States repealed the FSC regime and enacted the ETI legislation.<sup>55</sup>

The ETI changed the criteria by which a corporation may qualify for tax benefits. The ETI defined “Extraterritorial Income” as “the gross income of the taxpayer attributable to foreign trading gross receipts of the taxpayer.”<sup>56</sup> Under the ETI, any foreign source income of a United States corporation could be deducted from the corporation’s gross income if deemed “Qualifying Foreign Trade Income,”<sup>57</sup> defined as “the taxable income of the taxpayer attributable to foreign gross trading gross receipts of the taxpayer.”<sup>58</sup> In application, a corporation qualifying under the ETI could deduct taxable income of a transaction equal to the greatest of: “(A) 30 percent of the foreign sale and leasing income derived from such transaction; (B) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction; or (C) 15 percent of the foreign trade income derived by the taxpayer from

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<sup>51</sup> *Id.*; See also I.R.C. 921 (repealed 2000).

<sup>52</sup> *Id.*; See also I.R.C. 923 (repealed 2000).

<sup>53</sup> See Jeff Stancill, *supra* note 1, at 427.

<sup>54</sup> See William Chou, *supra* note 38, at 422-425.

<sup>55</sup> See Jeff Stancill, *supra* note 1, at 427.

<sup>56</sup> 26 U.S.C. 114(e).

<sup>57</sup> See William Chou, *supra* note 38, at 429.

<sup>58</sup> I.R.C. 941(b)(1).

such transaction.”<sup>59</sup> Many corporations benefited from the law, as it enabled them to minimize the burden of an additional foreign presence, often through tax-exempt divisions in various Caribbean Nations.<sup>60</sup> Unlike the FSC, the ETI allowed deductions for property “manufactured within or outside of the United States.”<sup>61</sup> Nonetheless, the ETI required that the property be disposed of abroad.<sup>62</sup>

Shortly after the ETI was adopted as legislation, the European Union made formal complaints to the WTO, contending that the ETI was an illegal subsidy.<sup>63</sup> The European Union “estimated that American subsidies approximated four billion dollars per year, and alleged that this was a damaging blow to international competition” in Europe.<sup>64</sup> The United States, however, argued that the ETI compensated for double-taxation and was within the meaning of a provision, “which qualifies the list of prohibited export subsidies and reaffirms the principle that member nations need not tax income from foreign sources.”<sup>65</sup>

In 2002, the WTO ruled that the ETI violated the SCM and required that ETI be repealed or modified.<sup>66</sup> Further, the WTO Panel found that the ETI violated article 3.1(a) of the SCM Agreement because it granted subsidies “contingent in law or in fact upon export performance.”<sup>67</sup> Additionally, WTO ruled that the ETI violated Article 3.3 of the WTO “Agreement on Agriculture” because it provided an export subsidy to United States corporations.<sup>68</sup> The WTO held that the ETI provisions violated the foreign articles/labor limitations of Article III:4 of

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<sup>59</sup> See William Chou, *supra* note 38, at 429; See also I.R.C. 941.

<sup>60</sup> See Kristin Byrd, *supra* note 3, at 354-355.

<sup>61</sup> See William Chou, *supra* note 38, at 430.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> See Jeff Stancill, *supra* note 1, at 428.

<sup>65</sup> See William Chou, *supra* note 38, at 423.

<sup>66</sup> <http://www.state.gov/e/eeb/rls/rm/2002/12385.htm>.

<sup>67</sup> See William Chou, *supra* note 38, at 423.

<sup>68</sup> [http://www.wto.org/english/tratop\\_e/dispu\\_e/108rw2-5\\_e.pdf](http://www.wto.org/english/tratop_e/dispu_e/108rw2-5_e.pdf); See Kristin Byrd, *supra* note 3, at 340.

