KEVIN CONWAY *on the* EU/U.S. Export Subsidy Debate

BY RAMONA DZINKOWSKI

At a time when the U.S. economy can least afford to be dealt another blow, American manufacturers may soon be taking a further hit to their bottom line. The World Trade Organization (WTO) has determined that the U.S. government has been subsidizing exporters through foreign sales corporations (FSC) and, more recently, through the extraterritorial income system (ETI) so hasn't been complying with WTO rules. According to the WTO, the U.S. government must either level the playing field by the end of this fiscal year or get ready for European Union (EU) countermeasures that could cost U.S. companies up to $4 billion.

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The U.S. government has committed to meeting both the requirements of the WTO and the needs of U.S.-based exporters. Sweeping changes to the domestic and international tax structure could emerge, which may take several forms and have numerous implications for corporate financial strategy and management. In this exclusive interview for *Strategic Finance*, Kevin Conway, senior VP of Tax at Vivendi Universal and expert on the EU/U.S. export subsidy debate, talks about the potential impact of the EU ruling on American firms and the possible changes to the U.S. corporate tax structure.

RD: **Can you explain the debate over foreign sales corporations and the ETI system and how, through their use, the U.S. is violating WTO rules?**

KC: The EU position is that U.S. exporters are taxed at 29.25% as opposed to 35%, which is the normal tax rate for U.S. companies. The complaint said that this was a direct and clear violation of the subsidies code under the WTO agreements, which prohibit giving subsidies to support exports. Subsidies are defined as a government forgoing revenues. In this case, the EU claims, and has won their argument, that, through foreign sales corporations, the U.S. is forgoing revenues and that this is in direct violation of the WTO agreements the U.S. is a party to. The U.S. argument was that FSC rules have been in place since 1984 and in fact adopted the FSC tax exemption regime in response to the dispute that had been going on since 1971 under the GATT [General Agreement on Tariffs and Trade].

In the U.S. opinion, the FSC is not an illegal export subsidy and in substance is the economic equivalent of the territorial tax system in Europe, which generally does not tax corporate income earned outside the country. We argued that FSCs just reduce the tax rate on income outside the U.S. In our opinion, under GATT, we could have reduced the tax rate to zero, but what we did instead was reduce it to 29.25%. When we set up the FSC, we set up a technical requirement that the foreign sales corporation be a non-U.S. corporation and that there must be certain monies spent outside the U.S., such as marketing money, for example. But the FSC distinguishes between exporters and nonexporters, and that's why the EU complained.

Ultimately the WTO rejected the U.S. arguments, saying that if you decide to have a tax system that taxes income earned all over the world, as the U.S. does, you can't provide a subsidy to exports. Congress reacted immediately, coming up with the ETI system to try to remedy what they perceived as the violation to the trade rules. This again was challenged by the EU, and last year the WTO ruled that the extraterritorial income continued to subsidize U.S. exporters through tax benefits. The Bush administration is now working toward bringing the U.S. into compliance.

RD: **How likely is it that the issue will return to international court if the U.S. doesn't repeal the FSC/ETI**

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benefits by the EU's deadline?

KC: I really don't think that's going to happen. Congress and the administration won't stand by and let those sanctions be imposed, and I think the EU will give the U.S. Congress a chance to act. This issue has been in international court too long, and I'm very confident that the U.S. will reach compliance with the WTO rules. It makes no sense to continue with this debate; we've lost the argument. We can't have companies focusing on penalties—they have to be focusing on productivity, reducing costs, and becoming more competitive.

RD: **How will the U.S. address the EU's complaint? What options are there in terms of domestic tax/industrial policy to continue to support these exporters while abiding by the WTO ruling?**

KC: Chairman [Bill] Thomas [R.-Calif.] of the House Ways and Means Committee introduced the American Competitiveness and Corporate Accountability Act in July 2002 that would repeal the ETI rules and proposes to use the tax revenues saved to make general reforms in the U.S. international tax system that would benefit U.S. multinational companies. U.S. companies are taxed on worldwide income, and when they earn income in countries like Germany and the U.K., they have to pay U.S. tax on the earnings when they bring the earnings back, but they get a credit for the foreign tax they've paid. These rules are very complex, and people argue that they are so complex that U.S. multinationals wind up paying double tax. The Thomas bill essentially reforms the U.S. international tax rules, making U.S. multinational companies much more competitive. That's one answer.

Representatives Philip Crane [R.-Ill.] and Charles Rangel [D.-N.Y.], two senior ranking members of the House Ways and Means Committee, introduced the Jobs Protection Act of 2003 in April. It would also repeal the FSC/ETI tax regime and reduce the corporate tax rate to 31.5% from 35% on income attributable to domestic production activities. The reduction would begin in 2006 and be fully phased in by 2010. The Crane-Rangel bill also has a transition provision that phases FSC benefits out slowly over six years. That will make a big difference to many exporters.

