ANNEX A

I. INTRODUCTION

1. It is with regret that the European Communities returns for a second time to the Panel to seek resolution of a disagreement as to the existence or conformity with the covered agreements of measures taken by the United States purportedly to comply with the previously adopted recommendations of the WTO Dispute Settlement Body (the "DSB") in this case.

2. However, the European Communities considers that compliance with DSB recommendations should not only be prompt, as required by Article 21.1 of the *Understanding on rules and procedures governing the settlement of disputes* (the "DSU") and Article 4.7 of the *Agreement on Subsidies and Countervailing Measures (*the "*SCM Agreement*"*)*, but should also be complete and consistent with the implementing Members' WTO obligations. As the European Communities will explain below, the actions of the United States in this case meet none of these requirements.

3. The European Communities will first set out the background to this dispute and the previous

European Communities.[6] However, it is useful to recall the fundamental aspects and key provisions of the ETI Act.

8. The ETI Act consisted of five sections of which elements of sections 2 and 5 were relevant

income earned from the performance of services "related or subsidiary to" qualifying sales or lease

by the taxpayer from the transaction;[16] or (iii) 15 per cent of the foreign trade income derived by the taxpayer from the transaction.[17]

21. The European Communities did not consider that the ETI Act complied with the original recommendations and rulings of the DSB. Specifically, it considered (a) that the United States continued to violate Article 3.1(a), item (e) of Annex I, Article 3.1(b) and Article 3.2 of the *SCM Agreement*, as well as Articles 3, 8 and 10.1 of the *Agreement on Agriculture*; and (b) that the ETI was contrary to Article III:4 of the *General Agreement on Tariffs and Trade 1994* (the "GATT 1994").[18]

22. On 20 December 2000, in accordance with Article 21.5 of the DSU, the DSB referred the matter to the original Panel.[19] The Panel report was circulated to the Members of the World Trade Organization (the "WTO") on 20 August 2001. As recalled in more detail in Section III.A below, the Panel found the ETI Act to be inconsistent with Articles 3.1(a), 3.2 of the *SCM Agreement*, 10.1 and 8 of the *Agreement on Agriculture* and III:4 of the GATT 1994. It further found that contrary to Article 4.7 of the *SCM Agreement*, the US had failed to fully withdraw its prohibited subsidy. To the extent the United States had acted inconsistently with the *SCM Agreement*, the *Agreement on Agriculture* and the GATT 1994, the United States had nullified or impaired benefits accruing to the European Communities under those agreements.[20]

23. Following this, on 15 October 2001 the United States notified the DSB of its intention to appeal certain issues of law covered in the Panel Report and legal interpretations developed by the Panel.[21] The Appellate Body fully upheld, with modified reasoning, the Panel's findings concerning the FSC and ETI subsidy schemes.

24. On 29 January 2002 the DSB adopted the Panel Report, as modified by the Appellate Body report, declaring that the ETI Act violated Articles 3.1(a), 3.2 and 4.7 of the SCM Agreement, Articles 8, 10.1 and 3.3 of the Agreement on Agriculture and Article III:4 of the General Agreement on Tariffs and Trade 1994 ent witT0014 Tc.15S 1994Tc0.0tion (its acU68;nc0A

Article 3.1(a) of the *SCM Agreement* by reason of the requirement of "use outside the United States" and fails to fall within the scope of the fifth sentence of footnote 59 of the *SCM Agreement* because it is not a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 of the *SCM Agreement*;

(b) the United States has acted inconsistently with its obligation under Article 3.2 of the *SCM Agreement* not to maintain subsidies referred to in paragraph 1 of Article 3 of the *SCM Agreement*;

(c) the Act, by reason of the requirement of "use outside the United States", involves export subsidies as defined in Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture* and the United States has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture*

8.169 We also observe that the United States does not dispute that prohibited FSC subsidies continue to be available after the time-period set for compliance in this

the United States in these proceedings. Brazil argued that, after the expiration of the time-period for withdrawal of the prohibited export subsidies, it should be permitted to continue to grant certain of these subsidies because it had assumed contractual obligations, under municipal law, to do so.[197] We rejected this argument, and observed that:

> … to continue to make payments under an export subsidy measure found to be prohibited is not consistent with the obligation to "withdraw" prohibited export subsidies, in the sense of "removing" or "taking away".[198]

230 Thus, as we indicated in that appeal, a Member's obligation under Article 4.7 of the

33. At its meeting on 17 February 2005, the DSB referred this dispute, if possible, to the original Panel in accordance with Article 21.5 of the DSU to examine the matter referred to the DSB by the European Communities in document WT/DS108/29. At that DSB meeting, the parties to the dispute also agreed that the Panel should have standard terms of reference. The Panel was composed on 2 May 2005.

V. THE JOBS ACT

A. SUMMARY OF THE JOBS ACT

34. The Jobs Act introduces a new US manufacturing tax deduction and makes numerous other changes to US tax rules, most of which are unrelated to the FSC or ETI subsidy schemes (section 102 ff. of the Jobs Act). It also provides for repeal of certain provisions of the ETI Act and is thus the purported US compliance with the previous Panel and Appellate Body reports in this dispute.