GATT 1994 by favoring products produced in the United States over products produced outside of the United States.<sup>69</sup> Finally, the WTO found that the ETI did not effectively withdraw the FSC subsidy by November 1, 2000, in accordance with the WTO's prior recommendations.<sup>70</sup>

Consequently, on May 7, 2003, the WTO, in an attempt to offset the competitive advantage of the United States, authorized European Union countervailing duties on U.S. exports in the amount of \$4.034 billion.<sup>71</sup> In March 2004, the EU imposed a tariff of five percent on certain United States exports, intended to total approximately \$4 billion dollars.<sup>72</sup> The retaliatory tariff increased by one percent per month until it reached 17 percent in March 2005.<sup>73</sup> The WTO's ruling and authorization of punitive damages forced Congress to repeal the ETI and to create new legislation to provide a tax solution that would enable United States companies to compete on a global scale.

#### **D. OBJECTIVES OF THE NEW LEGISLATION**

The early years of the 21<sup>st</sup> century were marked by the threat of a recession, if not an actual recession. It is well known that by 2000, the "dotcom bubble" burst, taking the NASDAQ and the Dow Jones Industrial Average with it. In 2001, Congress and President George W. Bush enacted a tax cut in an effort to stimulate the depressed American economy. As a result, by the third quarter of 2003, the economy grew 7.2 percent, the largest growth in nineteen years.<sup>74</sup> However, it was feared that European sanctions against U.S. exports could damage the upswing in the economy. According to Kenneth Dam, Deputy Secretary of the Treasury in 2002, "The threat of substantial retaliatory sanctions

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<sup>69</sup> See Kristin Byrd, *supra* note 3, at 340.

<sup>70</sup> *Id.*

<sup>71</sup> See David LeBron, *supra* note 2, at 112.

<sup>72</sup> <http://web.archive.org/web/20061117030601/http://www.pwc.com/us/eng/tax/Tax-Bill-Summary.pdf>.

<sup>73</sup> *Id.*

<sup>74</sup> See Kristin Byrd, *supra* note 3, at 349.

against U.S. exports is not something that any of us takes lightly.”<sup>75</sup> Also, Dam noted that, the repeal of the ETI was a “serious issue with significant consequences for U.S. businesses and [the] U.S. economy.”<sup>76</sup>

Congress and the President sought to establish tax incentives to continue to stimulate the economy while complying with the WTO regulations. As Dam noted, the U.S. rules for taxing foreign-source income were “unique in their breadth of reach and degree of complexity” and “is evidence that the competitive disadvantage caused by our international tax rules is a serious issue.”<sup>77</sup> The United States government’s solution was to enact the American Jobs Creation Act of 2004.

#### **E. OVERVIEW OF THE CHANGES MADE TO THE AMERICAN JOBS CREATION ACT OF 2004**

The Act was signed by President Bush on October 22, 2004. It was perhaps the most significant tax reform for businesses since the FSC.<sup>78</sup> The Act has been ridiculed since its inception for the obvious protection of certain special interest groups. In a letter to congressional leaders, Treasury Secretary John Snow complained that the bill contained many provisions for “special interests.”<sup>79</sup> Reporters mocked the bill for providing tax breaks for “NASCAR track owners and importers of Chinese ceiling fans.”<sup>80</sup> Regardless of the negative press associated with the Act, it did in fact accomplish its initial goal of repealing the ETI. The Act also

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<sup>75</sup> <http://web.archive.org/web/20070707224939/http://www.state.gov/e/eeb/rls/rm/2002/12385.htm>.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> American Jobs Creation Act of 2004, available at <http://web.archive.org/web/20050326160221/http://www.cbiz.com/ata-skb/pdfs/American+Jobs+Creation+Act+2004.pdf> [CBIZ].

<sup>79</sup> *CCH Tax Briefing: American Jobs Creation Act of 2004: Congress Approves Corporate Tax Cut – And Much More – In FSC/ETI Repeal Legislation*, October 11, 2004, 1-2 [CCH].