Thomas introduced a second ETI repeal bill in July 2003, the American Jobs Creation Act of 2003 (H.R. 2896), which provided for a reduced 32% top tax rate for corporations with less than $10 million in taxable income and three-year phaseout of ETI benefits.

U.S. Senate Finance Committee Chair Charles Grassley [R.-Iowa] and Senator Max Baucus [D.-Mont.] introduced the Jumpstart Our Business Strength (JOBS) Act (S. 1637) in September 2003 that would provide a repeal of the ETI rules with some manufacturing tax cuts (top rate on income from manufacturing in the U.S. reduced from 35% to 32%) and some international tax reforms that, among other provisions, would permit a limited repatriation of foreign income at a 5.25% rate. The JOBS Act would give ETI beneficiaries a three-year transition period.

What's likely to happen from a tax policy standpoint is that Congress will combine the features of the three bills. The Crane-Rangel bill has attracted growing support since its introduction with its emphasis on support for U.S. manufacturing jobs creation. The JOBS bill has recently passed the Senate Finance Committee, a major milestone in the U.S. tax legislative process.

RD: **Given the EU may not accept anything less than a full repeal of the FSC, can you see a better alternative?**

KC: Since a lot of the major exporters are technology companies, I would suggest increasing the research tax credit and putting into effect the corporate tax rate reduction immediately. Also, I think Congress should reconsider putting into effect a transition rule as further delays in repealing the FSC will immediately give rise to another EU complaint, and tying the issue up in court yet again serves no purpose.

RD: **What will the potential impact on domestic exporters be?**

KC: If U.S. taxes go down on global income and the corporate tax rate falls for all U.S. goods produced domestically, many companies will benefit. But the impact of any of the bills in front of Congress today could be very different in the case of a small vs. a large company. For a company that's just a domestic manufacturer and has nothing but exports, if Congress passes into law a transitional system whereby companies have up to six years of continued subsidies, combined with a gradual reduction in income tax, there may be little or no impact. Yet it's conceivable that a company that's a big exporter and manufacturer, and which also has operations outside the U.S., could be in a much better position with the repeal of FSC and the reform of the international U.S. tax system.

RD: **What will happen to companies that rely on the FSC to export into Europe if no alternative benefit is offered? Will exporters have to look to alternate markets or operating structures?**

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KC: There's no question that this will have a big impact on some companies, but, obviously, any company that loses the FSC benefit will see their tax bill go up. We're talking about the level of tax on profit, so its main impact is on cash and reported tax expense. Some companies claim that if they don't get the FSC benefit it's going to impact jobs. I believe that in most cases, however, it should not change the way they do business. Exporters will still export if the FSC is repealed and the tax rate increases to 35%, particularly if they get some offsetting benefit on the domestic manufacturing rate.

RD: **What are the immediate financial impacts of repealing the FSC, and how can companies offset the loss of their yearly tax benefit?**

KC: Of course, if they lose the tax benefit, the effective tax rates will go up. Currently they have a worldwide effective tax rate of 30% or less on exports.

If they lose the FSC benefit, the income tax expense on pre-tax earnings will increase, and their cash taxes also will go up because they will pay more U.S. federal income tax. In other words, they will be adversely impacted with respect to their income tax expense reported to shareholders and the cash taxes they pay to the U.S. government.

The way to mitigate that is to look to other tax provisions that exist today in the Internal Revenue Code in terms of utilizing credits for taxes paid to jurisdictions outside the U.S. If a company operates both inside and outside the U.S., there may be some benefit that they'll get when they lose the FSC benefit. The Internal Revenue Code should allow them to use more foreign tax credits for taxes paid outside the U.S. to offset U.S. income. That will only help companies that have operations both inside and outside the U.S. If they're just U.S. domestic manufacturers who export, they won't get any relief from those provisions.

RD: **Is it possible that we'll see more U.S. companies buying companies in Europe as a result?**

KC: If FSC is repealed by the U.S., and Congress passes a bill that will revise the international U.S. tax system and reduce domestic corporate income tax, I don't think we'll see any change in the M&A strategy of U.S. companies.

RD: **What sort of accounting and control issues should corporate finance officers be aware of?**

KC: The difficult thing that companies will have to face is how to deal with the impact of the changes, quantifying the impact of those changes, and addressing this in their annual reports and in other shareholder communications. That's going to depend on if we have a solution through Congress and when we have it. It's going to require companies to really monitor carefully what's happening and be sensitive to what the outcome could be in their particular case.

RD: **What advice can you give a CFO in handling the FSC and EU customs duty issue?**

KC: First of all, I don't envision a solution that's going to make everyone happy. CFOs and other corporate finance officers really need to be looking at the provisions of the bills in front of Congress at this time and start running some numbers on what the potential implications would be. They should start thinking about how these alternatives could affect treasury, cash flow, and overall profitability. What Congress does with the international corporate tax system, the basic tax rate on domestic producers, transitional FSC tax benefits, or an alternate system of research credits will have varying impacts depending on the size of the company and whether or not they have holdings abroad. ■

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