1. The limited scope of the repeal (section 101(a)-(b) of the Jobs Act)

35. Section 101 (a) of the Jobs Act repeals certain provisions inserted into the IRC by the ETI Act.

First, the Jobs Act repeals section 114 of the IRC (section 101(a) of the Jobs Act);

It further repeals "Subpart E of Part III of subchapter N of chapter 1 (relating to qualifying foreign trade income)", which were inserted into the IRC by section 3 of the ETI Act (section 101(b)(1) of the Jobs Act);

Last, the Jobs Act provides for certain "conforming amendments" of the IRC to take account of the fact that it repeals the parts of the IRC just mentioned (section 101(b)(2) to (6) of the Jobs Act).

2. What the Jobs does not repeal immediately, or does not repeal at all

36. Although section 101 of the Jobs Act repeals section 114 of the ETI Act, it does not repeal the provisions contained in other relevant sections of the ETI Act. In particular, it does not repeal section 2 (entitled "Repeal of Foreign Sales Corporation rules") and section 5 (entitled "Effective date"). This means that the repeal of the FSC scheme, set out in section 2 of the ETI Act, continues to operate, but it does so subject to the limitations in section 5. Of these limitations, the first one provided for the full survival of the FSC scheme for a transitional period which has now expired. The second one concerns the continuing effects (potentially indefinitely) of the scheme for transactions relating to certain binding contracts entered into by FSCs in existence on 30 September 2000 (see section 5 (c) of the ETI Act).

37. The continuing effect of section 5 of the ETI Act demonstrates that there is still no correct implementation of the original Panel report in this dispute. The FSC scheme is, in part, still effective.

38. Second, in the period between promulgation and 31 December 2004, the Jobs Act did not apply (section 101(c) of the Jobs Act). This means that US exporters have continued benefiting fully from the ETI scheme for all export transactions agreed up to the end of 2004.

39. Third, for export transactions in the period between 1 January 2005 and 31 December 2006, the ETI scheme remains available on a reduced basis (section 101(d) of the Jobs Act). Yet, during this transition period the ETI scheme is maintained for any transaction falling within its scope.

40. Fourth, for certain transactions the repeal of the ETI provisions simply does not apply (section 101(f) of the Jobs Act). The ETI scheme is "grandfathered" (that is, continues to apply) for the

ETI ACT	JOBS ACT	RESULT/EFFECT
	purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.	see §50]. *(*See section D below*)

C. THE TRANSITIONAL PERIOD

42. For the years 2005 and 2006, pursuant to section 101(d) of the Jobs Act, the ETI benefits are still available as follows:

- 80 per cent in 2005
- 60 per cent in 2006.

43. Even taking as a basis (for purely illustrative purposes) the US$4043 million mentioned in the Arbitrator's Decision in this dispute[23] (which is a lesser amount than actually budgeted for the ETI Act in 2004), the ETI Act would still confer a subsidy for US$3234.4 million and US$2425.8 million for 2005 and 2006 respectively.

44. There are only three differences between the transitional clause of the ETI Act and that of the Jobs Act. First, the end dates are different. Second, the duration of the transition period of the Jobs Act is longer than the one of the ETI Act (from 1 January 2005 to 31 December 2006 in the Jobs Act, from 1 October 2000 to 31 December 2001 in the ETI Act.). Third, whereas for the transition period the ETI Act provided for continuing enjoyment in full, the transition period of the Jobs Act provides for enjoyment of 80 per cent and 60 per cent of the otherwise applicable benefits in the first and second year respectively.

45. These differences do not of course warrant any distinction from the situation reviewed by this Panel and the Appellate Body in the original Article 21.5 proceedings. The basis for the Panel's and the Appellate Body's findings was the fact that the WTO inconsistent subsidy continued to be available after the date set out in the original Panel report for its withdrawal "without delay". The same reasoning applies to the new transition and grandfathering provisions contained in the Jobs Act.

46. Apart from the gradual reduction in amount, during the transitional period the ETI Act will continue to apply as usual. Thus, the benefits will continue to be available to any US producer

D. *THE "GRANDFATHERING CLAUSE"*

49. The Jobs Act does not apply to any transaction in the ordinary course of a trade pursuant to a binding contract (1) which is between the taxpayer and a person who is not a related person (as defined in section 943(b)(3) of the IRC), and (2) which was already in effect on 17 September 2003 (the date of the introduction of the bill before the Senate). In other words, the ETI Act will continue to be available to all exporters who have engaged themselves contractually to provide goods. Moreover, just like the ETI Act the Jobs Act contains a provision according to which a "binding contract shall include a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor."

50. The Joint Explanatory Statement of the Committee of Conference already interprets the term "binding contract" in a flexible way by specifying that

> a replacement option will be considered enforceable against a lessor notwithstanding the fact that a lessor retained approval of the replacement lessee.[24]

51. The grandfathering clause applies to both sale and leasing contracts. Furthermore, these contracts cover (1) goods that have already been sold or leased as well as (2) goods which may be sold or leased in the future if the buyer/lessee exercises an option.