<sup>80</sup> Jeffrey Sparshot, *President OKs Overhaul of Corporate Tax Law*, WASH. TIMES, Oct. 23, 2004, at 1.

creates approximately \$140 billion tax break, primarily for American corporations.<sup>81</sup>

### ***I. Repealing the ETI***

The Act phased out the ETI over a two year time span.<sup>82</sup> Additionally, it grandfathered contractual agreements entered into before September 18, 2003.<sup>83</sup> A few weeks after its enactment, the European Union lifted sanctions against the United States.<sup>84</sup> However, Europe requested that the WTO convene a panel in order to address the Act's phase-out of the ETI, and to examine whether it actually complied with the WTO.<sup>85</sup>

In September 2005, the WTO panel concluded, in paragraphs 7.65 and 8.1 of its report, that "to the extent that the United States, by enacting Section 101 of the American Jobs Creation Act of 2004, maintains prohibited FSC and ETI subsidies through [the] transitional and grandfathering measures, it continues to fail to implement fully the operative DSB recommendations and rulings to withdraw the prohibited subsidies and to bring its measures into conformity with its obligations under the relevant covered agreements."<sup>86</sup> In 2006, the panel's findings were upheld on appeal.<sup>87</sup>

### ***II. Other Benefits from the Act: The Definition of Manufacturer***

The 650 pages of the Act do not simply repeal the ETI, but in fact appear to substantially alter the tax laws. The Act has changed the tax deduction structure for manufacturers, and

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<sup>81</sup> *Id.*

<sup>82</sup> American Jobs Creation Act of 2004, Pub. L. No. 108-357, 101, 118 Stat. 1418, 1423-24.

<sup>83</sup> *Id.*

<sup>84</sup> Stancill, *supra* note 1, at 431.

<sup>85</sup> Request for the Establishment of a Panel, *United States – Tax Treatment for “Foreign Sales Corporation,”* WT/DS108/RW2 (Jan. 14, 2005).

<sup>86</sup> Appellate Body Report, *United States – Tax Treatment for “Foreign Sales Corporations,”* WT/DS108/AB/RW2 (Jan. 26, 2006).

<sup>87</sup> United States- Tax Treatment for “Foreign Sales Corporations,” available at [www.wto.org/english/tratop\\_e/disp\\_e/cases\\_e/ds108\\_e.htm](http://www.wto.org/english/tratop_e/disp_e/cases_e/ds108_e.htm).

expanded the universe of those who fall under the definition of manufacturers to include domestic production activities such as traditional manufacturing, construction performed in the United States, engineering, energy production, computer software, films and videotape, and processing of agricultural products.<sup>88</sup> Furthermore, a nine percent deduction for income from domestic production activity is phased in starting in 2005-2010.<sup>89</sup> As a result, many more taxpayers will benefit from the deduction than those who benefited from the ETI. The manufacturer's deduction became available for corporations, individuals and pass-through entities, such as S corporations, partnerships, and trusts in December 31, 2004, and their deduction is generally applied at the shareholder or partnership level.<sup>90</sup>

Some special interest groups saw the potential to broaden the definition of "manufacturer" and lobbied Congress. For example, "a national retail coffeehouse chain will be allowed to call its coffee roasting a manufacturing process, although it lost on having in-store beverages preparing qualify."<sup>91</sup> Thus, what once was a \$50 billion exclusion for corporations under the ETI, has turned into \$76 billion worth of deductions.<sup>92</sup>

### ***III. Agricultural Reform***

Agribusinesses, as well as traditional farmers, qualify as "manufacturers" under the Act.<sup>93</sup> Additionally, the act provides for twenty agricultural tax breaks and incentives.<sup>94</sup> For example, involuntary conversion treatment occurs when "a farmer sells livestock (other than poultry) held for draft, dairy, or breeding purposes in excess of the number that would normally be sold during that time period," such excess being treated as involuntary

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<sup>88</sup> American Job Creation Act of 2004, *supra* note 84.

<sup>89</sup> *Id.* at 102.

<sup>90</sup> 108 P.L. 357; *See also* CBIZ, *supra* note 80.

<sup>91</sup> CCH, *supra* note 81, at 2-3.

<sup>92</sup> *Id.* at 2.

<sup>93</sup> *Id.* at 5.

<sup>94</sup> *Id.*



conversion, "if the sale occurs on account of drought or other weather-related conditions.."<sup>95</sup>

#### ***IV. Small Business Expensing and Depreciation***

In 2002, Congress decided to allow an increase of the "threshold for small business current expensing from \$25,000 to \$100,000" until 2006,<sup>96</sup> for qualifying property placed in service that does not exceed \$400,000.<sup>97</sup> The enhanced treatment was designed to stimulate the economy, and the Act extended this measure until 2007.

Additionally, the Act provided for a "15-year recovery period, using straight-line depreciation, for qualified leasehold improvements for nonresidential real estate placed into service after the date of enactment and before January 1, 2006".<sup>98</sup> Prior to this, leasehold improvements on nonresidential real property generally were depreciated over 39 years.<sup>99</sup> To qualify for the exemption, the work must be "an improvement to the interior of a building, made by either the lessor or lessee and placed in service more than three years after the building is placed in service."<sup>100</sup>

The Act also provides a special section for restaurant improvements. Leasehold improvements on restaurant property formerly were depreciated over 39 years using the straight line method.<sup>101</sup> Under the Act, qualified leasehold improvement property can be depreciated over 15 years,<sup>102</sup> provided "such improvement is placed in service more than 3 years after the date such building was first placed in service, and (B) more than 50 percent of the building's square footage is devoted to preparation

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<sup>95</sup> Roger A. McEowen & Neil E. Harl. *Selected Farm and Small Business Tax Issues*. 10 DRAKE J. AGRIC. L. 57, 67 (2005).

<sup>96</sup> CCH, *supra* note 81, at 3.

<sup>97</sup> *Id.* at 3.

<sup>98</sup> *Id.*

<sup>99</sup> See CBIZ, *supra* note 80.

<sup>100</sup> See CCH, *supra* note 81, at 3.

<sup>101</sup> *Id.*

<sup>102</sup> National Association of Tax Professionals ("NATP") at 9.  
<http://www.natptax.com/2004jobactssummary.pdf>

of, and seating for on-premises consumption of, prepared meals.”<sup>103</sup> The act also tightened a vehicular loophole, reducing the amount of available deductions.<sup>104</sup>

### ***V. S Corporation Reform***

Previously, the number of permissible S corporation shareholders was 75.<sup>105</sup> The Act increased that number to 100.<sup>106</sup> Also, family members can elect to be treated as a single S corporation shareholder.<sup>107</sup> The new law defines members of a family as “the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor.”<sup>108</sup> An individual is not “considered a common ancestor if ...the individual is more than 6 generations removed from the youngest generation of shareholders who would ...be members of the family.”<sup>109</sup> Spouses are treated “as being of the same generation as the individual to which such spouse is (or was) married.”<sup>110</sup> The increase in the number of shareholders benefits S corporations as it allows them to have more shareholders and therefore presumably more capital.

Additionally, the Act permits Individual Retirement Accounts to hold shares in S corporations.<sup>111</sup> In the case of transfers of stock to a spouse, “or to a former spouse incident to divorce (as described in §1041), any suspended loss or deduction with respect to that stock will be treated as incurred by the S corporation in the succeeding tax year with respect to the transferee. the Act allows suspended losses or deductions to be transferred to a spouse in the

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<sup>103</sup> American Jobs Creation Act of 2004, *supra* note 84.

<sup>104</sup> CBIZ, *supra* note 80.

<sup>105</sup> CCH, *supra* at 79, at 3.

<sup>106</sup> *Id.*

<sup>107</sup> See NATP, *supra*, note 102 at 13.

<sup>108</sup> American Jobs Creation Act, Pub. L. No. 108-357, §231m 118 Stat. 1418, (2004).

<sup>109</sup> *Id.* at §231.

<sup>110</sup> *Id.* at §231.