52. With respect to goods already sold or leased, grandfathering covers sales contracts the goods relating to which have already been ordered but not yet exported, or lease contracts which expire some time in the future but which, under US accounting rules, only produce ETI benefits at the end of their life.

53. The differences between the "grandfathering" clause of the ETI Act and that of the Jobs Act are even fewer than for the transition clauses. The Jobs Act does no more than replacing "FSC" by "taxpayer" and provides an express cross-reference to the IRC provision defining "related persons".

VI. LEGAL ARGUMENT

A. INTRODUCTION

54. The essential reason why the Jobs Act is inconsistent with the WTO obligations of the United States is that it does not entirely remove the prohibited subsidies which were required to be withdrawn as a result of the previous recommendations of the DSB nor does it remove the violation of Article III:4 of the GATT 1994. This constitutes a violation of Article 4.7 of the *SCM Agreement* and of Articles 19.1 and 21.1 of the DSU. The European Communities sets out the reasoning leading to this conclusion in Section VI.B below.

55. As a consequence of the prohibited subsidies not having been withdrawn, the violations of Articles 3.1(a) and 3.2 of the *SCM Agreement,* Articles 10.1, 8 and 3.3 of the Agreement on Agriculture and Article III:4 of the GATT 1994, persist. This consequential conclusion is set out in Section VI.C below.

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[24] House of Representatives, 108th Congress, 2nd Session, American Job Creation Act of 2004, Conference Report to accompany H.R. 4520, Report 108-755, 7 October 2004 (excerpt in **Exhibit EC-3**, full text available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_reports&docid=f:hr755.108.pdf), p. 265, footnote 7.

B. THE UNITED STATES CONTINUES TO VIOLATE ARTICLE 4.7 OF THE SCM AGREEMENT AND ARTICLES 19.1 AND 21.1 OF THE DSU

56. The Panel and the Appellate Body found in the first Article 21.5 proceeding that the transitional and "grandfathering" clauses permitting continued availability of FSC subsidies meant that the United States had failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 of the *SCM Agreement.*[25] The Panel exercised judicial economy in respect of the violation of Article 21 of the DSU claimed by the European Communities in that proceeding.[26]

57. The Appellate Body upheld this finding and expressly recognised that Article 4.7 of the *SCM Agreement* contains an obligation for an implementing Member to withdraw subsidies declared to be prohibited "without delay" and that there was no legal basis for extending the time-period in order to protect "private parties".[27]

58. As the European Communities has explained in Section V.A.2 above, the grandfathering clause for FSC subsidies contained in section 5(c)(1)(B) of the ETI Act is still in force and so this violation Article 4.7 of the *SCM Agreement* subsists.

59. Further, as the European Communities has explained in Sections V.B, C and D above, the transitional and grandfathering clauses in the Jobs Act are identical in all material respects to those in the ETI Act, except that they provide for continued availability of ETI subsidies rather than FSC subsidies. Accordingly, they are also inconsistent with the obligation of the United States to withdraw the ETI subsidies without delay pursuant to Article 4.7 of the *SCM Agreement* for the same reasons.

60. The fact that the FSC and ETI subsidies will remain available for quite some time is confirmed by the estimate of the budget effects of the Jobs Act circulated by the US Congress Joint Committee on Taxation on 5 October 2004, which stretches to year 2014.[28]

61. The continuing availability of FSC and ETI subsidies also gives rise to a continued violation of Article III:4 of the GATT 1994. This is not inconsistent with Article 4.7 of the *SCM Agreement* but only with Articles 19.1 and 21.1 of the DSU.

62. Article 19.1 of the DSU provides as follows:

LIST OF EXHIBITS

EC-1 *The American Jobs Creation Act of 2004*, H.R. 4520, 118 Stat. 1418, Public Law 108–357, 22 October 2004

EC-2 *FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, 15 November 2000, US Public Law 106-519, 114 Stat. 2423 (2000)

EC-3 House of Representatives, 108th Congress, 2nd Session, American Jobs Creation Act of 2004, Conference Report to accompany H.R. 4520, Report 108-755, 7 October 2004

EC-4 Estimated budget effects of the Chairman's mark relating to H. R. 4520, the "American Jobs Creation Act of 2004", 5 October 2004

EC-5 Congressional Budget Office, Cost Estimate for the American Jobs Creation Act of 2004, Revised 9 November 2004

ANNEX A-2

FIRST WRITTEN SUBMISSION OF THE UNITED STATES

(2 June 2005)

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US – FSC (AB)	Appellate Body Report, *United States – Tax Treatment for "Foreign Sales Corporations"*, WT/DS108/AB/R, adopted 20 March 2000
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US – FSC (Article 21.5) (AB)	Appellate Body Report, *United States – Tax Treatment for "Foreign Sales Corporations" – Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/AB/RW, adopted 29 January 2002

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 US 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.

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 US 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, US officials consulted closely with officials of the European Communities at all levels. US officials explained the types of transition rules that are standard in US 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.

[1] Exhibit EC-1.

8. With respect to the grandfather provision of section 101(f), the EC officials never indicated to US 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 17 September 2003, and (3) which has been binding on both parties at all 142170.847Eg2

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 1 Nove