<sup>111</sup> CCH, *supra*, note 79 at 4.

case of divorce.”<sup>112</sup> It relaxes the rules for determining potential current beneficiaries of an electing small business trust.<sup>113</sup> Further, it allows distributions from an Employee Stock Ownership Plan maintained by an S corporation to repay certain loans.<sup>114</sup>

### ***VI. State Sales Tax***

The Act allows individuals to deduct state sales taxes instead of deducting state income tax.<sup>115</sup> This law was geared to help individuals in states, such as Florida, that do not have any income tax.<sup>116</sup> However, it also benefits taxpayers whose sales tax exceeded their income tax for the year.<sup>117</sup> This allowance was only made available from the tax years beginning in 2003 and ending January 1, 2006.<sup>118</sup> However, the sales tax deduction cannot be deducted in the calculation of the Alternative Minimum Tax (“AMT”).<sup>119</sup>

### ***VII. Foreign Repatriation***

The Act created a temporary incentive for United States companies to repatriate accumulated foreign earnings by permitting a tax benefited elective cash dividend to shareholders from controlled foreign corporations.<sup>120</sup> These provisions allowed a temporary window “for companies to bring profits earned and kept overseas back into the United States without having to pay the thirty-five percent corporate tax.”<sup>121</sup> The deduction is limited to:

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<sup>112</sup> See NATP, *supra*, note 102 at 12.

<sup>113</sup> CCH, *supra*, note 79 at 4.

<sup>114</sup> *Id.*

<sup>115</sup> American Jobs Creation Act, Pub. L. No. 108-357, §501, 118 Stat. 1418 (2004).

<sup>116</sup> CBIZ, *supra*, note 78.

<sup>117</sup> *Id.*

<sup>118</sup> American Jobs Creation Act, Pub. L. No. 108-357, §701, 118 Stat. 1418 (2004).

<sup>119</sup> CBIZ, *supra*, note 78.

<sup>120</sup> American Jobs Creation Act, Pub. L. No. 108-357, §422, 118 Stat. 1418 (2004).

<sup>121</sup> Byrd, *supra* note 3 at 361.

(1) the greater of \$500 million, the amount shown on the certified financial statement as earnings permanently reinvested outside the United States, or in the case a financial statement “fails to show a specific amount of earnings permanently reinvested outside the United States and which shows a specific amount of tax liability attributable to such earnings, the amount equal to the amount of such liability divided by 0.35;”<sup>122</sup> (2) “the amount of the dividends must be invested in the United States under a domestic reinvestment plan;” (3) the dividends must be paid in cash; (4) the dividends must surpass the average repatriation level from all controlled foreign corporations over a five-year base period.<sup>123</sup> This provision was applicable for either the taxpayer’s last taxable year before the date of enactment or the taxable year after the date of enactment.<sup>124</sup>

The deductions created by the Act helped soften the blow of the repeal of the ETI. Also, the Act allows for the dividends invested into the United States to be invested in research and development.<sup>125</sup> Companies spend billions of dollars on research and development, especially pharmaceutical companies, and this option was apparently meant to encourage corporations to conduct their research and development in the United States and expand their companies in the United States rather than moving their business abroad.

### ***VIII. Foreign Tax Credit Reform***

Additionally, the Act “extended the foreign tax credit carry-forward period from five to ten years.”<sup>126</sup> Further, it reduced the carry-back period for the foreign tax credit from two years to one year.<sup>127</sup> Moreover, the Act “re-sources subsequent U.S.-source income as foreign,...where a taxpayer’s foreign tax credit

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<sup>122</sup> See *supra*, note 120 §422.

<sup>123</sup> *Id.*; see also, PWC, *supra*, note 72.

<sup>124</sup> See *supra*, note 120 §422.

<sup>125</sup> *Supra*, note 120 §422.

<sup>126</sup> PWC, *supra* note 72.

<sup>127</sup> *Id.*

limitation has previously been reduced as a result of an overall domestic loss.”<sup>128</sup>

Furthermore, the Act abolished the AMT credit limit of 90 percent, allowing 100 percent tax credit against the AMT.<sup>129</sup> While this provides companies some relief, it has been suggested that “Congress should reevaluate repealing the AMT provisions altogether in order to simplify the tax code and provide companies with the greater ability to plan for their annual tax liability.”<sup>130</sup> Research has demonstrated “that the repeal of the AMT tax would: increase fixed investment, raise the Gross Domestic Product, increase labor productivity, reduce the cost of capital, and ultimately create 100,000 jobs between 1998 and 2002.”<sup>131</sup>

#### **F. WILL CONGRESS HAVE TO GO BACK TO THE DRAWING BOARD?**

As previously noted, the WTO ruled that the sections of the Act that phased out the ETI over two years, and the sections of the Act that grandfathered contractual agreements entered into before September 18, 2003 with no expiration date, were in violation of the SCM.

The WTO found that the ETI violated the SCM agreement because it granted subsidies geared towards exports. As previously noted, the ETI allowed deductions for property manufactured within or outside of the United States as long as the property was sold, leased or consumed outside of the United States. Additionally, the WTO panel noted that “as long as there is differential tax treatment between domestically-produced goods that are sold abroad and those that are sold domestically such that the former is more tax-advantageous than the latter, export contingency is not eliminated.”<sup>132</sup>

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<sup>128</sup> PWC, *supra* note 72.

<sup>129</sup> CCH, *supra* note 79.

<sup>130</sup> Byrd, *supra* note 3 at 359-360.

<sup>131</sup> *Id.* at 360 (citing Margo Thorning, *Repeal of the AMT, U.S. Investment and Economic Growth*, ACCF Center for Policy and Research Special Reports. Available at <http://www.accf.org/publications.php?pubID=78>).

<sup>132</sup> Chou, *supra* note 38 at 432.

In order to comply with the WTO's ruling the Act changed the definition of manufacturer to include domestic production activities, such a construction in the United States. Thus, the tax breaks for manufacturers can no longer be said to be targeting exports, even though exporters will enjoy tax benefits if they qualify under the Act's definition of manufacturers, and accordingly these tax breaks for manufacturers should be in compliance with the SCM.

As previously noted, WTO ruled that ETI violated the WTO's Agriculture Agreement and provided an export subsidy to United States companies. Under the ETI, farmers could only claim the tax exclusion if "the commodity involved was actually exported outside the United States."<sup>133</sup> As mentioned above, under the Act most farmers should qualify as manufacturers, thus they will receive their deductions regardless of whether or not the commodity they produce is exported. Therefore, the rules for agribusiness and individual farmers under the Act should comply with the SCM and the Agriculture Agreement of the WTO.

Further, the WTO held that the ETI provisions violated the foreign articles/labor limitations of Article III: 4 of GATT 1994 by favoring products produced in the United States over products produced outside of the United States.<sup>134</sup> As the Act does not seem to distinguish between a tax break for goods produced within the United States and those produced elsewhere it should be in compliance with the WTO, though what could create a problem is that it does allow a tax break for United States manufacturers. However, these manufacturers do not necessarily have to be manufacturing products, as the Act defines manufacturers to include those who engage in construction or engineering, even though they provide a service as opposed to a product. Therefore, this part of the Act should comply with the WTO, though it may take considerable effort by legal counsel to persuade a WTO panel that the Act is actually in compliance.

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<sup>133</sup> McEowen & Harl, *supra* note 95 at 60.

<sup>134</sup> Byrd, *supra* note 3 at 341.

### **G. CONCLUSION**

The United States taxes individuals and companies based on their worldwide income, and the European Union taxes based on a territorial system. Trade between the United States and the European Union accounts for a large portion of both regions' economic activities. The United States and the members of the European Union also belong to the WTO, which was formed to end individual countries' enforcement of trade rules. The WTO disapproves of government subsidies in any form. However, only certain types of subsidies are classified as illegal subsidies under the SCM.

The WTO declared that the FSC and the ETI constituted illegal subsidies. In 2002, the WTO authorized sanctions against the United States for illegal subsidies in violation of WTO agreements. These sanctions remained in place until the violating legislation was repealed. In 2004, Congress replaced the ETI with the Act. Prior to the passage of the Act, Congress considered different approaches to comply with WTO regulations and in its final form, the Act dramatically changed the Code, not only in a fashion that avoided the sanctions but also in ways, as previously explored, that benefited even business not engaged in international trade. While the question of violation of the WTO may not have been fully answered, Congress may have taken a necessity and turned it into a benefit.